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# **HISTORY OF ECONOMIC THOUGHT**

**Units 1 to 21**

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# Unit-1

## ANCIENT AND MEDIEVAL ECONOMIC THOUGHT

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### 1.1 Introduction

Though economics, in the sense of a scientific body of knowledge, is of a relatively recent origin, economic thought as such is as ancient as human thought itself. Thoughts an economic problem will be found lying scattered even in the most ancient works. But the first attempts to develop economics as an independent scientific discipline can be located only in the period of manufacture and, therefore, naturally in societies or countries where modern manufacture took roots first. As Marx observed, "Political economy...as an independent science first sprang into being during the period of manufacture." Economic thoughts or ideas on the other hand, can be found even in the earliest available works. But it is to be noted that these works are not mainly concerned with the economic problems. Economic problems in the most ancient works come in for rejection and opinion in the course of

things, because these ancient works are mainly and primarily scriptures. The earliest; economic thought lies embedded in the mythologies and religious writings of the ancient religions. It is not our intention to take you back to these ancient times and ancient works, though, as is customary for tracing the history of any particular generation of modern thought, we shall start with a brief account of economic thought that we come across in the writings of the Greek and Roman philosophers.

It is to be remembered, however, that even in that of the Greeks, economics did not become a specialised field of scientific enquiry. Economic thought in their writings too is just ancillary to their reflections on ethics and politics. However, the Greek philosophers like Plato and Aristotle appear to be the first thinkers who, at least, made some fumbling attempt at scientific interpretation of economic phenomena.

## 1.2 Learning Objectives:

After going through this Unit you will be able to understand

- . Plato's Economic Thought
- . Aristotle's Economic Thought
- . Medieval Economic Thought
- . St Thomas Aquinas

## 1.3 Plato's Economic Thought

That the Greek philosophers made one of the earliest attempts at a scientific interpretation of economic and political phenomena and institutions, is evident in, Plato's analysis of the origin of state in his Republic. Plato's analysis of it shows the objectivity which is the true spirit of the scientific approach, and it is through this analysis that he approaches the specifically economic question of division of labour which he finds to be the basis of Greek city state. He observes, "A state...arises...out of the needs of mankind; no one is self-sufficient, but all of us have many wants... Then as we have many wants, and many persons are needed to supply them, one takes a helper for one purpose and another for another, and when the partners and helpers are gathered together in one habitation, the body of inhabitants is termed a state."

His analysis of the origin of the Greek city state is also, at the same time, an analysis of the origin of the economic institution of division of 'labour. It is obvious from the above quotation that Plato traces the origin of division of labour, to the multiplicity of human wants and the impossibility of individual self-sufficiency which, combined with differences in individual skills, leads to division of labour.

While reflecting on specialisation (division of labour) and exchange, he also pines towards the advantages of the system on division of labour. As he observes must infer that all things are produced „ more plentifully and easily and of a better quality when one man does one thing which is natural to him and does it at the right time, and leaves other things,“. Most historians of economic thought including Schumpeter, have observed that Plato thinks of the effects of division of labour exclusively in terms of superior quality of products. But his very explicit mention that as a result of specialisation or division of / labour, "things are produced mote plentifully and easily" is evidence enough that the quantitative' aspect of it and also the cost-

lowering effect of it were not out of his sight. It is true, however, that he had no idea of that connection between the market size and the division of labour which Smith, much later, made famous.

Plato also commented upon the institution of money. According to him, money is just a “symbol” devised for the purpose of facilitating exchange. He also believed that it was peculiar to an individual (city) state and he argued against the use of gold or silver for money, as he conceived money to function only domestically and to be useless abroad. These ideas on money, in fact, convey the proposition that the value of money is independent of the stuff it is made of. On the basis of it, Schumpeter claims “Plato as the first known sponsor of one of the two fundamental theories of money, just as Aristotle may be claimed as the first known sponsor of the other.” (*History of Economic Analysis*, p. 56) The two theories referred to here are described by Schumpeter as the **Cartal** theory, which he associates with Plato, and the **Metalist** theory.

Plato’s name is also associated with the idea of communism but his communism was far removed from the modern concept of communism. His communism was confined, to the ruling class of the Greek society only. In Plato’s Ideal State there are two classes, the rulers and the ruled. Equality was visualized by him only among the rulers in the ideal state and not between the rulers and the ruled. Plato’s fervor for equality even among the rulers (guardians and auxiliaries) seems to have suffered abatement by the time he wrote his *Laws* wherein he allows for restricted inequality of distribution of wealth. The minimum possession of wealth was now to consist of one lot while the maximum was not to exceed four lots. The surplus was to go to the state.

It should be kept in view that in spite of Plato’s attempts at objective analysis, his economic thought, on the whole, remained tied to the apron strings of ethics.

#### Self Check Exercise- 1

Q.1 Discuss Plato’s Economic Thought

### 1.4 Aristotle’s Economic Thought

Plato’s economic thought, though, at places, it made use of objective analysis, was still tied to ethics. It was his disciple, Aristotle, who took firmer steps towards an objective analysis of economic phenomena. He was in a way, the first analytical economist, even if his economic thought was spelt out as a part of his reflections on political and ethical themes in his *Politics and Ethics*. His economic thought touches upon such topics as the scope of economics, institution of private property, wealth, value and money.

He *distinguishes between two types of economy*: Ooeconomicus or the science of household management, and Chrematistics or the science of supply or acquisition. Aristotle described the former as economy proper and the latter simply as the art of acquisition. While discussing the science of supply, he is led to analyse the art of

exchange through which the needs of the household are increasingly met. In this context he distinguishes between natural and unnatural exchange. The former of the two is but an extension of the economy of the household designed for the satisfaction of men's natural wants. The economy proper and natural exchanges are based upon the different stocks of goods and the enlargement of the association of men beyond the confines of the household. But, according to Aristotle, it is from this very simple type of exchange that a more complicated and unnatural exchange arises where the objective is not the satisfaction of the daily wants of the household but the acquisition and accumulation of riches or wealth.

In opposition to his own teacher Aristotle denounced communism even in its restricted Platonic sense and defended the institution of private property. He mainly argued in terms of incentives, observing that "people pay most attention to their own private property and less to that in which they have but a part interest." (*Politics*, Bk II) Moreover, equal distribution, in his opinion, led to quarrels among men who differed in the skill and industry they put in their work.

He not only denounced communism and defended the institution of private property- but also defended slavery. He argued that a life of slavery was advantageous for persons whom he described as "natural slaves", that is persons who possessed only physical power like animals and no mental or intellectual ability at all. He did make a distinction between "natural slaves" and "legal slaves", allowing also the possibility that a legal slave might possess the soul of a free man, while a free man might have the soul of a slave. But the recognition of possibility, in no way, persuaded him to give up the defense of slavery regarding such a possibility, probably, as the exception that proves the rule.

An important contribution, of Aristotle to economic thought was his distinction between exchange value and use value which he was the first to discover. He is led to it while discussing the science of supply or acquisitions (*Chrematistics*). Aristotle had defined natural exchange belonging to the science of household management or economy proper (*Oeconomicus*) as the exchange which has for its objective the satisfaction of the natural wants of men. But, he argued, the existence of natural exchange for the satisfaction of men's natural wants provided hunting ground for those who indulged in unnatural exchange, the objective of which was not to satisfy men's natural wants but to make money. This distinction was based on the distinction between use value and exchange value. As he observed, 'Of everything which we possess there are two uses: both belong to (the thing as such, but not in the same manner, for one; is the proper, and, the other the improper or secondary use of it. For example, a shoe is used for wear, and is used to exchange; both are uses of the shoe.'" Thus, he revealed for the first time the distinction between use value and exchange value which has remained a part and parcel of economic thought ever since. He also emphasized that exchange value depended upon use value.

However, Aristotle failed to develop a theory of price. He considered the case of monopoly and condemned monopoly price as

“unjust.” His views on prices were not objective but rooted in his ethics. Schumpeter does not subscribe to the interpretation that Aristotle had a metaphysical theory of exchange value, according to which exchange value is determined by some metaphysical quality of the commodity, inherent in it and is independent of the circumstances or human valuations or action. He did seem to define the “just price” as the one in which there was commutative justice in the sense of equivalence in exchange so that neither of the parties concluding an exchange gained at the expense of the other. But this equivalence was not postulated in terms of some metaphysical quality inherent in the commodity. Schumpeter’s inference from Aristotle’s condemnation of monopoly price as “unjust” is that in Aristotle’s view, the competitive price which results independently of the actions of individuals was the “just price” which established an objective equivalence in exchange.

Aristotle’s theory of money was in conspicuous opposition to Plato’s theory. His discussion of money also follows the familiar distinction between natural and unnatural exchange. Money too, according to him, can be used in two ways: as a medium of exchange and as a source of acquisition of added exchange value. The former is the natural use of money, while the latter is the unnatural use of it. In this we can find a distinction between money and capital too. The former refers to money, but the latter refers to money capital, that money which brings in an income or added value; that is, money which is lent out at interest. Moreover, while Plato had recognized only one function of money. Aristotle had recognized almost all the important functions of money described in modern textbooks. Plato had seen its function only as a medium of exchange, but Aristotle had discovered its additional functions as measure of value and as medium of store of value also. Not only that, he had also described the factors which led to the invention and use of money in a manner which has hardly changed since then, *is* he refers to the inconveniences of the barter system of exchange leading to ‘the emergence of money. Besides, he gives almost the modern definition of money when he says that it has a “conventional” existence for which reason it is called money. In paraphrase it means that anything which, by custom or convention, is universally acceptable as a medium of exchange is money which is a *modern* definition of money. However, while Plato’s concept of money was that of “legal money”, Aristotle’s concept is that of “customary money.”

Aristotle had also briefly mentioned that some commodities such as precious metals were better fitted for playing the role of money thus foreshadowing some of the commonplace observations in the modern textbooks on the qualities of good money such as homogeneity, divisibility, portability, relative stability of value, etc. He also expressed the view that in order to act as a medium of exchange, money itself must be one of the commodities, that is, a thing that is useful and has exchange value independently of its value as money. This is to say that money should have a “commodity value” or “intrinsic value” also apart from its value as the medium of exchange. The commodity value or intrinsic value of money depends on the quantity and quality of the

substance it is made of. For convenience, people may decide to put a stamp on it in order to save the trouble of weighing the quantity and finding the quality of the substance contained in a monetary unit, but this stamp, according to Aristotle, is not the cause of its value. This proposition, as Schumpeter observes, points toward the Metalist Theory of money in contrast to Plato's Cartalist Theory.

Wherever there is discussion of money, the subject of interest must also crop up. Aristotle's observations on interest were not objective, though they followed logically from his distinction between natural and unnatural use of money. We have already explained above that, according to Aristotle, money lent at interest represented unnatural use of money. Unnatural was also unjust for him. So, he condemned Charging of interest, confusing all types of interest with usury. Instead of looking at the problem objectively and scientifically, he looked at Un-ethically and politically. That is why he failed even to-classify money loans according to their, purposes and made too distinction between a money loan that finances consumption and a money loan that finances, say, maritime trade.

Self Check Exercise- 2

Q.1 Discuss Aristotle's Economic Thought

## **1.5 Medieval Economic Thought**

Writers on the history of economic thought are unanimous on the opinion that Roman contribution to economic thought is negligible. Accordingly, we are here skipping over this period and coming straight to the consideration of the economic thought during the middle ages or the medieval period which is generally supposed to extend from the time of the fall of the Roman empire to that of the Renaissance. Roughly the medieval period may be said to cover the period between the fifth and the fifteenth century.

Economic thought generally leaves the marks of the objective socio-economic conditions of the society in which such thought takes shape. It will be found to be particularly true in case of the medieval economic thought. It will, therefore, be useful to keep in mind the socio-economic structure of the medieval society of Europe in order to appreciate the medieval economic thought.

The essential feature of the medieval society of Europe was its feudal socio-economic structure. The feudal structure of the society was characterized by its division into classes with distinct status for each class and with pre-determined mutual obligations and rights. In its structure, therefore, it resembled, to an extent» the ancient Greek society of the limes of Plato and Aristotle. This is the reason that we find a lot of resemblance between the medieval and the Greek economic thought.

Another important fact about medieval economic thought is that it is mainly found in the utterances and writings of the Christian Canonists due to the reason that the Church was the all-dominating force during this period and it controlled each and every segment of social life. The economic thought of the times, therefore, appears



chiefly in the form of the ethical injunctions of the Church. Thus, the medieval economic thought shows not only the influence of the Greek economic thought notably of Aristotle, but also the influence of the Christian ethics as molded by the Canonists.

The Canonists were the representative thinkers of the medieval feudal society and to them economics was a body of laws, not scientific but ethical, the objective of which was to realize the good administration of economic life. And, the good administration of economic life meant the fulfillment of the mutual obligations and rights of the different classes into which the medieval society was very rigidly divided. Anything which came in the way of this fulfillment was "unjust" according to the Canonists. The Greeks could have described it as "unnatural", conveying nevertheless the same meanings.

The class division of the feudal society of the Middle Ages and its consequent inequalities were accepted by the contemporary church as the natural order. Therefore, for the canonists, justice consisted in the fulfillment of mutual obligations and the maintenance of the status which was rigidly fixed for each class. Anything going against it was "unjust."

The above idea of "justice" pervades throughout the medieval economic thought. The Canonist thinkers are also referred to as "scholastics". Therefore their economics or economic thought is also described as the Scholastic economics or economic thought.

### Self Check Exercise- 3

#### Q.1 Discuss Medieval Economic Thought

## 1.6 St. Thomas Aquinas

The most dominant, influential and representative thinker of the times was undisputably St Thomas Aquinas. His views on various problems of economic import show a compromise of Christian ethics with prevailing objective socio-economic conditions. There was in his Writings, a general condemnation of avarice which in its economic form was nothing but the art of money-making. But he accepted the prevailing inequalities of wealth and position as having been ordained by God and, therefore, just. There was, thus, no point in interfering with what had been ordained by God. But, as in other cases here, too, he preferred to qualify this acceptance of status quo by enjoying mercy and charity *in* the form of giving alms to the poor. This general approach brings out the compromise of the revolutionary Christianity that once it was with the demands of the feudal, socio-economic reality. St. Thomas Aquinas's views on such problems as private property, commerce and trade are significant from this point of view.

### 1.6.1 on Private Property

St. Thomas Aquinas defended- the institution of private property on almost the same arguments which Aristotle had defended it. The medieval Christianity no more entertained the ideal of communism or

common ownership which was distinctive mark of primitive or original Christianity. May be, it was due to the fact that it was no longer a religion of the slaves, the destitute and the down trodden and had. Instead, become the religion more of the ruling propertied classes than of the depressed and property less classes. In fact, in the feudal society of the middle ages, the Church itself was the biggest owner of property, the biggest and the most powerful landlord of all. Being so circumscribed by the socio-economic conditions of life, the spokesmen of the interests of the Church like St Thomas Aquinas could not but modify compromise and reinterpret all those tenets of the original Christian movement which went against the interests of big property-holders who made up the ruling class of feudal landlords including the Church itself.

St Thomas Aquinas argues that the property is not against the natural law but is an invention of the human mind which is justifiable because, as Aristotle had argued earlier, people take better care of what they possess for themselves than of what belongs to all and sundry. People tend to exert themselves more strenuously on their own account than on account of others. He also argued that social order could be better preserved, if the possessions of the individual families were distinct, because, then, there would be no occasion for quarrelling about the use of things possessed in common.

But, in line with his general approach, St Thomas Aquinas prefers to temper the absolute right of private property exhorting the people to keep the common weal in view while using their right of private property. St. Thomas went to the extent of justifying even theft by a starving person.

### **1.6.2 Trade and Commerce**

As regards trade and commerce, St. Thomas Aquinas distinguishes between “just” and “unjust” exchange in a manner resembling that of Aristotle when he made a distinction between “natural” and “unnatural” exchange. According to St Thomas, trade and commerce which were undertaken with the sole objective of making money and, therefore, might involve extorting an “unjust” price from the buyers or paying an “unjust” price to the seller were “unjust” and, therefore, were condemnable.

However, a rather more detailed description of St. Thomas Aquinas's and other scholastic's views on trade and commerce will bring out the following points: (1) There was “something basic” about commerce in itself: (2) Nevertheless, commercial gain and commerce could be justified, (i) If it was undertaken with the objective of making a living only; or (ii) if it was undertaken with the objective of acquiring means to serve charitable purpose: or (iii) if it was undertaken with the objective of serving the public weal (*publicam utilitatem*), provided the money earned was moderate and could be considered as a reward for work; or (iv) if the trade involved some improvement of the thing traded; or (v) if the trade involved inter-temporal or inter-local differences in the value of the commodity traded; or (vi) if the trade

involved risk and the gain from it could be regarded as a “just” reward for risk undertaken by the trader.

According to Schumpeter, St. Thomas’s wording leaves some doubt about the conditions in which he was prepared to admit consideration stated under (iv) to (vi) above. But some other, especially Duns Scotus and Richard Middleton, went somewhat further, specially as regards justifying the social usefulness of the practice of buying in a cheaper market and selling in a dearer market. However, it should be noted that even the qualifications stated under (ii) and (iii) above went beyond the teachings of Aristotle.

The above account shows that St. Thomas Aquinas and other Scholastics accepted trade and commerce to be “just”, if certain conditions were satisfied. Thus there was a qualified acceptance of trade and commerce by St Thomas Aquinas and others which was an improvement upon the views held by Aristotle on the subject.

It may be observed in this context that the typical attitude of the medieval thinkers on trade and commerce was determined by the fact that the medieval society was based on self-sufficient units and, therefore, there was little scope for production for exchange. Production was mainly carried up for direct consumption. Hence there was not much scope for trade and commerce. This explains the anti-commerce attitude of the thinkers, specially of the earlier part of the middle ages. They denounced it unless it was “just” and contributed to the public weal. In the beginning the Christian law-givers (the Canonists or the Scholastics) were not willing to go even so far and the doctrine, *‘nullus Christianus debet esse mercator’* (“No Christian should be a merchant”) was commonly held and preached in the early middle ages. But, in the later middle ages, as the economic conditions changed and commerce and trade began to increase, the view on it also began to change. The insistence not only on “just” trade but also on “just” price and “just” wages which having gone through the medium of ethics were converted into customary or conventional prices and wages, was relaxed. And trade based on customary or conventional prices which were now treated as “just” prices was considered to be natural and “just” and, therefore, acceptable.

### **1.6.3 “Just” Price and “Just” Cost**

In the context of “just” trade or exchange above, we referred to the concept of “just” price, because the medieval Thinkers believed that trade which involved extortion of an ‘unjust’ price from a buyer and imposing of an “unjust” price on a seller was “unjust” trade. This brings us to explain the concept of the “just price. What has been said above about “just” exchange implies that price or value to the medieval thinkers was something objective. It is testified to by the writings of Albertus Magnus. According to him, in an ideal exchange, goods containing the same amount of labour and expense are exchanged against each other. This leads one to conclude that the medieval thinkers held a sort of cost-of production theory, of value and price, though it took on an ethical form, bringing in “justice” in the calculation of the cost of production.

However, it is to be remembered that as we observed above, "justice" to the medievalist philosophers and law-givers meant the preservation of the existing customs and conventions. Therefore, generally, the "just" price in practice meant the customary price or the conventional price. It was conceived as that price which was necessary to maintain the producer and enable him to keep up his status in the community.

This was so, as long as the medieval economy was a sort of natural economy based upon village self-sufficiency and the absence of the means of transport and communication as was the case during the early middle ages. But with a change in the objective conditions, these ideas began to lose their rigidity. The concept of the "just" price and "just" cost become flexible. St Thomas Aquinas himself allowed for fluctuations around the "just" price. For example, he justified a higher price in cases where the seller stood to suffer a special loss. Later, on such considerations as the cost of transport, miscalculation, and differences of status of the parties to an exchange deal were also paid attention to and deviations from the "just" price were allowed on these accounts. In course of time as the market extended and the forces of demand and supply began to assert themselves, deviations were allowed due to changes in these forces as well. So much so that in the fifteenth century, St Antonio, though he still harped on "justice" and fairness, qualified the doctrine of "just" price to such an extent that according to R.H. Tawney, it opened the door to the "recognition of the impersonal forces of the market"

Schumpeter also opines that scholastics of the late middle ages came to identify "just" price not simply with *normal* competitive price but with any competitive price. In their opinion, according to Schumpeter, whenever such a price existed, it was "just" to pay and accept it regardless of the consequences (gain or loss) of it to the trading parties.

#### **1.6.4 "Just" Wage**

It is obvious that the concepts of "just" price and "just" cost include the concept of a "just" wage too. In fact, the example which St Thomas took in order to illustrate the principle of equivalence which must be satisfied, if a price was to be a "just" price, was the payment of the due wages for services rendered. He placed the payment of due wages exactly on the same footing as the obligation of paying and charging the just price.

By the just wage was meant that rate of remuneration which was required to enable the worker to live decently according to his social status in the community. It was presumed, however, that the customary or conventional wages satisfied the above condition. Therefore, the customary wages were identified with the just wages.

#### **1.6.5 Money and Interest (Usury)**

The medieval philosophers and economists views on money and interest or usury as they described it testify, rather forcefully, to the part played by the changing objective conditions in modifying people's opinions. But before we come to illustrate this particular point, it is to be noted that as regards the cause of the emergence of money and its functions, the medieval thought simply resurrects Aristotle's explanation in terms of the inconveniences of the barter system of exchange and investing money with the functions of a common medium of exchange, measure of value and even of the store of value.

However, as regards the interest, their doctrine is but a special case of their general doctrine of the "just" price. In the early middle ages, the canonists or the scholastics prohibited and condemned usury that is lending money on interest at that time, (there was practically no scope for the productive employment of money capital. Therefore, money was deemed to be unproductive or "barren" as the Greek had earlier regarded it. Money during this period was mostly borrowed by the, needy people, afflicted with flood or famine or some other, natural calamity, for purpose of direct consumption for keeping up the status and dignity of the class to which they happened to belong. So, money being barren and unproductive charging any interest from the borrower over and above the principal amount lent out was regarded as an extortion of an unjust price. Therefore, charging of interest (usury) was condemned, as unjust price and prohibited. This is how St Thomas and his contemporaries looked at the problem.

But, with the lapse of time, as society went on expanding economically and avenues for the profitable employment of money capital opened up and as the money capital went on acquiring greater and greater importance as a factor of production, the views on usury or lending money on interest kept on losing their original stringency. The emphasis, during the later middle ages, first kept on shifting from prohibition to regulation. In the fourteenth century, decrees were passed not to prohibit but to fix the maximum rates of interest. However, through the fifteenth and the sixteenth centuries money capital had, gained so much importance as means of profitable employment, that the view of the medieval canonists on usury became a sort of a check on economic advance. Being out of harmony with the needs of the times, they came, into conflict with practice and were, therefore, modified subsequently.

The Canon law did not withdraw prohibition at once. It began, first, by granting concessions in exceptional cases, such as when there was a loss suffered by the lender or when a delay (*mora*) occurred to the returning of the loan. With the passage of time, the period of the gratuitous loan, after which *mora* or delay began to be calculated for charging justified interest became shorter and shorter till, at last, it disappeared altogether. Among the scholastics of the later period like Navarrus, there was a tendency to do away with any period of interest - free loan.

Schumpeter, in his *History of Economic Analysis*, also points out that although majority of scholastic doctors did not admit that the gain the lender foregoes by lending was in itself a justification for charging

interest, yet they did admit that the gain foregone by the lender turns into actual loss when the opportunity for such gain was part of the lender's normal environment. This, observes Schumpeter, means two things : (1) merchants themselves who held money for business purposes, evaluating this money with reference to the expected gains, were considered justified in charging interest both on outright loans and in cases of deferred payments for commodities: (2) If the opportunity of gain contingent on the possession of money was quite general, that is, if there was a money market, then everyone even if not in business himself, might accept the interest determined by the market mechanism. This proposition, according to Schumpeter, is no more than a special case of the principle, generally accepted in the late Middle Ages, that even one may, in justice, pay and ask the current price for everything. If it was not in evidence in the 13th century and was much in evidence in the 16th century, it was merely due to the fact that money markets had been uncommon in the former and became quite common in the latter.

Schumpeter also observes that the scholastics' justification of interest was never or hardly ever based upon the advantage that borrowers might reap from the loan it was exclusively based on the disadvantages of the lender. If what Schumpeter says is correct, it would mean that the scholastic doctors of late Middle Ages explained and justified interest only from the supply side and completely ignored the demand side. This would imply that they assumed that loans were taken only for consumption and they continued to consider money as barren as far as, at least, the borrowers were concerned. Schumpeter is silent on these implications of his above observation.

#### Self Check Exercise- 4

Q.1 Discuss St. Thomas Aquinas

### 1.7 Nicole Oresme

Before we conclude this lesson, it would be proper to give a brief account of Nicole Oresme's contribution to the medieval economic thought. His claim to a distinct position amongst the contributors to the medieval economic thought almost wholly lies in his contribution to the theory of money.

He develops a theory of money which begins with a detailed account of the origin of money along the Aristotelian lines. But it is enriched with a careful discussion of the qualities of good money commodity, referring in this context to the qualities of stability, divisibility, portability, etc., which leads him to observe that gold and silver are ideal money commodities. He presented a strictly metalist theory of money which we find, subsequently, in Adam Smith in almost the same form.

Oresme distinguishes between the proper uses of gold and silver in the system of coinage. Although he concludes in favour of both which means he favoured bimetallism, yet his bimetallism is tempered with realization of the need for ensuring that the proportions of the

market value of the two metals should rule the ratio of their monetary value which indeed is an application of the general medieval doctrine of the "just" price. It is not only a moderate view of bimetallism but also a view which implies that the value of money is ultimately derived from the value of money commodity. It is this latter emphasis of his which makes his monetary theory a metalist theory.

Oresme holds that the prerogative of coinage should rest with the prince as the representative of the community, as he enjoys the greatest prestige and authority. But he was very emphatic that the prince is not and ought not to be the lord of money in circulation, for money is legal instrument for exchanging natural riches among men. Money, therefore, legally and morally belongs really to those who own such natural riches. This leads him to condemn vehemently any attempt by a prince to debase money by reducing the metallic content of the monetary unit. Prince has, according to him, no right to tamper with the wealth of his subjects by altering the proportion, weight, or material, of which their money is made. Gain derived from debasement, he stressed, was worse than usury. It is concealed tax, he argues, which leads to dislocation of trade and impoverishment. This shows that Oresme was not only a theoretical but also a practical metalist.

He, in fact, anticipated Gresham's Law also, when he observes that when coin is debased, "despite all precautions they (gold and silver) are carried out to places where they are rated higher" and so diminishes the amount of good money in the realm of the prince who debases money.

Oresme should not be considered as a lone and exceptional figure, in so far as the above views are concerned. He represented the contemporary opinion and was rather exceptionally eloquent on the subject of money. It has been also observed that the spirit which breathes through the writings of Oresme belongs in a way to a much later age bordering on the mercantilist age. Trade appears in his writings to be taken for granted. The main emphasis in his writings is on the problems of the merchants and his concern appears to be to protect the interest of the merchant class from the oppressive practices of the prince.

#### Self Check Exercise- 5

Q.1 Discuss Nicole Oresme's contribution to the medieval economic thought.

## 1.8 Summary

Economic thought as such is as ancient as human thought itself. The first attempts to develop economics as an independent scientific discipline can be located only in the period of manufacture and, therefore, naturally in societies or countries where modern manufacture took roots first. Economic thoughts or ideas on the other hand, can be found even in the earliest available works. But it is to be noted that these works are not mainly concerned with the economic problems.

Economic problems in the most ancient works come in for rejection and opinion in the course of things, because these ancient works are mainly and primarily scriptures. The earliest; economic thought lies embedded in the mythologies and religious writings of the ancient religions. That the Greek philosophers made one of the earliest attempts at a scientific interpretation of economic and political phenomena and institutions, is evident in, Plato's analysis of the origin of state in his Republic. Plato's analysis of it shows the objectivity which is the true spirit of the scientific approach, and it is through this analysis that he approaches the specifically economic question of division of labour which he finds to be the basis of Greek city state. Plato's attempts at objective analysis, his economic thought, on the whole, remained tied to the apron strings of ethics.

Plato's economic thought, though, at places, it made use of objective analysis, was still tied to ethics. It was his disciple, Aristotle, who took firmer steps towards an objective analysis of economic phenomena. He was in a way, the first analytical economist, even if his economic thought was spelt out as a part of his reflections on political and ethical themes in his *Politics and Ethics*. His economic thought touches upon such topics as the scope of economics, institution of private property, wealth, value and money. Writers on the history of economic thought are unanimous on the opinion that Roman contribution to economic thought is negligible. Accordingly, we are here skipping over this period and coming straight to the consideration of the economic thought during the middle ages or the medieval period which is generally supposed to extend from the time of the fall of the Roman empire to that of the Renaissance. Roughly the medieval period may be said to cover the period between the fifth and the fifteenth century.

Economic thought generally leaves the marks of the objective socio-economic conditions of the society in which such thought takes shape. It will be found to be particularly true in case of the medieval economic thought. It will, therefore, be useful to keep in mind the socio-economic structure of the medieval society of Europe in order to appreciate the medieval economic thought. The essential feature of the medieval society of Europe was its feudal socio-economic structure. The feudal structure of the society was characterized by its division into classes with distinct status for each class and with pre-determined mutual obligations and rights. In its structure, therefore, it resembled, to an extent the ancient Greek society of the times of Plato and Aristotle. This is the reason that we find a lot of resemblance between the medieval and the Greek economic thought.

The most dominant, influential and representative thinker of the times was un-disputably St Thomas Aquinas. His views on various problems of economic import show a compromise of Christian ethics with prevailing objective socio-economic conditions. There was in his Writings, a general condemnation of avarice which in its economic form was nothing but the art of money-making. But he accepted the prevailing inequalities of wealth and position as having been ordained by God and, therefore, just. There was, thus, no point in interfering



with what had been ordained by God. But, as in other cases here, too, he preferred to qualify this acceptance of status quo by enjoying mercy and charity *in* the form of giving alms to the poor. This general approach brings out the compromise of the revolutionary Christianity that once it was with the demands of the feudal, socio-economic reality. Nicole Oresme's claim to a distinct position amongst the contributors to the medieval economic thought almost wholly lies in his contribution to the theory of money.

He develops a theory of money which begins with a detailed account of the origin of money along the Aristotelian lines. But it is enriched with a careful discussion of the qualities of good money commodity, referring in this context to the qualities of stability, divisibility, portability, etc., which leads him to observe that gold and silver are ideal money commodities. He presented a strictly metalist theory of money Oresme should not be considered as a lone and exceptional figure, in so far as the above views are concerned. He represented the contemporary opinion and was rather exceptionally eloquent on the subject of money. It has been also observed that the spirit which breathes through the writings of Oresme belongs in a way to a much later age bordering on the mercantilist age. Trade appears in his writings to be taken for granted. The main emphasis in his writings is on the problems of the merchants and his concern appears to be to protect the interest of the merchant class from the oppressive practices of the prince.

## 1.9 Glossary

**1. Just-Price:** A somewhat archaic term developed by St. Thomas Aquinas that the price of a good should equal the worth generally agreed to by society. This is based on a notion of justice and fairness that goods should only be exchange for something of equal value or worth. For example, if ice cream readily sells for a dollar a scoop throughout the city, but one vendor charges two dollars, then this higher price would not be considered a just price. This view of a just price is relies on the view that each good has an intrinsic value which is inconsistent with modern views of markets, prices, and subjective values.

**2. Natural transactions** were related to the satisfaction of needs and yielded wealth that was limited in quantity by the purpose it served.

**3. Un-natural transactions** aimed at monetary gain and the wealth they yielded was potentially without limits. He explained the un-natural wealth had no limits because it became an end in itself rather than a means to another end—satisfaction of needs.

**4. Just Wage:** just wage was meant that rate of remuneration which was required to enable the worker to live decently according to his social status in the community.

**5. Political economy:** The study and use of how economic theory and methods influences political ideology. Political economy is the interplay between economics, law and politics, and how institutions develop in different social and economic systems, such as capitalism, socialism and communism. Political economy analyzes how public policy is created and implemented.

### **1.10 Answers to self check Exercises**

Self Check Exercise-1

Ans.1 Please refer 1.3

Self Check Exercise-2

Ans.1 Please refer 1.4

Self Check Exercise-3

Ans.1 Please refer 1.5

Self Check Exercise-4

Ans.1 Please refer 1.6, 1.6.1 to 1.6.5

Self Check Exercise-5

Ans.1 Please refer 1.7

### **1.11 References/ Suggested Readings**

1. Eric Roll: "*A History of Economic Thought*".
2. Alexander Gray: "*The Development of Economic Doctrine*".
3. C. Gide and G. Rist: "*A History of Economic Doctrines*".
4. J.A. Schumpeter: "*History of Economic Analysis*".

### **1.12 Terminal Questions**

Q1. Describe Plato's contribution to economic thought with reference to his views on rent, value money and income?

## **Unit- 2**

### **MERCANTILISM: MAIN PRINCIPLES**

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- 2.1 Introduction
- 2.2 Learning Objective
- 2.3 Mercantilism As State-making  
Self Check Exercise-1
- 2.4 Mercantilism and Accumulation of “ Treasure”  
Self Check Exercise-2
- 2.5 Mercantilists “Fear of Goods”  
Self Check Exercise-3
- 2.6 Mercantilists Doctrine of Favourable Balance of Trade  
Self Check Exercise-4
- 2.7 Mercantilists and Protection Policy  
Self Check Exercise-5
- 2.8 Mercantilism and 'Export Monopolies  
Self Check Exercise-6
- 2.9 Mercantilists on Money and Interest  
Self Check Exercise-7
- 2.10 Mercantilists on Value and Price  
Self Check Exercise-8
- 2.11 Mercantilists On Wages and Population  
Self Check Exercise-9
- 2.12 Mercantilism and Hierarchy of Occupations  
Self Check Exercise-10
- 2.13 Mercantilism and Bullionism  
Self Check Exercise-11
- 2.14 Mercantilism : A Critique  
Self Check Exercise-12
- 2.15 Summary
- 2.16 Glossary
- 2.17 Answers to self check Exercises
- 2.18 References/ Suggested Readings
- 2.19 Terminal Questions

## **2.1 Introduction**

Economic thought begins to shed its ethic- religious garb and assumes a more or less mundane and secular form with the development of what has come to be known as mercantilism. Infact, it is hazardous to define what mercantilism is, because it does not denote a systematic body of economic doctrines. It rather refers to a set of principles or ideas which motivated the policies and practices of statesmen during the period spanning the decline of feudalism and the rise of industrialism or capitalism proper. This period may be taken to extend from the end of the fourteenth century or the beginning of the fifteenth to almost the middle of the eighteenth century.

The mercantilist economic thought was the result of certain fundamental economic and political forces which were operating during the period, and which marked the decline of the old feudal system and the emergence of a new social system forming in its place. Rather a most important such fundamental change was the emergence of unified national states and the sentiment of nationalism. But, in addition to it, there were some other momentous changes also. There were, for example, the destruction of the power of the medieval church consequent to the Reformation, revolution in the methods of farming and, notably, the rise of commercial capitalism, discovery of the New World and its treasures of precious metals, the greater need of money for the purposes of the stability and sovereignty of the National state and, consequently greater concern for wealth, and the inroads made by money, into the natural economy of feudalism.

The mercantilist economic thought will be found to be bearing very clear marks of the above said economic, political and social changes that were taking place during the period from the decline of feudalism through the rise of commercial capitalism to the displacement of the latter by industrial capitalism. It will not be wide of the mark to describe mercantilism as the economics or economic thought representing various stages or phases of commercial capitalism, though the late mercantilists' writings betrayed the interests of a nascent industrial capitalism also.

Some of the more important principles with which mercantilism have been frequently associated are explained and discussed in the following sections.

## **2.2 Objective**

After going in detail, this unit you will be able to:

- Explain the Concept of Fear of Goods of Mercantilist
- Describe the Doctrine of Favourable Balance of Trade of Mercantilist
- Illustrate the Mercantilism and Bullionism
- Give the views of Mercantilists on Money and Interest

### **2.3 Mercantilism As State-making**

Some commentators following Schmoller, identify mercantilism with state-making. Prof. Heckscher, in his *Mercantilism*, also adopts this thesis. According to him; mercantilism is "a phase in the history of economic policy" which contains a number of economic measures designed to secure political unification and national power. In this view, the building up of nation-state is put in the forefront and mercantilists' policy recommendations and principles concerning monetary problems, protection and free trade, etc. are viewed as mere devices and instruments to achieve that end.

This view, however, is one-sided. No doubt, a great deal of mercantilist literature from Mun to Hornick claims to speak in the interest of national advancements. But a view which makes political unification and strengthening of the nation-state the end, to which both economic theory and economic practice were subservient, ignores the more powerful causal influence on political institutions which proceeded from changes in the economic structure of the society.

It is true that a dominant note underlying mercantilist economic thought is the desire to make the nation-state strong. But it is hardly surprising that mercantilist clothed their views in the garb of a policy, designed to strengthen, the nation -state or that they looked to the state to carry out their theories. There was a great expansion -of commerce which naturally led to divergence of individual trading interest, all of whom looked towards a strong central authority to protect them against the claims of their rivals. Therefore the nation-state was, in fact, the creature of warring commercial interest whose only common aim was to have a strong state, provided they could manipulate it to their exclusive advantage. Therefore the mercantilist policies frequently identified the merchants' profits with the national good, that is, the strengthening of the power of the state .In view of it, Eric Roll's observation that the mercantilists, while appearing to be speaking in the interest of the nation and 'he state, were, in fact, promoting the interests of merchant capital makes much sense.

The mercantilists demanded a nation-state strong enough to protect the trading interests and to break down the many medieval barriers to the expansion of trade and commerce. Thus the doctrine of -state intervention was a distinguishing feature of mercantilist economic theory. Commercial or merchant capital required wider and consolidated markets which were also sufficiently protected to allow secure exploitation. Therefore the mercantilists' frequently advocated for monopoly, protection and state regulation.

As a matter of fact, the interests of merchant capitalists and-the interests of the state were mutually, dependent A strong unified state was essential for the protection and promotion of the interests of the merchant class. On the other hand, the strength of the state mainly depended upon the wealth which was passing more and more into the hands of the merchant capitalists. Thus the nation-state, the then recent phenomenon, depended for its strength on the class of the merchant capitalists.

Wealth being the ultimate objective of merchant capitalists and wealth also being the main source of the strength and power of the nation-state, we find in the mercantilist literature, a strong plea for adopting such economic policies which would result in increasing wealth for the merchant capitalists which they, of course, identified with increasing national wealth as well as for increasing strength of the nation-state.

Self Check Exercise -1

Q.1 Identify mercantilism with state-making.

## **2.4 Mercantilism and Accumulation of “Treasure”**

We observed above that mercantilists gave the highest priority to the amassing of wealth. But the mercantilist notion of wealth was the popular notion that wealth consisted in money or gold or silver they very often described as “treasure”. It is true that some mercantilists, particularly those belonging to the late period, were aware that real wealth consisted in real goods. But the general notion, especially amongst the early mercantilists, who are generally described as the bullionists, was that wealth consisted in money (which at that time used to be full-bodied metallic gold or silver money), gold or silver.

The mercantilist notion of wealth as “treasure” consisting of money, gold and silver can be explained historically. Due to the emergence of money and its increasing use in exchange and as store of value, the production of wealth and the circulation of wealth came separated from each other. Money, then, embodying exchange-value comes to be identified with wealth. The concept of wealth thus becomes separated from the real goods which possess use-value to reappear as monetary stock of exchange value. Moreover, there was a long tradition of attaching importance to the accumulation of precious metals in Greece, Rome and the middle Ages. During the mercantilist period in which commerce was the dominant force, the circulation of commodities was the essence of economic activity. Its end, that is, accumulation of money, gold and silver corresponded to the traditional ideas of wealth as well as to the aim of national policy.

Accordingly, the search for, gold and silver treasure in distant lands is the specific form which commercial expansion first takes on. Columbus, Luther, Hales, Serra, Malynes and Misselden all emphasized the importance of accumulation of treasure.

Self Check Exercise -2

Q.1 Discuss about Mercantilism and Accumulation of Treasure.

## **2.5 Mercantilists “Fear of Goods”**

Another important characteristic of mercantilism is what Prof. Heckscher has described as their “fear of goods”. This, in fact implies their, fanatically exclusive concern with selling. This, in a way, follows, logically from the mercantilists’ very high regard for accumulating treasure in the form of money or precious metals which at the end

could be realized only through the sale of goods. Unsold goods were looked upon as loss of treasure and hence their fear of goods. The fear of stocks of unsold goods existed in all their writings, even though in different forms. It can be observed in the writings of Malynes in the form of abhorrence of luxury imports, in the writings of Misselden in the form of a desire for treasure, and also in the arguments of Thomas Mun, and even such advanced mercantilists as D' Avenant, Barbon and Child, on the balance of trade.

According to Heckscher there were, in fact three attitudes to goods : (1) from the point of view of exchange (as source of revenue to local government,) in which case cheapness and dearness were immaterial (This was described as the Staple Policy); (2) from the point of view of consumers which required a policy of cheapness and plenty, that is, the Policy of Provision; and; (3) from the point of view of the interest of producers which implied "fear of goods", on the one hand, and "gospel of high prices," on the other, which led to the Policy of Protectionism. The first two views and their associated policies were predominant during the middle ages, but in time a divergence arose between the Staple Policy and the Policy of Provision, on the one hand, and the Policy of Protectionism, on the other, and the latter pushed the former to the background. Thus according to Heckscher the "Policy of protectionism, together with the monetary policy, represented the most important original contribution of mercantilism to the history of economic policy".

However, it was not only the mercantilist's attitude to goods which led them to propound the theory of protection. More fundamentally, it was their love of treasure which implied not only their "fear of goods" and "gospel of high prices" but also a strong concern for accumulating export surplus. The latter led them to propound one of their most famous doctrines, if not the most famous doctrine, of economic policy, namely, their doctrine of the favourable balance of trade. Their theory of protection followed from this. Before we examine the mercantilists' theory of protection, it would be proper, at first to consider their doctrine of favourable balance of trade.

Self Check Exercise -3

Q.1 Discuss Mercantilists views on Fear of Goods.

## **2.6 Mercantilists Doctrine of Favourable Balance of Trade**

Accumulating treasure (gold and silver) through the accumulation of export surplus was the hall-mark of the theory of economic policy developed by the mercantilists. Favourable balance of trade was, for the mercantilists, both an analytical tool and a practical policy to achieve the objective of accumulating export surplus. Fellner has rightly observed that as an analytical tool it should mean the modern concept of the balance of payments, though the mercantilists designated it as the balance of trade. In fact, Thomas Mun, a famous British mercantilist, had himself observed and explained, in his *England's Treasure By Foreign Trade*, that what mattered was the concept that we now designate as the balance of payments. The favourable balance of trade, which includes both visible and invisible

exports on one side, and imports, on the other, results in an export surplus. This surplus is compensated in the balance of payments of a country by the import of precious metals (gold and silver) or "treasure" to an equivalent amount in value. Thus the analytical concept of the balance of payments, which the mercantilists mostly went on describing as the balance of trade, was used to explain that treasure could be accumulated by accumulating an export surplus which, in turn, could result only from such economic policies which would help the country to have a favourable balance of trade with the foreign countries trading with it.

We have already observed that the mercantilists' love of treasure was explained by a number of factors. Since the mercantilists were in the habit of promoting their own interests in the name of the nation and the state, it was not unnoted that they would seek the state intervention in favour of policies which would help in achieving a favourable balance of trade and the resulting inflow of precious metals, that is, treasure which they stressed, would facilitate financing large armies and their activities. Moreover, credit system was yet in a primitive state while more money was needed to create a more adequate tax base, and more money in those times meant more precious metals. In times of war monetary metals were also useful for purchases from allies and neutrals. More money was also required to finance growing trade, if prices were not to fall.

They argued that unless a country was naturally endowed with rich mines of gold and silver, the only way to get hold of this treasure was to have a favourable balance of trade, if one ignores the method of politically subjugating countries possessing gold and silver mines and plundering their treasure directly and openly from which, indeed, the merchant capitalists backed by their states did not shy away.

Favourable balance of trade requires increasing commodity exports and invisible exports in relation to commodity imports and invisible imports. The attitude of the British mercantilists on the particular issue of policy on the matter was not identical, because, they themselves being active merchant capitalists, their individual interests differed. However, they frequently approved government guaranteed monopoly as well as other state support to the trading **companies** engaged in foreign trade. As a matter of fact, the mercantilist's doctrine of a policy of favourable trade logically led them to recommend to the state adoption of protection.

Mercantilists, of course, gave other analytical reasons also in order to plead for policies that would bring about a favourable balance-of trade. Amongst (those arguments was the one according to which value could not arise in domestic trade and it could arise only in foreign trade. 'As observed by Karl Marx in his Theories of Surplus Value, the mercantilists' belief was that value and surplus value were created not in the process of production but only in the sphere of circulation, that is, in trade. They further believed that trade was a zero-sum game in which one party could gain only at the expense of the 'other party. Seller's gain was Use buyer's loss and vice versa. Hence, they argued, value and wealth could not be created through the



expanding of domestic trade of a country as such. But value and wealth could be created by expanding favourable foreign trade, as the gain from foreign trade was at the expense of traders belonging to other countries. D' Avenant (1697), for example, argued that in domestic trade the nation in general did not grow richer but foreign trade made a net addition to a country's wealth. This was the mercantilists' analytical arguments for assigning top priority to foreign trade activity as well as campaigning for policies that would result in a favourable balance of trade for their country.

It is not difficult to see that this analysis was all wrong; that value and wealth arose not only in trade but also in production that trade was not a zero-sum game. Nevertheless, the policies which the mercantilists recommended were the right policies considering the objectives which they were expected to and the circumstances in which they were recommended. It is due to this that Schumpeter has observed in his *History of Economic Analysis* that the mercantilists recommended right policies for wrong reasons.

Self Check Exercise -4

Q.1 What is Mercantilists Doctrine of Favourable Balance of Trade

## **2.7 Mercantilists and Protection Policy**

A policy of protection was the logical corollary following from the mercantilist doctrine of favourable trade. In the beginning, protection policy meant simply encouraging exports and discouraging imports by state action. This mainly implied abolition of export duties if any, and bounties for exports, and imposition of high import duties and even prohibition of certain imports. Gradually, the policy of protection as recommended by the mercantilists became more comprehensive as the basis of trade regulation began to change to a protectionist character.

The emphasis, in the later period, shifted to the protection and promotion of home manufactures. Mercantilists argued for state - policies which would encourage manufactures by supplying them with cheap labour and cheap raw materials so that manufacturing costs remained low and thus the country's exports were boosted. In fact "When it comes to the remoter stage of, encouraging enterprises which in their consequences will lead to a healthier balance of trade" observes Alexander Gray, "no limit can be assigned to the list of expedients devised or prescribed." They asked for monopoly patent rights in respect of new processes introduced, direct importation of foreign workers and experts to establish new industries, fixation of prices and wages by the state, the whole series of devices to encourage shipping and the navy exemplified by the Navigation Laws, etc.

Although the fundamental premise on which the mercantilists argued for a policy of protection was that of securing a favourable balance of trade, in course of time there was hardly any better argument in favour of protection which they had not anticipated. We find in their writings the infant-industry arguments, the military or defense argument, the key-industry as well as the general autarky argument, and also the

work- creation or the employment argument. Schumpeter points out that we also “find the argument that today has come into such prominence in connection with the multiplier approach Infant-industry argument was very common during the Elizabethan period and it pervaded to the end, that is, up to the threshold of the industrial revolution. Some important examples are Yarranton’s recommendation of protection to linen manufactures for a period of seven years only. Arthur Dobb expressly observed that “Premiums are only to be given to encourage manufacture....in their infancy.” Protectionist legislation inspired 'by the employment argument was; according to Schumpeter, still older by at least a hundred years. Malynes, Misselden. Child, Petty, Borbon, Locke all have it. The employment argument was advanced not only per se, but also in its indirect form, via the stimulus that inflowing precious metals and the consequent increase in money Supply would give to business. Malynes and Misselden, though antagonists, both advanced this argument which is referred to as the “lubricant argument”, because the increase in money supply resulting from die inflow of precious metal was believed to “lubricate the wheels of business”.

Self Check Exercise -5

Q.1 Dicuss Mercantilists views on Protection Policy.

## **2.8 Mercantilism and 'Export Monopolies**

On the level of practical argument, mercantilist doctrine of favourable balance of trade asserted that monopoly and quasi-monopoly, whatever be their effects on domestic industry and trade, fulfilled an essential function in foreign trade. They argued that monopoly gains from foreign trade were net gain for the nation, for these gains were at the expanse of foreigners and therefore the sum to be deducted for losses from the gross monopoly gains from foreign trade was zero. Absence of competition in export trade enabled the monopoly-holders to keep export prices high and boost profits. Even in domestic trade and industry they were not averse to monopolism.

Self Check Exercise -6

Q.1 Dicuss Mercantilists views on Export Monopolies.

## **2.9 Mercantilists on Money and Interest**

It should be obvious from the mercantilists’ love of “treasure”, which comprised not only precious metals but also money, and remembering that they prized precious metals no less as a force augmenting the supply of money than in themselves' as wealth, that they were in live habit of confusing money with capital, or rather that the only form of capital that they recognized was money. They identified money with capital because they looked upon money as wealth and wealth-creating force. Mercantilists knew capital only in its primitive form, that is, money.

Mercantilists had and propagated the notion that money possessed an active force which lubricated the wheels of trade and business. Thus, according to them, trade depended upon plentiness of money. In the mercantilist era of expanding trade activity, money supply had also to increase in step with it, otherwise either a pan of goods would have remained unsold or the prices would have fallen, both of which were dreaded by mercantilists. Consequently, the mercantilist literature shows a high regard for money.

The mercantilist views on interest or "Usury" presents an interesting example of class interests determining man's thinking. So long as the class of merchant capitalists was insignificant and the scope for profitable employment of money capital was extremely limited as was the case under feudalism, the mercantilist writers wrote and spoke in favour of interest charging and against the prohibition of "usury" or lending money on interest. But later on, in the heydays of mercantilism when trade, both domestic and foreign, was expanding by leaps and bounds and money was in short supply relatively to the expanding trade and interest rates tended to rise and thus threatened mercantile profits, the mercantilists' views on usury and interest changed. They began to call for control on interest rate. Gerald Malynes, for example, made distinction between interest and usury. Basing himself on Wilson's discourse, he vehemently described the charging of extortionate rates of interest. Sir Thomas Culpeper also asked for a statutory maximum rate of interest. But perhaps, even more important than these is the opinion of Sir Josiah Child who, in his *New Discourse of Trade* (1669), states that a low rate of interest is the cause and not the effect of wealth.

The difference between the attitude of early or potential merchant capitalists and that of the later full-blooded merchant capitalists is explained by the fact that the former were mainly money capitalists and not genuine merchant capitalists, while the latter were genuine active merchant capitalists. While the former were interested in high rates of interest, the latter derived their income from trade and commerce using borrowed money capital also in substantial amounts along with their own capital and wealth, therefore rates of interest were fixed at very low levels.

There were also seeds of a demand and supply theory of the rate of interest in the mercantilist writings of the late period. They did articulate the proposition that the rate is determined by supply of loans and the demand for loans; where the demand for them stems from profitable uses of the borrowed capital. A primitive version of the Quantity Theory of the money referring to both the quantity and velocity of money can also be traced in the mercantilist writings, notably in the writings of Bodin and Cantillon.

Self Check Exercise -7

Q.1 Discuss Mercantilists views on Money and Interest

## **2.10 Mercantilists on Value and Price**

We mentioned, in the beginning of this lesson, some of the momentous changes that had been taking place during the period of

the rise of mercantilism, notably the breaking up of the old feudal society along with the hold of the church on the lives of the people, the expansion of markets and the expansion of trade, ' and the rise of commercial capitalism. The action and interaction of these complex socio-economic forces began to be changed these medieval views on value and price which show a definite shift from the idea of "just price" to that of "natural price" and 'market price". With increasing extent of the market, the forces of demand and supply became more important than customs and conventions in the-determination of price. The rising importance of the market forces of demand and supply in the determination of prices was acknowledged as early as the fourteenth century in the writings of Jean Buridan. "The value of a thing", he states, "should not be measured by its intrinsic worth... it is necessary to take into account the need of man, and to .value things according to their relation to this need." Although it is more a 'normative injunction than a statement of a positive law yet it does refer to the market forces of demand and supply. Other mercantilists, such as Buonnisegni (1591) and Scaccia (1618) in Italy and Grotius (1623) and Pufendorf (1672) in Holland, also made wants and desires an important factor determining value. Thus the **competitive forces of the market, which though subtly** and indirectly. referred to in the writings of the scholastic doctors belonging to the final period of medievalism when the natural economy and the hold of the church on the minds of the people were fast breaking up and money capital arid merchant, capital were on the rise, were explicitly acknowledged now as the determinants of value and price.

Later on, especially in the writings of William Petty and Locke (1690) such thought becomes more objective. Their writings made a clear distinction between "natural price" and "market price". The latter, according to them, rose or fell, while the former was inherent in the object itself. According to Petty, "natural value" was determined by the expenses of practically the sole source of value. On the whole, the mercantilists, just before the rise of industrial capitalism and classical political economy, were articulating a sort of cost-of- production theory of the "natural" value and price.

#### Self Check Exercise -8

Q.1 Dicuss Mercantilists views on Value and Price.

### 2.11 Mercantilists On Wages and Population

Mercantilists, in pursuit of maximum mercantile profits, believed in the "gospel of high prices" in the sphere of trade, particularly in the sphere of foreign trade and at the same time, keeping manufacturing cost at the minimum possible. The latter led them to a proposition which, on the analogy of Adam Smith's proposition of the "economy of high wages" may be described as the mercantilists, proposition of the "economy of low wages". They were in the habit of arguing that keeping wages as low as possible and raw materials as cheap as possible was the way to keep manufacturing costs low and thus to increase and strengthen the competitive power of domestic goods in the foreign

markets. So, they would frequently plead for state regulation of wages for keeping them at the minimum. On the other hand, they would ask for intensification of labour also. Montchretien, a French early mercantilist, for example, is particularly noted for his exhortations to hard work and condemnation of leisure and his claim that both economic prosperity and morality demanded the work intensity of a bee hive.

Mercantilists' views on the population problems were linked to their "gospel of low wages" to which we have referred to above. From the point view of theory, their views on population foreshadowed Malthusian theory of population. They advanced the now familiar Malthusian proposition that population tends to grow "to the size which can just be supported by the available food resources. But the policy conclusions that they derived from this proposition were not in favour of a policy of controlling the growth of population. On the contrary, they favoured a policy of increasing population. This was obviously in the economic interest of the merchant capitalists who not infrequently, also happened to be primitive manufacturer capitalists (under the putting-out system of manufacture common at the times), because such a population policy would ensure a perfectly elastic supply of labour (to use the modern terminology) and thus keep the wages at the biological subsistence minimum. Only such a policy could conform to their gospel of low wages. "Of course, as was their habit of reasoning or rationalizing their practices, they would give other arguments also suggesting their concern for the well-being and strength of their nation-states while, at bottom, it was more a concern for the interests of the merchant capitalists than of the nation-state. Thus they apparently argued that a large and increasing size of population would ensure both an increase in the potential number of soldiers and sailors, which was necessary for the national safety and strength in those warring times, and an increase in the number of productive workers. Consequently, as Alexander Gray observes, "encouragement to increased population can almost claim to be an essential part of mercantilism."

Self Check Exercise -9

Q.1 Discuss Mercantilists views on Wages and population.

## **2.12 Mercantilism and Hierarchy of Occupations**

A very important doctrine of the mercantilists which; along with quite a number of their doctrines, was derived from their fundamental doctrine of the favourable balance of trade and their allied conceptual proposition that the net addition to a nation's wealth or surplus value (to use the Marxian concept) could arise only in foreign trade, was their doctrine of the hierarchy of occupations. In the model of their conception agriculture occupied the lowest rung in the hierarchy of occupations. In mercantilists' view agriculture did not help bring into the country any money and precious metals or "treasure", to use their favourite expression. It is because they believed that agriculture just supplied enough provision of necessary for the upkeep of the nation

and spared hardly any surplus to be 'disposed of at favourable prices in the foreign markets. Compared to agriculture, industry and manufacture were believed by the mercantilists to be much more helpful in this respect, since, according to them, these occupations could produce a definite surplus over and above what was required to meet the needs of the people at home. This surplus could be utilized for exports to foreign countries which would help in developing a favourable balance of trade with foreign countries resulting in an inflow of "treasure" into the country. So, industry and manufacture occupied a higher rung compared to agriculture in the mercantilist hierarchy of occupations.

But the top rung in this hierarchy was occupied by trade, particularly, foreign trade, which was, in (the opinion of mercantilists, the most active agent of engineering an inflow of "treasure" into the country. The merchant class had now become not only respectable but was also being made the most respectable class. As Gray puts it. "If a former age had doubted the acceptability of a merchant in the sight of the Almighty, the merchant had now come into his own, and has become the head-stone of the corner."

Self Check Exercise -10

Q.1 Discuss Mercantilists views on Hierarchy of Occupations.

### **2.13 Mercantilism And Bullionism**

A distinction is generally made between mercantilism proper and its earliest and rather crude form known as bullionism. It is contended by some commentators that the bullionists are distinguished from their relatively refined and sophisticated younger brothers, the so-called mercantilists proper, in rather the crude emphasis of the former, who belonged to the first generation of mercantilists on the desire to accumulate treasure. They are also said to be the ones who really deserved the charge, made by Adam Smith, that mercantilists made the mistake of conceptually confusing wealth with money and precious metals, while the mercantilists proper did not deserve this structure.

This distinction, However, is valid only to a limited extent, because the difference is more apparent and superficial than real. The desire for treasure was common to both, though the means suggested by the bullionists were relatively crude compared to relatively sophisticated ones of mercantilists proper.' Adam Smith's charge against the mercantilists referred to above cannot be made to stick to the so-called bullionists as a whole. For example, an early French mercantilist, Montchretien (1576-1621), had a clear concept of the distinction between "treasure"(money and precious metals 'and' stones) and true or real wealth. He observes "It is not the abundance of gold and silver, the quantities of pearls and diamonds which make states rich and opulent; it is the convenience of things necessary to life, and fit for wearing; he who has more of these has more of wealth." Nor can all the later mercantilists be absolved of the charge of careless confusing wealth with money and precious metals.

In view of the above, it has been suggested by historians of economic thought like Eric Roll that if a distinction has to be made between bullionists and mercantilists, it can be done only on the basis of the means recommended by each of the schools of course. If they can be described as two different schools of mercantilist thought) in order-to achieve the objective of accumulating treasure which was the fundamental objective subscribed to by both the bullionists and the so-called mercantilists proper.

The bullionists are noted for their emphasis on the necessity of encouraging the import and discouraging ' the export of gold and silver. This was a view which was held as back as the middle ages. The bullionists demanded the revival of the old export prohibitions on precious metals. This school is represented, notably, by Malynes who asked for state intervention to check the exports of precious metals consequent to foreign exchange, transactions. In spite of his concern about usury, he felt it to be only a symptom of a more deep rooted evil, that is the exchange transactions of private financiers, which were often usurious and which, by reducing the volume of bullion (precious metals) in the country, raised interest rates. Therefore the emphasis of bullionists like Malynes was on state measures to check and control foreign exchange transactions so that the exchange rate did not deviate from what he described as the true parity, meaning by it what later came to be described as the Mint Par of Exchange. He argued that there would be no bullion movements, if exchange rate between nations equaled the true parity. But if it deviated from this parity to the dis-favour of a country, gold and silver bullion would move out of that country. Hence the state was asked to re-establish the office of the Royal Exchanger to control private exchange transactions so as to keep the exchange rate of the national currency equal to the true parity. In the course of building up his argument, Malynes in fact, presented an idea which later developed into the theory of the Specie, Points. The mercantilists proper, like Misselden and Mun on the other land, emphasized the measures which would result in a favourable balance of trade of the country and thus accumulate an export surplus which would be paid for by the foreigners in gold and silver, and thus /there would be an inflow of treasure into the country. They were critical of the view of Malynes and argued that both bullion movements and fluctuations in exchange rates depended upon the country's balance of merchandise (commodity) trade.

It has also been observed by some commentators that the - struggle between the bullionists and the so- called mercantilists proper was the theoretical expression or the contrast between commercial capital and industrial capital in the development of commercial capitalism.

Self Check Exercise -11

Q.1 Dicuss Mercantilists views on Bullionism.

## **2.14 Mercantilism : A Critique**

The mercantilists' theory of economic policy came under severe criticism, first By the Physiocrats, and then, by Adam Smith and his

followers of the classical school of economics who subscribed to the then new gospel of free trade, 'the rather harsh judgment of the Physiocrats (who criticized the mercantilist hierarchy of occupations and showed a strong preference for putting agriculture on the highest turning, and thus turning the mercantilist hierarchy upside down) and the classical on the mercantilists was based upon two misinterpretations according to Alexander Gray. Firstly, it was believed that their doctrine of the favourable balance of trade and the hierarchy of occupations were substantially the whole of mercantilism which, in fact, is not true. In fact is that their doctrine of the favourable balance of trade was only a particular aspect of their more comprehensive theory of economic policy. It is true, however, that the mercantilists, in their theory of the favourable balance of trade, failed to consider the consequences that would follow, if all the countries adopted together in practice the foreign trade policy recommended by them. It was of the essence of their argument that what one country gained, the other lost. As Gray observes, "the idea of mutually advantageous trade, eluded them". And, they failed to see that all countries could not develop a favourable balance of trade simultaneously.

Gray also observes that the mercantilists also failed to consider the question as to what would happen in a country which, as the result of their policies, finds itself stuffed with bullion. This charge of Gray is not wholly true. Some of them did refer to the increase in the quantity of money and the consequent rise in prices which their theory tended to prefer. They were also conscious of its role in lowering<sup>1</sup> the interest rates which too they preferred. Their failure lay rather in their not carrying their arguments in this regard to their full logical conclusion. They did not consider, for example, how the inflation that would result from the stuffing of the country with bullion would, in turn, influence its exports and imports and, in the end, its balance of trade. But, then, the mercantilists were, in fact, practical men and not primarily analytical economists.

A charge against 'mercantilism popularized by Adam Smith's criticism was that the mercantilists were "guilty of the folly of Croesus in thinking that wealth consisted in gold and silver instead of the things that gold and silver could bring", and that they thus suffered from Midas mania. This charge against the mercantilists is not well founded. Most of the mercantilists, especially of the later period but also some early one like Montchretien were quite aware of the reality that gold and silver were valuable for what they could buy; that real wealth consisted in the goods which gold, silver and money could buy. Thus they did not generally commit the mistake of confusing treasure of precious metals and money with real wealth. According to Schumpeter, Serra, Misselden, Mun, Child, Cary, Coke, Yarranton, Borbon, D' Avenant and Petty can all be cited in support of it "however much they may have over assessed the importance of an increase in 'treasure, wealth was defined explicitly or by implication-much as we define it ourselves".

The mercantilist doctrines considered as a body of practical policies as the means of attaining the objectives which the



mercantilists strived for are not only understandable but also make sound sense, considering the particular historical and socio-political circumstances in which they were formulating their practical principles of economic policy. But when considered as analytical propositions, their doctrine will be found to be not only wanting in rigour but also nonsensical, it is this that led Schumpeter to observe that they recommended right policies but for wrong reasons.

J.M. Keynes, too, while developing his *General Theory*, found in mercantilism a practical wisdom implied in his own Macro theory and observed: "As a contribution to statecraft, which is concerned with the economic system as a whole and with securing, the optimum employment of the System's entire resources, the method of the early pioneers of economic thinking in the sixteenth and seventeenth centuries may have attained to fragments of practical wisdom which the unrealistic abstractions of Ricardo first forgot and then obliterated."

Self Check Exercise -12

Q.1 Critically discuss Mercantilism.

## 2.15 Summary

Economic thought begins to shed its ethic-religious garb and assumes a more or less mundane and secular form with the development of what has come to be known as mercantilism. Infact, it is hazardous to define what mercantilism is, because it does not denote a systematic body of economic doctrines. It rather refers to a set of principles or ideas which motivated the policies and practices of statesmen during the period spanning the decline of feudalism and the rise of industrialism or capitalism proper. This period may be taken to extend from the end of the fourteenth century or the beginning of the fifteenth to almost the middle of the eighteenth century.

Some commentators following Schmoller, identify mercantilism with state-making. Prof. Heckscher, in his *Mercantilism*, also adopts this thesis, According to him; mercantilism is "a phase in the history of economic policy" which contains a number of economic measures designed to secure political unification and national power. In this view, the building up of nation-state is put in the forefront and mercantilists' policy recommendations and principles concerning monetary problems, protection and free trade, etc. are viewed as mere devices and instruments to achieve that end.

There was a great expansion of commerce which naturally led to divergence of individual trading interest, all of whom looked towards a strong central authority to protect them against the claims of their rivals. Therefore the nation-state was, in fact, the creature of warring commercial interest whose only common aim was to have a strong state, provided they could manipulate it to their exclusive advantage. Wealth being the ultimate objective of merchant capitalists and wealth also being the main source of the strength and power of the nation-state, we find in the mercantilist literature, a strong plea for adopting such economic policies which would result in increasing wealth for the

merchant capitalists which they, of course, identified with increasing national wealth as well as for increasing strength of the nation-state. Accumulating treasure (gold and silver) through the accumulation of export surplus was the hall-mark of the theory of economic policy developed by the mercantilists. Favourable balance of trade was, for the mercantilists, both an analytical tool and a practical policy to achieve the objective of accumulating export surplus. Fellner has rightly observed that as an analytical tool it should mean the modern concept of the balance of payments, though the mercantilists designated it as the balance of trade. In fact, Thomas Mun, a famous British mercantilist, had himself observed and explained, in his *England's Treasure By Foreign Trade*, that what mattered was the concept that we now designate as the balance of payments. The favourable balance of trade, which includes both visible and invisible exports on one side, and imports, on the other, results in an export surplus. This surplus is compensated in the balance of payments of a country by the import of precious metals (gold and silver) or "treasure" to an equivalent amount in value. Thus the analytical concept of the balance of payments, which the mercantilists mostly went on describing as the balance of trade, was used to explain that treasure could be accumulated by accumulating an export surplus which, in turn, could result only from such economic policies which would help the country to have a favourable balance of trade with the foreign countries trading with it.

The mercantilist views on interest or. "Usury" presents an interesting example of class interests determining man's thinking. So long as the class of merchant capitalists was insignificant and the scope for profitable employment of money capital was extremely limited as was the case under feudalism, the mercantilist writers wrote and spoke in favour of interest charging and against the prohibition of "usury" or lending money on interest.

## **2.16 Glossary**

- 1. Mercantilism:** An economic theory from pre-capitalist times which held that a country's prosperity depended on its ability to generate large and persistent surpluses in its foreign trade with other countries.
- 2. A policy of protection** was the logical corollary following from the mercantilist doctrine of favourable trade. In the beginning, protection policy meant simply encouraging exports and discouraging imports by state action. This mainly implied abolition of export duties if any, and bounties for exports, and imposition of high import duties and even prohibition of certain imports.

3. **“Treasure”**, which comprised not only precious metals but also money, and remembering that they prized precious metals no less as a force augmenting the supply of money than in themselves' as wealth, that they were in live habit of confusing money with capital, or rather that the only form of capital that they recognized was money. They identified money with capital because they looked upon money as wealth and wealth-creating force. Mercantilists knew capital only in its primitive form, that is, money.
4. According to Petty, **“natural value”** was determined by the expenses of practically the sole source of value. On the whole, the mercantilists, just before the rise of industrial capitalism and classical political economy, were articulating a sort of cost-of- production theory of the “natural” value and price.
5. **Fear of goods:** Another important characteristic of mercantilism is what Prof. Heckscher has described as their “fear of goods”. This, in fact implies their, fanatically exclusive concern with selling. This, in a way, follows, logically from the mercantilist’s very high regard -for accumulating treasure in the form of money or precious metals which at the end could be realized only through the sale of goods. Unsold goods were looked upon as loss of treasure and hence their fear of goods.
6. **Bullionism:** A' distinction is generally made between mercantilism proper and is earliest and rather crude form known as bullionism. It is contended by some commentators that the bullionists are distinguished from their relatively refined and sophisticated younger brothers, the so-called mercantilists proper, in rather the crude emphasis of the former, who belonged to the first generation of mercantilists on the desire to accumulate treasure.

## 2.17 Answers to self check Exercises

Self Check Exercise-1

Ans.1 Please refer 2.3

Self Check Exercise-2

Ans.1 Please refer 2.4

Self Check Exercise-3

Ans.1 Please refer 2.5

Self Check Exercise-4

Ans.1 Please refer 2.6

Self Check Exercise-5

Ans.1 Please refer 2.7  
Self Check Exercise-5  
Ans.1 Please refer 2.8  
Self Check Exercise-6  
Ans.1 Please refer 2.9  
Self Check Exercise-7  
Ans.1 Please refer 2.10  
Self Check Exercise-8  
Ans.1 Please refer 2.11  
Self Check Exercise-9  
Ans.1 Please refer 2.12  
Self Check Exercise-10  
Ans.1 Please refer 2.13  
Self Check Exercise-11  
Ans.1 Please refer 2.14  
  
Self Check Exercise-12  
Ans.1 Please refer 2.14

## **2.18 References/ Suggested Readings**

5. Eric Roll: "*A History of Economic Thought*".
6. Alexander Gray: "*The Development of Economic Doctrine*".
7. C. Gide and G. Rist: "*A History of Economic Doctrines*".
8. J.A. Schumpeter: "*History of Economic Analysis*".

## **2.19 Terminal Questions**

- Q1. Discuss main feature of Mercantilist economic ideas in their historical context?
- Q2. Why Mercantilist did prefer state intervention on economic life?

**Unit-3**  
**SOME REPRESENTATIVE**  
**FORE RUNNERS OF CLASSICAL ECONOMICS**

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**Structure**

- 3.1 Introduction
- 3.2 Objectives
- 3.3 William Petty (1623-1687)
  - 3.3.1 On Methodology
  - 3.3.2 On Value
  - 3.3.3 Theory of Wages or the Value of Labour
    - 3.3.4 The Theory of Surplus Value
    - 3.3.5 Theory of Rent
    - 3.3.6 Theory of Interest
    - 3.3.7 Money and Prices
    - 3.3.8 Public Finance
    - 3.3.9 Revenue

Self Check Exercise-1

- 3.4 David Hume (1711-1776)
  - 3.4.1 on Money and Prices
    - 3.4.1.1 Theory of money
  - 3.4.2 On Interest
  - 3.4.3 On Value, Rent and Social classes
  - 3.4.4 on Balance of Trade

Self Check exercise-2

- 3.5 Richard Cantillon (1680-1734)
  - 3.5.1 Monetary Theory
  - 3.5.2 Foreign Exchange
  - 3.5.3 Value and Price
  - 3.5.4 Wages
  - 3.5.5 Income Analysis

Self Check Exercise-3

- 3.6 Summary
- 3.7 Glossary
- 3.8 Answers to self check Exercises

### 3.9 References/ Suggested Readings

### 3.10 Terminal Questions

## 3.1 Introduction

The eighteenth century is the period when the seeds of the economic thought which, later on towards the last couple of decades of that century itself and during the first half of the nineteenth century, came to be systematized into what is now described as the “classical economics” or “classical political economy”, were sown. This was the age during which industrial capitalism was gradually gaining ascendancy over commercial or merchant capitalism. It is during this period that we come across economic thinker who, while still having one foot in mercantilism, were dearly showing signs of presenting ideas and theories which substantially differed from the ideas and theories generally preached by the mercantilists during the heyday of merchant capitalism. The new economic thought of this new generation of thinkers was already exhibiting the influence of the fast changing economic reality in the West, specially in Great Britain and France. These writers on economic themes were the forerunners of the classical\* economics which can aptly be described as the **economic** theory of industrial capitalism in the manner in which mercantilism could be described as the economic theory of commercial capitalism.

Three streams of thought will be found to have influenced the economic thought of this transition period from commercial capitalism to industrial capitalism. One of these thought streams was the development of philosophical thought from its medieval canonical origins to philosophical radicalism which shifted the focus away from the dominance of the church to mundane and secular matters and particularly to the importance of the individual and his freedom in society. It had the effect of making economic propositions more and more positive in nature and less and less ethic - normative. The second thought stream can be witnessed in the British and French economic thought proceeding from later mercantilism, while the **third** thought stream was peculiarly French in origin and **is** represented by the thought system of the French Physiocrats. Writers and thinkers belonging **to** the last two streams of thought are generally regarded **As** the forerunners of the classical economists proper, though the first thought stream of philosophical radicalism lay at the roots of the economic thought streams represented by the last two categories as much as at the roots of classical economics itself.

In the present lesson we shall consider the economic thought of a few representative thinkers belonging to the second of the three thought streams, mentioned above. The representative forerunners of the classical economics chosen for discussion in this lesson, in the light of the syllabus **prescribed for** you, are William Petty and David Hume belonging to Britain and Richard Cantillon belonging to France.

## 3.2 Objectives

After going through this unit you will be able to:

- Explain the economic thought of William Petty's.
- Give David's Hume View on money and price, value, Rent and on Balance of Trade.
- Present the views of Richard Cantillon on wages and Foreign exchange.
- Elucidate the Contribution of Petty, Hume and cantilion in economic thought

### 3.3 William Petty (1623-1687)

Petty is a seventeenth century economic thinker whose ideas and propositions are generally regarded to be much in advance of his times, So much so that in the eyes of Karl Marx and his followers he, and not Adam Smith, was the founder of modern political economy". One of Petty's main contribution which are considered to be much in advance of his times and which has been particularly appreciated in recent times is his contribution to the methodology of the science of economics. In this respect he was indeed much above both the physiocrats and the classical economists proper.

#### 3.3.1 Methodology:

He is known to have introduced, through his writings, a spirit of empiricism which made economic theory a scientific and systematic study. The great emphasis that the modern ' methodologists put on the quantitative methods in social sciences can all be seen in his views which, considering **that he wrote a little more than three centuries back** when the science of economics was in its infancy, is indeed marvelous. In his Political Arithmetic **he** writes, "Instead of using only, comparative and superlative words, and intellectual Arguments, I have taken the course to express myself in terms of Number. Weight, or Measure; to use only Arguments of sense, and to consider only such causes: as have visible Foundations in Nature". But this should not be taken to mean that he was one of those who believed in replacing reasoning by the assembling of facts; He was not an empiricist in the narrow sense popularized much later after him in the nineteenth century by the German Historical School of Economics who gave the slogan : "Let facts speak for themselves". On the contrary, as Schumpeter observes, he was "first and last a theorist. But one of those for whom science is indeed measurement who forge analytic tools that will work with numerical facts and heavily despise any others; whose generalizations are the joint-products of figures and reasoning that are never allowed to pan company." He could, if challenged, fight for his methodology and thus "start what would have been the first controversy oh 'method'. "But none challenged him on it. Only a few followed, though quite a many admired, while the vast majority very quickly forgot. His was the inspiring message of reasoning with figures which, in the words of Schumpeter, "wilted in the wooden hands of the Scottish professor and was practically lost to most economists for 250 years."

Thus, it will not be wrong but quite proper to describe him as the founder of econometrics. Although his message regarding method was lost yet the impulse imparted by it to vital statistics and thus to general statistics was not lost.

### 3.3.2 On Value

In the latter half of the seventeenth century, the commercial capital had yielded much ground to industrial capital, particularly in England. Its impact on economic thought was to divert its focus from trade and commerce (the sphere of circulation) to production, from the relations of merchants and financiers to those of capital and labour. Of greatest importance in this change of approach and content of economic thought was the appearance of a new problem of value and price. Till then it had been conceived almost wholly in terms of exchange. But with the growth of industry, production instead of exchange became the chief concern of the economists. It was no longer possible to insist 'in the manner of the mercantilists that value and wealth in the social sense were created by exchange or trade and commerce. The problem of value and wealth began to be reformulated and answered a- new in a manner which traced their origins to production instead of exchange. Petty was the most important and the earliest English economist who originated and pursued this line of thought which ultimately culminated into the classical economics.

Petty's most important contribution to the theory of value lies in his discovery of the real source of value and wealth in production as contrasted with the mercantilist conception, of value and wealth arising in trade and commerce. He was able to arrive at this discovery through his analysis of value.

He distinguished between "natural price" and political price" or "the true price current". By the "natural price" he meant what we now call the "normal value", while his "political price" or the "true price current" was not different from what we now know as the "market price". The theory of value which he articulated in his writings was a labour theory of value. Explaining the determination of value, he writes in his *Treatise of Taxes and Contributions*: "If a man can bring to London an ounce of Silver out of the Earth in Peru, in the same time that he can produce a bushel of Corn then one is the natural price of the other, now if by reason of new and more easy Mines a man can get two ounces of Silver as easily as formerly he did one the Corn will be as cheap at ten shilling the bushel, as it was before at five shillings, caeteris paribus, "It is 'clear from this statement that according to Petty, the "natural" value of a commodity was- determined by the amount of labour spent on its production. It will also be seen, when we come to explain Adam Smith theory of value that Petty's example, given in his above statement, is not different from Adam Smith's deer-beaver example and that Adam Smith's labour theory of value had already been anticipated by Petty.

Petty was not unaware of the differences in the quality of the different types of labour. But he seems to have not attached much



importance to this factor. What matters most and almost alone is the total labour time consumed in producing a commodity.

As he states:

“And for as much as possibly there may be more An and Hazard in working about the Silver, than about the Com, yet all comes to the same pass, for let a hundred men work ten years upon com. and the same number of men the same time, upon Silver, I say, that the neat proceed of the Silver is the price of the whole neat proceed of the Corn and like parts of the one. the price of like parts of the other.”

Thus he ignores the influence of the quality of labour on the determination of value and seems to imply that when an average is struck over a long period and covering a large quantity, his proposition will hold well. This leaves his labour theory of value rather in a crude form, but the fact remains that his was most probably, the first value theory which shifted the focus of analysis from commerce to production and pioneered the idea that labour was the source of value and wealth. This idea was implicit in his oft-quoted statement that “Labour is the Father and active principle of Wealth, as lands are the Mother.” He speaks of “Wealth Stock or Provision of the Nation” as being the effect of the former or past labour. He was the first to have traced not only value but also surplus value to labour, as it would be clear from both his theory of wages and theory of rent.

### **3.3.3 Theory of Wages or the Value of Labour**

Petty applies his labour theory of value to explain the value of labour or the determination of wages, in doing so; he says the foundation of the classical theory of wages is the Subsistence Theory of Wages. The sum and substance of his theory of wages is that the worker receives *only* that much wages which are just sufficient to enable him to get the necessary means of subsistence, though his labour produces much more, than “just where withal to live” given to him as the wages of his labour. The Marxian concept, of wages, as his value of ‘labours that actually produces, a surplus of value over and above the value paid as wages to the labourer is found in not too rudimentary form in the following statements of Petty; (1) “The day's food of an adult Man, at a Medium, and not the day's labour, is the common-measure of Value.” (2) That a day's food of one sort, may require more labour to produce, than another sort is also not material since we understand the easiest-gotten food of the respective countries of the World. (3) Nor is it material 'that some 'Man will eat more than others since by a day's food we understand' 1/100 part of what 100 of all' Sorts and Sizes will eat, so as to Live, Labour and Generate.” All these statements taken together clearly imply that, according to Petty, wages are determined by the labour required to produce the worker's subsistence. The last of the above three statements taken from Petty's *Verbum Sapient* anticipates almost even to the phrasing of Ricardo's statement or rather restatement of the same wage hypothesis when the latter defines the natural-period Of labour or wages as the one “necessary to enable the laborers, one with another, to subsist and to perpetuate their race.”

### 3.3.4 The Theory of Surplus Value

The first of the above three statements', when properly interpreted will reveal the idea of surplus created by labour in the process of production. The statement implies the idea that the wages paid to the worker for one day labour which equals the worker's subsistence for one day is less than his labour for one day in value terms: that is the labour embodied in his subsistence for one day is less than the one-day labour performed by him. The difference between the two is the surplus of value created by labour.

The idea of surplus created by labour in the process of production is also embodied in Petty's statement that a "Law that appoints such wages should allow the labourer but just wherewithal to live; for if you allow double; then he works but half so much as he could have done, and otherwise would which is a loss to the Public of the fruit of so much labour." Marx himself had found in this statement an embryonic theory of surplus value which is evident from the following interpretation of this passage that he gave in his *Theories of Surplus value*. According to Marx, the passage means that "if the worker were to get for six hours labour the value of six hours, he would get twice as much as he now gets when he is given the value of six hours' labour (for twelve hours' labour). He will then work only six hours." Why the labourer will not work for more than six hours in this case, even though it would increase his income is not clear from Petty's observations unless we impute to him an implicit assumption that the labourer is interested only in earning, the subsistence. However, on this implicit assumption, it does mean that the labourer would, in this case, work for himself only that is, for earning his subsistence only and that he would not put in any unpaid, additional or surplus labour for the sake of his employer.

If we identify Petty's "Publick" in the above statement with the capitalist class, his statement, becomes illuminating. It would then imply that if labourer was paid the full value of the product of his labour, there would be a loss to the capitalist employers (publick) "of the fruit of so much labour."

Petty also conveys the idea that since wages are determined by the necessary means of subsistence, the level of wages would depend on (a) natural productivity of land, that is, whether food is abundant and therefore cheap and whether it is scarce and therefore dear and (b) the level of necessary expenditure (for subsistence needs) which is conditioned by the local climate. The cheaper is the food, the lower, is the wage level: and, similarly, the lower is the necessary expenditure for subsistence, the lower is the wage level.

### 3.3.5 Theory of Rent

Petty's theory of rent follows from his theory of the surplus value which we hinted above. In fact, rent was the only surplus he knew as he demonstrates the creation of surplus only in the case of agricultural production' which might have been due to the fact that agricultural production was as yet the most predominant type of production.

Trying to answer the question posed by himself - to what the mysterious nature of rents is, he arrives at a proposition which anticipates Ricardo. His answer that the natural and true rent of a piece of land for any particular year is the difference between the proceeds of the harvest on the given piece of land and the seed plus what the producer "himself, have both eaten and given to others in exchange for Clothes and other Natural necessities" Rent is thus a surplus over and above the **costs of cultivation which include the farmer's wages for the work done and the cost of seed. He fails, however, to take note of costs of implements used for cultivation.**

It can be seen that the above is no mere explanation of rent; it is also an explanation of the origin of value and surplus value which he sees in labour. Furthermore, since rent was the only surplus he knew, his concept of rent includes the concept of profit also.

Petty was also the first to have an idea of *differential* rent. But while demonstrating it, he takes note of differences in situation only and not of differences in fertility. He states: "as for example, if the corn which feed the London, or an Army, he brought forty miles together, then the corn growing within a mile of London, or the quarters of such Army, shall have added into its natural price much as the charge of bringing it thirty nine miles both amount into..."

The above explanation of differential rent also includes within it the Ricardian proposition that rent is price determined and not price determining. This shows that the Ricardian theory of rent had been anticipated in its essentials by Petty about a century and a half before Ricardo.

### 3.3.6 Theory of Interest

Petty described interest or "usury" as the rent on money. However, he does not show that rent and interest are two distinct shares in the surplus created by labour in agricultural or, for that matter, in any type of production. His theory of interest is in fact, a duplication of his theory of rent. He derives his theory of interest from his theory of rent on land. He argues that anyone who buys with money a given piece of land buys, in fact, the rent on this land for 21 years on the average. Therefore the value of this piece of land will be 21 times the average annual rent on this land. Hence, from the point of view of the purchaser of land, rent is nothing but the interest on his capital. Thus he regards interest as merely rent yielded by money. 'As for Usury', he observes, "the best that can be, is the Rent of so much Land as the Money lent will buy." In this approach he anticipated the interest theory of the physiocrats. Since in Petty's times rent was the general form in which surplus value was found, he regards interest as a secondary form of surplus value.

Insofar as interest was determined by rent, it showed, according to him, "the vanity and fruitlessness of making Civil Positive Laws against the Law of Nature." The implication is that the market determined rate of interest should not be interfered with by the state or any other outside agency which is a clear pointer towards a policy of *laissez-faire* which, long after Petty, **was vehemently pleaded for by**

**the physiocrats and which had become in Adam Smith's times the chief gospel of industrial capitalism.**

### **3.3.7 Money and Prices**

His views on money exhibit mercantilist influence. But he is saved by his statistical approach from confusing money with capital. In trying to discover the optimum or the right supply of money in a country he discovers the concept of the velocity of money.

He was opposed to controls on interest rate as well as exchange rate. He had assimilated all the most refined ideas of his predecessors on the effect of debasement of money and the place of bullion in foreign trade. He was against debasing currency which was cheating the creditors like bankruptcy merchants. On bullion movements he said in a passage reminiscent of Thomas Mun that merchants will still carry abroad either commodities or specie with which to buy foreign goods according to relative prices. England need not be impoverished, he argued, if they took out specie since the commodities they brought home would probably yield a profit.

Although Petty does not discuss specifically the relation between money and prices, 'yet he makes some illuminating statements on the subject A reduction in the silver content of the coin, he argues, is bound to diminish the amount of goods which people are willing to give in exchange for it Thus he points towards inflation and fall in the value of money as the effect, of debasement.

### **3.3.8 Public Finance**

Petty wrote a full treatise on public finance under the title. *Treatise of Taxes and Contributions*, which is a straightforward discussion of the sources of public revenue, the forms of public expenditure, and of the best means of raising the former and disbursing the latter.

Like Thomas Mun, he regards taxation as inevitable. But he advises monarchs and princes to desist from extravagant expenditures, for, in his opinion, the money which the king raises by way of taxes can, if wisely spent, stimulate trade and industry ; it would thus return in increased measure to people's pocket. He also advised economy in administrative and defense expenditures. But he was in favour of welfare expenditure on unemployment relief works lest the labourers should "lose their faculty of labouring."

### **3.3.9 Revenue**

Raising measures were influenced by the philosophy of Hobbes. Since the state is believed to protect the property of the individuals, they are regarded as obliged to contribute to the state revenues. The contribution of individuals should be in proportion to their properties. He seems to argue for a **proportional tax system so that the relative distribution of wealth was not disturbed.** He advises, "let the Tax be never so great, if it be proportional unto all, then no man suffers the loss of any Riches by it" He believes that it is impossible to devise such a tax system, if "for not knowing the

**Wealth of the people, the Prince knows not what they can bear, and for not knowing the Trade, he can make no judgment of the proper season when to demand his Exhibition.” This statement, apart from emphasizing the need of statistical information, points towards two important classical principles of taxation, namely, the principle of ability to pay and the principle of convenience.**

**Self Check Exercise – 1**

- Q.1 Discuss William Petty’s Theory of Wages.**
- Q.2 Discuss William Petty’s Theory of Surplus Value.**
- Q.3 Discuss William Petty’s Theory of Rent.**
- Q.4 Discuss William Petty’s Theory of Interest.**
- Q.5 Discuss William Petty’s views on Public Finance**
- Q.6 Discuss William Petty’s views on Revenue**

### **3.4 David Hume (1711-1776)**

David Hume, a teacher of Adam Smith, had been famous more as a social and moral philosopher than as an economist, though his occasional insights into the economic problems as revealed in his Essays were of no mean order. An important reason why his merit as an economist, was not acknowledged was that he did not write any systematic work dealing with political economy in a relatively exhaustive manner. His writings on economic problems though had seemed to be peripheral in nature. Any way, he is generally known less for his originality and more for his lucidity of views. His economic thoughts are mainly found in his essays such as "Of Money", "Of Interest", "Of Commerce" and "Of Balance of Trade" in his Political Discourses (1752). In a reaction to the above traditional view of his contribution, some commentators in recent times have tended to regard him the most important Pre-Smithian economist which indeed is an exaggeration, especially in view of the quality of the contributions of both Petty and Cantillon.

In fact, he sometimes tended to repeat the mercantilist errors, even though his economic thought in its totality was anti-mercantilist. His praise of merchants **for example, as “one of the most useful races of men”** and as the motive force of production bespeaks of the **mercantilist influence though it sounds strange after the writings of Petty, Locke and North.** Occasionally he praised the use of money in stimulating trade and urged the desirability of “treasure” **too though at the same time, he adopted and emphasized** Locke’s view that money was only a symbol and its quantity did not matter.

#### **3.4.1 Money and Prices**

Hume’s most interesting contribution to economic thought relates to money, prices and interest. In his views on money and prices he follows Locke and articulates the basic relationship between money and prices as embodied in the Quantity.

##### **3.4.1.1 Theory of money**

The level of prices, according to him is determined by the amount of money. Money, according to him, represents commodities and the

value of' money or its inverse, the price level, is determined by the relation between the quantity of money and the quantity of goods for which it is to exchange. Hume had in mind the great changes in prices caused by the increasing output of precious metals from the newly discovered American mines. But he drew no distinction between changes in the value of money commodity itself and the changes in the exchange relationship between money and goods caused by an increase in the volume of circulating money. That is why perhaps, he asserted that the quantity of money did not matter. .

However, the most illuminating and analytically most important part of his theory of money and prices is the dynamic analysis of changes in the quantity of money on prices from which he derives the proposition of beneficial inflation. According to him, it is the period between the increase in the quantity of money in circulation and the ultimate equilibrium price level that, rising prices stimulate trade and industry. Increase in money is beneficial owing to the time lag with which its effects appear. "It is only in this interval or intermediate situation, between the acquisition of money and rise "in prices," says he "that the increasing quantify of gold and silver is favourable to industry." Prices of different goods are affected, in turn, and the increase in money will "quicken the diligence of every individual before it increases the price of labour." In other words Hume was referring to what later Keynes called a "profit inflation" which takes place at the cost of the labouring class.

### **3.4.2 On Interest**

Hume is specially noted for his lucid treatment of the topic of interest: Besides believing that it was a form of surplus value like rent of land, he also showed that along with profits it was a consequence of a prosperous state of trade and industry rather than its cause. In his essay, "Of Interest", Hume begins stating that a low rate of interest was the surest sign of the flourishing state of a country's trade. It was a proposition that had already been stated before him by Culpeper and Child. He then, goes on to state in the manner of Petty, Locke and North before him that a low rate of interest is not a cause but an effect of a flourishing trade and industry. Therefore, following his predecessors he opposes state, regulation of interest. However, he went further than Locke by rejecting his view that a low rate of interest was the result of an abundance of money, though he conceded that both will generally be found together. Following Dudley North, he also gives a demand-and-supply explanation of the market rate of interest. So, he observes that a high rate of interest would be caused by a "great demand for borrowing" and "little riches to supply that demand." But he goes on to remark that both of these are the result of a small amount of industry and commerce. Again, following North's view of the profit -creating quality of capital Humes adds a third determinant of the rate of interest, that is, the profit arising from commerce.

For him, profit and interest were interdependent. As he observes, "The low profits of merchandise induce the merchants to accept more

willingly of a low interest." On the other hand, "no man 'will accept at low profits, where he can have high interest"

### **3.4.3 On Value, Rent and Social classes**

Hume seems to have a Very rudimentary labour theory of value. "Everything in the world," says he "is purchased by labour." There are implicit ideas in his writings suggesting his acceptance of Petty's views on surplus value resulting from labour and taking the forms of rent and interest.

Following Locke, he believed that rent on land arose on account of unequal distribution of property in land. "Those who possess more land than they can cultivate share it with those who have none, on the condition that the cultivators give them a portion of the harvest", writes he. "It is in this way that there is established what one can call interest on land to contrast it with interest on money. "It is interesting to note that while Petty had described interest as "rent on money ', Hume described rent as "interest on land" which, in a way shows the mercantilist influence colouring his views.

His position on social classes also shows his bias in favour of the merchant class, and against the feudal class of landlords. He observed, that landlords who, received incomes without any exertion of their own were inclined to be extravagant. Consequently, they would diminish rather than increase the amount of available capital and would thus help in increasing the rate of interest. This line of argument was inherited by Adam Smith from him. Hume regards the commercial class, on the other hand, as constantly working in, the interests of the nation, by creating both an abundance of capital and low profits. He writes, "Among merchants, there is the same overplus of misers above, prodigals, as among the possessors of the land, there is the contrary. "The merchant class being frugal in habit and interested in increasing its wealth and capital helps in the process *pt* capital accumulation and increasing the number of lenders and the amount of loanable funds and thus help in lowering the rate of interest. It is clear that it was the considerations of capital accumulation which determined his attitude on social classes which, taking into consideration that capital accumulation was the base of the new capitalist economy that was emerging and forming in his times, was a progressive attitude.

### **3.4.4 Balance of Trade**

Any treatment of Hume s contribution to economic thought will be incomplete without a reference to his views on the mercantilist doctrine of the favourable balance of trade and his explanation of what has come to be known as the automatic mechanism of long-run equilibrium of balance of payments. The quantity theory, relation between money and prices that he, like Locke before him, had accepted led him to refute the mercantilist doctrine of the favourable balance of, trade by demonstrating that balance of trade of a country could , not be permanently favourable or unfavourable. It is, because the international movements, of series-would; affect the domestic price levels of the trading countries in such a manner that the, imbalances in the balances

of; trade of trading countries would tend to be automatically corrected. A country, having a favourable balance of trade will receive an inflow of specie which will lead to an increase in money supply in that country, which, in turn, will rise prices there. The higher-prices would, reduce exports and increase imports so that the surplus, in the merchandise trade of the country will; tend to be eliminated automatically. The reverse, change will take place in the country having unfavourable balance of trade and therefore an outflow of specie which, would result in a decrease in the supply of money and consequently in falling prices. This would increase its exports and decrease its imports and, hence, its unfavourable balance of trade would tend to be corrected automatically.

The above proposition was in no way original. It could be found in some faint form or the other in the writings of mercantilists like Serra, Misselden, Malynes, North and Gervaise. But, as Schumpeter observes, "Cantillon and Hume did hit the bull's eye." Hume added several points, says Schumpeter, which were new and "his achievement consisted in shaking off the dust of mistakes..... of the mercantilist inheritance in assembling these pieces into a neat and well-rounded theory"

#### **Self Check Exercise – 2**

**Q.1 Discuss David Hume's Theory of Money.**

**Q.2 Discuss David Hume's views on Interest.**

**Q.3 Discuss David Hume's views on Value, rent and social classes.**

**Q.4 Discuss David Hume's views on Balance of Trade.**

#### **3.5 Richard Cantillon (1680-1734)**

*Cantillon's Essai Sur la Nature du Commerce (Essays on the Nature of Commerce)*, first published in 1755, is now generally regarded as "the most systematic, the most lucid and at the same time the most original statement of economic principles before Smith." He was a French economist rediscovered first by Jevons and later put on a rather high pedestal by Schumpeter in modern times. His importance in the history of economic thought lies not only in his lucid and well planned treatise referred to above but also in some original contributions that he made to not merely economic thought as such but to economic analysis as well. His original contributions, mainly relate to the analysis of foreign trade, the mechanism of foreign exchange, money, banking and credit, and interest.

##### **3.5.1 Monetary Theory**

He also subscribed to the Quantity Theory of money and, like Hume analyzed the effects of increase in the quantity, of money in a dynamic manner. But his analysis is acknowledged to be better worked out than even Hume's. Assuming an increased output from gold and silver mines, he demonstrates how the benefits, of increased purchasing power consequent upon increased money supply are distributed. The owners, smelters, refiners, and other workers, are the



first to benefit from it and; they are able to increase their demand for food, clothes and other, manufactured goods. The suppliers of these commodities; thus benefit in the next round and they, too then, increase their expenditure. But the share of commodities that goes to the people benefiting in the successively later rounds goes on diminishing due to the cumulative rise in prices. The dynamic path of rising, prices and the consequent changes in the distribution of wealth are very carefully analyzed and explained. Even the international effects are not ignored. Taken as a whole, this monetary analysis of Cantillon remains an excellent demonstration of an important aspect of monetary theory. It shows that he was the first to have adopted an income expenditure approach which was later developed, first, by WickSELL and, then, by Keynes. His above said analysis contains the essence of the multiplier analysis also. It was analytically far above the level of Hume's analysis.

Cantillon was also aware that the effect of an increase of money, commodity and the effects of an increase of paper money were only apparently the same, for, inasmuch as the paper or credit money is based on public confidence, this "fictitious" money, in his view, would vanish "at the first gust of discredit", that is, at the break of public confidence.

### **3.5.2 Foreign Exchange**

On the topic of foreign exchange too Cantillon tried to explain principles underlying economic practice in accordance with his general approach. According to Schumpeter, it was Cantillon who first described in a faultless manner the automatic mechanism of balance of payments and foreign exchange equilibrium, an achievement which is wrongly ascribed to Hume. He showed better than anyone before him, the relation between merchandise trade, speculation and specie movements, and also their interaction with exchange rates and price mechanism and the elaborating upon the automatic mechanism of balance of payments equilibrium. He also explained in a lucid manner, the deviation of the exchange rate from the mint par of exchange.

### **3.5.3 Value and Price**

Cantillon's treatment of value, price and wages was hardly original. In these areas, he hardly did more than reformulating ideas of his predecessors and imparting some elegance to their expression and explanation. He showed an eclectic approach to these problems. He starts with a labour theory of value in the manner of Petty but he transforms it into a cost-of-production theory. He allows the demand-and- supply principle also to play a role.

Like Petty, he traced the origin of wealth into labour. However, in chapter XX of his *Essai* he goes on to develop theory of value which is summarized in the very title of it which is as follows. "The Price and Intrinsic value of a thing in general is the measure of the Land and Labour which enter into its Production". His analysis implies that if any two goods are produced by the same amount of land and labour of the same quality they will have equal value. But the proportions in which

land and labour determine the value of particular goods will vary. In some cases like a watch spring, for example, labour makes up practically the whole of the value. On the other extreme are goods like wood where land makes up practically the whole of the value.

He made a distinction between the normal price, which he named as the *intrinsic* value, and the market price, which he described as the *fluctuating* price. The former, according to him, was determined by the cost of production, while the latter was determined by the forces of demand and supply. The excess of supply over demand would depress the market price below the intrinsic value of the commodity, while the excess of demand would raise the former above the latter.

Schumpeter points out that Cantillon reasoned on the basis of the most perfect of perfect competition. But he did not pay attention to imperfections of competitions and determination of monopoly price.

### **3.5.4 Wages**

Like Petty, Cantillon too faced up to the problem arising from the dual source of value (land and labour) in his theory. So, in chapter XI of his *Essai* he inquires if “some relation might be found between the value of Labour and that of the product of Land. “This enquiry into the par between Land and Labour, which may rightfully be described as Petty's problem, leads Cantillon to the discussion of wages and practically to restating Petty's subsistence theory of wages. His conclusion is that the wages or the intrinsic value of labour is determined by the amount of land required to support the labourer's sustenance plus an equal amount for the rearing of two children up to the age at which they can work. Cantillon's theory of wages, like Petty's before him, clearly points towards the classical theory of wages as we shall see in a subsequent lesson. He was also quoted by Smith. Moreover, he also anticipated much of Smith's reasoning on the difference in the wages of different occupations.

### **3.5.5 Income Analysis**

Perhaps his most original contribution was his income analysis which had not been adequately appreciated till Schumpeter highlighted it in chapter XIV of his *Essai*. Cantillon observes that rent is a surplus arising on the “costless” factor, land, and appropriated by the reinter class of landlords. This is the only net income of the economy. He emphasizes the importance of this net income being spent immediately for the economic system or the income process to go on. According to Schumpeter, the specific contribution of Cantillon is his emphasis on the way in which this net income is spent. According to Cantillon, the product of land is divided into three approximately equal parts, one part of which replaces farmers' outlays inclusive of his own upkeep, another goes to him as profit, and the remaining third part goes to the seigneurs (landlords) who spend the whole of it in towns where one-half of the population lives. Farmers spend  $\frac{1}{4}$  part of their income ( $=\frac{2}{3}$  of product of land) on manufactures produced in towns. Thus one-half of the total products of land or net income ( $\frac{1}{3}$  by landlord +  $\frac{1}{6}$  by farmers) are spent in towns which expenditure becomes the

income of merchants and entrepreneurs who spend it on foodstuffs and raw materials.

The above scheme or model of the circular flow of income of Cantillon, observes Schumpeter, presents the following interesting points. Firstly, Cantillon had a clear conception of the function of the entrepreneurs which he explained with particular reference to farmers who pay out the contractual incomes which are "certain", as he says it, with the hope of making a profit by selling at "uncertain" prices, that is, by undertaking risk. Cantillon was, in all probability, the first to have a clear idea that the function of an entrepreneur is to undertake risk. Secondly, Cantillon's description of the sequence of payments and deliveries which starts from the farmers and end with them is something novel unprecedented by his predecessor or contemporaries. Moreover, it is something "which is not explicit in the schema of most theorists of any time. He was the first to make the circular flow of economic activity concrete and explicit", and also the "first to draw a *tableau economique*, though he did not condense it to a table" Schumpeter.

#### **Self Check Exercise – 3**

**Q.1 Discuss Monetary Theory of Richard Cantillon.**

**Q.2 Discuss Richard Cantillon's views on Foreign Exchange.**

**Q.3 Discuss Richard Cantillon's view on Value and Price.**

**Q.4 Discuss Richard Cantillon's view on Wages.**

**Q.5 Discuss Richard Cantillon's Income Analysis.**

### **3.6 Summary**

The eighteenth century is the period when the seeds of the economic thought which, later on towards the last couple of decades of that century itself and during the first half of the nineteenth century, came to be systematized into what is now described as the "classical economics" or "classical political economy", were sown. This was the age during which industrial capitalism was gradually gaining ascendancy over commercial or merchant capitalism. It is during this period that we come across economic thinker who, while still having one foot in mercantilism, were clearly showing signs of presenting ideas and theories which substantially differed from the ideas and theories generally preached by the mercantilists during the heyday of merchant capitalism. The new economic thought of this new generation of thinkers was already exhibiting the influence of the fast changing economic reality in the West, specially in Great Britain and France. These writers on economic themes were the forerunners of the classical\* economics which can aptly be described as the economic theory of industrial capitalism in the manner in which mercantilism could be described as the economic theory of commercial capitalism.

Three streams of thought were found to have influenced the economic thought of this transition period from commercial capitalism to industrial capitalism. One of these thought streams was the development of philosophical thought from its medieval canonical origins to philosophical radicalism which shifted the focus away from the dominance of the church to mundane and secular matters and particularly to the importance of the individual and his freedom in

society. It had the effect of making economic profitions more and more positive in nature and less and less ethic - normative. The second thought stream can be witnessed m the British and French economic thought proceeding from later mercantilism, while the **third** thought stream was peculiarly French in origin and **is** represented by the thought system of the French Physiocrats. Writers and thinkers belonging **to** the last two streams of thought are generally regarded **As** the forerunners of the classical economists proper, though the first thought stream of philosophical radicalism lay at the roots of the economic thought streams represented by the last two categories as much as at the roots of classical economics itself.

### 3.7 Glossary

1. **Tablaue Economique** : *tableau economique* seek to explain the circulation of the *produit net* amongst the three different social classes. The *Tableau* is based on the Physiocratic classification of social classes into landlords or proprietary class, the class of cultivator farmers and the sterile class comprising of manufactures and traders, etc. The land is owned by the landlords but cultivated by the tenant farmers who are assumed to be the only genuinely productive class, though the Physiocrats did not say it explicitly and instead tended to describe even landlords as a productive class merely because it supplied the use of land which alone, according to them, produced the *produit net*, *that is* surplus product. The surplus produced by the class of tenant farmers circulates amongst the different social classes in a manner so as to provide far the needs of the farmers themselves over and above their subsistence needs as well as for the needs of the proprietary class of landlords (inclusive of the king, the church, the public servants and all other dependents on the income of the land-owners and also for the needs of the sterile class.) The *Tableau*, in essence, highlights and explains two very important analytical points. Firstly, it explains how the *produit net* circulates between the three social classes; and secondly, how this *produit-net* or surplus product is reproduced from year to year.

#### 2. William Petty (1623-1687)

Petty is a seventeenth century economic thinker whose ideas and propositions are generally regarded to be much in advance of his times, So much so that in the eyes of Karl Marx and his followers he, and not Adam Smith, was the founder of modern political economy". One of Petty's main contribution which are considered to be much in advance of his times and which has been particularly appreciated in recent times is his contribution to the methodology of the science of economics. In this respect he was indeed much above both the physiocrats and the classical economists proper.

### 3. David Hume (1711-1776)

David Hume, a teacher of Adam Smith, had been famous more as a social and moral philosopher than as an economist, though his occasional insights into the economic problems as revealed in his Essays were of no mean order. An important reason why his merit as an economist, was not acknowledged was that he did not write any systematic work dealing with political economy in a relatively exhaustive manner. His writings on economic problems though had seemed to be peripheral in nature. Any way, he is generally known less for his originality and more for his lucidity of views. His economic thoughts are mainly found in his essays such as "Of Money", "Of Interest", "Of Commerce" and "Of Balance of Trade" in his Political Discourses (1752). In a reaction to the above traditional view of his contribution, some commentators in recent times have tended to regard him the most important Pre-Smithian economist which indeed is an exaggeration, especially in view of the quality of the contributions of both Petty and Cantillon.

### 4. Richard Cantillon (1680-1734)

*Cantillon's Essai Sur la Nature du Commerce (Essays on the Nature of Commerce)*, first published in 1755, is now generally regarded as "the most systematic, the most lucid and at the same time the most original statement of economic principles before Smith." He was a French economist rediscovered first by Jevons and later put on a rather high pedestal by Schumpeter in modern times. His importance in the history of economic thought lies not only in his lucid and well planned treatise referred to above but also in some original contributions that he made to not merely economic thought as such but to economic analysis as well. His original contributions, mainly relate to the analysis of foreign trade, the mechanism of foreign exchange, money, banking and credit, and interest.

**5. Classical Economics:** The tradition of economics that began with Adam Smith, and continued with other theorists including David Ricardo, Thomas Malthus, Jean-Baptiste Say, and others. The classical economists wrote in the early years of capitalism, and they uniformly celebrated the productive, innovative actions of the new class of industrial capitalists. They focused on the dynamic economic and political development of capitalism, analyzed economics in class terms, and advocated the labour theory of value.

## 3.8 Answers to self check Exercises

### Self Check Exercise-1

Ans.1 Please refer 3.3.3

Ans.2 Please refer 3.3.4

- Ans.3 Please refer 3.3.5  
Ans.4 Please refer 3.3.6  
Ans.5 Please refer 3.3.8  
Ans.6 Please refer 3.3.9

#### Self Check Exercise-2

- Ans.1 Please refer 3.4.1 and 3.4.1.1  
Ans.2 Please refer 3.4.2  
Ans.3 Please refer 3.4.3  
Ans.4 Please refer 3.4.4

#### Self Check Exercise-3

- Ans.1 Please refer 3.5.1  
Ans.2 Please refer 3.5.2  
Ans.3 Please refer 3.5.3  
Ans.4 Please refer 3.5.4  
Ans.5 Please refer 3.5.5

### 3.9 References/Suggested Readings

1. Eric Roll: "*A History of Economic Thought*".
2. Alexander Gray: "*The Development of Economic Doctrine*".
3. C. Gide and G. Rist: "A History of Economic Doctrines".
4. J.A. Schumpeter: "*History of Economic Analysis*".
5. M. Blaug: *Economic Theory in Retrospect*.

### 3.11 Terminal Questions

- Q1. Write short note on ideas of Richard Cantillon?  
Q2. What is the contribution of David Hume on Money and Prices, Rent, Interest, value and social classes?

## Unit- 4

### PHYSIOCRATIC ECONOMIC THOUGHT

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#### Structure

- 4.1 Introduction
- 4.2 Learning Objectives
- 4.3 Physiocrats' Doctrine of the Natural Order  
Self Check Exercise-1
- 4.4 Policy Implications of "Natural Order" Concept  
Self Check Exercise-2
- 4.5 Agriculture and Net Product  
Self Check exercise-3
- 4.6 Policy Implications of "*Product Net*" Doctrine  
Self Check exercise-4
- 4.7 Social Classes  
Self Check Exercise-5
- 4.8 Tableau Economique  
Self Check Exercise-6
- 4.9 Summary
- 4.10 Glossary
- 4.11 Answers to self check Exercises
- 4.12 References/Suggested Reading
- 4.13 Terminal Questions

#### 4.1 Introduction

Along with some of the economists of the late seventeenth century and the first half or so of the eighteenth century, a few of whom we mentioned and whose economic thought we examined in the last lesson, the Physiocrats may rightly be considered as the forerunners of the classical school of economics. In fact, in their general orientation and especially with reference to the implications of their economic doctrines, they were closest to the classical. Adam Smith's economic thought, for example, shows a very strong influence of the theories propounded by the Physiocrats. Physiocratic economic thought was developed in the 18th century France. Though it was based on somewhat different experience and was also expressed in different form, yet it resembled, in many respects, the thought of the 18th

century English economic thinkers. Both of these streams of economic thought united in Smith.

It has been observed rightly by commentators on and historians of economic thought that Physiocratic School was the first ever school of economic thought in its true sense. The thought and teachings of the Physiocrats are described as a school of economic thought, because it is informed with a basic and systematic line of approach to the analysis of economic problems. A uniform line of reasoning runs through the views of their leader, Quesnay, as well as those of the followers. The most important feature of their unified approach was their belief in the natural order or *order naturelle*. Physiocracy etymologically means *rule of nature* and since the physiocrats believed in and preached the rule of nature or natural order, they came to be known and described as such.

## **4.2 Learning Objectives**

After going through this lesson you will be able to:

- Explain the Physiocrats' Doctrine of the Natural Order
- Give the Policy Implications of "Natural Order" Concept
- Explicate the Physiocrats view on Social Classes.
- Present the Policy Implications of "Product Net" Doctrine
- Describe the concept of Tableau Economique

## **4.3 Physiocrats' Doctrine of the Natural Order**

The essence of the Physiocratic system according to Gide, "lay in their conception of the "natural order." But, what is this concept of the natural order? In the first place, the Physiocrats' concept of the natural order refers to a type of system which is natural in the sense that it is not an artificial system; that it is not a system that has been contrived or arranged by men. The 'system' in the above statement, of course, refers to "social system" which includes its economic system also.' It is not a system created by the volition of the people in the form of some sort of social contract. Does it then, imply a state of nature as opposed to a civilized state? In so far as the latter implies the existence of certain social, political and economic institutions, while the former implies absence of such institutions, this cannot be the meaning of the Physiocrats' concept of the natural order, for as Gide observes, "they were quite captivated by the ideas of orderliness, authority, sovereignty and property". Therefore their concept of the natural order could not possibly imply the natural state of the "noble savage" of Rousseau's conception.

The Physiocrats' concept of the natural order rather means their belief that human societies are subject to the operation of natural laws in the same manner in which the physical world around us is subject to such laws or the manner in which human and animal organisms are governed by natural laws. This interpretation is highly plausible, in as much as the leader of the Physiocratic School of thought, Quesnay, was a physician turned an economist. He had arrived at physiocracy via physiology.



The above interpretation of the Physiocratic concept of the natural order appears to be plausible also in view of their idea, to which they gave utmost importance in their system of thought, that there is interdependence of all social classes in a socio-economic system which finally depends upon nature. If the interpretation is accepted, it would appear that their concept of natural order had a meaning which we ascribe to the concept of a scientific law establishing a relationship between cause and effect, though the Physiocrats themselves were in the habit of describing their natural order as to refer to the laws of Providence or the laws ordained by Nature or God. They positively asserted that these providential or natural or even divine laws were entirely different from the "positive" laws that are determined and legislated by governments.

There are other characteristics of the laws comprising their "natural order" which also strongly point towards the interpretation that by the "natural order" they meant scientific laws. They regarded the natural order as the universal order meaning by it that the laws of nature (or the natural order) were not limited by time and space in their operations. In this regard they did not distinguish between the laws which govern physical world and the laws which govern the behavior of a social system their "natural order" was not only universal but also immutable which too strengthens the above interpretation. Their belief in the universality of the natural order is reflected in the following statement of Turgot. "Whoever is unable to overlook the accidental separation of political states one from, another, or to forget their diverse institutions, will never treat a question of political economy satisfactorily." Their belief in the immutability of natural laws or order is reflected in the following statement of Turgot "The rights of man are not founded upon history they are rooted in his nature."

If the above interpretation of the Physiocrats' concept of natural order is valid, as it seems to be, the Physiocrats will have to be credited with pioneering of the idea that laws of political economy are similar to the laws of the physical sciences and thus transforming what till then was regarded as a moral science into a positive science. As Gide remarked on it "And this we might say was a change tantamount to a transformation from a moral to a natural science."

Physiocrats' natural order was not only universal and immutable but also, to them, obviously the best by this they meant that the natural order, since it was ordained by Nature or Providence or God, would work for the benefit of all, provided it was not interfered with by man-made laws. It would be remembered that the existing institution of private property as well as the class structure of the society were viewed by the Physiocrats as the part and parcel of the "natural order" of their conception. It implied the individual's right to enjoy the benefits of private property, the freedom to use one's labour in whatever way one liked, and also to enjoy other such individual freedoms as were consistent with such freedoms of others in the pursuit of the individual self-interest. In the words of Eric Roll, "The natural order was an anticipation of utilitarianism at a time when the economic and political conditions were not yet ripe for it. This, according to him, "explains the

contradictions of the physiocratic system itself and the theoretical and practical conclusions that were drawn from it.”

Self Check Exercise-1

Q.1 Discuss Physiocrats’ Doctrine of the Natural Order.

#### **4.4 Policy Implications of “Natural Order” Concept**

The policy implied in the physiocratic concept of the natural order was that the working of the economic system should not be interfered with by man and man-made institutions, because its working is governed by laws of nature which are immutable. Therefore nothing but only harm would result from any tinkering with it by the state and its institutions. The Physiocrats were the first to argue cogently and systematically in a scientific manner for policy of “*laissez faire, laissez passer*”, that is, “let things alone, let them take their course.”

The concept of the natural order implied that every man could be trusted to find out for himself the best way of attaining the “natural order” which was by definition the most beneficial for him. ‘He should, in no way, be coerced to make his choices. According to Quesnay’s interpretation, the concept implied the principle, “to secure the greatest amount of pleasure with the least amount of outlay”. This is the hedonist principle on which later the neoclassical school built up its own theoretical structure, particularly the Austrian branch of it. It is of the very essence of the “natural order” that the particular interests of the individual can never be separated from the common interests of all, but this could be possible only under a system free from all type of outside interference. As Quesnay observes, “the movements of society are spontaneous and not artificial and the desire for joy which manifests itself in all its activities unwittingly drives it towards the realization of the ideal type of State.” This, as Schumpeter rightly remarks, is *laissez-faire* principle, pure and simple.

Their doctrine of “*laissez faire*” which they derived from their most basic concept of the “natural order” should not be interpreted as a doctrine of passivity or fatalism. To the contrary, it was believed by them to be the most actively beneficial or the optimizing principle of human happiness.

At the level of the international economy, their concept of the natural order implied the classical doctrines of free trade. It can be easily seen that in this respect physiocracy was a reaction to mercantilism. While the latter called for a comprehensive system of state regulation of economic activity, the former implied the exact opposite of it, that is, a policy of *laissez faire* without the slightest interference in economic activity by the state. Any interference with the economic activities of the individuals by the state would, in their opinion, violate the “natural order” and thus destroy the beneficence which it could certainly ensure.

Self Check Exercise-2

Q.1 Discuss Policy Implications of “Natural Order” Concept.

#### **4.5 Agriculture and Net Product**

We mentioned above that the Physiocrats regarded the natural order not only as immutable but also as beneficent and bountiful. The beneficent and bounteous character of the natural order or Nature was nowhere as conspicuously obvious to them as in agriculture. But in order to understand the bounteous character of the natural order as revealed to the Physiocrats in agriculture, we must first understand their concept of *product net* or “net product”.

The Physiocrats, along with the more advanced pre-classical economic thinkers like Petty and Cantillon, deserve the credit for having finally discarded the mercantilist belief (that value and wealth were created in exchange or trade). On the other hand, they transferred the creation of value and wealth to the sphere of production. But they were so much obsessed with their concept of the natural order and its grandeur that they could see the creation of value and surplus value; and the accumulation of wealth only in a sphere of production where the role of Nature in production was too obvious. In other words, they observed the creation of *product net* or net product only in agriculture. *Product net* or the net product is nothing but the surplus of the total product over and above what is necessary to produce, that total product. The necessary inputs to produce a given output of any agricultural produce are the seeds and the consumption requirements of the labouring farmers on the land. Most probably, they had in their mind the example of food crops when they were arriving at their concept of the *product net*. Since, in agricultural production, particularly in food-grain production, inputs and output consisted of the same product, the surplus of total output over and above the inputs used to produce that output, that is, the *product net* or the net product could be seen most easily in the form of a concrete quantity, that, perhaps, explains the Physiocrats' misconception that *produit net* arises in agriculture alone. And, obsessed as they were with the grandeur or the working of the natural order, they ascribed the creation of this surplus or net product not to the farmer's labour as such but to the bounteousness of Nature.

It is for this reason that the Physiocrats never tired of singing the praise of agricultural activities and propagating the view that agriculture was the only productive activity, while all other activities such as manufacture and trade were unproductive or in their words, they were *sterile*. Thus in their hierarchy of occupations agriculture occupied the top rank. They thus completely inverted the mercantilist hierarchy of occupations. This is incidentally another respect in which physiocracy can be described as a reaction to mercantilism. Physiocrats are known for their anti-Colbertism, not only because Colbert in their country was an advocate of state regulation of economic activity which went against their doctrine of the natural order but also because according to the Physiocrats' belief, the policies advocated by him promoted industry at the expense of agriculture.

### Self Check Exercise-3

Q.1 Discuss Physiocrats' view on Agriculture and Net Product.

#### 4.6 Policy Implications of “*Produit Net*” Doctrine

The Physiocrats derived their political philosophy as well as their theory of economic policy from their doctrine of *Produit net* as well as their doctrine of the natural order. We have, already seen that the physiocrats derived their *laissez faire* policy from their concept of the natural order. They arrived at the same policy conclusion via their doctrine of *produit net* also. Since, as pointed, out in the preceding section, this doctrine implied that agriculture was the only source of surplus, therefore, the Physiocrats argued, the mercantilist measures of Colbert designed to promote industry were useless. As the said measures, were nothing but various forms of state regulation of economic activity and a negation of freedom of trade, therefore their condemnation of Colbertism implied a policy of unfettered trade and other activities. As observed by Eric Roll, it was against the measures of Colbert designed to foster industry “that the Physiocrats raised their battle cry of “*laissez -faire, laissez - passer*”. According to the physiocrats, industry did not create values; it only transformed them" from one form into another one. Therefore, they argued, no amount of state regulation of industry could produce a surplus over and above what goes into the manufacture of a given output by way of inputs. State regulation, in their view, could thus add nothing to the wealth of the community. On the contrary it would make production more cumbersome and less economical. So, they recommended the abolition of state intervention in economic activities and the setting up of a regime of free enterprise and unfettered economic activity, that is, they were all out for a policy of *laissez -faire, laissez passer*.

The Physiocrats derived their theory of single tax system also as a logical corollary from *their produit net* doctrine. Since, according to this doctrine, neither industry nor trade produced any surplus over and above the inputs used in them and, therefore since they were sterile occupations, there was no point in taxing industry and trade in any form. Since agriculture was believed by them to be the only occupation which produced surplus or *produit net*, it was reasonable to impose a single tax, namely, a tax on to agriculture. Any tax which was levied on any other economic activity such as industry or trade was sure to be shilled, in somewhat or the other, on agriculture, that is, land; Such an attempt by the state would tantamount to taxing agriculture, that is, land in a roundabout manner which would not only be not straightforward and honest manner but also uneconomical. Hence the- the tax policy recommended by the Physiocrats was to have a single tax on land only. Thus their theory of economic policy absolved the traders and manufacturers, the capitalist class, from all tax obligations to the state.

The above policy- implications of the Physiocratic doctrine of the *produit net* as well as those of their concept of the natural order demonstrate Eric Roll's observation that “there is almost 'a feudal air about the physiocratic attitude to land yet because land was regarded as the only source of wealth, the practical conclusion was one which was against the landed interest.” In fact, as Roll further remarks, “when it came to the discussion of economic problems, the physiocrats were

already forced to look through capitalist glasses. For them the owner of land had already become a capitalist who employed the labourer."

The last observation in the above quotation from Eric Roll's *History of Economic Thought* would be further elucidated in the following section on the Physiocrats' views on social classes.

Self Check Exercise-4

Q.1 What do you know about Policy Implications of "*Produit Net*" Doctrine.

#### **4.7 Social Classes**

The Physiocrats' model, like the classical model after them, was essentially a three -class model. But the social classes demarcated by the physiocrats were somewhat different from the classical model. In the classical model, we have the three social classes of landlords, capitalist and workers, each one of which is identified with a particular factor of production. Landlords are identified with land; the capitalists with capital; and the workers with labour. But the Physiocrats' classification neither runs along the lines nor is it as sharp and clear cut as the above described classical classification.

Physiocratic classification of social classes basically follows from their classification of economic activities or occupations into productive activities and non-productive or sterile activities. According to them, productive activities were those activities or occupations which produced a surplus or *produit net*, while those activities or occupations which did not create a surplus of product were non-productive activities. And since, as already explained, the Physiocrats, belated agriculture to be the only activity which could and did produce a surplus or *produit net*, therefore, in their schema, there were basically only two broad social classes, namely, the productive and the non-productive or sterile classes. All those who were associated with agriculture, that is, land, were regarded as the productive class, while those who were occupied in other professions like manufacture, trade and commerce, and-even administrations, etc. were regarded as non-productive classes. To anyone who raised the objection that, there were profits in manufacture, trade and commerce also, they would reply that such profits were only a part of the *produit net* or surplus produced in agriculture and transferred to the people engaged in these occupations. As we have observed earlier also, in their view people engaged in non- agricultural production or other activity like trade merely transformed inputs into outputs of equal value without producing a surplus. As regards trade, it represented an exchange of equivalents; therefore, there was no question of any surplus arising in the process of exchange. When exchange was not between equally positioned parties there was unequal exchange, as the result of which the stronger party might gain at the expense of the other party. But the exchange does not create any fresh, value or surplus, thus they looked upon all non-agricultural classes as non-productive classes and, therefore, as "hirelings" or "*stipendies*" of the agricultural classes which practically meant the land owning classes inclusive of the state and the church as land -owners.

However, the above classification was more of a technical or analytical classification and less of a social classification. Physiocrats' social classification admitted three social classes of the landlords (inclusive of the state and the church as land-owners and also their dependents), the fanners and the manufacturers (possibly inclusive of all other sterile classes). It is especially noteworthy that the Physiocrats presented the landlord in the garb of a capitalist who pays the cultivator-farmer for his labour power the use values (necessaries of existence) which maintain him during the period of production and receives in return more than its equivalent. Landlord is also represented as providing various kinds of advances (capital) to the cultivator farmers other than their subsistence. In the classical model, the farmer is capitalist and the landlord is a pure reinter. But in the Psysiocratic model, the farmers are cultivators of land and therefore they represent the working class. The landlord, on the other hand, is both the land-owner and capitalist rolled into one. This is what is meant by Eric Roll's re-statement of Marx's view that for the Physiocrats, "the owner of land had already become a capitalist who employed labourers," to which we referred towards the end of the preceding section.

The development referred to above with regard to the social class of landlords was nowhere as clear as in the writings of Turgot. He begins with a consideration of produit net in its most primitive form. Surplus created by the cultivators of soil was the only fund from which the other social classes could get their subsistence. The cultivator, after having produced the surplus, could realize it by buying the labour of others. Thus those employed in manufactures became the stipends of the cultivator. But, according to Turgot, a time comes when the owner-cultivator (cultivator -proprietaries) ceases to be the only one concerned with the appropriation of the produit -net. At this stage, the proprietor becomes separated from the cultivators. Non- holders of land become hired workers in the form of either pure cultivators or as hired workers of manufacturers. In this way three distinct social classes of landlords, cultivator- farmer class and the manufacturing class crystallise in the Physiocratic model.

Self Check Exercise-5

Q.1 Discuss Physiocrats' view on Social Classes.

## 4.8 Tableau Economique

Quesnay's *tableau economique* which contains an analysis of flow of income has been rightly described as most spectacular achievement of the Physiocrats. A noted Physiocrat, Mirabeau the Elder, went so far as praising it as to make it comparable, in importance, to the invention of writing and money. Alexander Gray, on the extreme, grossly underrated its importance by characterizing it as no more than a literary curiosity. Recent assessments like those, of Schumpeter and Blaug made against the background of the phenomenal development

income analysis since the time Prof. Gray wrote his history of the development of the economic doctrines, are nearer to the assessment of Mirabeau the Elder, though it doubtful if Mirabeau understood the real importance of it 'he history of economic analysis. '

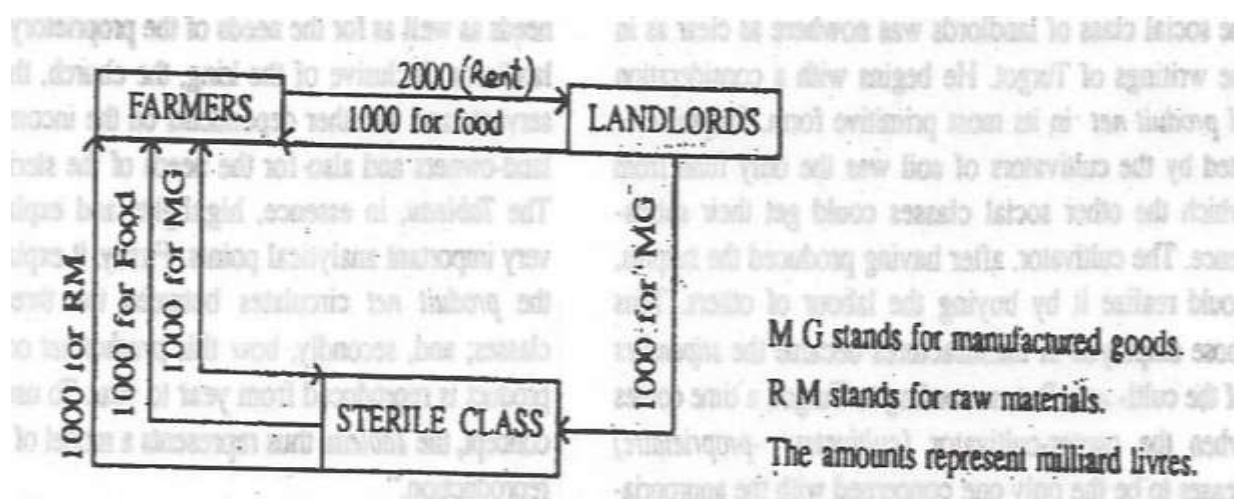
As a matter of fact, Quesnay's *tableau economique* seek to explain the circulation of the *produit net* amongst the three different social classes. The *Tableau* is based on the Physiocratic classification of social classes into landlords or proprietary class, the class of cultivator farmers and the sterile class comprising of manufactures and traders, etc. The land is owned by the landlords but cultivated by the tenant farmers who are assumed to be the only genuinely productive class, though the Physiocrats did not say it explicitly and instead tended to describe even landlords as a productive class merely because it supplied the use of land which alone, according to them, produced the *produit net*, that is surplus product. The surplus produced by the class of tenant farmers circulates amongst the different social classes in a manner so as to provide for the needs of the farmers themselves over and above their subsistence needs as well as for the needs of the proprietary class of landlords (inclusive of the king, the church, the public servants and all other dependents on the income of the land-owners and also for the needs of the sterile class.) The *Tableau*, in essence, highlights and explains two very important analytical points. Firstly, it explains how the *produit net* circulates between the three social classes; and secondly, how this *produit-net* or surplus product is reproduced from year to year. To use Marx's concept, the *Tableau* thus represents a model of "simple reproduction."

A very simplified description of the analysis of the flow or circulation of the *produit net* as implied in the *Tableau* can be given as follows. The annual gross product of the-agricultural sector is assumed to be 5000 milliard livres of which 2000 milliard livres are assumed to represent the necessary expenses of production inclusive of the farmer's subsistence. The prices are assumed to be constant through. Therefore, although the illustration works with money values, yet, in fact, physical quantities are implied in them. It is obvious from the above assumptions that the *produit net* or the surplus product is 3000 milliard livres worth of product. It is further assumed that this surplus consists of 2000 mill, livres worth of food and 1000 mill livres worth of raw materials: This is the/situation-at the end of the agricultural production period and at the start of the process of circulation of his surplus. It is also assumed that the farmers possess at the start not only the whole surplus in kind but also the whole amount of money (say, 2000 mill, livres). Landlords hold nothing but have a claim on the tenant farmers for rent to the amount of 2000 mill, livres. The sterile class possesses 2000 mill, livres worth of manufactured goods produced in the preceding period.

The farmers pay their 2000 mill, livres to the landlords as rent on land. Landlords spend 1000 mill, livres on buying food from the farmers who thus get back one - half of money paid to the landlords as rent. The landlords spend the other half of their rent income on manufactured goods so that the sterile class receives an income of

1000 mill, livres: The farmers also spend 1000 mill, livres on manufactured goods which makes the total-income the sterile class 2000 mill, livres. But the sterile class spends one-half of it on buying food from the farmers and the other half on buying raw materials from the farmers. Thus the farmers receive back the whole of the money with which the process of circulation started.-The flow circuit is completed and the farmers are now ready to make use of the money received to restart the process in the next period.

The flow analysis of the *Tableau* as depicted in the above example can also be illustrated with the help of the following flow diagram:—



The Physiocrats, either Quesnay himself or anyone else, did not present the *Tableau* in the above form, but it captures and explains all the essentials of Quesnay's *Tableau*. Another modern alternative method of capturing and explaining the argument of the *Tableau* in its essential, form is to present it in the form of a matrix table as follows.

RECEIPTS OF ↓ PAYMENT OF →	FARMERS	LANDLORDS	STERILE CLASS	TOTAL
FARMERS		1000	2000	3000
LANDLORDS	2000			2000
STERILE CLASS	1000	1000		2000
TOTAL	3000	2000	2000	

In the above matrix table, the rows show the receipts of the respective classes. The top row, for example, shows the receipts of the farmers and the row above the bottom row (representing totals of the columns) shows the receipts of the sterile class. And, the row in between the farmer's row and the row of the sterile classes shows the receipts of the landlords. The columns indicate the payments of the respective classes. Thus the landlords receive 2000 mill, livres from



the farmers as rent; therefore this amount lies in the row of the landlords and in the column of the farmers. The landlords pay out 1000 mil, livres to farmers for purchasing food from them so that this amount enters in the row of the farmers and the column of the landlords. The other 1000 mill, livres are paid by the landlords to the sterile class for the purchase of manufactured goods from them. So it enters the column: of landlords and the row of the sterile class. Thus you will see that the receipts and payments of each social class are equal

It can be seen that Quesnay's Tableau is a relatively more elaborate expression of the idea contained in Cantillon's income analysis. The Tableau, as observed by Schumpeter, is an "overall description of a stationary economic process" in which there is no growth over time. It is similar to Karl Marx's simple reproduction model. Its schema of social classes as a tool of analysis was taken over from Cantillon. The tableau represents flow of expenditure as well as products between different social classes. Schumpeter has pointed out three important aspects of the Tableau as an analytical tool. It achieves a tremendous simplification by choosing social classes instead of individuals, flow of expenditure and products among whom would have been unmanageable. More importantly, the above-said simplifications achieved by the Tableau opened up great possibilities for numerical theory or econometrics. In fact Quesnay did try to estimate: the values of annual output and other aggregates which show that he did a genuinely econometric work of - the type done in modern times by Leontief (cf. Leontief's *The Structure of American Economy*). Karl Marx whose flow-of-income analysis stood midway between Quesnay's and Leontief's had not cared to make his model statistically operative." Lastly, in the words of Schumpeter, "Cantillon-Quesnay tableau method was the first method ever devised to convey an explicit conception of the nature of economic equilibrium. The Tableau also conveys the idea of a pervading inter-dependence of all economic phenomena which, though, was fully discovered later on by Leon Walras. Moreover, as, again, observed by Schumpeter.

"Quesnay identifies general equilibrium, that is, equilibrium of the economy as a whole in distinction to the equilibrium in any particular small sector of it, with the equilibrium of social aggregates exactly as do the modern Keynesians."

Self Check Exercise-6

Q.1 What do you know about Tableau Economique.

## 4.9 Summary

Physiocrats may rightly be considered as the forerunners of the classical school of economics. In fact, in their general orientation and especially with reference to the implications of their economic doctrines, they were closest to the classical. Adam Smith's economic thought, for example, shows a very strong influence of the theories propounded by the Physiocrats. Physiocratic economic thought was developed in the 18th century France. Though it was based on somewhat different experience and was also expressed in different form, yet it resembled, in many respects, the thought of the 18th

century English economic thinkers. The Physiocratic School was the first ever school of economic thought in its true sense. The thought and teachings of the Physiocrats are described as a school of economic thought, because it is informed with a basic and systematic line of approach to the analysis of economic problems. A uniform line of reasoning runs through the views of their leader, Quesnay, as well as those of the followers. The most important feature of their unified approach was their belief in the natural order or *order naturelle*. Physiocracy etymologically means *rule of nature* and since the physiocrats believed in and preached the rule of nature or natural order, they came to be known and described as such.

The Physiocrats' concept of the natural order refers to a type of system which is natural in the sense that it is not an artificial system; that it is not a system that has been contrived or arranged by men. The 'system' in the above statement, of course, refers to "social system" which includes its economic system also. It is not a system created by the volition of the people in the form of some sort of social contract. The Physiocrats' concept of the natural order rather means their belief that human societies are subject to the operation of natural laws in the same manner in which the physical world around us is subject to such laws or the manner in which human and animal organisms are governed by natural laws. This interpretation is highly plausible, in as much as the leader of the Physiocratic School of thought, Quesnay, was a physician turned an economist. He had arrived at physiocracy via physiology.

The policy implied in the physiocratic concept of the natural order was that the working of the economic system should not be interfered with by man and man-made institutions, because its working is governed by laws of nature which are immutable. Therefore nothing but only harm would result from any tinkering with it by the state and its institutions. The Physiocrats were the first to argue cogently and systematically in a scientific manner for policy of "*laissez faire, laissez passer*", that is, "let things alone, let them take their course."

Agriculture was the only productive activity, while all other activities such as manufacture and trade were unproductive or in their words, they were *sterile*.— Thus in their hierarchy of occupations agriculture occupied the top rank. They thus completely inverted the mercantilist hierarchy of occupations. This is incidentally another respect in which physiocracy can be described as a reaction to mercantilism. Physiocrats are known for their anti-Colbertism, not only because Colbert in their country was an advocate of state regulation of economic activity which went against their doctrine of the natural order but also because according to the Physiocrats' belief, the policies advocated by him promoted industry at the expense of agriculture. According to the physiocrats, industry did not create values; it only transformed them from one form into another one. Therefore, they argued, no amount of state regulation of industry could produce a surplus over and above what goes into the manufacture of a given output by way of inputs. State regulation, in their view, could thus add nothing to the wealth of the community. On the contrary it would make

production more cumbersome and less economical. So, they recommended the abolition of state intervention in economic activities and the setting up of a regime of free enterprise and unfettered economic activity, that is, they were all out for a policy of *laissez-faire, laissez passer*.

The Physiocrats derived their theory of single tax system also as a logical corollary from *their produit net* doctrine. Since, according to this doctrine, neither industry nor trade produced any surplus over and above the inputs used in them and, therefore since they were sterile occupations, there was no point in taxing industry and trade in any form. Since agriculture was believed by them to be the only occupation which produced surplus or *produit net*, it was reasonable to impose a single tax, namely, a tax on to agriculture. Any tax which was levied on any other economic activity such as industry or trade was sure to be shilled, in somewhat or the other, on agriculture, that is, land; Such an attempt by the state would tantamount to taxing agriculture, that is, land in a roundabout manner which would not only be not straightforward and honest manner but also uneconomical. Hence the tax policy recommended by the Physiocrats was to have a single tax on land only. The Physiocrats' model, like the classical model after them, was essentially a three -class model. But the social classes demarcated by the physiocrats were somewhat different from the classical model. In the classical model, we have the three social classes of landlords, capitalist and workers, each one of which is identified with a particular factor of production. Landlords are identified with land; the capitalists with capital; and the workers with labour. But the Physiocrats' classification neither runs along the lines nor is it as sharp and clear cut as the above described classical classification.

Quesnay's *tableau economique* which contains an analysis of flow of income has been rightly described as most spectacular achievement of the Physiocrats. Quesnay's *tableau economique* seek to explain the circulation of the *produit net* amongst the three different social classes. The *Tableau* is based on the Physiocratic classification of social classes into landlords or proprietary class, the class of cultivator farmers and the sterile class comprising of manufactures and traders, etc. Quesnay tableau method was the first method ever devised to convey an explicit conception of the nature of economic equilibrium. The *Tableau* also conveys the idea of a pervading interdependence of all economic phenomena which, though, was fully discovered later on by Leon Walras. Moreover, as, again, observed by Schumpeter.

## 4.10 Glossary

1. **Physiocrats:** A very early school of economics (originating in France in the 18th Century) which likened the interactions between different sectors and classes of the economy, and the monetary flows between them, to the circulation of blood through the human body.

2. **Tableau Economique** seek to explain the circulation of the *produit net* amongst the three different social classes. The *Tableau* is based on the Physiocratic classification of social classes into landlords or proprietary class, the class of cultivator farmers and the sterile class comprising of manufactures and traders, etc. The land is owned by the landlords but cultivated by the tenant farmers who are assumed to be the only genuinely productive class, though the Physiocrats did not say it explicitly and instead tended to describe even landlords as a productive class merely because it supplied the use of land which alone, according to them, produced the *produit net*, that is surplus product. The surplus produced by the class of tenant farmers circulates amongst the different social classes in a manner so as to provide for the needs of the farmers themselves over and above their subsistence needs as well as for the needs of the proprietary class of landlords (inclusive of the king, the church, the public servants and all other dependents on the income of the land-owners and also for the needs of the sterile class.) The *Tableau*, in essence, highlights and explains two very important analytical points. Firstly, it explains how the *produit net* circulates between the three social classes; and secondly, how this *produit-net* or surplus product is reproduced from year to year.

#### 4.11 Answers to self check Exercises

Self Check Exercise-1

Ans.1 Please refer 4.3

Self Check Exercise-2

Ans.1 Please refer 4.4

Self Check Exercise-3

Ans.1 Please refer 4.5

Self Check Exercise-4

Ans.1 Please refer 4.6

Self Check Exercise-5

Ans.1 Please refer 4.7

#### 4.12 References/ Suggested Reading

1. Eric Roll: "*A History of Economic Thought*".
2. M. Blaug: *Economic Theory in Retrospect*.
3. Alexander Gray: "*The Development of Economic Doctrine*".
4. C. Gide and G. Rist: "*A History of Economic Doctrines*".
5. J.A. Schumpeter: "*History of Economic Analysis*".
6. I. Rima: *Development of Economic Analysis*

#### 4.13 Terminal Questions

Q1. Explain the nature and working of Physiocratic Tableau Economique. Discuss its significance in the history of economic thought?

Q2. How far do you agree with the view that the essence of the Physiocratic System lay in their conception of the Natural order?

## Unit- 5

# THE CLASSICAL SCHOOL OF ECONOMICS (1)

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### Structure

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### 5.1 Introduction

It is difficult to give a precise definition of the term, "classical economics". However, since the term is usually associated with the thought system of Adam Smith, David Ricardo and his followers, we may safely take it to refer to those lines of economic thought and belief which their works embody.

The study of their works will reveal that a very important feature of their mode of thinking was their peculiar philosophical approach which underlies their economic teachings it is their belief in the absolute superiority of the *natural order* of things. It is a belief which they share with the physiocrats and which leads them, not unlike the Physiocrats, to the doctrine of *laissez-faire*. Classical economics is almost synonymous with *laissez-faire* economics, despite the exception which some later classical economists belonging to rela-

tively industrially underdeveloped countries of the times made in the field of international trade by presenting a theory of protection against the theory of free trade forcefully preached by the English classical economists. In other words, the classical economics was the economics of the competitive stage of the capitalist system of production.

Another distinguishing mark of the classical school of economic thought is its emphasis on production. In its focus of analysis, it differs from both the mercantilists who preceded the classical economic thinkers and the Austrian and Jevonian economists who followed them. While the mercantilists deemed trade or exchange to be the real source of wealth and consequently focused on trade, particularly foreign trade, the Austrians and Jevonians exalted consumption and subjective utility relegating production to a rather humble place in the background. But to the classical economists, production was the real source of wealth and consequently they sought to understand and explain the economic system of capitalist society through the study of the laws of its production.

According to Karl Marx belief in the labour theory of value and the theory surplus value was the hallmark of the classical economics or the classical political economy as it was known at the time. This is a tenet which all the noted classical economists from Smith down to J. S. Mill appear to have adopted.

Finally, it may not be wrong to suggest that classical economics was essentially an expression of the essential interests of the then rising class of the industrial bourgeoisie during the competitive stage of industrial capitalism. Its deductions and policy conclusions in favour of *laissez-faire* and free competition and against state intervention and monopolistic privileges of the mercantilist times along with its emphasis on production in the place of commerce and exchange as such are pointers in this direction.

It is observed by Joseph Schumpeter in his *Economic Doctrine and Method* that “*laissez-faire*” doctrine is not an essential tenet of the classical system, for there can be found protectionist disciples of Adam Smith such as Carey, for example, But it may be noted that the *laissez-faire*, though went through some modification in the hands of some later economists in the classical line under the impact of the particular economic conditions prevailing at the time in their home countries, seldom went out of the main-stream of classical economic thought. It was mainly in the field of international trade that its truth and objectivity was questioned. Within the national economy it held full sway even according to the “protectionist” disciples of Adam Smith.

## 5.2 Learning Objectives

After going through this lesson you will be able to:

- Explain Adam smith’s Social Philosophy
- Describe Adam smith’s economic Philosophy
- Elucidate Adam smith theory of value and Distribution
- Present Adam smith’s view on Economic Progress.

### 5.3 Adam Smith (1723-1790)

In the folklore of economics, Adam Smith is described as the father of political economy. But Say, a French disciple of him described his magnum opus, *An Enquiry into the Nature and Causes of the Wealth of Nations*, as a “vast chaos”. Alexander Gray had asserted that “Adam Smith was not the founder, the inventor, or the discoverer of Political Economy. That he did so much was entirely due to the fact that so much had been done before him. In no sense was he a pioneer.” In more recent times, Schumpeter almost dittoed Gray’s opinion when he observed that “no matter what he actually learned or failed to learn from predecessors, the fact is that the *Wealth of Nations* does not contain a single analytic idea or principle of method that was entirely new in 1776.”

However, despite the above opinions, the fact remains that Adam Smith’s name is one of the greatest, and to many the greatest, in the history of economic thought. Here under, we shall explain some of his more important contributions to economic thought.

#### 5.3.1 Adam Smith’s Social Philosophy

It is not possible to fully appreciate Adam Smith's economic model without having a clear idea of his social philosophy which determined his general approach or standpoint with respect to that analyzing and explaining the laws which govern the ‘behavior of the competitive capitalist economy that he observed taking shape around him. Two important features of his social philosophy which he expounded in his *Theory of Moral Sentiments*, and which can be observed *passim* in the *Wealth of Nations* too, were his “naturalism” and ‘optimism.’

His belief in naturalism implied a belief in the spontaneous character of all social institutions. From which followed the inference that there was no need of any outside deliberate and premeditated organization. According to his social philosophy, there was no need for any planned intervention of the general will, however far-seeing and reasonable it might be. Nor was there any necessity for a preliminary understanding among the members of society as it is stipulated in the “social contract” theory of society. This social philosophy led him to the conclusion that the economic phenomena of an economy works not as the result of some conscious plan but, to the contrary, it is the result of the Spontaneous action of millions of individuals, each of whom follows his own self-interest.

One of his most fundamental postulates was that men are guided in their behaviour by their individual self-interest. A second postulate which was inseparable from the first was that men are also endowed with an instinct for fellow-feeling which imparts to them a sense of justice and morality. The latter propensity restrains the propensity to follow one’s self-interest from degenerating into “selfishness” which negates both justice and morality. Those propensities or “natural principles,” as Adam Smith describes them, lead them to advance



those ends-which a refined and enlightened reason would recommend. But all this takes place spontaneously as an unintended result. The meaning of his "naturalism" or his idea of the "natural order" is nowhere as lucidly expressed as in his famous dictum that man in pursuit of his self-interest is "led as if by an Invisible Hand to promote ends which were no pan of his original intention."

The above-explained idea of the "natural order" of Smith's "naturalism" is similar to the physiocratic concept of the "natural order" and is, therefore, analogous to the concept of a scientific law. The spontaneous character of economic phenomena which is implied in Smith's naturalism, in fact, refers to economic laws which operate independently of individual wills.

Smith appeared to be aware that the laws of development of an economy or even society in its all aspects (which are covered by his naturalism) are in a way different from the "natural laws", that is, the laws of nature! The "natural law" suggests regularity and repetition. But Smith's emphasis was much more on the spontaneity and less on the constancy of economic phenomena. This implied that the nature of economic phenomena could change. They need not remain constant what is constant about them is their spontaneous character. Smith's naturalism implied that an economy is a living organism which develops for itself its own indispensable organs without being conscious of it.

Linked to Adam Smith's naturalism is the idea of optimism. The "natural order" of his conception is not only spontaneous but also beneficent. The belief in the beneficent character of the natural order is what is meant by the idea of "optimism." The implication is that an economy which develops its organs spontaneously in a natural manner and is not contrived would turn out to be beneficent also. As a matter of fact, Adam Smith's social philosophy, bears the imprint of the eighteenth century rational thought and enlightenment which generally tended to identify the "natural" with the "just" and the "advantageous".

Another very important feature of his social philosophy, which top was in line with the eighteenth century rational thought, was his emphasis on freedom of the individual. In fact, his naturalism implied that the individual should be left free to follow his own self- interest He did not see any conflict between private individual interest and the social interest. There was a harmony between the two. By pursuing his own interest, man is "led by an invisible hand to promote ah end which was no part of his intention" And, this "end" is not just any kind of end but generally a beneficent end.

### **5.3.2 *Laissez-faire or Smith's Economic philosophy***

Adam Smith's economic philosophy followed logically from his social philosophy explained in the preceding section. If the natural order was spontaneous as well as beneficent as believed by Smith, the state had hardly any role to play except a protective one in an economy. State, in his view, could be never as effective as when not interfering with the natural economic activities of the individuals, their "natural" economic activities being those which they follow in pursuit

of their individual self-interest. In other words, his social philosophy led him directly to propounding the principle of *laissez-faire*.

Adam Smith was thus against state intervention in economic life. His economic philosophy was that the state should leave individuals free to seek to maximize their individual benefit and under the force of the natural law, this economic freedom of the individuals would automatically maximize the common or social benefit also. As Blaug observes, Smith's *laissez-faire* doctrine implied that free-market economy too optimizing characteristics.

Whether it was simple barter or complicated economic activities related to trade and industry; whether it was domestic, trade or foreign trade; the principle of *laissez-faire*, according to Smith, held good. The order would arise spontaneously and any interference with the natural order of things would only result in diminishing the social good. State intervention would lead to misallocation of resources and thus diminishing the actual social product. It was, therefore, unwise to put obstacles in the way of natural flow of individual economic activities. Domestic measures to promote one type of economic activity in preference to another were harmful, because such state measures would stultify the individual pursuit of maximum profit and would thus diminish the social product also.

The principle of *laissez-faire*, according to Smith was no less valid in foreign trade: either. "It is the maxim of every prudent master of a family, never to attempt to make, at home what it will cost him more to make than to buy what is prudent in the conduct of every private family can scarcely be a folly in that of great kingdom." The conclusion followed that it was unwise to artificially block imports from foreign countries and to subsidize exports. Such a policy would certainly result in misallocation of resources and thus would harm rather than benefit the national economy of a country. It was as clear a warning against the adoption of the mercantilist economic policies as it could be. Free foreign trade, it was suggested, was as much in the national interest as the free domestic trade.

Adam Smith shared his faith in *laissez-faire* as well as his anti-mercantilism with the physiocrats. But his doctrine of *laissez-faire* as well as anti-mercantilism stance was more general than that of the physiocrats. Unlike the physiocrats, he showed no bias in favour of agriculture or, for that matter, in favour of or against any particular type of economic activity. His doctrine of *laissez-faire* was based upon the more general consideration of the misallocation of resources that results from a policy of restraints and regulations. The universality of his doctrine imparted to it a special strength.

Smith's economic philosophy of *laissez-faire* led him to criticize wholesale the mercantilist theory and practice. He condemned all wage regulations as well as regulations regarding apprenticeship, and also all types of monopolies and other privileges. He believed that privileges arose, not from social institutions but from government policies which contravened the natural law. Therefore, his doctrine of *laissez-faire* implied that all privileges be abolished and the state

should act impartially for the setting up and preservation of free competition.

It should, however, be remembered that Adam Smith was a hard-headed realist and was not orthodox in his views. He was always ready to concede that there could be exceptions to the general rules. Though the general rule suggested in his *laissez-faire* doctrine was that the state was unfitted for economic functions, yet he allowed for state role, under certain circumstances. In the first, place, he would permit state intervention in order to ensure free competition and, therefore, to ban large organizations like joint -stock companies of the mercantilist era which tended to acquire monopolistic privileges and, therefore, impeded free competition. Moreover, due to lack of personal interest such collective organizations also hinder the free play of the principle of individual self-interest. But in such cases too he allowed for exceptions such as banks, insurance companies and public utilities. His plea for non-intervention by the state was not absolute. Under certain circumstances he would let state control even the interest rate, not to speak of allowing it to take the responsibility of supplying certain type of services such as postal services, compulsory primary education, state examinations, issuing of bank-notes of minute value of £5, etc.

### **5.3.3 Smith on Division of Labour**

Division of labour occupies a key position in Adam Smith's theory of economic development. It is not without reason that the *Wealth of Nations* which essentially embodies a theory of capitalist economic" development starts with the discussion of the division of labour. It is because, according to Adam Smith, labour is the ultimate source of the wealth of nations. As he observes, "The annual labour of every nation is the fund which originally supplies it with all the necessities and conveniences of life which it annually consumes." Therefore, the implicit logic' of his theory suggests that the wealth of nations ultimately depends on the quantity and productivity of labour. He put division of labour in the forefront of his analysis because the latter, that is, the productivity of labour depended upon the division of labour.

In the first place, his discussion points towards a particular type of division of labour which is generally not taken note of in the conventional discussion of division of labour. He classified labour into two types: the productive labour and unproductive labour. Productive labour was that which produced more value than what was consumed by it in the process of production. In other words, productive labour was that labour which produced a surplus. Non-productive or unproductive labour, cm the other hand, was that labour which produced no surplus. in this Smith was carrying on the Physiocratic tradition but his was a more generalized concept, inasmuch as it was not confined to agriculture alone. Obviously, the wealth of a nation or, to use modem terminology, the, national income of a country would depend on the division of the: total labour force of it into productive labour and non-productive labour. The greater is the proportion of the

labour force employed in “productive” activities, the greater is the level of national income.

However, the conventional treatment of the subject of division of labour refers to occupational division of labour, territorial division of labour and division of labour by processes. The discussion of division of labour which made Smith famous for, refers primarily to the last mentioned type as is obvious from the example of the pin-manufacturing factory made famous by him. The advantages of division of labour to which Adam Smith refers, it is said, had already been anticipated by as remote thinkers as Plato, Aristotle and Xenophon. But all these ancient and not so ancient thinkers had generally the occupational division of labour in view. It was Adam Smith who, first, focused on division of labour processes which is a distinctive feature of the factory system of production which is the base of modern industry.

The significance of Smith’s analysis of division of labour lies in the commanding heights it occupies in his theory because of its productivity enhancing effect and the consequent opening up of possibilities of increasing surplus potential. Labour productivity is enhanced by division of labour (by processes), because (1) it increases the dexterity, that is, skill which results from specialization; (2) it helps to effect saving of time and tools ;(3) it facilitates the use of machines which “facilitate and abridge labour; and enable one man to do the work of many”; (4) it facilitates invention of machines which, as mentioned under (5), abridge labour.

However Smith was observant enough to observe that the “division of labour is limited by the extent of the market,” and thus underlined the importance of expanding markets for realizing the advantages of division of labour.

His discussion of division of labour is important also because it highlights the importance of exchange. Because when division of labour is comprehensively established, each individual supplies a minute’s part of his own wants, depending for the rest on others. The whole economy becomes, then, an inter-mesh of exchanges prompted by self -interest and founded on division of labour.

#### **5.3.4 Smith’s Theory of Value**

Alexander Gray's observation that “On essential points, Adam Smith, for all is acuteness, is sometimes singularly confused” is nowhere as valid as in the case of his analysis' of value. He seems to have more than one explanation of the determination of value. However, while discussing the problem of value he, first, notices the famous paradox of value, namely, that “the things which have the greatest value in use (e. g. water) have frequently little or no value in exchange; and, on the contrary, those things which have the greatest value in exchange (e. g. diamonds) have frequently little or no value in use. “Adam Smith tries to solve this paradox, first, by making a distinction between “value in use” and “value -in-exchange.” His value-in-use is not identical with the modern concept of utility which refers to a subjective relationship. It is rather nearer to an objective concept

because he distinguishes the satisfaction yielded by diamonds from that yielded by a commodity like water on the basis of the physical properties of the two kinds of commodities which serve different kinds of wants. Thus in his analysis, value-in-use of a commodity is a condition of exchange and not a determinant of exchange value. He could not explain the paradox of value in terms of the use value; because he had not in his possession the analytical concept of the "marginal" utility.

Finding it impossible to explain the paradox in terms of the use value, he explained it in terms of scarcity or supply. Diamonds being scarce had greater **exchange value despite its relatively small use value. Water on the other hand, being abundant in supply and had or no exchange value despite its use value is being very high.**

But scarcity implied that the commodity required much more toil and trouble to acquire than a commodity like water which was abundant in supply and had; therefore little or no scarcity. In this way he squared up his explanation of the paradox of value with his labour theory of value.

We have already referred to the confusion in Smith's theory of value which has more than one version and Adam Smith frequently alternates without warning, one version with the other. Broadly speaking, he has at least two types of labour theory of value the "labour embodied" version and the "labour command" version. According to the former, the ratio of exchange between a pair of commodities is determined by the relative quantities of labour required as inputs to produce the commodities. This version is illustrated with the famous beaver-deer example. If it takes twice the amount of labour to kill a beaver as it takes to kill a deer, then "one beaver should naturally exchange for two deer " However, he qualifies this proposition by stating that this principle was valid in the early and rude state of society when land and capital had not become private property. But in the state of society when land and capital, become the property of particular persons, the value of a commodity is determined by the amount of labour that it can command in exchange for it. This is the "labour command" version of his labour theory of value. It has been suggested that in this version, labour is suggested not as a determinant of value but as a measure of value. Some commentators have gone to the extent of suggesting that Adam Smith had no labour theory of value in the sense of labour-inputs determining relative exchange values; and that what passes for his labour theory of value is only a search for a constant measure of value which he finds in labour.

It is our view that the interpretation suggested last in the above paragraph is rather far-fetched. In our view, Smith suggested labour both as a measure and the determinant of exchange value. Moreover, the above two versions are not irreconcilable, even though Smith's careless and imprecise statements do sometimes make them appear to be contradictory. Firstly, in the "early and rude state of society", labour embodied and labour commanded are equal, because, "In this slate of things the whole produce of labour belongs to the labourer; and the quantity of labour commonly employed in acquiring or producing any

commodity is the only circumstance which can regulate the quantity of labour which it (might commonly to purchase, command, or exchange for" (WON, BKI, ch. vi). But in the advanced state of society "when stock has accumulated in the hands of particular, persons" it is suggested, Smith's discussion implies that labour a commanded is pure than the labour embodied in the commodity, and. the difference between the two is suggested to account for the rent on land and profit to capital employed with labour to produce the given commodity. According to this interpretation, exchange value in Smith's theory is determined by labour commanded by a commodity in exchange for it: This would be true only if "labour embodied" in a commodity is identified with wages paid for the labour-input going into its production. This identification is wrong, for Adam Smith' himself observes that in this advanced state of society, the whole of the produce of labour does not belong to the labourer. The 'value which the workmen - add to 'the materials, therefore, resolves itself in this case into two parts, of which thé one pays' their wages, the other the profits of their employer upon the whole stock of materials and wages which He advanced. The labour embodied in the commodity and the labour commanded in exchange are still the same, but the "productive" labour employed by the Capitalist employer produces a surplus over and above What is paid to it in the' form of wages, and this surplus no longer belongs to the worker but goes to the capitalist employer as profit a part of which is given by him to the landlord as rent on land employed in production of the commodity. Talking the general nature of the growth model implied in Smith's *Wealth of Nations* with its classification of labour into productive and nonproductive labour, the former is, defined as surplus, producing labour, and the surplus forming the basis of capital accumulation which is the feed stock of the engine of growth in this model, the labour-embodied version of his labour theory of value is the version which is consistent with this model.

Smith also made a distinction between the "natural price" and the "market price" of commodities. In this context, Adam Smith seems to suggest another theory of value determination; namely, the cost-of-production theory of value determination. In this version (WON BKI, ch. 7), it is assumed that in every society there is an "ordinary", that is, an average rate of wages, profit and rent. These are described as the "natural rates" of wages, profit and rent at the time and place where they prevail. They are the components of the "natural price" of a commodity; that is, the natural price of a commodity is that price of its which brings in just enough to yield the natural rates of wages, profits and rent In other words, the natural price of a of a commodity is the price which equals the cost of production. It can be seen that even this version can he made to be consistent with the labour-embodied version of Smith's labour theory of value, if we remember that Adam Smith had explicitly mentioned that the value which the workmen *add* to the value of materials on which they work, that is, the total value created by labour, is one part wages and the other part accounts for profit and rent.

The natural price is described as the price which “is sufficient to pay the rent of land, the wages of the labour, and the profits of stock employed according to their natural rates.” But the actual or the “market price” which prevails actually at any given time “is regulated by the proportion between the quantity which is actually brought to market, and the demand of those who are willing to pay the natural price of the commodity.” In other words, the market price is determined by the relative strength of the forces of demand and supply at any given time. It can be higher or lower than the natural price depending upon the relative strength of competition among the buyers, on the one hand, and among the sellers; on the other. But the natural price is the central price around which the market price oscillates and to which it tends to return to.

He, of course, noted the exceptional cases when the market price may remain above the natural price for long. This happens when free competition is absent due to well-guarded “secrets in manufactures”, where conditions of production are limited while the demand is great, as in the case of wines requiring a peculiar soil and situation, and of course, when there is monopoly.

### **5.3.5 Adam Smith's Theory of Distribution**

Adam Smith's cost-of-production theory of value leads him to discuss how the natural rates of wages, profits and rent are determined. As in his theory of value, even so in his theory of distribution too, one may notice more than one line of explanation. He has a three-factor model which is common feature of all the versions of the classical model: Therefore; Smith fails to distinguish between interest and profits.

#### **5.3.5.1 Wages:**

The Chapter viii of Book I -of his *Wealth of Nations* (WON) which discusses the distributive shares of labour, that is, wages, contains more than one proposition regarding the determination of wages. At the start of the chapter we find the statement that “the produce of labour constitutes the natural recompense or wages of labour”, and in the original state of society, “the 'Whole produce of labour belongs to the labourer.” One wonders whether in this statement Smith is making a moral statement or a statement of historical fact or statement of an economic principle. On the face of it, it does not appear to be the last of the above three possibilities.

Later on in the chapter, he puts forth an explanation which may be described as both a demand-and- supply theory and a “bargaining” theory of wages. Wages, according to this explanation of Smith, depend on a contract between workers and their employers. The former seek to get as high a wage rate as they can force out of the employers. But the latter, in their self interest seek to pay as low a rate as they can possibly force on the workers. The equilibrium wage rate would thus depend on the relative bargaining strength of the parties to the bargain. Since the bargaining strength of either party depends on the degree of unity or combination among it, there would

be a tendency towards combination on either side. Since Smith, was a hard-headed realist, he could Observe the reality around him and consequently remark that the employers being few in number could Combine rather very easily, while .this is not quite easy for workers. Moreover, he recognized that there were at the times laws and customs which prohibited combinations among the workers, while “masters are always and everywhere in a; sort of tacit, but constant and uniform, combination, not to raise the wages of labour above their actual rate.” The wage bargain is consequently heavily tilted in favour of the employer.

The above is most probably the explanation of the determination of the market rate of wages and not the natural rate of wages. However, the above discussion also leads him to observe that, there is a lower limit beyond which the wages cannot be pushed for an appreciable period of time. This lower limit is determined by the requirement that the wage must be sufficient for a worker to support' himself and to enable him to bring up a family, otherwise the race of workmen, that is, the working class could not be maintained. This clearly points towards the subsistence minimum determining the lower limit of wages. This is the well-known classical long-period theory of wages known as the subsistence theory of wages or the Iron Law of Wages.

The proposition was supported by Smith with an anticipated Malthusianism. High.-wages, he believed, will increase the number of workers along the Malthusian times. Increasing demand, for labour pushes up wages and high wages stimulated the production of workers. “It is in this manner that the demand for men, like that for any-other commodity, necessarily regulated the production of men quickens it when it goes on too slowly, and stops it when it advances too fast.”

Smith's discussion on wages foreshadows the wages-fund theory of wages also, according to which the wage rate is determined by the size of wages fund. The larger is this fund, the higher are the wages. “The demand for those who live by wages,” he observes, “it is evident, cannot increase but in proportion to the increase in funds, which are destined to the payment of wages.” Adam Smith was very perceptive in his observation that the size of the wages fund in itself was not very important. It would be, of course, large in a society where wealth (national income) was great. But, as regards, the determination of level of wages, it is not the greatness of national wealth but its “continual increase” that is decisive. It is therefore not necessarily in the richest economics but in the most “thriving“, that is, growing economies that wages are the highest.

#### **5.3.5.2 Profits**

Adam Smith's theory of profit also does not suffer from lack of variety. His first proposition in this regard made in the chapter on value in *WON* is that it is a deduction from what he described as the "natural recompense of labour", that is, the whole produce of labour. When stock becomes the private *property* of particular persons or class of



persons and the workers are separated from the ownership of stock, the owners of capital stock employ it to set to work "industrious people whom they will supply with materials and the subsistence in order to make a profit by the sale of their work". In this state of society, "the value which the workmen add to the materials resolves itself in this case into two parts, of which the one pays their wages, the other the profits of their employer upon the whole stock of materials and wages which he advanced."

At this place Smith dismisses the proposition that profits may be a special type of wages with the argument that they bear no relationship to the labour of inspection and supervision but they are generally related to the size of the capital stock employed.

The above is obviously an exploitation theory of profits in which profits are shown to be a share, along with landlord's rent, in the surplus produced by the "productive" labour employed by the capitalist employer. This version of Smith's theory of profits was adopted and further developed by Karl Mark. Although this explanation of profits, like the labour-embodied version of his labour theory of value, fits into the general designs of the model of *WON*, yet it is not the theory of profits to which he sticks consistently. In his specific discussion on profits, he appears to depart from the labour theory of value in a marked manner. He makes profits, however, a function of the stock of capital. He speaks of the difficulties of identifying an average rate of profits because of variation in time, place and type of business. However, on the basis of empirical data related to different periods and countries, he arrives at a conclusion which is more famous as Ricardo's "fundamental theorem of distribution", namely that the wages and profits are inversely related. However, Smith's explanation of this theorem was different from that of Ricardo, Smith explains it in terms of the degree of competition. As the capital increases, he argues, the competition among the capitalist employers increases. It has the effect of increasing the demand for labour and thus increasing wages. Increase in wages has the effect of lowering profits. Moreover, the increasing competition among the capitalist producers has the effect of lowering price also which too tends to lower profits. Thus there is a general tendency of falling profits.

Adam Smith's theory implies that there is an exception to the above said inverse relationship between profits and wages. In new colonies (We can now say that in under-developed countries taking up planned economic development), wages and profits may be high together, because though capital there might be increasing, yet it is relatively scarce in absolute terms as well as in relation to the opportunities of profitable employment. On the other hand, in very highly developed economies which have attained to the full complement of riches that their human and natural resources permit and have, therefore, stopped growing and are in a stationary state, both profits and wages would be low.

Adam Smith also adds certain other caveats. Profits must always be at least "something more than what is sufficient to compensate the occasional losses to which every employment of stock is exposed" On

the other hand, they can never be higher than what “exits up the whole of what should go to the rent of the land and leaves only what is sufficient to pay the labourer.”

#### **5.3.5.3 Rent**

Initially, in the chapter on value in the *WON*, rent, like profits, is shown to be a deduction from what is the “natural recompense” of labour. Along with profits, it is only a share in the surplus produced by the industrious and “productive” labour. It may be to and receive from the capitalist employer of “productive” labour.

Later on, he makes rent a constituent element of price like wages and profits. But, still later on in the chapter on rent, he abandons the above views in favour of still another view which is reflected in this statement that rent “enters into the composition of price of commodities in the different way from wages and profit. High or low wages and profit are the causes of high or low price; high or low rent is the effect of it. It fore shadows the Ricardian proposition that rents are high because prices are high.

Smith has the concept of differential rent only. “As the prices go up, the rent on land also goes up as it depends on demand for land for cultivation which increases with rising agricultural prices. Moreover, Smith regards landlord as a monopolist and rent as a monopoly price which, according to him, was the highest price which a monopolist can extort exploiting the demand conditions. Despite the characteristic Smithian confusion, his theory of rent anticipates Ricardo’s theory of rent.

His theory of rent, to confuse the matter, carries the Physiocratic influence also, as he imputes it to the generality and boundary of nature, as is evident from his following observation: “Land, in almost any situation, produces a greater quantity of food than what is sufficient to maintain all the labour necessary for-bringing it to market, in the most liberal way in which that labour is ever maintained. Something therefore, always remains for a rent to the landlord.”

#### **5.3.6 Adam Smith On Economic Progress**

Adam Smith’s model that emerges from his *Wealth of Nations* is essentially a model of economic growth which the classical used to describe as “economic progress.” This is particularly evident in Book II of the *WON* where the focus on economic progress or growth is very explicit though the Book I is generally occupied with explaining the general economic framework within which economic progress on his conception would take place.

In this context, he distinguished between “natural” economic progress and “contrived” economic progress. The concept of natural economic progress is derived from his social philosophy of naturalism which we explained in the very beginning of our discussion of Adam Smith’s contribution to economic thought (see section above). Since his naturalism implied spontaneous in contradiction to conscious planning by government or any other authority representing the general will of the society, “natural” economic progress for him meant growth of

national income and wealth that results spontaneously from the myriads of economic decisions taken and acted upon by individuals independently of one another without any premeditated plan of co-ordination. Individuals make their choices and execute those choices guided simply by their individual self-interests. But the aggregate effect of these uncoordinated individual decisions and actions is to promote the economic progress or growth of the society, though it is not the original intention of the individual. This is what is meant by “natural” economic progress. This is the economic progress which takes place with the framework of a policy of *laissez-faire*, non-intervention by the state in economic activities of the people and a freely competitive market system.

The “contrived” economic progress is, on the other hand, the economic growth that results from conscious measures or policies adopted by the state to influence the economic activity in the society in a particular manner and direction according to pre-meditated plan. The economic growth that resulted from the mercantilist policies, for example, was a “contrived” economic progress. It results from “artificial” methods instead of resulting from the natural order of things. On this definition, the growth that takes place in the modern centrally planned economies would also be “contrived” economic progress.

Smith’s model of economic “progress” is a model of “natural” economic progress. According to him, economic progress depends primarily on two things.

The quantity of “productive” labour employed, “productive” labour having been defined as the labour which Adduces a surplus over and above what is necessary to replace itself; (2) The Productivity of labour, that is, the size of the surplus of alternatively, the total output which a unit of labour is capable of producing on the average. The first factor depends on the extent of the division of labour, the increasing extent of which can be possible only with an increasing use of capital. If we leave aside Smith’s characteristic confusion on whether capital accumulation is a precondition of and precedes division of labour or the latter precedes and calls for capital accumulation, the fact remain that capital accumulation is the crucial determinant of economic progress is Smith’s model. Both the quantity of industrious labour employed and the productivity of labour are crucially determined by the capital stock of the rate or capital accumulation.

Capital accumulation is determined by the rate and amount of saving done by the people. It is Smith’s argument that if individuals are left free to pursue their self-interest in an environment of personal liberty and security, more savings will be made automatically from year to year. Moreover, such savings will be made by the individuals voluntarily by virtue to their “frugality” which results naturally from “the” desire of bettering our condition, a desire which, though generally calm and dispassionate, comes with us from the womb and never leaves us till we go into the grave”. Moreover, Adam Smith also argued that savings are always used either to make investment or capital goods or to employ productive labour. “What is usually saved”,

observes he, “is as regularly consumed as what is annually spent, and nearly in the same time too”, though “it is consumed by a different set of people...” This is the famous classical “saving-is-spending theorem”. Savings when used for capital accumulation add to the national output which increase makes it possible to save still more and to increase the rate of capital accumulation still further and thus, according to Smith, there starts a cumulative process of increase in national income and wealth which is his natural economic progress.

Capital accumulation thus leads to growth of income and purchasing power. This increases demand and consequently, the extent of market which, in turn widens the scope for increasing the division of labour and thus enhancing productivity of labour and also facilitating technological improvement. Economic progress thus become self-sustained and a natural process. It may be emphasized here even at the cost of repetition that the process of economic growth analyzed in Smith’s model results spontaneously, and not in a contrived manner, from the myriads of individual decisions and economic activities undertaken independently of one another by individuals who are trying to maximize individual gains. It is this which makes this process of economic growth a process a natural economic progress. Is the above process of economic growth or progress an endless spiral? Adam Smith’s answer to such a question would be a no. As we observed earlier in the context of his theory of distribution, he believed this process to end in a stationary state when the society has attained that fully complement of riches which, its resources allow. In this stationary state there is no further economic progress, even when the society has attained that full complement of riches which its resources allow. In this stationary state there is no further economic progress, even when the society enjoys a very high level of income and wealth and it is highly prosperous. Further progress ends and the 'economy lands itself' in a stationary state because capital 'Accumulation comes to a natural stop. Capital increases competition pushing up wages which eat into capitalist’s profits reducing these to a level so low that further accumulation remains no longer profitable. On the other hand, high wages stimulate growth in population and -increase in working population to an extent that the real wages once again touch the subsistence level. Thus in the stationary state of Smith, both profits, and wages are low despite the level of prosperity of the economy. According to him it is not in the most prosperous but in the most advancing or growing economies that wages and profits are high.

#### Self Check Exercise-1

- Q.1 Discuss Adam Smith’s Social Philosophy.
- Q.2 Discuss Adam Smith’s Economic Philosophy.
- Q.3 Discuss the views Adam Smith on Division of Labour.
- Q.4 Discuss Adam Smith’s Theory of Value.
- Q.5 Discuss Adam Smith’s Theory of Distribution.
- Q.6 Discuss views of Adam Smith on Economic Progress.

### 5.3 Summary

The term classical economics" is usually associated with the thought system of Adam Smith, David Ricardo and his followers, we may safely take it to refer to those lines of economic thought and belief which their works embody.

The study of their works will reveal that a very important feature of their mode of thinking was their peculiar philosophical approach which underlies their economic teachings it is their belief in the absolute superiority of the *natural order* of things. It is a belief which they share with the physiocrats and which leads them, not unlike the Physiocrats, to the doctrine of *laissez-faire*. Classical economics is almost synonymous with *laissez-faire* economics. Adam Smith's name is one of the greatest, and to many the greatest, in the history of economic thought. Some of his more important contributions to economic thought were Adam Smith's Social Philosophy; social philosophy determined his general approach or standpoint with respect to that analyzing and explaining the laws which govern the 'behavior of the competitive capitalist economy that he observed taking shape around him. Two important features of his social philosophy which he expounded in his *Theory of Moral Sentiments*, and which can be observed *passim* in the *Wealth of Nations* too, were his "naturalism" and 'optimism.'

His belief in naturalism implied a belief in the spontaneous character of all social institutions. From which followed the inference that there was no need of any outside deliberate and premeditated organization. According to his social philosophy, there was no need for any planned intervention of the general will, however far-seeing and reasonable it might be. Nor was there any necessity for a preliminary understanding among the members of society as it is stipulated in the "social contract" theory of society. This social philosophy led him to the conclusion that the economic phenomena of an economy works not as the result of some conscious plan but, to the contrary, it is the result of the Spontaneous action of millions of individuals, each of whom follows his own self-interest.

Economic philosophy followed logically from his social philosophy If the natural order was spontaneous as well as beneficent as believed by Smith, the state had hardly any role to play except a protective one in an economy. State, in his view, could be never as effective as when not interfering with the natural economic activities of the individuals, their "natural" economic activities being those which they follow in pursuit of their individual self- interest. In other words, his social philosophy led him directly to propounding the principle of *laissez-faire*.

Adam Smith was thus against state intervention in economic life. His economic philosophy was that the state should leave Individuals free to seek to maximize their individual benefit and under the force of the natural law, this economic freedom of the individuals would automatically maximize the common or social benefit also. As Blaug

observes, Smith's *laissez-faire* doctrine implied that free-market economy too optimizing characteristics.

Whether it was simple barter or complicated economic activities related to trade and industry; whether it was domestic, trade or foreign trade; the principle of *laissez-faire*, according to Smith, held good.

Division of labour occupies a key position in Adam Smith's theory of economic development. It is not without reason that the *Wealth of Nations* which essentially embodies a theory of capitalist economic development starts with the discussion of the division of labour. It is because, according to Adam Smith, labour is the ultimate source of the wealth of nations. As he observes, "The annual labour of every nation is the fund which originally supplies it with all the necessities and conveniences of life which it annually consumes." Therefore, the implicit logic of his theory suggests that the wealth of nations ultimately depends on the quantity and productivity of labour. He put division of labour in the forefront of his analysis because the latter, that is, the productivity of labour depended upon the division of labour.

Adam Smith seems to have more than one explanation of the determination of value. However, while discussing the problem of value, he first notices the famous paradox of value, namely, that "the things which have the greatest value in use (e. g. water) have frequently little or no value in exchange; and, on the contrary, those things which have the greatest value in exchange (e. g. diamonds) have frequently little or no value in use." Adam Smith tries to solve this paradox, first, by making a distinction between "value in use" and "value-in-exchange." His value-in-use is not identical with the modern concept of utility which refers to a subjective relationship. It is rather nearer to an objective concept because he distinguishes the satisfaction yielded by diamonds from that yielded by a commodity like water on the basis of the physical properties of the two kinds of commodities which serve different kinds of wants. Thus in his analysis, value-in-use of a commodity is a condition of exchange and not a determinant of exchange value. He could not explain the paradox of value in terms of the use value; because he had not in his possession the analytical concept of the "marginal" utility.

Finding it impossible to explain the paradox in terms of the use value, he explained it in terms of scarcity or supply. Diamonds being scarce had greater **exchange value despite its relatively small use value. Water on the other hand, being abundant in supply and had or no exchange value despite its use value is being very high.**

But scarcity implied that the commodity required much more toil and trouble to acquire than a commodity like water which was abundant in supply and had; therefore little or no scarcity. In this way he squared up his explanation of the paradox of value with his labour theory of value.

Smith also made a distinction between the "natural price" and the "market price" of commodities. In this context, Adam Smith seems to suggest another theory of value determination; namely, the cost-of-production theory of value determination. In this version it is assumed that in every society there is an "ordinary", that is, an average rate of

wages, profit and rent. These are described as the “natural rates” of wages, profit and rent at the time and place where they prevail. They are the components of the “natural price” of a commodity; that is, the natural price of a commodity is that price of its which brings in just enough to yield the natural rates of wages, profits and rent. In other words, the natural price of a commodity is the price which equals the cost of production. Adam Smith’s model that emerges from his *Wealth of Nations* is essentially a model of economic growth which the classical used to describe as “economic progress.” This is particularly evident in Book II of the *WON* where the focus on economic progress or growth is very explicit though the Book I is generally occupied with explaining the general economic framework within which economic progress on his conception would take place.

In this context, he distinguished between “natural” economic progress and “contrived” economic progress. The concept of natural economic progress is derived from his social philosophy of naturalism which we explained in the very beginning of our discussion of Adam Smith’s contribution to economic thought. Smith’s model of economic “progress” is a model of “natural” economic progress. According to him, economic progress depends primarily on two things.

The Productivity of labour, that is, the size of the surplus of alternatively, the total output which a unit of labour is capable of producing on the average. The first factor depends on the extent of the division of labour, the increasing extent of which can be possible only with an increasing use of capital.

Capital accumulation is determined by the rate and amount of saving done by the people. It is Smith’s argument that if individuals are left free to pursue their self-interest in an environment of personal liberty and security, more savings will be made automatically from year to year.

Capital accumulation thus leads to growth of income and purchasing power. This increases demand and consequently, the extent of market which, in turn widens the scope for increasing the division of labour and thus enhancing productivity of labour and also facilitating technological improvement. Economic progress thus become self-sustained and a natural process.

The quantity of “productive” labour employed. The Productivity of labour, that is, the size of the surplus of alternatively, the total output which a unit of labour is capable of producing on the average. The first factor depends on the extent of the division of labour, the increasing extent of which can be possible only with an increasing use of capital.

## **5.4 Glossary**

1. **Laissez-faire:** A term used to describe minimal governmental involvement in an economy, allowing market forces and individuals to make their own decisions, with little or no regulation.
2. **Social Philosophy:** Social philosophy is the study and analysis of society and social establishments in terms of moral

values rather than practical relations.

3. **Division of Labour:** Division of Labour is the term used in economics to refer to the specialization that occurs when different functions or roles are involved or used in the production of goods and services. Among economists, the benefits and significance of the division of labour are a matter of some contention.
4. **“Natural” economic progress:** This is the economic progress which takes place with the framework of a policy of *laissez-faire*, non-intervention by the state in economic activities of the people and a freely competitive market system.
5. **Contrived” economic progress:** The “contrived” economic progress is, on the other hand, the economic growth that results from conscious measures or policies adopted by the state to influence the economic activity in the society in a particular manner and direction according to pre-meditated plan.
6. **“Productive” labour:** defined as the labour which adduces a surplus over and above what is necessary to replace itself.

## 5.5 Answers to self check Exercises

Self Check Exercise-1

- Ans.1 Refer to section 5.3.1
- Ans.2 Refer to section 5.3.2
- Ans.3 Refer to section 5.3.3
- Ans.4 Refer to section 5.3.4
- Ans.5 Refer to section 5.3.5
- Ans.6 Refer to section 5.3.6

## 5.7 References/ Suggested Readings

9. Eric Roll: *“A History of Economic Thought”*.
10. Alexander Gray: *“The Development of Economic Doctrine”*.
11. C. Gide and G. Rist: *“A History of Economic Doctrines”*.
12. J.A. Schumpeter: *“History of Economic Analysis”*.
13. M. Blaug: *Economic Theory in Retrospect*.
14. J.A. Schumpeter: *Ten Great Economists*.
15. Adam Smith: *The wealth of Nations*.

## 5.8 Terminal Questions

Q1. Assess the contribution of Adam Smith to the Theory of Value?

Q2. Discuss the Adam Smith Theory of Distribution?



## Unit- 6

# THE CLASSICAL SCHOOL OF ECONOMICS (2)

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### Structure

- 6.1 Introduction
- 6.2 Learning Objectives
- 6.3 David Ricardo (1772-1823)
- 6.4 Ricardo's Theory of Value
  - Self Check Exercise-1
- 6.5 Ricardo's Theory of Distribution
  - Self Check Exercise-2
    - 6.5.1 The Dynamic Implications of Ricardo's Distribution theory
    - 6.5.2 Ricardo on Individual Factor Shares
  - Self Check Exercise-3
- 6.6 Ricardo's Theory of Economic Development
  - Self Check Exercise-4
- 6.7 Ricardo's Theory of International Trade
  - Self Check Exercise-5
- 6.8 Summary
- 6.9 Glossary
- 6.10 Answers to self check Exercises
- 6.11 References/ Suggested Readings
- 6.12 Terminal Questions

### 6.1 Introduction

In the last lesson we discussed the different theories of Adam Smith. In the present lesson we will go through the different theories given by David Ricardo. In the succeeding paragraphs we will be discussing each of his theory in detail.

### 6.2 Objectives

After going through this lesson you will be able to:

- Explain the Ricardo's theory of Value
- Elucidate the Ricardo's Theory of Distribution
- Describe the Ricardo's Theory of Economic Development
- Give detailed Explanation of Ricardo's Theory of International Trade

### 6.3 David Ricardo (1772-1823)

It was David Ricardo who systematized what has come to be known as the classical economics. The later classical economists had hardly anything substantive to add to his system except for some marginal additions here and there. Taking, into consideration the requirements of the syllabus, we shall be dealing, in the present lesson, with his theories of value, distribution, economic development and international trade.

### 6.4 Ricardo's Theory of Value

We referred to the confusion in Adam Smith's theory of value which seems to have three versions, two of which are different versions of the labour theory of value. Ricardo extricates the value theory from the Smithian confusion and adopts the labour-embodied version of the labour theory of value.

He starts the discussion of the subject of value in his *Principles of Political Economy and Taxation* in the manner of Smith, by making distinction between use value and exchange value and observing that the former is "indispensable or necessary condition for the latter. Anything which has no use value cannot have exchange value either but, like Smith, he too does not consider use value to be the determinant of exchange value.

He also makes a distinction between *rare* things like works of art and *reproducible* things. Exchange value of the former is determined solely by their scarcity. But the exchange value of the latter type of goods is determined, according to him, by the amount of the present and past labour required to produce them. By past labour is meant the labour that is congealed in the instruments of labour, that is, the capital equipment with which the present labour works in order to produce commodities, he reformulated Smith's labour theory of value by stating that it is "the comparative quantity of commodities which labour will produce that determines there, present or past relative value, and not the comparative quantities of commodities which are given to the labourer in exchange for his labour."

The above statement has two important implications. Firstly that Ricardo rejects Smith's labour-command version of the labour theory of value. Secondly that he is concerned with analyzing the determination of *relative* prices of exchange ratios and not with the determination of absolute prices of commodities.

He did not believe that the factor, land, contributed to the creation of value. Labour, past and present is the only source of value in his theory. Thus the model of value determination which Ricardo presents is essentially a factor model. He takes note of the different kinds of labour but solves the problem by- considering skilled labour to be equivalent to certain, multiple times of ordinary unskilled labour. The said multiple can be discovered from the prevailing wage structure which is assumed to reflect the relative productivities of the different kinds of labour.

Where labour is the only factor of production, as implied in Ricardo's theory of value, relative prices of any pair of goods would equal the ratio between the labour quantities required to produce the two goods. Assume X and Y to be two goods and was the wage rate further suppose that X requires  $Q_x$  units of labour to produce one unit of it, and Y requires  $Q_y$  units of labour to produce one unit of Y. In that case cost of production per unit of 'X' would be  $Q_x w$ , and the cost of production per unit of Y would be  $Q_y w$ . In long-run equilibrium the price of a good equals its cost. Therefore the price of X ( $P_x$ ) would be  $Q_x w$  and the price of Y ( $P_y$ ) would be  $Q_y w$ . Therefore, their relative price

$$\frac{P_x}{P_y} = \frac{Q_x w}{Q_y w} = \frac{Q_x}{Q_y}$$

This demonstrates Ricardo's value theorem which states, as observed above; that relative price of goods equal the ratio of the labour quantities required to produce them.

Ricardo had also stressed that his concern was to explain the changes in the relative values or prices of goods. The above theorem led him to pronounce that relative value may change equally for two goods, if the amount of labour necessary to 'produce them changes at the same rate, thus leaving their comparative values (exchange ratio) unchanged.

Since labour costs usually make up the major cost of producing commodities, a pure labour-cost theory of relative value like Ricardo's will be able to predict the changes in relative prices when two or three factors of production are employed. As Paul Samuelson observes "the operational significance of a one-factor hypothesis lies in the powerful predictive value that it gives to technology alone".

The problem for Ricardo's theory of value arises when capital is introduced. It cannot be dismissed simply by treating it as past or indirect labour as Ricardo tried to do in the first instance. Capitalist system of production is roundabout and, therefore, the length of the period of production becomes relevant and important, if capital is taken to mean the wages advanced to workers during the production period, and then the capitalist must discount interest on it. If the period of production in the case of a given pair of goods is the same, the inclusion of interest costs would make no difference to Ricardo's theorem of relative prices. In the presence of capital and interest, the imaginary example of two goods X & Y that we used above will yield the following equation for determining relative prices ( $\frac{P_x}{P_y}$ ) of the two goods:

$$\frac{P_x}{P_y} = \frac{Q_x w (1 + r)^{t_x}}{Q_y w (1 + r)^{t_y}} = \frac{Q_x (1 + r)^{t_x}}{Q_y (1 + r)^{t_y}} = \frac{Q_x}{Q_y} (1 + r)^{t_x - t_y}$$

where  $r$  is the rate of interest;  $t_x$  is the production period for commodity X and  $t_y$  is the production period for commodity Y. Other variables have already been explained above.

It can be seen that if period of production in both cases is the same, that is, if  $t_x = t_y$  then,  $\frac{P_x}{P_y} = \frac{Q_x}{Q_y}$  as

before and Ricardo's theorem would be still valid. But it will not be valid, if  $t_x$  and  $t_y$  are not equal. Thus, in this case which is rather usual in real life, a simple labour theory of value like Ricardo's cannot exactly predict changes in relative prices.

In the second edition of the *Principles of Political Economy and Taxation* Ricardo took note of differences in the period of production of different goods and also of differences in fixed capital/labour ratio and admitted that his basic labour theory of value would be modified. Nevertheless, he stressed that these factors could not affect that relative values by more than 6 or 7 percent "for profit could not probably, under any circumstances, admit of a greater general and permanent depression than to that amount".

In view of the above admission of Ricardo, Stigler has described Ricardo's value theory as "93 per cent labour theory of value." Schumpeter's view on it is also similar, as he observed that in view of the admission of the effect of "carrying charges," labour quantity theory was held by Ricardo only as an approximation in as much as the theorem is asserted by him even after the admission of other factors/Marshall, on the other hand, had concluded that Ricardo had come over to the cost-of-production theory of value.

It has been also observed that Ricardo seemed to have some confusion between value, which he regarded as determined by labour, and price, which he regarded to be determined by cost of production. His statements, "On Natural and Market Price" in chapter xxx of his *Principles* are quoted as evidence of this supposed confusion. But these statements are essentially meant to explain the difference between the "natural price" and the market price" in the manner, of Adam Smith. He believed his labour quantity theory of value to be valid in the case of the natural price, while he held that the market price was determined by factors which he regarded as "accidental" or "temporary" factors. As he observes, "In speaking then of exchangeable value of commodities.....I mean always that power which it would possess, if got distributed by any temporary or accidental cause, and which is its natural price."

Self Check Exercise-1

Q.1 Discuss Ricardo's Theory of Value.

## 6.5 Ricardo's Theory of Distribution

Although Ricardo's *Principles* opens with the discussion of value, yet value was not the chief concern of Ricardo's analysis. In a letter to McCulloch, he had written, "After all the great problem of rent, of wages, or of profits might be elucidated by determining the proportion in which the total product is distributed between the proprietors, the capitalists, and the workers, but this is not necessarily connected with the doctrine of values." His chief concern was with distribution and he

had observed that. "To determine the laws which regulate this distribution is the principal problem in political economy".

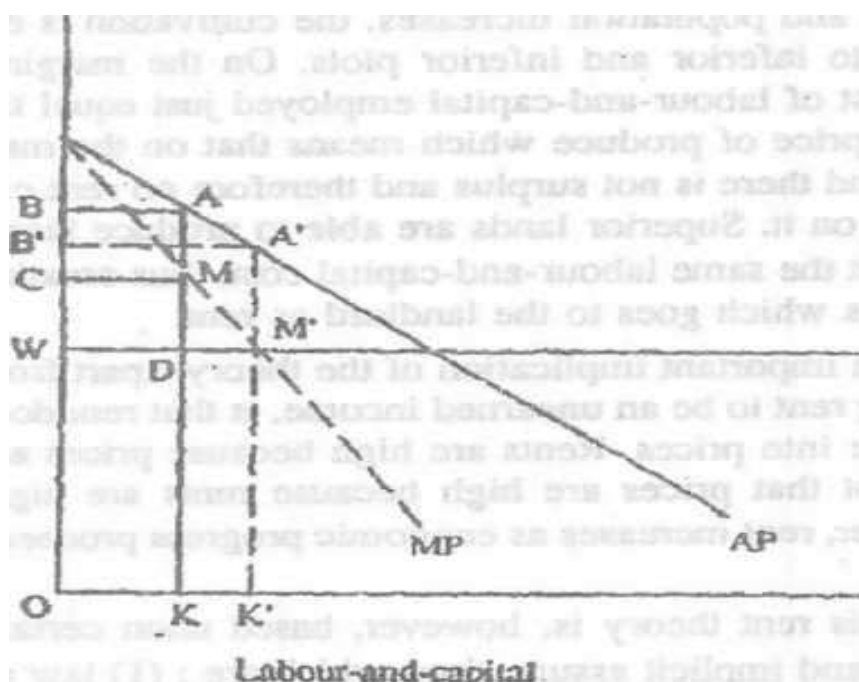
Though Ricardo has both a macro and a micro theory of distribution, his main concern as, expressed in the above statements, was with the former.

His macro theory of distribution is a theory of relative class shares. His model, like the classical model in general, is a three-factor model. The three factors of production considered are land, capital and labour, each one of which is associated, with and therefore, stands' for a particular social class land for the feudal, capital for the capitalists, and labour for the working class.

Their respective class shares in the total national product are rent, profits (of which interest is a part) and wages.

Ricardo's macro-model of distribution is based upon certain assumptions and hypotheses. It can be properly grasped by assuming that the economy consists of nation-wide farm which, of course, is an abstraction from reality but helps in simplifying the analysis without obscuring the essential points of Ricardo's theory. We further, suppose that this farm is cultivated by the capitalist farmers employing wage labour, while the land is the private property of the landlord class who rents out its use to the capitalist farmers. It further assumes that capitalist farmers combine labour and capital in a certain fixed proportion on land. It is also assumed that land can be put to only one use, namely, the cultivation of com. Ricardo also adopted the hypothesis of diminishing marginal returns to the variable composite factor, labour-and capital which means that as more and more "doses" or units of the variable composite factor, labour-and capital, are employed in the cultivation of the fixed factor, land, and the marginal and the average product of the composite factor go on diminishing as shown by the downward sloping lines MP and AP in the following diagram, the technology used in production is assumed to be constant.

Product



In the diagram, the units of the composite factor, labour-and capital, are measured along the horizontal axis and the product is measured along the vertical axis. How much of this composite factor is employed depends on the availability of capital stock. Supposing, to start with, that only OK amount of capital stock is available, then OK units of labour-and capital, would be determined by the marginal principle that is, under purely competitive conditions assumed in the model, the price per unit of the variable composite factor would equal its marginal product KM, as MP is the marginal product curve. Therefore the total share of this factor would equal the area of the rectangle OKMC. The difference between the total product OKAB, and the share of the variable factor, labour-and-capital, OKMC, is the surplus over and above the cost of cultivation. This surplus indicated by the Area ABCM is the above diagram is rent that is appropriated by the landlord class.

The horizontal line WW' in the above diagram represents the classical long-run supply curve of labour which is perfectly elastic at the subsistence level of wages. Ricardo subscribed to the classical subsistence theory of wages, according to which the long-run or the natural rate of wages is determined by the amount of subsistence required by a worker to maintain himself and his family.

Since capital is assumed to consist of wages-fund which is used to employ labour alone, the composite factor, labour-and-capital, can be reduced to a single factor, labour, as regards the abstract model depicted in the above diagram. Therefore, OK can be assumed as the total labour employed. This means that the total wages bills will equal the area OKDW. This represents the share of the working class in the total national product.

In Ricardo's model, profits or the share of the capitalists in the total national product is residual share. The class of capitalist farmers in the model is the employer, while land and labour are the hired factors. Profits are what are left over after the hired factors are paid out in the form of rent and wages. Thus the residue (Total Product minus Rent minus Wages) which in our diagram equals the area WCMD represents profits.

The rate of profit equals the ratio between profits and wages (profits/wages) as capital is assumed to consist of only wages-fund. This means that the rate of profit equals  $WD.DM/OK.KD$ . Since  $WD = OK$  the profit rate equals  $DM/KD = MK-KD/KD$  which equals  $MK/KD - 1$ , that is, Marginal Product / Wage Rate - 1. This means that the rate of profit is direct function of marginal product and inverse function of the wage rate. This is described as the com rate of profit, because the whole analysis is real analysis in terms of the physical units of the only commodity, can that can be cultivated on the land according to assumption.

From the above analysis of distribution and profits, Ricardo arrived at what is described as his fundamental theorem of distribution which states that "profits depend on high or low wages," that is, both profits and wages as aggregates, and profit rate and wage rate are inversely related. Since due to diminishing returns the cost of

subsistence wages rises, his theory also implies that the rate of profits tends to decline as capital accumulates and economic progress takes place.

Self Check Exercise-2

Q.1 Discuss Ricardo's Theory of Distribution.

### 6.5.1 The Dynamic Implications of Ricardo's Distribution theory

In the classical theory generally and Ricardo's theory particularly capital accumulation is done by the capitalist class only. Landlords live extravagantly even beyond their means; therefore they do not save. The working class has no scope for saving at all, as the wages can afford just willingness and the ability to save. Profits are thus the source of savings and capital accumulation. So long as the profit rate is positive, the capitalists would accumulate capital which is employed in production. In terms of our model, this would mean that from period to period the amount of labour-and- capital applied on land would go on increasing. The total national product would go on increasing. But, due to 'diminishing returns, the marginal product would go on diminishing. Since, as we have already demonstrated above, profit rate depends directly on the marginal product of labour and capital, it will go on falling till a time comes when the profit rate becomes zero. In terms of our model, this takes place when capital increases from  $OK$  to  $OK'$ . In this situation, the total product equals  $OK'A'B'$ . The share of the composite factor, labour-and-capital, is  $OK'M'W'$ . But the share of labour or wage share  $OWOK'$  also equals  $OK'M'W'$ . The share of landlords or rent is, of course, the surplus over and above the cost of labour-and-capital employed. This surplus in our diagram now is  $WM'A'B'$  which is much bigger than the rent share  $ABCM$  in the initial situation when capital equaled  $OK$  only. Thus, it can be seen that when the capital has accumulated up-to the level  $CK'$  nothing is left from the total product after the hired factors are paid their respective shares in the form of rent and wages. Profits are zero. Further capital accumulation is not possible and thus economic progress comes to a halt and Ricardo's "Stationary state" arrives. This is the most important dynamic implication of Ricardo's distribution theory.

In addition, the above dynamic analysis also implies that as capital accumulated and consequently economic progress or growth takes place, the share of the landlord class, that is, rent goes on increasing.

But the share of the working class which is bound to increase in absolute amount due to increased employment does not increase or decreases on the average, that is, the wage rate in real terms remains the same. The share of the capitalist class (i.e. profits) goes on declining, due to which economic progress also ultimately comes to an end.

This implied that the interests of the landlord were opposed to the interests of not only the capitalist class (profits) but also to the interests of society in general (economic progress).

### 6.5.2 Ricardo on Individual Factor Shares

We have explained above Ricardo's general theory of class shares. In the present section we propose to give a little greater detail regarding his views on individual factor shares.

**(1) On Rent:** Ricardo looked upon rent as the part of the produce of land which is given to the landlord for the use of the "original and indestructible qualities" of land. His theory of rent is a theory of differential rent, as he explains rent arising from differences in either fertility of situation of different plots of land, or, in the case of rent on the intensive margin, from differences in the product of the marginal dose of labour-and- spatial and the products of the intra-marginal doses which are higher, while each unit of labour-and-capital gets a reward equaling the marginal product. The difference accounts for the surplus that goes to the landlord as rent. On the extensive margin, as capital accumulates and population increases, the cultivation is extended to inferior and inferior plots. On the marginal land cost of labour-and-capital employed just equal the market price of produce which means that on the marginal land there is not surplus and therefore no rent can be paid on it. Superior lands are able to produce larger output at the same labour-and-capital cost, thus creating a surplus which goes to the landlord as rent.

An important implication of the theory, apart from showing rent to be an unearned income, is that rent does not enter into prices. Rents are high because prices are high, not that prices are high because rents are high. Moreover, rent increases as economic progress proceeds on.

This rent theory is, however, based on certain explicit and implicit assumptions which are:

- (1) Law of Diminishing Returns operates in agriculture;
- (2) Either there is no technological progress checking the effect of diminishing returns in agriculture or the technological change too is subject to diminishing returns;
- (3) Land is a factor which has zero supply prices which may be true if it is treated as a free gift of nature or, in terms of the opportunity-cost or transfer-eating's principle, if it has a perfectly in-elastic supply.
- (4) The assumption (3) would be valid only if land is considered from the point of view of the economy as a whole and not from the point of view of individual uses of land or individual producer.
- (5) The foregoing condition implies that Ricardo assumed land to have only one specific use namely, the raising of corn.

**(2) On Wages:** Ricardo distinguishes between the "market wages" or the market rate of wages, and the "natural wages" or the "natural" rate of wages. The former is said to be determined by the relative strength of the forces of demand and supply at any given time. But the latter, that is, the natural rate of wages is said to be determined by the subsistence level which is rather old wine, as this proposition had been put forth by more than one thinker including Adam Smith. Ricardo defines the "natural wages" as that level of wages which is "necessary to enable the labourers, one with another, to subsist and perpetuate



their race, without either increase or diminution.” Ricardo, though, improved upon the traditional form of the subsistence theory of wages by introducing social and historical factors in the form of “habit” and “custom”. The subsistence wage level to which the natural wage level or rate tends to equal in the long run depends, according to him, “on the quantity of the necessities and conveniences which become essential to him (worker) from increasing habit” The introduction of “habit” and “custom” makes the subsistence minimum a historical and cultural minimum instead of a physiological minimum.

Depending upon the correlation of the forces of demand for and supply of labour, the market wages could be higher or lower than the subsistence minimum as defined above which determines the natural wages. But given sufficient time the wages would return to the ' level of natural wages, that is, the historical and cultural subsistence minimum. The mechanism through which this adjustment takes place is the usual demographic one which, since Malthus, has come to be described as the Malthusian mechanism, though it has a more ancient history. When capital accumulation is rapid and economic progress or growth is also consequently rapid, market wages rise above the natural wages or the subsistence level. But this, sooner or later, leads to increase in population and labour force which brings the market wages back to the level of natural wages.

The natural wages in money terms would rise during the course of capital accumulation and economic progress. But they would rise in the same proportion in which the food prices would increase due to the operation of the law of diminishing returns, which implies increasing costs, in agriculture. Resulting, the natural wages in real terms that is, the corn rate of natural wages would remain at the subsistence minimum, unless, of course, the consumption “habits” and “custom’s” of the workers change.

**3. On Profits:** As already pointed out, profits in Ricardo's theory of distribution are residual shares. In chapter VI of his *Principles* Ricardo states his fundamental theorem of distribution, namely, that profits are inversely related with wages. Since during the course of capital accumulation and economic progress, as the margin of cultivation is extended, the cost of production of subsistence goods which determine the natural wages increases due to diminishing returns, it follows from his fundamental theorem that the rate of profit tends to fall as accumulation and economic progress proceed on.

Ricardo also presented the proposition that the rate of profit in agriculture set the rate of profit in industry. If the rate of profit in industry is higher than that in agriculture, the capital, under the assumed competition conditions, would move out of agriculture into industry. The increased competition in industry lowers industrial prices and consequently it lowers profit rate there to equal the rate of profit in agriculture so that in the economy as a whole the rate of profit tends to be uniform.

Self Check Exercise-3

Q.1 Discuss the Dynamic Implications Ricardo's Theory of Distribution.

## 6.6 Ricardo's Theory of Economic Development

Like Adam Smith's model, Ricardo's model too is essentially a model of economic development. It was not without reason that Ricardo has stressed that to explain the laws of distribution was the principal problem of Political Economy. Distribution and economic development are intimately inter-linked in his model. The former influences as well as is influenced by the process of economic development.

Ricardo had adopted from Smith the definition of "productive labour" as that labour which produces a positive surplus value over and above the value of the subsistence goods which labour consumes during the process of economic development. The process of economic progress, that is, economic development depends on the employment of such labour. But this requires capital which cannot be provided by the landlords whose life style promotes extravagant consumption. The labouring class generally gets wages which are just sufficient to provide subsistence leaving no margin for saving. The only social class that can save and accumulate capital is the capitalist class who in Ricardo's times, and even in times preceding it, was a frugal class. Their savings and accumulation of capital depended on their income, that is, profits. Profits provided to them the motive as well as the power to save and accumulate.

Like Smith and other classical economists, Ricardo also believed in the saving-is-spending theorem. What was saved, according to this classical theorem, was also consumed but by a different set of people, that is, by the productive labour employed with the help of capitalists' savings turned into wages-fund that is a form of capital. This meant that Ricardo did not visualize any difficulty coming in the way of the processes of economic development from the side of demand. He subscribed to Say's Law which states that supply creates its own demand.

The process of economic development, however, depends on the existence of profits which is the motive for which the capitalists producers accumulate and invest capital and also the source of their savings and accumulation. So long as positive profits are there, process of economic development would go on without any hitch.

But Ricardo's model of economic development is not an entirely hitch less model. In his model the hitch arises due to the operation of the law of diminishing returns in agriculture. Ricardo's analysis of distribution had led him to his fundamental theorem of distribution, namely, that profits were inversely related with wages, higher wages meant lower profits. When accumulation and economic development are rapid, the demand for labour rises, while the supply of labour cannot be raised immediately. So the "market wages" rise. But this is only short-lived phenomenon as, in time, higher wages would lead to increase in population and labour force and market wages would be pushed down

again to the subsistence level. Therefore the hitch could not come from the demand side of labour, for it could not come from the demand side of labour, for it could not raise wages and lower profits but for a short temporary period. This hitch must come from a factor or cause which raises the cost of producing the workers subsistence permanently and thus raises the “natural wages” and lowers profits.

This factor Ricardo discovered in the law of diminishing returns which, according to him, operated in agriculture which produced substantially the whole of worker's subsistence. As capital accumulation and economic development go on, population increases and demand for food and oilier agricultural goods increases. Cultivation increases at both the extensive and the intensive margin. But as diminishing returns operate, greater and greater quantities of labour and capital are successively required to produce the same amount of subsistence goods from period to period. This implies increasing cost of worker's subsistence and consequently increasing natural wages (not in real terms but in money or cost terms) and decreasing profits over time. This is Ricardo's explanation of the falling tendency of the rate of profit. Thus, in Ricardo's model, the rate of profit goes on falling as capital accumulation and economic development proceed on till it is, comes zero.

When the rate of profit falls to zero or even somewhat earlier, for even capitalists must have some minimum profit income to provide them with their customary and habitual consumption, the motive for further capital accumulation would disappear and consequently the process of economic development would come to an end and the “stationary state”, in which there is not development and growth but repetition of one and the same level of economic activity, would arrive.

#### Self Check Exercise-4

Q.1 Discuss Ricardo's Theory of Economic Development

### **6.7 Ricardo's Theory of International Trade**

One of Ricardo's most durable contributions to economic theory has been his theory of international trade. He was the first economist who advocated the need for a separate theory of international trade. The basis on which he argued for a separate theory of international trade, namely, the relative immobility of factors of production between countries is even to the present day universally accepted. What is referred to as the “classical theory of international trade” or the “comparative-cost theory” is almost solely the work of Ricardo.

Ricardo urged that the labour theory of value did not apply to international exchange of goods, because there was no force working in foreign trade which could equalize the rate of profit between countries. What could, then, determine the international exchange of goods?

Adam Smith, in this context, had referred to a proposition which purported to state absolute differences in costs between countries to be the condition of international trade. Supposing a given amount of labour (assuming labour to be the only factor of production) in country

A can produce either 20 units of commodity X or 10 units of commodity Y, while the same amount of labour can produce in another country B either 10 units of X or 20 units of Y, we have an imaginary example of absolute differences in costs which, according to Smith, was the condition for international trade to take place. In this case the country A has absolute cost-advantage in the production of commodity X, while it has absolute disadvantage in the production of Y compared to the other country B. On the other hand, country B had Absolute cost-advantage in the production of Y and absolute cost disadvantage in the production of X. Accordingly, A would specialize in the production of X and B would specialize in the production of Y and, then, they would exchange each other's goods to the greater benefit of both. While stating the above principle Smith was simply extending his principle of division of labour to the sphere of international economy. He had specifically observed in this regard that what is prudent in the case of a householder that is, the principle not to produce what can be obtained cheaper from other through exchange could not be improvident in the case of a nation.

But Smith had failed to recognize that though absolute differences in costs was a sufficient condition for international trade to take place, it was yet, not the necessary condition.

The merit of Ricardo's contribution in this field precisely lies in the recognition of the above fact which required a rather more acute analytical ability than to recognize the advantage of international division of labour on the basis of absolute difference in costs. Ricardo was the first to suggest the condition which was both necessary and sufficient for international trade to take place. The condition which, according to Ricardo was both necessary and sufficient for international trade to take place was that there should be differences in comparative costs of the countries. This principle of comparative costs is Ricardo's Comparative Cost Theory of international trade.

The principle of comparative cost advantage states that international trade will take place as it will be beneficial to the trading countries even when one country can produce both goods cheaper compared to the other, provided this cost advantage of the former and cost disadvantage of the latter are not equal as between goods. If they continue with the imaginary example of two countries A and B, and two goods, X and Y, and suppose that with a given amount of labour, A can produce either 20 units of X or 20 units Y, but B produce with the help of the same amount of labour either 10 units of X or 15 units of Y, this will illustrate the case of "differences" in comparative costs". A can produce both X and Y cheaper than B. But compared to Y A had greater comparative advantage in the production of X as it can be produced at half the cost at which B can produce it. In the production of Y, its advantage over B is comparatively less. It can produce Y at  $\frac{3}{4}$  the cost of B. Another way of looking at and explaining it is to use the concept of the opportunity cost. In A one unit of Y can be produced at the cost of one unit of X but in B one *unit* of Y can be produce at the cost of 66 units of X. Therefore, in the absence of international trade, A will have to give up 20 units of X in order to produce 20 Units Y which,

according to Ricardo's labour theory of value, would be the domestic ratio of exchange between X and Y in country A. In country B, on the other hand, this ratio of exchange would be  $10 X = 15 Y$  or  $20 X = 30 Y$ . Therefore, if A specializes in the production of X only, in which its comparative cost advantage is greater, and imports Y and B in exchange for X, it can get Y cheaper than what it will cost to produce domestically. At the cost of 20 X it can get 30 Y, while it could produce itself 20 Y at the cost of only 20 X.

Similarly, according to Ricardo's principle of comparative cost, it will be profitable for B to specialize in the production of Y, in which its comparative cost disadvantage is less, and exchange it for A's X. Thus it has the chance of getting 15 X at the cost of 15 Y, while it will have to give up 22.5 Y for 15 X, if it produced X itself.

Thus, Ricardo demonstrated that absolute differences in costs are not necessary for international specialization and trade to take place and that existence of difference in comparative costs are a sufficient condition for it. Even when a country can produce any given two goods cheaper than another country, it is to the benefit of both countries that a country should specialize in the production and export of the goods in which it has comparative cost advantage or its comparative cost disadvantage is less.

Ricardo also demonstrated that there is a positive gain from international trade and specialization taking place according to the principle of comparative cost advantage. If we consider the above example, if there was no international specialization and trade and both A and B produced X as well as Y for themselves, the total production in A with 2 units of labour would be 20 X + 20 Y, and with the same amount (2 units) of labour the total production in B would be 10 X + 15 Y so that total for both would be 30 X + 35 Y at the cost of 4 units of labour. But, if there is specialization and trade between the two countries A would devote its 2 units of labour to the production of X, in which its comparative cost advantage is greater, and would thus produce 40 X. B would devote its 2 units of labour to the production of Y, in which its comparative cost disadvantage is less, and would thus produce 30 Y. At the cost of 4 units of labour now the total production would be 40 X + 30 Y which shows a gain of 10 X and loss of 5 Y compared to the no-trade situation. But 5 Y in A equals 5 X and in B. That means the loss on account of loss in Y cannot be greater than so that there is a minimum net gain of 5 X.

The above gain from international trade can be shown in terms of saving in costs. In the absence of international specialization, the cost of 30 X + 35 Y is 4 units of labour, but when there is specialization and trade so that A produces only X and B only Y, the cost of 30 X + 35 Y would be  $1.5 + 2.3 = 3.8$  units of labour yielding a saving of 0.2 units of labour.

Ricardo observed that the distribution of gain between the trading countries would depend on the barter terms of trade. If these terms are nearer to the comparative cost ratio of country A in our example ( $20 X / 20 Y$ ), it is the oilier country B which will have the greater share in the gain and in the case of the international barter terms of trade

equaling the cost ratio in country A the whole of gain would go to B. The pattern of the distribution of gain 'would be of the reverse type, if the barter terms of trade were nearer to the cost ratio in B.

Ricardo had not used the example that we have used above in order to explain his theory, though his example was similar to ours. He mentioned the two countries as Portugal and England and the two goods as cloth and wine. Ricardo is generally regarded as the father of the abstract method of reasoning which relies on abstracting the matter to be analyzed from reality by making simplifying assumptions. His theory of international trade is also based upon a number of assumptions, such as : (1) There is only one factor of production, namely, labour; (2) There are only two countries and only two goods ; (3) The production is subject to the law of constant returns ; (4)'There are no, transport and insurance costs; (5) There are no tariff and the trade is free ; and (6) factor or factors of production are perfectly mobile within countries but are perfectly immobile between countries.

However, the essential point of Ricardo was to show that international trade is different from internal or domestic trade. If the differences in costs of the types illustrated in the above example existed between any two regions of a given country, the factors being perfectly mobile, within countries, they would move into the region which could produce both the goods cheaper. That is to say the trade within countries takes place according to the principle of absolute difference in costs, while trade between countries takes place according to the principle of differences in comparative costs. It is in this implication that Ricardo's theory of international trade not only differs from but is also an improvement on Adam Smith's theory.

Self Check Exercise-5

Q.1 Discuss Ricardo's Theory of International Trade.

## **6.8 Summary**

It was David Ricardo who systematized what has come to be known as the classical economics. The later classical economists had hardly anything substantive to add to his system except for some marginal additions here and there. Taking, into consideration the requirements of the syllabus, we have dealt, in the present lesson, with his theories of value, distribution, economic development and international trade.

## **6.9 Glossary**

1. **Terms of Trade:** The ratio of the average price of a country's exports, to the average price of its imports, is its terms of trade. In theory, an improvement in a country's terms of trade raises its real income (since it can "convert" a given amount of its own output into a larger amount of consumable products through trade) – although in practice it depends on how those terms of trade gains are distributed.

2. **Distribution:** The distribution of income reflects the process by which the real output of goods and services produced by the economy is allocated to different individuals and groups of people. Distribution can be measured across individuals (comparing high-income and low-income households)
3. **Comparative Advantage:** A theory of international trade that originated with David Ricardo in the early 19th Century, and is maintained (in revised form) within neoclassical economics. The theory holds that a national economy will specialize through international trade in those products which it produces relatively most efficiently. Even if it produces those products less efficiently (in absolute terms) than its trading partner, it can still prosper through foreign trade. The theory depends on several strong assumptions – including an absence of international capital mobility, and a supply-constrained economy.
4. **Tariff:** A tariff is a tax imposed on the purchase of imports. It is usually imposed in order to stimulate more domestic production of the product in question (instead of meeting domestic demand through imports).

## 6.10 Answers to self check Exercises

Self Check Exercise-1

Ans.1 Please refer section 6.4

Self Check Exercise-2

Ans.1 Please refer section 6.5

Self Check Exercise-3

Ans.1 Please refer section 6.5.1

Self Check Exercise-4

Ans.1 Please refer section 6.6

Self Check Exercise-5

Ans.1 Please refer section 6.7

## 6.11 References/ Suggested Readings

16. Eric Roll: *"A History of Economic Thought"*.
17. Alexander Gray: *"The Development of Economic Doctrine"*.
18. C. Gide and G. Rist: *"A History of Economic Doctrines"*.
19. J.A. Schumpeter: *"History of Economic Analysis"*.
20. M. Blaug: *Economic Theory in Retrospect*.
21. David Ricardo: *Principles of political Economy and Taxation*.
22. M. Blaug: Ricardian Economics.
23. G. Stigler: *Essays in the History of Economics*.

24. P. Sraffa and M. Dobb: The works and Correspondence of David Ricardo.

### **6.12 Terminal Questions**

- Q1. Discuss the views of Ricardo regarding the consequences of capital accumulation on the distribution of national income among various social classes?
- Q2. Why Ricardo is sometimes described as a pessimist?



# **LESSON 7**

## **THE CLASSICAL SCHOOL OF ECONOMICS (3)**

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### **Structure**

- 7.1 Introduction
- 7.2 Learning Objectives
- 7.3 Malthus's Theory of Population
- 7.4 A Critique of Malthus's Theory of Population  
Self Check Exercise-1
- 7.5 Ricardo-Malthus Controversy On Say's Law of Markets
- 7.5.1 What was the Controversy About  
Self Check Exercise-2
- 7.6 Summary
- 7.7 Glossary
- 7.8 Answers to self check Exercises
- 7.9 References/ Suggested Readings
- 7.10 Terminal Questions

### **7.1 Introduction**

In the present lesson we are introducing you to another famous classical economist, namely, Thomas Robert Malthus (1766-1834) who is more famous for his theory of population than for any other contribution of his to economic thought. All the same, since J.M. Keynes discovered in him a precursor of his own, Malthus's controversy with Ricardo on the subject of Say's Law has been also in the limelight. In the present lesson, we shall be focusing on these two contributions of Malthus to the classical economic thought.

### **7.2 Learning Objectives**

After going through this lesson you will be able to:

- Elucidate Malthus Theory of Population
- Give the criticism of Malthus theory of population
- Explain Ricardo-Malthus Controversy On Say's Law of Markets

### **7.3 Malthus's Theory of Population**

It has been now universally accepted that the so-called Malthusianism which refers to the principle of population growth as explained by Malthus in his Essay on Population (1798) was neither a

new nor an original idea. Any number of economic thinkers before him can be found to have referred to the principle of population expounded in Malthus's Essay on Population According to Schumpeter; "divested" of non-essentials, the Malthusian Principle sprang fully developed from the Bram of Botero in 1589." Petty in his "Essay Concerning, the Multiplication of Mankind" (1686) had even hinted at the law of geometric progression, Susmitch (1740), Franklin (1751), R. Wallace (1753), Miraheau (1756) who wrote that "Men will multiply to the lines of subsistence like rats in a barn", Steuart (1767) etc. all had state multiply to the limits of subsistence like rats in a bam", Steuart (1767), etc. all had stated the principle apart from Adam Smith who, as we have already mentioned, had explicitly stated that "demand for men, like that for any other commodity, **regulates the** production of men", and **that "every** species of animals naturally multiplies In proportion to the means of subsistence, and no species can multiply beyond it" The geometrical progression in population growth was referred to not only by Petty but also by Susmitch, R. Wallace and Ortes (1774). All of them preceded Malthus. Marx was perhaps not wrong in describing Malthus as a "plagiarist". If, inspite of so many already having referred to this demographic principle, it has come prominently associated with the name of Malthus so much so that the principle is now described as Malthusianism, it is due to the context in which Malthus was able to provoke a heated controversy over this theory and the political use to which it was put.

The context was the spreading influence of French Revolution and the philosophy of Enlightenment that was an important source of inspiration for the French Revolution. While the philosophical radicalism of Enlightenment movement preached the idea of perfectibility of man and society the political fall-out of the French Revolution was a threat to the established feudal interests of the landlord class and the church in the British society. There is a view, not lacking in evidence, that Malthus's theories had the ulterior motive of defending the interests of the feudal classes in Great Britain. As regards his Essay on Population, it was intended to refute the idea of perfectibility of man and society as preached by social philosophers and reformers like Godwin and his disciples in Great Britain.

Malthus's theory of population is based on two basic postulates, viz. (1) food is necessary for the existence of man; and (2) the passion between the sexes is inevitable and will remain nearly in its present state.

From the above postulates, be deduced that; (1) "the power of population was indefinitely greater than the power in the earth to produce subsistence for man". (2) "Population, when unchecked, increases in a geometrical ratio. Subsistence increases only in an arithmetical ratio," but (3) "By that law of nature which makes food necessary to the life of man, the effects of those two unequal powers must be kept equal." Therefore, (4) "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." The last (4) deduction

implies that population is brought in balance with the available subsistence of food supply through the operation of “natural” or “positive” checks in the form of starvation, malnutrition, famine, disease and even vice, wars and natural calamities which push up mortality rate. A “preventive” check in the form of prudent postponement of marriage is mentioned but is not given importance as, in his opinion, it led to vice.

The above, in nutshell, is the sum and substance of Malthus’s argument in the first edition of his *Essay on Population*. There are certain basic flaws in the above deductions of Malthus. The two basic postulates mentioned above are insufficient to warrant Malthus’s deductions. The deductions (1) and (2), for example, do not follow automatically, unless some additional postulate is made to support the proposition that production of subsistence is bound to lag behind the production of men. An effort was made by Malthus in this direction in the second edition of his Essay by adding the postulate of diminishing returns in agriculture which he borrowed from Anderson. Even the postulate of diminishing returns in agriculture does not warrant the deduction (2) above. The ratios mentioned there are not supported with adequate evidence. It is uncertain whether Malthus used the two ratios, the geometrical for population increase and the arithmetical for increase in subsistence, as a metaphor or whether he meant it literally, though it is certain that he kept repeating these ratios to the end of his life.

In the controversy provoked by the Essay, Godwin criticized Malthus’s theory with the following arguments : (1) Malthus’s principle denied all possibility of large progress ; (2) Abortions and similar practices preventing births, though “painful and repulsive “ were perfectible to the Malthusian checks of misery and vice ; (3) Men of the more enlightened classes already postponed marriages to avoid poverty resulting from large family and. in Godwin's view, with the spread of enlightenment such prudence would become a common characteristic of the entire population. Stigler, in his essay “The Ricardian Theory of Value and Distribution”, expresses the view that Godwin was right not only with reference to the historical fact that this was the tendency in the nineteenth century but also by contemporary evidence of wide-spread postponement of marriage.

Malthus surrendered some ground in the second edition of the Essay published in 1803 by giving special prominence to a newly recognized preventive check in the form of moral restraint and he also improved upon his first version by introducing the law of diminishing returns in the production of subsistence, though without verifying it empirically.

## **7.4 A Critique of Malthus’s Theory of Population**

Apart from what has already been said above, Malthus’s principle of population has been criticized comprehensively. Stigler is surprised at Malthus’s “lack of interest in the economics of population”, which is borne out by the following facts’ There is no appreciation of the need of analyzing the concept of subsistence level. Malthus did not care even

to isolate the factors which determine this level and changes in it Nor has he cared to analyse the time required for population to respond to changes in the means of subsistence. The time lag is left vague. Most importantly, there is no analysis of the factors which govern the rate of growth of output which, according to his theory, determines the growth rate of population. Moreover, Malthus is utterly blind to the fact that population might increase due to fall in death rate resulting from the autonomous factors of improvement in sanitation and medical facilities as well as from the progress, of medical science and inventions. Malthus also said nothing about the age and sex distribution of population, particularly about the proportion of women of child-bearing age which has important bearing on the potential of population growth. Moreover, he looked upon birth rates as independent of death rates. Finally, though he was aware that the family size was, in almost all societies, inversely related to the height of income- class, yet he drew no important conclusion from this fact.

Malthus did not care to test his theory by empirically verifying its implications. The basic implication of the theory was that the standard of living of the people could not increase over a long period because any increase in output would be eaten up by the increase in the number of mouths. As Stigler observes, "If the subsistence level has any stability, and hence any significance, Malthus's theory was wrong, if the standard of living of the masses raised for any considerable period of time." According to Stiger, Malthus did not investigate this possibility and ignored the opinions of such authorities as Sir Frederick Eden that the standard of living had been raising for a century (of Frederick Eden. *The State of the Poor*, 1797). His theory could also be contradicted, if population grew at a constant geometrical rate in an "old country", for the implication of this theory in that case is that the means of subsistence were also growing at this rate, because, according to this theory, population never precedes food supply. Despite the rapid increase in population in almost all the West European countries at the time which Malthus could scarcely fail to notice, he persisted in considering this as only a confirmation of his fertility hypothesis.

Even Ricardo had questioned the assumption that food increased sluggishly in arithmetical progression. He pointed out that "it has been calculated, that under favourable circumstances, population may be doubled in twenty-five hut under the same favourable circumstances the whole capital of the country might possibly be doubled in a shorter period." And, Nassau Senior had observed that "in the absence of disturbing causes food has a tendency to increase faster than population, because, in fact, it has generally done so..... But Malthus was generally blind to all facts around him which obviously contradicted his hypothesis.

It is interesting to note that Malthus, in his *Principle of Political Economy*, made, observations which contradicted his theory of population but he did not recast it formally. For example, while dealing with wages, he observes. "The great increases of command over the first necessary of the life (from 1720 to 1750) did not however, produce a proportionate increase of population. The result was that their

increased corn ages, instead of occasioning an increase of population exclusively, were so expended as to occasion a decided elevation in the standard of their comforts and convinces." In a historical survey of wages, he finds them rising from the mid-14th to the 16th century then falling for a century which, as Stigler observes, is 'hardly a clear example of a strong tendency of wages to approach a subsistence level.' In fact, Malthus went so far to investigate the factors (liberty and education) which lead workers to increase their standard of comfort rather than their numbers, when income rises. 'Like a successful general', observes Stigler. "Malthus occupied all the positions".

However, since Malthus introduced in the second edition of his *Essay* a new preventive check in the form of moral restraint, the above referred observation of Malthus regarding workers increasing their standard of living rather than their numbers when their income increased could be explained with reference to the working of the moral restraint. But as Mark Blaug has observed, the introduction of moral restraint as a check made the theory "perfectly general and perfectly empty. Rising standards would show that moral restraint was working and falling standards would show that positive checks were operating. In such a form, the theory can never be refuted but a theory that is not falsifiable by any conceivable event is a tautology masquerading as a theory." (Blaug). This means that Malthus's theory in the second edition of the *Essay* turns into a tautology with the introduction of the preventive check of moral restraint.

Malthus's theory does not provide an unambiguous definition of over-population either. Moreover, the assumption of diminishing returns is a static assumption. Malthus failed to recognize that technological progress could counteract the effect of diminishing returns. Malthus's principle sets up too simplistic a relation between increase in population and increase in food supply in a country. It ignores the fact that the relationship between population and aggregate output and not simply the food supply is more meaningful. But such an approach would have made Malthus's principle of population infructuous because if the total output increased at a greater rate than the population, Malthusian positive checks would not come to operate even if food production lagged behind, shortage of domestic food production could be met with by food imports.

A serious shortcoming of the theory is its very weak empirical content. Malthus quoted some evidence from American colonies where, according to him, population increased at an average annual rate of less than 3 per cent. But he also admitted that the standard there did not decline which implies that food supply there also increased in step with the increase in population. That lends no support, to but, to the contrary, provides refutation of his principle.

As a matter of fact, it is not possible to understand the true meaning of Malthus's theory without learning about his motives. As has been already observed, he was not at all interested in the economics of population. His motives were more political than scientific. His prime motive was to somehow demonstrate that society was not "perfectible" and therefore radicalism of the French Revolution type was futile. Not

only that but even any major reform within the established system was doomed to failure. Moreover, it was not the social system but the poor themselves who were responsible for their miserable conditions. "The truth is" observed he, "that the pressure of distress on this part of the community is an evil so deeply seated that no human ingenuity can reach it." The best that could be done was, in his opinion, the abolition of the Poor Laws which was only a "palliative". He was opposed to the Poor Laws which involved some financial burden on the landlords and at the same time, prevented mobility and cheapening of labour which was not in the interest of the rising class of capitalists either." 'the poor-laws of England', wrote he in the first edition of his *Essay*, "tend to depress the general condition of the poor", as their effect is <sup>u</sup> to increase population without increasing the food for its support." His motive in propounding and propagating his principle of population was to provide a "scientific" as well as a "moral" basis for the abolition or at least the "reform" of the Poor Law. How single-minded on this motive he could be to the extent of even being callous which ill-behaves a person that he was is evident from the following forceful assertion of his in the second edition of his *Essay*.

"A man who is born into this world already possessed, if he cannot get subsistence from his parents on whom he has just demand and if the society do not want his labour, has no claim of right to the smallest portion-food and, in fact, has no business to be where he is. As R.L. Meek observes, "Whatever die intentions of its author may have been, the Malthusian theory of population remained to the end what had been at the beginning—an apology for the condition of the working people and a warning against all attempts to ameliorate the condition of society."

However, even the devil must get his due. Stigler believes that Mai thus deserves commendation for two important services which are rather above the quality of his work. Firstly, he was the first to assign to population an important role in economic theory. He brought population from the backstage to the center stage of economic theory. This chiefly explains why this principle of population is known after his name, though this principle had been mentioned by many thinkers before him. It is also true that his theory flew in the face of empirical facts and was too obviously refuted by history and it had, therefore, failed and had thus become a big factor in the near-abandonment of population studies by later economists. But as Stigler observes, "this seriously reduces his contribution to economics but does not eliminate it." Secondly, his contribution also lies in the recognition that it is possible to deal fruitfully with population in terms of economic theory which has not little analytical significance. Another commendable' analytical consequence of his theory was that by making the population growth depend upon food supply, his theory lent support to the subsistence theory of wages and also prepared the way for the Ricardian preoccupation with the land-using bias of economic progress. Moreover, by explaining poverty in terms of a simple race between population and the means of subsistence, it provided the touchstone for all classical thinking about economic policy.

Needless to say that he was the first to systematize a general theory of population, though there were many others before him who had anticipated the essentials of his theory.

Self Check Exercise-1

Q.1. Critically explain Malthusian theory of Population.

## **7.5 Ricardo-Malthus Controversy On Say's Law of Markets**

In order to understand Ricardo-Malthus controversy on Say's Law of Markets, it is necessary, first, to know what Say's Law of Markets is. In brief Say's Law conveys the proposition that supply creates its own demand so that aggregate demand for goods equals the aggregate supply of goods and hence general over-production or a general glut of goods cannot take place. However, Say's law conceded the possibility of partial overproduction that is, overproduction in some particular industry or industries. But, in that case, Say's Law implied that overproduction in one industry would be matched with underproduction in some other industry or industries such that if we consider the economy as a whole, there would be neither overproduction nor underproduction but aggregate production would exactly equal the aggregate demand for it at cost-covering prices inclusive of the going rate of profit.

The above proposition, it is generally believed, was challenged by Malthus who had instead presented an opposite thesis, namely, that unless there is a class of unproductive consumers, the capitalist system of production cannot have a smooth run but would run into "hitch" arising from insufficient "effectual" demand lack of sufficient effectual or effective demand would result in unsold goods or a general glut of goods in the markets.

His argument in support of his thesis was based upon his theory of value. We explained in the lesson on Adam Smith that he had two versions of the labour theory of value, namely, the labour-embodied version and the labour-commanded version. While Ricardo opted for the former, Malthus adopted from Smith his labour-commanded version, according to which the value of a commodity, is determined by the amount of labour that it can command in exchange for it. The advocates of this version of Smith's labour theory of value were mistaken in thinking that labour embodied in a commodity was equal to the wages paid for its production, while the exchange value of it was always greater than it, the implication being that labour commanded by a commodity in exchange was greater than labour embodied in it. The inference was wrong, for the labour embodied, in fact, equaled labour commanded but labourers were paid a wage which in labour value terms was less than the labour expended by them in the production of the commodity. However, whichever version of the labour theory of value one prefers the fact remains that the exchange value of a commodity is greater than the wages paid to the productive workers. Therefore the wages of the workers would not be sufficient for purchasing the total product at cost-covering prices inclusive of the capitalist's profits at

the going rate. The capitalists cannot be expected to fill up the gap between the aggregate supply and the workers' effectual demand, because capitalists, by definition are interested in saving and accumulating capital. Consequently, unless there is a class of unproductive consumers like landlords, church, state retired officials, etc. this gap could not be filled up and consequently glut of goods would appear.

Moreover, Malthus's theory of value implied that profit was "implied to the labour costs of commodities in the process of exchange. If it is so, it could not be realized, for the demand of workers is not sufficient to enable the capitalists to realize profits. So, additional demand is necessary. Capitalists' demand won't do, because they would generally buy goods with goods, that is, they are not pure buyers : they are sellers also, which means that they are adding as much to aggregate supply as to aggregate effectual demand, therefore the gap cannot be filled. Realization of profits is also not possible because, if as Malthus believed like the mercantilists, profit arises in exchange, some capitalists may profit but only by inflicting an equivalent loss on others so that net profit realized by the capitalist class would be zero. "the powers of production", writes Malthus in his *Principles*, "to whatever extent they may exist, are not about sufficient to secure the creating of a proportionate degree of wealth. Something else seems to be necessary in order to call these powers fully into action. This is an effectual and unchecked demand for all that is produced. And what appears to contribute most to the attainment of this object is such a distribution of produce, and such an adaptation of this produce to the wants of those who are to consume it as constantly to increase the exchangeable value of the whole mass."

Hence, as Marx has observed, to Malthus, "it is necessary to have buyers who are not sellers, in order that the capitalist can realize his profit and sell the commodities at their value. Hence the necessity for land owners, retired officials, holders of sinecures parsons, etc. not forgetting their lackeys and other hangers oh." Workers are "productive consumer" in the Smithan sense that they produce more value than what they consume in the process of production. Spending by capitalists that part of their profits, which they do not directly consume for themselves, on employing industrious workers would not only not solve the problem but would further aggravate it by producing a greater surplus of goods which cannot be sold at cost- covering prices inclusive of a positive rate of profit, because workers' wages are inadequate to buy the total output. As Malthus observes, "no power of consumption on the part of labouring classes can ever alone furnish an encouragement to the employment of capital". Therefore what is needed is a class of "unproductive consumers" like landlords, retired officials, holders of sinecures, persons, etc. who consume but do not produce. Thus Malthus's theory of gluts becomes, in the words of Marx, "an apologia for the existing state of affairs in England for landlordism, State and Church, pensioners, tax-gatherers, tenants, national debtors, stock jobbers beadies, parsons and menial servants...assailed by the



Ricardians as so many useless and superannuated drawbacks of bourgeois production and as nuisance."

Ricardo, on the other hand, had taken a stand on Say's Law which was diametrically opposed to that of Malthus and upheld Say's Law. Ricardo, often, went to the extent of stating Say's Law in a form which implied logical impossibility of gluts taking place. "No man produces", observed Ricardo 'but with a view to consume or sell, and he never sells but with an intention to purchase some commodity, which may be immediately useful to him or which may contribute to further, production. By producing, then, he necessarily becomes either the consumer of his own goods or the purchaser and consumer of the goods of some other person."

The above statement of Ricardo is only a restatement of Say's Law and implies the impossibility of aggregate demand falling short of aggregate supply and therefore the impossibility of general overproduction and gluts.

Malthus seemed to argue that capital accumulation could not go on smoothly in a hitch-less manner unless there was a class of *unproductive consumers* who consumed, goods without producing any types of goods themselves. In the absence of such unproductive consumers, there will be under-consumption, on the one hand, and over-saving, on the other. Consequently a part of the aggregate output would remain unsold or would have to be sold at prices too low for capitalists to make any profit at all. A general glut of commodities would appear and capital would become redundant. With the disappearance of profit the process of capital accumulation would come to halt. Thus he saw (and this goes to his credit because he was the first economist to see it) that the capitalist accumulation is not hitch-less but is inherently crisis-ridden. It is a different matter that his explanation of it was misconceived and misplaced.

But Ricardo who, in the classical tradition, subscribed to Say's law ruled out any possibility of crisis of general overproduction and redundancy of capital. According to him "There cannot...be accumulated in a country any amount of capital which cannot be employed productively." While for Malthus productive consumers, who produced commodities to sell in exchange for the commodities which they wanted to buy aggravate rather than solve the problem of insufficient effectual demand, for Ricardo they guaranteed that there would be no lack of demand for goods. "While the profits of stock are high," he wrote, "men will have a motive to accumulate. Whilst a man has any wished-for gratification unsupplied, he will have a demand for more commodities and it will be an effectual demand *while he has any new value to offer in exchange for them* (emphasis added). As he argued "Productions are always bought by productions, or by services. Money is only the medium by which the exchange is affected. Too much of a particular commodity may be produced, of which there may be such a glut in the market, as not to repay the capital expended on it; but this cannot be the case with respect to all commodities."

The above statement shows that Ricardo upheld Say's Law in full, while Malthus tried to refute it.

### 7.5.2 What was the Controversy About

The controversy between Malthus and Ricardo regarding the possibility or otherwise of general overproduction and glut in the market is generally understood to refer to a controversy over Say's Law. Not only at the popular level but even J.M. Keynes, who had a penchant for looking for his precursors, real or imaginary, in any statement of past economists which had some resemblances to his new-found idea of his *General Theory*, looked at and interpreted the Ricardo- Malthus controversy that way. He in fact, regretted that Malthus's theory of gluts was ignored, observing that "if only Malthus, instead of Ricardo, had been the parent stem from which. 19th century Economics proceeded, what a much wiser and richer place the world would be today." But more recent specialized assessment of Malthus's analysis of gluts has led to the dispelling of the popular belief that the Ricardo-Malthus controversy was about the validity or otherwise of Say's Law.

M. Blaug in his *Economic Theory in Retrospect*, has demonstrated that Malthus was not interested in refuting Say's Law and thus to assert the possibility of *temporary* general overproduction. But his interest, in fact, was in asserting the possibility of *permanent* general overproduction. What Malthus wanted to demonstrate was that in the absence of exogenous spending by "unproductive consumers", the process of capital accumulation leads inherently and inevitably to secular stagnation. The fact that Malthus was not concerned with the refuting of Say's Law is obvious from his failure to make use of arguments which were quite at hand, such as inflexibility of wages and prices. Not only that but during the course of his analysis of the subject he never gave up the Smithian saving-is-spending theorem and continued to stress that saving meant "the conversion of revenue into capital". How can there be deficiency of "effectual" or effective demand causing Keynesian general unemployment and providing a refutation of Say's Law when what is saved is understood to be automatically invested as it is implied in the Smithian classical saving-is-spending theorem which Malthus never discarded? Moreover, as Blaug observes, there is no hint whatever in Malthus's writings of the decisive Keynesian break with orthodox analysis, making saving a function of income rather than of rate of interest, 'therefore it is wrong to interpret Malthus as a precursor of Keynes.

As a matter of fact, what Malthus had in mind while expounding his theory of gluts was an inherent tendency of the capitalist system to land itself into a state of secular stagnation. This is the true meaning of his theory of gluts which is apparently, only apparently, an anti-thesis of Say's Law. At the root of Malthus's thinking was a typical under-consumptions fallacy, according to Blaug, Malthus held an under-consumptions theory of the over-saving type every act of saving, Malthus's argument implied, tends to reduce the demand for consumption goods and since the savings are automatically invested, the supply of goods is simultaneously increased. So, the remedy, according to Malthus, lay in reducing saving and investment and

increasing consumption for which was required a class of a people who were pure consumers; who consumed goods but did not save and invest and thus did not add to the supply of goods. And, for this purpose, he had around him a readymade social class primarily made up of the feudal class of landlords including the church and the state.

Mark Blaug rightly observes that the debate between Ricardo and Malthus on the possibility of general gluts would never have caused the confusion that it did. If both the participants had made up their minds as to what Say's Law really implied. While Ricardo did not believe that the post-Napoleonic-War depression was the harbinger of secular stagnation, Malthus believed that it was indeed so. Accordingly Ricardo was led to insist on Say's Law as fully valid, at every moment in time, though he meant by it to affirm the long-run tendency of a free-market competitive economy towards full employment equilibrium. Malthus, on the other hand, failed to challenge Say's Law effectively.

It is to the merit of Malthus that he saw the problem of stagnation resulting from deficiency of "effectual" demand. But his conception of the problem was inaccurate and his analysis is full of blunders and confusion. Ricardo's defense of Say's Law was dogmatic and not impeccable but it was logical, given his premises and assumptions.

Finally, one should not forget that below the surface of the Ricardo-Malthus controversy lay the question of political bias also. Malthus was rather an unashamed and crude apologist of the interests of the feudal classes. His analysis as well as presentation of both the problem of population and the problem of gluts was too obviously, rather crudely, apologetic in character. Ricardo, on the other hand, was on the side of the rising class of industrial capitalists. But his analysis was much more sophisticated having the appearance of objectiveness and his implicit pleas for policies that promoted the interests of the capitalist class were more subtle.

#### Self Check Exercise-2

Q.1. Discuss Ricardo-Malthus Controversy On Say's Law of Markets.

## 7.6 Summary

In the present lesson we have introduced you to another famous classical economist, namely, Thomas Robert Malthus (1766-1834) who is more famous for his theory of population than for any other contribution of his to economic thought. All the same, since J.M. Keynes discovered in him a precursor of his own, Malthus's controversy with Ricardo on the subject of Say's Law has been also in the limelight. In the present lesson, we have focussed on these two contributions of Malthus to the classical economic thought.

## 7.7 Glossary

1. **Distribution:** The distribution of income reflects the process by which the real output of goods and services produced by the economy is allocated to different individuals and groups of people. Distribution can be measured across individuals (comparing high-income and low-income households), or across classes (comparing the incomes of workers, small businesses, and capitalists).
2. **Value** the amount of money which something is worth to assess the amount of money which something is worth.
3. **Stagnation:** A prolonged [recession](#), but not as severe as a [depression](#).
4. **Depression:** A bad, depressingly prolonged RECESSION in economic activity. The textbook definition of a recession is two consecutive quarters of declining output. A slump is where output falls by at least 10%; a depression is an even deeper and more prolonged slump. The most famous example is the Great Depression of the 1930s. After growing strongly during the 'roaring 20s', the American economy (among others) went into prolonged recession. Output fell by 30%. Unemployment soared and stayed high: in 1939 the jobless rate was still 17% of the workforce. Roughly half of the 25,000 BANKS in the United States failed. An attempt to stimulate growth, the New Deal, was the most far-reaching example of active fiscal policy then seen and greatly extended the role of the state in the American economy. However, the depression only ended with the onset of preparations to enter the Second World War.
5. **Thomas Robert Malthus** was born as a second son of a relatively wealthy, middle-class couple on 13 February 1766 in 'The Rookery' country house near Wotton in Surrey. He died on 29 December 1834 on a visit to Bath, and is buried in Bath Abbey. Thomas Robert Malthus is more famous for his theory of population than for any other contribution of his to economic thought.

## 7.8 Answers to self check Exercises

### Self Check Exercise-1

Ans.1      Please refer section 7.3 and 7.4.

### Self Check Exercise-2

Ans.1      Please refer section 7.5 and 7.5.1

## **7.9 References/ Suggested Readings**

1. Eric Roll: "*A History of Economic Thought*".
2. Alexander Gray: "*The Development of Economic Doctrine*".
3. C. Gide and G. Rist: "A History of Economic Doctrines".
4. J.A. Schumpeter: "*History of Economic Analysis*".
5. M. Blaug: *Economic Theory in Retrospect*.
6. R.L.Meek (ed.): *Marx and Engels on Malthus*.

## **7.10 Terminal Questions**

- Q1. Critically examine the views of Thomas Robert Malthus on Population?
- Q2. What are the main implications of Say's Law of Market?

## Unit- 8

### THE CLASSICAL SCHOOL OF ECONOMICS (4)

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#### Structure

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- 8.16 Summary
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- 8.19 Terminal Questions

## 8.1 Introduction

The main body of classical economics had been sketched out in the writing of Adam Smith, David Ricardo and T.R Malthus. But the way in which the tenets of classical economics were presented in their works was not the ideal way. That there was a lot of confusion in Adam Smith's *Wealth of Nations* in which opposing theories on one and the same subject walked hand-in-hand. In spite of Ricardo's having removed some cobwebs of confusion that infected Smith's *Wealth of Nations*, Ricardo himself was not a lucid writer. Malthus's arguments were no less than utterly convoluted as it generally happens with a person who is committed to some how or other, to prove, a particular thesis.

The later economists in the classical tradition are known more for their having systematized and popularized the classical economics, the framework of which had been prepared by the then major classical economists mentioned above, than for any brilliant new theories of their own. Among these later economists in the classical tradition, two names particularly stand out. They are Jean Baptiste Say, who is now much more known on account of his Law of Markets popularly known after his name as Say's Law than for anything else, and John Stuart Mill who indeed was much more than a mere economist but whose *Principles of Political Economy* served as the most popular textbook on economics in the whole English-speaking world till Alfred Marshall's *Principles of Economics* displaced it towards the last quarter of the last century. In the present lesson, we shall deal with the contribution of these two thinkers to the evolution of the science of economics.

## 8.2 Learning Objectives

After going through this lesson you will be able to:

- Explain Say's Law of market
- Elucidate Say's Doctrine of Immaterial Products
- Explain Say's Distribution Theory
- Mill's view on Different aspects of economic theory

## 8.3 Jean Baptiste Say (1767-1832)

J. B. Say, a French economist in the classical tradition and a contemporary of both Ricardo and Malthus, was famous in his times as the most successful interpreter and populariser of Adam Smith's economics in France. His Law of Markets popularly known as Say's Law which has been too much in discussion since the publication in 1936, of Keynes's *General Theory* was not regarded as a very spectacular idea

at that time in spite of the Ricardo-Malthus controversy over all. The idea underlying this law, though not as explicitly and lucidly expressed before Say, was, nevertheless, part and parcel of the mainstream classical economics. Anyway, one of his important contributions has been to sort out the confusion in Smith's work and to present the essentials of his system in an orderly and systematic manner with a remarkable lucidity.

#### 8.4 Say on Smith

In a sort of preface to his famous work, *Traite' Economique Politique* (which may be translated into English as *A Treatise on Political Economy*) he rightly heaps high praise as well as levels scathing criticism on Adam Smith's work. "The work of Smith" observes he, "is only a confused assemblage of the soundest principles of Political Economy, supported by luminous examples and by the most curious notions of statistics, mingled with instructive reflections; but it is a complete treatise neither of the one nor of the other; his book is a vast chaos of just ideas, jumbled with positive knowledge."

J.B Say took upon himself the task of rescuing the wisdom in Smith's work from the cobweb of the "vast confusion" in which it was entangled by bringing enough order and method in the statement of this wisdom and thus to "render the doctrine popular." He achieved this objective very successfully in his book, *Traite d' Economique Politique*, published in 1803.

#### Self Check Exercise-1

Q.1 Who was Jean Baptiste Say? Discuss his views on Smith.

#### 8.5 On the Nature of Political Economy

J. B Say was perhaps the first economist to explicitly recognize economics or political economy (no distinction between the two was made at that time) as an exact science. He seems to look upon its method of analysis as deductive in nature. For, he states that the science of political economy consists of a small number of fundamental principles or postulates and a large number of corollaries derived from them. The fundamental principles are not speculative in nature and are no figment of imagination. They are derived from the nature of things exactly in the same manner as the principles of physical sciences are derived from the nature of things.

It was this conception of the nature of economics which enabled him to write his treatise in a most systematic manner, he classifies all economic activities into three categories production (which subsumes exchange also) distribution and consumption. He also takes note of three factors, land, labour and capital in the classical tradition but a specific novel feature of his treatment of factors of production- is that the fourth factor, enterprise (organization), which fully established itself in Marshall's *Principles*, has been articulated by him and according to Gray, it is "looming large" in Say's *Treatise*.

#### Self Check Exercise-2



Q.1 Discuss views of J.B. Say on the nature of Political Economy.

## 8.6 Say's Theory of Value

Say's theory of value is not strictly in conformity with the classical tradition rather in this theory it deviates from its pure classical form, it is neither a labour theory of value nor a purely cost-of-production theory. It, in a way, breaks new ground by giving importance to utility in the determination of value. In the classical tradition, utility or value-in use is only a condition but not a determinant of exchange value. Say, on the other hand, turned it into the determinant of value. The idea of cost of production entering value of commodities seems to have been eliminated by Say except as a lower limit. In Say's, theory of value, cost of production does not determine value directly, though it does influence it indirectly through influencing the supply which determines utility of a commodity which, in turn, determines its value. It is not "the value of the productive services which determines the value of product," according to him. On the contrary, "it is the utility of the product which makes it sought out and which confers on it a value ; and it is the faculty of being able to create this utility which makes the productive services be sought out, and which confers upon them a value.' All this he says in the first chapter of his *Treatise*. He also speaks here of utility of a commodity 'raising its price to the cost of production, for, if it fails to do it, nothing of the commodity would be produced so that utility which, according to Say, is a direct function of scarcity would rise sufficiently to equal the cost of production. Thus, the cost of production sets only the lower limit below which value of a commodity cannot fall but, above it, value is determined by utility. He states emphatically that "the value of the means of production comes from the value of the product which may result, which is founded on the use which can be made of this product or the satisfaction which can be drawn from it."

It is obvious that Say had already one foot in the neoclassical world, as regards his value theory. Except for the concept of the *marginal* utility, he had anticipated W.S. Jevons's theory of value to a fair extent. Say, in fact, is said to have laid down the foundation for the functional relationship between cost, price, and consumer's preference which is a characteristic feature of all variants of modern theory of value.

Self Check Exercise-3

Q.1 What do you know about Say's Theory of Value?

## 8.7 Say's Doctrine of Immaterial Products

Say made an analytical use of his utility theory of value in eliminating Adam Smith's distinction between productive and unproductive labor on the basis of the materiality or "vendibility" of commodities the basis on which he excluded all types of direct services such as the services of physicians, teachers, lawyers, singers, dancers, administrators, etc. from the category of "productive labour". He, instead, set up a utility criterion for determining whether a

particular type of labour was productive or unproductive. The condition which was regarded by him to be necessary and sufficient was that it should result in the creation of some form of utility; it was not necessary for labour to realize itself into a material or "vendible" commodity in order to be productive. So long as a service has utility and is sought out by those for whom it has utility, it is a productive labour, though like the service of a doctor or a teacher or a singer, etc. it does not qualify to be a vendible or material commodity.

Say categorizes all such direct services which do not result into any vendible or material product as "immaterial products." His so-called doctrine of immaterial products implies that (1) direct services like the service of a doctor are "productive", provided they possess utility as the physician's service has utility for patients; (2) these services are immaterial products, the distinctive quality of which is that they are consumed as they are produced and, unlike material products, are not amenable to preservation and are thus incapable of accumulation. His distinction between material and immaterial products, however, had an implication similar to the one and the same that Smith's distinction between productive and unproductive labour on the basis of "vendibility" of goods produced which are consumed in the very process of their production, accumulation of capital and economic progress would be retarded.

Say did not apply his utility criterion to make a distinction between productive and unproductive labour on the basis of "surplus" creation, in fact, his utility approach to the distinction between productive and unproductive labour had the effect of eliminating the classical preoccupation with the search for and the analysis of surplus. This was an important deviation from the traditional classical economic analysis. In the process, he also removed the historical basis of the income shares of the different social classes which, explicitly or implicitly had been the chief characteristic of both the English and the French Political Economy.

#### Self Check Exercise-4

Q.1 What do you know about Say's Doctrine of Immaterial Products?

### 8.8 Say's Distribution Theory

Once the labour, theory of value and along with it the search for the origin of surplus and its appropriation were abandoned by Say there was no alternative for him except to adopt concept of production as a cooperative process in which all factors of production cooperate on' an equal footing and get their shares according to their respective contributions.

Say was one of the first of those economists who explained the demand for factors of production as a *derived*, demand. The central feature of his theory of distribution is the concepts of the "productive services" and of the "entrepreneur". According to him, labour, natural resources (land) and capital have value because of the productive services that they supply. Their productive services consist in this that they help in producing commodities which have utility. Commodities get

their values from their utilities, and the factors of production get their value from the values of the commodities which they cooperate to produce. Thus, in his distribution theory, as later in the Austrian distribution theory, the utility of final goods produced is the ultimate determinant of the value of factors of production. All the factors of production possess the two attributes necessary for them to have value. These two attributes are their *scarcity* and their *indirect* utility.

Say did not give a complete explanation of the process through which the factors of production derive their value from the utility of the goods which they help to produce, though he did give some hint on it. The entrepreneur is made the link between the factor markets and the product markets, because they are “the intermediaries who demand the productive services required for any product in relation to the demand for the product. The factors of production, or rather the owners of the factors of production, motivated by a variety of considerations offer their factors services for sale. A market for factor services is established and depending upon the correlation of the forces of demand and supply certain definite factor prices result. Factor prices are thus dependent upon the prices of products which they produce. But the product prices, as already observed are determined by their utility to their consumers. Thus the ultimate determinant of factor prices is consumers’ demand.

Although he did not express it clearly, Say was groping towards a Walras type, general equilibrium theory in which there was some sort of functional relationship between costs, products prices, utilities and factor prices.

The importance of Say’s work lies in the fact that he was the first to cut loose entirely from the labour theory of value and from all its implications for distribution. He was also the first to stress positivist method of study in economics. This entitles him to the status of one of the chief founders of the formalist equilibrium analysis which is the essence of the present- day value theory.

Self Check Exercise-5

Q.1 What do you know about Say’s Distribution Theory?

## **8.9 Say’s Law of Markets**

Say’s contributions to the development of economic thought that we have mentioned above in the preceding sections of this lesson are not much remembered today. But his Law of Markets, which had been explicitly or implicitly subscribed to by all mainstream classical and neoclassical economists, has become, in the words of Alexander Gray, “Say’s passport into the company of the immortals.” We have already explained its essential idea in the last lesson in the context of the Ricardo-Malthus controversy over it. This essential idea underlying this law is that supply creates its own demand- As Say himself observes, “it is production which creates markets for goods,” Goods and services are only superficially bought with money. In reality, they are bought with other goods and services. Say looks upon money merely as the “carriage” which, having effected the exchange of two goods, will immediately go on to exchanged others. In fact, products are always

exchanges for products. Therefore, as Say puts it. "Sale does not take place not because money is scarce, but because other products are so." It follows, then, that general overproduction is impossible. If certain products are in excess supply, it can only be due to there being shortage of some products elsewhere so that' partial overproduction is matched with partial underproduction. The remedy is to produce more of the products which are in short supply which will automatically provide market for products in excess supply.

Say drew three conclusions from his Law of Markets: (1) The more numerous and extensive the markets, the more lucrative they are, because increased demand leads to more remunerative prices. (2) The Hume-Smun proposition that everyone is interested in the prosperity of everyone else; there is a harmony of interests of producers and consumers because everyone is both a seller and a buyer: prosperity of every one results in increase in demand for the products of others. (2) There should be free foreign trade, because imports do not harm domestic production but open markets abroad for domestic products, as imports are exchanged with exports.

It should be noted that Say's Law could be valid only in a barter economy. When Say applies it to a money economy, he is assuming that money functions only as a medium of exchange and it is never hoarded. Because if it is hoarded or if it is demanded and used as store of value the Law of Markets would not work. If we split the economy into two markets a product market and a money market, and suppose that there are goods of which  $n-1$  are réal goods and  $n$ th good is money, then Say's Law would imply that money market is always in equilibrium, that is, the demand for money always equals the supply of money. This form of stating the law becomes Say's *Identity* which is merely a tautology. Similarly, when we assume that what is saved is automatically invested, an assumption which is *implied* in the classical "saving-is-pending" theorem, Say's Law again becomes an *identity* that is, a tautology which can never be refuted.

But it is said that what Say and other classical economists meant by Say's Law of Markets was that a freely competitive economy has the tendency to attain full-employment equilibrium, provided all price inclusive of factor prices are perfectly flexible. In this version, Say's Law does not rule out temporary general overproduction and unemployment but stresses that such a situation is a disequilibrium situation which tends to be corrected automatically through appropriate changes in prices. Such a situation in the product market is represented by the following inequality.

$$\sum_{i=1}^{n-1} P_i D_i < \sum_{i=1}^{n-1} P_i S_i$$

Where the left-hand side represents aggregate demand and the right-hand side represents aggregate supply. Thus the above inequality tells

that there is excess supply or general overproduction in the product market.

When there are only two markets, as we have assumed, and one of them suffers from excess supply, the other one must be having excess demand. This means that the market for  $n$ th, good, that is money market has excess demand as shown by the following inequality:

$$D_n > S_n$$

Where  $D_n$  is the demand for money and  $S_n$  is the supply of money.

Both the markets are in disequilibrium and therefore the economy as a whole is also in disequilibrium.

But, if prices are flexible, then product prices would fall, as supply of products is greater than the demand for them Demand for money, as Patinkin observes, is demand for real balances. When prices fall, people would find more real balances ( $M/P$ ) in their hands than they desire to hold. Hence they would try to get rid of their excess holdings of money by spending them on goods and for supplying it as loanable funds in the money market. This will result in a direct rise in the demand for products, on the one hand, and a fall in the sale of interest, on the other. The latter factor would lead to increase in investment, that is, increased demand for investment goods. This process would go on till the full-employment equilibrium is attained so that

$$\sum_{i=1}^{n-1} P_i D_i < \sum_{i=1}^{n-1} P_i S_i$$

and there is full-employment equilibrium in the economy.

The above interpretation of Say's Law is termed as Say's Equality which is a more meaningful than Say's Identity.

Self Check Exercise-6

Q.1 What do you know about Say's Law of Market?

## 8.10 John Stuart Mill (1806-1873)

There is a rare unanimity of opinion amongst economists, past and present, on the contribution of J.S. Mill to economics. It is generally assessed as a skillful "restatement" of the classical doctrines. Schumpeter's view is also, more or less, the same in as much as he describes Mill's *Principles of Political Economy* as the *classic* work of the period 1790-1870. But Schumpeter also observes that the economics of the *Principles* are no longer Ricardian." because Schumpeter sees some qualifications introduced by Mill which, in his opinion, are no mere qualifications of Ricardian economics despite Mill's having himself regarded it as such. Perhaps, Alexander Gray's observation that "his work is a restatement of the main doctrines of Ricardo and Malthus by one not insensible of the criticisms of the intervening thirty or forty years" is a more objective and representative a view of Mill's contribution to economics. In Gray's opinion, "Apart from certain elaborations of the theory of foreign trade, it is doubtful

whether Mill added much, or anything, to the body of economic doctrine.”

### **8.11 Mill on the Scope and Method of Economics**

Mill's views on the scope and method of economics show the influence of Adam Smith and Comte. The influence of the former is evident in his self-proclaimed aim to write an “up-to-date Adam Smith” and the reason that he gives for it Smith, observes Mill, “invariably associates the principles with their applications,” and “perpetually appeals to other and for larger considerations than pure Political Economy affords.” This implies that Mill regarded Political Economy not as a “pure or positive” science but as a discipline which loses its significance, if it shies away from making policy recommendations. No doubt, in his *Essays on Some of the Unsettled Questions of Political Economy* (1844) Mill gives the impression of regarding Political Economy to be a positive and analytical discipline, but if one is to judge his views on the matter in the light of his practice, one is led to the conclusion that for him Political Economy was a normative discipline which should be based on objective analysis.

On the other hand, under the influence of Comte who argued forcefully for a comprehensive social science and, therefore, for an interdisciplinary approach, Mill was inclined to redefine the scope of abstract economics so that Political Economy is regarded as only one department of a comprehensive sociology which was still to be created.

Self Check Exercise-7  
Q.1 What do you know about J.S. Mill? Discuss his views on the Scope and Method of Economics

### **8.12 Mill on Value**

Although Mill declared that “Happily there is nothing in the laws of value which remains for the present or any future writer to clear up; the theory of the subject is complete,” which was rather too strong a statement to make, yet Mill's theory of value, though recast in Ricardian mold, was not purely Ricardian in content, for it had admitted into it utility also as a determinant, though in somewhat peripheral manner. It is, in fact, restatement of Senior's theory of value rather than of Ricardo himself. He believes that utility determines the upper limit to the value of a commodity otherwise it is cost-of-production theory of Senior's mold. His cost of production includes “abstinence” to which is also added the reward for the capitalist's risk.

Mill distinguishes between goods produced under constant returns and perfect competition and goods produced and sold under monopolistic conditions. In the case of the former the price is shown to equal the cost of production and demand is believed to be of no consequence. In the case of the latter, the market price is shown to be determined by demand and supply. His theory focuses also on explaining the role of contention in smoothening out the differences between market prices and “natural” value which is either a monopoly

value or the long-run value determined by the cost-of-production forces.

### **8.13 Mill on Distribution**

Mill is famous for making a distinction between the laws of distribution and the laws of production. According to him, while production is determined by “natural laws” which depend on technical conditions of production and cannot be interfered with by man and his socio-economic institution, distribution is determined by “human institutions.” and “laws on customs of society” which, therefore, can be changed by social and political action.

Prof. Knight as well as Schumpeter interpreted the above distinction by Mill between laws of distribution and laws of production on the failure of the classical economists to perceive the distribution problem as a problem of valuation. But Mark Blaug's view on the matter is more objective and to the point. According to Blaug, “By this distinction Mill means not that the pricing of productive factors in functional distribution is independent of the technical conditions of production, but that the personal distribution of income among three main classes of society is influenced by the distribution of property itself the product of historical change.”

Self Check Exercise-8

Q.1 Discuss views of J.S. Mill on Value and Distribution.

#### **8.13.1 Theory of Capital and Interest**

Mill defines capital as stock, previously accumulated of the products of former labour which is nothing but the Ricardian concept which views capital as “past labour” and “congealed labour.” He also carries on the classical tradition of regarding capital as essentially consisting of advances to workers and its allied concept of the wages-fund.

As regards his theory of interest, it incorporates the abstinence theory of interest of Senior and is, at the same time, an improvement on it. While Senior talked of saving involving abstinence to be taking place, as it were, at a constant real (subjective) cost and, therefore, ignored individual difference, Mill's account of it suggests that the supply of saving has an increasing subjective cost and, therefore, the supply curve of saving is positively sloped. The demand side, however, is ignored in the general tradition of classical economics.

Rate of interest is looked upon as the reward for not consuming one's capital. In this context, Blaug makes a distinction between Senior's meaning of abstinence as sacrifice of consumption involved in creating capital and Mill's meaning of it as not consuming one's capital. The latter interpretation, that is, Mill's interpretation raises the question as to why a reward (interest) for not consuming one's capital is necessary. Neither Senior nor Mill has clearly explained that this reward is necessitated due to the time preferences of the people in favour of present over future consumption which is due to both, a rational feeling that one may not live to enjoy future consumption and a

failure to recognize the full worth, of consumption at a future date. But, according to Blaug, the essential idea of it is there. Therefore, unless a reward is paid, one would not give up present consumption for future consumption. Thus, Mill is led to conclude that rate of interest measures "the comparative value placed in the given society, upon the present and the future."

### **8.13.2 Theory of Wages**

As regards the determination of wages Mill's name is intimately associated with the Wages-Fund Doctrine to which he held very strongly, though he recanted it in the end. There was a classical tradition of mistakenly identifying capital with wage fund only out of which the workers were paid their wages, so that they could subsist through the period of production which, too, on the analogy of the agricultural production period, was mistakenly believed to be a year. This wages-fund determined the demand for labour. The greater was its size, the larger the demand for labour. On the other hand, at any given time the supply of labour which depended upon population was given. The rate of wages, which is determined by the demand for and supply of labour, was thus, according to the wages-fund theory, a simple matter of dividing the wages-fund by the number of workers available to work. This would yield the average rate of wages.

Mill's wages-fund theory had the implication that if capital accumulated at a greater rate than the rate of increase in population, the wage rate would raise over time on the implicit assumption that capital consisted of wages-fund only. On the other hand, if population increased -at a rate, greater than the rate of accumulation of capital, the wage rate would decline over time. It had another implication also which is this that if given the wages-fund, the workers combined into trade unions in order to raise their wages, it - would decrease employment and cause unemployment among workers. Thus the wages-fund doctrine could be and most probably was indeed used as a weapon against the trade union movement. It could and was also used as a Malthusian warning to the working class against multiplying themselves too rapidly for blaming them for their low wages on account of their preference for large families.

The- wages-fund theory, of course, had certain basic flaws such as: (1) capital does not consist of wages-fund only; it comprises fixed capital and raw materials also. (2) It follows, therefore, that the wages-fund is not fixed even in the short period which is the simplistic assumption of this theory. (3) Moreover, the theory fails to explain how the total capital is divided between wages-fund, on the one hand, and fixed capital and raw materials, on the other. (4) Nor does the theory explain whether the proportion of the total capital that makes up the wages-fund is a fixed proportion or whether it would change over time. If it changes, in what direction it would change?

The most that can be said for the wages-fund theory is "that the wages fund doctrine contains whatever theory of the demand for labour was developed by the classical economist" (Blaug)



### 8.13.3 Theory of Rent

Mill restated Ricardo's theory of rent almost in *toto*, offering no amendments. He believed it to be a surplus over and above the cost of production determined by differences in fertility of different plots of land. He also restated the general Ricardian corollary that any factor that raised agricultural prices would increase rents. Or any factor that reduced agricultural prices would decrease rents. One typical Millian policy conclusion that is drawn from this theory of Ricardo is that rent being an unearned income, it should be taxed and even socialization of land should be considered.

### 8.13.4 Dynamic Theory of Class Shares

His theory of class shares is also a perfect restatement of Ricardo's Theory. He interprets "economics progress" as taking place as the result of increase in population, capital accumulation and technological progress which raises productivity. His general conclusion is that economic progress has the effect of raising the share of rent; money wages also rise due to diminishing returns in agriculture and consequently the share of profits tends to decline. He also repeats Ricardo's *fundamental theorem* of distribution expressing an inverse relationship between wages and profits.

In Mill's own words, "The economic progress of a society constituted of landlord, capitalist, and labourers, tends to the progressive enrichment of the landlord class; while the cost of the labourer's subsistence tends on the whole to increase, and profits to fall."

Self Check Exercise-9

Q.1 Discuss J.S. Mill's Theory of Capital and Interest.

Q.2 Discuss J.S. Mill's Theory of wages.

Q.3 Discuss J.S. Mill's Theory of Rent.

## 8.14 Mill on Stationary State

The concept of a stationary state is an integral part of classical economics. We have it in Mill as much as in Adam Smith and Ricardo. Schumpeter has aptly pointed out that the concept of stationary state has two meanings. In one sense it refers to the actual condition of the economic process which the classical economists expected to materialize sometime in future. In the other sense, it refers to a conceptual construct or a tool of analysis that is employed to isolate, for the purpose of a preliminary study, the group of phenomena that would be observable in an unchanging economic process.

The classical used the concept in both the senses, thought they did it consciously in the first sense and unconsciously in the second sense. Following the analysis of Ricardo, Mill also reached the conclusion that the process of economic or "industrial" progress was bound to end into a stationary state due to fall in profits to the bare minimum beyond which there could be no further accumulation of capital and no growth of population either, 'industrial progress' being

dependent on the accumulation of capital would thus come to a standstill.

The most characteristic feature of Mill's treatment of the concept of stationary state, however, is his belief that only by arriving into a stationary state can we hope for a solution of the social problem. Though alarmed at the economic significance of the prospect of the stationary state, he was very much sanguine of its ethical and spiritual import. Therefore, unlike his predecessors who were dismayed by the idea of the stationary state he seemed almost to welcome it. On the whole, he believed that such a state of society would represent a considerable improvement on the then state of society from the point of view of spiritual attainments, while economic conditions, though not improving further would also be better.

According to Schumpeter, Mill was also "the first to recognize *explicitly* the methodological importance of "using the concept of the stationary state in the analytical sense."

#### Self Check Exercise-10

Q.1 Discuss views of J.S. Mill on Stationary state.

### 8.15 Mill and the Theory of International Trade

Like many others Mill simply restated Ricardo's Comparative Cost Theory of international trade. But in it, his important contribution to the theory of international values is his theory of reciprocal demand which improves upon and adds to Ricardo's analysis of gain from international trade and its distribution between the trading countries.

Ricardo had pointed out that the distribution of gain from international trade would depend on the terms of trade between the participating countries. But he had failed to explain how these terms of trade would be determined except to mention the two limits given by the domestic comparative cost rates of the two countries. Under conditions of bilateral monopoly, the terms of trade would be indeterminate between these two limits. Ricardo and his immediate followers did not bother about the problem and carelessly and arbitrarily assumed that the gain would be equally divided between the participating countries.

Some writers after Ricardo, particularly Torrens, had realized that the indeterminateness of the terms of trade could be removed, at least under conditions of perfect competition (or even, unilateral monopoly), by the mechanism of what Torrens was first to mention (in print) as the Reciprocal Demand. But it was Mill who set the theory of reciprocal demand on its feet.

Making the usual simplifying Ricardian assumptions of only two countries of equal size and productive capacity and only two commodities, Mill sets out to find out the equilibrium terms of trade with the help of the "antecedent" law of demand and supply. He concludes that the equilibrium ratio of exchange between the goods of the two countries, that is, the terms of trade between them would be determined by the condition that the quantity of each of the two goods that the importing country is willing to accept at that exchange ratio be

equal to the quantity that the exporting country is willing to part with at that exchange ratios. This is described as the Equation of International Demand. If the above said quantities are not equal, competition of “buyers” and “sellers” will adjust the exchange ratio in a manner so as to fulfill the condition of equilibrium. This, in nutshell, is Mills Doctrine of Reciprocal Demand.

#### Self Check Exercise-11

Q.1 Discuss of J.S. Mill’s theory of International Trade.

### 8.16 Summary

In the present lesson, we have dealt with the contribution of Jean Baptiste Say, who is now much more known on account his Law of Markets popularly known after his name as Say’s Law than for anything else, and John Stuart Mill who indeed was much more than a mere economist but whose *Principles of Political Economy* served as the most popular textbook on economics in the whole English to the evolution of the science of economics. J. B Say was perhaps the first economist to explicitly recognize economics or political economy (no distinction between the two was made at that time) as an exact science. He seems to look upon its method of analysis as deductive in nature. For, he states that the science of political economy consists of a small number of fundamental principles or postulates and a large number of corollaries derived from them. The fundamental principles are not speculative in nature and are no figment of imagination. They are derived from the nature of things exactly in the same manner as the principles of physical sciences are derived from the nature of things.

It was this conception of the nature of economics which enabled him to write his treatise in a most systematic manner, he classifies all economic activities into three categories production (which subsumes exchange also) distribution and consumption. He also takes note of three factors, land, labour and capital in the classical tradition but a specific novel feature of his treatment of factors of production- is that the fourth factor, enterprise (organization), which fully established itself in Marshall's *Principles*, has been articulated by him and. according to Gray, it is “looming large” in Say’s *Treatise*. Say’s theory of value as not strictly in conformity with the classical tradition rather in this theory be deviates from its pure classical form, it is neither a labour theory of value nor a purely cost-of-production theory. It, in a way, breaks new ground by giving importance to utility in the determination of value. Say made an analytical use of his utility theory of value in eliminating Adam Smith’s distinction between productive and unproductive labor on the basis of the materiality or “vendibility” of commodities the basis on which he excluded all types of direct services such as the services of physicians, teachers, lawyers, singers, dancers, administrators, etc. from the category of “productive labour”. His so-called doctrine of immaterial products implies that (1) direct services like the service of a doctor are “productive”, provided they possess utility as the physician's service has utility for patients; (2) these services are immaterial

products, the distinctive quality of which is that they are consumed as they are produced and, unlike material products, are not amenable to preservation and are thus incapable of accumulation. Say was one of the first of those economists who explained the demand for factors of production as a *derived* demand. The central feature of his theory of distribution is the concepts of the “productive services” and of the “entrepreneur”. According to him, labour, natural resources (land) and capital have value because of the productive services that they supply. Their productive services consist in this that they help in producing commodities which have utility. Commodities get their values from their utilities, and the factors of production get their value from the values of the commodities which they cooperate to produce. Thus, in his distribution theory, as later in the Austrian distribution theory, the utility of final goods produced is the ultimate determinant of the value of factors of production. All the factors of production possess the two attributes necessary for them to have value. These two attributes are their *scarcity* and their *indirect* utility. Say’s contributions to the development of economic thought that we have mentioned above in the preceding sections of this lesson are not much remembered today. But his Law of Markets, which had been explicitly or implicitly subscribed to by all mainstream classical and neoclassical economists, has become, in the words of Alexander Gray, “Say’s passport into the company of the immortals.” Say puts it. “Sale does not take place not because money is scarce, but because other products are so.” It follows, then, that general overproduction is impossible. If certain products are in excess supply, it can only be due to there being shortage of some products elsewhere so that partial overproduction is matched with partial underproduction. The remedy is to produce more of the products which are in short supply which will automatically provide market for products in excess supply.

Mill’s views on the scope and method of economics show the influence of Adam Smith that Mill regarded Political Economy not as a “pure or positive” science but as a discipline which loses its significance, if it shies away from making policy recommendations. No doubt, in his *Essays on Some of the Unsettled Questions of Political Economy* (1844) Mill gives the impression of regarding Political Economy to be a positive and analytical discipline, but if one is to judge his views on the matter in the light of his practice, one is led to the conclusion that for him Political Economy was a normative discipline which should be based on objective analysis.

On the other hand, under the influence of Comte who argued forcefully for a comprehensive social science and, therefore, for an interdisciplinary approach, Mill was inclined to redefine the scope of abstract economics so that Political Economy is regarded as only one department of a comprehensive sociology which was still to be created. He believes that utility determines the upper limit to the value of a commodity otherwise it is cost-of-production theory of Senior’s mold. His cost of production includes “abstinence” to which is also added the reward for the capitalist’s risk.

Mill distinguishes between goods produced under constant

returns and perfect competition and goods produced and sold under monopolistic conditions. In the case of the former the price is shown to equal the cost of production and demand is believed to be of no consequence. In the case of the latter, the market price is shown to be determined by demand and supply. Mill is famous for making a distinction between the laws of distribution and the laws of production. According to him, while production is determined by “natural laws” which depend on technical conditions of production and cannot be interfered with by man and his socio-economic institution, distribution is determined by “human institutions.” and “laws on customs of society” which, therefore, can be changed by social and political action. His theory of class shares is also a perfect restatement of Ricardo's Theory. He interprets “economics progress” as taking place as the result of increase in population, capital accumulation and technological progress which raises productivity. His general conclusion is that economic progress has the effect of raising the share of rent; money wages also rise due to diminishing returns in agriculture and consequently the share of profits tends to decline. He also repeats Ricardo's *fundamental theorem* of distribution expressing an inverse relationship between wages and profits concept of stationary state has two meanings. In one sense it refers to the actual condition of the economic process which the classical economists expected to materialize sometime in future. In the other sense it refers to a conceptual construct or a tool of analysis that is employed to isolate, for the purpose of a preliminary study, the group of phenomena that would be observable in an unchanging economic process. The most characteristic feature of Mill's treatment of the concept of stationary state, however, is his belief that only by arriving into a stationary state can we hope for a solution of the social problem. Though alarmed at the economic significance of the prospect of the stationary state, he was very much sanguine of its ethical and spiritual import. Like many others Mill simply restated Ricardo's Comparative Cost Theory of international trade. But in it, his important contribution to the theory of international values is his theory of reciprocal demand which improves upon and adds to Ricardo's analysis of gain from international trade and its distribution between the trading countries.

## 8.17 Glossary

### 1. Jean Baptiste Say (1767-1832)

J. B say, a French economist in the classical tradition and a contemporary of both Ricardo and Malthus, was famous in his times as the most successful interpreter and populariser of Adam Smith's economics in France. His Law of Markets popularly known in Say's Law which has been too much in discussion since the publication in 1936, of Keynes's *General Theory* was not regarded as a very spectacular idea at that time in spite of the Ricardo-Malthus controversy over all. The idea underlying this law, though not as

explicitly and lucidly expressed before Say, was, nevertheless, part and parcel of the mainstream classical economics. Anyway, one of his important contributions has been to sort out the confusion in Smith's work and to present the essentials of his system in an orderly and systematic manner with a remarkable lucidity.

## **2. John Stuart Mill (1806-1873)**

There is a rare unanimity of opinion amongst economists, past and present, on the contribution of J.S. Mill to economics. It is generally assessed as a skillful "restatement" of the classical doctrines. Schumpeter's view is also, more or less, the same in as much as he describes Mill's *Principles of Political Economy* as the *classic* work of the period 1790-1870. But Schumpeter also observes that the economics of the *Principles* are no longer Ricardian." because Schumpeter sees some qualifications introduced by Mill which, in his opinion, are no mere qualifications of Ricardian economics despite Mill's having himself regarded it as such. Perhaps, Alexander Gray's observation that "his work is a restatement of the main doctrines of Ricardo and Malthus by one not insensible of the criticisms of the intervening thirty or forty years" is a more objective and representative a view of Mill's contribution to economics. In Gray's opinion, "Apart from certain elaborations of the theory of foreign trade, it is doubtful whether Mill added much, or anything, to the body of economic doctrine."

- 3. Distribution:** the act of sending goods from the manufacturer to the wholesaler and then to retailers.
- 4. Comparative advantage:** A theory of international trade that originated with David Ricardo in the early 19th Century, and is maintained (in revised form) within neoclassical economics. The theory holds that a national economy will specialize through international trade in those products which it produces relatively most efficiently. Even if it produces those products less efficiently (in absolute terms) than its trading partner, it can still prosper through foreign trade. The theory depends on several strong assumptions – including an absence of international capital mobility, and a supply-constrained economy.
- 5. The term 'reciprocal demand'** was introduced by Mill to explain the determination of the equilibrium terms of trade. It is used to indicate a country's demand for one commodity in terms of the quantities of other commodities it is prepared to give up in exchange. It is reciprocal demand that determines the terms of trade which in turn determines the relative share of each country. Equilibrium would be established at that ratio of exchange between the two commodities at which quantities demanded by each country of the commodity

which it imports from the other should be exactly sufficient to pay for another.

**6. Capital Accumulation:** This refers to profits that a company uses to increase its capital base. Capital accumulation involves acquiring more assets that can be used to create more wealth or that will appreciate in value. Alternatively, capital accumulation can also refer to when an institutional broker or individual investor acquires a large number of shares of a particular stock or mutual fund over an extended period of time.

**7. Real-Balance Effect:** A change in aggregate expenditures on real production made by the household, business, government, and foreign sectors that results because a change in the price level alters the purchasing power of money. This is one of three effects underlying the negative slope of the aggregate demand curve associated with a movement along the aggregate demand curve and a change in aggregate expenditures. The other two are interest-rate effect and net-export effect. The real-balance effect is somewhat analogous to the income effect underlying the negative slope of the market demand curve.

**8. SAY'S LAW:** A principle of classical economics developed the French economist Jean-Baptiste Say that is commonly summarized as "supply creates its own demand." This law, also referred to as Say's "theory of markets" or "law of markets," indicates that the act of producing aggregate output generates a sufficient amount of aggregate income to purchase all of the output produced. This principle indicated that excess production or insufficient demand for production was unlikely to occur, at least for any extended period. When combined with flexible prices and saving-investment equality, Say's law further implied that an economy would achieve and maintain full employment of resources. This law was singled out by John Maynard Keynes in his critique of classical economics, but remains relevant in current macroeconomic analysis, reflected in the circular flow model.

## **8.18 Answers to self check Exercises**

Self Check Exercise-1

Ans.1 Please Refer Section 8.3 and 8.4

Self Check Exercise-2

Ans.1 Please Refer Section 8.5

Self Check Exercise-3

Ans.1 Please Refer Section 8.6

Self Check Exercise-4

Ans.1 Please Refer Section 8.7

Self Check Exercise-5

Ans.1 Please Refer Section 8.8  
Self Check Exercise-6  
Ans.1 Please Refer Section 8.9  
Self Check Exercise-7  
Ans.1 Please Refer Section 8.10 and 8.11  
Self Check Exercise-8  
Ans.1 Please Refer Section 8.12 and 8.13  
Self Check Exercise-9  
Ans.1 Please Refer Section 8.13.1  
Ans.2 Please Refer Section 8.13.2  
Ans.3 Please Refer Section 8.13.3  
Self Check Exercise-10  
Ans.1 Please Refer Section 8.14  
Self Check Exercise-11  
Ans.1 Please Refer Section 8.15

## **8.19 References/ Suggested Readings**

7. Eric Roll: "*A History of Economic Thought*".
8. C. Gide and G. Rist: "A History of Economic Doctrines".
9. J.A. Schumpeter: "*History of Economic Analysis*".
10. J.S Mill: "*Principles of Political Economy*".
11. M. Blaug: "*Economic Theory in Retrospect*."

## **8.20 Terminal Question**

- Q1. Explain J.B. Say's contribution to economic Thought?
- Q2. Describe the Mill Theory of Value?



## Unit -9

# THE CRITIQUES OF THE CLASSICAL THOUGHT (1): THE GERMAN ROMANTICS

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### Structure

- 9.1 Introduction
- 9.2 Learning Objectives
- 9.3 The German Romantics  
Self Check exercise-1
- 9.4 Gentz (1764-1832)  
Self Check Exercise-2
- 9.5 Adam Mueller (1779-1829)  
Self Check exercise-3
- 9.6 Frederick List (1789-1846)  
Self Check Exercise-4
- 9.7 Summary
- 9.8 Glossary
- 9.9 Answers to self check Exercise
- 9.10 Reference/ Suggested Reading
- 9.11 Terminal Questions

### 9.1 Introduction

The classical economic philosophy though in ascendancy during the first half of the nineteenth century and even beyond it till the Neoclassical economic thought began to replace it during the last quarter of the nineteenth century, did not go unchallenged. The critique of the classical economic thought came from various sources. 'There was a critique which was internal to it in the sense that it merely endeavored to eliminate what were believed by the authors of this type of critique as the logical inconsistencies and analytical imperfections of the mainstream classical economics without attempting to reject the fundamental principles of it. This critique took the form of not an explicit negation of its general conclusions, but the form of a technical argument which accepts many of the fundamental tenets of the mainstream classical economics as represented by the thought of Smith and Ricardo but opposes their application to certain practical problems. This line of critique is represented by the dissident streak in the writings of Malthus and Lauderdale who questioned and doubt the validity of Say's Law. Another source of its critique which was more political than economic in character was the German romantics who questioned the unbridled individualism and laissez-faire implications of

the classical doctrine and instead tended to glorify nation and the state. A third type of critique came from the French socialists who brought into the open the seamy side of the capitalist economic development. Still another type of critique emanated from Marx and his followers who, though they claimed their own theory to be a continuation of the classical tradition of Smith and Ricardo, criticized the later classical economists whom Marx described as “vulgar” economists who abandoned the labour theory of value and the theory of surplus value of Smith and Ricardo and, instead, confined their analysis to superficial phenomena.

## **9.2 Objectives**

After going through this lesson you will be able to:

- Explain Adam Mueller contribution to the theory of money
- Give a detail critique of Classical thought by Frederick List
- Elucidate the contribution of Gentz in economic thought

## **9.3 The German Romantics**

In the early nineteenth century Germany was economically backward compared to even its immediate Western neighbor's like France and Holland not to speak of England. There neither the practice nor the theory of capitalism was in a developed state. Those who were eager to bring Germany economically and intellectually on level with its neighbour's could not ignore for too long the economic philosophy of the classmates from both France and England. The German Romantic Movement appeared as a reaction against the influence which the classical economics was beginning to have in Germany too. The German romantics turned for their inspiration to the pre-classical mercantilists who, in Germany, were known as the cameralists as regards what passed for their economic theory and economic policy. They also rejected the general philosophy underlying the classical system of economic thought namely, the philosophy of French Enlightenment which preached anti-feudal values of individual freedom and liberalism. Instead, they seem to have evolved a philosophy of their own which was rooted in their peculiar view of the Middle Ages and its feudal values. Therefore they opposed the philosophy of natural law and its implied individualism and utilitarianism. Their thought was influenced by the reactionary part of the thought of Fichte and Burke. Neither of them was, on the whole, a romantic or even a full-blooded feudalism. But their thought was complex enough to serve as a source of inspiration for opposing systems of thought.

French Revolution had threatened all the feudal regimes in Europe and backward countries like Germany became weary of the philosophies, both economic and political, which explicitly or implicitly supported the philosophy of French Enlightenment which was believed to have led to French Revolution. Burke, who was essentially a follower of the liberal utilitarian tradition of Locke and Smith, had made property alone the basis of government, giving landed property the pride of place. This and other such emphasis in his works could be isolated from his liberal utilitarian views to give support to the reactionary

feudal values. This colour in his thought was too loud in his *Reflections on the French Revolution* which was a forceful polemic against the French Revolution and its ideals. In this work of his we find an unconcealed anti-democratic element, emphasis on -stability, tradition and history against change progress and the abstract rights of the individuals and popular government. It was these elements which appealed to its German reaction as symbolized by the German Romantics. Edmund Burke's *Reflections on the French Revolution*, translated into German in 1793 by Gentz, became the chief source of inspiration for the German Romantics.

They also derived inspiration and ideas from Fichte who laid much emphasis on the state, each part of which, he believed, had the rationale of its existence by virtue of its participation in the whole. The glorification of the State and the Nation which is the hall-mark of German Romantics was inspired largely by Ficht's philosophical thought.

Self Check Exercise-1

Q.1 What do you know about The German Romantics?

#### **9.4 Gentz (1764-1832)**

Gentz was an admirer of the English liberalist school, to begin with. He was an admirer of even the French Revolution. Even when his opinion on the French Revolution remained no longer approbatory, he continued to believe in the liberal as much as the conservative parts of Burke's thought. He continued to have his faith in the virtues of free trade and did not regard even the supremacy of England in foreign trade as harmful as the later protectionists did. He shrouds even Smith's optimism and like him regarded self-interest as the main motivating force of human conduct. He also partook of Smith's belief that the pursuit of self-interest by every individual results in the common good of all.

But, later, his views were transformed and the emphasis on liberal values dried up. His later views on the state were no longer in harmony with Smith's views. He particularly emphasized the power of the state, through its fiscal policy, to influence the economic activity of the nation. He argued for indirect taxes and set up feudal domains as model for farmers.

His emphasis on the role of the state is much in evidence in his theory of money also. According to him, it is the word of the state which makes anything into money, which led to Knapp's state theory of money. It became the common characteristic of all German romantic economic thought. Gentz's concept of money naturally led him to support inconvertible paper money.

Self Check Exercise-2

Q.1 What do you know about Gentz? Discuss his views.

#### **9.5 Adam Mueller (1779-1829)**

Gentz was popularly regarded as essentially the politician rather than the theorist of the German Romantic School, while Adam Mueller

was regarded and in fact, was a theorist of the Romantic School. This is not to say that the theorizing of the latter had led him to formulate any systematic economic theory alternative to the classical theory which he and his friends of the Romantic School criticized and rejected in his theorizing we do not find any economic analysis as such but at least only what can be described as economic thought.

Like his friend Gentz, Adam Mueller too was sympathetic to Adam Smith's system which is obvious from his review of Fichte's *Handelstact*, in which he criticized Fichte from the standpoint of Smithian economic philosophy. But, in his later writings, he comes out as an anti-Smith. In his later writings and philosophical romantic meanings, he emphasized altruism and religion in place of Smith's "egoism", or "self-interest", and "materialism". The rather most outstanding feature of his thinking was the glorification of the state which was the antipode of Smith's thought which glorified the individual and his freedom to pursue his self-interest. According to Mueller, state was the supreme organism of which individuals were tiny cells.

He postulated only two social sciences which he described as Law and Wisdom which included both economics and politics. Religion was supposed to unite them. Without religion, he argued, economic activity loses its purpose. Production, in his opinion, should be done for its own sake and for God's sake and not for the material rewards which motivates individual's behaviour in the world of Adam Smith. In contradiction with the classical thought, he asserted that labour was not the sole source of produce.

His theory of property, wealth, production and capital was idealist in the philosophical sense and was highly vague. It served a reactionary purpose in so far as it led him to idealist feudalism and reject capitalism without any consideration paid to its progressive elements. Accordingly, we find in him a strong fascination for the feudal system which recognizes no absolute right in private property. He also proposed a marriage between Roman-British law and feudal laws to buttress feudalism.

He had a totalitarian concept of the state and wealth that was defined by him in terms of the totalitarian state as strengthening, of the "national household". Along with the glorification of the state comes inevitably the glorification of the nation. He was no purchaser of the classical doctrine of *laissez-faire*. Instead, he opposed it directly and vehemently. He was in favour of complete national autarky to which he gave no idealist and mystic garb. His argument for attaining national autarky had nothing to do with the mercantilists materialist principle is balancing of incoming and outgoing flows of money or species. Nor was it a simple closing of doors on imports. His was a more active plea to nourish a love for home-produced goods a plea for adopting the *swadeshi* spirit in a fundamentally religious manner. He argued that free trade was destructive of national cohesion whereas it made each member of the state a citizen of the world thus uprooting him from his nation and its specific ethos. In this respect, he shows clearly the influence of Fichte who wanted his ideal state to be insulated from the shocks of the outside world. Mueller, perhaps, went a step ahead by

wanting it to be closed to the outside world because he was apprehensive that otherwise it might lose the blind obedience of its citizens.

Mueller's theory of money also bore the signs of Fichte's influence, derived as it was from Fichte's distinction between Welt geld (world money) and Land geld or Nation geld (national money). He had a mystic approach to the concept of money which he interpreted as the economic form which the inevitable union of the individuals making up the state assumes. Like the state, he argues, money also binds the individuals of a state or nation together. In answer to the question what money is, his reply is: "an imperial word" which leads him to the defense of inconvertible paper money? As usual, his arguments are not economic in character but reflect a mystical nationalism and state worship. Inconvertible paper money is preferred by him to metallic money not on account of any material economic advantages of the former against the latter, but because the latter is cosmopolitan in nature by virtue of which it destroys the link which lies each individual indissolubly to his own state and nation. Paper money, on the other hand, is national and patriotic in nature and represents the medieval values.

He, in a mystical manner, advocated not only inconvertible paper money but also protection and no taxation of landed property. All this shows that Mueller had hardly any economic argument on any economic problem he had only mystically nationalistic arguments on economic concepts as well as economic issues. All this served feudal reaction to progressive capitalism.

Self Check Exercise-3

Q.1 What do you know about Adam Mueller? Discuss his views.

## **9.6 Frederick List (1789-1846)**

An economic thinker of note in Germany in the first half of the nineteenth century was Frederick List who has carved a permanent place for himself in the history of economic thought by virtue of his theory of protection which was directly opposed to the classical doctrine of free foreign trade. Though he too was nationalistic in his approach, yet he was no sentimental or mystic nationalist. On that very account he cannot be placed strictly speaking, in the company of the German romantics. His arguments were genuinely economic and analytical in character in spite of much of his economic thought having been inspired by his economic nationalism.

Frederick List can be aptly described as the representative of a nascent German industrialism. But, while relatively advanced capitalist development and a more solid foundation of capitalism in England had made Smith and Ricardo great advocates of free trade, the underdevelopment of Germany at the times made List into an apostle of economic nationalism. He rejected liberalist cosmopolitanism implied in the classical political economy on the ground that it ignored the nation without which the individual could not exist, according to him. The individualism or the "atomism" of Smith, he argued, ignored the national bond and treated individuals not as citizens, of a nation but

only as producers and consumers. According to him, the position of an individual even as an economic unit depended upon the strength of the national power. It is this idea of nationality of his which unites him with his romantic cousins.

His idea of nationality leads him to propound what has come to be known as his doctrine of *productive power*. Unlike the classical economists and much like the romantics, he argued that the national power should not be estimated in terms of the exchange-value. What was important to a nation and to individuals was not so much the actual size of the material wealth which they possessed as their productive power. He defined productive power as ability to replace, preferably, with an increase, what had been consumed. A true view of national productive power, according to him, would take into account all the nation's resources in their mutual relationship. His "productive power" was derived from both economic and non-economic factors. In this context, he referred to moral and political institutions, freedom of thought and conscience freedom of press, trial by jury, just government, justice, etc., which means that he believed that non-economic factors are also the determinants of economic development. But he also emphasized that of all the "productive forces, manufacture, that is, and industrialization was the most important."

His idea of nationality as the binding force and his doctrine of the productive power combined with his pan-Germanism as well as his qualified approval of war are some of the features of his thought which tempt to give him a place among the romantics. But his nationalism was, as a matter of fact, quite different from the nationalism of romantics. While the romantics had a mystical notion of nationalism and served the interest of feudalism, List's nationalism eschewed romantic pseudo-poetical and mystical phrase mongering and also had a different purpose to serve the purpose of serving the interests of the nascent industrial bourgeoisie of Germany.

List's theory of economic policy led to the recommendation of a policy aimed at integrating and expanding the national market and protecting it from foreign competition. There was still feudal particularism rampant in Germany in which the different states were independent and they had mutual custom barriers, but they were open to foreign imports. List argued for an economic policy which would remove the mutual custom barriers of the German states and create a free-trade zone for the whole German nation. Change was first introduced in the state of Prussia in 1818 when it was divided to impose customs only at the frontier; to levy duty on manufactures not exceeding ten per cent; and to allow in the raw materials free of duty. The associations of merchants and industrialists sought to be generalize the arrangement, and in 1834, the whole of Germany except Austria was made into a single economic unit, thus integrating the national market which was in the interest of capitalist economic development based upon' modern large scale industry in the country and which also favored the interests of German merchants and industrialists. When the national market was integrated in 1834, the

tariffs on imports were low. But the pressure from industrialists led to the imposition of higher tariffs.

It was particularly at this juncture that List developed his theory of protection and became the economic theoretician of the national industrial bourgeoisie of Germany. His most famous work *National System of Political Economy*, published in 1840 expounded a theory of protection particularly suited to the needs of Germany embarking upon modern industrialization. His theory of protection was derived from his doctrine of productive power. From the point of view of developing the productive power of a nation, he postulated an ideal arrangement as the one in which there was an equilibrium between the different branches of production-Manufacture was considered by him not only as an indispensable part of such an arrangement but also as a sector that would hold balance and occupy the key position in it. Though he admitted that both industry and agriculture were essential to the strength of the nation yet he also stressed that without industry, other sectors of the economy could not develop and flourish. He argued that industrialization led to improvements in agriculture and also to the development of arts and sciences which a purely agricultural nation could not attain. But his emphasis on the strategic role of industrialization in developing the productive power of a nation in no way implied a neglect of agriculture. On the contrary, he stressed that a balance between agriculture and industry was the true principle of division of labour and, in this context; he asserted that Smith's exposition of this matter was one-sided due to what List believed to be Smith's neglect of the national interest.

List had a sort of "*stages theory*" of economic development. He argued that nations could be classified on the basis of the degree of attained civilization which, according to him progresses from, a savage stage through the pastoral, agricultural, agricultural-cum-manufacturing to the agricultural-cum-manufacturing- cum-commercial stage. This, according to him, the highest stage of economic development was a stage where all the three sectors-agriculture, industry and commerce which broadly correspond to the present-day classification of sectors as the primary, the secondary and the tertiary sector-were highly developed and in balance with each other. He believed that each and every nation might not be adequately equipped to attain the highest stage of development. But nations like Germany which possessed the necessary material and human resources could attain to the highest stage and must aim at it.

An important part of his theory which was counter-Smithian and counter-classical in nature was his view that equilibrium between agriculture, manufacture or industry, and commerce did not arise spontaneously as the natural result of the free working of the market forces which would stress the desirability of the classical policy of laissez-faire. On the contrary, he assigned to the state a positive and dynamic role in helping to attain the highest stage of development through such a balance. His theory of economic development smacks of the modern doctrine of balanced growth in which state plays a determining role. Accordingly, List rejected the classical doctrine of

laissez-faire. He did not reject the importance of democratic institutions as a non-economic determining factor in economic development. But, at the same time, he also emphasized that the state and government of a nation must take measures to ensure the establishment of manufacturing industry not only with the objective of competing with the industries of other nations but -also and more importantly with the aim of enabling the nation to possess a *permanent* productive power from which would follow benefits to future generation.

From the above follows his case for protection of home industries from foreign competition. But his argument for protection is the now famous "infant industries" argument: l'action should be used as a measure by the state to help in the establishment of industries. But, at the same, time, he emphasized that a policy of protection of home industries against foreign competition should be resorted to only if the nation had natural advantage in setting up the industries but the establishment of which was being thwarted by the competition emanating from the fully developed industries of foreign countries. Protective tariffs under such conditions were necessary and justified as educative measures. They should be used to nurse infant industries but only till the time these industries stood on their feet and became strong enough to face foreign competition.

There was no room for the protection of agriculture in his theory of protection. He advanced mainly three arguments against protection of agriculture. Firstly, List argued that industrialization itself benefited agriculture enough to obviate the need of protection to it. Secondly, he believed that differences of soil and climate provided a sort of natural protection to agriculture; therefore it did not require state protection. Lastly, he explicitly argued that industry required for its development cheap raw materials and food which would not be possible, if agriculture was protected. The last of the above arguments was, in fact, the most genuine on his part taking into consideration his general economic philosophy which was to serve and promote the interests of the rising industrial capitalists in Germany. The other two were merely auxiliary arguments, though, in the context of the contemporary conditions in German agriculture, they too were valid. German agriculture being quite flourishing and prosperous at the time did not require protection but it rather required wider market. An important implication of this part of his theory of protection was that England would be well- advised to abolish its Com Laws which would have, of course, met the need of German agriculture for a wider market.

Another important feature of List's theory of protection was that it recommended a policy of protection only as temporary and transitional measure. This, in fact, is implied in his "infant industry" argument. Protection was to be valid till a nation's industries developed to the level of the industrially most developed nation, namely, England. But what is more important is that he emerges from his theory not as an absolute anti- free trader and therefore an anti-classical but an ultimate supporter of the classical doctrine of free trade. As soon as all "suitable" nations, that is, those which had potential for industrial development developed their industries to the level of the industries of



the most developed nation (England), the time would be ripe for replacing the system protection with system of universal free trade.

The foregoing conclusion of List shows that, in fact, there was an inherent similarity between his theory and the classical theory despite his protection that apparently ran counter to the classical doctrine of free trade. List and his thought system as much represented industrial capitalism as the classical thought system, Moreover as we saw List's argument on protectionism issued into the free-trade argument. That is why, as Roll observes, J.S. Mill also accepted it evidently realizing that it ran within the free-trade logic.

All in all, List's economic theory and the manner of its presentation has such a composite flavour that he can be regarded as an heir to the eighteenth century thought, an off-shoot of German romanticism and also as a fore-runner of the historical school of economics at one and the same time.

Self Check Exercise-4

Q.1 What do you know about Frederick List? Discuss his views.

## 9.7 Summary

In this lesson we referred to the critiques of the German Romantics. The German Romantic Movement appeared as a reaction against the influence which the classical economics was beginning to have in Germany too. The German romantics turned for their inspiration to the pre-classical mercantilists who, in Germany, were known as the cameralists as regards what passed for their economic theory and economic policy. They also rejected the general philosophy underlying the classical system of economic thought namely, the philosophy of French Enlightenment which preached anti-feudal values of individual freedom and liberalism. Instead, they seem to have evolved a philosophy of their own which was rooted in their peculiar view of the Middle Ages and its feudal values. Therefore they opposed the philosophy of natural law and its implied individualism and utilitarianism. Their thought was influenced by the reactionary part of the thought of Fichte and Burke. Neither of them was, on the whole, a romantic or even a full-blooded feudalism. But their thought was complex enough to serve as a source of inspiration for opposing systems of thought.

French Revolution had threatened all the feudal regimes in Europe and backward countries like Germany became weary of the philosophies, both economic and political, which explicitly or implicitly supported the philosophy of French Enlightenment which was believed to have led to French Revolution. Burke, who was essentially a follower of the liberal utilitarian tradition of Locke and Smith, had made property alone the basis of government, giving landed property the pride of place. This and other such emphasis in his works could be isolated from his liberal utilitarian views to give support to the reactionary feudal values. This colour in his thought was too loud in his *Reflections on the French Revolution* which was a forceful polemic against the French Revolution and its ideals. In this work of his we find an unconcealed anti-democratic element, emphasis on -stability, tradition

and history against change progress and the abstract rights of the individuals and popular government. It was these elements which appealed to its German reaction as symbolized by the German Romantics. Edmund Burke's *Reflections on the French Revolution*, translated into German in 1793 by Gentz, became the chief source of inspiration for the German Romantics.

They also derived inspiration and ideas from Fichte who laid much emphasis on the state, each part of which, he believed, had the rationale of its existence by virtue of its participation in the whole. The glorification of the State and the Nation which is the hall-mark of German Romantics was inspired largely by Ficht's philosophical thought.

## 9.8 Glossary

1. **Capitalism:** An economic system in which privately-owned companies and businesses undertake most economic activity (with the goal of generating private profit), and most work is performed by employed workers who are paid wages or salaries.
2. **Production:** The process by which human labour (or "work") is applied, usually with the help of tools and other forms of capital, to produce useful goods or services.
3. **Productivity:** In general, productivity measures the effectiveness or efficiency of productive effort. Productivity can be measured in many different ways. Physical productivity measures the actual amount of a good or service produced (eg. tons of steel, or number of haircuts). Productivity can also be measured in terms of the value of output. Most commonly, productivity is measured as the amount of output produced over a certain period of work (eg. output per hour); this is considered a measure of labour productivity. But other approaches are also possible, including measurements of capital productivity (output relative to the value or physical quantity of invested capital) and "total factor productivity" (which is an abstract statistical measurement of the overall effectiveness of production).
4. **Egoism:** Egoism can be a descriptive or a normative position. Psychological egoism, the most famous descriptive position, claims that each person has but one ultimate aim: her own welfare. Normative forms of egoism make claims about what one ought to do, rather than describe what one does do. Ethical egoism claims that it is necessary and sufficient for an action to be morally right that it maximize one's self-interest. Rational egoism claims that it is necessary and sufficient for an action to be rational that it maximize one's self-interest.
5. **Self-Interest:** Acting in the way that is most personally beneficial. Adam Smith, the father of modern economics, famously explained that it is possible to achieve the best

economic benefit for all even when, and in fact because, individuals tend to act in their own self-interest. Smith wrote, "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 self-interest." Smith's explanation of the invisible hand showed that through the self-interested actions of dozens, hundreds and even thousands of people, without any centralized planning, goods and services get created that benefit both producers and consumers.

- 6. Materialism:** a way of thinking that gives too much importance to material possessions rather than to spiritual or intellectual things. philosophy : the belief that only material things exist.

## 9.9 Answers to self check Exercises

Self Check Exercise-1

Ans.1. Please Refer Section 9.3

Self Check Exercise-1

Ans.2. Please Refer Section 9.4

Self Check Exercise-1

Ans.3. Please Refer Section 9.5

Self Check Exercise-1

Ans.4. Please Refer Section 9.6

## 9.10 References/Suggested Readings

12. Eric Roll: "*A History of Economic Thought*".
13. Alexander Gray: "*The Development of Economic Doctrine*".
14. C. Gide and G. Rist: "*A History of Economic Doctrines*".
15. J.A. Schumpeter: "*History of Economic Analysis*".

## 9.11 Terminal Questions

Q1. On what ground the German Romantics criticized the classical thought?

Q2. Write a Short note on the contribution of Gentz in the economic thought?

## Unit - 10

# THE CRITIQUES OF THE CLASICAL THOUGHT (2): SOCIALIST CRITIQUES

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### Structure

- 10.1 An Introduction
- 10.2 Learning Objectives
- 10.3 Socialist Critiques
  - Self Check Exercise-1
- 10.4 Sismondi (1773-1842)
  - Self Check Exercise-2
- 10.5 Saint-Simon (1760-1825)
  - Self Check Exercise-3
- 10.6 Charles Fourier (1772-1837)
  - Self Check Exercise-4
- 10.7 Robert Owen (1771-1858)
  - Self Check Exercise-5
- 10.8 Pierre Joseph Proudhon (1809-1866)
  - Self Check Exercise-6
- 10.9 Summary
- 10.10 Glossary
- 10.11 Answers to self check Exercise
- 10.12 References/ Suggested Reading
- 10.13 Terminal Questions

### 10.1 An Introduction

In the last lesson we referred to the critiques of Malthus and the German Romantics. Both of these critiques were backward looking in the sense that their policy implications were a reversion to the feudal values and the feudal economic system. In this sense, it is obvious; the said two critiques served the interest of feudal reaction. But, at the same time, there was another type of critique of the classical system of economic thought which, unlike the classical, did not ignore the seamy side of capitalist economic development and, like Malthus uncovered the inherent contradiction of capitalist economic system. But, unlike the critiques of Malthus and the German Romantics this critique was forward-looking. The source of this critique was the socialists.

## 10.2 Objectives

After completing this chapter you will be able to:

- Explain the economic thought of Pierre Joseph Proudhon
- elucidate the economic thought of Charles Fourier
- enlighten the contribution of Saint-Simon in economic thought
- Give detailed sketch of social critique on classical thought

## 10.3 Socialist Critiques

The socialist critique of classical economics was progressive and even revolutionary in nature. Instead of serving the vested interests of the feudal class of landlords and the clergy, its policy implications served the interests of the working classes.

The socialist critique of classical economics was inspired by two factors. One of these was the revulsion and the revolt that the socialist critics felt against the evils of the capitalist system of production favoured by the classical, particularly against the proletarianisation and pauperization of the workers. This critique was focused on the production process through which a class of wage workers was created and the attendant exploitation of the workers by the capitalist employers during the first three or four decades of the nineteenth century. It uncovered the story of exploitation, oppression and misery of the working class, highlighting the substitution of wage-slavery in place of feudal serfdom. It emphasized how the capitalist mode of production and production relations led to the exploitation of the workers who, in the market place, suffered from an inherent weakness of bargaining power vis-a-vis their capitalist employers. It detailed how economic inequality between the two classes made the life of the workers even harsher and more miserable than under feudalism where the workers at least enjoyed security, while under the wage-slavery of capitalism they did not have even this safety net.

While the classical had emphasized mainly the positive attributes of capitalism and swept its negative aspects under the carpet, the socialist critique exposed and highlighted these negative aspects. 'Therefore, while the classical had emphasized, directly or indirectly, that capitalism implied an undreamed expansion of production and wealth along with expanding economic intercourse among nations of the world and the attendant cultural benefits such as liberalism in politics and the abolition of oppressive feudal and mercantilist regulations, the socialist, on the contrary, emphasized that such progress entailed costs which were borne by the working classes only. They highlighted the fact that the costs of capitalist economic progress were pauperism, unemployment, hard labour long working hours, dangerous and insanitary working condition and oppressive supervision for the workers in the factories.

The earliest working class agitations against the above listed evils of capitalism which led to the establishing and strengthening of the trade union movement were inspired by this socialist critique. This critique gradually developed into an economic theory of opposition to

the capitalist economic system as a whole which served the purpose of socialism.

The other source of inspiration for the socialist critique of classical thought lay in the liberalist ideology which had earlier prepared the way for the French Revolution, destruction of feudalism and the introduction of capitalism. The natural law philosophy and-utilitarianism which were associated with liberalist tradition were capable of being interpreted in both a revolutionary and a conservative way. Socialist thinking was inspired by the progressive liberalist ideals of freedom, justice, and equality; rule of reason and the greatest happiness of the greatest numbers.

The above two sources of inspiration intermingled with each other in the critiques of classical thought by individual socialist thinkers. But in general the British socialist critique was inspired by the first of the two factors mentioned above or, perhaps, it would be more correct to state that they were inspired more by the first and less by the second factor which might have been due to historical reasons. On the other hand, again for historical reasons, the French socialist critique in general was inspired more by the second factor and less by the first.

Moreover, it can also be said that some British socialists were inspired in their critique by certain aspects of the works of Smith and Ricardo and even Malthus themselves. The former two who believed in the labour theory of value and also had the concept of surplus value, had an implicit theory of exploitation of labour by capital which could be turned against capitalist system itself. The British socialists like Bray, Gray, Thompson and Hodgkin who are generally referred to as the Ricardian socialists were inspired by these aspects of the classical analysis itself.

We present below a brief account of the individual critiques of some of the more important thinkers belonging to the so-called socialist school.

#### Self Check Exercise-1

Q.1 Discuss about The socialist critique of classical economics.

### 10.4 Sismondi (1773-1842)

Sismondi, who was a Swiss, lived a good part of his life in France and also published almost all his works in French, on account of which he is often taken for a French thinker. In his first work *De la Richesse Commerciale* published in 1803, he appears as an uncritical disciple of Adam Smith. But in his second major work, *Nouveaux Principes De. Economie Politique*, published in 1819, he is no longer an uncritical follower of Smith. On the contrary, in this work- he throws up certain challenges to the classical system of Smith, Say and Ricardo.

While in his first work, *De la Richesse Commerciale* he had accepted Smith's account of the virtues of free competition which was believed to lead to a harmonization of individual and social interest, in his *Nouveaux Principes*, he challenges this basic premise of the classical political economy. Instead, he now highlights the evils which flow from a system of unfettered competition in the pursuit of individual self- interest within an environment of factory system of large scale

production. His analysis harps on the disharmonies of the capitalist system of production in contradistinction with the Smithian emphasis on the harmony between the Individual self-interest and general interest of the society.

Sismondi's model is rather quite simple, so simple that Gray is tempted to describe him "to be a man of one idea," that idea being that the capitalist system of production inevitably results in an excess of production of goods for which there cannot be an adequate demand. This overproduction is not the overproduction of some particular good or goods but is a general overproduction of goods. Sismondi thus joined issues with Say and Ricardo on Say's Law of Markets which is a cornerstone of not only the classical but also the neoclassical economics.

His argument ran as follows. Since capitalist production is motivated by the desire for maximum possible individual profit, the capitalist manufacturers try to squeeze these profits by paying to their workers a bare minimum subsistence in the form of wages. This becomes possible on account of the Malthusian principle of population, according to which the supply of population and consequently the supply of labour is infinitely elastic in relation to demand for labour. The workers are compelled to work for maximum hours for minimum of wages. A twelve to fourteen hours working day was quite common in his days. In this way the ancient physical slavery is replaced by only a system of wage slavery which is worse as it does not have even the relieving feature of security that the former had. While the workers produce more and more goods under the new system of large scale production with the help of machinery, they do not have enough purchasing power to buy the ever-increasing supply of goods. Thus there is a constant lack of adequate effective demand on account of under-consumption. Thus Sismondi's simple model expresses the classical premises of harmony of individual and social interest, of free pursuits of self-interest by individuals being led by an Invisible Hand to serve the social interest at large and of the capitalist process of economic development being a smooth "hitch-less" process passing from one state of equilibrium to another without crises intervening at all to be a false premises.

The above led him to reject the classical doctrine of *lasszie-faire* too which he, in his first work, had acclaimed. Unfettered competition was no longer a state of bliss. Mere accumulation of wealth is not enough. What is more important, in his view, is the control over wealth so that it is directed towards the increase in human happiness. So government's intervention is necessary. The classical conception of the functions of state is thus- also thrown overboard. It is wrong to confine its function to merely protecting the life and property of citizens. The state should, according to him, intervene to play a more positive role of protecting the economically weak against the economically strong and protecting the permanent interest of all against the temporary interest of each, and thus "to prevent men being sacrificed to the progress of a wealth from which they will derive no profit." If the society or the state as its representative and executive power does not intervene and the capitalist industrial system is left to take its natural course, the conflict

of interest will always be resolved to the advantage of the economically strong which will be nothing short of the triumph of injustice.

Sismondi also rejected the classical views on division of labour, inventions and large scale production as being beneficial to society. The pursuit of individual self-interest, he believed, led to increasing the speed of the machine of large-scale industrialism which, if not checked by the state, was sure, in its accelerated course, to plunge the "social chariot" into the abyss. He looked upon inventions as if they were the arch villain serving as a weapon in the hands of individual pursuit of self-interest which spurred and accelerated the speed of the machine of large scale industrialism. So, in contradistinction to the classical tradition of eulogizing inventions, he deprecates them. According to him, they kill intelligence in man and lower his bodily vigor, health and cheerfulness, thought they might increase his power to produce wealth. The normal effect of inventions is substitution of labour with machinery resulting in decrease in the demand for labour. This causes unemployment and misery for the poor. His opposition to inventions is not absolute, though since inventions lead to increase in productivity, therefore they should be welcome, if the existing consumption demand cannot be satisfied with the already available means and technology. As he observes, "Whenever demand for consumption surpasses the means of production, any new discovery is a benefit for society, because it provides the means of satisfying existing needs. On the contrary, wherever production is fully sufficient for consumption, any similar discovery is a calamity because it does not add to the enjoyment of consumers anything else than that of satisfying their needs at a lower {nice, while it suppresses the very life of the producer." But he modifies the argument to state that if any invention extends the market for a commodity by lowering its cost and price to enable the poor sections who could not buy it earlier to buy it, then it is socially beneficial.

Sismondi's critique of classical economics was illuminating, inasmuch as it brought into the open the inner contradiction of the capitalist large-scale factory production on account of which the system stumbles into crises of overproduction. But his critique was reactionary in the sense that the remedy that he suggested for the evils of the large-scale capitalist factory system of production was to revert to the old system of handicraft production and even to the feudal type handicraft guilds. His criticism of capitalist production has been described by Lenin as petty-bourgeois, because he was looking at capitalist system from the point of view of petty producers and believed that the only way to prevent the proletarianisation of producers and the consequent misery of the proletariat was to revert to the handicraft system of petty production.

Sismondi was not a socialist in the modern sense of the term. In no ease did he argue for the abolition of private property. But he was writing at a time when ideas of utopian and bourgeois socialism were taking shape and his criticism of capitalism, describing in highly sympathetic terms the pathetically miserable conditions of the proletariat (incidentally, he was the first to use the term "proletariat" in the modern sense) that he was taken for a socialist by his



contemporaries. Moreover, he had also proposed measures which were considered at the time to be dangerously socialist though they are now considered merely reformist in character and are part and parcel of modern capitalism; for example, his proposals for social insurance and social security fear waters and also profit-sharing schemes for the workers.

Self Check Exercise-2

Q.1 Who was Sismondi? Discuss his views in detail.

## **10.5 Saint-Simon (1760-1825)**

Saint-Simon had a chequered life of rises and falls and it was only during the last ten years or so of his life that he produced his mature thought. One important anti-classical trait that he shares with Sismondi is that, unlike the classical, he does not believe that capitalism is a natural and permanent social system. Instead, he hypothesizes that it can be logically replaced by what he considers an improved socio-economic system which will be based upon cooperation between people rather than the classical competition. He visualized an industrial social system in which the economic and political power of the feudal lords and the class of money capitalists, both of whom he categorized as the "proprietary classes" will be eliminated and only the working "industrialists" would remain. He had classified the society of his times into only two classes, the idle "proprietors" who were the "drones" and the 'industrialists' who were the hard-working busy-bees of the society. The former was comprised of landlords and capitalist rentiers who did not actively participate in the social process of production. This class also included military and judicial bureaucracy. The other class, the class of the "industrialists" comprised all other sections of the society which, in Saint-Simon's estimate, made up 96 percent of the then French society. Thus his class of "industrialists" contained all those who actively worked physically or mentally and included even merchants, bankers and factory owners (entrepreneurs) along with peasants, hired factory and other workers, artisans, scholars\* and artists. He considered the incomes of the proprietary classes, the "drones" of society as illegitimate, while the incomes of the "industrialists, the "bees" of society, were legitimate. His was a pre-Marxian class approach, but a clear class approach, nevertheless.

Saint-Simon did not oppose the institution of private property in principle. He was opposed to what he considered the misuse of this institution. He did not argue for its abolition but only for a social control over it which indeed was an anti-classical thought running against the *laissez-faire* philosophy of the classical. He held that industrial Equality consisted in each drawing from society benefits exactly proportionate to his share in state...including, of course, his capital." However, when he speaks of capital, he has in mind industrial capital and not money capital. He believed that the government should play an active role in protecting the workers from the idle, unproductive and parasitic class of "proprietors;" that is, landlords and money capitalists. But he regarded entrepreneur capitalists, as distinguished from pure money capitalists, with approval, believing that they were natural organizers of production

and were, therefore, essential for the well-being of society. This indeed is a view reminiscent of Say.

Insofar as Saint-Simon did not oppose the institution of private property, he cannot be regarded as a true socialist. But his disciples, notably Saint-Armand Bazard and Prosper Enfantin, after his death interpreted and developed his ideas in a manner so as to impart to them an overtly socialistic slant. These ideas were published by them under the title, *Doctrine de Saint-Simon Exposition*.

In this work, the Saint-Simonians made Saint-Simon's ideal of "industrialism" the basis of a much more radical reform and attack on the capitalist system than we find in Saint-Simon's works themselves. The main lines of argument of Saint-Simonians were as follows. The institution of private property was attacked by them from the point of view of production and distribution on the one side, and from the point of view of justice and utility, on the other. As we have observed, Saint-Simon had emphasized on the contradiction between the "industrialists" or the "workers" or the "bees" of society, on the one hand, and the "proprietors" or "idles" or the "drones" of society's on the other. He had also underlined the impossibility of these two classes coexisting side by side. But Saint-Simon, due to a queer misconception, had justified the incomes of the industrial capitalists, though not of the pure money capitalists. His followers intervened here and asserted that private property in capital in general and not only in purely money capital was the worst of all privileges that levied a toll upon the industry of others." Saint-Simonians' definition of private property is sharply characterized by the power of levying such a tax on the earnings of those who do not possess property but depend only on their "industry."

Property was defined by them as anything not destined for immediate consumption but they had, in their mind, private property right on the agents of production, namely, land and capital. They argued that the distribution of these agents of production land and capital takes place in such a manner that the owners of property are able to exact a toll from the workers in the form of rent and interest. Thus the workers were exploited which was evidently the consequence of the institution of private property. Exploitation in their sense of the word was not limited to workers. Carrying on the master's tradition, they argued that even the entrepreneurs were exploited when the money capitalists charged interest from them. Entrepreneurs' profit was not considered exploitation of workers except when they shrank the wages of workers excessively. This only implies that they regarded profit as remuneration for entrepreneurs' work as organizers of production. However, they had no clear idea of a dividing line where profits cease to be a just remuneration for work done and became a "toll" on the workers' industry.

The Saint-Simonians also believed that the system of private property was not in the best interest of production even. It is because the institution of inheritance is inseparable from the institution of private property. But the institution of inheritance does not ensure that the agents of production, land and capital, will necessarily be transmitted into the hands of those who are capable of using them most efficiently

in production and in a manner best suited to the interest of society. Under the system of private property, each individual is guided only by the interests of his own family. No general view of production and social interests is taken. At this point their theory of economic crises, if it can be described as a theory, merges with that of Sismondi, since both of these are rooted in the notion of anarchic production that is perceived to be inevitable under atomistic competitive capitalism. This is indeed Saint-Simonian argument against the spirit of individualism emphasized in the classical political economy; Individual freedom under the system of private property, according to the argument of Saint-Simonians, leads to imbalances in investment between various sectors. "This wants of a broad-view of the needs of consumers and of the resources of production is the cause of those industrial crises whose origin has given rise to so much fruitless, speculation..." This obviously implies anarchy in production which, according to them can be eliminated by collectivism or socialism.

Their concept of socialism was that the state should become the sole inheritor of all sorts of wealth and the institution of private property should be done away with. The state should distribute the property in a way which would promote the general interest of the society. The best of citizens would be entrusted with tasks calling forth their utmost efforts. And, they would be paid according to their work. Thus their concept of the state and its functions was opposed to the classical concept which restricted the functions of the state only to the governance of people in the sense of protecting their life and property. But the state of Saint-Simonians' concept had to play a comprehensive role. It was to be a collectivist state entrusted with all the powers which the individuals under competitive capitalism wield, blindly guided by their individual self-interest. According to their conceptualization the state's function was to be the economic administration of things rather than the governance of men. This was the one idea of theirs which was first borrowed by Proudhon and, later by Marx and Lenin from them.

The Saint-Simonians also advanced historical argument in favour of the abolition of institution of private property and inheritance. This argument takes a dynamic view of the institution of private property and inheritance explaining how this institution evolved over historical time and asserting that the same historical forces are found to transform it in future too, understandably along the lines visualized by them. "Property", they argued, "is a social fact which, along with other social facts, must submit to the laws of progress. Accordingly it may be extended, curtailed or regulated in various ways at different times." The concept of private property in ancient times extended to men also. But, later, came to be confined to things only. They called attention to the changes in inheritance laws that took place over time in France from will to primogeniture to equal sharing among heirs, etc. The last stage in the sequence according to them was to be an arrangement in which everybody would be a proprietor during his or her life but the state would be the only inheritor. As they observe in *Doctrine de Saint-Simon : Exposition*, "The law of progress as we have outlined it would tend to establish an order of things in which the State, and not the family, would

inherit all accumulated wealth and every other form of what economists call the funds of production".

Self Check Exercise-3

Q.1 Who was Saint-Simon? Discuss his views in detail.

### **10.6 Charles Fourier (1772-1837)**

Amongst the French utopian socialists of early 19th century a famous name was Charles Fourier. His thought related to matters of political economy was based mainly on his observation and experience as he had hardly made any special study of the works of English and French economists. One specific feature of his thought was that he questioned the beneficence of the competitive capitalist system which the classical economists had underlined. Against the classical tradition of regarding capitalism as the natural and permanent socio-economic system, Fourier asserted that there could not be a more, imperfect system than the capitalist system "which brings with it all hardships." He regarded it merely a stage in social development. He had a sort of stages theory of social development and postulated four stages of socio-economic development: slavery, feudalism and free competition capitalism-which would be replaced by a new system based on cooperation rather than competition.

Fourier thought that capitalist production eulogized by the classical economists was anti-social, as the sole motive of production in such a system was to make as much individual profit as possible without any regard for the needs of the society. He too focused on the antagonism of interests instead of the classical harping on the harmony of interests.

The social system which, he conceived would displace the capitalist system and it would be characterized by "harmonies" and "composite association." But before that there would be a transition period when private property though not eliminated, would be subordinated to collective interests and control. They would be separate association of groups of families for communal labour, meals, leisure, etc. Such associations would overcome the drawbacks of the capitalist system based on wage-slavery and work would become a pleasure. This would soon convince people of the advantages of the new social system and prepare them to change over to a full socialist system based upon mutual cooperation and harmonism.

Self Check Exercise-4

Q.1 Who was Charles Fourier? Discuss his views in detail.

### **10.7 Robert Owen (1771-1858)**

Amongst the utopian socialists of the 19th century Robert Owen occupies a very high place. Marx described him as one of the patriarchs of socialism. Since he was a successful British industrialist, he knew all the evils and inequities of capitalist industry from the inside. Therefore he too, like other utopians, had dreams of reorganizing society on an equitable and cooperative basis. But he did not merely

dream but actually experimented with his ideas and even lost his fortune in these experiments.

Owen's socialism was based upon Ricardo's theory, particularly on his labour theory of value. He was the first to draw anti-capitalist conclusions from the classical economic theory. He refuted the Malthusian conclusions of the classical theory that the poor themselves were to blame for their poverty. Adducing statistical data on the actual and potential growth of production particularly on agricultural production, he 'demonstrated that it was not the poor themselves who were to be blamed for their poverty. On the contrary, it was the contemporary socio-economic system which was responsible for it.

His political economy, for what it was worth, was quite confused, though he sought to base his proposition on Ricardian value theory. He regarded labour both as a creator and as the measure of value. He rightly concluded that the worker under capitalism did not receive in wages the full equivalent of his labour. But he wrongly attributed it to the use of money. From it followed his queer proposal of introducing the labour unit as the measure of value and affecting exchange of commodities on the basis of this measure and the abolition of money. He believed that such a system would ensure the workers their just reward equivalent to their full labour. This, in his opinion, would remove overproduction and crises. Not only would that it also benefit landlords as well as capitalists. It is "only from labour liberally remunerated, that high profits can be paid for agricultural and manufactured products." How this can come about is not explained. But the proposition seems to imply the same old mercantilist misconception that profit arises in exchange.

As in the case of French utopian socialists, even so in the case of Owen the anti-classical ideas are to be found in denying that free competition and unhindered pursuit of individual self-interest result in the maximizing of social welfare ; in the stressed desirability of social interests having precedence over individual interests ; and in the plea that the state should play an active role in protecting the weak and the down-trodden against the strong instead of following the classical laissez-faire policy.

Self Check Exercise-5

Q.1 Who was Robert Owen? Discuss his views in detail.

### **10.8 Pierre Joseph Proudhon (1809-1866)**

A later French utopian socialist of somewhat different hue was P.J. Proudhon, though some of his thoughts had a strong similarity with those of Sismondi. His critique of capitalism, like that of Sismondi, revealed a petty-bourgeois outlook.

Proudhon's starting point, as with other utopian socialists, was the exploitation of the property-less working classes by the propertied classes which was perceived by him to be a great social and economic injustice. His thought was inspired, therefore by the moral idea of justice. But his definition of justice" was peculiarly his own. He interpreted it as reciprocity, equality and equilibrium in a system which, under the influence of Kant's and Hegel's philosophy (Kant's antinomies

and Hegel's thesis-antithesis dialectics), he perceived to be full of contradictions. But his search was more for the right idea which would abolish contradictions in the abstract than for the political means to remove those contradictions- That "right idea" he discovered in the idea of justice which he defined as equilibrium of opposing forces. He believed that society could make the fullest use of its powers when the forces of which it was composed were in equilibrium.

The most famous part of his thought is related to the institution of private property. But the above-mentioned idea of justice—the reconciliation and equilibrium of opposing forces—which underlay all his theories and practical proposal was particularly marked in his attitude towards property. Even though he had coined the phrase, "property is theft", yet he never cared to analyze the different forms of legal property and the economic relations underlying them nor did he condemn private property as such. On the other hand, he looked upon it as an essential condition of liberty. He also accepted the Lockean natural-law proposition that labour was the only source of wealth and constituted the 'only title to property, 'therefore he affirmed that every One was entitled to own and enjoy the fruits of his labour; this 'means that even within his own premises, his aphorism that "property is theft" was not universally valid. Property earned by dint of labour could not be "theft" if it was not abused to extract a tribute from others labours. He believed, though, that capitalist property gave power to its owners to extract an unearned tribute in the form of rent, interest and profits from the working classes. His policy conclusion, however, was not that private property should be abolished but that rent, interest and profits should be abolished as they were unearned and unjust incomes.

Nowhere does Proudhon propose the socialization of the means of production in order to eliminate the unjust and exploitative consequences of private property rights in the means of production. In his *Theory of Property* (1866) published posthumously, he, went to the extent of favoring retention of private property in its existing form with the provision of "equilibrating" guarantees. This sounds very much like Sismondi's. The assumption implied from the argument is that the contradictions would be reconciled and equilibrium would be established, if property was parceled out and consequently of agriculture, industry and other production were carried on by innumerable small producers. A definitional sleight abolishes property, for in such situation property is believed by Proudhon to disappear in effect, as the duties and claims of very one would be balanced and the power to extract unearned tribute from others would no longer exist.

On the subject of state and its functions, he argued against its existence as a coercive force and its displacement with, voluntary associations and "mutualism" for the administration of things as was proposed by Saint- Simonies also. These elements in his thought were a source of the political philosophy of anarchism.

Proudhon was realistic enough to recognize that large-scale industry could not be abolished entirely. Therefore the problem arose as to how it could be intergrated into his model of small-scale production by petty fanners and artisans. The solution that he suggested was that

large-scale enterprises should be made over to voluntary associations of independent workers free from state interference. The workers could imitate the capitalists and form companies to run large-scale enterprises. Thus, Proudhon laid the foundations of the economic philosophy of syndicalism.

But his syndicalism had to face the reality of the need for capital. The discussion of this problem led him to propound another theory which was peculiarly and specifically his own. He presented the theory and the proposal for setting up Exchange Banks. He had defined the abuse of private property rights as the ability and fact of extracting income without labouring for it and one important form that his unearned income took was interest on money. He argues that if everyone in need of money capital was able to obtain loans free of interest, no exploitation would take place and, moreover, the workers' syndicates would have no problem regarding the acquiring of money capital.

In this approach to the problem Proudhon unrealistically assumes money to be only a medium of exchange and applies to it the moral principle of the medieval scholastics. He concludes that lending money at interest amounted to charging for one and the same commodity again and again without losing property in it which was, of course, not "justice." The solution suggested was to set up a system of free credit through the establishment of Exchange Banks.

Exchange Banks of Proudhon's concept were to be established without any capital and thus without any interest burden. They would issue inconvertible currency notes, acceptable in exchange, against commercial bills arising from a credit sale. Interest being abolished, exploitation through property would also disappear, and every worker or group of workers would be able to get free money capital to buy means of production.

The scheme of exchange banks was indeed utopian and impracticable. Moreover, how could exploitation by the propertied class be abolished by merely abolishing interest? What about rent and profits?

Self Check Exercise-6

Q.1 Who was Pierre Joseph Proudhon? Discuss his views in detail.

## 10.9 Summary

The socialist critique of classical economics was progressive and even revolutionary in nature. Instead of serving the vested interests of the feudal class of landlords and the clergy, its policy implications served the interests of the working classes.

The socialist critique of classical economics was inspired by two factors. One of these was the revulsion and the revolt that the socialist critics felt against the evils of the capitalist system of production favoured by the classical, particularly against the proletarianisation and pauperization of the workers. This critique was focused on the production process through which a class of wage workers was created and the attendant exploitation of the workers by the capitalist employers during the first three or four decades of the nineteenth century. It uncovered the story of

exploitation, oppression and misery of the working class, highlighting the substitution of wage-slavery in place of feudal serfdom. It emphasized how the capitalist mode of production and production relations led to the exploitation of the workers who, in the market place, suffered from an inherent weakness of bargaining power vis-a-vis their capitalist employers. It detailed how economic inequality between the two classes made the life of the workers even harsher and more miserable than under feudalism where the workers at least enjoyed security, while under the wage-slavery of capitalism they did not have even this safety net.

While the classical had emphasized mainly the positive attributes of capitalism and swept its negative aspects under the carpet, the socialist critique exposed and highlighted these negative aspects. Therefore, while the classical had emphasized, directly or indirectly, that capitalism implied an undreamed expansion of production and wealth along with expanding economic intercourse among nations of the world and the attendant cultural benefits such as liberalism in politics and the abolition of oppressive feudal and mercantilist regulations, the socialist, on the contrary, emphasized that such progress entailed costs which were borne by the working classes only. They highlighted the fact that the costs of capitalist economic progress were pauperism, unemployment, hard labour long working hours, dangerous and insanitary working condition and oppressive supervision for the workers in the factories.

The earliest working class agitations against the above listed evils of capitalism which led to the establishing and strengthening of the trade union movement were inspired by this socialist critique. This critique gradually developed into an economic theory of opposition to the capitalist economic system as a whole which served the purpose of socialism.

## 10.10 Glossary

1. **Feudalism:** A type of economy (such as that in Europe in the Middle Ages) that is primarily agricultural, but productive enough to support a class of artisans and merchants. Feudal societies are composed of two main social classes: nobles and peasants. The nobility extracted the agricultural surplus from peasants through a system of tradition, mutual obligation, and (when necessary) brute force.
2. **Classical Economics:** The tradition of economics that began with Adam Smith, and continued with other theorists including David Ricardo, Thomas Malthus, Jean-Baptiste Say, and others. The classical economists wrote in the early years of capitalism, and they uniformly celebrated the productive, innovative actions of the new class of industrial capitalists. They focused on the dynamic economic and political



development of capitalism, analyzed economics in class terms, and advocated the labour theory of value.

3. **Capitalist Class:** The group of individuals (representing just a couple of percent of the population in advanced capitalist countries) which owns and controls the bulk of private corporate wealth, and which as a result faces no compulsion to work in order to support them.
4. **Socialism:** An economic system in which most wealth is owned or controlled collectively (through the state, other public institutions, or non-profit organizations), and the operation of markets is influenced or managed through regulation and planning.
5. **Trade Unions:** in developed countries, at least, trade union membership and influence has declined over the past three decades. Fewer wages are now set by collective bargaining, and far fewer working days are lost to strikes. unions, which are in effect a cartel of workers, probably make unemployment higher than it would be without them, as collective bargaining often pushes wages above the level that would bring labour supply and demand into equilibrium. These higher wages increase supply and reduce demand, with the result that there are more jobless people. Unions thus deepen a conflict between those in the labour market who are insiders, that is, union members, and those who are outsiders, typically non-unionised, poorly paid or jobless people. However, unions can combat the excessive market power of some firms, particularly when the firms (or a government) dominate a particular job market. They can support workers who are badly treated by management. They may sometimes provide an efficient, and thus valuable, channel for communication between workers and managers, particularly in countries such as Germany, where conflict between management and unions is viewed as unhealthy.
6. **Laissez-faire:** Let-it-be [economics](#): the belief that an economy functions best when there is no interference by [government](#). it can be traced to the 18th-century French physiocrats, who

believed in government according to the natural order and opposed [mercantilism](#). [Adam smith](#) and others turned it into a central tenet of [classical economics](#), as it allowed the [invisible hand](#) to operate efficiently. (But even they saw a need for some limited government role in the economy.) In the 19th century, it inspired the British political movement that secured the repeal of the Corn Laws and promoted [free trade](#), and gave birth to *the economist* in 1843. In the 20th century, laissez-faire was often seen as synonymous with supporting [monopoly](#) and allowing the [business cycle](#) to boom and bust, and it came off second best against [Keynesian](#) policies of interventionist government. However, mounting evidence of the inefficiency of state intervention inspired the free market policies of Ronald Reagan and Margaret Thatcher in the 1980s, both of whom stressed the importance of laissez-faire.

### 10.11 Answers to self check Exercises

Self Check Exercise-1

Ans. 1. Please refer Section 10.3

Self Check Exercise-2

Ans. 1. Please refer Section 10.4

Self Check Exercise-3

Ans. 1. Please refer Section 10.5

Self Check Exercise-4

Ans. 1. Please refer Section 10.6

Self Check Exercise-5

Ans. 1. Please refer Section 10.7

Self Check Exercise-6

Ans. 1. Please refer Section 10.8

### 10.12 References/Suggested Readings

16. Eric Roll: "*A History of Economic Thought*".

17. Alexander Gray and A. E. Thompson: "*The Development of Economic Doctrine*".

18. C. Gide and G. Rist: "*A History of Economic Doctrines*".

### **10.13 Terminal Questions**

Q1. Critically examine the positive and critical idea of the socialist school against the classical school?

Q2. Explain Saint Simon's views on economy and society, with special reference to his criticism of classical economic thought?

## Unit- 11

# THE CRITIQUES OF THE CLASSICAL THOUGHT (3): THE HISTORICAL SCHOOL

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### Structure

- 11.1 Introduction
- 11.2 Learning Objectives
- 11.3 The Rise of the Historical School
  - Self Check Exercise-1
- 11.4 The Founders of Historical School
  - Self Check Exercise-2
- 11.5 The Younger Historical School
  - Self Check Exercise-3
- 11.6 The Historical School: An Over-all View
- 11.7 A Critique of the Historical School
  - Self Check Exercise-4
- 11.8 Summary
- 11.9 Glossary
- 11.10 Answers to self check Exercises
- 11.11 Suggested Reading
- 11.12 Terminal Questions

### 11.1 Introduction

While the first half of the nineteenth century was dominated by the development and propagation of the classical system of economic thought as founded by Adam Smith and systematised by David Ricardo, on the one hand, and the critiques of the classical economics by the German Romantics and the utopian socialist thinkers of France and Great Britain, on the other, the second half of the century was dominated by three new currents of economic thought, namely, the Historical School of economic thought, the economic thought of Karl Marx and the neoclassical economic thought. Of these, the economics of Karl Marx was generally ignored and even suppressed on account of its political implications which were perceived to be dangerously subversive of the established values and institutions. Of the other two, the historical school was the senior of the two and was highly critical of the classical economics. Even within the historical school, there were two schools of thought, the senior and the junior school which are also referred to as the older and the younger school. The latter, that is, the junior historical school led by Schmoller was almost contemporaneous

with the emergence of the neoclassical school, but the older historical school of economics led by Roscher had precedence in time to some extent over the neoclassical school.

## 11.2 Objectives

After reading this lesson you will be able to:

- Explain the view of Historical School
- Give in detail the criticism of the Historical school

## 11.3 The Rise of the Historical School

While the German Romantics had targeted their critique of the classical economics mainly at its emphasis on individualism and its plea for confining the role of the state to the minimum one of protecting the life and property of the people, and while the utopian socialists criticism of it was mainly concerned with exposing the seamy side and contradictions of the capitalist system which the classical economics promoted, the critique of the historical school was provoked mainly by the analytical method of classical economics, particularly, as it was shaped by Ricardo and his followers.

Any one who goes through Ricardo's *Principles of Political Economy and Taxation* and even other works of his cannot fail to notice the high level of abstraction used by him in his analysis of economic phenomena. He usually tears the phenomenon he wants to analyze out of its historical and social context and thus simplifies it and abstracts it from reality. The same tendency could be noticed in Say also. The followers of Ricardo and Say gave a new fillip to the abstracted tendency of the classical economic analysis by reducing the science of economics to a small number of deductive propositions. It, no doubt, lent a sort of mathematical precision to it. But this, method was not adequate to explain the different varieties of economic phenomena which, have historical, social, natural and institutional complications also. Such a deductive science based upon the assumptions of the universal character of all economic phenomena could not be helpful in solving many practical economic problems of particular nations and societies.

It was this methodological weakness of the classical economics which led Arnold Toynbee to observe in his paper, "Ricardo and the Old Political Economy," that "A logical artifice became the accepted picture of the real world.... he (i.e. Ricardo) unconsciously fell into the habit of regarding laws which were those only of that society which he had created in his study for purposes of analyses as applicable to the complex society really existing around him. And the confusion was aggravated by some of his followers and intensified in ignorant popular versions of this doctrine." The implication of this statement is that there was quite a big gap between the classical economic theory and the concrete economic reality. The extent of this gap was realized, when an attempt was made to apply the laws of the classical political economy to countries and societies where economic conditions were different from those existing in England and France.

The judicial school of economics which sprang of in Germany during the second half of the nineteenth century focused its critique on this particular deficiency of classical economics and sought to offer an alternative method of economic analysis and professedly an alternative theory also. However, while this school of economic thought was successful in exposing the methodological weakness of the classical economics, its attempt to provide an alternative economic theory was far from successful.

However, the originality and merit of the historical school lies in this that the economists of this school were the first to seek either in history or in the observed contemporary fact a means of reconstructing the science of economics as a whole. Some economic thinkers like Sismondi before them had also noticed the abstract nature of the classical economic analysis. But none before them had undertaken the task of reconstructing economic theory along the lines that the historical school of economics did.

Self Check Exercise-1

Q.1 What do you know about Historical School.

### **11.4 The Founders of Historical School**

Wilhelm Roscher (1817-1894) is unanimously regarded as the main founder of the historical school of economics. His views are mainly found in two of his works, namely, *The Grundriss* published in 1843 and *System der Volkswirtschaft* published in 1854.

Roscher's professed aim was "simply to describe what people have wished for and felt in matters economic, to describe the aims they have followed and the successes achieved as well as to give the reasons why such aims were chosen and such triumphs won. Such research can only be accomplished if we keep in close touch with the other sciences of national life, with legal and political history, as well, as with history of civilization." (Preface to the *Grundriss*).

The last part of the above statement of Roscher indicates that he wanted to correct the methodological drawbacks of the classical school by the adoption of an inter-disciplinary approach to the analysis of economic phenomena with a relatively greater emphasis on the historical method. What he proposed to do was to try to complete the current, that is, the classical theory by adding a study of contemporary facts and opinions. In his *System der Volkswirtschaft*, he did no more than punctuating his exposition of the classical doctrines with many erudite excursions in the domain of economic facts and ideas. He did not seem to make even an attempt to lay the foundations of a reconstruction of economic theory as a whole. Even Knies, himself an important member of the historical school, observed that Roscher's work meant "a competition of historiography rather than a correction of political economy."

But, according to Schmoller who was the leader of younger historical school, Roscher work could rightly be regarded as an attempt to connect the teaching of the current political economy with the "cameralist" traditions of the seventeenth and eighteenth centuries Germany.

On the whole, it appears that whatever innovation was introduced by Roscher went to meet a pedagogic demand rather than to fulfill a scientific need. Another founder of the historical school of Germany was Bruno Hildebrand (1812-1878). His *National okonomie der Gegenwart* (1848) shows much more fundamental opposition to the classical political economy and also a more definitive historical method than Roscher's works. His programme was more ambitious. He argued that history not only vitalized and perfected the science of economics but it could also help in reconstructing it anew.

In his work referred to above, he declares other subject of his work as "to open a way for an essentially historical standpoint in political economy, and to transform the science of political economy into a body of doctrines dealing with the economic development of nations." Hence, in his opinion, the science of economics required to be reconstructed as the science of national economic development.

Hildebrand had evolved a form of stages theory of economic development. He generalized that the national economy of a country passes through three stages of development which he described as the natural economy, the money economy and the credit economy. But he did not make a genuine attempt to even modify the classical theory of production and distribution, not to speak of rebuilding it anew.

Karl Knies (1821-1898) was another important economist belonging to the older historical school. His *Political Economy from the Historical Point of View* (1885) shows that he differed from his predecessors as much as Hildebrand differed from Roscher. In this work, he does not simply question the classical presumption of existence of "natural" laws but goes beyond it by doubting if there can be possible any general laws of development at all. In this doubt of his he obviously differs from Hildebrand who had no doubt that such laws were possible. He goes on to observe that all that can be said is that there are certain analogues or models presented by the development of different countries. In his views, political economy is simply a history of ideas concerning the economic development of a nation at different stages of its growth.

The above three founders of the historical school gave much attention to a criticism of the classical method, but they failed to agree on the aim and scope of the science of economics. They left it to their heirs the task of applying their principles to concrete situations. This task was accomplished by the new younger historical school which sprang up around Schmoller towards the end of 1870's.

Self Check Exercise-2

Q.1 Who were Founders of the Historical School.

## **11.5 The Younger Historical School**

His contribution of the younger historical school formed around Schmoller had two distinctive features. In the first place, the economic thinkers belonging to this school gave 'up' the sterile controversy over the existence of economic laws that was kicked up between Hildebrand and Knies. They were careful enough not to deny the existence of social laws or uniformities. They went further by admitting that the search for

the uniformities was the chief object of the science of economics like that of any other science, natural or social. As a matter of fact, they can be described as "economic determinists," as regards their views. Their contention, which was very reasonable, that the laws of economics and, for that matter, of any social science could not be applied mechanically. "We know now," declared Schmoller, "that physical causation is something other than mechanical, but it bears the same stamp of necessity." Nevertheless, they did deny that these laws could be discovered by the abstract and deductive method of the classical economists. On this issue, they were in complete agreement with their predecessors of the older historical school.

But, for all their acceptance of the existence of economic laws, they were skeptical on the possibility of discovering and formulating what Hildebrand described as the "laws of development" and which he stressed so much as the main object of the science of economics. The reason, as given by Schmoller was that "we have no knowledge of the laws of history, although we sometimes speak of economic and statistical laws,".

Secondly, the younger historical school was not content with merely to advocate the use of the historical method in the analysis of economic phenomena. They made attempts to put their methodology into practice. But the consequence of it was not an orderly and more realistic economic theory but only a disorderly maze of historical data. Political economy, in their hands, was lost in a maze of realistic studies of the present or the past; their studies were heavily descriptive but lacked analysis and generalization.

However, the debate that the historical school of economics had ignited influenced economic thought outside Germany also. Labour question, for example, remained unsolved and could not be solved; it was contended under the influence of the historical school, by the deductive method of analysis of the classical political economy. In England, the influence of the economic thinking of the historical school was reflected in the controversy over the scope and method of economics. This is particularly noticeable in the views of Cliffe Laslie who, in his reply to Cairnes, emphasized the use of induction, constant necessity of keeping economics in contact with other social sciences, the historico-relative nature of economic laws, and the use of history as a means of interpreting and analyzing economic phenomena. Arnold Toynbee also stressed the same approach.

Self Check Exercise-3

Q.1 Discuss about the younger Historical School.

## **11.6 The Historical School: An Over-all View**

It has been observed, not wrongly, that the contribution of the historical school of economics was more negative and less positive. By-negative contribution -of theirs we mean their contribution as critics of the classical political economy. It is easier to give an exposition of their critique of classical economics but very difficult to give a lucid account of their positive ideas. It is because their positive ideas are not explicitly and, unambiguously stated. They are vaguely stated. The



emphasis on the need of historical method is unambiguous and quite loud too. But there is no clarity regarding the exact and detailed meanings of the historical method. Moreover, every author claiming to have adopted the historical method defines the positive tasks of the historical economic science after his own position but claims it to represent the school.

The Critical Content: As regards the historicists' critique of the classical economics, it had three targets in the main. Firstly, it attacked the classical belief in the universality of their economic laws. Secondly it attacked the underlying psychological assumptions of the classical doctrine which were taken by the historicists to be based on a crude human egoism. Thirdly, it brought under criticism the classical economists' use or abuse of the deductive method of analysis.

1.. The historical criticized the classical on account of their inordinate emphasis on the so-called universal character of their economic laws which they tended to compare with the natural law i.e. the laws of the natural sciences. The classical aim that their economic laws were valid at all times and places was challenged by the historicists. Hildebrand described it as their "universalism," while Knies called it their "absolutism" or "perpetualism". But both questioned this claim. The historical school, instead, maintained that economic laws and, for that matter, laws of all social sciences were not absolutely imperative; but they were subject to change in both theory and practice.

Taking up the case of practice, they pointed out that a uniform code of economic legislation could not be applied indifferently to all countries and at all stages of the economic evolution of a country. Economic practice in their view, had to be modified and adopted according to the time and place. But as Carl Menger of the Austrian School pointed out the above point made out by the historical school was nothing new and it would have been accepted by the classical themselves, although they sometimes forgot to mention it, especially when justifying the economic institutions of the past or when advocating the universal adoption of the policy of *laissez-faire*.

On the theoretical level, the historical school stressed the historico-relative character of economic laws. They emphasized that economic laws were not like the laws of physics and chemistry with which the classical economists never tired of comparing them. The historicists-asserted very forcefully that economic laws had neither the universality nor the inevitability of the laws of natural sciences. As Knies observed, "The conditions of economic life determine the form and character of economic theory. Both the process of argument employed and the results arrived at are products of historical development. The generalizations of economies are simply historical explanations and progressive manifestation of truth as it is known at that particular stage of development. No single formula and no collection of such formula can ever claim to be final." This means that the historicists regarded economic laws as at once both "provisional" and "conditional" and not as universal and inevitable.

But the historicists stretched this point too far. As Marshall pointed out, even the laws of natural sciences like physics and

chemistry are provisional as subsequent discoveries could lead to their modification. They are also conditional, because they are also true only under the condition of the absence of disturbing causes. In fact, there is no difference between economic laws and the laws of physical sciences except in the degree of proof which supports them. Even the historico-relativity of economic laws was not denied by all classical, particularly, by J.S. Mill. However, it is to be admitted that the historicists brought the historico- relative character of economic laws into a sharp focus just when some economists were in danger of forgetting it.

2. The historicists also questioned the most fundamental psychological assumption of classical theory, namely, Adam Smith's postulate that men, in their actions, are guided purely by their "self-interest" which the historicists loved to describe as "egoism" or "selfishness". It was the contention of the historical school that self-interest or personal gain was far from being the 'sole motive of human actions even in the economic field. Man, according to them, is guided in his actions by a variety of motives such as variety, desire for glory, the joy that work itself gives, sense of duty, pity, benevolence, and love of kin or simply by custom. To say that man is always actuated by purely selfish motives, says Knies is to deny the existence of any better motive or to regard man as a being who has a number of centers of psychic activity each operating independently of the others.

In reply to this criticism of the historical school, it is often said that the assumption of self-interest motive of human conduct refers to the group and not to the individual. Moreover, even Wagner, who is regarded as belonging to the historical school, had stated that with respect to the group, the conduct was motivated by self-interest. But it was also to be conceded that the classical economists, even though they did not deny the possibility of other motives modifying the motive of self-interests, neglected to take sufficient account of such modification. Sometimes it really seems as if they would, in the words of Hildebrand, "transform political economy into a mere natural history of egoism."

The final reproach of classical economics by the historical school in their charge that the classical misused the analytical method of abstraction and deduction. This made classical theory abstract and unrealistic. Their method, according to the historicists, was not adequately reinforced by the inductive method based upon observation. The older Historical school of Roscher was vociferously in favour of the inductive method to the extent of even banishing from economics the classical method of abstraction and deduction.

The historicists' criticism of the deductive method was closely connected with their attack on the fundamental psychological assumption underlying the classical economic theory to which *the* referred above. According to them the classical economists believed that all economic laws could be deduced by a simple process of reasoning from one fundamental postulate.

But, the historicists argued, if we consider the multiplicity of motives actually operating in the economic world, the inadequacy of the classical economic theory derived deductively from the single postulate

of the motive of self-interest would be readily exposed. The result of the classical deductive method was not a faithful picture of reality but only a caricature of it.

The criticism, however, mixes up two issues, namely, the particular use that the classical economists made of the abstract deductive method, and the validity of the method itself. This criticism that the classical often committed the mistake of starting with insufficient premises was valid and could not be denied. It was also true that even when the premises were correct, the classical seldom took the precaution of checking their results against actual facts; But this is different from denying the very legitimacy of the deductive method which a number of writers of the historical school, particularly of the older historical school, tended to do. However the approach of Schmoller to the subject of method was balanced and objective when he observed that 'Induction and deduction are both necessary for the science, just as the right and left foot are needed for walking'.

**The Positive Content** The positive content of the teachings of the historical school is more important to understand their alternative system, but it is precisely the positive content which is rather vague compared to their critical content. However, this much is certain that whatever positive content their teachings had was related to methodology and that too was mainly related to the theory of methodology. It is difficult to find any model in their writings which could admirably illustrate the practice of historical method which they proposed as an alternative to the classical deductive method.

Economic phenomena may be approached for study from two opposing standpoints which the historicists described as the "mechanical" approach and the "organic" approach. The mechanical approach is an approach involving generalizations which reduce the complexity of the economic world to a set of small number of formulae. This is the method of abstracting from the complexities of economic phenomena which was followed by the classical. The other approach, that is the organic approach, on the other land, pays attention to the complexities of economic phenomena and also to the constantly changing quality of the phenomena. The historicists recommended this latter approach in place of the former.

Their contention was that the mechanical approach of the classical resulted in the neglect of a whole set of important factors affecting economic phenomena, such as institutions and organizations, associations and combinations, the structure of competition, struggles between contending interests of small and big producers, of employers and employees, of individuals and society, of country and town, etc. economic phenomena is not only complex but also varied and changing which cannot be comprehended with the mechanical approach, argued the historicists. It is because such an approach makes no attempt to explain the economic differences which separate nations: and differentiate epochs.

The 'mechanical approach was evidently inadequate in the eyes of the historicists. It neglects man's environment and isolates man's economic activity from it for study. But a country's not only geographical

factors 'but also' its scientific and artistic training, moral and intellectual character, system of government, social customs; etc., influence the nature of its economic institutions! These factors, argued the historicists, change from epoch to epoch. Therefore, if we want to understand the different aspects of economic behaviour with all its ramifications, we must not isolate economic activity from its environment and study it, as it were, in a vacuum. We should rather study it in connection with the medium through which it finds expression and in connection with the environment that influences it. As it was observed by Roscher, "National life, like any other form of existence, forms a whole of which the different parts are very intimately connected. Complete understanding even of a single aspect of it requires a careful study of the whole." This is the first and the foremost point that the historical school stressed. The other points followed from it.

Social environment, they argued, was not fixed but changing. It gets transformed and keeps on evolving new forms and structures from time to time. No two stages are ever quite the same. Each stage calls for explanation which can be furnished by history alone. Knowledge of the preceding stages 'is necessary to know the present. Alongside theory, there is room for another kind of study akin to biology, that is, a detailed description and a historical explanation of structure of economic life of each nation.

## **11.7 A Critique of the Historical School**

We have already observed that the criticism of the classical economics by the historical school was understandable, even though it often tended to exaggerate its drawbacks. But, what they wanted to put in place of the classical economics was hardly clear. Nor did their practice illuminate their views on the matter. What they presented to the world in the form of their positive work was anything- but' a *science* of economics. A science without generalization cannot be thought of, but generalizations were shunned, by the historical school dogmatically. Consequently, their works hardly reveal any economic theory, though they produced tones of historical description. No wonder, then, that they have left to posterity no durable theory of any sort except their contribution to the debate on methodology of economics.

The historical school was so much blinded by their dislike of the analytical method of the classical that they failed to see and appreciate that it is generalizations which impart to a branch of study a scientific character. There can be no science without generalizations. The concrete description of historical data in all its complexity which the historical school seemed to suggest as an alternative method of studying economic phenomena could not take the place of an economic science. Concrete description of historical data, howsoever indispensable, is only a first step in the process of building up an economic 'science: Description is not explaining, and a science that does not attempt to explain is no science at all.

History is, no doubt, important in understanding economic phenomena and formulating scientific theories explaining them, but history by itself cannot 'furnish explanation of economic phenomena.

What is important is not descriptive history but its interpretation. And, as regards interpretation, we can, find no unanimity on the explanation of any given historical event. History itself needs explanation. Descriptive accounts of historical details in which the historical school reveled can give no clue to reality and so it can never take the place of science of economics.

The older historical school had set a higher mission for themselves, namely, the formulation of the laws of economic, development. Only a few held this view and even among them there was no unanimity over how to do it Knies, for example, thought that such a law of development should be sufficiently general to include the' economic development of all nations. Roscher believed in the existence of parallelism in the history of various nations. This implies that all nations, in the course of their economic development, pass through similar phases or stages. These similarities, in fact, constitute the laws of economics.

The above view was open to criticism according to the basic philosophy of the historical school itself, as it very often asserted that there could not be a universal law of development applicable equally to all countries and all times.

Self Check Exercise-4

Q.1 Discuss Over all view of the Historical School .Also give its criticism.

## **11.8 Summary**

the first half of the nineteenth century was dominated by the development and propagation of the classical system of economic thought as founded by Adam Smith and systematised by David Ricardo, on the one hand, and the critiques of the classical economics by the German Romantics and the utopian socialist thinkers of France and Great Britain, cm the other, the second half of the century was dominated by three new currents of economic thought, namely, the Historical School of economic thought, the economic thought of Karl Marx and the neoclassical economic thought Of these, the economics of Karl Marx was generally ignored and even suppressed on account of its political implications which were perceived to be dangerously subversive of the established values and institutions.

It was this methodological weakness of the classical economics which led Arnold Toynbee to observe in his paper, "Ricardo and the Old Political Economy," that "A logical artifice became the accepted picture of the real world.... he (i.e. Ricardo) unconsciously fell into the habit of regarding laws which were those only of that society which he had created in his study for purposes of analyses as applicable to the complex society really existing around him. And the confusion was aggravated by some of his followers and intensified in ignorant popular versions of this doctrine." The implication of this statement is that there was quite a big gap between the classical economic theory and the concrete economic reality. The extent of this gap was realized, when an attempt was made to apply the laws of the classical political economy to

countries and societies where economic conditions were different from those existing in England and France.

The judicial school of economics which sprang of in Germany during the second half of the nineteenth century focused its critique on this particular deficiency of classical economics and sought to offer an alternative method of economic analysis and professedly an alternative theory also. However, while this school of economic thought was successful in exposing the methodological weakness of the classical economics, its attempt to provide an alternative economic theory was far from successful.

However, the originality and merit of the historical school lies in this that the economists of this school were the first to seek either in history or in the observed contemporary fact a means of reconstructing the science of economics as a whole. Some economic thinkers like Sismondi before them had also noticed the abstract nature of the classical economic analysis. But none before them had undertaken the task of reconstructing economic theory along the lines that the historical school of economics did.

## 11.9 Glossary

1. **The Historical School** developed in the late nineteenth century as an alternative to neoclassical economic theory and policy. It was most prominent in Germany and is usually called the German Historical School but there were representatives of this way of thinking elsewhere, notably in Britain and the United States. The Historical School emerged as a result of several intellectual influences, most notably Charles Darwin's theory of evolution. The success of evolutionary thinking led many thinkers, including Karl Marx as well as the members of the Historical School, to seek an evolutionary form of economic theory to contrast with the static theories of neoclassical economics. The Historical School critics of neoclassical economics objected to its atomistic and deductive nature as well as its static nature. They wanted a holistic theory that emphasized the overall structure of economies rather than their individual parts. They wanted a theory that tied the development of economies to a social, political and cultural background. In this matter the Historicists were influenced by the nation states of Europe such as Germany and Italy. There was an earlier Historical School that included B. Hildebrand (1812-1878) and Karl Knies (1821-1894) but the German Historical School reached the pinnacle of its development in the late nineteenth century with the works of Gustav Schmoller (1838-1917). Some other members of the German Historical School this period were L. Brentano, and G.F. Knapp. An example of economic historicism outside of Germany is the American historian Charles Beard. The German Historical School did not limit its attention to historical studies. A major area they concerned themselves with was national economic

policies. Their studies led them to a justification of protectionist economic policy as an instrument of nation building.

2. **Derived Demand:** The notion that the demand for a factor of production, or an input used in the production of a good, depends on the demand for the output being produced. This concept highlights the two key aspects of factor demand. One is that factor demand depends on the value of the good being produced. Inputs that produce more valuable outputs are themselves more highly valued. Two is that factor demand depends on the productivity of the input. Inputs that produce more output are themselves more highly valued.
3. **Deductive method** is also known as analytical, abstract & a priori method. This method was advocated by the Classical school of Britain. Deductive method proceeds from General to Particular. We start from a few indisputable facts about human nature and draw inferences from them about concrete individual cases. The important steps in deductive method are 1. Selection of problem, 2. Formulating assumptions, 3. Formulating hypothesis & 4. Verifying hypothesis. Example for Deductive method: Law of DMU states that as the stock of good increases the MU from it decreases. The principle of progressive taxation is derived
4. **Inductive method** is also called empirical, historical & a posteriori method. Inductive method was used by historical school of Germany. Inductive method proceeds from Particular to general. It is a process where facts are collected, arranged & general conclusions are drawn. The important steps in deductive method are 1. Selection of problem, 2. Formulating assumptions, 3. Formulating hypothesis & 4. Verifying hypothesis. The important steps in inductive method are 1. selection of problem, 2. Collection of data, 3. Observation & 4. Generalisation. From this law. Example for Inductive method: From the practical experience of several farmers Law of Diminishing returns emerged.
5. **Perpetualism:** a belief in the permanence of a given thing, the belief that a given thing (e.g. the world, a political system) will last forever.
6. **Absolutism:** the political doctrine and practice of unlimited, centralized authority and absolute [sovereignty](#), as vested especially in a [monarch](#) or [dictator](#). The essence of an absolutist system is that the ruling power is not subject to regularized challenge or checks by any other agency, be it judicial, legislative, religious, economic, or electoral. King [Louis XIV](#) (1643–1715) of France furnished the most familiar assertion of absolutism when he said, “L’état, c’est moi” (“I am the state”). Absolutism has existed in various forms in all parts of the world, including in Nazi Germany under [Adolf Hitler](#) and in the Soviet Union under [Joseph Stalin](#).

## **11.10 Answers to self check Exercises**

Self Check Exercise-1

Ans.1. Please Refer Section 11.3

Self Check Exercise-1

Ans.2. Please Refer Section 11.4

Self Check Exercise-1

Ans.3. Please Refer Section 11.5

Self Check Exercise-1

Ans.4. Please Refer Section 11.6 and 11.7

## **11.11 References/ Suggested Readings**

19. Eric Roll: "*A History of Economic Thought*".
20. Alexander Gray: "*The Development of Economic Doctrine*".
21. C. Gide and G. Rist: "A History of Economic Doctrines".
22. J.A. Schumpeter: "*History of Economic Analysis*".

## **11.12 Terminal Questions**

Q1. Write a detailed critique of Historical School?

Q2. Write a short note on founders of Historical School?



## **Unit- 12**

### **ECONOMICS OF KARL MARX (1)**

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#### **Structure**

- 12.1 Introduction
- 12.2 Learning Objective
- 12.3 Karl Marx's Method
- 12.4 Marx's Stages Theory of Social Evolution
  - 12.4.1 Different Historical Stages of the Development of Society
- 12.5 Summary
- 12.6 Glossary
- 12.7 Answers to self check Exercises
- 12.8 References/ Suggested Reading
- 12.9 Terminal Question

#### **12.1 Introduction**

As we pointed out in the “Introduction” of the last lesson on the historical school of economics, the second half of the nineteenth century was dominated by three different streams of economic thought, namely, the historical school of economics, the economics of Karl Marx and the neoclassical economics. We have already introduced you to the main ideas and contributions of the historical school. The economics of Karl Marx, unfortunately, was not taken seriously in his life-time, partly because of its non-conventional and even revolutionary approach to the analysis of the capitalist economic system and, perhaps more importantly, because of its revolutionary political implications. Particularly on account of the latter, the establishment thought it prudent to banish it from the mainstream economics. Consequently, it continued to languish as a parallel economics, though it was full of great insights, in the same manner in which the insightful parallel cinema has been made to languish in the face of the mainstream commercial cinema of our times. But the economics of Karl Marx was, in fact, a continuation of the classical tradition of Petty, Smith and Ricardo, on the one hand, and it was, on the other hand, a critique of capitalism and its economics, both the classical and the neoclassical economics. The Marxian critique of it was also a socialist critique but with a difference. The difference lay in this that its approach was scientific and not utopian, and moreover, while the pre-Marxian socialist critiques of Sismondi, Saint-Simon and Saint-Simoni. Fourier and Owen were overwhelmingly normative—lacking in analysis, Karl Marx's critique was outstandingly positivist and highly analytical and therefore scientific and not utopian.

#### **12.2 Learning Objective**

After going through this lesson you will be able to:

- Explain Karl Marx's Method
- Elucidate the Marx's Stages Theory of Social Evolution
- explicate the different Historical stages of the Development of Society

### 12.3 Karl Marx's Method

Karl Marx's method of analysis, when shorn of its logical intricacies and methodological abstractions, may be said to follow from his general philosophy or world outlook which is now well-known as "the philosophy of "dialectical and historical materialism." Historical materialism is the method of dialectical materialism applied to the study of social phenomena of which economic phenomena make up a particular category. But, what is dialectical materialism?

The adjective in the phrase, dialectical materialism, refers to the approach or the methodological philosophy that guides the study of natural and social phenomena, while the noun, materialism, refers to the philosophical materialism which, in conjunction with the dialectical method helps in the interpretation and causal explanation of both the natural and the social phenomena.

The main features of the Marxian dialectical method are as follows:

(1) As opposed to the metaphysical approach, the dialectical method does not regard the natural and social phenomena "as an accidental agglomeration of thing unconnected with and independent of, each other, but as a connected and integral whole, in which things, phenomena are organically connected with, dependent on, and determined by, each." (Stalin) (2) Unlike the metaphysical approach, the dialectical method does not regard phenomena to be unchanging and in state of rest ; on the contrary, it regards phenomena to be changing and in a state of movement "where something is always arising and developing, and something always disintegrating and dying" (Stalin) (3) More importantly, the dialectical method does not look upon development as a simple process of quantitative growth ; on the contrary, it regards development as a process in which simple and smooth quantitative changes accumulate, almost imperceptibly, till a nodal point is reached when there is sudden leap from a *quantitative* to a *qualitative* change. (4) Still more importantly, the dialectical method holds that internal contradictions are inherent in all things and phenomena; therefore, the process of development from the lower to the higher state takes place not in a smooth and harmonious manner but through a struggle between opposite tendencies. As Lenin expresses it, "Development is the 'struggle 'of opposites." And, "dialectics is the study of the contradictions within the very essence of things."

Philosophical materialism of Marx is directly opposed to philosophical idealism. According to the later, the "absolute idea." the "universal spirit" (God), or "consciousness" is primary, while matter or

nature is derivative and secondary; matter or nature is mere a reflection or embodiment of the "absolute idea" the "universal spirit" or the "consciousness". To the contrary, philosophical materialism believes that matter or nature is primary, while the ideas and consciousness are derivatives and secondary, being the reflection of matter, nature or objective being. Applied to society and its development, this, in the words of Marx himself, means that "It is not the consciousness of men that determines their existence, but their social existence that determines their consciousness."

But Marx's materialism is not mechanical materialism; it is dialectical materialism. Being dialectical, it implies that although matter, nature and objective social existence are the ultimate determinants of consciousness and ideology, the normal relation between the objective existence and consciousness is one of mutuality. This means that while objective conditions determine ideology, the latter also reacts upon the former. Moreover, since, as already explained above, dialectics implies that all development takes place through "struggle of opposites" which are inherent in all matter and all social formations, this struggle is also reflected in ideology so that we have an ideology of the rising forces contending with a parallel ideology of the declining and decaying forces in a society.

The above depicts the broad outline of Marx's method of studying both the development of the capitalist socio-economic system and its ideology in general as well as the economic part of it as reflected in the classical political economy. It requires repetition that Marx's method is known not merely as "dialectical materialism" but as "dialectical and historical materialism" and, as we said in the very beginning, historical materialism is nothing but the method of dialectical materialism applied to the study of historical development of society which is also sometimes referred to briefly as Marx's materialistic interpretation of history.

Marx's method of dialectical and historical materialism leads him to identify the crucial factor which determines the nature of a particular socioeconomic formation and demarcates it from other socioeconomic formations. He identifies this crucial factor as Use "mode of production." A mode of production is comprised of two things the *forces* of production and -the *relations* of production. The forces of production consist of various means of production inclusive of the people themselves "who operate the instruments of production and carry on the production of material values thanks to a certain *production experience and labour skill* (Stalin). The technique of production or technology is also a component of the forces of production. This is one aspect of a mode of production. The other aspect is the relations of production. "In the social production of their existence," observes Marx. "Men inevitably enter into definite relations, which are independent of their will, namely relation of production appropriate to the given stage in the development of their material forces of production. The totality of these relations of production constitutes the economic structure of society, the real foundation, on which arises a legal and political

superstructure and to which correspond definite forms of social consciousness.”

Marx's important implication in the above statement is that at any given stage of the development of productive forces, there is a definite form of production relations which is in turn with the prevailing productive forces. When the relations of production are in harmony with the prevailing productive forces, the socio-economic system develops smoothly and the productive forces are further developed. But in the course of this- development a time comes when contradictions between the productive forces and the production relations surface up. In class societies, and according to Marx all societies in history except the primitive- society have been class societies, these contradictions assume the form of class contradictions. These contradictions shackle the productive forces and prevent their further development.-The socio-economic system lands into a crisis which is resolved only through a social revolution which brings about a qualitative transformation of society, substituting new production relations in place of the old and thus leading the society to the higher level of its evolution.

It is the above method of dialectical and historical materialism which was Marx's general method of, analysis of the development of the capitalist system. While applying the method to the study of the laws of capitalist development, “the key causal factor towards which Marx began by orienting himself was the socioeconomic production relation between the class of capital-owners and the class of wage-earners.” (R. L. Meek). Lento too had -observed that in the first place. Marx had begun “by selecting from all social relations the ‘production relations’ as being the basic and prime relations that determine all other relations.

R.L. Meek has at so pointed but that within the general framework of the analytical method explained above, Marx. It so “developed a highly idiosyncratic method of enquiry” which “might perhaps he called the “Logical historical method. “ 'I' here is no better way even according to R.L. Meek, to describe this “logical- historical” method than to quote Engels from his review of Marx's *Critique of Politic at Economic* in 1859. Engel observes. “The criticism of economics could be exercised in two ways: historically and logically. Since m history, as m its literary reflection, development as a whole proceeds Iron the most simple to the most complex relations, the historical development of the literature of political economy provided a natural guiding-thread with which criticism could link up and the economic categories as a whole would' thereby appear m the same sequence as in the logical development This form apparently has the advantage of greater clearness, since indeed it is the *actual* development that is followed. History often proceeds by jumps and zigzags and it would in this way have to be followed everywhere, whereby not only would much material of minor importance have to be incorporated hut there would be much

interruption of the chain of thought; furthermore, the history of economics could not be written without that of bourgeois society and this would make the task endless, since all preliminary work is lacking. The logical method of treatment was, therefore, the only appropriate one. But this, as a matter of fact, is nothing else than the historical methods, only divested of its historical form and disturbing fortuities."

Apart from the above two aspects of Marx's method of economic analysis, R.L. Meed, in his essay, "Karl Marx's Economic Method," refers to a third aspect also, an aspect which arises from Marx's desire to find out how the sudden intrudence of capitalism would impinge upon a pre-capitalist society in which there is commodity production, that is production for exchange, but the means of production are as yet owned by the workers themselves. This is the method of abstraction which goes back to Smith and Ricardo and is particularly conspicuous in Marx's analysis of value in the first volume of his *Capital*. As observed by Engel, in his analysis of value. Marx "proceeds from the simple prediction of commodities as the historical promise, ultimately to arrive from this basis [at] capital" That is to say, Marx, first, abstracts from capitalist commodity production and production relations by assuming a state of *simple* commodity production and then proceeds to analyze its "logically and historically secondary form," namely, the capitalistically modified commodity" production. This feature is in no way peculiar to Marx's method. As we observed above, it can be traced back to Smith and Ricardo apart from the fact that to start with a simplified model abstracted from factual complexities and, then to introduce the desired complexities in order to find out how their introduction impinges upon the abstract simple model is the established procedure of scientific method of analysis.

Self Check Exercise-1

Q.1 Discuss Karl Marx's method of analysis.

## **12.4 Marx's Stages Theory of Social Evolution**

Marx applied his method of dialectical and historical materialism to the study and analysis of the forces underlying the course of social evolution. As we pointed out in the preceding section, Marx had identified that what 'distinguishes one type of socioeconomic formation from another was the mode of production and the mode of production referred to the sum total of the productive forces, on the one hand, and the production relations, on the other. Marx's hypothesis was that of all the material forces which could possibly determine the structure and the change in the structure of society, the mode of production was the most probably determining factor. His approach of philosophical materialism ruled out the possibility of any spiritual factor determining the historical course of social evolution.

Considering the probable material conditions which could influence the nature and evolution of society, one's attention immediately goes to the natural or geographical environment with which a society exists. But can it play the determining role in the development of the society and its economy? The answer to such a question in the light of the method of historical materialism would be in the negative. It may influence social development in some minor ways but it cannot determine to explain the historical development of human society. It cannot be a determining factor in the development of society, because while the development of society takes place at a rapid pace, compared to it the natural or the geographical environment is almost static. Thus, there is no correspondence between the change in social structure and changes in natural and geographical environment.

Another material factor to which the development of society could be linked is the demographic factor, because people are an essential part of the material conditions of life and society. Without a certain minimum number of people, society and a material life of society cannot be thought of. But, does it mean that the growth of population and the density of population are the material factor which determines the course and structure of social history? The answer to such a question also in the light of Marx's historical materialism would be in the negative. The demographic factors, both quantitative and qualitative, may influence the development of society in minor ways but they cannot be the chief factors determining the structure and transformation of society. These factors cannot explain why a particular socio-economic formation in history had the specific structure that it possessed and why a particular socio-economic structure, say primitive communal structure, is transformed into a socioeconomic structure like the slave society and not into some other structure such as a feudal or a capitalist society. Moreover, that there is no correspondence to be found between the size of population and the level of social development.

Marx's method of historical materialism leads him to specify the mode of production as the chief determining factor of social evolution. It is the nature of the mode of production which according to Marx, determines the nature of any given social economic structure, and it is the change in the mode of production that brings about a change in the socioeconomic structure leading society from a lower level of development to a higher level. Within a given socioeconomic structure, when the productive forces are in harmony with the prevailing production relations, development proceeds smoothly. But the laws of dialectics ensure that the *quantitative* growth of productive forces would eventually take the form of a *qualitative* change calling for a change in the production relations also. It is at this stage that the internal contradictions of the existing society begin to surface up. In a class society, such contradictions take the form of class contradictions, because the change in production and, consequently, social relations that the qualitative change in productive forces call for, threaten the economic interests of established ruling class and promotes the

interests of a new rising class which threatens to become the ruling class of the future. Thus, there breaks out a class struggle, eventually taking the violent form of class war, in which the old decadent production relations along with the old, decadent ruling class are overthrown and superseded by new and progressive production - relations and by a new and progressive social class which becomes the new ruling class. In this way, the production relations, once again, get into harmony with the new productive forces, breaking them free from the fetters of the old production relations and thus unleashing their full developmental potential. The society, as the result of it, progresses into higher level of development.

The above description is the barest outline of Marx's basic theory of evolution of society. On the basis of this dialectical and historical materialism approach, Marx conceptualized the development of society to be taking place through a process of progressive change from a lower stage of development to a higher stage. In this ' progressive sequence, he distinguished the following historical stages; primitive communism, slavery, feudalism, capitalism and socialism. Of these, the first four could be identified in history. The fifth stage of socialism was a projection or a prediction following logically from Marx's basic theory. That is why the socialism predicted by him is described as "scientific socialism" in contrast to the "utopian socialism" which was based not on any scientific theory but on the idealistic and spiritual dreams of idealist philosophers. Moreover, Marx had also conceived that socialism itself would have two stages : a lower stage in which the productive forces are not fully developed to ensure an ideal distribution and therefore which has to conform to the production and distributive principle of "from each according to his ability, to each according to his work," and a higher stage described as "communism" in which the productive forces are amply developed to yield enough abundance of goods to ensure the implementation of the ideal production and distributive principle of "from each according to his ability, to each according to his needs".

#### **12.4.1 Different Historical Stages of the Development of Society**

Now we shall describe, following Marx, the different historical stages of the development of society.

1. **Primitive Communism:** The earliest human society, the pre-historic society, going back to the stone age, which is also described as the hunting stage and which Adam Smith often referred to as the "early and rude stage" of society, was characterized by a very low level of development of the productive forces. The nature of productive activity and the means of economic production were such that it was not possible for an individual to carry on economic production of any meaningful type independently of his fellow members of the primitive society which used to be made up of a group of closely related families and, later, a group of tribes. The main occupation in the primitive society used to be hunting or manual fishing or fishing with the most elementary technique of fruit-gathering. And, the instruments of

production also used to be of the most elementary type such as stone tools and later, the bow and arrow. Due to this elementary nature of both the instruments of production and the technology, it was not for an individual to combat the forces of nature and the beasts of prey. The members of a given primitive society were thus obliged to work in common. Moreover, under the conditions of primitive society the productivity was so low that there was no possibility of any surplus arising over and above what was absolutely necessary for the people to barely subsist. Where there is no surplus to appropriate and conditions of production are such as described above so that the process of production has of necessity to be communal, the ownership of instruments of production has also to be common. Thus we find that in this prehistoric age as described above, the process of production as well as the ownership of the instruments of production are common which is indeed a type of communism. In this state, the forces of production and the relations of production are in harmony with each other, based as they are on a system of common production and common ownership. But it was a communism based on want, scarcity and poverty and, therefore, it was a primitive communism.

2. **Slavery:** As the new productive forces take birth and grow within the old socio-economic system, productivity increases. As these new productive forces ripen and are strengthened, it is found that the old production relations do not help but hamper the further development of the new progressive forces. A contradiction between the new productive forces and the old production relations assumes a critical form. The crisis is ultimately solved by a revolutionary transformation of production relations so that they conform to the new productive forces. This general Marxian law explains the transformation of the stage of, primitive communism into the stage of slave system. As the nature of instruments of production changes to have an improved and more productive forms from the simple and less productive stone tools to iron and other metal tools and as the main production activity shifts from crude hunting and fruit-gathering to pasturage, land-cultivation and handicrafts, productivity rises to a level at which human labour becomes, for the first time in history, capable of producing surplus of product over and above what is required to maintain it. It is this circumstance which gives rise to a new system of production and social relations. The system of private property is born and its most conspicuous manifestation takes place in the form of private property in slaves. Under primitive communism when productive forces were too underdeveloped to make the production of surplus possible, the captives of inter-communal and inter-tribal wars were a burden on the victorious capturing communities. Therefore they used to normally killed. But with the growth of the productive forces and appearance of the potential for surplus, the prisoners of such wars began to be turned into and used as slave workers instead of being killed off. Thus arose a new system of social relations based on private property and the society divided into two social classes of slave and slave-owners, the exploited class of slaves and the exploiting class of the slave owners.



The new production and social relations embodied in the new social system of slavery conformed to the new productive force and helped in the production and growth of surplus and consequently the economic development of the society.

But the dialectics of social history could not let the socio-economic development under slavery groom smoothly for all times. In a system where the workers (slaves) are treated like dumb driven cattle that could be bought and sold and even killed like animals, the workers could have no interest and enthusiasm left in their work. A stage comes when the production relations of the slave-system become fetters on the further growth of the productive forces. The production relations and the productive forces once again find themselves in contradiction with each other, and the contradiction is resolved once again through a social revolution from a slave-system into a new social system known in social history as feudalism.

3. **Feudalism:** When there is further improvement of forces of production under the above- system in the form of improved smelting and working of iron and other metals, the spread of the iron plough and the boom, further development in agricultural technique, horticultural development and growth of dairy farming, the rise of manufactories and handicraft workshops, etc., the production and social relations represented in the slave-system come into conflict with these new productive forces. The new productive forces require a work force which has initiative as well as some unforced voluntary interest in work which is not possible under the slave-system known in history as the feudal system. Under feudal system, the former slaves are turned into serfs. Under the feudal system the feudal lords own the means of production, particularly land which is the most important means of production at this stage of economic development. The feudal lords also own in a way, but only in a way which means not fully as was the case with slaves, the serfs, whom their masters cannot kill but can buy and sell. Serfs enjoy a relative freedom as they are given some land to till for themselves on the condition of working free without any reward on the feudal lord's lands for a certain number of days in a week. An alternative arrangement may be that the serf cultivates the landlord's land on the condition that he would part with a certain proportion of the produce of land to the landlord. But the serfs used to be legally bound to their master's estates and they could not run away to full freedom from them.

The above is the chief feature of feudal production relations. But alongside the above lord-serfs relationship in agriculture, there also existed individual peasant ownership, individual ownership of instruments of labour by handicraftsmen. These relations of production conformed to the new productive forces and helped in their further development. The productivity increased thereof and the society moved on to a higher level of socio-economic development. In the meanwhile, the productive forces developed to take on a qualitatively new form such that the old production relations of feudalism came into conflict with and in the way of fully exploiting the potential of the new

productive forces and the further improvement of these forces. The contradiction between the new productive forces and the old feudal production relations was resolved through a new social revolution which transformed the feudal system into a capitalist system.

4. Capitalism: During the stage of feudalism which roughly coincides with the medieval period of history, many changes which ultimately gave birth to new productive forces went on taking place in small, imperceptible quantities till they accumulated enough to become noticeable. Towards the last period of feudalism the 17th century and the first half of the 18th century which was, in fact, a period of transition to capitalism rather than feudalism proper, there were a series of spectacular inventions, particularly in Great Britain which ushered in the very well-known Industrial Revolution in Great Britain. It was this revolution in industrial technology which brought about a qualitative transformation of the productive forces. In place of small handicraft workshops and manufactories there came into existence large mills and factories equipped with machines. Large-scale factory production began to push out small -scale handicraft production due to the former's higher productivity and the consequent cheapening of machine-made goods. Division of labour by processes and sub-processes, of which Adam Smith's famous example of a pin-manufacturing factory was representative of, the contemporary new productive forces, began to predominate over division **of labour** by occupations the tremendous potential of the new productive forces could not be exploited under the feudal production relations which still bound labour to the manors and estates of the feudal lords. One of the foremost preconditions for exploiting the full production potential was that the supply of free labour must be freely available. Irregular supplies and that too of migratory rather than free and permanent labour are not conducive to the development of large-scale mechanized factory production. This pre-condition could not be fulfilled under the feudal production relations which restricted the mobility of labour by tying the serf labour to the manors and estates of the feudal lords and which ensured to the peasants and the artisans the ownership of their instruments of labour. The new system of production required a free wage labour—free not only in the sense of mobility but, more importantly, also in the sense of having been “freed” from their instruments of labour. This becomes possible only when the peasants are deprived of their land and other instruments of production, serfs are liberated from their feudal obligation to be tied down to their lords' estates-, and artisans are also deprived of their means of production. Since it was not possible under the feudal social and production relations, there arose a conflict between the new productive forces and the old product production relations. The old production relations, however, began to change in consequence to the development of the new productive forces themselves which, due to the superior productive and competitive power of the large scale mechanized factory production, gradually ruined the traditional handicraft workshops and manufactories and thus “freed” artisans to become a free labour force

which possessed nothing but their labour power to sell. As large-scale mechanized production penetrated agriculture the small peasants also came to ruin or they were cheated out of their land and other instruments through various types of social and political moves like the Enclosure Movement in Great Britain. So they too entered the force of "free" labour. The former serfs also entered the ranks of "free" or wage labour either in town and cities or on the large scale farms in the rural areas. Even the Enlightenment Movement of the eighteenth century in Europe which played no mean role in bringing about the French Revolution liberating the class of serfs and winning for the people individual freedom from feudal bonds contributed to the formation and establishment of new production relations conforming to the new productive forces, thus unleashing the great production potential of the new productive forces to which the history of capitalism of the nineteenth and the early twentieth century is witness.

Under capitalism, capital becomes the dominant factor and the class of capitalists the dominant social class. It is the capitalist class which owns the means of production but unlike under slavery and feudalism it does not have a legal property right on the persons of workers. Workers are legally free, but since they do not possess the instruments of labour, they have to live by selling their labour power to the capitalists or else they have to starve. So though legally free, they too bear the cross of bondage, the bondage of wage slavery which is hidden rather than open personal slavery or serfdom but a slavery which is no less real. There remain, of course, landlords also, but they too are gradually nudged out by the capitalists who buy land out of them. The remnants of the feudal class of landlords play no role in the capitalist system of production. They become mere rentiers and tend to fade out as a social class.

The capitalist system revolutionizes the character of production which takes on a socialist or collective form. Thousands of workers work together in one and the same factory to produce the final product and no one individual can claim it to be the end product of his own individual labour. It is the result of the collective labour of all of them. Thus the process of production becomes socialist in character. The contradiction arises as while production is collective, the ownership and appropriation under capitalism is private. It is this contradiction between social production and private individual appropriation based on the individual's right to private property which, after a time, assumes critical dimensions and lands the capitalist system into recurrent economic and social crises. It is the stage when the capitalist social and production relation become fetters on the further development of productive forces. This contradiction, predicted Marx, would be resolved through a fresh social revolution which would be a socialist revolution bringing in its wake new production relations which would correspond to the social character of modern production system.

The four stages of social evolution explained above belonged to history during Marx's life time. The next stage predicted by Marx in the light of his theory of dialectical and historical materialism was the stage of socialism.

5. **Socialism:** According to Marx, the historical stage that would succeed capitalism in the process-of social evolution would be that of socialism. Under socialism, the means of production would be owned not individually or by some voluntary associations of individuals but collectively by the society as a whole. The right of private property in means of production would be abolished, though this right would be retained in respect of personal consumption goods. This would make both production and appropriation social -in character and in this way the contradiction between the social character' of the productive forces and the private character of ownership of means of production would be resolved. The forces of production and the relations of production would be, once again, in harmony with each other which would unfetter the forces of production leading the society into a state of increasing material abundance.

Marx's socialism, as we pointed out in the beginning of this section of the present lesson, is described as *scientific* socialism in contradistinction to the socialism of thinkers like Sismondi, Saint - Simon and Saint-Simon ties, Fourier, Owen, et.al, which was described by Marx and his followers utopian socialism. They made this distinction because they believed that their socialism was predicted on the basis of a scientific analysis of social evolution, while the utopian socialism was based on good intentions, moralistic ideals and idealistic dreams.

In the stage of socialism as conceived and predicted by Marx, there was not to be an equal distribution in the absolute and the popular sense, From this point of view, Marx had visualized, in his *Gotha Programme*, two stages of socialism : a-lower stage and a higher stage. In the lower stage of socialism, the principle of work and distribution was to be "from each according to his- ability to each according to his work." This meant that everyone would work according to his ability and he would be rewarded according to the quantity and quality of his work. This obviously be implies that inequalities would remain but they would be based not on private property but on differences in the amount and quality of labour performed. This principle would be necessitated, according to Marx, because at the lower stage there would not be enough abundance of material goods to conform to an *ideal* distribution system.

Marx believed that when production increased abundantly and socialism went on to its higher stage, it would be possible to effect the *ideal* principle which, according to him, would be: "from, each according to his ability to each according to his needs' This higher stage of socialism where it becomes possible to put into practice the principle, "from each according to his ability to each according to his needs," was described by Marx as "communism".

It is to be noticed that neither in the lower stage of socialism nor in the higher stage called "communism" there would be equality in the absolute or the popular sense.

#### Self Check Exercise-2

Q.1 Discuss Marx's Stages Theory of Social Evolution.

## 12.6 Summary

The second half of the nineteenth century was dominated by three different streams of economic thought, namely, the historical school of economics, the economics of Karl Marx and the neoclassical economics. We have already introduced you to the main ideas and contributions of the historical school. The economics of Karl Marx, unfortunately, was not taken seriously in his life-time, partly because of its non-conventional and even revolutionary approach to the analysis of the capitalist economic system and, perhaps more importantly, because of its revolutionary political implications. Particularly on account of the latter, the establishment thought it prudent to banish it from the mainstream economics. Consequently, it continued to languish as a parallel economics, though it was full of great insights, in the same manner in which the insightful parallel cinema has been made 'to languish in the face of the mainstream commercial cinema of our times. But the economics of Karl Marx was, in fact, a continuation of the classical tradition of Petty, Smith and Ricardo, on the one hand, and it was, on the other hand, a critique of capitalism and its economics, both the classical and the neoclassical economics. The Marxian critique of it was also a socialist critique but with a difference. The difference lay in this that its approach was scientific and not utopian, and moreover, while the pre-Marxian socialist critiques of Sismondi, Saint-Simon and Saint-Simon. Fourier and Owen were overwhelmingly normative—lacking in analysis, Karl Marx's critique was outstandingly positivist and highly analytical and therefore scientific and not utopian.

Karl Marx's method of analysis, when shorn of its logical intricacies and methodological abstractions, may be said to follow from his general philosophy or world outlook which is now well-known as "the philosophy of dialectical and historical materialism." Historical materialism is the method of dialectical materialism applied to the study of social phenomena of which economic phenomena make up a particular category. But, what is dialectical materialism?

The adjective in the phrase, dialectical materialism, refers to the approach or the methodological philosophy that guides the study of natural and social phenomena, while the noun, materialism, refers to the philosophical materialism which, in conjunction with the dialectical method helps in the interpretation and causal explanation of both the natural and the social phenomena.

The main features of the Marxian dialectical method are as follows:

(1) As opposed to the metaphysical approach, the dialectical method does not regard the natural and social phenomena "as an accidental agglomeration of things unconnected with and independent of, each other, but as a connected and integral whole, in which things, phenomena are organically connected with, dependent on, and determined by, each." (Stalin) (2) Unlike the metaphysical approach,

the dialectical method does not regard phenomena to be unchanging and in state of rest ; on the contrary, it regards phenomena to be changing and in a state of movement “where something is always arising and developing, and something always disintegrating and dying” (Stalin) (3) More importantly, the dialectical method does not look upon development as a simple process of quantitative growth ; on the contrary, it regards development as a process in which simple and smooth quantitative changes accumulate, almost imperceptibly, till a nodal point is reached when there is sudden leap from a *quantitative* to a *qualitative* change. (4) Still more importantly, the dialectical method holds that internal contradictions are inherent in all things and phenomena; therefore, the process of development from the lower to the higher state takes place not in a smooth and harmonious manner but through a struggle between opposite tendencies. As Lenin expresses it, “Development is the ‘struggle of opposites.’” And, “dialectics is the study of the contradictions within the very essence of things.”

Philosophical materialism of Marx is directly opposed to philosophical idealism. According to the latter, the “absolute idea,” the “universal spirit” (God), or “consciousness” is primary, while matter or nature is derivative and secondary; matter or nature is mere a reflection or embodiment of the “absolute idea” the “universal spirit” or the “consciousness”. To the contrary, philosophical materialism believes that matter or nature is primary, while the ideas and consciousness are derivatives and secondary, being the reflection of matter, nature or objective being. Applied to society and its development, this, in the words of Marx himself, means that “It is not the consciousness of men that determines their existence, but their social existence that determines their consciousness.” But Marx’s materialism is not mechanical materialism; it was dialectical materialism.

## 12.7 Glossary

1. **Primitive Communism:** The earliest human society, the pre-historic society, going back to the stone age, which is also described as the hunting stage and which Adam Smith often referred to as the “early and rude stage” of society, was characterized by a very low level of development of the productive forces. The nature of productive activity and the means of economic production were such that it was not possible for an individual to carry on economic production of any meaningful type independently of his fellow members of the primitive society which used to be made up of a group of closely related families and, later, a group of tribes. The main occupation in the primitive society used to be hunting or manual fishing or fishing with the most elementary technique of fruit-gathering. And, the instruments of production also used to be of the most elementary type such

as stone tools and later, the bow and arrow. Due to this elementary nature of both the instruments of production and the technology, it was not for an individual to combat the forces of nature and the beasts of prey. The members of a given primitive society were thus obliged to work in common.

Moreover, under the conditions of primitive society the productivity was so low that there was no possibility of any surplus arising over and above what was absolutely necessary for the people to barely subsist. Where there is no surplus to appropriate and conditions of production are such as described above so that the process of production has of necessity to be communal, the ownership of instruments of production has also to be common.

2. **Slavery:** As the new productive forces take birth and grow within the old socio-economic system, productivity increases. As these new productive forces ripen and are strengthened, it is found that the old production relations do not help but hamper the further development of the new progressive forces. A contradiction between the new productive forces and the old production relations assumes a critical form. The crisis is ultimately solved by a revolutionary transformation of production relations so that they conform to the new productive forces. This general Marxian law explains the transformation of the stage of, primitive communism into the stage of slave system. As the nature of instruments of production changes to have an improved and more productive forms from the simple and less productive stone tools to iron and other metal tools and as the main production activity shifts from crude hunting and fruit-gathering to pasturage, land-cultivation and handicrafts, productivity rises to a level at which human labour becomes, for the first time in history, capable of producing surplus of product over and above what is required to maintain it.
3. **Feudalism:** When there is further improvement of forces of production under the above- system in the form of improved smelting and working of iron and other metals, the spread of the iron plough and the boom, further development in agricultural technique, horticultural development and growth of dairy farming, the rise of manufactories and handicraft workshops, etc., the production and social relations represented in the slave-system come into conflict with these new productive forces. The new productive forces require a work force which has initiative as well as some unforced voluntary interest in work which is not possible under the slave-system known in history as the feudal system. Under feudal system, the former slaves are turned into serfs. Under the feudal system the feudal lords own the means of production, particularly land which is the most important means of production it this stage of economic development. The feudal lords also own in a way, but only in

a way which means not fully as was the case with slaves, the serfs, whom their masters cannot kill but can buy and sell.

4. **Capitalism:** During the stage of feudalism which roughly coincides with the medieval period of history, many changes which ultimately gave birth to new productive forces went on taking place in small, imperceptible quantities till they accumulated enough to become noticeable. Towards the last period of feudalism the 17th century and the first half of the 18th century which was, in fact, a period of transition to capitalism rather than feudalism proper, there were a series of spectacular inventions, particularly in Great Britain which ushered in the very well-known Industrial Revolution in Great Britain. It was this revolution in industrial technology which brought about a qualitative transformation of the productive forces. In place of small handicraft workshops and manufactories there came into existence large mills and factories equipped with machines. Large-scale factory production began to push out small -scale handicraft production due to the former's higher productivity and the consequent cheapening of machine-made goods. Under capitalism, capital becomes the dominant factor and the class of capitalists the dominant social Class. It is the capitalist class which owns the means of production but unlike under slavery and feudalism it does not have a legal property right on the persons of workers.
5. **Socialism:** According to Marx, the historical stage that would succeed capitalism in the process-of social evolution would be that of socialism. Under socialism, the means of production would be owned not individually or by some voluntary associations of individuals but collectively by the society as a whole. The right of private property in means of production would be abolished, though this right would be retained in respect of personal consumption goods. This would make both production and appropriation social -in character and in this way the contradiction between the social character' of the productive forces and the private character of ownership of means of production would be resolved. The forces of production and the relations of production would be, once again, in harmony with each other which would unfetter the forces of production leading thé society into a state of increasing material abundance.
6. **Division of labour:** People are better off specialising than trying to be jacks of all trades and ending up masters of none. The logic of dividing the workforce into different crafts and professions is the same as that underpinning the case for Free Trade: everybody benefits from doing those



things in which they have a Comparative Advantage and using income from doing so to meet their other needs.

## **12.8 Answers to self check Exercises**

Self Check Exercise-1

Ans.1. Please Refer Section 12.3

Self Check Exercise-2

Ans.1. Please Refer Section 12.4 and 12.4.1

## **12.9 References/ Suggested Readings**

1. J. Stalin: "*Dialectical and Historical Materialism.*"
2. F. Engels: "*Origin of Family, Private Property and the State*".
3. F. Engels: "*Anti Duhring.*"
4. K. Marx: "*A critique of Political Economy.*"
5. R.L. Meek: "Karl Marx's Economic Models."

## **12.10 Terminal Question**

Q1. Explain Marx's stages theory of Social Evolution?

## **LESSON 13**

### **ECONOMICS OF KARL MARX (2)**

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#### **Structure**

- 13.1 Introduction
- 13.2 Learning Objectives
- 13.3 Theory of Value
- Self Check exercise-1
- 13.4 Theory of Surplus Value
- Self Check exercise-2
- 13.5 Profits as Exploitation
- Self Check exercise-3
- 13.6 Competition in Marx's Model
- Self Check exercise-4
- 13.7 "The Great Contradiction" in Marx's Value Theory
- Self Check exercise-5
- 13.8 The Transformation Problem
- Self Check exercise-6
- 13.9 Theory of Capitalist Accumulation and Development
- Self Check exercise-7
- 13.10 Theory of Capitalist Crises
- Self Check exercise-8
- 13.11 Summary
- 13.12 Glossary
- 13.13 Answers to self check Exercises
- 13.14 References/Suggested Reading
- 13.15 Terminal Questions

#### **13.1 Introduction**

Karl Marx's theory of value is a continuation and refinement of the classical labour theory of value of Petty, Smith and Ricardo. Like Smith and Ricardo, he too makes a distinction between use value and exchange value of commodities.- There is a tendency among the historians of economic thought to identify the classical (which includes the Marxian also) concept of use value or "value-in-use" with the neo-classical concept of "utility" which is rather wrong. The classical and Marxian concept of use value, unlike its neoclassical counterpart, is

not a subjective concept: it is not conceived to reflect a subjective or psychological relation between the subject (the buyer) and the object (commodity) as is the case with the neoclassical concept of “utility”. On the other hand, it refers to those *Objective* properties of a commodity by virtue of which it satisfies a particular human want. In this sense, the use value of commodities would be as dissimilar and heterogeneous as there are different kinds of commodities. Therefore, Karl Marx, in the classical tradition, made use value only a condition of exchange of commodities but not a determinant of the rate of exchange of commodities.

### 13.2 Objectives

After going through this lesson you will be able to:

- Explain the Marx view's on Value and Profit
- Elucidate the Theory of Capitalist Accumulation and Development
- Explain the theory of Capitalist Crises

### 13.3 Theory of Value

Like Ricardo, Marx also posed the question as to what makes commodities which are so heterogeneous with regard to their value-in-use comparable quantitatively so as to yield a definite ratio of exchange between any given pair of commodities. His own answer to the question is typical Ricardian in character in as much as he relates this comparability and the ratio of exchange to the common property of all commodities, namely, that they are all products of labour. And, again, like Ricardo, he derives the proposition that the ratio of exchange between any pair of goods is determined by the relative quantities of labour required to produce them. If, for example, the production of a unit of commodity, X, requires 20 units of labour, while the production of a unit of another commodity, Y, requires only 10 units of labour, then the normal ratio of exchange between X and Y would be :  $1X = 2Y$ .

He was aware of the difficulties created by the fact that kinds of labour required to produce different types of commodities might differ—a problem which was raised by Ricardo too. Marx solved this problem too exactly in the same manner as Ricardo. He treated skilled labour as some definite multiple of the simple abstract labour. This multiple can be found out from the prevailing structure of wage rate. Schumpeter had charged Ricardo with circular reasoning because he too had solved the difficulty in this manner. Therefore, evidently, he would like to stick this charge of circular reasoning into Marx's theory of value also. But, as Blaug pointed out in the context of namely, for reducing skilled labour to a definite multiple of the common unskilled labour, is a permissible methodological device, unless the problem in hand is the analysis and explanation of distribution itself. Another problem which Marx solved in the manner of Ricardo was the problem of how to treat the capital input in the production of commodities. It was treated, as Ricardo before him treated it, as “past” labour or

“congealed” labour. Thus, ultimately, all costs were reduced to labour costs.

The above would suggest that Marx's theory of value was no more than a mere reproduction of Ricardo's labour theory of value. But, in fact, it is not so. Marx's labour-quantity theory of value is “the only quite thorough going one ever written.” Moreover, it was an improvement upon Ricardo's theory, because when Marx put forth his hypothesis of relative quantities of labour required to produce any given pair of commodities determining the rate of exchange between that pair of commodities, he was referring not to just the simple common type of abstract labour. In fact, his hypothesis explicitly referred to the “socially necessary” labour time required to produce different commodities as the determinant of the rate of exchange of commodities. The concept of “socially necessary labour” is a definite improvement on the classical labour-quantity theory of Value of Smith and Ricardo. This concept was forged by Marx to answer the possible criticism that an outmoded technique of production might require a larger amount of labour to produce a commodity compared to an improved current technique of production. Does it mean that the value of the commodity would be determined by the labour quantity required to produce the commodity with the outmoded technique? Or does it mean that the value of the commodity would be determined by the labour-quantity required to produce it under the current improved technique? Or, will there be more than one value of one and the same commodity at a time, depending upon the techniques of production used? There was still another problem. Will a commodity have value merely because its production involved expenditure of labour? What, if there is not enough demand for it in society? There are very weighty questions which the classical did not raise even, not to speak of answering [hem. The concept of “socially necessary labour” was designed by Marx to obviate the above difficulties. Socially necessary labour-time required to produce a commodity is that amount of labour-time which is required to produce a commodity, for which there is demand in the society, under the prevalent, that is the generally accepted technique of production in the society and “with the average degree of skill and intensity prevalent at the time.”

According to Blaug the concept of socially necessary labour-time in so far as it refers to the labour required to produce a commodity “with the average, degree of skill and intensity prevalent at the time,” also implies the assumption of constant costs. This would also reinforce Marx's postulate that value-in-use is a precondition of exchange but not the determinant of value-in-exchange. Under constant costs, the long-run supply curve is horizontal and therefore a shift in the demand curve due to any change in the perceived value-in-use of a commodity will have no effect on the value-in-exchange.

Self Check Exercise-1

Q.1. Discuss Theory of Value of Karl Marx.

## **13.4 Theory of Surplus Value**

Marx's theory of value would be incomplete without an explanation of his concept of surplus value. The concept of the surplus goes back to Petty. It was vividly expressed in the particular form of surplus in agriculture in the writings of the Physiocrats of France. The concept came to be generalized so as to cover industrial production also in the writings of Smith and Ricardo. But it remained in somewhat confused state and unscientifically explained till Marx explained it scientifically by applying the labour theory of value to determine the value of the commodity, labour.

A very important breakthrough that Marx made in the labour theory of value and which distinguished his theory from the classical labour theory of value of Smith and Ricardo was the distinction that he made between "labour" and "labour power." This distinction was of great analytical and, therefore, of great scientific importance. Marx's argument was that under capitalism labour becomes just like any other commodity. Therefore, its value or, which is the same thing as its wages, were also determined according to the labour theory of value. But he emphasized that the commodity which is bought and sold in the labour market is not labour as such but the "labour power," that is, the capacity of a worker to work; therefore the wages that the capitalist employer pays to the worker is not the value or price of the work or labour actually performed by him but they are the value of his labour-power. The value of the commodity, labour power, is determined by the cost of producing the subsistence necessary for the worker to maintain himself and his family in the customary standard of living. Let us suppose that it costs under the prevalent condition five hours of socially necessary labour-time on the average to produce workers subsistence. The wage rate would, then, represent this amount of socially necessary labour-time. But the capitalist employer, once he has purchased the labour power of a worker, would, in the absence of any legal and social restrictions, try to exploit it to the full by making the worker work for as long in a day as he can possibly do. Supposing the normal working day extends for ten hours, then, for the first five hours the worker would be working to replace the cost of his subsistence wage which, according to our above supposition, is five-hour labour. In the remaining five hours he works to produce a surplus of value (measured by the remaining five-hours of labour-time) which is appropriated by the capitalist employer of labour.

It is obvious from the above that there are two ways open to the capitalist for increasing the surplus value. One way is to increase the length of the working day, while the labour-cost of workers subsistence remains constant. In our above imaginary example, if the working day is extended, say, to twelve hours, while the cost of production of a worker's subsistence remains constant at five-hours of labour-time, the total surplus of value by a worker per working day would increase from the earlier level measured by five hours of labour-time to a higher level now measured by seven hours of labour-time. Marx described this as the Absolute Surplus Value. The other way of increasing surplus value is akin to what is suggested in Ricardo's theory also „This is to cheapen the production of workers subsistence,

though the length of the working day remains constant. Continuing with our earlier example let us suppose that there is improvement in agricultural productivity so that now a smaller amount of socially necessary labour time, say, three hours of it, is required to produce a worker's subsistence. Since the working day continues to be ten hours, worker would now work for three hours to replace the value of his subsistence wage and during the remaining seven hours, he would be producing surplus value for the capitalist employer. This way too the surplus of value increases to equal seven hours of labour-time. Marx described this as the Relative Surplus Value.

At the threshold of his analysis in the first volume of his *Capital*, Marx from both land and money capital and therefore, identified the surplus value with the capitalist's profit. In any way, in Marx's model, the source of all forms of property income profit, interest and rent is to be found in the surplus of value created by labour.

Now we can formalize Marx's theory of value and surplus value as follows. The value of a commodity is equivalent to the amount of socially necessary labour that, directly or indirectly, goes into its production. Indirect labour is in the form of the machines and raw materials used in the production of the commodity. This indirect labour-cost represents what Marx calls *constant capital* comprising machines and raw materials. Under free competition assumed by Marx, their exchange value equals their labour cost and they cannot transfer to the final commodity produced with their help more or less than their own value. Therefore Marx described this form of capital (machines and other forms of fixed capital plus raw materials) as *constant capital* and used the symbol 'C' for it. The direct labour-cost of a commodity is made up of the labour-time expended by the workers in the production of the commodity which equals the length of the working day multiplied by the number of workers employed to produce the commodity. But as explained above, the working day of a labourer is analytically split up into two parts: one part in which the worker replaces the value of subsistence advanced to him as wages which Marx denoted with the symbol,  $v$ , and the remaining part in which he produces the surplus value for his capitalist employer. It is obvious that in Marx's model, the constant capital does not add to the value of the final commodity more or less than its own value. But the capital in the form of wages paid to workers adds more than its own value to value of the final commodity. That is why this form of capital (which is invested in the employment of labour alone) has been described by Marx as the *variable capital* and as denoted by the symbol,  $1$ . The surplus value added by labour, or the variable capital, is denoted by the symbol,  $s$ . Thus, according to Marx's theory of value and surplus value, the value of a commodity equals  $c + v + s$ .

Self Check Exercise-2

Q.1. Discuss Marx's theory of Surplus value.

### 13.5 Profits as Exploitation

It is, obvious from the above explanation that surplus value created by labour is the only source of profits. Abstracting from land

and money capital, profits are identical with surplus value produced by labour but appropriated by the capitalists under the production and property relations prevalent and legalized in a capitalist society. Surplus value is unpaid labour and therefore represents exploitation of labour. Profits depend on surplus value which, in turn, depends on the exploitation of labour. Thus there is a direct link between profits and exploitation.

The Rate of Exploitation is defined to equal the rate of Surplus Value ( $s$ ) which is the ratio between the surplus value ( $s$ ) and the *variable capital* ( $v$ ) invested in the form of wages paid to the labour employed.

$$\text{Thus, } s' = \frac{S}{V}$$

The Rate of Profit is related not to the variable capital, but to the total capital, employed. This is the ratio between the total profits which, under the simplifying assumptions of Marx, equal the total surplus ( $s$ ) and the total capital used in the production of the Commodity ( $c + v$ ). That is

$$\text{Rate of Profit} = \frac{s}{c+v} = \frac{s/v}{1 + c/v}$$

We have already explained above that  $s/v$  measures the *rate* of surplus value or the *rate* of exploitation. The  $c/v$  ratio - in the above equation represents what Marx described as the *organic composition of capital* which in the mainstream economics is usually referred to as the capital labour ratio. The above formula clearly indicates that the rate of profit is a *direct* function of the rate of surplus value or which is the same thing, the rate of exploitation ( $s/v$ ), but it is an *inverse* function of the organic composition of capital ( $c/v$ ). This means that the rate of profit increases and decreases with the rise and fall in the rate of surplus value or exploitation. But it falls with a fall in the organic composition of capital and it rises with a fall in the organic composition of capital.

Self Check Exercise-3

Q.1. Discuss how Marx's treats profit as exploitation.

### 13.6 Competition in Marx's Model

Karl Marx's theory of capitalist development is based upon the assumption of free competition. It is the force of competition which validates his theory of value. In the absence of competition, his labour theory of value might not apply.

It is, again, the assumption of free competition which validates his postulate, which he shares with the classical that there tends to be a uniform rate of profit in a capitalist economy as a whole. If there are different rates of profit in the economy, capital would move to the sectors where the rate of profit is higher from the sectors where it is

lower. Thus competition would ensure that in equilibrium there is one and only one rate of profit that prevails throughout the economy.

The assumption of competitive capitalism is basic to Marx's model of capitalist development. Since capitalists are motivated by the desire to have higher and higher profits, it is this desire of the capitalists, which makes them search for more productive methods of production. When some of them succeed in inventing and putting to use an improved technique of production, it becomes possible for them to produce commodities with lower labour costs. So long as the use of the new technique does not become general, the price of these commodities would continue to remain higher as they would be determined by the *socially necessary* labour-time required to produce them. Since the technique in general use in the society is still the old one, the socially necessary labour-time to produce these commodities which determines their exchange values is higher than that under the new technique. Therefore, the capitalists who make use of the improved technique and thus produce at a lower labour-cost are able to increase their profits as well as their competing power. The force of competition will compel the other capitalists also to shift to the new technique of production. Those who are not able to do it would be competed out of existence. Thus it is the force of competition which, in Marx's model, determines the most prominent features of capitalist economic development. There is an implicit assumption in Marx's model that all technological improvement is of the labour-saving type. From this follows that the force of competition tends to increase the organic composition of capital ( $c/v$ ) over the course of capitalist development. The rising organic composition of capital, as we observed in the preceding section of this lesson, implies a falling rate of profit. This competition in Marx's model is an indirect cause of the falling tendency of the rate of profit in contrast to Adam Smith's model wherein it is the direct cause of the falling tendency of the rate of profit. Secondly, it also leads to both the concentration and centralization of capital, as small capitalists are squeezed out of existence under the pressure of competition.

Marx's model also demonstrates that over the course of capitalist economic development such changes take place which *lead* to turn competition into its opposite in a dialectical manner. Thus considered over a long period, competitive capitalism tends to turn into monopoly capitalism.

#### Self Check Exercise-4

Q.1. Is it true that Karl Marx's theory of capitalist development is based upon the free competition.

### 13.7 “The Great Contradiction” in Marx's Value Theory

One of the fundamental criticisms against Marx's labour theory of value is that it suffers from a “great contradiction”. This Contradiction shows up in the form of the contradiction between its implication that a higher organic composition of capital ( $c/v$ ) results in a lower profit rate and the real-world reality showing rather the reverse relationship.



If the relative prices are assumed to correspond to the relative labour values of commodities, the net product of equal quantities of labour would sell for equal quantities of money. Since, under free competition, there is a uniform wage rate, the rate of surplus value would also be uniform. But, if the organic composition of capital is not the same throughout the economy, while profit per worker employed is uniform, it would imply that the rate of profit on the total capital employed would be lower in industries employing more capital per man, that is, in industries having higher organic composition of capital and till the profit rate would be higher in industries employing less capital per man, that is, the industries having lower organic composition of capital. This implication of Marx's labour theory of value contradicts his postulate of a uniform rate of profit under free competition. Moreover, this implication of Marx's labour theory of value flies in the face of another fact also. A higher organic composition of capital implies the substitution of capital in place of labour. Now, why will a capitalist substitute capital in place of labour, if this was going to end up in lowering his rate of profit? This, according to the critics of Marx's labour theory of value, is the "great contradiction" in it.

#### Self Check Exercise-5

Q.1. Is it true that Karl Marx's theory of capitalist development is based upon the free competition.

### 13.8 The Transformation Problem

One of the replies which could be given to the "great contradiction" criticism is that since exchange value in Marx's theory is determined by socially necessary labour-time, the capitalists who take an early lead in substituting more capital-intensive technique in place of the prevalent technique of production are able to produce the given commodity with less labour than the socially necessary amount of it and are thus able to have higher profit rate till the new more capital-intensive technique was generalized in the economy as a whole under the pressure of competition. When this happens, there would be a uniform, though higher, organic composition of capital in the economy as a whole and there would be then a uniform, though a lower profit rate for the economy as a whole.

Another reply could be that Marx never intended his labour theory of value to be a theory of relative prices except, perhaps, under conditions of "simple commodity production," that is, when the means of production are owned by the workers themselves as is the case under the system of handicraft production. Marx was aware of the contradiction and also of the reality that the specific nature of different industries might require different capital labour ratio or organic composition of capital. His simple labour theory of value of volume I of *Capital* was only the first approximation to the explanation of relative values under "capitalistic commodity production" Therefore Marx provided the solution of the so-called "great contradiction" in his labour theory of value in volume of *Capital* by transforming labour value, into

prices. This problem of transforming labour values into prices has come to be known as the “transformation problem in the Marxian economics.

We shall explain hereunder the transformation of values into prices with the help of Marx's own example as depicted in the following table:

Capital Compositions by Industry		Used-up (C)	Cost Price (C+V)	Surplus Value	Value of commodities	Profit at $pt = 22\%$	Price of Production	Deviation of Price' from value
I	80 C + 20 V	50	70	20	90	22	92	+2
II	70 C + 30 V	51	81	30	III	22	103	-8
III	60 C + 40 V	51	91	40	131	22	113	-18
IV	85C + 15v	40	55	15	70	22	77	+7
V	95 C + 5 V	10	15	5	20	22	37	+ 17
Total	390 C +110 V	202	312	110	422	110	422	0

In the above model, five different industries with different organic composition of capital (c/v) but with the same amount of total capital investment (=100) in each have been assumed to make up the whole economy. It is also assumed that the turn-over rate of constant capital (c) or the durability of it is not the same ; moreover, it is assumed to be more than one period so that in any one period of production only a fraction of its value would be transferred to the cost of producing the final output This fraction in absolute amount and not in the form of a ratio has been shown in the third column of the above table under the heading, “used-up C\ I The cost of production is the sum of the used-up capital in production plus the variable capital, that is, wages paid to the labour used. Thus the cost price of each industry equals C + V

where C is used-up constant capital. But the value of the product of each industry equals  $C + V + S$  where S is the surplus value calculated at the assumed rate of surplus value of 100 percent ( $s/v = 1$ ). The price at which the product of each industry would sell must yield to the capitalist the prevailing uniform rate of profit; that is, the price cost price + profit =  $C + V + p' (C + V)$  where  $p'$  is the prevailing rate of profit which, according to Marx, is determined by the ratio of the aggregate, surplus (110) to the aggregate capital investment in the economy as a whole ( $390 C + 110 V = 500$ ) which, in the above example, comes to  $100/500 \times 100 = 22\%$ . The price of the product of each industry is thus derived by adding the values in columns 4 and 7 against each industry.

It can be seen from the above table that the market prices do not equal the labour values. On the other hand, the commodities, which are produced with an organic composition (C/V) greater than that which prevails in the economy as a whole sell at prices higher than their values (commodities produced in industries I, IV and V), and the commodities produced in industries having an organic composition of capital lower than that which prevails for the economy as a whole sell at price which are lower than their values (commodities produced in industries II and III). Only in the case of an industry in which the organic composition of capital is the same as that for the economy as a whole will the price of the commodity equal its value. All this is understood to come about as the result of free competition.

Self Check Exercise-6

Q.1. What is Transformation Problem.

### 13.9 Theory of Capitalist Accumulation and Development

Karl Marx's economics, the main body of which is to be found in the three volumes of his *magnum opus*, *The Capital*, and his *Grundriss* was essentially a theory of capitalist economic development. His theories of value and surplus value were mainly the conceptual steps leading to the uncovering of the laws of motion of the capitalist economic system which is only another way of stating that the objective of Marx's economic theory was to lay bare the laws which govern the capitalist economic development. In this too his basic concern was the same as that of the classical economists, particularly of Ricardo. Therefore, as Eric Roll has observed, Marx's theory of economic development is not something added to the main body, but is an integral part of it.

Moreover, like the classical, Marx also conceived capitalist economic development to hinge upon capital accumulation so that in both the theories, the theory of capital accumulation becomes essentially the theory of economic development. Marx's theory of economic development under capitalism is found scattered in *Capital*, Vol. I under the topic. Accumulation, and in his theories of the falling rate of profit and of crises in Vol. III of *Capital*, his analysis of capitalist crises in Vol. I II of his *Theories of Surplus Value*, and in his discussion of the problem of reproduction in Vol. III of *Capital*.

Marx's theory of capitalist accumulation and development can be presented in a summary form as follows.

Economic development or progress implies movement, and the first and foremost condition of such movement is reproduction which is not just a "simple", reproduction but is "extended" reproduction; Simple reproduction is a process in which the level of accumulation and development remains constant and goes on repeating use itself from period to period as reflected in 'the classical concept of the "stationary state." Under conditions of simple reproduction, only the consumed capital is reproduced without there being any net addition to the capital stock of the economy. Therefore, the real condition of economic development or progress is that the reproduction of capital should take place in an extended form; that is the reproduction of capital should be at a scale which does not merely replace the amount of capital consumed in the process of production but also makes a net addition to the capital stock. The greater is this net addition to the capital stock, the greater is the rate of capital accumulation and economic development.

The condition of extended reproduction operates in all forms of society as the condition of progress. Social production must include reproduction, if the society is to subsist and progress. Moreover, the same particular conditions which determine social production also determine social reproduction. This means that the conditions which determine capitalist production also determine capitalist reproduction. Capitalist production, according to Marx, is done to amass surplus value. Therefore, capitalist reproduction requires that not only the capital which is employed to create and amass surplus value be re-employed in the same manner from period to period but at least a part of the surplus value realized is also converted into new capital from period to period. If no part of the surplus is converted into additional capital but is, instead, consumed by the capitalists as income, there would be only simple reproduction and no further accumulation and development. Thus, accumulation means the transformation of surplus value into capital.

Surplus value originally exists in the form of a part of the value of the product. The value of the product is realized when it is sold in the market. A part of the realized value in money represents the surplus value in money form. This surplus in money form can be used as additional capital along with the original capital that helped to produce this surplus. But, in order that the surplus is used as additional capital, it is a necessary condition that additional material means of production (machines and raw materials and additional labour-power) are available. According to Marx, both of these are produced in the previous period of production. It is because a part of the surplus value appropriated by the capitalists was employed by them in producing additional means of production (machines and raw materials) and additional means of subsistence (wage goods). The latter takes care of making the demand for labour-power effective. But, as regards the supply of labour-power, Marx, unlike the classical, does not rely on the Malthusian mechanism but instead depends on his doctrine of relative

overpopulation and the industrial reserve army. Additional employment of labour helps to produce more surplus value which, in the next period, is again used as capital to employ more labour-power in order to produce still more surplus value to be converted into fresh capital. This is the spiraling process of extended reproduction through which capital accumulates over time.

The pace or the rate of capital accumulation in Marx's theory depends on the following factors; (1) The rate of surplus value which, as you know, is also described as the rate of exploitation of labour. Given the size of the capital to be used as *variable capital*, that is, for employing labour, the total surplus value which is the source of capital accumulation would be greater, the greater is the rate of surplus value. It is due to this that the rate of surplus value is said to be the chief determinant of the rate of capital accumulation in Marx's theory. (2) Another important factor which determines the rate of capital accumulation in Marx's theory is the proportion of the surplus value which is actually transformed into capital. The surplus value which is appropriated by the capitalists as profits can be either consumed or saved to be converted into capital. The higher is the proportion of the surplus value or profits that is consumed by the capitalists, the lower is the proportion of it that would be saved and converted into capital. It is thus that the decisions of the capitalists regarding consumption and saving influence the rate of capital accumulation. According to Marx, the decisions of the capitalists with regard to consumption and saving (reinvestment) do not remain the same at different stages of capitalist accumulation and development. Generally, they tend to consume a small proportion of the surplus value or profits and save and reinvest a rather high proportion of it at the lower stages of capitalist accumulation and development. But, at the later advanced stages, they tend to increase their consumption, though as a proportion of the higher profit-incomes it may be falling. (3) The productivity of labour is another important factor that determines the rate of capital accumulation and economic development. It influences capital accumulation through its effect on the rate of surplus value which, as we pointed out above, is the chief determinant of the total surplus value that is the ultimate source of capital accumulation. Increase in productivity of labour results in an increase in the volume of production that can be effected with a given amount of labour. The surplus product increases which enables the capitalists to increase their consumption without diminishing accumulation. Increase in labour productivity in the subsistence or the wage-goods industries decreases the value (wages) of labour-power so that a worker has to work fewer hours to replace the wages paid to him and he works longer hours for producing surplus value for his capitalist employer. Moreover, with the cheapening of labour-power, the same amount of variable capital can employ a larger number of workers to produce a larger amount of surplus value. The higher productivity of labour also increases the supplies of the material means of production (machines and raw materials) to equip the additional work force for production. In this way capitalist accumulation and development are accelerated.

### Self Check Exercise-7

Q.1. Discuss Theory of Capitalist Accumulation and Development.

#### **13.10 Theory of Capitalist Crises**

The summary picture of Marx's theory of accumulation and development as given above can give the misleading impression that the process of capitalist accumulation and development is a smooth one. In fact it is not so. As a matter of fact Marx; method of dialectical and historical materialism to which he adhered strictly and consistently ruled out any possibility of there being a smooth process of capitalist accumulation, not to speak of the impossibility of his ignoring the empirical fact of economic crises actually taking place in history and in his own life-time also. In fact of the important respects in which Marx's economic theory differed from the classical theory was that while in the latter the process of capital accumulation and development is conceived to be a smooth one which lands smoothly into a stationary state, in the former it is shown to be inherently crisis-ridden due to its internal contradictions which ultimately lead to the "breakdown" of the capitalist socio-economic system. Marx's theory of economic crises is in fact, the first endogenous explanation of the business cycles.

According to Marx, economic crises result from the dynamic changes that take place in the process of capitalist economic development and which assume the form of internal contradiction of the system. On the whole, there are three major internal causes of capitalist crises mentioned by Marx. One of these refers to the inherent tendency towards under-consumption and relative overproduction under capitalism. The second cause referred to in Marx's analysis of crisis is another inherent tendency of capitalism namely, the falling tendency of the rate of profit. The third factor referred to as an inherent cause of crisis by Marx proceeds from the anarchic character of production under capitalism which leads to disproportionate growth of different sectors of the economy resulting in what are described as the "disproportionality crisis" in the Marxian economic theory. These causes might work independently or, more probably, in concert with each other to cause economic crises.

Marx argues that the motive of capitalist production is the creation of maximum possible surplus value and the transformation of a good part of it into new capital as explained in the preceding section. This process depends on the size of the working population, on the one hand, and the rate of 'surplus value, on the other. But it is not enough to create the surplus value. To be worthwhile for the capitalists it must be realized also in the form of profits. The product containing the surplus value must be sold at its value, otherwise profits cannot be realized and the process of exploitation would remain incomplete. However, according to Marx, the conditions for producing surplus value and the conditions for realizing surplus value are not identical under capitalism. The production of surplus value depends on the 'productive forces of the society but its realization depends on the consuming power of society and on the proportion between the

different Sectors of the economy, particularly between the sectors producing capital goods and the consumption goods. But the power of consumption of society is limited due to the capitalistic production relations on account of which the majority of the people (the working classes) are not only kept poor but are also rendered relatively poorer and poorer as explained in Marx's doctrine of increasing misery of the proletariat. This results from the inevitable competitive nature of capitalism which pushes on the process of capital accumulation by substituting more and more constant capital (C) in place of the variable capital (V) and thus increasing labour productivity. Those who take a lead in this process of raising the organic composition of capital are able to enhance their profits while the generally accepted technique in the society is still the old one with 'a lower organic composition. But the others, if they are not to be eliminated in the competitive struggle, also follow suit so that the organic composition of capital keeps on rising for the economy as a whole. The process leads to a continual displacement of labour by machinery which process may be temporarily halted due to increased demand for labour during boom periods which may even cause a rise in wages. But this rise in wages becomes a cause for the capitalists to introduce labour saving techniques of production. In this way there is an inherent tendency in the capitalist system towards increasing the productive powers and at the same time, depressing the power of consumption of society. This inherent contradiction between production and consumption, between the production and realization of surplus value under capitalism becomes a prominent cause of capitalist crises of under-consumption and relative over-production.

Marx regarded the conflict between capitalist production and consumption as only one aspect of capitalist crisis. The other aspects which, also follow from the inherent contradictions of the capitalist system are the falling tendency of the rate of profit and the disproportion between the different sectors of capitalist production issuing from the inherent anarchy of capitalist production.

We have referred above to the tendency of the organic composition of capital (C/V) to rise under capitalism under the force of the competitive struggle of the Capitalists for higher and higher profits. We had also explained above in section 13.3 of this lesson that the rate of profit; according to Marx, is an *inverse* function of the degree of the organic composition capital (C/V). Therefore, as capitalist accumulation and development proceeds, the organic composition of capital goes on rising under the force of competition amongst the capitalists. Consequently, the rate of profit tends to fall under capitalism. Since the capitalist production is motivated by the desire for profits, the declining rate of profit tends to kill that motive. The rate of profit might, at some stage, fall to such a low level that it provides no incentive to the capitalist for investment and accumulation. When this stage is reached, the capitalist system of production, "breaks down."

The falling tendency of the rate of profit does not necessarily lead the capitalist system straight into its "breakdown," for, as Marx

stressed, it is only a tendency which might be checked by certain counteracting forces. These counteracting forces are, briefly, raising the intensity of labour by the capitalists, depressing the workers' wages below the value of their labour-power, that is, below the subsistence level, cheapening of the elements of constant capital, which might result from improved productivity of labour in the machine-making industries and raw-material producing industries, and foreign trade and investment which give special advantages to the capitalists of advanced countries. But these counteracting forces can check the falling tendency of the profit rate only temporarily. It is bound to reappear partly because these very forces would either tend to raise the organic composition of capital still further or depress the consumption power of the society in relation to its power of production.

The problem of realization of surplus value resulting in realization crisis can arise, apart from the inadequate effective consumption demand from the disproportion between different sectors of the economy which is endemic in capitalist economies due to anarchy in production. We can explain this case by both a model of simple reproduction and a model of expanded or extended reproduction.

Under simple reproduction the whole of the surplus value is consumed by the capitalists and therefore there is zero growth of the economy over time. Dividing the total economy into two sectors, one sector (Department I) producing capital goods or machines and the other sector (Department II) producing consumption goods, the condition of realization of the surplus is that the demand of Department I for consumption goods produced in Department II must equal the demand of Department II for the capital goods produced in Department I. The demand of Dept. 1 for the consumption goods of Department II is made up of the wages received by the labour employed in Department I ( $V_1$ ), and the surplus value or profits ( $S_1$ ), received by the capitalists of Department I which, in this case of simple reproduction, is wholly expended on consumption. Denoting the demand of Department II for the capital goods produced in Department I by  $C_2$ , the condition of the realization of surplus value is:  $C_2 = V_1 + S_1$  which simply states that the demand of Department II for capital goods is produced in Department I must equal the sum of the *variable* capital employed in Department I and the surplus created in Department I.

When there is expanded or extended reproduction, there is a positive growth of the economy over time- It is the case of accumulation of capital over time. This means that in this case the surplus value created by labour in either sector or Department of the economy is partly converted into constant capital and partly into variable capital ( $\Delta C + \Delta V$ ) and the rest is ( $\Delta S - \Delta C - \Delta V$ ) is spent on an increase in the consumption of the capitalists. The condition of realization of surplus value in this case is essentially the same as in the earlier case of simple reproduction, namely, that the demand of Department 1 for the consumption goods produced in Department must equal the demand of Department II for the capital goods produced in Department I. But now these demands assume an expanded form and the condition of the realization of surplus value would be given by the



equality:  $C_2 + \Delta C_2 = V_1 + (S_1 - \Delta C_1)$ . The second term, the right-hand side of this equation, represents the consumption of the additional labour employed in Department I  $\Delta V$ , and the consumption of the capitalists of Department I

Since production under competitive capitalism is unplanned and is the result of the countless individual decisions taken independently of one another, there is no guarantee that the condition of realization of the surplus value would be satisfied. When this condition is not satisfied, crises in the form of unsold goods would appear. Such crises result from the disproportionate growth of the different sectors of the economy and are, therefore, described as disproportionality crises.

Self Check Exercise-8

Q.1. Discuss Theory of Capitalist Crises.

## 13.11 Summary

Karl Marx's theory of value is a continuation and refinement of the classical labour theory of value of Petty, Smith and Ricardo. Like Smith and Ricardo, he too makes a distinction between use value and exchange value of commodities.- There is a tendency among the historians of economic thought to identify the classical (which includes the Marxian also) concept of use value or "value-in-use" with the neo-classical concept of "utility" which is rather wrong. The classical and Marxian concept of use value, unlike its neoclassical counterpart, is not a subjective concept: it is not conceived to reflect a subjective or psychological relation between the subject (the buyer) and the object (commodity) as is the case with the neoclassical concept of "utility" on the other hand, it refers to those *Objective* properties of a commodity by virtue of which it satisfies a particular human want. Surplus value created by labour is the only source of profits. Abstracting from land and money capital, profits are identical with surplus value produced by labour but appropriated by the capitalists under the production and property relations prevalent and legalized in a capitalist society. Surplus value is unpaid labour and therefore represents exploitation of labour. Profits depend on surplus value which, in turn, depends on the exploitation of labour. Thus there is direct link between profits and exploitation. The Rate of Exploitation is defined to equal the rate of Surplus Value (s) which is the ratio between the surplus value (s) and the *variable capital* (v) invested in the form of wages paid to the labour employed.

Karl Marx's theory of capitalist development is based upon the assumption of free competition. It is the force of competition which validates his theory of value. In the absence of competition, his labour theory of value might not apply.

It is, again, the assumption of free competition which validates his postulate, which he shares with the classical that there tends to be a uniform rate of profit in a capitalist economy as a whole. If there are different rates of profit in the economy, capital would move to the sectors where the rate of profit is higher from the sectors where it is

lower. Thus competition would ensure that in equilibrium there is one and only one rate of profit that prevails throughout the economy.

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One of the fundamental criticisms against Marx's labour theory of value is that it suffers from a "great contradiction". This Contradiction shows up in the form of the contradiction between its implication that a higher organic composition of capital ( $c/v$ ) results in a lower profit rate and the real-world reality showing rather the reverse relationship.

If the relative prices are assumed to correspond to the relative labour values of commodities, the net product of equal quantities of labour would sell for equal quantities of money. Since, under free competition, there is a uniform wage rate, the rate of surplus value would also be uniform. But, if the organic composition of capital is not the same throughout the economy, while profit per worker employed is uniform, it would imply that the rate of profit on the total capital employed would be lower in industries employing more capital per man, that is, in industries having higher organic composition of capital and till us profit rate would be higher in industries employing less capital per man, that is, the industries having lower organic composition of capital. This implication of Marx's labour theory of value contradicts his postulate of a uniform rate of profit under free competition. Moreover, this implication of Marx's labour theory of value flies in the face of another fact also.

## 13.12 Glossary

**1. The Rate of Exploitation** is defined to equal the rate of Surplus Value ( $s$ ) which is the ratio between the surplus value ( $s$ ) and the *variable capital* ( $v$ ) invested in the form of wages paid to the labour employed.

**2. Productivity:** the relationship between inputs and output, which can be applied to individual factors of production or collectively. labour productivity is the most widely used measure and is usually calculated by dividing total output by the number of workers or the number of hours worked. Total factor productivity attempts to measure the overall productivity of the inputs used by a firm or a country. Alas, the usefulness of productivity statistics is questionable. The quality of different inputs can change significantly over time. There can also be significant differences in the mix of inputs. Furthermore, firms and countries may use different definitions of their inputs, especially capital. That said, much of the difference in countries' living standards reflects differences in their productivity. Usually, the higher productivity is the better, but this is not always so. In the UK during the 1980s, labour productivity rose sharply, leading some economists to talk of a 'productivity miracle'. Others disagreed, saying that productivity had risen because unemployment had risen - in other words, the least productive workers had been removed from the figures on which the average was calculated. There was a similar debate in the United States starting in the late 1990s. Initially, economists doubted that a productivity miracle was taking place. But by 2003, they conceded that during the previous five years the United States enjoyed the fastest productivity growth in any such period since the second world war. Over the whole period from 1995, labour productivity growth averaged almost 3% a year, twice the average rate over the previous two decades. That did not stop economists debating why the miracle had occurred.

**3. Profit:** the main reason firms exist. in economic theory, profit is the reward for risk taken by enterprise, the fourth of the factors of production - what is left after all other costs, including rent, wages and interest. Put simply, profit is a firm's total revenue minus total cost. Economists distinguish between normal profit and excess profit. Normal profit is the opportunity cost of the entrepreneur, the amount of profit just sufficient to keep the firm in business. If profit is any lower than that, then enterprise would be better off engaged in some alternative economic activity. Excess

profit, also known as super-normal profit, is profit above normal profit and is usually evidence that the firm enjoys some market power that allows it to be more profitable than it would be in a market with perfect competition.

4. **Capitalism:** the winner, at least for now, of the battle of economic 'isms'. capitalism is a free-market system built on private ownership, in particular, the idea that owners of capital have property rights that entitle them to earn a profit as a reward for putting their capital at risk in some form of economic activity. Opinion (and practice) differs considerably among capitalist countries about what role the state should play in the economy. but everyone agrees that, at the very least, for capitalism to work the state must be strong enough to guarantee property rights. according to Karl Marx, capitalism contains the seeds of its own destruction, but so far this has proved a more accurate description of Marx's progeny, communism.
5. **Competition:** Competition occurs between different companies trying to produce and sell the same good or service. Companies may compete with each other for markets and customers; for raw materials; for labour; and for capital.
6. **Communalism:** The word communalism refers to the process of forming collective communities, where property and resources are owned by the community and not individuals. It can also mean a system of government in which the state is seen as a loose federation.

### 13.13      **Answers to self check Exercises**

Self Check Exercise-1

Ans.1      Please Refer section 13.3

Self Check Exercise-2

Ans.1      Please Refer section 13.4

Self Check Exercise-3

Ans.1      Please Refer section 13.5

Self Check Exercise-4

Ans.1      Please Refer section 13.6

Self Check Exercise-5

Ans.1      Please Refer section 13.7

Self Check Exercise-6

Ans.1      Please Refer section 13.8

Self Check Exercise-7

Ans.1 Please Refer section 13.9

Self Check Exercise-8

Ans.1 Please Refer section 13.10

### **13.14 References/ Suggested Readings**

1. Eric Roll: *"A History of Economic Thought"*.
2. M. Blaug: *Economic Theory in Retrospect*.
3. J.A. Schumpeter: *"History of Economic Analysis"*.
4. I. Rima: *Development of Economic Analysis*
5. Joan Robinson: *"An Essay on Marxian Economics"*.
6. J.A. Schumpeter: *"Ten Great Economists"*.

### **13.15 Terminal Questions**

Q1. Explain Marx view on Surplus, Value, Competition and Profit?

Q2. Explain the theory of Capitalist Accumulation and Development? Does this led to capitalist crisis?

## Unit- 14

### NEO-CLASSICAL ECONOMICS

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#### Structure

- 14.1 Introduction
- 14.2 Learning Objectives
- 14.3 Similarity between the Neoclassical and the Classical Economics  
Self Check exercise-1
- 14.4 Neoclassical Economics: Distinctive Features  
Self Check exercise-2
- 14.5 Summary
- 14.6 Glossary
- 14.7 Answers to self check Exercises
- 14.8 References/ Suggested Reading
- 14.9 Terminal Questions

#### ➤ 14.1 Introduction

Neo-classical Economics is the name that is generally, given to a particular development in the science of economics which took place, more or less simultaneously, in more than one country during the latter half of the nineteenth century but more particularly during the last three decades of it. It was a development which brought about a more or less complete transformation in both the objective of and the method of economic analysis, even though the fundamental assumptions with regard to the human behaviour as well as the socio-economic institutions continued to remain the same in the new theories as they were in the classical theory. The new theory was as much concerned with the explaining of the behaviour of an economic system which was based upon the economic, social and legal institutions of what may be described as competitive capitalism as the old classical theory but the focus of analysis in the new theory was remarkably different from that in the classical theory. It is due to this that the new economic theory which consolidated itself towards the last quarter of the nineteenth century came to be termed as the “neoclassical economics.” It displayed quite strong similarities as well as dissimilarities with classical economics.

#### 14.2 Learning Objectives

After going through this unit you will be able to:

- List the Similarity between the Neoclassical and the Classical Economics
- Give Distinctive features of Neo Classical Economics

### 14.3 Similarity between the Neoclassical and the Classical Economics

It would be proper for us to begin with describing the similarity between the neoclassical and the classical economics. As we have already observed above, there is a similarity between the neoclassical economics and the classical economics in so far as the basic objective of their analysis is the same, namely, the explaining of the behaviour of a particular type of economic system known to us as competitive capitalism. This obviously, involves certain assumptions -with regard to socio- economic and legal institutions, on the one hand, and .with regard to motives of human behaviour, on the other, it will be found that these assumptions underlying both the neoclassical and the classical economics are identical. Both of these schools of economic thought assume liberalist socio-economic and legal institutions. To put it more specifically; both the theories are based on the explicit or implicit assumptions of the institutions of private property and individual freedom. Hither of them presupposes a socio-economic system in which every individual is free to own property in any form, except, of course, in human form, and is free to make use of it in whatever way he likes, provided it does not endanger the similar property rights of other fellow individuals. The individuals are assumed to have right of private property not merely in consumption goods but more importantly, also in means of production. All means of production such as land and various forms of capital, apart from labour, are assumed to be owned and disposed of individually. Both the theories also assume the economic institution of market in which goods are freely bought and sold. The buyers and sellers are generally assumed to operate in the market individually and freely in competition with one another and not in combinations. In other words, both the theories assume free competition in the markets for goods and factor services. Monopoly is generally ignored or, when analyzed, is treated as an exceptional case. These roots of neoclassical economics, in fact, go back into Adam Smith's *Wealth of Nations*.

The behavioural assumptions, that is, the assumptions with regard to the motive of human behaviour, are also identical in both the theories. Both assume individuals to behave rationally and the rational behaviour in both the theories is interpreted to mean a regard for one's "self-interest" to use Smith's favourite expression. In the neoclassical economics, it is given an overtly utilitarian colour and is interpreted as "maximizing" behaviour: individuals as consumers are assumed to be maximizing utility from their money expenditure, and as producers are assumed to be maximizing their money profits.

Another aspect in which both the theories resemble is their implicit assumption that the capitalist economic system has been with us from the very beginning and will last forever. This observation fits much more the neoclassical economics rather than the classical economics, for some of the classical economists, particularly Adam

Smith, were aware that the capitalist economic system that they analyzed was preceded by other types of socio-economic systems. But this awareness did not influence their analysis of capitalism any way. Moreover as Marx used to observe, for the classical history ended with the establishing of the capitalist society, that is, they assumed that capitalism was going to last forever. This, for all practical purposes, the classical assumption was the same as the neoclassical assumption, namely, that capitalist system is eternal. In other words, in both the theories we find an ahistorical approach.

Another similarity between the two schools of thought which, in a way, follows directly from the ahistorical approach of both is that both the theories are deductive theories derived from a given set of premises by the deductive method of reasoning. While Adam Smith did care to adduce some empirical evidence based upon some historical data or cross-country data, the classical theory, on the whole and particularly of Ricardian mould, was deductive in nature. The neoclassical economics not merely carried on this methodological classical tradition but also perfected it and followed it to the extreme making its analysis, in this process, even much more abstract than the classical analysis.

Since both the schools of economic thought were influenced, in their world outlook, by philosophical radicalism and its concomitant utilitarianism which put the individual and his interest at the centre of all considerations and regard society merely as an aggregation of individuals and social interest merely as the sum of individual interests (which is evident in Adam Smith's famous and oft-quoted observation to the effect that individuals in pursuit of their individual self-interest are led by an invisible Hand to promote the best interest of society as well), both streams of economic thought, the classical as much as the neoclassical, symbolized extreme individualism which the historicist critics of the classical school described as "atomism."

The two streams, of economic thought under consideration are similar also because both regard all types of economic transactions to be taking place under the guidance of the market mechanism. Moreover, both the streams convey their common underlying conviction that a freely working market mechanism has an optimizing characteristic. In this sense, the neoclassical welfare economics is nothing but a sophisticated analytical version of the proposition of Adam Smith referred to above, in which the Invisible Hand is stated to lead the individuals pursuing their individual self-interest to promote the best interest of the society as a whole. Blaug, in the chapter on Adam Smith in his *Economic Theory in Retrospect*, has very aptly observed that Adam Smith's "Invisible Hand" is nothing but a reference to the optimizing character of a freely competitive market economy.

Both the theories are similar in a formal sense also, as either of them aims at a fundamental explanation of the process of exchange, even though their routes of doing this were different, the classical theory doing it by going into the sphere of production and coming up with the labour theory of value, while the neoclassical theory (disregarding Marshall's synthesis) did it by unraveling the subjective



psychological relationship between the subject and the object and coming up with the utility theory of value.

Another important and fundamental similarity between the two schools is to be observed in their common belief in the famous Say's Law Which visualizes a unique full-employment equilibrium in a freely competitive economic system in which all prices inclusive of the factor prices are perfectly flexible both upwards and downwards. It was this underlying similarity between the two schools of thought which led J.M. Keynes, in his *General Theory of Employment, Interest and Money*, to club together both under the title of "classical theory" whenever he wanted to criticize the so-called "classical theory" and contrast it with his own new theory of aggregate effective demand. It is thus not without reason that in both the theories the analysis of business cycles was neglected.

Last but not least, the two theories are also similar in as much as both of them claimed to have developed a universally valid theory, even though their shared claim was based on different premises. The classical made the claim of universal applicability of their laws on the assumption that the stratified society of their times was eternal. The neoclassical, who had replaced the classical labour theory of value with their utility theory of value based upon subjective and psychological approach, claimed universality for their laws on the assumption that human psychology at all times and places the same and consequently their theory was applicable under all possible social orders.

Self Check exercise-1

Q.1 Discuss the Similarity between the Neoclassical and the Classical Economics.

#### **14.4 Neoclassical Economics: Distinctive Features**

The neoclassical economics marks a conspicuous break from the classical approach to economic analysis. In the economics of the neoclassical school the focus of economic analysis shifted from the long-run problems of development and growth, which was the chief preoccupation of the classical economists, to the rather short-run problems of allocation of resources of a society. The theme of allocation of resources was not completely absent in the classical economics. But, there, it was only a subsidiary theme standing only as an adjunct to the main theme of production and distribution of wealth of nations and their interrelationship. The neoclassical economic brought about a reversal of the classical priorities in economic analysis. While in the classical analysis the grand themes of long- run development and growth and its impact on class distribution occupied the prime place, in the neoclassical economics these grand themes faded out and almost the whole canvas of neoclassical economics was occupied by the analysis of allocation of resources.

The above transformation brought about by neoclassical economics has been sought to be explained variously in terms of the socio-economic change that had taken place in the late nineteenth century capitalism and their political implications. Commentators of liberalist philosophical persuasion believe that the neoclassical

economics took birth in a period that had enjoyed unprecedented prosperity in which the crises of overproduction and under-consumption foreboded in the writings of Malthus, Sismondi and particularly Karl Marx, did not materialize in the critical form predicted in those analyses. A continuous process of economic growth was, therefore, assumed by the neoclassical economists as a matter of course requiring no special attention of the economists. Moreover, since the working class of the Western capitalist societies had also started to have a share in the economic prosperity by way of improved wages, though it was at the expense of the working classes of the colonies, it was thought that ominous warnings implied in Marx's analysis having classical roots could be ignored. Therefore, these commentators hold that the de-emphasizing of the problems of production, growth and distribution that is class distribution by the neoclassicists was natural and appropriate. But the commentators of radical philosophical persuasions have a different interpretation. The Russian Marxist political-economist, Bukharin, for example, has described neoclassical economics as "The Economic Theory of the Leisure Class." In a society in which prosperity and, therefore, production is taken for granted and in a society which is dominated by nonworking classes of reinters of various hues it is, more or less, natural that consumption instead of production should take the top priority. Karl Marx's economics had never been allowed to become a part of the mainstream economics and had been, as though by a tacit conspiracy, relegated to the background on account of its dangerous political connotations. Neoclassical economics was a sub-conscious, if not a conscious, effort by the mainstream economic thinkers of the establishment to divert attention from the classical themes of production and distribution, a territory on which they well knew they could not withstand the challenge of Marxian analysis. Hence their emphasis on problems of allocation and their preoccupation with the surface phenomena of the market forces demand and supply, on account of which Marx had described this type of economics as "vulgar" economics.

The genesis of neoclassical economics has been related to not only the socio-economic changes that had taken place in the Western capitalist societies but also to the philosophical and intellectual currents of the time. It is said by W.J. Barber, in his *History of Economic Thought*, that "In the main, neoclassical writers absorbed the late nineteenth century faith in progress and in the benevolence of its consequences .... These influences converged to direct the attention of economic theorists to an analysis of economic behaviour focusing on its decision-making units like households, firms and industries and on the wages in which choices made by their economic agents were converted into an orderly process." Referring to the neoclassical economics as "modern economics," Eric Roll also makes substantially a similar observation. "The truth" he observes, "is that the theory which had broken away from classicism and which had its' roots in the developments of the nineteenth-century capitalism, made the changes of the seventies inevitable. And it would be nearer the mark to regard

the concern of the new theory with the behaviour of the individual as a sign of the progress of liberal political philosophy."

In the neoclassical paradigm, all economic phenomena of a modern economy are reducible to a network of exchange transactions in the market. An economy is conceived merely as an interwoven web of exchanges. The whole focus is on the surface phenomena of demand and supply which is quite obvious as regards the consumption goods. But even the transactions of production processes are presented as resolving themselves into the buying and selling of inputs like raw materials, capital goods, labour, money capital, etc. Economic system is thus looked upon as a conglomeration of inter dependent markets. Consequently, the central problem in neoclassical economics is the analysis and explanation of the process of exchange or the price mechanism. Neo-classical economics reduced the whole science of economics to merely a science of prices.

This is not to suggest that the classical economics was not at all concerned with this problem. In fact, the roots of the demand-and-supply analysis of prices can be traced back to Adam Smith's discussion of the determination of the market and the "natural" prices. But, unlike the neoclassical economics, the classical economics showed an awareness that the surface phenomena of price of demand and supply were, ultimately, to be explained with reference to more fundamental forces related to social relations. Thus, while the classical economics cared to go behind the surface phenomena of demand and supply in order to unravel the underlying fundamental forces, the neoclassical economics merely confined itself to the apparent market phenomena of demand and supply. Whenever they cared to go behind these market phenomena, they did not discover there any particular historical social relations but found there only the subjective psychological factors of "utility" and "disutility".

The above distinctive way of treating the market phenomena of prices led the neoclassical economists to abandon the labour theory of value and to substitute in its place a theory of value which sought to explain the market phenomena of demand and supply in terms of the subjective factors of "utility," on the one hand, and "real cost" or "disutility," on the other.

By transforming the classical objective approach into a subjective approach to the market phenomena, the neoclassical economics brought about a rupture between economic analysis and the underlying social relations which in the classical economics were seen as class relations in the society of the times, comprised, as it was of the three social classes of landlords, capitalists and the workers. Thus the emphasis in the neoclassical economics shifted from society to the individual. As Eric Roll observes, "In nearly all classical literature economic analysis was allied with an historical view of the structure of society which underlay the whole economic process. In its place was put a view of society as an agglomeration of individuals." This change in approach leading to the subjective theory of value betrays an extremely individualist view of society making the neoclassical economics "atomistic" in the real sense of the term. In fact, the charge

of the German romantics and historicists that the classical economics of Adam Smith and his followers was "atomistic" fits much more suitably the neoclassical economics than the classical economics.

The final abandonment of the labour theory of value by the neoclassical economics snapped the last link between economic theory and the historical factor of production and social relations. The replacement of the objective labour theory of value by the neoclassical economics led it to claim universality for itself on seemingly firmer ground that human psychology in all times and places is the same. Consequently, the neoclassical economics had an unhesitant tendency to deny in theory and practice the historic-relative character of economic laws and to assert the absolute and universal validity of the laws of economics. The charge of claiming universal validity of its laws by the classical economics also has been made not very unjustly. But the ground of the claim of the classical was much less firm as they premised it on an obviously false assumption that the capitalist system based on a freely competitive market mechanism was an eternal socio-economic system.

The extreme individualist approach to economic analysis, to which we referred to above, led the neoclassical economists to an analysis of economic behaviour which focused on the behaviour of the micro units of society which took economic decisions. The focus of analysis in neoclassical economics was shifted to the economic behaviour of individual households and individual firms. An industry was treated no more than a mere summation of individual industries. Demand for the commodity was no more than the summation of individual demands and the aggregate demand in the economy was treated as no more than the summation of the demand for the products of the individual industries. The net result of this approach was that the neoclassical economics replaced the macro-economic analysis of classical economics' with its micro-economic analysis. Neoclassical economics, in effect, identified economics with microeconomics and the monetary and the business cycles theories appear to hang in its scheme of analysis. This was the state of affairs till after the Second World War when the neoclassical began to pay some attention to macro-analysis also under the challenge of the new growth theories. But, even then, the neoclassical economics is mainly and predominantly micro-economics.

This shift of focus of economic analysis from the classical macro-problems to the micro-problems resulted in the recording of analytical priorities for organizing economic theory and for selecting issues deserving attention in a reorganized theory which came to be termed as neoclassical economics. The consequence was the same as referred to earlier also, namely the elevation of the status of the theory of market prices to a level such that the neoclassical economics tended to identify price theory with the whole body of the science of economics. And, the price theory itself was reduced to a mere analysis of allocation of resources at the household level and the firm level. Nowhere is this outstanding characteristic of neoclassical economics as much and as lucidly evident as in the

classic neoclassical definition of the science of economics, given by Prof. Robbins, as the “study of human behaviour as a relationship between ends and scarce means that have alternative uses.” In the classical economics, the analysis of market prices was subsidiary and subordinated to the analysis of “natural value.” But in the neoclassical economics, the analysis of market prices became almost the “Open Sesame” for almost all analytical problems in economics.

A natural consequence of identifying economic theory with mere price theory was a shift from the classical and the Marxian concern for the long-run problems to the static problem of allocation of resources. The neoclassical economics abandoned the grand themes of growth and class distribution to exchange it for rather 'trifle' themes of allocation of resources. As Joan Robinson also observed, in her *On Re-reading Marx*, this shift of forces of economic analysis in the neoclassical economics displaced the big classical questions of growth and distribution by such little ones as “why does an egg cost more than a cup of tea ?”

*As we hinted at earlier also, it was not mere chance but an almost uninterrupted (in the sense of the absence of any “critical” crisis and not in the sense of the absence of any crisis) affluence of t* in the sense of the absence of any crisis) affluence of the nineteenth century capitalist society which distanced neoclassical economics from' the analytical modes of the classical and Marxian traditions. More than one commentator, and all of them are not Marxists in their ideology, he observed that the neoclassical economics, at least in its initial formulations, was consciously designed to provide a refutation of Marx. Thus, the pioneers of the neoclassical economics “effectively removed economics from historical time and detached from the ‘laws’ of history. The search for the laws of motion of society was largely abandoned to be replaced by the investigation of the market processes and their allocative properties.” (W.J. Barber)

Neoclassical economics also started the trend of casting economic analysis in the image of the "natural sciences. While Leon Walras made a rich use of the images and vocabulary of the science of physics, particularly of mechanics. Marshall supplemented it with the images and vocabulary of the science of biology. The objective was to reorganize economic science as a positive science like the natural sciences. This tendency resulted in the formulation of abstract models. It far exceeded the level of abstraction that we find in Ricardo. Moreover, the tendency of the neoclassical economics to abstract from reality and to construct their argument around "pure cases" led it to neglect very significant aspects of social reality. Another important result of neoclassical economists' method of analysis was the increasing use of mathematics. Since the neoclassical economics was pioneered by the “marginalist” school and since the marginal analysis, which deals with infinitesimally small incremental changes, was eminently suited to the use of the techniques of the differential calculus, mathematisation of economics by the neo-classical started with the use of differential calculus. But, by and by, other branches of mathematics also intruded into it. This trend too tended to make

neoclassical economics to detach itself more and more from the socio-economic reality. Although the use of mathematics might have helped to increase the rigour of the neoclassical economic analysis, yet at the same time, it tended to make it a sort of 'ivory tower' science losing touch with the real problems of a real, as distinct from an abstract, historical society. The charge against the excessive use of mathematics in a social science like economics to the effect that mathematics in economics is employed more to 'cover rather than reveal the truth' is not totally misplaced.

Finally, neoclassical economics has also been characterized as apologetics which means that it was inspired by the motive of providing a justification for the prevailing capitalistic socio-economic system and to defend it against the Marxian and other socialist criticism. This they did by developing, first, theorems of *real costs* which tended to demonstrate that a capitalist's "abstinence" was on an equal footing with the "toil and trouble" of the labour—theorems which said nothing about the real social differentiation of these individuals. However, as it was not possible to convincingly equate the abstinence of the capitalist with the "toil and trouble" of the labour in terms of the subjective costs, the neoclassical economics tended to abandon the cost approach more completely and to replace it with a more fully developed utility analysis. The apologetic character of neoclassical economics reached its zenith in the Paretian welfare economics which, abstracting from the important problem of distribution, tended to demonstrate that a free-market competitive capitalist economy had an inherent tendency to optimize social welfare and, hence, a laissez-faire competitive capitalist economy was the "ideal" economic system.

Self Check exercise-2

Q.1 Discuss the Distinctive Features of Neoclassical Economics.

## 14.5 Summary

Neo-classical Economics is the name that is generally, given to a particular development in the science of economics which took place, more or less simultaneously, in more than one country during the latter half of the nineteenth century but more particularly during the last three decades of it. It was a development which brought about a more or less complete transformation in both the objective of and the method of economic analysis, even though the fundamental assumptions with regard to the human behaviour as well as the socio-economic institutions continued to remain the same in the new theories as they were in the classical theory. The new theory was as much concerned with the explaining of the behaviour of an economic system which was based upon the economic, social and legal institutions of what may be described as competitive capitalism as the old classical theory but the focus of analysis in the new theory was remarkably different from that in the classical theory. It is due to this that the new economic theory which consolidated itself towards the last quarter of the nineteenth

century came to be termed as the "neoclassical economics." It displayed quite strong similarities as well as dissimilarities with classical economics.

The neoclassical economics marks a conspicuous break from the classical approach to economic analysis. In the economics of the neoclassical school the focus of economic analysis shifted from the long-run problems of development and growth, which was the chief preoccupation of the classical economists, to the rather short-run problems of allocation of resources of a society. The theme of allocation of resources was not completely absent in the classical economics. But, there, it was only a subsidiary theme standing only as an adjunct to the main theme of production and distribution of wealth of nations and their interrelationship. The neoclassical economic brought about a reversal of the classical priorities in economic analysis. While in the classical analysis the grand themes of long-run development and growth and its impact on class distribution occupied the prime place, in the neoclassical economics these grand themes faded out and almost the whole canvas of neoclassical economics was occupied by the analysis of allocation of resources.

The above transformation brought about by neoclassical economics has been sought to be explained variously in terms of the socio-economic change that had taken place in the late nineteenth century capitalism and their political implications. Commentators of liberalist philosophical persuasion believe that the neoclassical economics took birth in a period that had enjoyed unprecedented prosperity in which the crises of overproduction and under-consumption foreboded in the writings of Malthus, Sismondi and particularly Karl Marx, did not materialize in the critical form predicted in those analyses. A continuous process of economic growth was, therefore, assumed by the neoclassical economists as a matter of course requiring no special attention of the economists. Moreover, since the working class of the Western capitalist societies had also started to have a share in the economic prosperity by way of improved wages, though it was at the expense of the working classes of the colonies, it was thought that ominous warnings implied in Marx's analysis having classical roots could be ignored. Therefore, these commentators hold that the de-emphasizing of the problems of production, growth and distribution that is class distribution by the neoclassicists was natural and appropriate. But the commentators of radical philosophical persuasions have a different interpretation. The Russian Marxist political-economist, Bukharin, for example, has described neoclassical economics as "The Economic Theory of the Leisure Class." In a society in which prosperity and, therefore, production is taken for granted and in a society which is dominated by nonworking classes of reinters of various hues it is, more or less, natural that consumption instead of production should take the top priority.

Karl Marx's economics had never been allowed to become a part of the mainstream economics and had been, as though by a tacit conspiracy, relegated to the background on account of its dangerous political connotations. Neoclassical economics was a sub-conscious, if not a conscious, effort by the mainstream economic thinkers of the establishment to divert attention from the classical themes of production and distribution, a territory on which they well knew they could not withstand the challenge of Marxian analysis. Hence their emphasis on problems of allocation and their preoccupation with the surface phenomena of the market forces demand and supply, on account of which Marx had described this type of economics as "vulgar" economics.

The genesis of neoclassical economics has been related to not only the socio-economic changes that had taken place in the Western capitalist societies but also to the philosophical and intellectual currents of the time.

## 14.6 Glossary

1. **Equilibrium:** In neoclassical economics, equilibrium exists when supply equals demand for a particular commodity. General equilibrium is a special (purely hypothetical) condition in which every market (including markets for final products and factors of production, the latter including labour) is in equilibrium.
2. **General Equilibrium:** Neoclassical economics assumes that production, employment, investment, and income distribution are all determined by a condition of equilibrium (with demand equalling supply) in every single market (including markets for both factors of production and produced goods and services).
3. **Microeconomics:** The study of the economic behaviour of individual "agents" such as particular companies, workers, or households.
4. **Neoclassical Economics:** Neoclassical economics is the dominant approach to economics currently taught and practiced in most of the world (and especially dominant in Anglo-Saxon countries). It attempts to explain the behaviour of the economy on the basis of competitive, utility-maximizing behaviour by companies, workers, and consumers. Their actions in the markets for both factors of production and final products will ensure that all available resources are fully utilized (that is, the economy is supply-constrained) and every factor is paid according to its productivity.
5. **Surplus:** Any agent or sector in the economy (household, business, or government) experiences a surplus when its income exceeds its expenditure.
6. **Capitalist Class:** The group of individuals (representing just a couple of percent of the population in advanced capitalist countries) which owns and controls the bulk of private corporate wealth, and which as a result faces no compulsion to work in order to support them.



## 14.7 Answers to self check Exercises

Self Check exercise-1

Ans.1 Please Refer Section 14.3

Self Check exercise-2

Ans.1 Please Refer Section 14.4

## 14.8 References/Suggested Readings

23. Eric Roll: "*A History of Economic Thought*".

24. W. J. Barber: "*A History of Economic Thought*".

## 14.9 Terminal Questions

Q1. "Neo-Classical economics reduced the whole science of economics to merely a science of prices" elaborate this Statement?

Q2. Critically discuss the salient features of neo-classical economics?

## **Unit- 15**

### **THE MARGINAL REVOLUTION**

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#### **Structure**

15.1 Introduction

15.2 Learning Objectives

15.3 The Austrian School

15.3.1 Carl Menger (1840-1921)

15.3.1.1 Methodology

15.3.1.2 Monetary Theory

15.3.1.3 Value Theory

15.3.1.4 Theory of Production

15.3.1.5 The Distribution Theory

Self Check exercise-1

15.4 Friedrich von Wieser (1851-1926)

Self Check exercise-2

15.5 Eugene von Bohm-Bawerk (1851-1914)

Self Check exercise-3

15.6 Summary

15.7 Glossary

15.8 Answers to self check Exercises

15.9 Suggested Readings

15.10 Terminal Questions

#### **15.1 Introduction**

We mentioned in the preceding lesson (No. 14) on the neoclassical economics that neoclassical economics could rightly be considered to have taken birth with what is generally described as the “marginal revolution” in the history of economic thought. Anyway, the extensive use of marginal analysis in economics is one of the most distinctive features, if not the only, of the neoclassical economics. But, as Blaug has observed, the term, “marginal revolution” is misleading because the concept succeeded gradually and not suddenly as is implied in the noun in the term, “marginal revolution,” which, in fact started with the marginal utility analysis. And in the term “marginal utility,” to re-quote Blaug, “what was important .... was the adjective rather than the noun.” It is because the concept of utility had a longer history than the concept of the margin, though in a very limited use we find it in Ricardo’s theory of rent. But in Ricardo’s theory the use of the concept of the margin was a solitary exception and not a general

analytical tool that it became in the hands of the marginalist school of economics represented by an international group of economists such as those belonging to the Austrian school and the Lausanne school, the British economists like Jevons and Marshall, and the Swedish economist, Wicksell. It was, in fact, the introduction of the marginal analysis, rather than the discovery of the utility principle that stood out as the true dividing line between the classical economics and the neoclassical economics, because, as already observed, the utility principle had a longer history going back to Say and Condillac of the classical school.

The marginal revolution in economics directly led to some of the most distinctive features of the neoclassical economics. In the first place, it led to the abandonment of the classical concern for the analysis of the effects of changes in the quantity and quality of labour on the pace of capital accumulation, economic development and growth. But, after the marginal revolution of the 1870s, the analysis of factor supplies and their effects on development and growth disappeared from the economics which came to be known as the neoclassical economics. Only in the post-Second World War period some growth economists built up what is described as the neoclassical growth model. Till then development and growth were non-existent topics in neoclassical economics.

Another consequence of the marginal analysis was that in the absence of any interest in the analysis of supply, particularly in the long-run supply of factors, the neoclassical economics (with the exception of Marshall to some extent) worked with the ubiquitous assumption of given and constant factor supplies. It was this which led the neoclassical economists to conceive economic problems as merely problems of efficient allocation of resources and economic science as the “study of human behaviour as a relationship between ends and scarce means which have alternative uses.”

The above led the neoclassical economists to focus their analysis on demand and on the short-run only. The classical theory of economic development and growth was replaced by the neoclassical theory of general equilibrium within an essentially static framework.

The emphasis on optimum allocation of resources in neoclassical economics is much stronger however, in the writings of the Lausanne and Austrian schools of economics than in the British school led by Marshall who never completely abandoned the classical belief that economic welfare depended as much, if not more, on the growth of capital and labour as on the efficient allocation of resources. But the fact remains that even Marshall devoted more attention to the latter than the former.

The conventional assumption of a maximizing behaviour of the “economic man” which was firmly established in the neoclassical economics led via the marginal analysis, to the famous theorems of substitution at the margin and maximization of objective functions. This development eminently suited the use of mathematical reasoning in economic analysis. It was not the utility theory but the marginalism which opened the gates for the mathématisation of economics after the

1870. Neoclassical economists like Walras, Cournot, Edgeworth and Pareto were professedly mathematical economists, though Marshall, Wicksteed, Wicksell and Casell represented literary economists using mathematical tools where *necessary*.

Another consequence of the marginal revolution was that the neoclassical abandoned the classical class analysis of distribution. Class distribution was no longer the concern of economic analysis in the neoclassical economics. The analysis of class shares in national output was replaced by the so-called functional distribution which was interpreted merely as the determination of factor prices.

Having explained the broad features of neoclassical economics and the marginal revolution that the former heralded, we shall now describe the specific contributions of the Austrian school followed by the description of the specific contributions of Leon Walras W.S. Jevons and Knut Wicksell.

## **15.2 Learning Objectives**

After going through this lesson you will be able to:

- Explain the Menger theory of Production
- enlighten the Menger theory of Distribution
- confer the view of von Wieser
- explicate the contribution of Bohm-Bawerk in the history of economic thought

## **15.3 The Austrian School**

The so-called marginal revolution in the history of economic thought which is considered the hall-mark of neoclassical economics is associated with the name of the Austrian school in the popular mind, although W.S. Jevons, Jevon Walras and Marshall's names are also associated with it, not to mention the German economic thinker. Herman Heinrich Gossen whose work *The Isolated State*, published in 1854 had anticipated the marginal utility school of economics. In any case, between 1870 and the outbreak of the first World War, Vienna, the Austrian capital, was the site of the most famous and flourishing school of neoclassical economics led by Carl Menger. His two very important followers were Fredrich Von Wiesner and Behm-Bawerk.

### **15.3.1 Carl Menger (1840-1921)**

The contribution of Carl Menger to economics is marked by a high regard for the requirements of a comprehensive system which led him to generalize the neoclassical marginal-utility theory of value to include the groundwork of a sound theory of distribution, though it was left in an embryonic state. He made notable contributions to methodology, the theory of money and, most profoundly, the pure economic theory.

**15.3.1.1 Methodology:** In relation to methodology he stressed that the economic method must rest on an individualist foundation. He can be regarded as a great advocate of the micro-economic method. He argued that economic phenomena were not the direct expression of

some social force but were only the resultants of the conduct of individuals. Therefore, in order to understand the total economic process one had to analyse its constituent elements, that is, the behaviour of the individuals. Thus, like Jevons and Gossen's, he put the individual in the forefront. But he did it differently from them and other post-classical economists influenced by hedonist philosophy. He was all for the atomistic method of analysis considering it to be a methodological necessity, but he also emphasized that it had no ethical or social philosophy implications. He was, thus, the first to attempt building up of a subjective theory of value which was free from any hedonist assumptions.

**15.3.1.2 Monetary Theory:** In the field of monetary theory, his contribution is not popularly known. This contribution of Menger is to be found in a number of articles and memoranda which he produced in connection with the Austrian currency reform which are important contributions to the applied theory of money. His contribution to the pure monetary theory is to be found in a long paper entitled, *Gold*, published in 1892. In this contribution of his, the subjective theory of value was applied for the first time, to the analysis of monetary problem. It is regarded to have presented one of the best brief explanations of the functions of money in the process of exchange and price formation.

**15.3.1.3 Value Theory:** But his real claim to fame in the history of economic thought rests on his subjective theory of value. His analysis of value begins with what he regarded as the two poles of economic activity, namely, human wants and the means to satisfy them. He defines utility, in non-hedonistic and relative terms, as the ability of a thing to be put into a causal relationship with a want. Anything that has this quality becomes a "good," if (i) the want is present; (ii) the causal relationship between the thing and the want is recognized by the individual experiencing the want; and (iii) the individual concerned has the power to apply the thing for the satisfaction of the want. Having thus defined both "utility" and "goods," Menger classifies all goods, on the basis of technical considerations, into goods of the first, the second, the third and the higher orders. The category of goods of the first order is comprised of consumption goods which satisfy human wants directly; for example, bread. The goods of the second and the higher order (flour, wheat, mill) satisfy wants indirectly.

The objective of Menger in classifying goods into different orders on the basis of proximity to the final satisfaction of want is to bring out the technical conditions of production (which, later in his theory, acquires importance in the theories of production and capital) and to establish a relationship between the value of the goods of the first order and the value of the goods of the higher orders. In this way, Menger comes to elaborate the productivity view of the factors of production which Say and others had tried to introduce. He regarded factors of production only as "un-ripened" consumption goods and, therefore, believed that the value theory (marginal-utility) theory which

explained the prices of consumption goods could also explain the prices of "un-ripened" consumption goods, that is, the factor inputs, it was thus that he was led to the correct, though inadequate, statement of the marginal productivity theory of distribution.

Menger was also the first to define goods in a manner to include under this category not only services as we do now but also such non-material things as goodwill and patents. According to Stigler, this emphasis on non-material goods, which is properly extended to include things like monopolies, goodwill and patents, is a genuine though neglected contribution to economic thought."

Menger introduced another classification of goods also which was based on their quantitative relation to wants. The goods whose quantity was less than the want for them was classified by him as "economic" goods. Thus he introduced the concept of *relative* scarcity in defining economic goods. Where the quantity of a good is more than the want for it, there is *relative* abundance of the concerned good which was classified by him in the category of "non-economic" goods. He also made it explicit that the division of goods into the categories of economic and non-economic goods was not a permanent division. Depending on the quantitative relation of a good to its want at a particular time, a particular good could go out of one category to enter the other. But when a good was in the category of economic goods, it may be said to possess "scarcity," a term which the earlier English economists had never fully assimilated into their analyses. Auguste Walras, the father of the famous Leon Walras of the Lausanne school, had come very near to it in his concept of *rare to*, but it was Menger who was the first to define the neoclassical concept of "scarcity" in a precise manner without using the word itself.

His discussion of economic goods leads him to propound his theory of value. According to him, the value of a good to an individual who desires to possess it is derived from the judgment of (that individual in his mind which, in turn, is derived from his realization of an economic quality of the given good, namely, its quantitative relation with his want. As Carl Menger observes, "value is the significance which concrete goods or quantities of goods obtain for us from the fact that we are aware that the satisfaction of our wants is dependent On Our disposing Of these goods." Value arises from the limitation of goods in relation to wants. Free gifts whose quantity is abundant in relation to the want for them have no value.

It is obvious that Menger's concept of value is subjective. But, how is this subjective value determined? Menger argues that we feel different want with different intensity. Moreover, even one and the same want appears in units of different intensity. Each concrete act of satisfaction has a different significance, to the consumer according to the degree of satisfaction that he has already reached. He gives, in this connection, a numerical example which is no more than a formal statement of what is known as Gossen's First Law which states, "The amount of one and the same enjoyment diminishes continuously as we proceed with that enjoyment without interruption, until satiety is reached." It clearly points to the postulate of diminishing marginal

utility. However, it should be noted that in his formal statement and illustration, Menger insisted on the "ordinal" nature of his comparison of the intensity of successive manifestations of want. In other words, his concept of "intensity" or utility was "ordinal".

Menger argues that if for each concrete want there were a single good suited specifically to that want, the determination of value would have been a simple affair, as, in that case, the value of the good would equal the significance that the consumer attaches in his mind to the satisfaction of that want. But reality is not that simple. It is usually complicated by the fact that a consumer has to deal with *quantities* of goods, each one of which can be applied to satisfy more than one of a complex of concrete wants. Consequently, the individual portions of any given good would have different significance for a consumer according to the wants to which they are applied. A consumer will use these portions to satisfy his wants in a descending order of urgency. To discover the value of a portion, we have only to ask ourselves what satisfaction will a consumer be willing to forego, if that portion was deducted from the total quantity of the given good. The answer, obviously, will be the satisfaction of the least urgent want. Hence, according to Menger, the value to an individual unit of the available quantity of any given good equals the significance that he attaches to the satisfaction of the least important want to him. This was only a cumbersome way of saying that the value of a good to an individual equals what W.J. Jevons described as the "final degree of utility," or what we now refer to as the "marginal utility," of the good to him.

Menger goes on to explain the determination of prices of goods on the basis of the above concept of the subjective value which we now describe by the term, "utility". controverts Smith's proposition that exchange results from a "human propensity to truck." On the other hand, he believes that exchange is a part of the general activity of economy which is designed to supply the maximum satisfaction with the available means. This obviously refers to the neoclassical postulate of maximizing behaviour on the part of men and women. Exchange takes place because of differences in the relative subjective valuations of the same goods by different individuals. When any given pair of individuals A and B, actually enter into the act of exchanging portions of any given pair of goods, X and Y the relation between the subjective values of the two goods to each individual will alter until this relation is the same for both the individuals, A and B. At this point, the exchange will stop. This implies that equilibrium in exchange is established, when the ratio of marginal utilities (or the marginal rate of substitution between the two goods is the same for both the parties to the exchange).

He elaborates his theory of price further by examining in turn different market situations ranging from isolated exchange (two parties, two goods) to perfect competition. He demonstrated that in isolated exchange, the price or the ratio of exchange would lie within the limits set by the buyers and the seller's maximum and minimum exchange ratios and it would tend to equal the average of two ratios on the assumption of equal desire on the part of both, the parties to maximize

their individual satisfactions and equal bargaining power. The modern view on this case, however, is that equilibrium exchange ratio is indeterminate, under these assumptions within the above stated limits. But, although he did not say as much, yet he did say that variations from the average due to differences in the bargaining power would be determined by non-economic factors. Under monopoly, when there is only one unit offered, limits are set by the highest bid and the next highest bid. Within these limits, equilibrium price would be determined as under isolated exchange. If more than one unit are offered for sale the limits are set by the bid of the marginal bidder and the bid of the first intra-marginal bidder.

Menger was also aware that the monopolist could resort to price discrimination which was not possible under perfect competition.

#### **15.3.1.4 Theory of Production**

Menger made a very important contribution to the theory of production in the form of the postulate of variable factor proportions. It is a contribution, "the importance of which literally cannot be exaggerated" (Stigler). As Menger observes, "Rather we are taught by the most general experience that a definite quantity of any good of lower order can be "secured from goods of higher order which stand in very different quantitative relationship to each other....." This formulation of the principle of variable factor proportions as a *general* rule governing all resources is one of Menger's greatest achievements—an achievement which he is not required to share - with either Jevons or Walras. It was an achievement which was specifically his own. Classical theory had, of course, recognised in its theory of rent the possibility of varying the amount of capital-and-labour which could be applied to a given plot of land, but even the classical had generally assumed that the proportion between labour and capital could not be varied. The importance of the principle of variable factor proportions lies in this that it led to the propounding of the marginal productivity theory of distribution.

#### **15.3.1.5 The Distribution Theory**

According to Stigler, "The greatest contribution of the theory of subjective value to theoretical economics lies in the development of a sound theory of distribution." And, it was indisputably an achievement of Carl Menger who posed what is known as the problem of imputation, that is, the problem of arriving at the value of goods of the higher orders from the value of goods of the first order. On the basis of his subjective value theory, Menger reaches the conclusion that the value of goods of higher order inclusive of factors of production is "conditioned by the anticipated value of those goods of a lower order for the production of which they serve."

Menger's solution to the imputation problem is not too clear. But he seems to hold that the share of any individual factor is to be determined by the loss in value which the total product would suffer, if that factor was withdrawn from the cooperative combination of factors of production. Perhaps, he also means that the withdrawal of



the factor that he speaks of is to be interpreted to be taking place “at the margin.” This implies that Menger’s theory of distribution was a marginal productivity theory of distribution, though it was a primitive kind of marginal productivity theory of distribution.

There is an absence, in his theory, of the classical trinity of land, labour and capital. They are just goods of the higher order or inputs and, unlike in the classical theory, they are treated as subject to one and the same law of *imputation* as regards the determination of, their value. Thus, Menger laid down the foundations of the neoclassical view of distribution as a problem of factor pricing. The classical concern for class shares is obliterated completely.

Menger’s distribution theory had of course, certain shortcomings when viewed retrospectively from the vantage view point of later developments. He had failed, for example, to develop the indispensable postulate of diminishing returns. He also did not make an explicit statement of the assumption that the units withdrawn should be very, rather infinitesimally, small. Nor did he pose the problem of the exhaustion of the total product.

#### Self Check Exercise-1

- Q.1 What do you know about the Austrian School?
- Q.2 Discuss Monetary theory of Carl Menger.
- Q.3 Discuss Value theory of Carl Menger.
- Q.4 Discuss theory of production Carl Menger
- Q.5 Discuss The Distribution theory of Carl Menger.

### 15.4 Friedrich von Wieser (1851-1926)

Two very famous followers of Carl Menger and important economic thinkers belonging to the Austrian school of economics led by him were Friedrich Von Wieser and Bohm-Bawerk. In the pure theory of value, they did essentially no more than refining Menger’s subjective theory of value. Like Menger, they too put the individual at the fore-front of their analysis, and they continued to conceive utility in the manner of Menger as denoting “significance for conduct” They, however, emphasized the formal character of subjective valuation even more than Carl Menger himself did.

Nevertheless, Wieser is known to have introduced in the theory of value, the term, marginal utility (*Grenznutzen*) in his work, *Ursprung*. But his most durable contribution to the main body of the Austrian as well as the neoclassical theory in general is in the form of his concept of the “opportunity cost” Menger’s value theory had a deficiency in that it had neglected the cost element. Wieser’s concept of the opportunity cost was a definite step towards filling up this gap. With the help of this concept of his, Wieser started a type of analysis which brings him close to the Marshallian view of value. In his *Ursprung*, he almost seems to make value depend on both utility and cost though, in fact his analysis of cost and even its very concept is different from Marshall’s. Unlike Marshall, Wieser and all economists after him belonging to the Austrian school did not make use of the concept of “real costs” Disutility and other sacrifices in the traditional British sense find no place in Wieser’s and work for that matter, the

Austrian theory in general. His implied argument seems to be that if utility is conceived of in a purely formal, that is, analytical sense (i.e., in the sense of relative preference observed from acts of choice), then "disutility" ("real cost") is an unnecessary duplication. Every choice, seen from the standpoint of the alternative foregone, is a sacrifice, for choosing A, while the alternative B could also be chosen, is sacrificing B and choosing B instead is sacrificing A. *Therefore* the disutility of labour and sacrifice associated with waiting (the real-cost concept) could be adequately explained in terms of preference for income or leisure and for present or future goods.

In Wieser's view, the formation of value is 'a circular process. Like Menger, he also derives the value of goods of higher order from the value of goods of the lower order. This derived value, then, becomes the cost element once formed; it is taken as a datum. But logically it is only secondary, a 'derivative.' Wieser goes on to argue that the competition among the entrepreneurs tends to equalize, at the margin, the cost and the price of a good. The entrepreneurs exercise their demand for raw materials, capital goods, labour, etc., in the respective markets according to the existing or anticipated demands for the final products. There might be temporary destabilizing errors, the errors of judgment, but the forces of demand and supply would eventually correct so (that in equilibrium price would equal cost in the sense of the opportunity cost).

Wieser's law of cost or the opportunity-cost principle, as it came to be known later on, can be stated as follows; given the quantities "of the factors of production, competition for acquiring them for different branches of production would tend to distribute their given supplies in such a manner that the values of their different products would allow them to earn the same total amount in every alternative employment.

Wieser's opportunity-cost theory is regarded to possess great elegance which made the Austrian as well as the general utility analysis, at least in its more formal guise of a theory of choice, comprehensive and self-contained and self-consistent with only-minor variations, this theory was widely accepted and propagated by the later neoclassical economists like Wicksteed. It was a particular form in which the marginal productivity theory of distribution could be stated. Finally, it was the theory which eventually pushed out of the neoclassical economics the dubious doctrine of the real costs.

Self Check Exercise-2

Q.1 Discuss view of Friedrich von Wieser.

### **15.5 Eugene von Bohm-Bawerk (1851-1914)**

Though Carl Menger had laid the foundations of the Austrian school of economics and he, therefore, is acknowledged to be the leader of this school, yet the most outstanding member of this school of economic thought was Eugene von Bohm-Bawerk. He is famous in the history of economic thought primarily for his brilliant contribution to (the theory of capital and interest. But, in the course of expounding his theory of capital and interest, he develops a scheme in which his canvas covers the whole economic process. It was on this basis that

his most famous pupil. J.A. Schumpeter compared him to Karl Marx, describing him as the "bourgeois Marx."

Bohm-Bawerk's contribution to the Austrian theory of value is not very significant. It is mostly a restatement of Carl Menger's theory amended in the light of Wieser's opportunity-cost principle and to which he added his own principle of the marginal pairs.

In his theory of capital and interest he takes Karl Marx head on. He is the only well-known mainstream economist of the times who did not try to kill the Marxian view by ignoring it but instead, tried to counter it with a theory in which capital was demonstrated not to be an "exploiting" factor but a contributing factor to economic wealth and thus deserving share in the "surplus" in the form of interest. This might also have led Schumpeter to describe him as the 'bourgeois Marx.'

Unlike Marx, however, Bawerk's worked with the technological approach to capital, while to Marx capital represented a socio-economic relation. Bohm-Bawerk's two monumental works on the theory of capital and interest are *Capital and Interest* and *The Positive Theory of Capital*. Of these, the former is a critical examination of the various theories of capital and interest which had been put forth till his times so that it is indeed a history of the development of the theory of capital and interest till his times. The latter work, a positive work, represents his positive and brilliant contribution to the theory of capital and interest which has immortalized him in the annals of economics. The Austrian theory of capital and interest is solely the achievement of Bohm-Bawerk, indeed a history of the development of the theory of capital and interest till his times.

In Bohm-Bawerk scheme, except in the case of the most primitive of the primitive societies where man-made tools of production might not have been used, all forms of society employed what he describes as the indirect and roundabout methods of production. When a fisherman employs no boat, no fishing net and no other man-made tool to catch fish, but, instead, catches it with his bare hands, it is the direct method of production. On the other hand, when the fisherman first makes a boat and a net and then employs these tools to catch fish, the production takes on an indirect and roundabout character. It is thus that Bohm-Bawerk arrives at a technological definition of capital and "capitalistic" system of production. According to him, "the method of production which wisely follows an indirect course is not nothing more nor less than what the economist calls *capitalist* production capital is nothing but the sum total of intermediate products which comes into existence at the individual stages of the roundabout course of production." The boat and the net in the above example is this "sum total of intermediate products" representing the fisherman's capital. Bohm-Bawerk, despite his emphasis on the wealth-contributing property of capital, acknowledged that capital was only a *produced* means of production which was produced at an earlier stage with the help of the *original* factors of land and labour.

The capitalistic method of production is adopted despite its roundaboutness and the concomitant sacrifice of present or immediate good, because capitalistic method of production is more productive; this

method yields greater product. But this greater output has an opportunity cost in the form of the present consumption that will have to be foregone in order to build up a stock of capital. Thus, the essential point in explaining the capitalistic process of production was, for Bohm-Bawerk, to explain the mechanism through which the advantages of greater output were balanced by the disadvantages of foregoing present consumption which is necessary to build up a stock of capital in order to employ the capitalistic method of production.

Bohm-Bawerk offers an explanation of the above problem on the basis of the Austrian subjective theory of value. The individual in search of maximum utility weighs the utility from present goods against the utility from future goods. He makes an intuitive psychological assumption, namely that the people normally prefer present goods to future goods even when there is no uncertainty with regard to the future goods. He adduces certain arguments based upon human psychology in support of this assumption. Firstly, it is argued, human beings are generally optimistic about their future, always believing that their economic prospects would improve with the passage of time. This is to say that men generally tend to believe that they would possess much larger bundles of goods in future than they have at present. Therefore the marginal utility from the present goods to them is greater than the marginal utility from future goods to them. This explains the premium or the "agio" that people put on the present goods. Therefore, if they are to be induced to forego present goods in order to save for capital-building, they must be paid a reward equaling this premium or "agio". This is how, according to Bohm-Bawerk the rate of interest arises from the supply side. This "agio," however, is the other side of the human tendency to discount future wants. While we tend to overestimate our future means, says Bohm-Bawerk, we, at the same time, tend to underestimate our future wants. This results from a complex of causes, such as a psychological inability to properly perceive our future wants and a feebleness of will which makes us mentally impatient to spend an income as soon as we receive it. Thus, there is a systematic prospective underestimate or discount of future. Thus,, in Bohm-Bawerk theory, it is both the "agio" or the premium that people attach to the present goods and the systematic discount to which they subject future goods which explain the emergence of interest from the side of supply of capital.

But interest cannot emerge simply because the suppliers of savings that go into capital formation demand it. The borrowers of these savings or capital must also be in a position to pay interest, if interest is to emerge as a fact. This is made possible by the fact that the capital-using methods of production are more productive. The use of Capital helps in producing a "surplus" over and above what could be produced without the use of capital. This enables the entrepreneurs employing capitalistic method of production to meet the demand for interest.

Bohm-Bawerk's theory of capital and interest also provided an explanation as to why the period of production cannot be indefinitely lengthened, in spite of the capitalist roundabout method of production

being more productive. With every lengthening of the period of production, the total product would, no doubt, increase, but the marginal significance or the marginal subjective value of it would go on diminishing. Since this diminishing marginal subjective value which ultimately determines the price has to be set against the rate of interest demanded in the market, a time comes when further lengthening of the period of production is no longer profitable. Thus, there is a definite limit to the period of production which is determined by the introduction of the force of premium that the society puts on present goods and the force of productivity of the capitalistic roundabout methods of production.

Self Check Exercise-3

Q.1 Discuss views of Eugene von Bohm-Bawerk.

## 15.6 Summary

The marginal revolution in economics directly led to some of the most distinctive features of the neoclassical economics. In the first place, it led to the abandonment of the classical concern for the analysis of the effects of changes in the quantity and quality of labour on the pace of capital accumulation, economic development and growth. But, after the marginal revolution of the 1870, the analysis of factor supplies and their effects on development and growth disappeared from the economics which came to be known as the neoclassical economics. Only in the post- Second World War period some growth economists built up what is described as the neoclassical growth model. Till then development and growth were non-existent topics in neoclassical economics.

Another consequence of the marginal analysis was that in the absence of any interest in the analysis of supply, particularly in the long-run supply of factors, the neoclassical economics (with the exception of Marshall to some extent) worked with the ubiquitous assumption of given and constant factor supplies. It was this which led the neoclassical economists to conceive economic problems as merely problems of efficient allocation of resources and economic science as the “study of human behaviour as a relationship between ends and scarce means which have alternative uses.”

The above led the neoclassical economists to focus their analysis on demand and on the short-run only. *The* classical theory of economic development and growth was replaced by the neoclassical theory of general equilibrium within an essentially static framework.

The emphasis on optimum allocation of resources in neoclassical economics is much stronger however, in the writings of the Lausanne and Austrian schools of economics than in the British school led by Marshall who never completely abandoned the classical belief that economic welfare depended as much, if not more, on the growth of capital and labour as on the efficient

allocation of resources. But the fact remains that even Marshall devoted more attention to the latter than the former.

The conventional assumption of a maximizing behaviour of the “economic man” which was firmly established in the neoclassical economics led via the marginal analysis, to the famous theorems of substitution at the margin and maximization of objective functions. This development eminently suited the use of mathematical reasoning in economic analysis. It was not the utility theory but the marginalism which opened the gates for the mathématisation of economics after the 1870. Neoclassical economists like Walras, Cournot, Edgeworth and Pareto were professedly mathematical economists, though Marshall, Wicksteed, Wicksell and Casell represented literary economists using mathematical tools where *necessary*.

Another consequence of the marginal revolution was that the neoclassical abandoned the classical class analysis of distribution. Class distribution was no longer the concern of economic analysis in the neoclassical economics. The analysis of class shares in national output was replaced by the so-called functional distribution which was interpreted merely as the determination of factor prices.

## 15.7 Glossary

1. **Marginalism:** The study of marginal theories and relationships within economics. The key focus of marginalism is how much extra use is gained from incremental increases in the quantity of goods created, sold, etc. and how those measures relate to consumer choice and demand. Marginalism covers such topics as marginal utility, marginal gain, marginal rates of substitution, and opportunity costs, within the context of consumers making rational choices in a market with known prices.
2. For Blaug (1996) the **Marginalist Revolution** involved three changes to the economic paradigm. These are: (a) the shift from the growth and evolution of the economy as the focus of attention to allocative efficiency; (b) the shift from descriptive to mathematical reasoning with a concentrated focus on the maximization principle; and, (c) resolution of the Classical disjunction between the theories of value and distribution on the basis of a single principle – scarcity relative to consumer wants, needs and desire.
3. **Marginal Utility:** The additional satisfaction a consumer gains from consuming one more unit of a good or service. Marginal utility is an important economic concept because economists use it to determine how much of an item a consumer will buy. Positive marginal utility is when the consumption of an additional item increases the total utility. Negative marginal utility is when the consumption of an additional item decreases the total utility.

4. **Competition:** Competition occurs between different companies trying to produce and sell the same good or service. Companies may compete with each other for markets and customers; for raw materials; for labour; and for capital.
5. **Opportunity Cost:** The cost of an alternative that must be forgone in order to pursue a certain action. Put another way, the benefits you could have received by taking an alternative action.

### 15.7 Answers to self check Exercises

Self Check Exercise-1

Ans.1 Please refer Section 15.3

Ans.2 Please refer Section 15.3.1.2

Ans.3 Please refer Section 15.3.1.3

Ans.4 Please refer Section 15.3.1.4

Ans.5 Please refer Section 15.3.1.5

Self Check Exercise-2

Ans.1 Please refer Section 15.4

Self Check Exercise-3

Ans.1 Please refer Section 15.5

### 15.9 References/Suggested Readings

25. Eric Roll: *"A History of Economic Thought"*.
26. J.A. Schumpeter: *"History of Economic Analysis"*.
27. M. Blaug: *"Economic Theory in Retrospect"*.
28. J.A. Schumpeter: *"Ten Great Economists"*.

### 15.10 Terminal Questions

Q1. Summarize the main economic ideas of Austrian School?

Q2. Write a short note on:

1. Wieser contribution to economic thought
2. Bohm-Bawerk contribution to economic thought

## Unit- 16

### MARGINAL REVOLUTION (2)

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#### Structure

- 16.1 Introduction
- 16.2 Learning Objectives
- 16.3 W.S. Jevons (1835-82)
  - Self Check Exercise-1
- 16.4 Leon Walras (1834-1910)**
  - Self Check Exercise-2
- 16.5 Knut Wicksell (1851-1926)**
  - 16.5.1 Value Theory
  - 16.5.2 Theory of Distribution
  - 16.5.3 Theory of Capital
  - 16.5.4 Theory of Money
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- 16.6 Summary
- 16.7 Glossary
- 16.8 Answers to self check Exercises
- 16.9 References/ Suggested Readings
- 16.10 Terminal Questions

#### 16.1 Introduction

In the last lesson we considered the nature of what is known as the “marginal revolution” along with the contributions made to it by some famous thinkers belonging to the Austrian school of economics. But, along-with the Austrian school there are other famous names too who are famous for having started a trend in economic analysis which culminated into the marginal revolution in the history of economic thought. Amongst the most outstanding of these other thinkers were W.S. Jevons, Leon Walras, Knut Wicksell and Alfred Marshall. In the present lesson, we shall dwell on the contribution of the first three of these four economists, reserving the next lesson for Alfred Marshall.

#### 16.2 Learning Objectives

After studying this unit you will be able to:

- Minutiae the ideas of Wicksell on value, distribution, capital and Money
- Enlighten the contribution of Jevons in the field of economic thought



- Explicate the Walras role in Marginal Revolution

### 16.3 W.S. Jevons (1835-82)

It will not be off the mark to describe Jevons as the pioneer of the trend which culminated into marginal revolution in economic theory and replacement of the classical labour theory of value by the subjective utility theory of value. It was he who made the scattered fragments of the earlier utility analysis into a comprehensive theory of value, exchange and distribution. It was another thing that almost at the same time; the Austrian Carl Menger was also working independently along more or less similar lines. Jevons was also, along with the French economist, Cournot, one of the early economists who conceived economics as an exact science amenable to fruitful use of mathematical method of analysis. In a paper published in 1862, he sketched out a “general mathematical theory of political economy expressing his belief that the laws of economics could be reduced to a few principles cast in mathematical terms. Moreover, in this very paper he also laid bare another special feature of this theory, namely, his hedonistic approach to the question of motives of human conduct. He emphasized that the principles of economics referred to above had to be derived from what he described as “the great springs of human action” to be found in “the feelings of pleasure and pain.” This methodological approach to the study of economics was repeated and reaffirmed in his major work. *The Theory of Political Economy* (1871), wherein we find both a vindication of the abstract mathematical method and an explicit reference to hedonism.

Jevons, himself being a statistician, could not deny the importance of the empirical studies, but he emphasized that the basic laws of economics were of such a general nature that they could be aptly compared with the laws of the physical sciences which, according to him, “have their basis more or less obviously in the general principles of mechanics.” So he held that economics was similar “to the science of Statically Mechanics.” Therefore, the method of economics should also be similar to the method of the physical sciences. In other words, the economic method had to be mathematical in character like the method of physical sciences. The further reasons advanced in favour of his view were akin to those of Cournot. He opined, “To me it seems that our science must be mathematical, simply because it deals with quantities. Wherever the things treated are capable of being greater or less, there the laws or relation must be mathematical in nature.”

But the above similarity between Jevons's and Cournot's views did not deter the former from going behind the superficial market phenomena of demand and supply and their inter-relationship. On the contrary, he even criticized Cournot for confining himself simply to the system of functional interdependence between the quantities observed

in the market and for (be consequent neglect of the underlying factors of utility and value. Jevons, accordingly, set for himself the task of providing a mathematical exposition of the laws of the market as well as an “ultimate” theory of value which would lay bare the underlying factors also.

The central point of his theory of value is reflected in this observation that “value depends entirely upon utility.” This basic proposition of his theory of value was certainly an innovation in spite of the anticipation of this principle by economists like Say, Senior and Gossen. It was not the principle as such but the emphasis that Jevons placed on it and the analytical use that he made of it which lent it the character of an innovation, it was a definite departure from the classical view in which the fact of use-value or utility though recognized was not considered to become a proper basis for the explanation of value. The classical approach being objective comprehended the whole economic activity of society and ignored the individual subjective factors. Jevons’s innovation and departure from the classical approach consisted in this that he made it possible, for the first time, to formulate a theory of value based on utility as an alternative to the classical theory of value regardless of whether it was taken to mean a labour theory of value or a cost-of-production theory of value.

Jevons’s starting point for his analysis of value was the individual and his wants. And for the interpretation of individual behaviour he had at his disposal a philosophy whose objective was also the establishing of principles governing human actions. This philosophy was no other than hedonism which explained human conduct in terms of pleasure and pain, that is, in terms of seeking pleasure and avoiding pain. Therefore his theory starts with an exposition of the hedonistic principle of pleasure and pain based on Jeremy Bentham’s *A Table of the Springs of Human Action*. This philosophy of human conduct assumes man to be a pleasure-seeking machine and the motive governing human actions to be the maximizing of individual pleasure. Consequently, Jevons’s definition of utility is stated in hedonistic terms. It is defined as ‘the quality of an object that produces pleasure or prevents pain, “provided that the will or inclination of the person immediately concerned is taken as the criterion, for the time, of what is or is not useful.” Utility is not an intrinsic quality; it expresses a relation between an object and a subject. Jevons further argues that utility becomes meaningful in the explanation of value if the total utility of a commodity is carefully distinguished from the utility which an individual, at any given time, attaches to a portion of that commodity. In the manner of Gossen he examines the effect of changes in the total quantity of a commodity on the utility to an individual of portions of the commodity. He concludes that successive increments reduce the utility of every unit. He thus, makes a distinction between *total utility* and *degree of utility at any point*, from which he deduces the concept of “final degree of utility” which is defined as “the degree of utility of the last addition, or the next possible addition, of a very small, or infinitely small, quantity of

the existing stock." This concept of the "final degree of utility" is the corner stone of Jevons's theory of exchange and distribution.

As regards the determination of exchange value and price, Jevons's explanation of it is based on an adaptation of Gossen's Second Law and runs as follows: when a commodity is capable of satisfying wants in a number of different *uses*, *it* will be distributed among these uses in a manner such that the final degree of utility of the commodity is the same in every use. From this he arrives at the conclusion, in a rather awkward manner, that when two individuals exchange two commodities, the ratio of exchange between them "will be the reciprocal of the ratio of the final degree of utility of the quantities of the commodity available for consumption alter the exchange is completed." This implies that in equilibrium the marginal utility for each party will be proportionate to the price, from which it follows that "a person distributes his income in such a way as to equalize the utility of the final increments of all commodities consumed."

Jevons's Theory of exchange value and price, was deficient in several ways despite its innovatory character. He was not very successful in the detailed working out of his theory. It was left to the later economists to build the foundations provided by him and to present a more refined and plausible argument to connect the subjective value with the formation of market prices. It has also, been alleged that in spite of his emphasis on utility. He abandoned half-way his- attempt to explain the origin of value *in terms of utility*. Instead, he appeared to work with the market price as a datum and to describe its relation to quantities 'and final degrees of utility in the state of equilibrium. Moreover, this statement of Jevons has been found to be defective on account of his use of two very awkward concepts, namely, the "law of indifference" and the "trading body." Different prices of a particular good, according to Jevons, could result only from differences in preferences. But, since it is a matter of indifference to an individual whether he gets this or that portion of a *homogeneous* commodity there cannot be two prices of one and the same good at one and the same time. What., in fact, lie was trying to say through his clumsy "law of indifference" was, as later economists like Walras, Edge-worth, Marshall and Wicksell pointed out, that this result would be valid under the assumption of perfect competition.

His concept of the "trading body" was even more awkward and confusing. His "trading body" could be comprised of any number of buyers and sellers, ranging from a single individual to all individuals" inhabiting an economy. But he applied his theory of exchange between two individuals to the case of exchange between a multitude of buyers, and sellers without any modification, thus completely obscuring the problem of competition.

However, even though Jevons's subjective theory of value wanted in many respects yet his abandonment of the labour theory as well as cost-of- production theory of value was complete. He denied that labour or, for that matter, any costs involved in the production of a commodity could be the cause of value. Labour spent on the

production of a commodity was, he argued, "gone and lost forever." From the point of view of value determination, "bygones were forever bygones". But, in spite of his forceful assertions of the above type, he did admit that labour and other costs could affect value *indirectly* by limiting the supply of a commodity which determines its final degree of utility which, in turn determines value. Thus, he in- a way contradicted himself, though apparently he stuck to his monistic, explanation in terms of utility.

Another distinctive feature of Jevons's contribution was that he defined even labour in subjective terms. Parallel to his utility theory, he also built up a theory of disutility which was similar to the theory of the "real costs". Supply of labour was assumed to involve "pain" which Jevons identified with "disutility." 'But the employment of labour in production yields income which possesses utility. The equilibrium relation between labour and utility is given by the condition that "the increments of utility from the several employments (of labour)" are equal. But for a full determinate equilibrium, an additional condition is also required. This condition is that "labour will be carried on until the increment of utility from any of the employments just balances the increment of pain."

Jevons did not have a comprehensive theory of distribution. His theory of rent is almost an unmodified version of the classical theory of rent. This also led him to the doors of the marginal productivity theory of wages. Every worker, he observes, "seeks the work in which his peculiar faculties are most productive of utility, as measured by what people are willing to pay for their produce. Thus wages are clearly the effect not the cause, of the value of the produce." But he did not care to develop this idea into a systematic marginal productivity theory. Instead, he made his theory of wages ambiguous by giving an alternative explanation which suggests that he also held a residual theory of wages. He suggested that the wages of a worker were, in the final analysis, what remained after deducting rent tax and interest on capital from the total product produced with the labour. He had described the wages- fund theory as a truism in order to reject it but had also admitted it as a short-period theory of wages. The capitalists, he argues, invest capital and buy labour on expectation of making profits. They "sustain labour before the result is accomplished" which conveys the classical wages-fund idea. If the results of employing labour in production are above the capitalist expectations, they make large profits, but competition will tend to bring them to a normal level, while the supernormal profits would tend to disappear, under the force of competition, into either higher wages or lower prices or both.

Jevons's theory of capital, though not neatly expressed, has a modern flavour and a strong resemblance with the Austrian Bohm-Bawerk's theory. The function of capital is mentioned as "to make a great outlay in providing tools and machines which have for their sole object the production of some important commodity, and which will greatly facilitate production." Capital according to him helps to surmount "time elapsing between the beginning and the end of work." And, he also conveys the productivity of capital as well as the period-

of-production idea when he observes that “whatever improvements in the supply of commodity lengthen the average interval between the moment when labour is exerted and its ultimate result...such improvements depend upon the use of capital.” This led him to define the rate of interest as “the rate of increase of produce (occasioned by lengthening the period of production) divided by the whole produce.” Jevons preserved the classical abstinence element in his theory of capital and interest but he failed to work out a proper relation between the “sacrifice” that abstinence involves and the productivity of capital as determinants of the rate of interest. He may, thus well be described as knocking at the marginal productivity theory of interest.

#### Self Check Exercise-1

Q.1 Who was W.S. Jevons? Discuss his thoughts.

### 16.4 Leon Walras (1834-1910)

Leon Walras, along with Jevons and Menger, is regarded as a co-founder of the marginal utility school of economics and a harbinger of the marginal revolution in economics. His position in the history of economics stands somewhere, between Jevons and Menger. He resembles the former in his hedonistic approach to utility and also in the mathematical method of analysis. In fact Walras made use of the mathematical method of analysis in a much more thoroughgoing manner than Jevons. On the other hand, like Menger, he avoided some of the mistakes of Jevons in translating subjective values into prices. Because of this as well as his mathematical approach, Walras's influence on the modern mathematical economics has been very considerable in spite of his hedonistic approach to utility.

Walras's work, *Elements of Pure Economics* (1874), shows a strong influence of Cournot. It was probably this influence which enabled him to combine a utility theory of value with a mathematically précisé theory of market equilibrium. In spite of the difficulties (or, rather, because of them) which he met with in this code. Walras was increasingly led to enunciate a general non-“utilitarian” theory of economic equilibrium expressed in terms of functional equations. It is this which led Eric Roll to observe that “He is essentially the economists economist, rather than of the general reader or the politician.”

He enunciated his marginal utility doctrine in his famous work, *The Elements of Pure Economics*, the first part of which, dealing with the theory of exchange, was published in 1874, three years after Jevons and Menger had published their individual independent discoveries of the principle of marginal utility. Walras's own version was in no way a derivative of their ideas but an independently worked out hypothesis of his own.

Walras operates essentially with the same concept as Jevons but he continually searches for solutions of the most general character. Like Jevons and Menger he bases exchange value on utility and limitation of supply. Following his father, Auguste, Walras, he uses the French term, ‘rarete’ signifying scarcity of quantity. But he defines it in

a mariner to suggest the concept of “marginal utility.” He defines ‘*rarete*’ as the derivative of total utility, thus linking together not only utility and quantity of a good but also indicating the rate of change in utility per unit of change in the quantity of the good. There could be no more precise expression of the meaning of the concept of marginal utility.

Walras proceeds on to explain the existence of exchange on the basis of the utility-maximizing behaviour assumption, arguing that this leads the individuals to equalize marginal utilities of goods in consonance with Gossen’s Second Law. This results in trade and exchange. The desire of individuals to equalize marginal utilities together with the stocks of goods held by each individual will give a determinate demand or supply for each individual who can be represented by a functional equation or a curve. In this way, the supply and demand functions or curves could be found for each and every good.

As a matter of fact, Walras’s analytical objective was, above all, to produce a mathematical model which could bring out the full implications of a regime of perfect competition. He believed that the policy of *laissez-faire* was being advocated without any rigorous analysis of its implications. “How could these economists,” he observed, “prove that the results of free competition were beneficial and advantageous if they did not know just what these results were? And how could they know those results when they had neither framed definitions nor framed relevant laws to prove their point ‘?.... the fact that economists have later extended the principle of free competition beyond the limits of its true applicability is proof positive that the principle has not been demonstrated.”

Equilibrium in a freely competitive market is achieved when the price is such that at its demand and supply are equal. Walras uses a special device to show how this equilibrium price results from competition. In fact, he defines perfect competition in a manner so as to yield this special device for him. He seems to define perfect competition as a situation in which buyers and sellers could be brought together in a massive action “in such a way that the terms of every exchange are openly announced and an opportunity is given to sellers to lower their prices and to buyers to raise their bids.” The special device that he uses, therefore, is the device of *prix crie*, that is, price as called out by the auctioneer in an auction. At any such price called out by the auctioneer, each buyer announces the quantity he would buy, while each seller would also inform the quantity he would-sell. If the demand for the commodity at this price does not equal its supply, the auctioneer will call out another price and the same process will start fresh and will be repeated till that price emerges at which demand for the commodity equals its supply. This is the equilibrium price.

At the initial stage, Walras constructs only a two - commodity model in which all persons are assumed to be buyers of one commodity or sellers of the other commodity. On this assumption, the supply of one commodity, .X, and the demand for the other commodity,

Y, and also vice versa, will be interdependent, because the market demand for any one commodity, X or Y, is derived from the incomes, received by the sellers of the other commodity, Y or X. The price referred to above in the preceding paragraph should be taken to mean, in the context of the simple two-commodity model, as the price of one commodity in terms of the other or their ratio of exchange. As the result of the device of *prix crie* and the process of *tattonement* (the process of the auctioneer calling out the price and allowing the sellers and buyers the chance to revise their prices and bids till the equilibrium is reached) an equilibrium ratio of exchange ultimately emerges. And, in conformity with the general neoclassical assumption of utility maximizing behaviour of individual this equilibrium ratio of exchange between the given pair of commodities will be determined by the condition of maximizing utility that is by (John's Second Law or the condition of equality of marginal utilities).

In a core intricate model, there would be more than one exchange ratio, their number increasing with the number of goods. It is important to remember this because Walras's system unlike Marshall's is a general equilibrium system in which a change in the price of any one commodity or a particular exchange ratio would influence all other prices or exchange ratios. If there are three commodities X, Y, and Z. then there will be formally three exchange ratios ( $x : y$ ,  $x : z$ ,  $y : z$ ) to be determined. But one of these is redundant, because it can be derived from the other two. This leads to a larger principle slated by Walras, namely, that in a multi-commodity model of an economy, the number of equilibrium prices or exchange ratios is always one less than the number of commodities involved. In an economy with  $n$  number of goods, for example, only  $(n - 1)$  exchange ratios will have to be determined through the process of *tattonement* and *prix crie*.

The above procedure yields a complete set of demand and supply equation along with the equilibrium set of exchange ratios, from which Walras proceeds to the problem of general equilibrium. Here Walras uses the above explained general rule by employing the device of a *numeraire* (one good used as a unit of account only and therefore assumed not to be demanded for its own sake). The price of the *numeraire* good which becomes money (of account only) equals unity by definition. "This enables him to say that if there are  $n$  commodities, we need  $(n - 1)$  equations of demand and supply and  $(n-1)$  prices to determine. This, according to Walras, means there is a determinate solution to the problem of general equilibrium.

His analysis presents a system of mutually determined demands, supplies and prices but in which their connection with marginal utilities has not been made explicit.

Walras's theory of prices has been subject to various criticisms. In the first place, his artificial devices of the auctioneer, the *prix crie*, and the process of *tattonement* have been described as unrealistic. But he defended his analytical devices by asking his critics, "what physicist would deliberately pick cloudy weather for astronomical observation instead of taking advantage of a cloudless night?" He wanted to say that it was a sound scientific method to study initially only the general

abstract cases and to study the implications of complicating factors later. But the critics can rightly say that Walras, in fact, never went beyond the pure, abstract cases. Moreover, Walras never made it clear whether transactions do or do not actually take place at disequilibrium prices. If they do, then the marginal utility ratios of the participants would also change and so will also their demands and supplies. In consequence of it, the equilibrium prices which would emerge in this case would be different from what they would be otherwise, that is when no transactions take place at disequilibrium prices.

Wicksell had observed that Walras was led to his economic analysis by a desire to build up a strong case favoring laissez-faire as an answer to an attack on it by a follower of Saint-Simon. As a result of it, Walras gives another set of equations which reverses Jevon's procedure by taking price, rather than quantities exchanged as the independent variables. Walras, then, shows that given certain prices, each individual will proceed to exchange until the ratio of the marginal utilities of any given pair of goods to him equals their exchange ratio. This gives us determinate demand and supply functions, that is, a number of equations equal to the number of unknowns which shows that the general equilibrium is determinate. But it has been asserted recently by H. Mayer against this type of reasoning that this procedure, like that of Jevons, really bypasses the causal-genetic problem that is, the problem of the origin of prices from the subjective value roots. Eric Roll too has lent support to this criticism describing it as just criticism and opining that it makes Walras an important pioneer of the modern neoclassical trend of abandoning the search for the origin of value in favour of a purely formal but completely general theory of functional interdependence.

Another criticism of Walras's theory was directed against its conclusion that perfect competition 'has optimizing character, that is, it results in maximizing social utility. It is pointed out against this conclusion that the fact that at non-competitive prices some persons might wish to continue exchange, while others may not does not entitle us to say that on balance there is sacrifice of satisfaction. We have no criterion by which this can be scientifically demonstrated. On the other hand, common sense supports Wicksell's view that since changes in distribution of property might clearly be to the advantage of some people (in some cases to the advantage of the majority of the people), intervention in free competition which alters price or prices and therefore distribution of property might also produce an advantage to a majority.

Walras had hardly any genuine theory of production, though some elements of it may be gleaned from his theory of distribution. His theory of distribution has provided to the neoclassical theory of distribution its permanent structure. It was conceived by him as what we now refer to as functional distribution in contradiction with the classical conception of it as a theory of class shares in the national income. Therefore Walras's theory of distribution has been conceived as a special case of theory of pricing. Accordingly, he tries to solve this problem by applying the general equilibrium analyses to the



problem of pricing of factor services. As a matter of fact, his general equilibrium system would be incomplete, if it does not include the demand and supply functions of all the factor services and their prices. The prices of all factor services and the prices of all goods are determined simultaneously, according to Walras, in a system of general equilibrium. Through this route, he reaches conclusions similar to those of the later Austrians and he, thus, provides one of the earliest statements of the opportunity-cost principle and the neoclassical, marginal productivity theory.

Adjudged as a whole, Walras's economics is highly abstract and formal and in the process obliterates completely the social factors as if economics were not a social science but merely a science of functional relationships between quantities as such. He was thus led to identify economics entirely with the mathematical method. This obsession with mathematics and perceiving economics in the image of the science of mechanics made him confuse the form with the substance. Moreover, his system was a closed one and static in which the stocks of all commodities and factors of production were assumed to be given, thus ruling out any genuine theory of production, as we have already observed, time, uncertainty, growth, innovation, changes in tastes, advertising, and even business fluctuations are nowhere to be found in his system.

#### Self Check Exercise-2

Q.1 Who was Leon Walras? Discuss his thoughts.

### **16.5 Knut Wicksell (1851-1926)**

Knut Wicksell, the famous Swedish neoclassical economist, was a contemporary of Monger, Bohm-Bawerk, Marshall and Walras, but he is generally regarded as their intellectual descendent, though he made some very important original contributions to economic theory, particularly to the theories of Capital, interest and prices and had also anticipated some of the ideas embodied in the Keynesian economics.

#### **16.5.1 Value Theory**

When Wicksell entered to the arena of economics, the difference between the classical and the Austrian theories of value had become quite apparent. Though he entered the debate on value relatively late yet his quasi-mathematical presentation of the argument embodying the new marginal-utility approach made quite a stir. In his work, *Value, Capital and Rent*, he based his analysis of value on the proposition that value was not a constant objective magnitude but it was, instead, a magnitude which altered with each person's perception of the exchange situation. Scarcity was admitted by him to be a significant factor but, for him marginal utility was the crucial factor in the determination of value. He did allow for some relation between value and cost but only peripherally. He defined utility, however, most precisely as a mathematical function of the quantity of a good and marginal utility as the first derivative of this utility function. Thus,

according to him, marginal utility measures the rate of change in total utility.

He passes on from the above analysis to the consideration of the case when a good has several uses and reaches the allocation theorem that utility would be maximized when marginal utility of the good is the same in each use.

He dealt with the exchange problem more elegantly avoiding Jevons's "trading bodies" and interpreting it as a maximization problem. He also comes to the conclusion which we now know as the proportionality rule of equilibrium in exchange, namely, that in equilibrium marginal utilities of goods would be in the same proportion as their prices.

However, his originality consisted in his recognition of imperfect competition. In his *Lectures* he observed that competition and monopoly were not separate and distinct markets but they were rather the two extremes of a spectrum. Thus he foreshadowed Chamberlin and Joan Robinson. He took note of other forms of market also such as duopoly, bilateral monopoly and retailing also. In the case of bilateral monopoly, his conclusion was the same as Edge-worth's namely, that the equilibrium was indeterminate.

However, his distinctive mark on the theory of value was that he did not subscribe to the view that perfect competition had welfare-optimizing property, because he did not want to separate the question of social welfare from the question of distribution. In his view, only when there existed an optimum distribution, only then the perfect competition could be welfare- optimizing.

### **16.5.2 Theory of Distribution**

His theory of distribution, in the neoclassical tradition, is a theory of functional distribution in which the share of each factor is determined by imputing to it its share on the basis of its marginal productivity. His contribution to the neoclassical theory of distribution was that he reformulated the then marginal productivity theory so as to remove the differences that had developed between the alternative statements of it by Jevons, Bohm-Bawerk and Edge-worth. As Seligman observes "Wicksell took the marginal utility of Jevons, 'used it with the capital theory of Bohm-Bawerk and set both into a Walrasian equilibrium framework, thus enabling everybody to live under the same theoretical roof." He developed the marginal productivity theory to a high level and even suggested the product-exhaustion theorem. But he was generous enough to give credit to Wicksell for having initially discovered this theorem.

But his contributions to the theory of capital and monetary theory are regarded to be even, more outstanding.

### **16.5.3 Theory of Capital**

Though the basic elements of his theory of capital and interest were derived from Bohm-Bawerkian notions, yet the improvements and refinements that he introduced were such as to cast his theory virtually

into a new one. His emphasis on the element of time was specifically his own. What established the connection between the value and the technical aspects of capital, he argued, was the concept of time. Once this was done, capital could be looked upon as “single coherent mass of saved up labour and saved up land, which is accumulated in the course of years”.

His emphasis was also on capital accumulation and its effect on distribution which underlined his dynamic approach. Analyzing capital in terms of time strata, he is led to the proposition that the marginal productivities of stored-up labour and land are larger than those of current land and labour resources. This implied that stored-up land and labour (i.e. capital) produced enough to replace the used-up part of it and to leave positive surplus over and above it. This surplus, according to him, was interest. Time became the central concept as well as the variable dimension in capital, while interest was made to be the marginal product of “waiting.”

Wicksell defined technically the capital composition of an economy as total number of units of saved-up labour and land multiplied by the time-period during which such units remain invested, which led to the Wicksellian notion of capital having both “height” and “width”. Height referred to length of time that it took for various items of capital to mature, and width referred to the proportion of input services required to replace used-up capital goods. The elements of “height” and “width” in capital, according to Wicksell, are revealed more clearly under dynamic conditions. Expansion in “width” means a proportionate increase in the types of capital already existing, while growth of “height” means a shift to different types of capital that comes about as the result of shifts to more capital-intensive techniques.

#### **16.5.4 Theory of Money**

Wicksell's most notable contribution to the theory of money is his analysis of the “cumulative process”. He demonstrated that the cumulative process of price change, upward or downward, could be traced to a divergence between the *money* rate of interest and the *real* rate of interest. While the former is shown to be determined by the banking system, the latter is determined by the real factors of saving and investment and equals the marginal productivity of capital. He also introduced the concept of the *natural* rate of interest in the sense of the equilibrium real rate of interest which would equate saving and investment. When the banking system increases the supply of credit, the money rate of interest falls. If the real rate of interest is greater than it, this would result in increase in investment, thus raising the demand for factors of production. If there is already full employment, the rise in the demand for factors can be met only by offering higher prices for them in order to attract them from consumer goods industries into the investment goods industries. This increases incomes but reduces the supply of consumer goods. Consequently, prices of consumer's goods also begin to rise. Profits rise there also. Their demand for factors also increases which further raises factor prices and factor incomes which, in turn, further adds to the aggregate

demand and, consequently, inflation is further fuelled. Thus there is a cumulative process of rising prices. But as investment increases, its marginal product or the real rate of interest would fall. On the other hand, the banking system would be constrained to raise the money or the market rate of interest in the face of ever increasing demand for credit and there being a limit to their lending capacity. When the real rate of interest falls enough to equal the market rate that is the money rate of interest, the cumulative process of rising prices would come to a stop.

When the new equilibrium is attained, the level of prices would not fall back to the initial level, but, assuming that the new equilibrium real rate of interest also equates saving and investment, the new equilibrium would be a stable one. Thus, Wicksell's analysis of the cumulative process came very close to the later Keynesian notion of equilibrium at different heights of economic activity.

The significance of Wicksell's monetary theory lies in its bearing the connection between the monetary forces and the level of economic activity via the rate of interest which, in fact, foreshadowed what, later, Keynes stated in his General Theory.

#### Self Check Exercise-3

- Q.1 Discuss Knut wicksell's Value theory.
- Q.2 Discuss Knut wicksell's Theory of Distribution.
- Q.3 Discuss Knut wicksell's Theory of Capital
- Q.4 Discuss Knut wicksell's Theory of Money

### 16.6 Summary

There are famous names other than the Austrian school that are famous for having started a trend in economic analysis which culminated into the marginal revolution in the history of economic thought. Amongst the most outstanding of these other thinkers were W.S. Jevons, Leon Walras, Knut Wicksell and Alfred Marshall. In this lesson, we have dwelled on the contribution of the first three of these four economists.

It will not be off the mark to describe Jevons as the pioneer of the trend which culminated into marginal revolution in economic theory and replacement of the classical labour theory of value by the subjective utility theory of value. It was he who made the scattered fragments of the earlier utility analysis into a comprehensive theory of value, exchange and distribution. The central point of his theory of value is reflected in this observation that "value depends entirely upon utility." This basic proposition of his theory of value was certainly an innovation in spite of the anticipation of this principle by economists like Say, Senior and Gossen. Jevons's Theory of exchange value and price, was deficient in several ways despite its innovatory character. He was not very successful in the detailed working out of his theory. It was left to the later economists to build the foundations provided by him and to present a more refined and plausible argument to connect the subjective value with the formation of market prices. It has also, been alleged that in spite of his emphasis on utility. He abandoned

half-way his- attempt to explain the origin of value *in terms of utility*. Instead, he appeared to work with the market price as a datum and to describe its relation to quantities and final degrees of utility in the state of equilibrium. Moreover, this statement of Jevons has been found to be defective on account of his use of two very awkward concepts, namely, the “law of indifference” and the “trading body.” Jevons did not have a comprehensive theory of distribution. His theory of rent is almost an unmodified version of the classical theory of rent. This also led him to the doors of the marginal productivity theory of wages. Every worker, he observes, “seeks the work in which his peculiar faculties are most productive of utility, as measured by what people are willing to pay for their produce. Thus wages are clearly the effect not the cause, of the value of the produce.” But he did not care to develop this idea into a systematic marginal productivity theory. Instead, he made his theory of wages ambiguous by giving an alternative explanation which suggests that he also held a residual theory of wages. He suggested that the wages of a worker were, in the final analysis, what remained after deducting rent tax and interest on capital from the total product produced with the labour. He had described the wages- fund theory as a truism in order to reject it but had also admitted it as a short-period theory of wages. The capitalists, he argues, invest capital and buy labour on expectation of making profits. They “sustain labour before the result is accomplished” which conveys the classical wages-fund idea. If the results of implying labour in production are above the capitalist expectations, they make large profits, but competition will tend to bring them to a normal level, while the supernormal profits would tend to disappear, under the force of competition, into either higher wages or lower prices or both.

Jevons’s theory of capital, though not neatly expressed, has a modern flavour and a strong resemblance with the Austrian Bohm-Bawerk’s theory. The function of capital is mentioned as “to make a great outlay in providing tools and machines which have for their sole object the production of some important commodity, and which will greatly facilitate production.” Capital according to him helps to surmount “time elapsing between the beginning and the end of work.” And, he also conveys the productivity of capital as well as the period-of-production idea when he observes that “whatever improvements in the supply of commodity lengthen the average interval between the moment when labour is exerted and its ultimate result...such improvements depend upon the use of capital.” Jevons preserved the classical abstinence element in his theory of capital and interest but he failed to work out a proper relation between the “sacrifice” that abstinence involves and the productivity of capital as determinants of the rate of interest.

Leon Walras, along with Jevons and Menger, is regarded as a co-founder of the marginal utility school of economics and a harbinger of the marginal revolution in economics. His position in the history of economics stands somewhere, between Jevons and Menger. He resembles the former in his hedonistic approach to utility and also in the mathematical method of analysis. In fact Walras made use of the

mathematical method of analysis in a much more thoroughgoing manner than Jevons. On the other hand, like Menger, he avoided some of the mistakes of Jevons in translating subjective values into prices. Because of this as well as his mathematical approach, Walras's influence on the modern mathematical economics has been very considerable in spite of his hedonistic approach to utility.

Walras proceeds on to explain the existence of exchange on the basis of the utility-maximizing behaviour assumption, arguing that this leads the individuals to equalize marginal utilities of goods in consonance with Gossen's Second Law. This results in trade and exchange. The desire of individuals to equalize marginal utilities together with the stocks of goods held by each individual will give a determinate demand or supply for each individual who can be represented by a functional equation or a curve. In this way, the supply and demand functions or curves could be found for each and every good.

As a matter of fact, Walras's analytical objective was, above all, to produce a mathematical model which could bring out the full implications of a regime of perfect competition. He believed that the policy of *laissez-faire* was being advocated without any rigorous analysis of its implications. Walras had hardly any genuine theory of production, though some elements of it may be gleaned from his theory of distribution. His theory of distribution has provided to the neoclassical theory of distribution its permanent structure. It was conceived by him as what we now refer to as functional distribution in contradiction with the classical conception of it as a theory of class shares in the national income. Therefore Walras's theory of distribution has been conceived as a special case of theory of pricing. Accordingly, he tries to solve this problem by applying the general equilibrium analyses to the problem of pricing of factor services. As a matter of fact, his general equilibrium system would be incomplete, if it does not include the demand and supply functions of all the factor services and their prices. The prices of all factor services and the prices of all goods are determined simultaneously, according to Walras, in a system of general equilibrium. Adjudged as a whole, Walras's economics is highly abstract and formal and in the process obliterates completely the social factors as if economics were not a social science but merely a science of functional relationships between quantities as such. He was thus led to identify economics entirely with the mathematical method. This obsession with mathematics and perceiving economics in the image of the science of mechanics made him confuse the form with the substance. Moreover, his system was a closed one and static in which the stocks of all commodities and factors of production were assumed to be given, thus ruling out any genuine theory of production, as we have already observed, time, uncertainty, growth, innovation, changes in tastes, advertising, and even business fluctuations are nowhere to be found in his system.

## 16.7 Glossary

1. **Utility:** A consumer's utility is hard to measure. However, we can determine it indirectly with consumer behavior theories, which assume that consumers will strive to maximize their utility. Utility is a concept that was introduced by Daniel Bernoulli. He believed that for the usual person, utility increased with wealth but at a decreasing rate. Since consumer demand for utilities does not change dramatically with a change in price, these companies are regulated by the state or provincial and federal governments.
2. **Capital:** Broadly defined, capital represents the tools which people use when they work, in order to make their work more productive and efficient. Under capitalism, capital can also refer to a sum of money invested in a business in hopes of generating profit. (See also: circulating capital, fixed capital, human capital, machinery and equipment, physical capital, and structures.)
3. **Distribution:** The distribution of income reflects the process by which the real output of goods and services produced by the economy is allocated to different individuals and groups of people. Distribution can be measured across individuals (comparing high-income and low-income households), or across classes (comparing the incomes of workers, small businesses, and capitalists).
4. **Money:** Broadly speaking, money is anything that can be used as a means of payment (for example, to settle a debt). It includes actual currency, bank deposits, credit cards and lines of credit, and various modern electronic means of payment.
5. **Competition:** Competition occurs between different companies trying to produce and sell the same good or service. Companies may compete with each other for markets and customers; for raw materials; for labour; and for capital.
6. **Total Utility:** The aggregate level of satisfaction or fulfillment that a consumer receives through the consumption of a specific good or service. Each individual unit of a good or service has its own marginal utility, and the total utility is simply the sum of all the marginal utilities of the individual units. Classical economic theory suggests that all consumers want to get the highest possible level of total utility for the money they spend.
7. **Marginal Utility:** The additional satisfaction a consumer gains from consuming one more unit of a good or service. Marginal utility is an important economic concept because economists use it to determine how much of an item a consumer will buy. Positive marginal utility is when the consumption of an

additional item increases the total utility. Negative marginal utility is when the consumption of an additional item decreases the total utility.

8. **Gossen's Second Law:** In the words of Prof. Marshall, "if a person has a thing which can be put to several uses, he will distribute it among these uses in such a way that it has the same marginal utility in all. For if it had a greater marginal utility in one use than another, he would gain by taking away some of it from the second use and applying it to the first." The law of Equi-marginal utility is also known as the Gossen's Second Law.
9. **Rate of Interest:** "the rate of increase of produce (occasioned by lengthening the period of production) divided by the whole produce."

## 16.8 Answers to self check Exercises

Self Check Exercise-1

Ans.1 Please Refer Section 16.3

Self Check Exercise-2

Ans.1 Please Refer Section 16.4

Self Check Exercise-3

Ans.1 Please Refer Section 16.5.1

Ans.2 Please Refer Section 16.5.2

Ans.3 Please Refer Section 16.5.3

Ans.4 Please Refer Section 16.5.4

## 16.9 References/ Suggested Readings

29. Eric Roll: *"A History of Economic Thought"*.  
30. J.A. Schumpeter: *"History of Economic Analysis"*.  
31. M. Blaug: *"Economic Theory in Retrospect"*.  
32. J.A. Schumpeter: *"Ten Great Economists"*.

## 16.10 Terminal Questions

Q1. What is meant by Marginal Revolution in the history of economic thought? Do you agree with the view that what is important in this phrase is the adjective rather than noun?

Q2. Briefly state Wicksell's concept of "cumulative process"? how does it provide a basis for the monetary theory?



## Unit- 17

# MARSHALL'S ECONOMICS: MATURE NEOCLASSICISM (1)

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### Structure

- 17.1 Introduction
- 17.2 Learning Objectives
- 17.3 Allred Marshall (1842-1924)
  - 17.3.1 Marshall's Theory of Price
  - 17.3.2 Marshall Theory of Demand
  - 17.3.3 Consumer's Surplus
  - 17.3.4 Elasticity of Demand

Self Check Exercise-1

- 17.4 Summary
- 17.5 Glossary
- 17.6 Answers to self check Exercises
- 17.7 References/Suggested Readings
- 17.8 Terminal Questions

### 17.1 Introduction

In this lesson, we shall introduce you to the broad features of Marshall Theory of price which standardised the neoclassical theory of value. You will also become familiar about the Marshall theory of demand after going through this lesson. Besides this, two important concept of Consumer surplus and Elasticity of demand shall also be introduced in this lesson.

### 17.2 Objectives

After going through this lesson you will be able to:

- Elaborate the Marshall's Theory of Price
- Explain the concept of Consumer surplus
- Give detailed explanation of the theory of Demand
- Put in plain words the meaning of Elasticity of Demand

### 17.3 AllFred Marshall (1842-1924)

AllFred Marshall was a giant among the neoclassical economists of the late nineteenth and the early twentieth century. The distinctive feature of Marshall's brand of neoclassicism was that it avoided the

extremeness of views associated with the early immature marginal utility school which tended to explain all economic phenomena in terms of utility and vehemently denied any role to costs of production in the determination of values and prices in order to demonstrate, rather loudly, that their doctrine represented complete break-off from classical economics and was nothing but an anti-thesis of the classical economics. In contrast to this rather crude version of the early neoclassical economics, Marshall's version was a much more considered and mature version in which vulgar monism of the early immature neoclassical economics was rejected and in its place was put a version which had the flavour of a synthesis between the supply-oriented classical economics and the demand-oriented economics of the utility school. The mam body of Marshall's economics can be discovered in his *magnum opus*, *The Principles of Economics*, first published in 1890 but which went through eight editions during his own life-time. This is the nook from which most of the later neoclassical economists, particularly of the Anglo-Saxon school, learnt their economics and got guidance to work further and make their own contributions to the corpus of the neo-classical economics which ruled supreme till the publication of J.M. Keynes's *General Theory* in 1936. An event which is considered to have caused a revolution that shook the citadel of neoclassical economics.

### **17.3.1 Marshall's Theory of Price**

It was Marshall who started the standard neoclassical method of explaining the determination of prices of goods in terms of the interaction of the forces of demand and supply. The Marshallian demand and supply curves with which even every undergraduate student of economics is now familiar were potentially present in the French mathematical economist Cournot's work. But it was Marshall's *Principles* which popularized them. Marshall was a trained mathematician and his general method gives an unambiguous evidence of it but he had such an opinion of the nature of the science of economics that made him tuck his mathematics in footnotes and appendices rather than in the main text of the book. The Marshallian demand and supply curves are but the geometrical forms of the mathematical price-demand and price-supply functions which express the demand for and the supply of a good as functions of price. These functions were presented by Marshall for easy intelligibility in the form of schedules and curves, demand curves having negative slope and supply curves having positive slope.

He made use of the technique of equilibrium analysis in order not only to explain the market equilibrium between the forces of demand and supply which, according to him, determine the equilibrium prices of goods but also to explain how the demand curves get their negative slope and the supply curves their positive slope. However, what is peculiarly Marshallian in this demand and supply analysis of the determination of prices is his emphasis on the *interaction* between the forces of demand and supply as the determinant of equilibrium price. He took special care to make this emphasis explicit by comparing the

interaction between the forces of demand and supply to the operation of a pair of scissors employed in cutting a piece of paper or cloth or any other material. As it is not possible for one to say whether it is the upper or the lower blade of the pair of scissors which does the cutting, for it is, in fact, done by both in tandem with each other, similarly it is not possible for us to say that price of a good is determined by demand or supply, for it is, in fact, determined by both in tandem with each other.

The above said emphasis on interaction between the forces of demand and supply was made by Marshall in the context of the not uncommon prevailing impression that while in the long-period the classical "natural" price was determined by the supply factors, the "market" price was determined by demand factors alone the merit of Marshall's theory was that it dispelled the above misconception and underscored the fact that regardless of the time period, both the forces are working together and interacting with each other in determining price of a goods which is determined at a level at which the demand for the good is in equilibrium with its supply. By highlighting the role of both the forces in the determination of value and price, Marshall, in a way, brought the classical long-period approach and the short-period approach of the utility school together to form a synthesis, the Marshallian neoclassical synthesis.

A very famous and notable contribution of Marshall to the neoclassical theory of value was the introduction of the element of time in the analysis of value and price. This helped him to cast his analysis in a comparative-static form. On the basis of the time factor; he classified markets into extremely short- period market, short-period market and the long-period market which were obviously related respectively to the extremely short period (which was also described as the "market" period), the short period and the long period. The extremely short period or the market period was defined as a period so short that it was not possible in this period to change the total available supply of a commodity, it may refer to a particular day, week or even month, provided this period is less than the minimum time-period required to increase or decrease the production. To use his own original concept of elasticity, it may be said to represent a period in which the production or supply of a good is *perfectly* inelastic. The price that prevails in such a period was described, following the classical tradition, as the market price. The short period, on the other hand was defined as a period which was long enough to increase or decrease production by combining more of the variable factors with the fixed factors but which was not long enough to change all the factors. Thus the chief characteristic of the short period from the analytical point of view was that some of the factors of production were bound to remain fixed. The price which tended to prevail during this period was defined as the "short-period" or the "sub-normal" price by Marshall. The long period was conceived by Marshall as a period which was long enough to enable the turns in a given industry to change all the factors of production and thus to change the *scale* of their operations in order to increase or decrease production. The price which tended to prevail

in this period was defined by Marshall as the "long- period" or the "normal" price.

He made an analytical use of his concept of elasticity of supply by relating it to the element of time and thus reaching some important conclusions with regard to the determination of prices, the supply in the market period being perfectly inelastic, the dominant influence is that of the - force of demand in the determination of the market price but not to the total exclusion of the force of supply which is working all the time during the market period also, though passively, like when one of the blades of a pair of scissors is held stationary while the other is moving to do the cutting. In the short period which is relatively long enough to permit some variation in output and supply, the supply is still relatively inelastic, though not perfectly inelastic. The force of demand is still more dominant than the force of supply. Therefore, the short-period or the sub-normal price is influenced relatively more by the demand factors than the supply and cost factors. It is only in the long period that all factors of production become variable so that all the firms in an industry can freely change the scale of their plants depending upon the demand conditions. Moreover, new firms can enter the industry and the old non-profit making firms can leave the industry. This is a period in which supply can be adjusted *fully* to the demand conditions. Therefore, generally, the long period supply of a good is much more elastic than its short-period supply. Consequently, the long-period or the normal price tends to be influenced much more by the supply and cost factors than the demand factors. It tends normally to be lower than the short-period price. If there are constant returns, the changes in demand will have no effect on the long-period price, the long-period supply curve being perfectly elastic and horizontal in this case. And, if the industry is subjected to increasing returns, the long-period supply curve will be falling forward having a negative slope so that the long-period or normal price in this case will tend to fall with an increase in demand and tend to rise with a decrease in demand, thus underlining the relative importance of the supply and cost factors in the determination of long-period price.

The above explanation of Marshall's price theory clearly brings out his achievement in bringing about a synthesis between the classical and the utility approach. He had clearly indicated that behind the force of demand lies the marginal utility of the commodity, while behind the force of supply lies the costs of production.

### **17.3.2 Marshall Theory of Demand**

The neoclassical demand-and-supply theory of prices as such touches only the surface of the phenomenon of prices. It would have been but a superficial analysis, if the theory of prices did not go beyond the surface to discover the underlying factors which impart to the demand and supply curves their particular forms. Marshall's theory of demand attempts to explain the shape and position of the demand curve which embodies the law of demand.

According to Marshall, the demand for a good is influenced by a number of factors amongst which the price of the given good is an

important factor. Marshall's law of demand states that all other things remaining the same, a fall in the price of a good extends its demand and a rise in its price contracts its demand, thus implying an inverse relation between the change in the price of a good and the consequent change in the quantity demanded of it. Conceptually, he made a distinction between "extension" in demand and "increase" in demand, on the one hand, and "contraction" in demand and "decrease" in demand on the other. Extension in demand in Marshall's economics refers to a rise in demand for a good, when its price alone falls, all other things remaining the same, and, similarly, contraction of demand refers to the fall in demand when the price of the good alone rises, all other things remaining the same. In other words, extension and contraction in demand refer to shifts along one and the same demand curve. But increase in demand refers to a rise in demand for a good due to any cause or causes other than changes in its price. It refers to a 'right-ward shift in the position of the demand curve. Similarly, decrease in demand refers to a fall in demand due to any cause or causes other than a change in the price of the good concerned. This represents a left-ward shift in the position of the demand curve.

However Marshall derives the inverse relation between the quantity demanded of a good and its price with the latter as the independent variable on the basis of certain assumptions to which the neoclassical economists were, at the time, referring in their writings explicitly or implicitly. The basic neoclassical assumption was related to human conduct which was assumed to be rational in the sense that men as consumers seek to maximize their satisfaction or utility and as producers of goods they seek to maximize their money profits. The institutional assumption made by Marshall was that of a perfect market. And, his use of the analytical apparatus of continuous utility, demand, supply and other curves implied the simplifying assumption of perfect divisibility of goods. With the help of such assumptions in conjunction with the law of diminishing marginal utility, Marshall derived the law of demand stating an inverse functional relationship between the price of a good and the quantity demanded of it.

The concept of utility that he worked with was that of *cardinal-utility* which could be quantified, added and subtracted. He had also assumed that utility could be measured with and expressed in money. He was an independent discoverer of the law of diminishing marginal utility along with Jevons, Walras and Meager, though he had published his findings chronologically later than the former neoclassical economists. With the help of this law, he demonstrated that a consumer maximizes his utility and is in equilibrium when he purchases such a quantity of the given good that its price equals its marginal utility to him. A fall in the price of the good will induce him to purchase and consume more of the good in order to equate its marginal utility with the lower price. A rise in price will induce him to reduce his purchase and consumption of the good in order to equate its marginal utility with the higher price. This shows an inverse relation between the change in the price of a good and the quantity demanded of it by an individual consumer or buyer of a given good. All points of

consumer's equilibrium will be on his marginal utility curve. None explained it in as clear terms as did Marshall that what lies behind an individual demand curve is the individual marginal utility curve which slopes downwards to the right satisfying the law of diminishing marginal utility. The market demand curve was derived by him through a lateral summation of individual demand curves! This is how Marshall derived the law of demand and the negatively sloping market demand curve of a good.

Marshall's theory of demand was criticized by later economists not because of his conclusions but mainly because of his having made too many and too unrealistic assumptions. The main targets of criticism were his assumptions of cardinal utility, constancy of marginal utility of money and "independent" goods. The proponent of the "indifference" theory of demand, the "ordinalists" as they are described, pointed out that Marshallian results could be reached by a shorter route that is by making fewer and also less unrealistic assumptions. It was also pointed out that though he was, no doubt, aware that the price effect of a change in price on the demand for a good was a composite effect made up of income effect and substitution effect, his cardinal approach and assumption of "independent" goods did not help him to isolate the income effect of a price change from its substitution effect. And, this failure resulted also in his failure to explain Giffen's Paradox, thus making his theory restrictive in character.

The Marshallian model of demand explained above is a one-commodity model. In his multi-commodity model (which, in fact, is a two-commodity model extendable to any number of commodities) he recognizes the relationship of substitutability or rivalry between goods and derives through that model too the inverse functional relationship between the price of a commodity and the quantity demanded of it. The route to it was the law of maximum satisfaction alternatively also known as the law of equi-marginal utility and also as the law of substitution. Marshall observed that in search of maximum satisfaction from a given amount of total expenditure a consumer tends to allocate it among various goods in such a manner that the utility that he derives from the last shilling spent on each of them is the same. In his own words "good management is shown by so adjusting the margins of expense on each line of expenditure that the marginal utility of a shilling's worth of goods on each line shall be the same." And, in order to stress the process of substitution till that end is achieved, he observes, "And this result each one will attain by constantly watching to see whether there is anything on which he is spending so much that he would gain by taking a little away from that line of expenditure and putting it on some other line."

From the above he teaches what has come to be known as Marshall's "proportionality rule" which states that in equilibrium the ratio between the marginal utilities of any pair of goods equals the ratio between their market prices. If in such a situation, the price of any one good falls, all other things remaining the same, a consumer would gain by spending more on this good and less on others.

Substitution will take place till the above-said proportionality is again established, and in the new equilibrium position it will be found that the consumer buys more of the good, the price of which has fallen. Thus the law of demand stating the inverse functional relationship between the price of a good and the quantity demanded of it was derived by Marshall from his multi-commodity model also.

It would be wrong to say that Marshall was not aware of the relationships of rivalry and complementarity between goods simply because he, for certain analytical purposes, assumed goods to be "independent" of one another.' His law of substitution disproves such an inference. Moreover he explicitly discussed the pricing of substitute and complementary goods.

Perhaps Marshall's most outstanding innovations in the theory of demand were the concepts of Consumer's surplus and the elasticity of demand, of the two, the latter has proved to be more durable.

### **17.3.3 Consumer's Surplus**

Marshall's concept of consumer's surplus was an attempt to plant Ricardo's concept of rent as a surplus into the theory of demand. The basic idea underlying this concept was to convey that consumers generally enjoy a surplus of satisfaction when they purchase goods in the market. This surplus arises because the market price at which the purchase is made equals marginal utility, that is, the utility derived from the marginal unit. But the earlier or the intra-marginal units of the commodity purchased yield higher utility, though the price for each unit is the same. Thus, there is surplus of utility or satisfaction yielded by all intra-marginal units.

Consumer's surplus was defined by Marshall as the surplus of satisfaction which, could be measured by the difference between what the consumer would be willing to pay for the commodity rather than go without it and what he actually pays for it. In other words *it* was the difference between the total utility derived from the purchase and consumption of a given quantity of the commodity and the utility sacrificed in the form of the money spent on it. Since the money expenditure equals the marginal utility of the commodity multiplied by the number of units purchased, consumer's surplus could also be represented diagrammatically as the difference between the total area under the marginal utility curve and the area under the price line with the limit given by the perpendicular on the horizontal axis from the point of intersection between the price line and the marginal utility curve.

Marshall's consumer's surplus could be interpreted in absolute as well as relative terms. The concept of consumer's surplus explained above refers to the absolute consumer's surplus. In this sense, whatever be its analytical significance, it was of little practical use and it was criticized as such, it was described as imaginary and hypothetical. In the case of necessities like bread and water, it could be infinite and immeasurable.

Relative consumer's surplus referred to the gain in satisfaction that the consumers got in consequence of fall in price of a commodity as the result of progress. Since Marshall was in the habit of applying his Concepts and theories to the concrete practical problems of "ordinary business of life" there is - reason to believe that from the practical point of view, the concept of relative consumer's surplus was deemed by Marshall to be much more useful.

Although the concept of consumer's surplus could be and, in-fact, was used as an analytical device to analyze the welfare effects of economic policies, yet even as an analytical device it had a certain awkwardness about it, on account of which it did not endure for long and as at present, it has only historical importance As B. B. Seligman has observed. "Frank Knight leveled such an attack on the idea of the surplus that not even the heroic effort of John R. Hicks could restore it." J.R. Hicks had, indeed, tried to rehabilitate the doctrine of consumer's surplus with the help of his indifference analysis but somehow or the other it did not revive enough to be a part of the present-day mainstream neoclassical economics.

#### **17.3.4 Elasticity of Demand**

As we observed above, the innovative concept of Marshall's theory of demand that has proved eminently durable is his concept of the elasticity of demand of which he made a very explicit use. In fact, the idea of price-elasticity of demand was inherently present in Cournot's price-demand function. But it was Marshall who brought it into the open and made an explicit use of it in analyzing demand and tracing its effect on price formation.

Marshall defined elasticity of demand as that attribute of a good by virtue of which a small change in its price causes a relatively much or small change in its demand. Technically speaking, his concept of elasticity of demand expressed the relationship between the proportionate change in the quantity demanded of a good consequent upon a given proportionate change in its price. In more popular and simple terms, it expresses the ratio between the percent change in demand and the percent change in price from which the former results, that is, elasticity of demand equals the ratio:

$$\frac{\% \text{ change in Demand}}{\% \text{ change in Price}}$$

Defining elasticity of demand in this manner, Marshall, in-fact, restricted it to small variations rather infinitesimally small variations, in price only. This means that his concept of the elasticity of demand was the concept of the *point* elasticity of demand. But his pioneering innovation in this respect suggested a much wider scope for the use of the concept of elasticity. In the theory of demand itself, it led to the concepts of *arc* elasticity of demand, *cross* elasticity of demand and *substitution* elasticity of demand. The last of these concepts of elasticity could be and were extended into the theories of production



and distribution also. In addition to these, the concept led to the formulation of at least half a dozen other elasticity concepts such as income elasticity, output elasticity and elasticity of supply, etc.

Marshall made use of the concept in his analysis of value while exploring the effects coming from the side of demand. For this purpose he considered some useful coefficients of it. Zero elasticity represented perfectly inelastic demand which is an extreme theoretical value. On the other extreme, there was infinite degree of elasticity, showing a perfectly elastic demand curve which would be relevant as seen by an individual firm operating under perfect competition.

Another significant value of elasticity of demand was unity which separated the elastic from the inelastic demand. Inelastic demand in economics does not mean zero elasticity, to express which we use the term *perfectly* inelastic demand. The term, inelastic demand, as such, is used to express less than unit elasticity of demand, while the term, elastic demand, is used to denote more than unit elasticity of demand. This classification of elasticity on the basis of its degree was employed usefully in the analysis of value under different market forms. Inelastic demand tended to cause wider changes in the price of a good consequent upon a shift in the demand curve, an "increase" in demand raising the price relatively more than it would do, if the demand was elastic. Similarly, inelastic demand tended to lower the price relatively more as the result of a "decrease" in demand than it would do, if the demand was elastic.

It has been observed by some commentators that Marshall often states his economic propositions in such a manner that they do not abstract too much from the observed world and instead keep a visible link with it as a result of it. It is said, we can notice many a seed of business economics in his writings and in the application, of his concepts and theorem. This Contention can be demonstrated with the example of one particular measure of elasticity of demand suggested by him which could be very handy for practical use in everyday business of businessmen. We are here referring to the total revenue method of measuring elasticity of demand. The formula suggested by him was quite simple. Unit elasticity implied that the total revenue of a firm would remain constant despite the changes in the price of the good. But more than unit elasticity implied an *inverse* functional relationship between price of a good and the total revenue earned by a firm, a lower price bringing in larger revenue and a higher price bringing in lower revenue. On the other hand, less than unit elasticity implied a *direct* functional relationship between price and revenue, a lower price bringing in smaller revenue and a higher price of bringing in larger revenue.

Though, under perfect competition, the above formula could be of little use for a business firm in determining its price-output policy, as individual firms, under perfect competition act as price-takers rather than as price-makers, but under monopoly or other types of imperfect competition where there is scope for a business firm to act as a price-maker, the concept of elasticity of demand and the revenue method measuring it could be of great practical use in business.

Somehow or other, Marshall did not care to extend the concept of elasticity to supply in order to make his demand-and-supply analysis of value more symmetrical. But this deficiency was removed by his disciples so that now we find in the standardized version of the Marshallian theory of value the concept of elasticity of supply juxtaposed with that of the elasticity of demand. As a matter of fact, his references to different laws of production under which both firms and industry could operate had none-the-less hidden concept of elasticity of supply.

Marshall did not fail to pin point the categories of goods which could have either elastic or inelastic demand. In general, he pointed out necessities of life had inelastic demand, for the wants for them could not be postponed. On the other hand, the luxuries whose want could be easily postponed had elastic demand. He referred to other factors also, namely, the availability or non-availability of close substitutes, the level of price and the category of income-class, etc.

#### Self Check Exercise-1

Q.1 Discuss Alfred Marshall's Theory of price.

Q.2 Discuss Marshall's Theory of Demand.

Q.3 Discuss Marshall's Concept of Consumer Surplus.

Q.4 Discuss Marshall's Concept of Elasticity of demand.

## 17.4 Summary

Before we close this lesson beaming on Marshall, in Marshall's theory of demand it may be observed that his approach to the demand side of price determination had the effect of the neoclassical theory of demand completely cutting loose from the classical approach. The classical economists generally tended to advance the view that only tangible goods could have value. In contrast to it, Marshall, and following him the neoclassical economists in general, advanced the view that the end of productive activity was not producing of tangible goods as such but the production of satisfactions or utilities. The criterion of a good having value was that the buyer of it must be willing to pay in exchange for it which was possible, if the good had some utility for the buyer. This tended to obliterate the distinction between "tangible" or "material" and "intangible" or "non-material" goods the latter referring to services. As Marshall observed, "when man is said to produce material things, he really only produces utilities or in other words, his efforts and sacrifices result in changing the form or arrangement of matter to adapt it better for the satisfaction of wants." Elaborating further on it, he observed, "It is sometimes said that traders do not produce that while the cabinetmaker produces furniture, the furniture-dealer merely sells what is already produced. But there is no scientific distinction. They both produce utilities."

The last observation in the above quotation is significant from the point of view of the historical development of the theory of value. To the mercantilists, value arose only in exchange or trade. To the Physiocrats, it arose only in a particular kind of production, namely,

agriculture; all other activities were considered by them as “sterile”. Thus to them, value arose only in agriculture. The classical’s, and following them Marx, generalised the physiocratic idea of value arising in the process of production to include all branches of production, but they identified production with the production of only tangible or material goods. Thus to them value was associated with material goods. Non-materials goods or services of various sorts including the services of traders and merchants were considered by them as non-productive of value. But, Marshall and other neoclassical economists basing their view on the concept of production as the creation of utilities advanced the view that all types of activities, regardless of whether they did or did not result in “vendible” goods, that is, tangible material goods, were productive of value, provided they resulted in the creation of utilities.

## 17.5 Glossary

- 1. Consumer's Surplus:** The difference between what a consumer is willing to pay for each unit of a commodity consumed and the price actually paid.
- 2. Demand:** A relationship between market price and quantities of goods and services purchased in a given period of time.
- 3. Diminishing Marginal Utility (DMU):** An economic concept that refers to the notion that additional units consumed of a particular commodity provide less and less additional satisfaction relative to previous units consumed.
- 4. Elasticity of Demand:** A measure of sensitivity of quantity demanded to changes in market price.
- 5. Cost Function:** The relation between the cost and output is technically described as the Cost Function. The significance of cost-output relationship is so great that in economic analysis the cost function usually refers to the relationship between cost and rate of output alone and we assume that all other independent variables are kept constant. Mathematically speaking  $TC = f(Q)$  where  $TC$  = Total cost and  $Q$  stands for output produced.
- 6. Variable Costs of Production:** Production costs related to changing quantities of a variable factor of production in the short run.

**7. Elastic Demand:** When the percentage change in quantity demanded exceeds the percentage change in price, the demand is said to be elastic. That is, a certain percentage change in price leads to a greater percentage change in quantity demanded. The value of coefficient of elasticity will be greater than one but less than infinity when demand is elastic ( $1 < \eta < \infty$ ).

**8. Inelastic Demand:** As long as there is some positive response of quantity demanded to change in price, the absolute value of elasticity will exceed zero. The greater the response the larger the elasticity. However, when percentage change in quantity demanded is less than percentage change in price, demand is said to be inelastic. That is, a certain percentage change in price leads to a smaller percentage in quantity demanded. The coefficient of elasticity will be less than one but greater than zero ( $0 < \eta < 1$ ).

## 17.6 Answers to self check Exercises

### Self check Exercise-1

- |       |                             |
|-------|-----------------------------|
| Ans.1 | Please refer Section 17.3.1 |
| Ans.1 | Please refer Section 17.3.2 |
| Ans.1 | Please refer Section 17.3.3 |
| Ans.1 | Please refer Section 17.3.4 |

## 17.7 References/ Suggested Readings

33. Eric Roll: *"A History of Economic Thought"*.
34. J.A. Schumpeter: *"History of Economic Analysis"*.
35. M. Blaug: *"Economic Theory in Retrospect"*.
36. I. Rima: *"Development of Economic Analysis"*.

## 17.8 Terminal Questions

- Q1. Explain the Marshall's theory of demand in detail?
- Q2. Elucidate the Marshall concept of Consumer Surplus?

## Unit- 18

# MARSHALL'S ECONOMICS: MATURE NEOCLASSICISM (2)

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### Structure

- 18.1 Introduction
- 18.2 Learning Objectives
- 18.3 Theory of Production and Supply
  - 18.3.1 Concepts of Costs
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  - 18.3.3 Theory of Production
  - 18.3.4 Time and ProductionSelf Check exercise-1
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Self Check exercise-2
- 18.5 Theory of Distribution  
Self Check exercise-3
- 18.6 Summary
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- 18.8 Answers to self check Exercises
- 18.9 References/ Suggested Reading
- 18.10 Terminal Questions

### 18.1 Introduction

In the last lesson, we introduced you to the broad features of Marshall Theory of price which standardised the neoclassical theory of value. It was pointed out there that while in the early crude versions of neoclassical theory of value as represented by the theories of W.S. Jevons and Carl Menger, the supply side and the costs of production were completely ignored. Marshall put the neoclassical theory on an even keel by underlining the importance of both, the force of demand and the force of supply, as the true determinants of the value of goods. It was, according to him, the interaction between the contending forces of demand and supply which determined the prices of goods which were determined by the condition of equilibrium between the opposing forces of demand and supply. We further pointed out the great contribution of Marshall to the neoclassical theory of value and price in the form of the introduction of the element of time, on the basis of

which he classified value (and price) into (1) market value, (2) the short-run or the sub-normal value and (3) the normal value. While, in the case of the market value, in which production and supply were perfectly inelastic, the force of demand predominated in view of the perfectly inelastic production and supply, the cases of the short-run and long-run price were different. In their cases force of supply was not passive as it was in the case of the market value or price. It was because in their cases supply became an active force as it could be varied even in the short period, while it could be fully adjusted to the demand conditions only in the long run.

The early crude version of the neoclassical theory of value is' focused on what Marshall, -later on described as the *market* value and therefore the authors of these versions did not pay any attention to the analysis of supply. This gap in the neoclassical theory of value was removed by Marshall by introducing along with the concept of logical time in the theory of production on which the supply of a good ultimately depends.

## 18.2 Learning Objectives

After going through this lesson you will be able to:

- Explain the theory of production and supply
- Put in plain words the meaning of economies of scale
- Elucidate the theory of distribution

## 18.3 Theory of Production and Supply

### 18.3.1 Concepts of Costs

In Marshall's theory, production and supply are variable in both the short run and the long run, though they are supposed to be absolutely fixed in what Marshall described as the market period. When we come to analyse production, the discussion and analysis of costs of production acquire prime importance.

Discussing and analysing costs and production, Marshall refers to two concepts of it, the *money costs* and *the real costs*. Of the two, Marshall considers real costs as the more fundamental concept, while money costs are considered as mere translation of real costs into money terms. This approach links his concept of costs to Jevons's concept, as much as these real costs are sought to be defined in terms of 'disutilities' or "discomforts". As Marshall observes, "while demand is based on the desire to obtain commodities, supply depends mainly on the overcoming of the unwillingness to undergo discomforts." They are fundamentally related to supply of two factors, namely, labour and capital. The real cost of the supply of labour is the "painful" exertion that labour involves. This is indeed a form of "disutility" Since supply of capital depends on the supply of savings and saving also involves the "pain" of sacrificing present consumption or "waiting" for future consumption, therefore, the real cost of capital is also a form of "disutility".

Money costs are defined by Marshall as the money payment necessary to secure the painful exertion of labouring and waiting. The correspondence between the money costs and the real costs, according to Marshall, "is never to be assumed lightly." However, he elaborates that "if the purchasing power of money, in terms of effort, has remained about constant, and if the rate of remuneration for waiting has remained about constant, thus the money measure of costs corresponds to the real costs."

Stigler comments on the above that "the proof that real costs and money costs are proportional requires much more than the constancy of money income in terms of efforts. It requires that money costs (and prices) or all commodities be proportional to their marginal disutilities of labour, and also the condition of equal earnings in alternative occupations at the margin." This naturally implies that each labour is on the margin of transference between all occupations at the same wage or that among other things all labourers have identical disutility functions. Otherwise, it is impossible to infer, from the equality of wage costs (to take only one element of costs) of two commodities, that each represents the same amount of disutility of labour.

The concept of alternative or "opportunity" cost was not explicitly adopted by Marshall even though his concept was implicit in his idea of the existence of competition among various employments of given resources which is a fundamental idea occurring *passim* in his *Principles*.

### **18.3.2 Supply Curve**

Through the concept of the real costs Marshall carried on, in a way, the classical tradition but he, at the same time, admitted into his analysis of the costs a new element in the form of the opportunity cost. Anyway, both the concepts led to the postulation of a positively sloping supply curve of an individual firm and the lateral summation of the individual supply curves yielded the industry's supply curve which too rose upwards to the right showing a positive slope. The real-costs doctrine explained it with the argument that the production involved supplies of factor inputs which involved disutilities and sacrifices which were assumed generally to rise as the quantity offered increased. Though there might be some exceptional individuals who might have a positive satisfaction, (utility as opposed to disutility) from their work, yet for the vast majority, it was assumed, labour and saving implied pain and sacrifice that is disutility, which increased at an increasing rate implying an increasing marginal disutility. Therefore, supplies of factor inputs necessary for increasing production and supply of a good would be forthcoming only at rising factor costs yielding a rightward rising supply curve.

The above argument explaining the fact of rightward rising supply curve was reinforced by the neoclassical concept of the opportunity cost also. Factors of production were assumed to have alternative uses. Therefore any individual firm buying their services will have to compete with his rivals in order to acquire them. It will have to pay remuneration somewhat higher than a factor could earn in its

alternative employment, implying a rightward increasing supply curve of factor services which were reflected in the rightward rising supply curves of goods implying increasing marginal costs of production in whatever way they might be interpreted in terms of real costs or money costs.

The above, is a simple and straightforward Marshallian theory of supply. Marshall made use of it in his theory of price in order to arrive at his well-known conclusion, namely, that in equilibrium the price of a good tended to equal its marginal utility on the side of demand and its marginal cost on the side of supply.

### **18.3.3 Theory of Production**

Marshall's theory of production was much more complicated than what is indicated in the above simple and uncomplicated account of it. A notable aspect of his theory of production was the extension of the Ricardian law of diminishing returns to all factors of production instead of confining it to agriculture alone, though his statement of the law was not quite satisfactory inasmuch as he continued to state it in a manner that could mislead to the conclusion that it was relevant to agriculture alone, because its statement often referred to "the application of increased capital and labour to land." His statement of the law of diminishing returns was unsatisfactory in another way too, on account of which Stigler described his treatment of it as "one of the most disappointing parts of the *Principles*." It is considered disappointing on account of Marshall failing to carefully distinguish between the diminishing *marginal* and the diminishing *average* returns. The law of diminishing returns as finally stated by him reads. "The application of increased capital and labour to land will add a less than proportionate amount to the produce raised." This defective statement of the law was repeated by Marshall many times, but it should be noted that Marshall stated it in its appropriate form too, refining to the incremental, that is, the marginal returns.

Allied to the law of diminishing returns in Marshall's theory of production is his law of substitution which implies the assumption that factors of production are substitutes, though not perfect substitutes, of one another. His law of substitution implied that under the pressure of competition and the entrepreneur's desire for maximum profits, a cheaper factor would be substituted in place of a dearer factor, where cheapness and dearness are measured in terms of product divided by cost. Since under perfect competition no entrepreneur can act as a price-maker and each one has to accept the ruling price as a datum, maximising profits, in effect, meant for an individual entrepreneur the minimising of costs. Marshall's concept of substitution suggested that the costs could be minimised through a process, of substitution between factors till the ratio between the marginal productivities of any pair of factors was equal to the ratio between their prices.

However, Stigler has found fault with Marshall's treatment of the relationship between the law of substitution and the law of diminishing returns. According to Stigler, Marshall saw the former as "linked up" with the latter, while in fact the law of diminishing returns is only an



aspect of the law of substitution, because the fundamental cause to diminishing returns is that factors of production are not perfect substitutes of one another. Moreover, as already pointed out, though Marshall did carry out the concept of diminishing returns over to fields other than agricultural production, his statement of the law often seemed to restrict it to agriculture. When he referred to this law in the context of non-agricultural production, he generally speaks of "excessive application of resources or energies in any given direction".

His statement of the law of increasing returns is also found by Stigler to be inappropriate. Marshall states in this context that, "An increase of labour and capital lead generally to improved organization which increase the efficiency of the work of labour and capital" Stigler observes that this implies that the law of increasing returns is not at all parallel with the law of diminishing returns, because in the former case all factors are increased, while in the latter case all resources but one are held constant.

#### **18.3.4 Time and Production**

Marshall's famous innovation in the form of the introduction of the time factor, to which we have referred earlier also, is very much relevant to his theory of production and supply. Since his "marker period or the extremely short period is defined as a manner so as to exclude any possibility of varying it, this time-period is irrelevant from the point of view of the theory of production. But the short-run period of Marshall admits of variation in the firms' outputs. From this point of view Marshall classified money costs of production into two categories which he described as (1) the prime or the primary costs, and (2) the supplementary costs. The primary costs were defined to include the costs of raw materials and labour. In other words, the prime costs of Marshall are those costs which now we describe as the variable costs or the costs of the variable factors employed in production. Supplementary costs of Marshall, on the other hand, are those costs which we now describe as fixed costs or the costs of the fixed factors.

The importance of Marshall's logical classification of time into short period and long-period lies in this that it marks the period in which some factors are bound to remain fixed while others are variable from the period in which all factors are variable. The latter is Marshall's long period and the former is his short period. Since in the short period some factor or factors are bound to remain fixed, the individual firm can change its output by changing the quantities of only the variable factors like labour and raw materials. This implies that in the short period the law of variable proportions would prevail, as the result of which any increase or decrease in output can be obtained by a firm by increasing or decreasing the proportion in which the variable factors are combined with the fixed factors. It would give rise to increasing returns to factors proportions to start with but in most of the cases the diminishing returns are bound to set in. In consequence of it, suggests Marshall, average and marginal costs might fall to start with but a point will eventually be reached after which these would rise. In other words, the suggestion that the short-period costs curves of an individual firm are

U- Shaped is to be found in Marshall's theory of production. Marshall had also suggested that an individual firm would maximise its profits and minimize its losses in the Short period by producing such an output, at which its short-period marginal cost equals the price. Moreover, the firm will always gain by increasing its output so long as its marginal costs are falling. Another important point made out by Marshall which, later, led him to innovate the concept of "quasi-rent" was that in the Short period an individual firm requires to recover only its prime or variable costs, because the fixed costs are inevitable in the short period they cannot be avoided by the stopping of production even altogether. Therefore, so long as there is a chance of recovering a part of them by carrying on production even at a loss, it is to the benefit of the firm, because otherwise its losses would be greater. Shutting down the plant and thus ceasing production altogether would be in the interest of a firm only when the ruling price in the market is so low that it cannot recover even its variable costs. A price that equals the minimum average variable cost of a firm is, therefore, described as the "shut-down" price, as a slight movement of the market price below it would put the firm out of the business of production.

As already observed, the long period was defined by Marshall as a period which was long enough to allow the firms to change all of its factors and thus to change the *scale* of its plant. Although Marshall was not careful enough to explicitly pinpoint the distinction between change in factor proportion and the change in scale of production of a firm, yet this distinction between the two concepts was inherent in the manner in which he defined his short period and long period. Obviously, then, Marshall's theory of production implies that in the long period the costs of a firm are the result of returns to scale. If there are increasing returns to scale, the long-period cost curves of a firm would be falling forward. If there are constant returns to scale, they would be horizontal. And, if there are decreasing returns to scale, they would be rising towards the right. Generally, however, the returns to scale also begin to diminish after a point which makes the long-period cost curves of a firm also U- shaped which, however, are more elastic than the short period cost curves.

The above analysis of costs in Marshall's theory provides the basis for deriving the supply curves of an industry. Since, under perfect competition equilibrium of a firm takes place on the rising portion of its marginal cost curve, it is this portion of the marginal cost curve of a firm which lies behind its supply curve, which, too, therefore, is rising indicating that a larger supply of a good from a firm would be forthcoming only at a higher price, like the demand curve of an industry, its supply curve is also derived by a lateral summation of the individual firms' supply curves.

The fact, referred to above, that the short-period cost curves of a firm are less elastic than its long-period cost curves implies that the short-period supply curve of an industry is less elastic than its long-period supply curve. This Marshallian analysis of supply has important implication for his theory of value and price. Any change in demand

conditions would change the price more and supply less in the short period than in the long period.

#### Self Check Exercise-1

- Q.1 Discuss Marshall's Concept of Costs.
- Q.2 Discuss Marshall's Concept of Supply Curve.
- Q.3 Discuss Marshall's Theory of Production.
- Q.4 Discuss Marshall's Concept of Time and Production.

### 18.4 Economies of Scale

Marshall described the U-shape of the cost curves of a firm in terms of his concepts of economies and diseconomies of scale. He did not rigorously distinguish between changes in factor proportion and changes in scale. Changes in scale meant to him as changes in output which could be the result of both changes in factor proportions and changes in scale. In the real world, of course, both types of changes happen together, since, as Chamberlin pointed out later, optimum scale and optimum factor proportions are determined simultaneously. But the point is that Marshall did not distinguish, explicitly between the two even at the conceptual level.

Marshall is famous for having made an explicit distinction between internal economies and *diseconomies*, on the one hand, and *external* economies and diseconomies, on the other. Marshall's concept of internal economies referred to those advantages in production which are peculiar to an individual firm, that is, advantages which an individual firm does not share with other firms in the industry. These economies are generally due to such advantages in production which arise from the nature of the internal organization of a firm, the scale of its plant, the quality of its management, its exclusive access to certain resources or resources of certain quality which are not freely available to the other firms, and even from certain well-guarded trade secrets. Such advantages are specific to particular firms and not common to all. Therefore they are described as the internal economies of a firm. The effect of these economies is to make the cost curves (the average and the marginal) of a firm decline downwards to the right. In other words, they account for the operation of the law of increasing returns in a firm.

As a firm grows in size, its internal economies (which include economies of division (if labour as well as economies of indivisible factors) increase but only up-to a point, after which the internal diseconomies begin to prevail, while internal economies come to an end. By internal diseconomies Marshall means those disadvantages in production which are peculiar to individual firms and which it does not share with other firms in the industry. Like internal economies, they too depend on the internal organisation of the individual firm and the scale of its operations. When the internal diseconomies of a firm begin to prevail upon its internal economies, they are diminishing returns, in consequence of which the cost curves of a firm begin to rise. Thus, the U- shape cost Curves results from the internal economies and diseconomies of a firm, how long and at what rate the cost curves of

a firm would fall- or rise depends on the strength of its internal economies and diseconomies. This means that unless all firms in the industry have equal economies and diseconomies, their cost curves would not be identical. Since, in the real world, such complicit equality among different individual firms making up an industry is impossible, the real-world firms do not have identical cost curves. The more efficient firms have lower cost curves than the less efficient.

It should be noted that since internal economies and diseconomies of scale are related to the growth of the firm which takes place over a rather long period in which it is possible for a firm to change the scale of its operations, the concept of economies and diseconomies of scale is essentially a long-period concept.

Marshall's analysis of costs and its implications for equilibrium was quite sophisticated for its time. The roots of the famous controversy over equilibrium under increasing returns are to be found in Marshall's *Principles* wherein he explicitly mentioned that a firm enjoying increasing returns for too long would grow in size to such an extent that it would turn into a monopoly firm. There was not much significant improvement upon Marshall's conclusion when later economists working along the Marshallian tradition observed that equilibrium of the firm and perfect competition were incompatible under increasing returns.

But, what is particularly credit worthy in Maxell's analysis is that it suggests that the above conclusion of incompatibility of equilibrium of the firm and perfect competition under increasing returns is valid only when increasing returns are due to the internal economies of the firm. If increasing returns are the result of external economies, the above conclusion will not hold. This brings up for discussion Marshall's concept of external economies and diseconomies of a firm.

Unlike the internal economies, the external economies of a firm are those advantages in production which are not specific to an individual firm but are common to all the firms in an industry. They are shared by all the firms. While the internal economies of a firm result from the growth of the individual firm, the external economies result from the growth of the particular industry as well as growth of industry in general.

The concept of external economies is, no doubt, Marshall's contribution which plays a very important role in his theory of production. However, some commentators like Stigler are of the view that it is difficult to ascertain the precise nature of external economies. But Marshall's *Principles* mentions two general types of external economies. The one of these two types comprises those economies which arise from the use of specialized skill and machinery made possible by the increase in the aggregate volume of output of the particular kind in the neighborhood the other type comprises those economies which arise from the growth of knowledge and the progress of arts which, according to Marshall, depend chiefly on the aggregate volume of production in the whole civilized world. It is obvious that the first group of these economies refers to advantages of *localization* of a particular industry. They appear to make up the chief part of Marshall's

external economies. The external economics of firms which are related to localization mainly flow through the cross fertilization of ideas, the development of subsidiary and auxiliary industries, and the availability of skilled labour. The other types of external economies arise from other sources such as growth of knowledge and invention. Marshall has emphasized this general factor of "progress" in one of his definitions of external economies as "those dependent on the general development of the industry" It implies the notion of "the growth of correlated branches of industry. Which mutually assist one another, perhaps being concentrated in the same locations, but any how availing themselves of the modern facilities for communication offered by steam transport, by the telegraph and by the printing press."

Many of the external economies of a firm take on a *pecuniary* form For example, when with the growth of a particular industry, the specialized labour market develops, and the subsidiary and auxiliary industries also develop, the firms within that particular industry are able to get some of their inputs at cheaper prices. Similarly when the growth of industry in general leads to the development and cheapening of transport and credit facilities, all the firms benefit from it in a pecuniary form inasmuch as they now get these inputs at lower market prices. But there are some other external economies which cannot be marketised and therefore, do not take a pecuniary form. They are described as *non-pecuniary* external economies. These non-pecuniary external economies arise from situations where the production functions of the various firms in a given industry are technically interrelated for example; a coal-mining firm may find that the amount of water to be pumped out of its shafts decreases, as the number of firms in the coal-mining industry in the neighbourhood increases. While, in other cases, the concept of external economies may be found to be somewhat ambiguous, because, in those cases, the external economies of one firm might be the internal economies of some other firm or firms, in cases like the raining industry mentioned above, there is no such ambiguity. In such cases, the external economies of a firm are not the internal economies of any other firm Consequently, they are not marketised and, therefore, they have a non-pecuniary form.

The concept of external economies is of great analytical importance to the debate on equilibrium under increasing returns. As we observed earlier theory explaining Marshall's concept of internal economies, equilibrium and perfect competition are incompatible under increasing returns, if increasing returns result from internal economies. But, if the increasing returns result from external economies, equilibrium and perfect competition will be compatible. External economies do not result in making the firms' cost curves slope downwards but they result in *shifting* the firms' cost curves downwards. It is a situation in which while the individual firms have exhausted their internal economies and are, therefore, operating in the region of rising cost curves, they have not exhausted their external economies and, therefore, their cost curves are shifting downwards to the right. Such a situation may also be described as a situation in which the industry is

subject to increasing returns, though the individual firms are not enjoying increasing returns that result from internal economies.

Marshall's analysis of the above-mentioned case led him to another analytical innovation in the form of his hypothesis of the forward falling long-run supply curve of an industry. Normally, the long-run supply curve of an industry is *upward rising*. Under certain assumption, that is, when the industry is subject to constant returns, the long-run supply curve could be horizontal as was implicitly assumed in the classical economics. But the idea of negatively sloped, that is, forward falling long-run supply curve was unheard of before Marshall and it has remained one of his outstanding contributions to economic analysis.

It may be mentioned, however, that though internal diseconomies and external diseconomies are symmetrical counterparts of internal economies and external economies respectively. Marshall, on the whole, paid much more attention to the analysis and explanation of economies than to the analysis and explanation of diseconomies.

#### Self Check Exercise-2

Q.2 What do you mean by Economies of Scale.

### 18.5 Theory of Distribution

Marshall's approach to the problem of distribution was in line with the general neoclassical approach of the times as particularly articulated in the works of Leon Walras and Wicksell. Like theirs, Marshall's approach to the problem was also to treat distribution as *functional* distribution in contrast *with* the classical habit of treating it as a problem of class shares in the national income. This manner of treating distribution aimed at explaining the distribution of the total product among the factors of production which contribute their services to the production of that product. The different factors received their rewards in a free market economy in the form of market prices of their services. Hence, in line with the general neoclassical practice, Marshall treated the problem of distribution as a problem in the determination of factor prices and, while analysing this problem, offered his own version of the marginal productivity theory of distribution which, indeed, is the neoclassical theory of distribution.

Till Marshall, the neoclassical considered three basic factors of production, namely, land, labour and capital, to each one of which was assigned a particular share. Marshall added to this trinity of factors of production of fourth factor which he referred to as organisation meaning by it the organisational skill of the entrepreneur whose chief function was conceived by Marshall as combining and organising other (hired) factors of production for the most efficient production. Thus, in Marshall's model, organisation is the luring factor, while the other three factors are the hired factors. In *Marshall's Principles* we come across for the first time, a systematic four-fold classification of factors of production.

Within the above four-fold classification of factors, the corresponding factor shares were rent, wages, interest and profits

which were treated as the rewards for the productive services of respectively land, labour, capital and organisation. It is to be noted that unlike the classical but like the general neoclassical practice. Marshall did not identify these factors and their incomes with particular social classes. Rent for example, was not identified with the income of the feudal class of landlords. Nor were wages restricted to the working class, defined as they were as the reward for human effort, physical or mental, which is undertaken with a view to getting something in exchange for it. Thus, in Marshall's theory, salaries and even *imputed* "wages of management" in self-owned business fell in 'the category of wages. As regards rent, it was no longer associated with agricultural land only. Marshall's very notable contribution to the theory of rent was his proposition that rent would arise to even man-made goods or appliances and that it was not restricted to the natural resources, that is, the factor, land, which is a free gift of nature. Marshall's novel concept of the "quasi-rent" in this context has proved to be very useful and durable. Interest in Marshall's theory is regarded as the reward for "waiting" which Marshall raised to the status of almost an independent factor. But, in fact, he interpreted the concept of capital which rests on saving as "waiting." The classical concept of saving and capital as sacrifice those who supplied savings (capital) scarified, argued Marshall, only present consumption for-the sake of greater future consumption. Therefore, he argued saving, the source of capital, meant not a sacrifice but only "waiting" till the savers got back their savings with interest as the reward for "waiting". The net income received by the hiring factor, organizer, was not a homogenous income. It was only *gross* profit including not only rent and interest on the services of land and capital supplied by the organizer himself but also the "wages of management". Only when the rent on the owner- organizer's own land and interest on his own capital employed in production plus his imputed "wages of management" were deducted from the gross profit, the residual could be regarded as the net profit which, according to Marshall, tended to disappear in the long-run under conditions of perfect competitions so that in the long run the entrepreneurs or organizers earned no more than their wages of management.

This approach to distribution did away with the classical and Marxian concept of profit as the class share of the capitalist class in the national dividend. A good part of the income which the classical and Marxian tradition as well as some non-Marxian socialist traditions regarded as profits was transformed, in Marshall's theory into wages of management and interest on capital. Only the residual was regarded as *pure* profit which Marshall regarded as either a temporary short-run disequilibrium situation or the existence of monopoly conditions.

Having made the above described conceptual distinctions related to the theory of distribution. Marshall introduced his general demand and supply theory of price determination in order to explain the determination of factor prices and the functional factor shares. Marshall's theory of distribution is only a special case of his general price theory. He is careful to point out explicitly the difference between the determination of prices of goods and the determination of the prices

of factors of production, even though the factor prices too resulted from the equilibrium between the contending forces of demand and supply, On the side demand for factors of production as a *derived* demand, derived as it was from the demand for the goods which they helped to produce, therefore while the demand for goods depended on their marginal utility, the demand for factors of production depended on their marginal productivity.

On the side of supply Marshall observed more fundamental differences not only between factors of production and common goods which they help to produce but also between different factors of production themselves. The cost-of-production theory could not be applied mechanically to determine the supply curves of factors of production. Land, for example, is an irreproducible factor for all practical purposes. Labour cannot be separated from the labourer which had implications for the determination of the supply curves of labour. Moreover, labour is not a homogenous factor, as it has various types distinguished from each other on the basis of skills and abilities. Even capital could not be treated like an ordinary good. Marshall observed, in.dus context, the importance of making a distinction between the accumulated *stock* of capital 'and the *flow* of new investment, because the economic implications of the payments to the owners of the old and newly created capital were quite different. Where the accumulated stock of capital- was fixed, like the supply of land in the short period so that its supply could not be reduced even when its earnings fell to zero, its supply was elastic in the long period. It led him to the concept of the "quasi-rent." As he observed "That which is rightly regarded as interest on "free" or "floating" capital, or on new investments of capital, is more properly treated as a son or rent—a quasi-rent on old investments of capital And thus even the rent of land is seen, not as a thing by itself, but as the leading species of a large genus.....".

We, earlier, said that Marshall theory of distribution is a particular form of the neoclassical marginal productivity theory of distribution. The crude marginal productivity theory of distribution which preceded Marshall's version was based on the assumption of fixed supplies of factors of production and therefore it only explained the demand side of the factors of production It did not explain the supply side. As Marshall observed, the marginal productivity by itself could not explain the determination of factor shares; it could only explain how the demand for factors of production was determined. Marshall's version, which might be appropriately described as demand-and-supply theory, was a definite improvement upon the crude marginal productivity theory insofar as it brought into the picture the supply side also. A correct interpretation of Marshall's distribution theory would be that it is a demand-and- supply theory of factor prices stating that prices of each factor under perfect competition, though determined by the interaction of the forces of demand and supply, tend to equal its marginal and average net product in the long run.

Self Check Exercise-3



Q.2 Discuss Marshall's approach to the problem of distribution.

## 18.6 Summary

In this lesson we have dealt with the Marshall theory of Production and Supply. We studied the Concepts of Costs and supply curves. We also introduced you to the Marshall concept of Economies of Scale.

Marshall put the neoclassical theory on an even keel by underlining the importance of both, the force of demand and the force of supply, as the true determinants of the value of goods. It was, according to him, the interaction between the contending forces of demand and supply which determined the prices of goods which were determined by the condition of equilibrium between the opposing forces of demand and supply. We further pointed out the great contribution of Marshall to the neoclassical theory of value and price in the form of the introduction of the element of time, on the basis of which he classified value (and price) into (1) market value, (2) the short-run or the sub-normal value and (3) the normal value. While, in the case of the market value, in which production and supply were perfectly inelastic, the force of demand predominated in view of the perfectly inelastic production and supply, the cases of the short-run and long-run price were different. In their cases force of supply was not passive as it was in the case of the market value or price. It was because in their cases supply became an active force as it could be varied even in the short period, while it could be fully adjusted to the demand conditions only in the long run.

The early crude version of the neoclassical theory of value is focused on what Marshall, later on described as the *market* value and therefore the authors of these versions did not pay any attention to the analysis of supply. This gap in the neoclassical theory of value was removed by Marshall by introducing along with the concept of logical time in the theory of production on which the supply of a good ultimately depends.

## 18.7 Glossary

1. **Supply:** A relationship between market price and quantities of goods and services made available for sale in a given period of time.
2. **Short Run Production:** Production activity where only one factor of production may vary in quantity. All other factors of production are fixed in quantity. Substitution among factors is not possible.
3. **Economies of Scale:** Most economic production requires the producing firm or organization to make an initial investment (in real capital, in engineering and design, in marketing) before

even the first unit of production occurs. As total production then grows, the cost per unit of that initial investment shrinks. For this reason, most industries demonstrate economies of scale, whereby the unit cost of production declines as the level of output grows. Because of economies of scale, larger companies have an advantage in most industries, and the economy usually operates more efficiently when it is busy and growing (than when it is shrinking or stagnant).

4. **Distribution:** The distribution of income reflects the process by which the real output of goods and services produced by the economy is allocated to different individuals and groups of people. Distribution can be measured across individuals (comparing high-income and low-income households), or across classes (comparing the incomes of workers, small businesses, and capitalists).
5. **Production:** The process by which human labour (or “work”) is applied, usually with the help of tools and other forms of capital, to produce useful goods or services.
6. **Factors of Production:** The basic productive resources (labour, capital, and natural resources) that are essential inputs to every economic activity.
7. **Money:** Broadly speaking, money is anything that can be used as a means of payment (for example, to settle a debt). It includes actual currency, bank deposits, credit cards and lines of credit, and various modern electronic means of payment.
8. **Quasi-Rent:** the return on any factor of production which is more than what it should receive to remain in its present state of use. It is not the same as the profit, since it does not take account of other costs.
9. **Marginal Productivity of Capital:** the value of extra production of a unit of increased capital.

## 18.8 Answers to self check Exercises

Self Check exercise-1

- Ans.1 Please Refer Section 18.3.1
- Ans.2 Please Refer Section 18.3.2
- Ans.3 Please Refer Section 18.3.3
- Ans.4 Please Refer Section 18.3.4

Self Check exercise-2

Ans.1 Please Refer Section 18.4

Self Check exercise-3

Ans.1 Please Refer Section 18.5

## 18.9 References/Suggested Readings

- 37. Eric Roll: *"A History of Economic Thought"*.
- 38. J.A. Schumpeter: *"History of Economic Analysis"*.
- 39. M. Blaug: *"Economic Theory in Retrospect"*.
- 40. I. Rima: *"Development of Economic Analysis"*.
- 41. G.J. Stigler: *"Theories of Production and Distribution"*.
- 42. J.M. Keynes: *"Essay in Biography"*.

## 18.10 Terminal Questions

Q1. Bring out Marshall's two most outstanding innovations in the theory of demand?

Q2. Explain Marshall's concepts of internal and external economies and bring out their analytical importance?

## **Unit-19**

### **ECONOMIC THOUGHT OF PIGOU AND KEYNES**

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#### **Structure**

- 19.1 Introduction
- 19.2 Learning Objectives
- 19.3 Economic Thought of Pigou
- 19.4 Economic Thought of J.M. Keynes (1883-1946)
  - 19.4.1 Keynes's doctrine of effective demand
- 19.5 Summary
- 19.6 Glossary
- 19.7 Answers to self check Exercises
- 19.8 References/ Suggested Readings
- 19.9 Terminal Questions

#### **19.1 Introduction**

A C. Pigou (1877-1959) was a worthy heir not only to the academic chair of professorship of Alfred Marshall at the Cambridge university but also to the Marshallian trend of neoclassical economic thought. J.M. Keynes on the other hand, ended his academic career with the rare distinction of having brought about a revolution in economic thought which was anti-neoclassical in its nature, though Keynes, also a Cambridge economist, had started with the intellectual baggage of neoclassical thought. In the present lesson, we shall introduce you to the basic features of the economic thought of these two deservedly famous Cambridge economists.

#### **19.2 Objectives**

After going through this lesson you will be able to:

- Assess the Place of Pigou's economic thought in the history of economic thought
- Explain Pigou's externality effects
- Elucidate Keynesian consumption function

#### **19.3 Economic Thought of Pigou**

As we observed above Pigou was a very worthy heir to the neoclassical tradition as set forth in the work of Alfred Marshall whose,

perhaps, he was the most brilliant student. He carried forward and built upon the ideas of Marshall in a manner which bears the impression of his originality in spite of an underlying similarity of approach.

Marshall while discussing the nature of the science of economics had taken pain to emphasize, that economics studied wealth not for its own sake, but because wealth was the means to the welfare of man. Pigou not simply agreed with this proposition of his teacher but wrote his *magnum opus*, *The Economics of Welfare*, centering on this single idea. In 1912, at the age of thirty-five years, he had published an analytical work. *Wealth and Welfare* which represented a sort of first explorations into the economics of welfare. It was this very work which was, later, revised and expanded by him into his classic work, *The Economics of Welfare*. He did not write any conventional type of book on the principles of economics in the manner of J.S. Mill and Alfred Marshall, but his *Economics of Welfare* was a novel experiment of explaining important principles of economics from the standpoint of social welfare. In fact, most of Pigou's works were detailed explorations of some aspect or the other of welfare economics. He produced, subsequent to the publication of his *Economics of Welfare*, a number of more popular works such as *Income*, *Income Revisited* and *Lapses from Full Employment* which were, in fact, based upon his popular lectures and were intended to explain in a popular style the more technical features of his theory. They are generally deemed to be an excellent introduction to the main body of his economic thought as embodied in his more technical and analytical works such as the *Economics of Welfare*, *The Economics of Stationary States*, *Employment and Equilibrium*, *Industrial Fluctuations* and *a Study of Public Finance*.

Pigou subscribed to his teacher, Marshall's views on the nature of the science of economics. Marshall's influence on him is too obvious to need any elaborate explanation. He looked upon economics as a science which explored and explained economic phenomena. But he did not subscribe to the absolute and dogmatic positivism of economists like Prof. Robbins who had vehemently ruled the study of problems involving "ought" and "should" out of the scope of economics. Instead keeping alter the Marshallian tradition, he emphasized in his *Economics of Welfare* that economics was both a "light-bearing" and "fruit-bearing" knowledge, thus setting at rest the controversy whether economics was a science or an art. It was, according to him both its method of analysis made it a science, a positive science, but applying the results of economic analysis to solve practical problems of economic life was an art. In the former aspect, it was a "light-bearing" knowledge or science while in the latter aspect it was a "fruit-bearing" knowledge or an art.

The idea that welfare economics was a normative science which should follow the positivist method of study was very much implicit in his approach and practice. Although his ends were ethical and moral concerned as he was with finding out ways of optimizing economic welfare of the community, yet his method of going about it, that is, his analysis conformed to the highest standards of the scientific method.

His undiluted commitment to the scientific method was eloquent in his retort to Clapham's charge in his famous paper. "Of Empty Economic Boxes" that the theorists were unable to fit empirical data into their theoretical concepts like the laws of decreasing or increasing returns. Grand analysis, asserted Clapham, was little more than mere a collection of "empty boxes". Pigou's retort to it was that 'the basic function of scientific theories was to explore the implications of certain given set of propositions which inevitably necessitated the use of the method of abstraction, the so-called "empty boxes" said Pigou, were important constituents of the conceptual equipment of modern economics. Such "boxes" could not be dispensed with, he argued. Instead of doing away with them, the need, however was to improve them.

In his theory and practice of methodology also, Pigou carried on his master Marshall's tradition. He fully subscribed to Marshall's advice and practice of burying mathematics, except its simplest and therefore, popular forms, in footnotes and appendices in spite of the fact that most of the economic formulations were eminently suited to be treated mathematically. Excessive use of mathematics, in Pigou's opinion tended to make use of mechanical rather than biological analogies.

The philosophical stand point of Pigou's economic thought in general and his welfare economics in particular was the utilitarianism principle of the greatest good of the greatest number. Social welfare was conceived as the aggregate of individual welfare. But what was the most outstanding contribution of Pigou in this regard was his recognition and analysis of 'externality effects,' on account of which social welfare could not be treated as a mechanical summation of individual welfare.

Welfare itself was conceived by Pigou in subjective terms in the tradition of the neoclassical subjectivist school of economics. He located it in the mutual relationship of satisfaction (utility) and dissatisfaction (disutility). He distinguished between *the general* welfare and *economic* welfare, defining the latter as that part of general welfare which could be brought into relation with the measuring rod of money. This definition led to two important implications. Firstly, it implied the concept of cardinal utility, that is, the concept of quantifiable and additive utility. This is the concept of utility which Marshall and practically all his followers, not to speak of Pigou alone, adopted in their theories of consumer's demand and welfare economics. The second implication of the above definition of economic welfare by Pigou also points towards a Marshallian tradition of assuming that members belonging to one and the same community have on the average, equal capacities for enjoyment that a British pound represents, on the average, the same amount of satisfaction to all members of the British society, there might be some exceptions lying on the opposite extremes but they would, on the whole, cross-cancel each other's effect. 'This assumption was in line with the general humanistic and liberalist approach of Marshall which Pigou inherited from him. The Implication of this assumption, when placed

with the hypothesis of diminishing marginal utility, was that a more equal or a less unequal distribution of income and wealth would tend to increase economic welfare for a society, all other things remaining the same. This indeed one of the most distinctive features of the Pigovian welfare economics. Pigou's emphasis on this proposition marks him out from the "positivist" school of welfare economics that rejected that notion of individuals having equal capacity for enjoyment of income and wealth, apart from the fact that they emphasised the *ordinal* character of utility. Consequently, while the "positivists" ruled out the possibility of making inter-personal comparison of utility. Pigou on the other hand, stressed that interpersonal comparison of utility could be made. The two contending schools of thought on the issue had important social and political implications. The "positivist" approach implied a policy of nonintervention as regarded distribution while the Pigovian approach implied that egalitarian intervention its policies could increase aggregate economic welfare of a society. Politically, the "positivist" approach implied a *status quo*, while the Pigovian approach agreed for a "welfare state."

It should not be difficult to understand from the above description of Pigou's thoughts on economic welfare that, for him economic welfare of a society was essentially the function of two variables, namely, the size of the national output or national dividend and the distribution of the national output amongst the nationals of the given nation. The national output or income or dividend referred to *real* national income and not to money income as such. Given the distribution, the larger was the real national income, the greater would be the aggregate economic welfare. On the other, given the level of real national income, the more equal or less unequal was the distribution the greater would be the aggregate, economic welfare of a society. Pigou recognized that changes in distribution could have effects on the size of the national output, but he argued that unless an egalitarian economic policy had perverse effects on the size of real national income, it would tend to increase aggregate economic welfare.

On the other hand, given a distribution, economic welfare of a society, according to Pigou, was a direct function of the real national income. Economic welfare and the national dividend or the real national income. His discussion of the meaning and measurement of national income and the problems involved in its measurement were the most perceptive one long before. J.M. Keynes made national income accounting a popular and practically useful economic subject it was he who first of all, pointed out the oddity of national income showing a decrease on a master marrying his housekeeper. Though the instance referred to appeared to be mentioned in a lighter vein, yet it was a matter of great importance because it, in fact, implicitly questioned the practice of excluding from national income the unpaid work done by women as housework within their households. In this context, he had also hinted at the environmental consequences of production and seemed to be alarmed at the adverse environmental consequences of such productive activities as mining and quarrying which desecrated the country side and even caused health hazards.

They were not taken account of in the practice of national income accounting so that the national income was treated as remaining undisturbed by such, adverse environmental consequences. He had though, arrived at a broad definition of national income which covered all goods and services purchased with money including also the services provided by home ownership. He was also cognizant of the problems related to transfer payments, depreciation and double counting. He particularly emphasized the key question of "maintaining capital intact" and in his treatment of this problem he developed a concept of capital which contained elements of the Bohm-Bawerk and J.B. Clark. He recognized the importance of capital which he seemed to identify with the productive capacity of an economy which was depleted as well as renewed continuously in the process of production. Underlining the importance of keeping an economy's capital or productive capacity intact,' he called attention to the need for providing for depreciation allowance in real terms and not merely in money .terms. This highlighted the importance of making a distinction between *gross* national income and *net* national income.

Allied to the matter of measuring national income was the problem of index numbers to which Pigou devoted attention. Since welfare, according to Pigou, was a direct function of the size of real national income, determination of the rise of economic welfare over time required inter-temporal comparisons of real national income. The problem was rather complicated not only because of the changes in prices but also new types of goods might replace the old types. Pigou seemed to suggest the solution, namely, that given a constant distribution and constant tastes, an increase in national income would mean a genuine increase in economic welfare, if more money was offered to conserve the items added than would be offered for the items that went out. This naturally raised the knotty problem of index numbers to which, as we said above, Pigou paid great attention. The question at issue was how to distinguish between a genuine and a false increase in national income and the resulting well are thereof. Pigou's approach suggested that an increase in nominal national income that came about as the result of scarcity induced rise in prices would not reflect an increase *in* economic welfare. Moreover, he would like to set disutility of work against the increases in the real national income in order to arrive at a true estimate of increase in economic welfare over time, though he tended to believe that the real national income would be increased in most cases in spite of a simultaneous increase in the disutility of work also. Thus, to him, increase in real national income was not only a measure of increase in the physical volume of production but also a measure of increase in economic welfare of a community.

Pigou was probably the first economist to question the validity of the neoclassical practice of assuming social welfare to be a simple summation of individual welfare and identification of marginal *private* net product of a resource with its marginal *social* net product. It was he who introduced the analytically important distinction between *private* net product and *social* net product of a resource or a project



and by so doing he not only introduced a useful refinement in the neoclassical theory of resource allocation but also brought out the folly of treating social product as the mechanical summation of private products. Pigou forged the concept of “externality effects” to explain the divergence between the marginal *private* net product and the marginal *social* net product of a resource. Externality effects were caused by the presence of non-pecuniary and non-marketised external economies and diseconomies. For example, an increase in investment in the apple orchard industry supplies increased input to the bee-keeping and honey making industry, in the form of increased amount of pollens from which the bees gather honey but for which the bee-keepers have not to pay anything. In such cases, the marginal private net product is less than the marginal social net product, and, therefore the marginal social cost is less than the marginal private cost of a given increase in output of a given firm. This represents the case of external economies in production causing a divergence between the private net product and the social net product or, alternatively, between private costs and social costs of an investment project. Pigou’s famous example of the smoke coming out of the chimneys of the privately held factories damaging the environment the health of the people and even people’s clothes leading to their enhanced laundry bills for which losses the private firms causing such damage do not compensate represents the case of external diseconomies causing divergence between the marginal private net product of a given investment and the marginal social net product of it. In such cases, the marginal private net product of a given resource is greater than its marginal social net product or, alternatively, the marginal private cost is less than the marginal social cost of an output.

The externality effects pointed out by Pigou, in the first place, undermined the facile conclusion of the Paretian welfare economics that perfect competition had welfare optimizing character, even if we abstracted from the distribution problem in the manner of Pareto and his followers. Secondly, they helped Pigou to arrive at the “ideal” output in a more rational, refined and scientific manner. The traditional neoclassical norms of determining the “ideal” output by the condition of equalizing the marginal product of each resource in all the uses of it was thrown overboard as this norm ruled out, by implicit assumption, the presence of externality effects and consequently also the possibility of divergence between marginal private net product and marginal social net product of resources. The condition of realizing the “ideal” output that emerged from Pigou’s analysis was that the marginal *social* net product of each resource must be the same in the uses where it was employed.

Pigou’s analysis of externality effects highlighted the problem of market failure and thus he deserves the credit for- being the first to question the neoclassical doctrine of pure *laissez-faire* and its assumption of perfect competition having welfare-optimizing character. - But the question was how to fulfill the requisite condition of “ideal” output. In this context, Pigou bid farewell to the neoclassical

gospel of *laissez-faire* and, in its stead, called for state intervention in the form of a policy of taxes and bounties.

The idea of devising a system of taxes and bounties or subsidies was borrowed from Marshall who had discussed it in the context of his notion of consumer's surplus. Pigou adopted this idea to remove the divergence between the marginal private net product and the marginal social net product of resources. The policy suggested by him was to tax the industries causing external diseconomies and to give bounties to industries creating external economics.

Though Pigou was the chief architect of a systematic welfare economics, yet his contribution to economic thought was not limited to this area alone. He made significant contributions in other areas of pure theory also. He demonstrated his acumen in building abstruse models in his *Economics of Stationary State* which was an attempt to investigate the basic forces which might be applicable to both the static and the dynamic economies. His concern with the study of economic welfare which, according to him, fluctuated with fluctuations in the national income and its distribution led him to make a deep study of cyclical fluctuations which he had discussed even in the first edition of his *Economics of Welfare*, through being dissatisfied with the treatment of the subject there, he removed it from the subsequent edition of this work. But he produced a more extensive analysis of business fluctuations in his work. *The Industrial Fluctuations* in this work he underlined the importance of the psychological factors which generated optimistic and pessimistic business expectations leading to upswing and downswing in economic activity. He also brought out the significant feature of business fluctuations, namely, that production in capital goods industries exhibits greater fluctuations than then in consumer goods industries. In a highly technical work of his, *Employment and Equilibrium*, Pigou attempted to revive the classical employment theory by adopting some of the Keynesian concepts for his own use. In this work, he joined issue with Keynes over whether a general wage cut would or would not bring about full-employment equilibrium. While Keynes's analysis had denied this possibility, Pigou maintained that it was possible even on the basis of Keynes's principle of effective aggregate demand. In this regard he pointed towards Keynes' neglect of the substitution elasticity of demand for labour, on the one hand, and the "real wealth" effect, which has now come to be known as the "Pigou Effect," on the other hand. Pigou effect refers to the effect of increase in the value of the assets of asset-holders consequent upon fall in prices on people's consumption and saving. A general cut in wages leading to a general fall in costs and prices, argued Pigou, would increase the real wealth of asset holders, in the consequence of which they, would increase their consumption expenditure, thus augmenting aggregate effective demand and consequently raising employment level. Given sufficient time, full-employment equilibrium was, according to Pigou, attainable, provided the wage rates and all other prices were perfectly flexible.

## Self Check Exercise-1

Q.1 Discuss Economic Thought of Pigou.

### 19.4 Economic Thought of J.M. Keynes (1883-1946)

John Maynard Keynes, one of the most brilliant and famous economists of the Cambridge University, was a pupil of A.C. Pigou but the economic thought of Keynes which immortalized him in the history of economic thought ran counter to the neoclassical economic thought of which his teacher, A.C. Pigou, was a famous representative. Keynes's Principal work, *General Theory of Employment Interest and Money* (1936), which ushered in a revolution in the history of economic thought (now referred to as the Keynesian Revolution) and marked out his economics as different from the traditional,, (neoclassical) economics, focused on a unique central theme, namely, the determination of the level of income and employment in a capitalist free- market economy and the causes of fluctuations in this level. Earlier schools of economic thought had either ignored the problem completely or given only a peripheral attention to it. The classical economists were too much occupied with long-term problems of development and growth to pay any adequate attention to the short-run fluctuations in economic activity. Most of them believed in Say's Law of markets and the self- correcting character of a freely competitive economic system. Karl Marx's economics which was the only branch of economic, theory giving serious attention to the problem had been, as if by a conspiracy, kept out of the mainstream economics. Neoclassical economics, on the other hand, had completely transformed the agenda of the science of economics by confining it virtually to the study of the conditions of *optimum* allocation of resources, thus distracting attention from the classical problems of long-run development and growth and also from the short-run problems of cyclical fluctuations in the level of income and employment. The neoclassical economists appeared to have implicitly assumed that full employment was a normal condition of an economy and any lapses from the state of full employment tended to be self correcting in a freely competitive economy with perfectly flexible prices. These neoclassical premises were rudely shaken by the Great Depression of the thirties. It was against the background of the persistent mass unemployment during the Great Depression that Keynes formulated his revolutionary economic doctrine. Keynes who's theorizing was often informed with his practical experience as economic administrator and economic advisor on practical economic problems had a tendency towards unconventional and dissenting thought even when he continued to have a firm footing in the neoclassical economics of the Cambridge School. This was evident from his views as expressed in his *The Economic Consequences of Peace* and *the End of Laissez-faire*. Most of his early theoretical work was on monetary and financial themes and it was generally rooted in the Cambridge monetary theory as exemplified by his thoughts in his *Tract For Monetary Reform* and *Treatise on Money*, though even in

these works, particularly in the *Treatise*, one comes across stray seeds of ideas which later fructified in his *General Theory*.

The neoclassical premise that a freely competitive economic system tends to attain full-employment equilibrium automatically through the flexibility of prices in the long run was suspect in the eyes of Keynes who had observed that "in the long run we are all dead," thus underlining the importance and urgency of focusing economic analysis on short-run problems with a view to finding effective practical policies for their solution. His *General Theory* was aimed at reconstructing economics so that the short-run aggregate (macro-economic) problems could be made to occupy the centre stage. Thus, Keynes's economics pushed the micro- economic questions around which the neoclassical economic theory had been organized to the sidelines.

Keynes's *General Theory* leveled a critical attack on the neoclassical version of Say's Law as a prelude to the enunciation of his revolutionary theory of income and employment. Say's Law implicitly assumed that what was saved by a community was automatically invested by it so that there could never be a leakage from the income stream and, consequently, there could never be deviation from the state of full employment in a freely competitive economy. Any increase in population and labour force thereof would be automatically absorbed through a fall in the real wage rate. Similarly, any increase in savings would automatically be matched with an equivalent increase in investment through an appropriate fall in the rate of interest. The neoclassical analysis was also, in essence, a *real* analysis in which money was no more than a "veil" behind which were hidden the *real* forces. Money was believed to have no effect on the real forces, particularly, on the level of real income and employment. This implied the assumption that money functioned only as a medium of exchange and certainly not as a store of value. The quantity theory of money which, along with Say's Law, embodied the essence of the neoclassical macro-economic was premised on the ubiquitous neoclassical assumption of unique full-employment equilibrium and stated that any change in the quantity of money led directly to a proportionate change in the general price level in the same direction. Keynes's *General Theory* upset the apple-cart of neoclassical economics. It questioned the neoclassical contention of unique full-employment equilibrium and in place of the neoclassical proposition presented the proposition that full-employment equilibrium was only a limiting case, while equilibrium, depending upon the level of the aggregate effective demand, could take place at any level of output and employment. Moreover, it presented a *monetary* analysis which was opposed to the *real* analysis of the neoclassical school, Keynes's monetary analysis highlighted the function of money as a store of value in contradistinction to the neoclassical assumption that money functioned only as a medium of exchange.

#### 19.4.1 Keynes's doctrine of effective demand

Keynes's doctrine of effective demand explaining the determination of the level of output and employment was an original contribution of great import, particularly because it helped to explain situations of under employment equilibrium. In order to explain his novel theory of income and employment and his doctrine of effective demand, Keynes made use of the Marshallian analytical tools of demand and supply schedules. Employment was treated as the function, of the level of output. This proposition was derived from the concept of the production function. The nature of the production function assumed by Keynes was the same as in the neoclassical economics. In a simple, two-factor model with capital and labour as the two factors, the output was assumed to be a function of the employment of the quantities of capital and labour and the technology used. Since the *General Theory* was intended to present a short-run analysis, both the capital stock and technology were assumed to be constant so that output became a function of the level of employment of the variable factor, labour, only. The production function assumed was based upon the law of *eventually* diminishing returns.

In the neoclassical model, the equilibrium level of employment was determined in the labour market by the real factors of the marginal productivity of labour, which determined the firms demand schedule for labour, and the marginal disutility of work which determined the workers supply schedule of labour. The intersection of the two schedules yielded simultaneously both the equilibrium level of employment and -the equilibrium *real* wage rate. Since this equilibrium always took place on the supply schedule of labour, it implied that in equilibrium all labour that was *willing* to work at the going (equilibrium) real wage rate was able to Find employment. Hence, in the neoclassical model, there could never be *involuntary* unemployment and *voluntary* unemployment was consistent with full employment. Given this equilibrium employment, the equilibrium level of output or real income in the neoclassical model was determined by the production function.

Keynes's new theory reversed the above sequence apart from discarding the neoclassical notion of "neutrality" of money. According to him the level of output was determined first by the interaction of the demand and supply schedules of output and the equilibrium employment was then determined along with it by the production function. It was not a mere reversal of sequence but a fundamental change in the theory of employment, for, unlike in the neoclassical theory, it could not imply a unique full-employment equilibrium. The demand schedule of output (the aggregate demand function) having a diminishing, though positive, slope, and the supply schedule of output (the aggregate supply function) having an increasing positive slope need not intersected always at the full-employment level of output. To the contrary, contended Keynes, in capitalist laissez- faire economics, the normal situation was that they intersected at less-than-full employment level of output, thus yielding normally under-employment equilibrium with some amount of *involuntary* unemployment. Full-

employment equilibrium in laissez-faire economies was an exception rather than a normal phenomenon. The aggregate "effective demand" which determined the equilibrium level was defined by Keynes as that actual level of aggregate expenditure in the economy which corresponded to the both aggregate *expected* demand price and the aggregate supply price of output. In other words, it was the aggregate demand at the point of intersection between the aggregate demand and the aggregate-schedule of output.

This basic doctrine of effective demand led Keynes to the analysis of the components of the aggregate effective demand, namely, the consumption expenditure and the investment expenditure. In so doing Keynes pioneered systematic macro-economic theories of consumption and investment. His pioneering concepts of the consumption function and the propensity to consume has become an indispensable part of modern economic analysis. His theory of the consumption function implying diminishing marginal and average propensities to consume highlighted the increasing nature of the gap between income and consumption expenditure with rise in income which had to be filled up with enough investment expenditure in order to maintain any given level of income at which this gap was positive. In advanced industrialised capitalist economies this gap (representing saving) at the full-employment level of output could be substantial and could not be expected to be filled up automatically by private investment expenditure so that full-employment output could be maintained. Hence the underemployment equilibrium becomes the normal condition in capitalist free-market economies.

But, why will adequate private investment expenditure be not forthcoming? The neoclassical had suggested the mechanism of interest rate changes that, in their opinion, would bring about equality between full-employment level of savings and investment. Keynes rejected the validity of the classical proposition, because, according to him, equality between saving and investment was brought about not through changes in the rate of interest but through changes in the level of income. Moreover, the rate of interest in his model, unlike that to the neoclassical model, was not a real phenomenon but a monetary phenomenon determines as it was by the demand for and the supply of money. In this context, Keynes presented a new theory of the rate of interest known as the Liquidity Preference Theory of the Rate of Interest. Keynes's important innovation in this field was the addition of the *speculative* motive for holding money to the neoclassical transaction and precautionary motives. Since the neoclassical as well as the classical confined demand for money to the latter two motives, the demand for money in their models was interest-inelastic which implied the assumption of the function of money as a medium of exchange only. Keynes's speculative motive, on the contrary, highlighted the function of money as store of value. He demonstrated that because of this, the demand for holding money was sensitive to changes in the rate of interest. From this proposition he derived his liquidity preference schedule showing an inverse relationship between the rate of interest and the demand for money and becoming horizontal

(perfectly elastic) at a certain critically minimum rate of interest (which Keynes stipulated to be between 2 and 3 percent) causing what has come to be described as the "liquidity trap." The supply of money in Keynes's theory was determined autonomously by the central monetary authority. Any autonomous increase in money supply would push down the rate of interest, all other things remaining the same, while an autonomous decrease in the money supply would push it up. No amount of increase in money supply could lower the rate of interest, once it touched the critically minimum level at which the demand for money became perfectly elastic.

It was not merely in the above liquidity trap case that the neoclassical and classical interest rate mechanism would fail to ensure that equality between full-employment saving and investment. Even at higher levels, it might fail due to interest-inelasticity of investment. Interest-inelastic investment function might later- intersect the full-employment saving function at the zero or a negative rate of interest which rate could not be expected to prevail in practice. In view of these limitations, Keynes did believe that the rate of interest mechanism could be relied upon to bring about equality between investment and full-employment level of saving.

Keynes explained investment behaviour in terms of marginal efficiency of capital which was defined as that rate of discount' which would make the present value of the yield expected from the capital asset being considered to be produced over the whole of its expected life equal to its supply price. Since with every increase in investment, the expected yield would decrease due to increased supply of goods and the consequent fall in their prices while, on the other hand, the supply price of capital assets would increase due to the working of the law of diminishing returns, the marginal efficiency of capital or investment would diminish with increase in investment. The rational entrepreneurs would invest only so much that the marginal efficiency of capital or investment equaled the prevailing rate of interest which was determined autonomously in the money market. This implied an inverse relationship between the rate of interest and the amount of investment forthcoming, a result which was not different from the classical and neoclassical hypotheses, though the explanations were different. But as we observed above, Keynes believed that interest elasticity of the investment function was rather too low and during economic depressions the interest rate turned even rigid downward. Therefore, the monetary policy using interest-rate mechanism could not be relied upon much to overcome depressions' and attain full-employment equilibrium. In Keynes's view, the shifts in the marginal efficiency of capital schedule were much more important than movements along a particular marginal efficiency of capital schedule. And, the shifts in the MEC schedule were explained by changes in business expectations. Optimistic expectations shifted it to the right indicating larger investment expenditure at any given rate of interest, while pessimistic expectations shifted it to the left, indicating smaller investment at any given rate of interest. Expectations played a very

significant role in Keynes's economic thought making his analysis dynamic in character.

Since the business expectations relevant to investment in capital assets were long-term expectations which could not be determined scientifically due to lack of adequate objective factors to base them upon, they tended to be highly uncertain and volatile, in consequence of which the marginal efficiency of capital schedule too shifted and investment expenditure became highly volatile. Of the two components of aggregate effective demand, consumption expenditure and investment expenditure, consumption expenditure was, more or less, liable, but the investment expenditure was unstable. In Keynes's theory, thus, investment played a crucial role determining level of output and employment as well as fluctuations in it.

While analysing the relationship between investment and the level of output and employment, he enunciated the principle of the multiplier according to which any autonomous increase in investment would increase the real income of an economy multiplier times the autonomous increase in investment. The coefficient of the multiplier was demonstrated to be determined by the marginal propensity to consume (mpc) or its correlate, the marginal propensity to save (mps) as it was shown to equal  $\frac{1}{1 - \text{mpc}}$  or which is the same things  $\frac{1}{\text{mps}}$ . Though

the concept of the multiplier was earlier put forth by Kahn, yet Keynes's multiplier was different from Kahn's. The latter, described as the employment multiplier expressed the relationship between a primary increase in employment that comes about as the result of undertaking some public works programme and the ultimate increase in the total employment. But Keynes's multiplier, described as investment multiplier or income multiplier expressed the relationship between a change in investment and the consequent change in income when new equilibrium of the economy was achieved.

The theory of the multiplier had some very important implications which upset some conventional classical and neoclassical notions. In the classical and neoclassical theories, investment could not take place before a prior mere use in savings, but Keynes's multiplier theory implied that savings were no problem at all. Any additional investment was self-financing in as much as 'it helped to create enough savings by increasing the levels of income. Furthermore, the classical and neoclassical theories suggested that saving was always done at the expense of consumption, but Keynes's multiplier theory implied that consumption and saving could increase together due to the multiplier effect of investment on income, 'these opposing results in the two types of theories followed from the difference in their basic assumption. While the classical and neoclassical theories had assumed a unique 'full-employment equilibrium Keynes had assumed and even tried to demonstrate that underemployment equilibrium was not only possible but was also the normal situation in free-market economies. Keynes's theory evolved



against the background of the Great Depression was valid for situations of underemployment.

In situations of underemployment equilibrium with which Keynes's theory dealt, money, contended Keynes, was not neutral. An increase in the supply of money would lower the rate of interest which would increase investment expenditure which, through the multiplier effect, would increase real income and employment. However, in situations of deep depression when the rate of interest became rigid downwards, monetary policy could not be effective. Therefore Keynes's theory preferred fiscal policy to monetary policy. Even otherwise, due to assumed interest-inelasticity of the investment function, the Keynesian theory of economic policy had an inherent bias in favour of the fiscal policy as a contra cyclical measure, specially because it attributed fluctuations in economic activity to fluctuations in investment expenditure caused by changes in the marginal efficiency of capital which, in turn, were the result of changes in business expectations.

Keynes's theory also rejected the mechanical, direct and proportionate relationship between money and prices as postulated in the classical and neoclassical versions of the quantity theory of money. Keynes did not believe that changes in the quantity of money affected prices directly. In his opinion, changes in the quantity of money first affected the rate of interest and only through their effect on the rate of interest they influenced prices. Moreover, unlike in the traditional quantity theory, every increase in the quantity of money, in Keynes's view, was not inflationary. So long as unemployed resources were available, increase in the supply of money would increase the output of goods and leave the prices unaffected. There might develop situations even before the attainment of full employment when one or more complementary resources might become scarce while there are still other unemployed resources available at constant prices. Increase in money supply in such situations would raise the prices of scarce resources and through their effects on costs of production would raise the prices of goods also. Costs might increase due to diminishing returns too as output approaches the full-employment level. Keynes characterized such rise in prices as "bottleneck" inflation to distinguish it from "true" inflation which, according to him, could come about only after the full-employment state was attained.

The above were the main ingredients of Keynes's economic thought which utterly jolted the neoclassical beliefs and was indeed revolutionary for its times. The analytical concepts forged by him as the various propensities and the related consumption, saving and investment function along with the multiplier, proved to be mighty fruitful and have become very important and durable part of the "tool box" of economists. Though Keynes's General Theory was intended to be a short-period theory, yet it was capable of being used and was actually used by Keynes's followers like Harrods, Domar and Joan Robinson for solving long-run problems of development and growth.

### Self Check Exercise-2

Q.1 Discuss Economic Thought of J.M.Keynes.

Q.2 Discuss Keynes's doctrine of effective demand.

## 19.5 Summary

In this present lesson, we have introduced' you to the basic features of the economic thought of Pigou and Keynes the two deservedly famous Cambridge economists.

The philosophical stand point of Pigou's economic thought in general and has welfare economics in particular was the utilitarianism principle of the greatest good of the greatest number. Social welfare was conceived as the aggregate of individual welfare. But what was the most outstanding contribution of Pigou in this regard was his recognition and analysis of 'externality effects," on account of which social welfare could not be treated as a mechanical summation of individual welfare.

Welfare itself was conceived by Pigou in subjective terms in the tradition of the neoclassical subjectivist school of economics. He located it in the mutual relationship of satisfaction (utility) and dissatisfaction (disutility). He distinguished between *the general* welfare *and economic* welfare, defining the latter as that pan of general welfare which-could be brought into relation with the measuring rod of money.

On the other hand, given a distribution, economic welfare of a society, according to Pigou, was a direct function of the real national income .Economic welfare and the national dividend or the real national income. His discussion of the meaning and measurement of national income and the problems involved in its measurement were the most perceptive one long before. J.M. Keynes made national income accounting a popular and practically useful economic subject it was he who first of all, pointed out the oddity of national income showing a decrease on a master marrying his housekeeper. Though the instance referred to appeared to be mentioned in a lighter vein, yet it was a matter of great importance because it, in fact, implicitly questioned the practice of excluding from national income the unpaid work done by women as housework within their households. In this context, he had also hinted at the environmental consequences of production and seemed to be alarmed at the adverse environmental consequences of such productive activities as mining and quarrying which desecrated the country side and even

caused health hazards. They were not taken account of in the practice of national income accounting so that the national income was treated as remaining undisturbed by such, adverse environmental consequences. He had though, arrived at a broad definition of national income which covered all goods and services purchased with money including also the services provided by home ownership. He was also cognizant of the problems related to transfer payments, depreciation and double counting. He particularly emphasized the key question of "maintaining capital intact" and in his treatment of this problem he developed a concept of capital which contained elements of the Bohm-Bawerk and J.B. Clark. He recognized the importance of capital which he seemed to identify with the productive capacity of an economy which was depleted as well as renewed continuously in the process of production. Underlining the importance of keeping an economy's capital or productive capacity intact,' he called attention to the need for providing for depreciation allowance in real terms and not merely in money terms.

Though Pigou was the chief architect of a systematic welfare economics, yet his contribution to economic thought was not limited to this area alone. He made significant contributions in other areas of pure theory also. He demonstrated his acumen in building abstruse models in his *Economics of Stationary State* which was an attempt to investigate the basic forces which might be applicable to both the static and the dynamic economies. His concern with the study of economic welfare which, according to him, fluctuated with fluctuations in the national income and its distribution led him to make a deep study of cyclical fluctuations which he had discussed even in the first edition of his *Economics of Welfare*, through being dissatisfied with the treatment of the subject there, he removed it from the subsequent edition of this work. John Maynard Keynes, one of the most brilliant and famous economists of the Cambridge University, was a pupil of A.C. Pigou but the economic thought of Keynes which immortalized him in the history of economic thought ran counter to the neoclassical economic thought of which his teacher, A.C. Pigou, was a famous representative. Keynes's Principal work, *General Theory of Employment Interest and Money* (1936), which ushered in a revolution in the history of economic thought (now referred to as the Keynesian Revolution) and marked out his economics as different from the traditional,, (neoclassical) economics, focused on a unique central theme, namely, the determination of the level of income and employment in a capitalist free- market economy and the causes of fluctuations in this level. Earlier schools of

economic thought had either ignored the problem completely or given only a peripheral attention to it. The classical economists were too much occupied with long-term problems of development and growth to pay any adequate attention to the short-run fluctuations in economic activity. Most of them believed in Say's Law of markets and the self-correcting character of a freely competitive economic system. Keynes's *General Theory* leveled a critical attack on the neoclassical version of Say's Law as a prelude to the enunciation of his revolutionary theory of income and employment. Say's Law implicitly assumed that what was saved by a community was automatically invested by it so that there could never be a leakage from the income stream and, consequently, there could never be deviation from the state of full employment in a freely competitive economy. Any increase in population and labour force thereof would be automatically absorbed through a fall in the real wage rate. Similarly, any increase in savings would automatically be matched with an equivalent increase in investment through an appropriate fall in the rate of interest. The neoclassical analysis was also, in essence, a *real* analysis in which money was no more than a "veil" behind which were hidden the *real* forces. Money was believed to have no effect on the real forces, particularly, on the level of real income and employment. Keynes's doctrine of effective demand explaining the determination of the level of output and employment was an original contribution of great import, particularly because it helped to explain situations of under employment equilibrium. In order to explain his novel theory of income and employment and his doctrine of effective demand, Keynes made use of the Marshallian analytical tools of demand and supply schedules. Employment was treated as the function, of the level of output. This proposition was derived from the concept of the production function. Keynes explained investment behaviour in terms of marginal efficiency of capital which was defined as that rate of discount' which would make the present value of the yield expected from the capital asset being considered to be produced over the whole of its expected life equal to its supply price. Since with every increase in investment, the expected yield would decrease due to increased supply of goods and the consequent fall in their prices while, on the other hand, the supply price of capital assets would increase due to the working of the law of diminishing returns, the marginal efficiency of capital or investment would diminish with increase in investment.

The above were the main ingredients of Keynes's economic thought which utterly jolted the neoclassical beliefs and was indeed revolutionary for its times. The analytical concepts forged by him as the various propensities and the related consumption, saving and investment function along with the multiplier, proved to be mighty fruitful and have become very important and durable part of the "tool box" of economists. Though Keynes's General Theory was intended to be a short- period theory, yet it was capable of being used and was actually used by Keynes's followers like Harrods, Domar and Joan Robinson for solving long-run problems of development and growth.

## 19.6 Glossary

**1. Effective Demand:** The theory of effective demand was developed separately in the 1930s by John Maynard Keynes and Michal Kalecki. It explains why the capitalist economy is normally limited by the total amount of spending (that is, the economy is demand-constrained), and hence why unemployment almost always exists.

**2. Keynes, John Maynard (1883–1946)** British economist who elaborated theories concerning ways of counteracting the depression of the 1930s. He criticised the Versailles Treaty ending the First World War for the unfairness of the terms imposed on Germany. He published his Treatise on Money in 1930 and his General Theory of Employment, Interest and Money in 1935.

**3. Keynesian economics:** the belief that full-employment is not possible unless governments intervene to achieve it by adjusting the level of demand. This should be done either during a depression by reflationary policies such as increasing government expenditure and reducing taxation, or during a boom by deflationary policies such as cutting government expenditure and increasing taxation.

**4. Pigou, Arthur (1877–1959)** a Cambridge economist who opposed the theories of Keynes. He believed that employment can be stimulated by the rise in value of money balances caused by a decline in prices.

**5. Underemployment:** a situation in which workers in a company do not have enough work to do or are not used to their full capacity; they may therefore take up second jobs to fill their time and increase their earnings

**6. Depression** a period of economic crisis with high unemployment and loss of trade

**7. Multiplier:** 1. a number which multiplies another 2. a factor which tends to multiply something, as when the effect of new inputs such as investment is to produce a proportionately higher increase in national income

**8. Marginal Efficiency of Capital:** the highest rate at which a product will break even. The rate decreases as investment increases because investors will always invest in the most profitable projects first. Abbreviation MEC

**9. Liquidity Trap:** a situation in which a government is incapable of reducing real interest rates. This will happen if the interest rates are reduced to zero and people feel that holding money in cash is better than investing it. According to Keynes the only solution is for a government to increase spending.

**10. Precautionary Motive:** the motive for people or firms to hold money in case of emergencies, as opposed to the transactions motive where they hold money to use for some definite transaction in the future or the speculative motive where they hold money in the form of investments because they hope to make a capital gain

**11. Speculative Motive:** the motive for people or firms to hold money in the form of investments because they hope to make a capital gain, as opposed to the 'precautionary motive' where they hold money in case of emergencies, or the 'transactions motive' where they hold money to use for some definite transaction in the future.

**12. Transactions Motive:** the motive for people or firms to hold money to use for some definite transaction in the future, as opposed to the speculative motive where they hold money in the form of investments because they hope to make a capital gain or the precautionary motive where they hold money to use in an emergency.

**13. Involuntary Unemployment:** unemployment which is not wanted by the persons involved, but is caused by a fall in the number of jobs available.

**14 Utility:** 1. one of the public utilities (companies, such as electricity, gas or transport, which provide a service used by the whole community) 2. The usefulness of a product or service, the satisfaction which a consumer gets from a good or service he or she has bought, or the way in which a good or service contributes to a consumer's welfare.

**15. Welfare Economics:** the study of the way in which economic activity should result in increased welfare for the population. It concentrates on the objectives to be achieved in a welfare state.

**16. Disutility:** the measure of the dissatisfaction a consumer experiences with a good or service he or she has bought.

## **19.7 Answers to self check Exercises**

Self Check exercise-1

Ans.1 Please Refer Section 19.3

Self Check exercise-2

Ans.1 Please Refer Section 19.4

Ans.2 Please Refer Section 19.4.1

## **19.8 References/ Suggested Readings**

43. Eric Roll: *"A History of Economic Thought"*.
44. J.A. Schumpeter: *"History of Economic Analysis"*.
45. M. Blaug: *"Economic Theory in Retrospect"*.
46. I. Rima: *"Development of Economic Analysis"*.
47. A.H. Hansen: *"A Guide to Keynes"*.
48. D. Dillard: *"Economics of J.M. Keynes"*.
49. W. J. Barber: *"A History of Economic Thought"*.

## **19.9 Terminal Questions**

Q1. Assess the place of Pigou's economic thought in the history of economic thought?

Q2. On what ground did Keynes establish the inevitability of underemployment equilibrium in developed capitalist economies?

## Unit- 20

### PRICE THEORIES:

#### E.H. CHAMBERLIN AND JOAN ROBINSON

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### Structure

- 20.1 Introduction
- 20.2 Learning Objectives
- 20.3 Equilibrium under Monopolistic Competition
  - 20.3.1 Price Variation
  - 20.3.2 Product Variation
  - 20.3.3 Adjustment of Selling Outlays
  - Self Check exercise-1
- 20.4 Robinson's "Imperfect Competition" Theory
  - Self Check exercise-2
- 20.5 Differences in Chamberlin and Robinson's Theories
  - Self Check exercise-3
- 20.6 Summary
- 20.7 Glossary
- 20.8 Answers to self check Exercises
- 20.9 References/ Suggested Readings
- 20.10 Terminal Questions

### 20.1 Introduction

There were two "revolutions" in economics in the 1930s the Keynesian revolution (subject, matter of previous lesson) and the revolution in microeconomics whose high, point was the publication in 1933 of E.H. Chamberlin's *The Theory of Monopolistic Competition* and Joan Robinson's *The Economics of Imperfect Competition*. Since the pure competition was rarely found in the real world, the analysis of firm's behaviour with regard to the determination of price and output did not represent, for the most part, the actual market situations. Therefore, the conclusions which followed from the hitherto accepted theories of pure competition were found to be inapplicable to the behaviour of business firms in the real world situations. The "revolutionary" independent works of Chamberlin and Mrs. Robinson published in the same year established a *market-value theory not based on perfect competition*.



The theory of Monopolistic Competition of Chamberlin and the Imperfect Competition Theory of Robinson though similar in various ways, differ in some important aspects. But despite important differences, the profession has overruled both disputants and credited them with the simultaneous invention of the same theory (Robert Lekachman p.370). The essential part of these theories, particularly that of the theory of Monopolistic Competition, is that the pure competition and pure monopoly are the two opposite ends and limiting market conditions and lying between these two is a series of intermediate cases which differ from each other in relative strengths of monopoly and competitive elements or in degrees of imperfections.

The concept of monopolistic competition put forth by Chamberlin was more realistic than either pure competition or pure monopoly. Prior to this monopoly and competition were regarded as two mutually exclusive alternatives one would be absent when the other exists the most real world situations on the other hand, are a blend of both monopoly and competitive elements. The distinguishing feature of monopolistic competition is the *differentiation of the product* i.e., unlike perfect competition the products of various firms are not homogeneous, it is' because of this that the monopoly elements enter in the market situation. The differentiation of the product may be based either on certain characteristic of the product itself (patent, features, trade, marks, etc.) or on conditions surrounding the sale of the product (convenience- of sellers location, customer's service, etc.). Secondly monopolistic competition concerns itself not only with the problem of an individual isolated monopolist for whom the demand curve for his product is given, but also with that of group equilibrium. The word 'industry', as is generally used in economics in the context of pure or perfect competition and refers to a collection of firms that produce homogeneous products, loses its significance under monopolistic competition. In its place Chamberlin has used the word 'group'. A 'group' means 'a number of producers whose goods are fairly close substitutes'. And in a group, there are special problems as various firms within a group compete with each other and the demand for the product of one producer depends upon the price and the nature of the products of his close rivals. As Chamberlin states "From our point of view, each producer within a group is a monopolist, yet his market is interwoven with those of his competitors, and he is no longer to be isolated from them".

## 20.2 Learning Objectives

After going through this lesson you will be able to:

- Differentiate between Chamberlin and Robinson's Theories
- Assess the Robinson's theory of Imperfect Competition
- Explain Chamberlin theory of *Monopolistic Competition*

## **20.3 Equilibrium under Monopolistic Competition**

A firm under monopolistic competition has to face various problems which are absent in competitive market. In this kind of market, individual firm's market is isolated to a certain degree from those of its rivals with the result that its sales are limited and depend upon (a) its price, (b) the nature of its product and (c) the advertising outlay it makes. Equilibrium of an individual firm under monopolistic competition, therefore, involves equilibrium in three respects that is in regard to the price, the nature of the product, and the amount of advertising outlay it should make.

### **20.3.1 Price Variation**

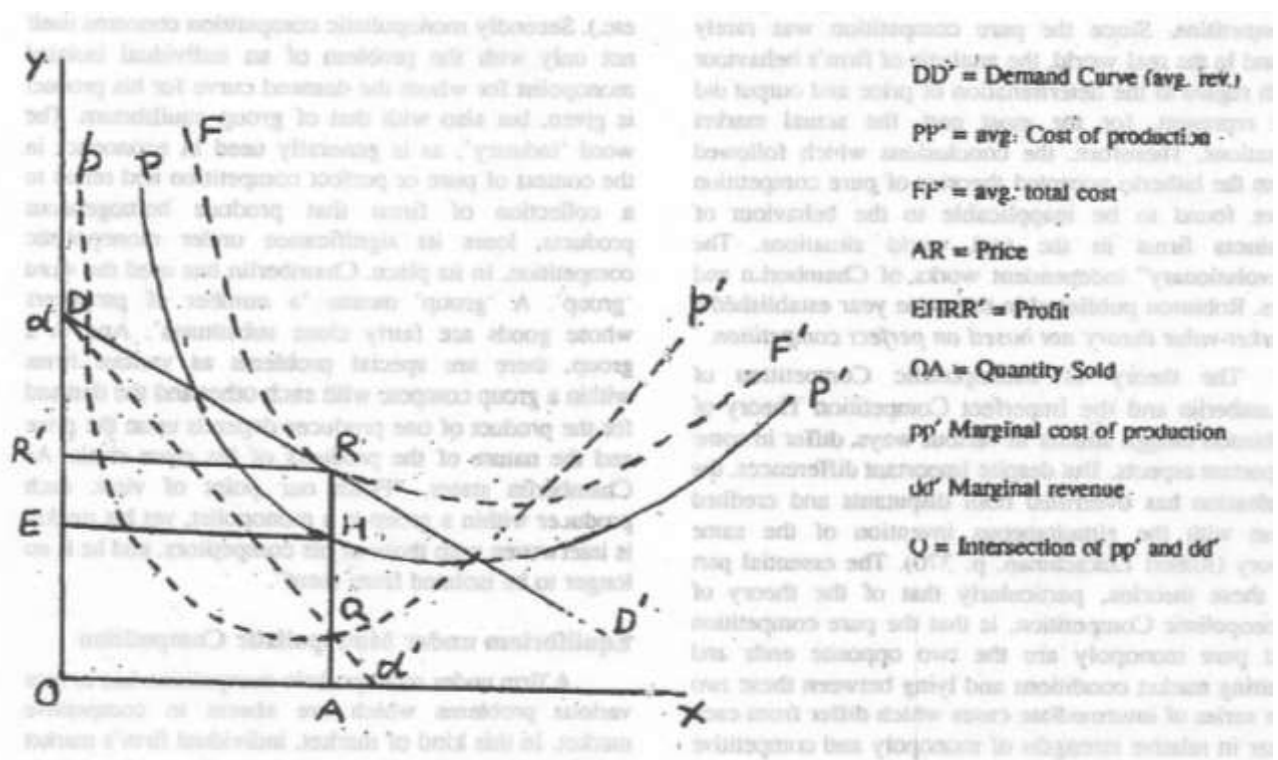
Because of the attachment of some consumers to its particular brand of the product, it has some monopolistic influence over the price of the product. If it raises the price of its product a little, it may lose many of its customers but unlike competitive market, not all of them. The demand curve confronting a firm under this type of market is not a horizontal straight line, but a downward sloping curve. Therefore it confronts various price output combinations.

### **20.3.2 Product Variation**

The problem of product variation is imposed upon the firm under monopolistic competition by- the fact of differentiation. The firm will try to adjust its product so as to conform more to the wishes of buyers. The variation of the product may refer to an "alteration in the quality of the product: technological changes, a new design, better material, new package or container, more courteous services, etc. Therefore, in a full explanation of the firm's equilibrium under monopolistic competition, in addition to the "price-equilibrium" one has to explain 'product equilibrium' as well.

### **20.3.3 Adjustment of Selling Outlays**

Thirdly, a seller under monopolistic competition can influence the volume of his sales by varying the amount of his selling outlays. The selling outlays change the demand for the product as well as its cost. Like the adjustments of price and product a seller under this type of market will so adjust the amount of his selling outlays as to render his total profits a maximum. This problem of adjusting his selling outlays is unique to monopolistic competition.



To Chamberlin, actual 'competition' includes the effort of competitor's to increase their monopoly powers. Chamberlin starts with a single firm and develops the idea of monopoly price and competitive prices as determined by the intersection of revenue or sales curve with expense curves. Hither the marginal revenue curve, or the average revenue curve (from which it is derived), may be used, to determine the monopoly output and price, the former by intersecting the rising marginal cost curve, the latter by the familiar Marshallian method of fitting the maximum profit area between it and the average cost curve, which includes rents of differentials and thus equals the average price.

The analysis with respect to all three variables then is extended beyond the firm to *groups* of sellers. Which may be taken as corresponding to conventional control "industries", depending on how broadly a "class of product" is conceived in a particular case. The group is analyzed, first under the assumption of symmetry (all its members assumed to have uniform cost and demand curves). Then some consideration is given to what might happen if a "diversity of conditions" existed. If selling costs are not great, and if they reduce the slope of the seller's demand curves, increasing them may result in a lower price. Variation in product may lead to either smaller or larger outputs. Group equilibrium (with "alert" competitors) must result in the optimum with respect to all the variables, and no profits above a necessary minimum for every producer.

The conclusion is drawn that under monopolistic competition the equilibrium price is higher, and the volume of output probably (not necessarily) lower, than under pure competition. The net profits of enterprise however, may or may not be higher than under pure competition because of the expense which is required to maintain the monopoly elements and which is often increased by a multiplication of

substitute products surrounding the monopolist. Chamberlin argues that monopolistic competition need not bring higher profits to the marginal firm in a given industry. Instead it may allow the existence of a larger number of firms making normal profit.

#### Self Check Exercise-1

Q.1 Diagrammatically explain Equilibrium under Monopolistic Competition.

### 20.4 Robinson's "Imperfect Competition" Theory

Mrs. Joan Robinson in 1933 published *The Economics of Imperfect Competition* ostensibly to show firm with that output and price of a single commodity can be (b) market determined by a technique based on assumption of rational decision by an individual entrepreneur, conditioned only by a demand that is beyond his control and by his own expenses (other than selling). One aim was to show the limitations of a theory of value and distribution based on the assumption of either perfect competition or perfect monopoly. She considers monopoly merely as the opposite of competition, and states that each seller has a monopoly of his own product. It is one of many conditions which in varying degrees make actual competition imperfect. She proposes, therefore, to modify the theory of value and distribution based, on perfect competition by reconstructing demand and supply curves so that they may show the effects of various imperfections in necessary minimum for every producer competition.

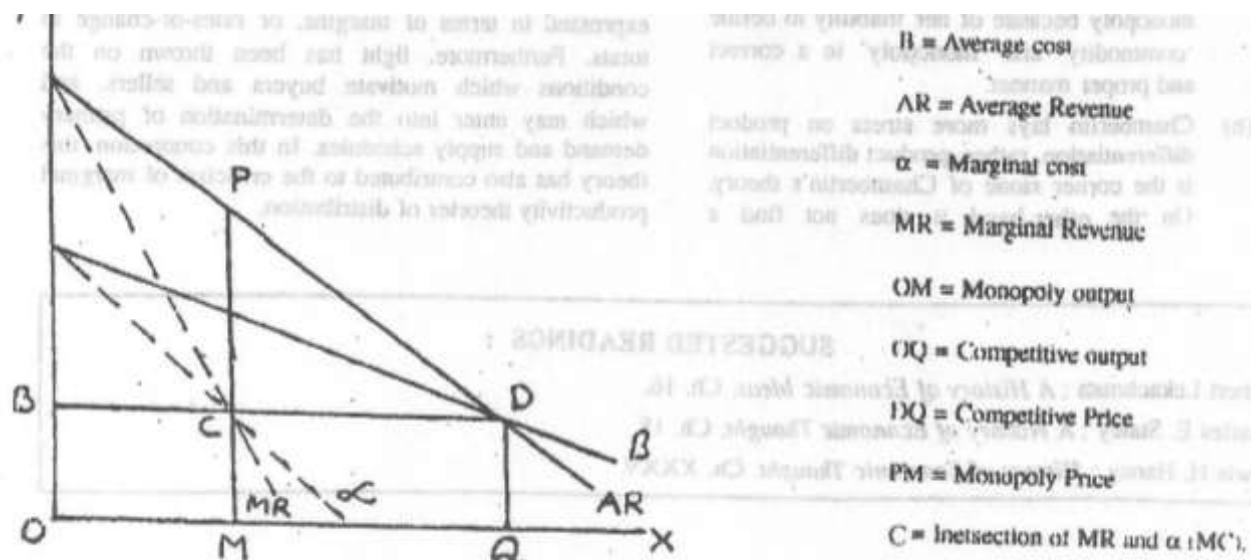
Mrs. Robinson's approach is based on that of Alfred Marshall. It is doubtful that the "imperfect competition" episode would have occurred had the leader of Neo-classicism not himself been disturbed by so many difficulties, and left so many loopholes.

Mrs. Robinson considers each industry as concerned with one product which is essentially homogeneous. She also starts with a single firm and deals with its calculated endeavor to adjust its output to its demand curve. But her emphasis is on the marginal revenue curve, the equalization of which with marginal cost curve she regards as the main problem. This emphasis is probably somewhat excessive, in view of the fact that the "marginal" aspect merely a derivative of the total or average revenue. Moreover, the treatment confuses (a) the time series varying total sales (or expenses) for a single firm with that output and price of a single commodity can be (b) the schedules of bids (or asked prices) for a market at a given time.

Mrs. Robinson discusses many conditions limiting the demand curve of an individual firm such as monopoly and competition of varying degrees, and considers price policies, quality and service. She also discusses conditions affecting the firm's supply curve, such as increasing, decreasing, or constant cost. She uses the long-run Marshallian declining cost curve as representing the market supply curve.

Considerable attention is given to conditions that lead individual firms to make discriminatory prices. However, she does not cover

oligopoly and selling costs in her analysis but goes beyond Chamberlin in the treatment of buyer's monopoly and monopsony. This case she considers as represented by the enterpriser's buying of labour, concluding that labour is "exploited", in that (under the conditions she assumes) it does not yet the full market value of its specific marginal product



### Self Check Exercise-2

Q.1 Discuss Robinson's "Imperfect Competition" Theory.

## 20.5 Differences in Chamberlin and Robinson's Theories

As stated earlier now most economists have veered round to the view that the two theories are different in some respects and further that Chamberlin's theory is more realistic description of economic phenomenon. Thus Samuelson remarks, "With cogency and pertinacity. Chamberlin has always insisted on differentiating his product from that of Mrs. Robinson. Posterity will agree". This notwithstanding, there are some important areas of difference between these two theories which we try to summarize as follows:

- Chamberlin regards real-world imperfect market situations as blending of competition and monopoly and explains price determination in the case where both competitive and monopoly elements are present, loan Robinson, on the other hand could not view most Of the actual market relations as a blend of competition and monopoly because of her inability to define 'commodity' and 'monopoly' in a correct and proper manner.
- Chamberlin lays more stress on product differentiation; rather, product differentiation is the corner stone of Chamberlin's theory. On the other hand, it does not find a significant place in Mrs. Robinson's Theory. It is due to product differentiation that

monopoly element is present in monopolistic competition. Mrs. Robinson admits that there are differences in the products of different firms due to which a customer buys from one producer than another and to her this makes it difficult to decide what precisely we mean by a 'commodity'.

- (c) Chamberlin successfully analyses non-price competition that is product variation and selling costs whereas Mrs. Robinson takes into account only price competition. By stressing on and incorporating only price competition in her theoretical framework, she could not make a break with the past.
- (d) Another fundamental difference the two authors is that whereas Robinson neglected the discussion of oligopoly, which *is* a very important form of imperfect competition. Chamberlin discussed this problem (oligopoly) in detail and provided his own solution of it she herself has said. "The reason oligopoly is neglected in *Economics of Imperfect Competition* is not that I thought it unimportant but that I could not solve it."
- (e) There are some important differences with regard to the concepts of welfare ideals and exploitation of labour as well.

#### Self Check Exercise-3

Q.1 What is the difference between Chamberlin and Robinson's theories.

## 20.6 Summary

Monopolistic and important competition theory has done good service in exposing the weakness of any theory based on the assumptions of pure or perfect competition it has exposed the differences and interrelations between demand and supply schedules and brought out the significance of- such schedules as expressed in terms of margins, or rates-of-change in totals. Furthermore, light has been thrown on the conditions which motivate buyers and sellers, and which may enter into the determination of primary demand and supply schedules. In this connection, this theory has also contributed to the criticism of marginal productivity theories of distribution.

## 20.7 Glossary

1. **Imperfect Competition:** a situation in which there are only a few sellers whose products are similar but not substitutes. The producers do not have a large enough share of the market to be important enough to influence the market. The situation is not quite a monopoly. Also called monopolistic competition.
2. **Marginal Product:** the quantity of a product (either physical or in revenue) which comes from a unit of increased input.

3. **Product Differentiation:** the process of ensuring that a product has some unique features that distinguish it from competing ones.
4. **Perfect Competition** noun a hypothetical model of a market where all products of a particular type are identical, where there is complete information about market conditions available to buyers and sellers and complete freedom for sellers to enter or to leave the market. Also called atomistic competition.
5. **Homogeneous Products:** identical products sold in the same market by different producers.
6. **Substitute Product, Substitute Good:** a product which may be bought instead of another when the price of the latter changes or if it becomes unavailable. An increase in the price of one will cause an increase in the demand for the other. This is the opposite of complementary products where the demand for one increases as the price of the other falls.

## 20.8 Answers to self check Exercises

Self Check Exercise-1

Ans.1 Please Refer Section 20.3,20.3.1,20.3.2 and 20.3.3

Self Check Exercise-2

Ans.1 Please Refer Section 20.4

Self Check Exercise-3

Ans.1 Please Refer Section 20.5

## 20.9 References/ Suggested Readings

1. Robert Lekachman: *"A History of Economic ideas"*.
2. Charles E. Staley: *"A History of Economic thought"*.
3. Lewis H. Haney: *"A History of Economic thought"*.

## 20.10 Terminal Questions

Q1. Explain and Evaluate Chamberlin theory of *Monopolistic Competition*?

Q2. The theory of *Monopolistic Competition* provides few new analytical tools; it is similar to the theory of "perfect Competition". Do you agree with the statement? Give reasons?

## **LESSON 21**

### **ECONOMIC THOUGHT OF SCHUMPETER AND VEBLEN**

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#### **Structure**

- 21.1 Introduction
- 21.2 Learning Objectives
- 21.3 Economic Thought of Schumpeter
  - Self Check Exercise-1
- 21.4 Veblen's Economic Thought
  - Self Check Exercise-2
- 21.5 Summary
- 21.6 Glossary
- 21.7 Answers to self check Exercises
- 21.8 References/ Suggested Readings
- 21.9 Terminal Questions

#### **21.1 Introduction**

J.A. Schumpeter and Veblen were famous economic thinkers. While Schumpeter in spite of his original and novel approach to economic problems, belonged to the mainstream of the economics, Veblen was more of a sociologist than a pure economist. Veblen's economic thought was, therefore, wide off the mainstream economics and since his thought gave highest importance to the effects of institutions in the analysis of economic problem, he is generally regarded as the founder of the "institutionalist" school of economics in the history of economic thought. In the present lesson with which we shall be finishing our course of studies in the history of economic thought we shall describe the main characteristics of the economic thought of these two famous thinkers.

#### **21.2 Objectives**

After going through this unit you will be able to:

- Give the contribution of Schumpeter in the History of economic thought
- Explain Veblen's economic thought
- Give the main features of Post- Keynesian economic theories



### 21.3 Economic Thought of Schumpeter

Joseph A. Schumpeter (1883-1950), one of the greatest economists of our times, was an Austrian who had studied at the feet of such famous economists as Wieser and Bohm-Bawerk and as student mingled with such famous personalities as a Ludwig von Mises and the young socialists. Otto Bauer and Rudolf Hilferding after occupying academic posts in the various universities of the central Europe, he ultimately shifted to the Harvard University in the U.S.A in 1932 where he spent the rest of his academic as well as physical life.

Schumpeter's economic thought, though brilliantly original carried some imprints of the early influences on him. Amongst these influences, the most notable was the influence of the Austrian school of economics of which he was a direct descendent. The other dominating influence on his thought was that of Leon Walras whom he regarded as the greatest modern economist. He had been so much impressed by Walras economics that he went to the extent of observing that anyone who did not study and understand the general equilibrium system of Walras could not become a good economic theorist. In addition to these influences, one could also detect traces of influences of the American economists. Irving Fisher and John Bates Clark on his early vision of the capitalist economic process. He found Fisher's efforts to employ accounting notion in economic analysis especially useful. However he preferred J.B. Clark's concept of capital as a fund "to Fisher's concept of capital. This influence is evident in Schumpeter's Theory of Economic Development. It has also been observed that J.B. Clark's scattered observations on dynamic theory provided Schumpeter with the inspiration to pioneer his study of the process of capitalist economic development.

Schumpeter was a great methodologist which is evident from not only his work. *The Economic Doctrine and Method* but also, more profusely, from his observations in the introductory chapter of his posthumous but *magnum opus History of Economic Analysis*. He attached a great importance to what he described as "visions" and interpreted as a "pre-analysis cognitive act that, according to him, supplied the raw materials for scientific analysis. It is this "vision" which, according to him, enabled an economic thinker and, for that matter, any scientific thinker to pose really meaningful questions. He did admit that the mathematical method was a useful tool of economic analysis but he did not over-rate it. Instead, he stressed that mathematics could not replace intuitive insight that came with "vision." It was such intuitive insight which led to the art of building meaningful and useful scientific abstractions, an art in which, according to him, Ricardo, Marx and Walras were supreme masters. This according to Schumpeter was the essence of the economic method. He also gave a high place to history in the economic method despite his advocacy of the mathematical method in economics. In his *History of Economic Analysis*, he went to the extent of observing that of the three important adjuncts of the economic method of analysis, namely, theory, statistics and history, if he was asked to choose only one, he would choose history. However, in theory as well as in his own practice of the

economic method, he emphasised the Complementarity of all three components of the method of economic analysis. At the same time, he also emphasised the importance of sociological factors.

However Schumpeter also opined that no single component of economic method could have a general validity, because each had its specific utility in specific cases. The historical method, for example, was appropriate for analyzing economic organizations while the theoretical- method of abstraction and model building was suitable for price theory nevertheless, he insisted, both "often converges and become indistinguishable."

Of all the social sciences, believed Schumpeter, only economics came nearest to the natural sciences as it was the only social science which dealt with phenomena that could be "quantified". But he also stressed that measurement and statistics were not sufficient to enable one to comprehend the *relationships* between economic facts. For it was required, in addition to measurement and statistics, theory also.

One single idea which became a sort of thread running through almost all the theories of Schumpeter and which not only distinguished his theoretical system from all others but also immortalized him in the history of economics was the concept of the entrepreneur as essentially an innovator. His main theoretical project, like that of Karl Marx, was to unravel the law governing the process of capitalist economic development and he discovered this basic law in the innovating entrepreneurs under capitalism. For him, the primary function of an entrepreneur was to act as an innovator, that is to break the circular flow of economic activity of a stationary equilibrium by the adventure of introducing a new product or producing the same product by a new method or by using some new raw material or by exploiting some new source of raw materials or by introducing a new form of business organization or by opening new markets for sale. Schumpeter's model starts from the assumption of a stationary equilibrium in which there is only a circular flow of economic activity, all flows having the same values from period to period and in which free competition had competed away all profit and interest. All firms in this static equilibrium are in perfect equilibrium with costs equaling revenues and profits and interest at zero levels. In such a situation come true innovators in search of profits and they create the scope for such profits by disturbing the reigning stationary, equilibrium and its accompanying circular flow of economic activity by undertaking the risk of venturing into introducing some innovation or innovations which would either lower the cost functions or the revenue functions or both. Schumpeter's model, then, traces the effects of such disturbances on the course of the development of a capitalist economy.

Schumpeter's theory successfully fused into one vast system the ideas that an economy continuously reproduces itself repeating, from period to period, levels of production and consumption and other economic flows, that the prime lever of change and economic development are adventurous innovator entrepreneurs whose continuous search for profits induces them into innovating ventures,

and also that capitalism will fail ultimately because of its own success. It may appear to be an intriguing and even a startling doctrine, but it describes briefly, though also too boldly, the essential message of Schumpeter's economic thought.

Thus, in Schumpeter's theory, economic development is the result of innovations. Innovation for him was a catch-all category for all such enterprises, which broke through the circular flow of economic activity characteristic of a stationary equilibrium in such a manner that it either raised the production function and in this way, lowered the cost function, or raised the revenue function. In either case the successful innovator received profits as the result of his innovating enterprise. Exceptional exogenous changes like wars, revolutions, crop variations and changes in fiscal policy could also affect stationary equilibrium and cause profits. But Schumpeter like Marx, was interested in discovering the internal logic or the endogenous forces which propelled the capitalist economic system on the course of development and this internal logic or endogenous principle he discovered in the innovational activity of the entrepreneurs.

Schumpeter emphasised the difference between inventions and innovations. Innovation referred not to inventions and discoveries as such but to the economic exploitation of inventions and discoveries, while inventions and discoveries were merely technological facts, innovations represented a sociological and economic process. Innovation was a matter of business firm's behaviour which showed up, as we observed earlier also, in various forms such as introducing goods, a new product, a new method of producing goods, a new organization of business, exploiting some new source of raw material or new markets, or expanding some new source of raw material or new market by exploiting new methods of advertising and promoting sales, the end result of which was the emergence of profits and interest due either to lowering of costs or raising of revenues or both. According to Schumpeter, innovation usually came with new business leadership. Since the old firms were entrapped in stagnation and the old firms which survived the economic change brought about by the new innovating firms were able to do so only because they let themselves to be transformed fundamentally under the impact of innovation.

The innovator, by him, could not succeed in breaking through the circular flow of stationary and stagnant equilibrium. According to Schumpeter, the innovator found in his task an ally in the economic institution of banks which helped him by providing finance for his innovational enterprise. Interest on this finance was paid out of the profits resulting from the success of innovation.

Once an innovator becomes successful and demonstrates new methods of making profits, a host of what Schumpeter described as the "imitators" rather than true innovators flock in. As the competition increases, profits tend to disappear and so does interest as it is according to Schumpeter, paid out of profits. Thus the economy, once again, lands into a stationary equilibrium exhibiting only a circular flow or what Marx called "simple reproduction. But, according to Schumpeter's theory, sooner or later, some new innovation would

arrive breaking through the stationary state which will be followed by a swarm of "imitating entrepreneurs. This, in brief, was Schumpeter's model of economic development.

It was observed above that the innovator depended for the execution of his innovation on bank finance. This introduced certain problems related to money, capital and interest. Since Schumpeter had adopted the Walrasian framework, it made him visualize money as a flow of spending moving in one direction while goods flowed in its opposite direction. Money was thus the link between economic events and it was also a "claim ticket and receipt voucher" tying together production and distribution. Yet, Schumpeter seemed to believe within the Walrasian framework that money had no power of its own, as its movement depended ultimately on the decisions of the entrepreneurs. Money in such a framework was only a technical matter, for even in the absence of its use the circular flow could go on. This led Schumpeter to distinguish between money as a *numeraire* and money as a physical entity. Schumpeter analyzed all the problems related with it with great clarity, expounding such issues as the marginal utility of money, the value of money, the velocity of money and also its legal aspects.

The concept of capital in Schumpeter's theory was also informed by the notion of flow. He did not identify it with concrete physical goods. He conceived it rather as an independent agent partaking of the nature of a fund of purchasing power which made his concept similar to Clark-Knight concept of capital and rather different from the Austrian concept of it as developed by Bohm-Bawerk and, later on by Hayek. Capital, according to Schumpeter was a means of purchasing goods and it was replenished through sales. Capital, for Schumpeter, became significant only when there was development; there was hardly anything in the circular flow situation of an economy to which it corresponded. It was obvious, then, that interest which was the reward for the service of capital in production was a part of the dynamic surplus an income flow which appeared only when growth and development took place. According to Schumpeter's theory, in the state of static equilibrium and simple circular flow, the total product was exhausted in the payment of wages and rent only and both interest and profits were absent. Interest in the opinion of Schumpeter was a price paid for the use of new productive services and was paid out of profits which resulted from innovations. It was, thus, "loanable funds" phenomenon arising in the money market which itself was an institution resulting from the process of development.

It was questioned by critics that there could be a state of stationary equilibrium without interest as stipulated in Schumpeter's model, because even in such a state some capital was required to maintain the capital intact. If there was no incentive in the form of interest, necessary maintenance or replacement capital would not be forthcoming.

Any theory explaining the process of capitalist economic development would be incomplete if it did not explain the business cycles to which it is inherently prone. Schumpeter was not unaware of this requirement. In his theory of cyclical fluctuations too, he assigned to

innovation the major and key role; He described the familiar phases of depression, recovery, prosperity and recession over the course of a business cycle. But, like Pigou, he was careful to observe that the history of business cycles did not reveal a unique universal pattern. As Pigou had observed, business cycles might belong to the same family but amongst them there were no twins. Although all cycles had, broadly speaking, similar features, yet each of them were also a unique phenomenon having its own specific features. According to Schumpeter marking off cycles from trough to trough or peak to peak was an artificial device which obscured the specific character of capitalist economic development.

In his detailed analysis of the phenomenon of business cycles, Schumpeter presented a schematic picture of an admittedly complex cyclical pattern of change. His argument was that all development resulted from innovation. But different innovations required different lengths of time to be fully absorbed. Moreover, the matter might be further complicated because of the fact that some of the innovations might be interdependent due to their being a part of a larger, more basic outburst of economic growth.

Consequently, Schumpeter's theory suggested that there might be working several simultaneous movements rather than there being a mere collection of fluctuations that kept succeeding each other through time. This view resulted into a multi-cycle theory which, of course, was also rooted in the belief that the economic system was to be described in terms of general equilibrium. Schumpeter's analysis concluded upon a three-cycle model as -the most practical way of describing the cyclical fluctuations taking place against the background of capitalist economic growth. It was he who named these three different Cycles of different durations which might overlap after the names of the economists whose works originally referred to the fluctuations peculiar to each one of them. The longest cycle having the average periodicity of round about fifty five years was named as the Kondratieff Cycle, while cycle having the intermediary duration of round about ten years was named as the Juglar Cycle and the shortest of them having the average periodicity of round about two years was named as the Kitchin Cycle. What Schumpeter stressed was that the three different types of cycles mentioned above did not represent independent movements but they had certain definable relationships to each other. The recovery phase of a Kondratieff Cycle, observed Schumpeter, exhibited a close approximation to general equilibrium for, at this point, there seemed to be a conjuncture among the three types of cyclical movements. But, on other occasions, what appeared to be Juglar prosperity or depression phase might be a part of another movement which modified the nature of the Juglar Cycle itself. Thus, according to Schumpeter, each Kondratieff cycle contained within it a number of Juglars and each Juglar contained some Kitchin cycles so that "...the sweep of each longer wave supplies neighborhoods of equilibrium for the wave of the next order." It was with such an imposing structure that Schumpeter tried to set up a conceptual frame work within which the necessary empirical data might be filled in order to give substance to his theory.

A crucially important adjunct of Schumpeter's innovation theory of development and fluctuations was his hypothesis that innovations did »not proceed smoothly but they, instead, came in clusters and spasmodic movements. When a leading innovator Overcame technological, financial and other hurdles in the way of a breakthrough the circular flow situation and thus opened a new way of making profits, a host of imitator entrepreneur's also rushed in. This characterized the period of a swing from a mere recovery to prosperity. But the seeds of recession and a downswing to depression were aim sowed towards the last stages of prosperity when the economy became upset and further gains became uncertain. All this results from the various errors and miscalculations made during the mad rush of the imitator entrepreneurs and the heightened competition thereof. In consequence of such errors and miscalculations, some firms went bankrupt. A period of recession and downswing into depression followed in which re-adjustment were sought. These readjustments involved destruction of a number of firms and wealth. When even such readjustments did not realize the expectations, the depression took root. The depression was overcome and a recovery started only with fresh innovations. In the meanwhile, during the downswing of economic activity and the phase of depression a lot of destruction of wealth due to the widespread failures and bankruptcies took place which Schumpeter looked upon rather benignly characterizing it as "creative destructions" This was, in essence, Schumpeter's innovation theory of cyclical fluctuations.

In spite of the destruction that took place during depressions in the capitalist economies, Schumpeter regarded it as "creative destruction" because all, ultimately, helped a capitalist economy to attain equilibrium at a higher level of output. The chief test of the success of an economy, according to Schumpeter, was its ability to expand production. Capitalism according to him passed this test with distinction.

However, Schumpeter was not quite sanguine about the future of capitalism, in spite of its having passed his above-stated test admirably. He anticipated the breakdown of capitalism to come about not on account of the economic factors as such but on account of the changes in the habits of thought that accompanied the development of capitalism. In its early history, argued Schumpeter, capitalism was an adventure and though the individual entrepreneur undertook risk for the expected return from his investment, yet what was more important was that the entrepreneur was also motivated by a desire to meet the implicit challenge to his industrial and commercial ability. But at the present stage of the development of capitalism, argued Schumpeter, economic progress has been mechanized and the function of the entrepreneur as essentially inovator has atrophied and is being reduced to a routine. The romanticism involved in the earlier business adventures had eroded, while bureaus and committees have displaced individual initiative and enterprise.

Consequently, small businessmen have been displaced by joint-stock mega corporations. Private property and freedom of contract

have become, in effect, article legal instruments. Millions of none descript stockholders have taken the place of active participants in the capitalist process. Capitalism in its late stages, Schumpeter seems to argue, fails to evoke the loyalty and emotional response required sustaining it and the people begin to turn away from it in spite of its effectiveness as a producing machine. Since the masses of the people are unable to express their faith, their disappointments and *dissatisfaction* are articulated by alienated intellectuals who, according to him, have a vested interest in popular unrest. It is these alienated intellectuals who, taking advantage of people's disappointments and dissatisfactions, propagate such ideologies which are non-conducive to the fulfillment of the requirements of capitalist production. As the people's minds are infected with these ideologies, the working of capitalist system is seriously undermined. In Schumpeter's own words "Capitalism, whilst economically stable, even gaining in stability, creates, by rationalizing the human mind, a mentality and a style of life incompatible with its own fundamental conditions, motives and social institutions, and will be changed, although not by economic necessity and probably even at some sacrifice of economic welfare, into an order of things which it will be merely matter of taste and terminology to call Socialism or not".

Though the explanations of Schumpeter and Marx were different, yet there was a similarity between their conclusions with regard to the future of capitalism. Both concluded that capitalism would, ultimately, break down not due to exogenous factors but due to the forces generated by it endogenously. However, their 'Visions' of these endogenous forces or internal conditions were different. Schumpeter was very much impressed by Marx's treatment of capitalism as a dynamic process and the stress in his analysis that capitalism was not and could not be stationary. This view was formally very close to his own, felt Schumpeter, though, on a deeper scrutiny, his system would be adjudged to be less endogenous than that of Marx. Schumpeter, in his analytical system, relied on the role of the innovator as the force motivating dynamic changes that broke through the circular flow which was peculiar to a stationary or static state. It is the innovator who, in Schumpeter's model, was able to divert the factors, of production from existing channels into new ones with the help, of course, received by him in the form of credit from the banking and other financial institutions and this engineered the dynamic changes in the capitalist system. This implied that in his model the economy required *deus ex machina* in the form of the innovator in order to go along a dynamic path. This has made Seligman to observe that "Schumpeter did not quite succeed in making economic development completely dependent on elements internal to the economy itself. In this regard, Marx's theory does seem superior." It is because Marx "by emphasizing the problem of accumulation of capital, the flow of economic resources through simple and extended reproduction, productivity, and the tendency of the rate of profit to fall, he sought to demonstrate that what made capitalism move were the forces generated from within."

Nevertheless, the first approximations of both; that is, Marx's "simple reproduction" model and Schumpeter's "circular flow" model, bore great similarity. Both were static models, Schumpeter's model had no accumulation, while Marx's had no innovator.

#### Self Check Exercise-1

Q.1 Discuss Economic Thought of Schumpeter

### 21.4 Veblen's Economic Thought

Thorstein Veblen (1857-1929), a brilliant student of the famous American neoclassical economist, J.B. Clark, was a maverick amongst the economists of his times. Though a pupil of J.B. Clark, he challenged the foundations of his master's teaching as well as the neoclassical doctrine in general. Veblen's thought system was representative of the American institutional school of economics which can be regarded as a "countrier-revolution" to the neoclassical revolution in economic thought. Some of his critique of the neoclassical economics bore a strong resemblance to the criticism of the classical economics by - the Historical School of Economics.

Veblen was strongly critical of the formalism of neoclassical economics which, in his view, leaned too lively on the deductive method ignoring important institutional and psychological empirical facts. Apart from it, he also viewed it as too static to provide a meaningful correspondence to reality, which was dynamic. The neoclassical method of assuming "all other things remaining the same" the "ceteris paribus" assumption and, then, tracing the effect of the single change on equilibrium was a static analysis, he maintained it, in his opinion, did not explain change.

Veblen had questioned even the very concept of equilibrium of neoclassical economics. Since the neoclassical concept of equilibrium was based upon the assumption of man as a rational calculating machine, it was too abstract a concept to be useful. Veblen had a fundamental objection to the assumption of rational calculating human behaviour for, according to him, human behaviour was motivated by instincts rather than rational calculations.

Veblen's economic thought was distinguished by its emphasis on two important drives that according to him, governed human actions in organized societies. One of these was the instinctive drive for workmanship and the other was the instinct for emulation. It was from this position that Veblen offered both a critique of orthodox neoclassical postulates and an alternative analysis of the economic processes.

He seemed to propagate the view that man had a natural instinct to produce to create and innovate, and only if he was not hindered by the institutional factors, he would produce so much that society would be embarrassed with abundance. If society had not, in fact, attained that abundance its cause lay in the social institutions which created a "leisure class" whose social function was to waste the abundance that human energy and instinct would produce. A highly organised market system was another institution which tended to suppress the output



built into it According to Veblen, the engineers, epitomizing the instinct of workmanship in societies with high technologies sought to expand output without limit. But their creative energies were frustrated by businessmen who, under the fear of spoiling the markets and destroying capital values, turned into the agents of institutionalized waste. His argument was that the big businessmen kept production artificially much below the technologically feasible limits in order to maximize their own profits.

It is obvious that the above line of thought was incongruous with the main stream neoclassical economics. Veblen had rejected practically all the basic propositions of neoclassical economics. He rejected the law of demand which stated that other things remaining the same, normally a larger quantity of a good would be purchased at a lower price than at a higher price of it with the arguments that people's instinctive drive towards emulation and conspicuous consumption would turn this law upside down. Luxury or prestige goods, he argued, might actually be purchased in smaller quantities, if their prices fell. He also rejected the neoclassical postulate that labour supply had a real cost as work meant "disutility" or "pain" to the worker. This postulate was not congruous with his basic postulate of human instinct for workmanship. Veblen's postulate was opposite to the neoclassical postulate because man's instinctive drive for workmanship implied that he got positive satisfaction (utility and not disutility) from productive work. Not only this much, but he also rejected the neoclassical assumption that the proper subject matter of the science of economics was a formal analysis of allocation of resources in a market economy and discovering of the condition of equilibrium. Instead, he stressed that the proper concern of the science of economics was opposite to it, namely, in analysis of the disequilibrium caused by the de-stabilizing impact of changes in tastes and technology.

The above brief account of Veblen's economic thought shows that Veblen was a maverick off-beat economic thinker whose non-conventional approach to economic problems and consequent conclusion ran counter to the assumption and doctrines of the mainstream economics of his times which, as we all know, was the neoclassical economics. He did not work with the basic neoclassical economics. He did not work with the basic neoclassical concept of "*homoaeconomicus*", that is, the concept of "economic man" who employs the calculus of "pleasure and pain" or "utility and disutility" and of "gains and losses" before he acts. Instead his thought sought to underline the impact of institutions and instincts. He is credited with having introduced an "institutional" approach to the study of economic problems.

Self Check Exercise-2

Q.1 Discuss Veblen's Economic Thought

## 21.5 Summary

J.A. Schumpeter and Veblen were famous economic thinkers. While Schumpeter in spite of his original and novel approach to economic problems belonged to the mainstream of the economics, Veblen was more of a sociologist than a pure economist. He is generally regarded as the founder of the "institutionalist" school of economics in the history of economic thought. Joseph A. Schumpeter (1883-1950), one of the greatest economists of our times, was an Austrian who had studied at the feet of such famous economists as Wieser and Bohm-Bawerk and as student mingled with such famous personalities as a Ludwig von Mises and the young socialists. Otto Bauer and Rudolf Hilferding after occupying academic posts in the various universities of the central Europe, he ultimately shifted to the Harvard University in the U.S.A in 1932 where he spent the rest of his academic as well as physical life.

Schumpeter's economic thought, though brilliantly original carried some imprints of the early influences on him. Amongst these influences, the most notable was the influence of the Austrian school of economics of which he was a direct descendent. The other dominating influence on his thought was that of Leon Walras whom he regarded as the greatest modern economist. He had been so much impressed by Walras economics that he went to the extent of observing that anyone who did not study and understand the general equilibrium system of Walras could not become a good economic theorist. In addition to these influences, one could also detect traces of influences of the American economists. He attached a great importance to what he described as "visions" and interpreted as a "pre-analysis cognitive act" that, according to him, supplied the raw materials for scientific analysis. It is this "vision" which, according to him, enabled an economic thinker and, for that matter, any scientific thinker to pose really meaningful questions. He did admit that the mathematical method was a useful tool of economic analysis but he did not over-rate it. However, in theory as well as in his own practice of the economic method, he emphasised the Complementarity of all three components of the method of economic analysis. At the same time, he also emphasised the importance of sociological factors. Schumpeter's theory successfully fused into one vast system the ideas that an economy continuously reproduces itself repeating, from period to period, levels of production and consumption and other economic flows, that the prime lever of change and economic development are adventurous innovator entrepreneurs whose continuous search for profits induces them into innovating ventures, and also that capitalism will fail ultimately because of its own success. It may appear to be an intriguing and even a startling doctrine, but it describes briefly, though also too boldly, the essential message of Schumpeter's economic thought. According to Schumpeter, innovation usually came with new

business leadership. Since the old firms were entrapped in stagnation and the old firms which survived the economic change brought about by the new innovating firms were able to do so only because they let themselves to be transformed fundamentally under the impact of innovation. In his theory of cyclical fluctuations too, he assigned to innovation the major and key role; He described the familiar phases of depression, recovery, prosperity and recession over the course of a business cycle. But, like Pigou, he was careful to observe that the history of business cycles did not reveal a unique universal pattern.

Thorstein Veblen (1857-1929), a brilliant student of the famous American neoclassical economist, J.B. Clark, was a maverick amongst the economists of his times. Though a pupil of J.B. Clark, he challenged the foundations of his master's teaching as well as the neoclassical doctrine in general. Veblen's thought system was representative of the American institutional school of economics which can be regarded as a "country-revolution" to the neoclassical revolution in economic thought. Some of his critique of the neoclassical economics bore a strong resemblance to the criticism of the classical economics by - the Historical School of Economics.

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## 21.6 Glossary

**1. Veblen, Thorstein Bunde (1857–1929):** US economist whose main concern was with the growth of large companies which could result in the position that the prosperity of a company need not coincide with the interests of the community at large; he invented the term conspicuous consumption to criticise the behaviour of wealthy individuals and firms.

**2. Veblen effect, Veblenian model:** a theory of buying behaviour proposed by Veblen, which explains much of consumption in terms of social influences or pressures rather than economic ones.

**3. Schumpeter, Joseph (1883–1950)** Austrian economist who emphasised the importance of entrepreneurship in driving forward economic change.

**4. Disequilibrium:** a situation which is not stable (as when a country's balance of payments is in deficit).

**5. Disutility:** the measure of the dissatisfaction a consumer experiences with a good or service he or she has bought.

**6. Utility:** one of the public utilities (companies, such as electricity, gas or transport, which provide a service used by the whole community) 2. The usefulness of a product or service, the satisfaction which a consumer gets from a good or service he or she has bought, or the way in which a good or service contributes to a consumer's welfare.

**7. Capitalism:** An economic system in which privately-owned companies and businesses undertake most economic activity (with the goal of generating private profit), and most work is performed by employed workers who are paid wages or salaries.

**8. Juglar cycle:** a business cycle about ten years in length.

## 21.7 Answers to self check Exercises

Self Check Exercise-1

Ans.1 Please Refer Section 21.3

Self Check Exercise-2

Ans.1 Please Refer Section 21.4

## 21.8 References/ Suggested Readings

1. Eric Roll: "*A History of Economic Thought*".
2. J.A. Schumpeter: "*Theory of Economic Development*".
3. J.A. Schumpeter: "*History of Economic Analysis*".

## 21.9 Terminal Questions

Q1. What is the characteristic feature of Schumpeter economics which distinguishes it from the other system of thought?

Q2. Discuss the main features of post-Keynesian economic theories?