History of Economic Thought
lecture 2

Sumanasiri Liyanage
Adam Smith (1723–1790)

- Author of the book: An Inquiry into the Nature and Causes of the Wealth of Nations (1776);
- He developed his theory through a critique (Book iv) and extension of the above.
Main Ideas: Division of labor

• Economic Growth depends not on trade but in productive activities, division of labor;

• The source of wealth is labor, labor in general;

• Wealth increases with the increase of productivity of labor and the number of productive labor;

• Distinction between productive and unproductive labor and social and technical division of labor.
Theory of Value

• Distinction between use value and exchange value;
• His object of investigation: exchange value;
• Two measure of value, (1) is determined by the quantity of labor expended (2) quantity of labor that a given commodity can purchase;
• Contradiction of his concept of value.
Theory of Distribution

- Society is divided into three basic classes: entrepreneur capitalists, wage laborers and landlords;
- Profit and wages as distinct category;
- He was not clear about the rent of land, (1) monopoly price of ag. Goods (2) productivity of land;
The Theory of Capital and Productive Labor

• What is Capital: “That part which, he expects, is to afford him this revenue is called capital”;

• Total value = total revenue --> equilibrium;

• Economic Growth depends on two variables (see the Figure).
Wealth of a Nation

depends upon

Productivity of Labor

which depends upon

Division of Labor

which depends upon

Extent of the Market

which depends upon

Capital Accumulation

Ratio of Productive and Unproductive Labor

which depends upon

Capital Accumulation

which depends upon

Capital Accumulation
International Trade

• Depends on absolute advantage;
• It should be free trade;
• International division of labor would be beneficial to every nation.
Post Smithian Political Economy

David Ricardo

Robert Malthus
Classical Economics, Malthus, and Marx

Thomas Mun  
(1571–1641)

<table>
<thead>
<tr>
<th>Precursors</th>
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</table>
| William Petty  
(1623–1687) |
| David Hume  
(1711–1776) |
| Adam Smith  
(1723–1790) |
| François Quesnay  
(1694–1774) |

Karl Marx  
(1818–1883)

David Ricardo  
(1772–1823)  
Thomas Robert Malthus  
(1766–1834)

William Nassau Senior  
(1790–1864)

John Stuart Mill  
(1806–1873)  
Jeremy Bentham  
(1748–1832)

Arrows indicate direction of influence
Robert Malthus (1766–1834): main ideas

• This is generally accepted by the classical theorists;
• Reply to Godwin who relate poverty to social system;
• Poverty is due to man’s unbounded yearnings multiply and the limits to increase means of subsistence.
Theory of Effective Demand

- As we will see Classical Political economists believe identity of aggregate demand and aggregate supply;
- Robert Malthus refuted this notion;
- He found that there will be a deficiency in demand because of the reduction of demand for luxury goods by land owner aristocrats.
Industrial Revolution in England (1760–1830)

- When Adam Smith wrote his book industrial capitalism was in its early phase;
- Transition from manufactory to factory;
- More innovations to reduce cost of production;
- Population moving from country to town;
- Conflict between the land-owning class and the bourgeoisie.
Philosophical and Methodological Bases of Ricardo’s Theory

• Abstract deductive;

• He believed that capitalist system guarantees (1) greatest individual happiness and (2) maximum growth of productive forces;

• Distribution of income as the main objective of economics;

• An economic model with three social classes.
<table>
<thead>
<tr>
<th>Tools and Assumptions used by Ricardo</th>
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<tbody>
<tr>
<td>1. Labor cost theory</td>
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<td>2. Neutral theory</td>
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<td>3. Fixed coefficients of production</td>
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<td>4. Constant returns in manufacturing and diminishing returns in agriculture</td>
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<td>5. Full employment</td>
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<td>6. Perfect competition</td>
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<td>7. Economic Actors</td>
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<td>8. Malthusian population thesis</td>
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<td>9. Wages fund doctrine</td>
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Theory of Value

• Resolving Adam Smith’s duality in value question;
• Value and Price;
• Amount of expended labor as the only determinant of value;
• Socially necessary labor, depending on prevailing technology;
• Applies only for reproduceable goods.
Ground Rent

[Diagram showing the extensive margin of land with bars labeled A and B, where A has a value of 100 bushels and B has a value of 90 bushels.]
Capital Accumulation

• Relationship between Profit and capital;
• Direct and inverse relationship;
• Tendency of Profit rate to fall due to diminishing marginal returns;
• A stationary state.
International Trade

- Theory of comparative advantage;
- Output per unit of labor;
- Opportunity cost

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<thead>
<tr>
<th></th>
<th>Wine (gallons)</th>
<th>Cloth (yards)</th>
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<tbody>
<tr>
<td>England</td>
<td>12</td>
<td>6</td>
</tr>
<tr>
<td>Portugal</td>
<td>8</td>
<td>1</td>
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<table>
<thead>
<tr>
<th></th>
<th>Wine</th>
<th>Cloth</th>
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<tbody>
<tr>
<td>England</td>
<td>1/2 yard of cloth</td>
<td>2 gallons of wine</td>
</tr>
<tr>
<td>Portugal</td>
<td>1/8 yard of cloth</td>
<td>8 gallons of wine</td>
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