History of Economic Thought
lecture 2

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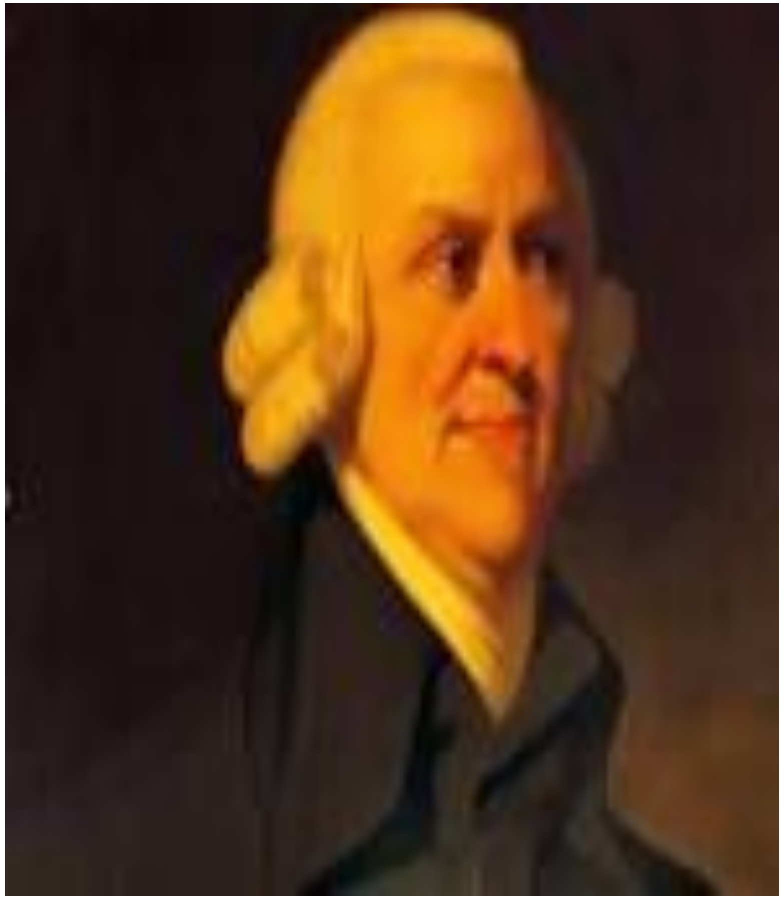
Adam Smith (1723- 1790)



- Author of the book: An Inquiry into the Nature and Causes of the Wealth of Nations (1776);
- Major Influences: Mercantilism, French school of Physiocrats, Bernard Mandavile (1714) book, The Fable of The Bees: or, Private Vices, Public Benefits (1714).
- He developed his theory through a critique (Book iv) and extension of the above.

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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

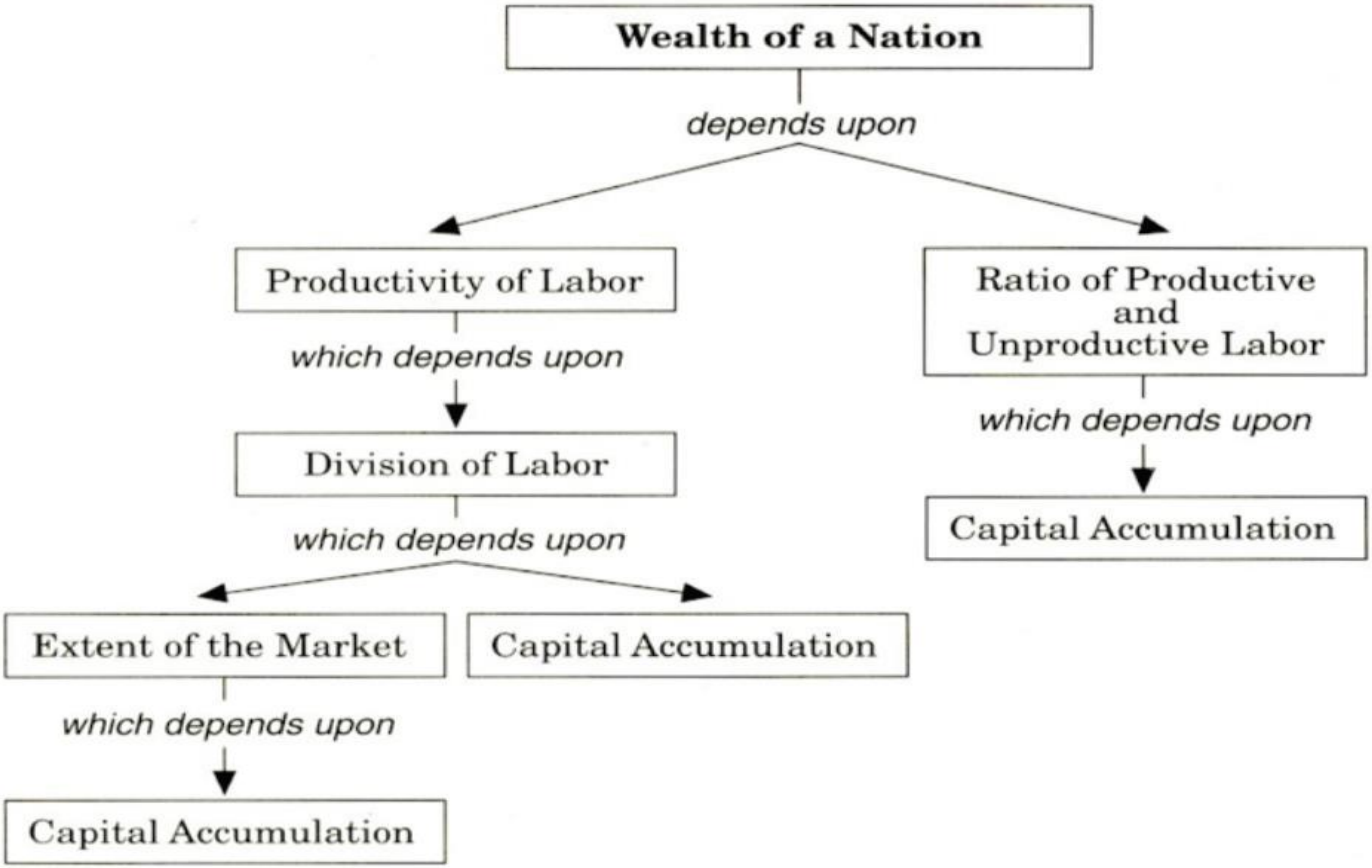
- **Distinction between use value and exchange value;**
- **His object of investigation: exchange value;**
- **Two measure of value, (1) is determined by the quantity of labor expended (2)quantity of labor that a given commodity can purchase;**
- **Contradiction of his concept of value.**

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
Ratio of Productive and Unproductive Labor
which depends upon
Division of Labor
which depends upon
Capital Accumulation
which depends upon
Extent of the Market
Capital Accumulation
which depends upon
Capital Accumulation

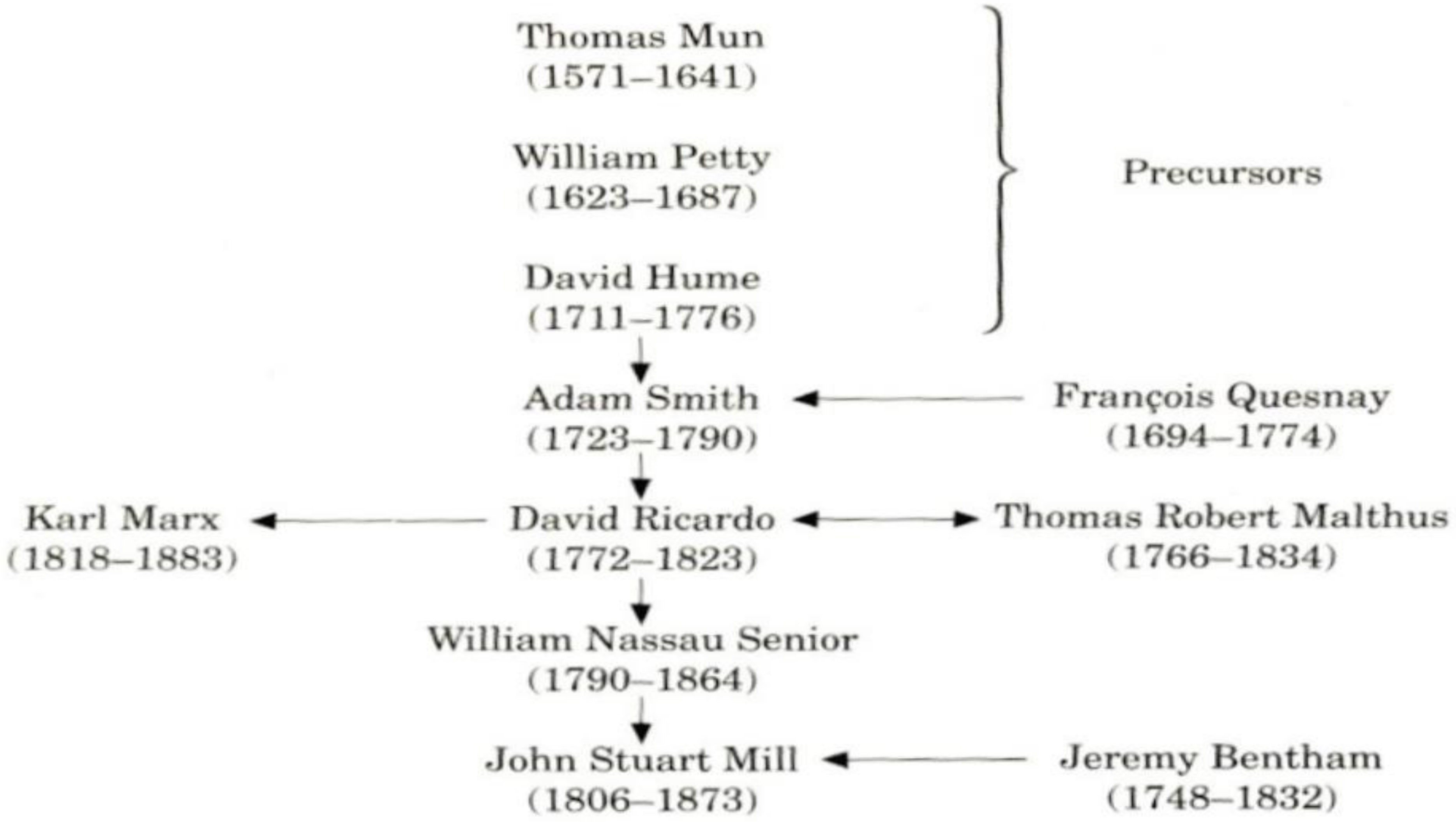
International Trade

- Depends of absolute advantage;
- It should be free trade;
- International division of labor would be beneficial to every nations.

Post Smithian Political Economy

David Ricardo

Robert Malthus

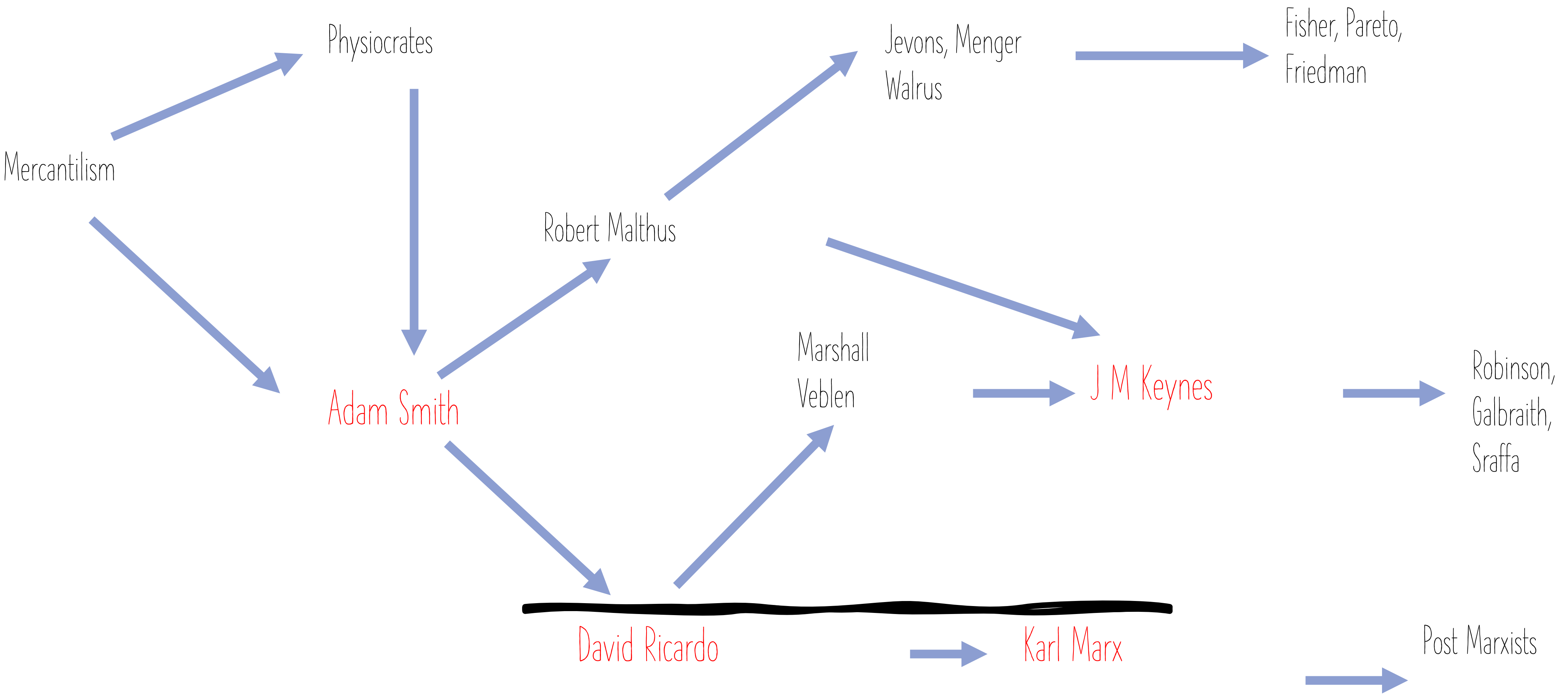


Arrows indicate direction of influence

Robert Malthus (1766- 1834): main ideas

- Theory of population in his book, *Essays on the Principle of Population*.
- 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.

The Historical Development of Economic Thought



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.**

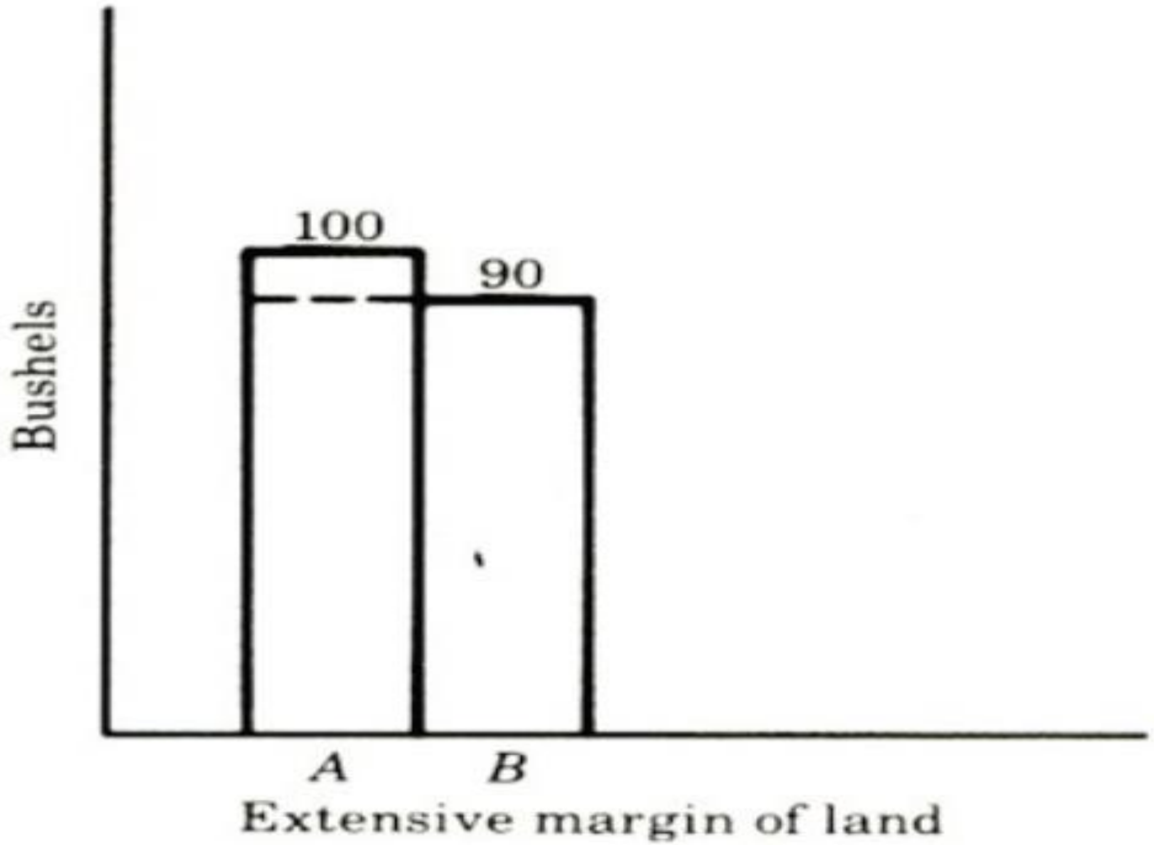
Tools and Assumptions used by Ricardo

1. Labor cost theory
2. Neutral theory
3. Fixed coefficients of production
4. Constant returns in manufacturing and diminishing returns in agriculture
5. Full employment
6. Perfect competition
7. Economic Actors
8. Malthusian population thesis
9. Wages fund doctrine

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



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;**

	Wine (gallons)	Cloth (yards)
England	12	6
Portugal	8	1

- **Opportunity cost**

	Wine	Cloth
England	1/2 yard of cloth	2 gallons of wine
Portugal	1/8 yard of cloth	8 gallons of wine