A History of Modern Economic Thought

This course introduces students to the ideas of some of the most well known economists. These ideas shape how economists think today, and determine how policy is made worldwide. The course starts with the contributions of classical economists such as Adam Smith and his contemporaries. All modern economic theories measure themselves against this classical yardstick. Think of it as a debate, with some thinkers opposing classical economics (Marxian economics) while others try to reform it (Georgism) or re-adapt it to modern circumstances (Neoclassical school, Austrians, Keynesians).

Above all, this is a course in critical thinking.

"*The important thing is not to stop questioning*." -Albert Einstein

The Big Picture

Session 1 – Classical Economics – Adam Smith and David Ricardo
Session 2 – Classical Economics – Karl Marx/Friedrich Engels and Henry George
Session 3 – Neoclassical Economics – The Marginalists
Session 4 – Austrian and Keynesian Economics
Session 5 – Looking Ahead...What Can We Learn from Economic History?

Major Themes

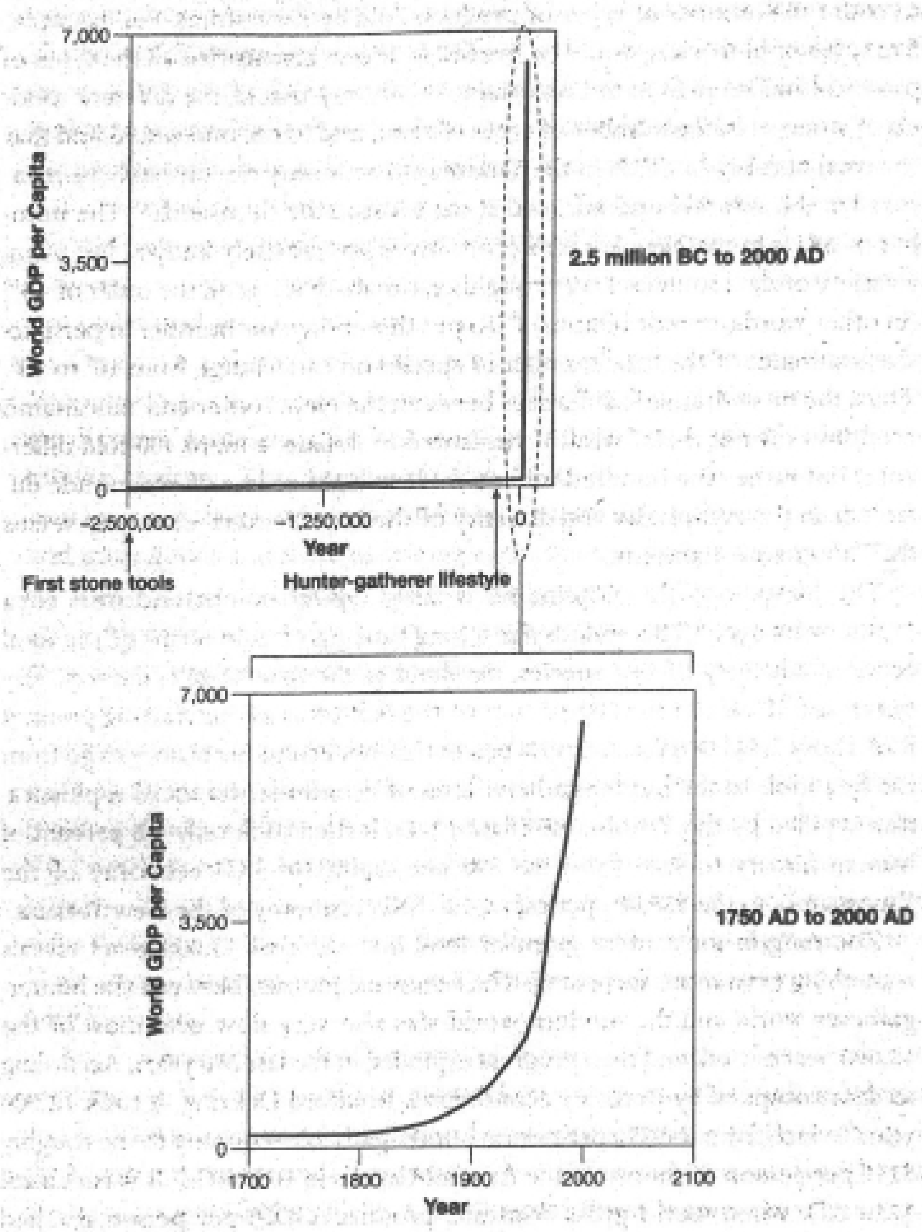
1. **Economics – The field of inquiry**
2. **Normative or Positive? ...or both?**
3. **The question of justice**
4. **The question of the distribution of wealth**
5. **Markets, surplus and commodities**
6. **The nature of wealth, value and price**
7. **The importance of labor, land, capital and money**
8. **The importance of the economic rent/surplus**
9. **Learning from economic history**

{comments in these brackets by author}

The Explosive Growth in Human Wealth

FIGURE 1-1

The Explosive Growth in Human Wealth



Source: Estimates for 1 million BC to 2000 AD from J. Bradford DeLong, University of California, Berkeley. Estimates for 2.5 million BC to 1 million BC are an extrapolation. GDP per capita is measured in 1990 international dollars.

Session One

Classical Economics: Adam Smith and David Ricardo

Why Study the History of Economics and Economic Thought?

“*Those who cannot remember the past are condemned to repeat it*.” - George Santayana

“*The only thing new in the world is the history you don't know*.” - Harry Truman

“*We learn from history that we do not learn from history*.” - Friedrich Hegel

“*History is written by the victors*.” -Walter Benjamin

“*The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interest is vastly exaggerated compared with the gradual encroachment of ideas*.” - John Maynard Keynes

The Angel of History

“*A Klee painting named 'Angelus Novus' shows an angel looking as though he is about to move away from something he is fixedly contemplating. His eyes are staring, his mouth is open, and his wings are spread. This is how one pictures the angel of history. His face is turned toward the past. Where we perceive a chain of events, he sees one single catastrophe, which keeps piling wreckage upon wreckage and hurls it in front of his feet. The angel would like to stay, awaken the dead, and make whole what has been smashed. But a storm is blowing from Paradise; it has got caught in his wings with such violence that the angel can no longer close them. This storm irresistibly propels him into the future to which his back is turned, while the pile of debris before him grows skyward. This storm is what we call progress*.” —Walter Benjamin

Definitions

Economy - A complex adaptive system emerging in society to meet the life needs and desires of human beings.

Political Economy, or Economics, is the study of the various ways that society can organize itself to provide for its needs and desires.

Changing Nature of Economics

{In the last 250-300 years economics has evolved (devolved?) from Moral Philosophy to Political Economy to Economics to Econometrics. 'Morality' has gradually been deleted from economics.}

A Natural Order

Production
Distribution
Consumption
Exchange

Two Ultimate Concerns of Economics

"Over most of the modern life of economics these two subjects, the theory of value and the theory of distribution, have been the ultimate concern. It is still thought that economics came of age when these two matters were tackled systematically in the latter part of the eighteenth century, most notably by Adam Smith.

...Along with what determines prices and distributive shares go the other central questions. The first is how income distributed as wages, interest, profits and rent is diffused or concentrated – how equitable or inequitable is the income distribution. The explanations and rationalizations of the resulting inequality over the centuries have commanded some of the greatest, or in any case some of the most ingenious, talent of the economics profession. In nearly all of economic history most people have been poor and a comparative few have been very rich. Accordingly, there has been a compelling need to explain why this is so – and, alas, on frequent occasion, to tell *why it should be so.* In modern times, with rising and increasingly general affluence, the terms of this subject have greatly changed. The distribution of income remains, however, the most sensitive business with which economists deal." (EP pp 6-7)

Economic History Concerned With the Surplus

"If we call wages the value of whatever a worker produces in goods and services as a result of his labor (including under the term labor all productive activity, however skillful), then every society produces a surplus over and above total wages. This surplus may fall into the hands of the landlords, employers, {moneylenders} or the government, as rent, profits, {interest}, or tax revenue and be put to multifarious uses, but it remains a surplus mainly attributable to society as a collective entity. It is not derived from the efforts of anyone *qua* individual, but from the actions, or simply the existence, of the collective body of citizens. Who receives this surplus initially and who receives the benefit of it – two separate issues – depend upon the laws and customs of particular societies. *Economic History is largely concerned with these latter questions*. It is incumbent upon economists, however, to analyze the implications for a modern economy of the origin, distribution and use of this surplus; a task singularly neglected

by economists, at least since the late nineteenth century. This failure stems from their setting aside the concept of economic rent." (NME p 71)

Historical Background Before Adam Smith

{If history is a storybook, then we have lost the first chapters and the final chapters may not yet have been written. Nevertheless, we work with what we have. We have to start somewhere. Today it is believed the world, as we know it, to be roughly fourteen billion years old. Since we only have roughly ten hours of study in this course, we will have to fast forward to the last written chapters of our story. In this course, we will begin with the waning of the Late Middle Ages [1500] and the beginning of our Modern World.}

The Modern World - The Scientific Revolution – [1500 – Present]

"The scientific revolution is a concept used by historians to describe the emergence of modern science during the early modern period, when developments in mathematics, physics, astronomy, biology (including human anatomy) and chemistry transformed the views of society about nature. The scientific revolution took place in Europe towards the end of the Renaissance period and continued through the late 18th century, influencing the intellectual social movement known as the Enlightenment. While its dates are debated, the publication in 1543 of Nicolaus Copernicus's *On the Revolutions of the Heavenly Spheres* is often cited as marking the beginning of the scientific revolution.

The concept of a scientific revolutions taking place over an extended period emerged in the eighteenth century in the work of Jean Sylvain Bailly, who saw a two-stage process of sweeping away the old and establishing the new. The beginning of the scientific revolution, the *Scientific Renaissance*, was focused on the recovery of the knowledge of the ancients; this is generally considered to have ended in 1632 with publication of Galileo's *Dialogue Concerning the Two Chief World Systems*. The completion of the scientific revolution is attributed to the 'grand synthesis' of Isaac Newton's 1687 *Principia*, that formulated the laws of motion and universal gravitation, and completed the synthesis of a new cosmology. By the end of the 18th century, the scientific revolution had given way to the 'Age of Reflection.' (W The Scientific Revolution)

Nicolaus Copernicus [1473-1543] Polish
Notable works: *On the Revolutions of the Heavenly Spheres* [1543]

"In 1517 Polish astronomer Nicolaus Copernicus published the first known arguments for the quantity theory of money. In 1519 he also published the first known form of Gresham's Law: 'Bad money drives out good.'" (W History of Economic Thought)

Sir William Petty [1623-1687] English

"In 1662 English economist Sir William Petty began publishing short works applying the rational scientific tradition of Francis Bacon to economics, requiring that it only use measurable phenomena and seek quantitative precision, coining the term '*political arithmetic*', introducing statistical mathematics, and becoming the first scientific economist." (W History of Economic Thought)

Petty on the Theory of Value

On value, Petty continued the debate begun by Aristotle, and chose to develop an input-based theory of value: *all things ought to be valued by two natural Denominations, which is Land and Labor*. Both of these would be prime sources of taxable income. Like Richard Cantillon after him, he sought to devise some equation or par between the '*mother and father*' of output, land and labor, and to express value accordingly. He still included general productivity, one's 'art and industry'. He applied his theory of value to rent. The natural rent of a land was the excess of what a laborer produces on it in a year over what he ate himself and traded for necessities. It was therefore the profit above the various costs related to the factors involved in production. (W William Petty)

Bernard Mandeville [1670-1733] Anglo-Dutch
Notable Works: *The Fable of the Bees* [1714]

The Actions of Men Cannot be Divided into Lower and Higher

"...philosopher, political economist and satirist. His main thesis is that the actions of men cannot be divided into lower and higher. The higher life of man is a mere fiction introduced by philosophers and rulers to simplify government and the relations of society. In fact, virtue (which he defined as 'every performance by which man, contrary to the impulse of nature, should endeavor the benefit of others, or the conquest of his own passions, out of a rational ambition of being good') is actually detrimental to the state in its commercial and intellectual progress. This is because it is the vices (i.e., the self-regarding actions of men) which alone, by means of inventions and the circulation of capital (economics) in connection with luxurious living, stimulate society into action and progress.)" (W History of Economic Thought)

Mandeville and Smith

"As we know, in *The Wealth of Nations* Smith describes this phenomenon as 'the division of labour'. Up until that time this phrase was not a familiar one. In *The Fable of the Bees*, however, Mandeville talks of men 'learning to divide and subdivide their labor' and refers to the same notion in the index to his book as 'labor, the usefulness of dividing and subdividing it.' It is from here, Edwin Cannan believes, that Smith probably derived his concept of the 'division of labor'.

In following Mandeville in this regard, Smith was led into a contradiction that was a perfect forecast of one of the major human problems of the industrial age. As is well known, Smith began his whole account of how wealth is created, and thus a nation benefited, with the lauded principle of the division of labor. However, in a later place in the book he had this dolorous {feeling or expressing great sorrow or distress} observation about the effects on the worker of this same division of labor:

> ***The man whose whole life is spent in performing a few simple operations...generally becomes as stupid and ignorant as it is possible for a human being to become. The torpor of his mind renders him, not only incapable of relishing or bearing a part in any rational conversation, but of conceiving any generous, noble, or tender sentiments, and consequently of forming any just judgments concerning many even of the ordinary duties of private life. Of the great and extensive interests of the country he is altogether incapable of judging.***

In the Smith of *The Wealth of Nations* we can see, then, a conflict between two very different influences - Hutcheson and Mandeville. Smith brings forth both of these voices in his own attempt at synthesis in his book. But the tragedy is that in history's judgment it is the Mandeville voice that is Smith's greater contribution. And so, for example, the atomization of work has been accepted into the modern world as a highly beneficial principle. Yet, in *The Theory of Moral Sentiments*, Smith himself labels Mandeville's voice as a 'noise'. So there is a profound and sad irony in the legacy Smith has bequeathed us. Smith had listened to Mandeville's noise in the world and indeed has himself become a contributor to it, whether in the principle of the division of labor or in the more central theme of self-interest. The significance of this is stated by another Smith scholar, Louis Dumont:

It is widely admitted that the central theme of Adam Smith, the idea that self-love works for the common good, comes from Mandeville...We are thus sent back from Adam Smith to Mandeville for the origin of the key assumption of The Wealth of Nations, and this is more than a minute point of literary history, for, as we going to see, the problem of the relation between economics and morality was acutely – indeed, explosively – posed by Mandeville at the beginning of the century." **(ASM pp. 125-126)**

Mandeville and the Austrians

"Mandeville's ironic paradoxes are interesting mainly as a criticism of the 'amiable' idealism of Shaftesbury, and in comparison with the serious egoistic systems of Hobbes and Helvétius. It is mere prejudice to deny that Mandeville had considerable philosophic insight; at the same time he was mainly negative or critical, and, as he himself said, he was writing for 'the entertainment of people of knowledge and education.' He can be said to have removed obstacles for the coming utilitarianism.

Mandeville's ideas about society and politics were praised by Friedrich Hayek, a proponent of Austrian economics, in his book *Law, Legislation and Liberty*." (W Bernard Mandeville)

Richard Cantillon [1680-1734] Irish-French

"Richard Cantillon consciously imitated Newton's forces of inertia and gravity in the natural world with human reason and market competition in the economic world. In his *Essay on the Nature of Commerce in General* {written in 1730 and published in 1755}, he argued rational self-interest in a system of freely-adjusting markets would lead to order and mutually-compatible prices. Unlike the mercantilist thinkers however, wealth was found not in trade but in human labor. The first person to tie these ideas into a political framework was John Locke." (W The History of Economic Thought)

John Locke [1632-1704] English

"Locke believed that people contracted into society, which was bound to protect their property rights. He defined property broadly to include people's lives and liberties, as well as their wealth. When people combined their labor with their surroundings, that created property rights. In his words from his Second Treatise on Civil Government [1689]:

> ***God hath given the world to men in common...Yet every man has a property in his own person. The labour of his body and the work of his hands we may say are properly his. Whatsoever, then, he removes out of the state that nature hath provided and left it in, he hath mixed his labour with, and joined to it something that is his own, and thereby makes it his property.***

Locke argued that not only should the government cease interference with people's property (or their 'lives, liberties and estates'), but also that it should positively work to ensure their protection. His views on price and money were laid out in a letter to a Member of Parliament in 1691 entitled *Some Considerations on the Consequences of the Lowering of Interest and the Raising of the Value of Money*, arguing that the 'price of any commodity rises or falls, by the proportion of the number of buyers and sellers', a rule which 'holds universally in all things that are bought and sold.'" (W History of Economic Thought)

Francois Quesnay [1694-1774] French {Physiocrat}

"He believed that trade and industry were not sources of wealth, and instead in his book *Economic Table* [1758], argued that agricultural surpluses, by flowing through the economy in the form of rent, wages, and purchases were the real economic movers. Firstly, said Quesnay, regulation impeded the flow of income throughout all social classes and therefore economic development. Secondly, taxes on the productive classes, such as farmers, should be reduced in favor of rises for unproductive classes, such as landowners, since their luxurious way of life distorts the income flow. David Ricardo later showed that taxes on land are non-transferable to tenants in his Law of Rent." (W History of Economic Thought)

Jacques Turgot [1727-1781] French {Physiocrat}

"His best known work, *Reflections on the Formation and Distribution of Wealth* [1766], developed Quesnay's theory that land is the only source of wealth. Turgot viewed society in terms of three classes: the productive agricultural class, the salaried artisan class and the landowning class. He argued that only the net product of land should be taxed and advocated the complete freedom of commerce and industry.

In August 1774 Turgot was appointed to be minister of finance, and in the space of two years he introduced many anti-mercantile and anti-feudal measures supported by the king. A statement of his guiding principles, given to the king were 'no bankruptcy, no tax increases, no borrowing'. Turgot's ultimate wish was to have a single tax on land and abolish all other indirect taxes, but measures he introduced before that were met with overwhelming opposition from landed interests. Two edicts in particular, one suppressing corvees (charges from farmers to aristocrats) and another renouncing privileges given to guilds, inflamed influential opinion. He was forced from office in 1776." (W History of Economic Thought)

Sir James Steuart [1713-1780] Scottish

"In 1767 Scottish mercantilist economist Sir James Steuart published *An Inquiry into the Principles of Political Economy*, the first book in English with the term 'political economy' in the title, and the first complete economics treatise." (W History of Economic Thought)

Merchant Capitalism or Mercantilism [1450-1750]

"We come now to one of the most ardently debated periods in this history. It is the era of the merchants, the time of what is variously called merchant capitalism or mercantilism. It is thought of as extending for three hundred years, from very roughly the middle of the fifteenth century to the middle of the eighteenth, with the end vividly marked by the beginning of the Industrial Revolution, the American Revolution and the publication of *Wealth of Nations* by Adam Smith. Smith's great work appeared in 1776, the year of the American Declaration of Independence. The two events were not unrelated; both were in stern reaction to the economic policies and practices of the mercantilist era." (EP p 31)

Mercantilism

"Mercantilism dominated Europe from the 16th to the 18th century. Despite the localism of the Middle Ages, the waning of feudalism saw new national economic frameworks begin to strengthen. After the 15th century voyages of Christopher Columbus and other explorers opened up new opportunities for trade with the New World and Asia, newly-powerful monarchies wanted a more powerful military state to boost their status. Mercantilism was a political movement and an economic theory that advocated the use of the state's military power to ensure that local markets and supply sources were protected, spawning protectionism.

Mercantile theorists held that international trade could not benefit all countries at the same time. Money and precious metals were the only source of riches in their view, and limited resources must be allocated between countries, therefore tariffs should be used to encourage exports, which bring money into the country, and discourage imports which send it abroad. In other words, a positive balance of trade ought to be maintained through a surplus of exports, often backed by military might. Despite the prevalence of the model, the term mercantilism was not coined until 1763 by Victor de Riqueti, marquis de Mirabeau, and popularized by Adam Smith in 1776, who vigorously opposed it." (W History of Economic Thought)

Mercantilism and Wages

"Wages had little or no part in mercantilist thought and practice. Here the role of foreign trade, as it would now be called, was a factor. The distant workers, be they slave, indentured or free, who produced cloth, spices, sugar or tobacco in remote lands, east and west, did not call for consideration. But neither did those nearer home. Domestic manufacturing was extensively in the household; there husband, wife and children worked into cloth the raw materials supplied them by the merchants. Again no wage as such was paid, the merchant entrepreneur simply paid for the work whatever was necessary to command the product. There was nothing here on which to erect a theory of wages, so none was prominent in mercantilist thought." (EP p. 38)

No State – No Market

"...a brief history of capitalism reveals some other powerful, if less simplistic, stories about government's place in the economy. In the Middle of the Second World Karl Polanyi, a radical Austro-Hungarian thinker who combined the reasoning of political economy with a deep understanding of anthropology, history and philosophy, wrote a very important book: *The Great Transformation.* In it, he argued that markets were far from '*natural*' or inevitable – rather, they resulted from purposeful policymaking: '*The road to the free market was opened and kept open by an enormous increase in continuous, centrally organized and controlled interventionism...Administration had to be constantly on the watch to ensure the free working of the system*.'

Polanyi traced the long history of local and international markets. In the process, he showed that the national capital market – the one studied in economics classes with supply and demand curves – was actually forced into existence by the state. Government, Polanyi asserted, does not '*distort*' the market. Rather, it creates the market. Put bluntly: no state, no market." (VE pp. 231-232)

The Great Transformation – Karl Polanyi

"Capitalism as a social order whose organizing principle is the ceaseless accumulation of capital cannot be understood without some appreciation of the historic changes that bring about its appearance. In this complicated narrative, it is useful to distinguish three major

themes. The first concerns the transfer of the organization and control of production from the imperial and aristocratic strata of pre-capitalist states into the hands of mercantile elements. This momentous change originates in the political rubble that followed the fall of the Roman Empire {476 AD}. There merchant traders established trading niches that gradually became loci of strategic influence, so that a merchantdom very much at the mercy of feudal lords in the ninth and tenth centuries became by the twelfth and thirteenth centuries an estate with a considerable measure of political influence and social status. The feudal lord continued to oversee the production of the peasantry on his manorial estate, but the merchants, and his counterpart the guild master, were organizers of production in the towns, of trade between the towns, and of finance for the feudal aristocracy itself.

The transformation of a merchant estate into a capitalist class, capable of imagining itself as a political, not just an economic force, required centuries to complete and was not, in fact, legitimated until the English revolution of the seventeenth {1688 Glorious Revolution} and the French Revolution {1789} of the eighteenth centuries. The elements making for this revolutionary transformation can only be alluded to here in passing. A central factor was the gradual re-monetization of medieval European life that accompanied its political evolution. The replacement of feudal social relationships, mediated through custom and tradition, by market relationships knit by exchange worked steadily to improve the wealth and social importance of the merchant against the aristocrat. This enhancement was accelerated by many related developments - the inflationary consequence of the importation of Spanish gold in the sixteenth century which further undermined the rentier position of feudal lords; the steady stream of runaway serfs who left the land for the precarious freedom of the towns and cities, placing further economic pressure on their former masters; the growth of national power that encouraged alliances between monarch and merchants for their mutual advantage; and yet other social changes.

The overall transfer of power from aristocratic to bourgeois auspices is often subsumed under the theme of the rise of market society - that is, as the increasing organization of production and distribution through purchase and sale rather than by command or tradition. This economic revolution, from which emerge the '*factors of production*' that characterize market society, must however be understood as the end product of a political convulsion in which one social order is destroyed to make way for a new social order. Thus, the creation of a large propertyless labor force requires a disruptive social change that begins in England in the late sixteenth century with the dispossession of peasant occupants from communal land, and does not run its course until well into the nineteenth century. In similar fashion, the transformation of feudal manors from centers of social and juridical life into real estate, or the destruction of the protected guilds before the unconstrained expansion of nascent capitalist enterprises embody wrenching sociopolitical dislocations, not merely the smooth diffusion of preexisting economic relations throughout society. It is such painful rearrangements of power and status that underlay the 'great transformation' out of which capitalist market relationships finally arise." (GT p. ?)

The Great Transformation - General Argument

"Polanyi argued that the development of the modern state went hand in hand with the development of modern market economies and that these two changes were inextricably linked in history. Essential to the change from a pre-modern economy to a market economy was the altering of human economic mentalities away from a non-utility maximizing mindset to one more recognizable to modern economists. Prior to the great transformation, markets had a very limited role in society and were confined almost entirely to long distance trade. As Polanyi wrote, 'the same bias which made Adam Smith's generation view primeval man as bent on barter and truck induced their successors to disavow all interest in early man, as he was now known not to have indulged in those laudable passions.'

The great transformation was begun by the powerful modern state, which was needed to push changes in social structure and human nature that allowed for a competitive capitalist economy. For Polanyi, these changes implied the destruction of the basic social order that had reigned because of pre-modern human nature and that had existed throughout all earlier history. Central to the change was that factors of production like land and labor would now be sold on the market at market-determined prices instead of allocated according to tradition, redistribution, or reciprocity. He emphasized the greatness of the transformation because it was both a change of human institutions and human nature.

His empirical case in large part relied upon analysis of the Speenhamland laws, which he saw not only as the last attempt of the squirearchy to preserve the traditional system of production and social order but also a self-defensive measure on the part of society that mitigated the disruption of the most violent period of economic change. Polanyi also remarks that the pre-modern economies of China, the Incan Empire, the Indian Empires, Babylon, Greece, and the various kingdoms of Africa operated on principles of reciprocity and redistribution with a very limited role for markets, especially in settling prices or allocating the factors of production. The book also presented his belief that market society is unsustainable because it is fatally destructive to human nature and the natural contexts it inhabits.

Polanyi attempted to turn the tables on the orthodox liberal account of the rise of capitalism by arguing that 'laissez-faire was planned', whereas social protectionism was a spontaneous reaction to the social dislocation imposed by an unrestrained free market. He argues that the construction of a 'self-regulating' market necessitates the separation of society into economic and political realms. Polanyi does not deny that the self-regulating market has brought 'unheard of material wealth', but he suggests that this is too narrow a focus. The market, once it considers land, labor and money as 'fictitious commodities' (fictitious because each possesses qualities that are not expressed in the formal rationality of the market), and including them 'means to subordinate the substance of society itself to the laws of the market.'

This, he argues, results in massive social dislocation, and spontaneous moves by society to protect itself. In effect, Polanyi argues that once the free market attempts to separate itself from the fabric of society, social protectionism is society's natural response, which he calls the '*double movement*'. Polanyi did not see economics as a subject closed off from other fields of inquiry, indeed he saw economic and social problems as inherently linked. He ended his work with a prediction of a socialist society, noting, 'after a century of blind 'improvement', man is restoring his 'habitation.'" (W *The Great Transformation*)

From Elinor Ostrom to Polanyi back to Adam Smith

"The work of Elinor Ostrom [1933-2012], an economist from Indiana University who received the Nobel Prize in 2009, helps clarify the richness in which new metrics can affect behavior and vice versa, in defusing the conflict beween government and market. Ostrom shows how the crude state-private divide that dominates current thinking fails to encapsulate the complexity of institutional structures and relationships – from non-partisan government regulators to state-funded universities and state-run research projects – that span the divide. Rather, she emphasizes common pool resources, and the shaping of systems that take into account collective behavior.

Ostrom's work supports Polanyi's historical conclusion in *The Great Transformation*: governments, along with the many institutions and traditions of a society, are the womb in which markets are nourished, and later the parent which helps them serve the common good. One vital government responsibility in the modern economy – which Ostrom also finds in successful pre-industrial economies – is to limit the amount of rent that emerges from any non-collective approach to wealth creation. That brings us back to Adam Smith's definition of the '*free market*' as being free from rent." (VE pp. 267-268)

Adam Smith [1723-1790] Scottish

Notable works: *The Theory of Moral Sentiments* [1759]

An Inquiry into the Nature and Causes of the Wealth of Nations [1776]

A New Philosophy

"By the eighteenth century, the initial emphasis on gold was beginning to look a trifle naive. New schools of thought were growing up which more and more emphasized *commerce* as the great source of national vitality. Hence the philosophical question to which they addressed themselves was not how to corner the gold market but how to create ever more and more wealth by assisting the rising merchant class in the furtherance of its tasks.

The new philosophy brought with it a new social problem: how to keep the poor poor. It was generally admitted that unless the poor were poor, they could not be counted upon to do an honest day's toil without asking exorbitant wages. '*To make the Society Happy..., it is requisite that great numbers should be Ignorant as well as poor*,' wrote Bernard Mandeville, the shrewdest and wickedest social commentator of the early eighteenth century. So the Mercantilist writers looked on the cheap agricultural and industrial labor of England and gravely nodded approval.

...Out of this melee came also a philosopher of astonishing scope. Adam Smith published his *Inquiry into the Nature and Causes of the Wealth of Nations* in 1776, thereby adding a second revolutionary event to that fateful year. A political democracy was born on one side of the ocean; an economic blueprint was unfolded on the other. But while not all Europe followed America's political lead, after Smith had displayed the first true tableau of modern society, all the Western world became the world of Adam Smith: his vision became the prescription for the spectacles of generations. Adam Smith would never have thought of himself as a revolutionist; he was only explaining what to him was very clear, sensible, and conservative. But he gave the world the image of itself for which it had been searching. After *The Wealth of Nations*, men began to see the world about themselves with new eyes; they saw how the tasks they did fitted into the whole of society, and they saw that society as a whole was proceeding at a majestic pace toward a distant but clearly visible goal." (WP pp. 40-41)

The Nature of Society

"To Smith and the great economists who followed him, society is not conceived as a static achievement of mankind which will go on reproducing itself, unchanged and unchanging, from one generation to the next. On the contrary, society is seen as an organism that has its own life history. Indeed, in its entirety *The Wealth of Nations* is a great treatise on history, explaining how '*the system of perfect liberty*' (also called '*the system of natural liberty*') – the way Smith referred to commercial capitalism – came into being, as well as how it worked." (WP p. 54)

Moral Philosophy

"At Glasgow, Adam Smith lectured on problems of Moral Philosophy, a discipline a great deal more broadly conceived in that day than in ours. Moral Philosophy covered Natural Theology, Ethics, Jurisprudence, and Political Economy: it thus ranged all the way from man's sublimest impulses toward order and harmony to his somewhat less orderly and harmonious activities in the grimmer business of gouging out a living for himself." (WP p. 42)

The Theory of Moral Sentiments

"Although *The Wealth of Nations* is widely regarded as Smith's most influential work, it is believed that Smith himself considered *The Theory of Moral Sentiments* to be a superior work…In the work, Smith critically examines the moral thinking of his time, and suggests that conscience arises from dynamic and interactive social relationships through which people seek 'mutual sympathy of sentiments'. His goal in writing the work was to explain the source of mankind's ability to form moral judgment, given that people begin life with no moral sentiments at all. Smith proposes a theory of sympathy, in which the act of observing others and seeing the judgments they form of both others and oneself makes people aware of themselves and how others perceive their behavior. The feedback we receive from perceiving (or imagining) others' judgments creates an incentive to achieve 'mutual sympathy of sentiments' with them and leads people to develop habits, and then principles, of behavior, which come to constitute one's conscience.

Some scholars have perceived a conflict between *The Theory of Moral Sentiments* and *The Wealth of Nations*; the former emphasizes sympathy for others, while the latter focuses on the role of self-interest. In recent years, however, some scholars of Smith's work have argued that no contradiction exists. They claim that in *The Theory of Moral Sentiments*, Smith develops a theory of psychology in which individuals seek the approval of the 'impartial spectator' as a result of a natural desire to have outside observers sympathize with their sentiments. Rather than viewing The *Theory of Moral Sentiments* and *The Wealth of Nations* as presenting incompatible views of human nature, some Smith scholars regard the works as emphasizing different aspects of human nature that vary depending on the situation." (W Adam Smith)

An Inquiry into the Nature and Causes of The Wealth of Nations

"There is disagreement between classical and neoclassical economists about the central message of Smith's most influential work: *An Inquiry into the Nature and Causes of the Wealth of Nations* [1776]. Neoclassical economists emphasize Smith's invisible hand, a concept mentioned in the middle of his work – Book IV, Chapter II – and classical economists believe that Smith stated his program for promoting the 'wealth of nations' in the first sentences, which attributes the growth of wealth and prosperity to the division of labor." (W Adam Smith)

The Value of Labor

"To see that labor, not nature, was the source of 'value', was one of Smith's greatest insights. Perhaps this was the consequence of having grown up in a country that bustled with trade, rather than in the overwhelmingly agricultural setting of France." (WP p. 49)

First Sentence in the Introduction to *The Wealth of Nations*

"The Annual labour of every nation is the fund which originally supplies it with all the necessaries and conveniences of life which it annually consumes, and which consists always either in the immediate produce of that labour, or in what is purchased with that produce from other nations." (WN Book 1, Introduction p. 1)

First Sentence in Volume 1, Book 1, Chapter 1 of *The Wealth of Nations*

"The greatest improvement in the productive powers of labour, and the greater part of the skill, dexterity, and judgment with which it is any where directed, or applied, seem to have been the effects of the division of labour." (WN Book 1, Chapter 1, p. 7)

The Wealth of Nations

***"...*the book is a revolutionary one. To be sure, Smith would hardly have countenanced an upheaval that disordered the gentlemanly classes and enthroned the common poor. But the import of *The Wealth of Nations* is revolutionary, nonetheless. Smith is not, as is commonly supposed, an apologist for the up-and-coming bourgeois; as we shall see, he is an admirer of their work but suspicious of their motives and mindful of the needs of the great laboring mass. But it is not his aim to espouse the interest of any class. He is concerned with promoting the wealth of the entire nation. And wealth, to Adam Smith, consists of the goods that *all* the people of society consume; note *all*– this is a democratic, and hence radical, philosophy of wealth. Gone is the notion of gold, treasures, kingly hoards; gone the prerogatives of merchants or farmers or working guilds. We are in the modern world, where the flow of goods and services consumed by everyone constitutes the ultimate aim and end of economic life." (WP p. 53)**

Smith and the Industrial Revolution

"Yet not much of what came to be called the Industrial Revolution was ever seen by Smith – not the really great factories, not the factory towns, not the regiments of workers gathering for and departing their toil, not the politically and socially emergent industrialists. By far the greatest part of the development came after his book was written. Smith describes the work of a pin factory, but one that was far from characteristic of the industrial plants of later decades. It was probably the most famous factory in all the history of economic enterprise, and it had for him, as also for almost all who have written of him, a nearly mystical importance. What captured his attention was not the machinery that characterized the

Industrial Revolution but the way the job was divided so each worker became an expert on his minuscule part of the task...

That the application of power and machinery to production, even in Smith's day, might have been a far greater source of efficiency than the specialized application of workers to a task is more than probable. And it has certainly been the case since. To this day, nonetheless, Smith's division of labor remains a totemic source of efficiency, a cliché in all discussion of international trade policy." (EP pp. 58-59, 69)

The Profit Motive a Modern Invention

"It may strike us as odd that the idea of gain is a relatively modern one; we are schooled to believe that man is essentially an acquisitive creature and that left to himself he will behave as any self-respecting businessman would. The profit motive, we are constantly being told, is as old as man himself.

But it is not. The profit motive as we know it is only as old as 'modern man'. Even today, the notion of gain for gain's sake is foreign to a large portion of the world's population, and it has been conspicuous by its absence over most of recorded history. Sir William Petty, an astonishing seventeenth-century character, claimed that when wages were good, labor was 'scarce to be had at all, so licentious are they who labor only to eat, or rather to drink'. And Sir William was not merely venting the bourgeois prejudices of his day. He was observing a fact that can still be remarked among the unindustrialized peoples of the world: a raw working force, unused to wage-work, uncomfortable in factory life, unschooled to the idea of an ever-rising standard of living, will not work harder if wages rise; it will simply take more time off. The idea of gain, the idea that each working person not only may, but should, constantly strive to better his or her material lot, is an idea that was quite foreign to the great lower and middle strata of Egyptian, Greek, Roman, and medieval cultures, only scattered throughout Renaissance and Reformation time; and largely absent to the majority of Eastern civilizations. As a ubiquitous characteristic of society, it is as modern an invention as printing." (WP pp. 24-25)

The Market System a Modern Invention

"But markets, whether they be exchanges between primitive tribes where objects are casually dropped on the ground or the exciting traveling fairs of the Middle Ages, are not the same as the market system. For the market system is not just a means of exchanging goods; it is a mechanism for sustaining and maintaining an entire society.

And that mechanism was far from clear to the minds of the medieval world. The concept of widespread gain was blasphemous enough, as we have seen. The broader notion that a general struggle for gain might actually bind together a community would have been held a little short of madness.

There was a reason for this blindness. The Middle Ages, The Renaissance, the Reformation – indeed the whole world until the sixteenth or seventeenth century – could not envisage the market system for the thoroughly sound reason that Land, Labor, and Capital – the basic agents of production which the market system allocates – did not yet exist. Land, labor, and capital in the sense of soil, human beings, and tools are of course coexistent with society itself. But the idea of abstract land or abstract labor did not immediately suggest itself to the human mind any more than did the idea of abstract energy or matter. Land, labor, and capital as 'agents' of production, as impersonal, dehumanized economic entities, are as much modern conceptions as the calculus. Indeed, they are not much older." (WP pp. 26-27)

Monopolies – The Great Enemy

"The great enemy to Adam Smith's system is not so much government *per se* as monopoly in any form: '*People of the same trade seldom meet together*,' says Adam Smith, '*but the conversation ends in a conspiracy against the public or in some diversion to raise prices*.' And the trouble with such goings-on is not so much that they are morally reprehensible in themselves – they are, after all, only the inevitable consequence of man's self-interest – as they impede the fluid working of the market." (WP p. 70)

Monopolies Opposed

"In an age when restrictive preferences, privileges and state grants of monopoly were commonplace, he opposed them all. He also opposed private combinations of producers and workers, although in a characteristic aside, he noted that there were more laws against combinations by the sellers of labor than against the similar practice by merchants and manufacturers who employed them. He was not, however, entirely optimistic as to the possibility of contending with private combinations. The impulse to such association was strong. In another deathless passage he observes that '*people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. It is impossible...*' he went on to say, '*to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice. But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies; much less to render them necessary*.'" (EP pp. 70-71)

Corporations a Modern Invention

"From Smith has come the commitment to competition as a principle in all capitalistic societies – competition that is presumed to ensure optimal industrial performance. Considerably less influential has been Smith's warning as to the institution that, along with the state itself, might destroy competition. This was the state-chartered company – in modern terms, the corporation. Where it had monopoly privileges as in the colonial era, he was especially critical. But he also thought little of its efficiency. Returning today, he would be appalled at a world where, as in the United States, a thousand corporations dominate the

industrial, commercial and financial landscape and are controlled by their hired management, something Smith thought especially to be deplored: '*Being the managers rather of other people's money than of their own it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own...Negligence and profusion therefore, must always prevail, more or less, in the management of the affairs of such a company*.'" (EP pp. 71-72)

The Motives of the Business Class

"Thus, by a strange injustice, the man who warned that the grasping eighteenth-century industrialists '*generally have an interest to deceive and even to oppress the public*' came to be regarded as their economic patron saint. Even today, in blithe disregard of his actual philosophy, Smith is generally regarded as a *conservative* economist, whereas in fact he was more avowedly hostile to the *motives* of businessmen than are most contemporary *liberal* economists." (WP p. 70-71)

Benevolence from *The Theory of Moral Sentiments*

"Smith's ethical doctrines are in fact a combination of Stoic and Christian virtues – or, in philosophical terms, a combination of Stoicism and Hutcheson. Hutcheson resolved all virtue into benevolence, a philosophical version of the Christian ethic of love. At an early stage in *The Theory of Moral Sentiments*, Adam Smith supplements this with the Stoic self-command:

> ***And hence it is, that to feel much for others and little for ourselves, that to restrain our selfish, and to indulge our benevolent affections, constitutes the perfection of human nature...As to love our neighbor as we love ourselves is the great law of Christianity, so it the the great precept of nature to love ourselves only as we love our neighbor, or what comes to the same thing, as our neighbor is capable of loving us...The man of the most perfect virtue...is he who joins, to the most perfect command of his own original and selfish feelings, the most exquisite sensibility both to the original and sympathetic feelings of others."* (TMS Introduction p. 6)**

Self-Interest from *The Wealth of Nations*

**"*In almost every other race of animals each individual, when it is grown up to maturity, is entirely independent and in its natural state has occasion for the assistance of no other living creature. But man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and show them that it is for their own advantage to do for him what he requires of them. Whoever offers to another a bargain of any kind, proposes to do this. Give me that which I want, and you shall have this which you want, is the meaning of every such offer; and it is in this manner that we obtain from one another the far greater part of those good offices which we stand in need of. It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never*

***talk to them of our necessities but of their advantages. Nobody but a beggar chooses to depend chiefly upon the benevolence of his fellow citizens*.” (WN Book 1, Chapter 2, p. 18)**

The Invisible Hand

“Smith's statement about the benefits of 'an invisible hand' may be meant to answer] Mandeville's contention that ‘Private Vices ... may be turned into Public Benefits’. It shows Smith's belief that when an individual pursues his self-interest under conditions of justice, he unintentionally promotes the good of society. Self-interested competition in the free market, he argued, would tend to benefit society as a whole by keeping prices low, while still building in an incentive for a wide variety of goods and services. Nevertheless, he was wary of businessmen and warned of their ‘conspiracy against the public or in some other contrivance to raise prices’. Again and again, Smith warned of the collusive nature of business interests, which may form cabals or monopolies, fixing the highest price ‘which can be squeezed out of the buyers’. Smith also warned that a business-dominated political system would allow a conspiracy of businesses and industry against consumers, with the former scheming to influence politics and legislation. Smith states that the interest of manufacturers and merchants ‘...*in any particular branch of trade or manufactures, is always in some respects different from, and even opposite to, that of the public...The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution, and ought never be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention*.’ Thus Smith's chief worry seems to be when business is given special protections or privileges from government; by contrast, in the absence of such special political favors, he believed that business activities were generally beneficial to the whole society.” (W Adam Smith p. 10)

The Working Class?

“Smith never faced the problem that was to cause such intellectual agony for later generations of whether the government is weakening or strengthening that system when it steps in with welfare legislation. Aside from poor relief, there was virtually no welfare legislation in Smith’s day – the government was the unabashed ally of the governing classes and the great tussle within the government was whether it should be the landowning or the industrial classes who should most benefit. The question of whether the working class should have a voice in the direction of economic affairs simply did nor enter any respectable persons mind.” (WP p. 69-70)

Ambiguity of Price in Smith

“The ambiguity in which Smith finally left the question of what determines price has been endlessly debated by scholars. It is an entertainment that need not trouble us. The simple fact is that Smith himself did not decide.

Coming to what determines the shares in income from the sale of the product that should go to the workers, the landlords and the employer-capitalist, Smith again identified the question to be asked and again was ambiguous as to the answer. Wages he regarded generally as the cost of bringing the worker into being as a worker and sustaining him in his job. This, the subsistence theory of wages, would later be converted by David Ricardo into the Iron Law of Wages, which was held to keep the laboring classes to the minimum wage necessary for their survival.

The return to capital and the capitalist – interest and profits were not clearly distinguished – Smith extracted only with some difficulty from a labor theory of value. The quantity of labor and the resulting cost of sustaining it determines price. The return to capital, in consequence, must be an exaction by the capitalist from the rightful claim of the worker whose toil establishes the price and to whom the return from the sale of the product is presumably due. Or it is the appropriation of a surplus value that the worker creates over and above what he is paid and to which, again, he has a seemingly rightful claim. And here Smith left the matter – insofar as his position is clear. This innocently subversive view would also be developed and refined in the next century by Ricardo. And it would become a major source of the revolutionary indignation and agitation of Karl Marx.

Finally, rent. The attention accorded to rent in the writings of Smith, and also later in those of Ricardo and others, has a slightly archaic aspect now. Why so much attention to this particular item of cost and income? We need to be reminded of how significant rent was in a time when agriculture was of central economic importance and the payment by tenants for the use of the land one of the great (and oppressive) transfers of income.

On rent Smith, again, has different and conflicting explanations. After first making it a determinant of price, along with wages and profit, he then makes it a residual from the return from prices after wages and profits are paid. 'Rent...enters into the composition of the price of commodities in a different way from wages and profit. High or low wages and profits are the causes of high or low price, high or low rent is the effect of it.' He then goes on to associate the level of this residual with the quality of the land. 'The rent increases in proportion to the goodness of the pasture.'

A Physiocratic overtone also enters here: in agriculture, Smith holds, nature labors alongside man, adding something of her own – again a *produit net* – to his efforts. There is an especially troubling contradiction between Smith's view of prices, which are presumed to reflect the cost of the labor incorporated in the product, and his view of the role of land, which '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. The solution of this matter is again to leave Smith to those who find scholarly sustenance in his contradictions." (EP pp. 66-68)

Another View of Smith's Understanding of Rent

"His emphasis on investments linked directly to his ideas about rent. Smith believed that there were three kinds of income: wages for labor in capitalist enterprises: profits for capitalists who owned the means of production: and rents from ownership of land. When these three sources of income are paid at their competitive level, together they determine what he called the '*competitive price*'. Since land was necessary, rent from land was a '*natural*' part of the economy. But that did not mean rent was productive: '*the landlords, like all other men, love to reap where they never sowed and demand a rent (from the earth) even for its natural produce*'. Indeed, Smith asserted, the principle of rent from land could be extended to other monopolies, such as the right to import a particular commodity or the right to plead at the bar. Smith was well aware of the damage monopolies could do. In the seventeenth century, a government desperate for revenue had granted – often to well-placed courtiers – an extraordinary range of monopolies, from the daily necessities such as beer and salt to mousetraps and spectacles. In 1621 there were said to be 700 monopolies, and by the late 1630s they were bringing in 100,000 pounds a year to the Exchecquer. But this epidemic of rent-seeking was deeply unpopular and was choking the economy: more than that, it was one of the proximate causes of the Civil War, which led to the execution of Charles I. Many Englishmen understood what Smith meant when he said that a free market was one free of rent.

...But he is often misconstrued. His understanding of politics and philosophy was never sidelined in his economic reasoning. His *Theory of Moral Sentiments* and *The Wealth of Nations* were not contradictory but part of his deep analysis of what drives human behavior and how societies organize themselves, and why some societies might grow in wealth more than others. Smith's analysis of '*free markets*' was closely tied to his understanding of production, and the need to limit rent-seeking behavior." (VE p. 40)

The Ultimate Moral Justification

"To be sure, he shared the beliefs of his day; in fact, he helped to forge them. It was an age of humanism and reason; but while both could be perverted for the cruelest and most violent purposes, Smith was never chauvinist, apologist, compromiser. '*For to what purpose*,' he wrote in *The Theory of Moral Sentiments*, '*is all the toil and bustle of this world? What is the end of avarice and ambition, of the pursuit of wealth, of power, and pre-eminence?' The Wealth of Nations* provides his answer: all the grubby scrabbling for wealth and glory has its ultimate justification in the welfare of the common man." (WP p. 74)

David Ricardo [1772-1823] British

Notable works: *Principles of Political Economy and Taxation* [1817]

Early Financial Success

"Although already a successful broker, he made the bulk of his fortune as a result of speculation on the outcome of the Battle of Waterloo {1815}, using methods that today would result in prosecution for insider trading and market manipulation. Prior to the battle, Ricardo posted an observer to convey early results of the outcome. He then deliberately created the mistaken impression the French had won by initially openly selling British securities. A market panic ensued. Following this panic he moved to buy British securities at a steep discount. *The Sunday Times* reported in Ricardo's obituary, published on 14 September 1823, that during the Battle of Waterloo Ricardo 'netted upwards of a million sterling', a huge sum at the time. Following this trading coup he immediately retired, his position on the floor would have been in any case untenable as a result of his actions. He subsequently purchased Gatcombe Park, an estate in Gloucestershire, now owned by Princess Anne, the Princess Royal, and retired to the country." (W David Ricardo)

The Question of Income Distribution

"Ricardo was drawn to economics by reading Smith's *The Wealth of Nations* {in 1799, at the age of 27}, but was concerned with something that he felt was glaringly absent from Smith's theory of value: how that value was distributed throughout society – or what we would today call income distirbution. It need hardly be said that, in today's world of growing inequality of income and wealth, this question remains profoundly relevant.

Smith had observed that the value produced by labor, when sold, is redistributed as wages, profits and rent; he had also seen that labor's exact share of this value – wages – would vary. However, Smith had no coherent explanation for the way in which wages were apportioned, or why they differed between professions and countries or over time. Ricardo, by contrast, felt that the distribution of wages was, as he stressed in his magnum opus *On the Principles of Political Economy and Taxation*, the '*principle problem*' in economics and ultimately regulates the growth and wealth of a nation." (VE p. 41)

Economic Justice

"Confusion about the meaning and extent of rent has arisen because economists have forgotten the original fundamental questions that Ricardo, especially, was asking. What determines the level of wages? What determines returns to landowners? Why are unearned incomes and their capitalized values so large? Why is economic progress accompanied by endemic poverty? Above all, what is economic justice? Such questions drive economists back to root concepts, like rent in the classical sense." (NME p. 95)

Class Struggle

"Smith had looked at the world and had seen in it a great concert; Ricardo saw a bitter conflict. To the author of *The Wealth of Nations* there was good reason to believe that everyone could share in the benefits of a benign providence; to the inquiring stockbroker writing about a half century later, not only was society rent into warring groups but it seemed inescapable that the rightful winner of the conflict – the hard working industrialist – was bound to lose. For Ricardo believed that the only class that could possibly benefit from the progress of society was the landlord – unless his hold on the price of grain was broken.

'*The interest of the landlords is always opposed to the interest of every other class in the community*,' he wrote in 1815, and with that unequivocal sentence an undeclared war became recognized as the crucial political struggle of a growing market system. And with the open declaration of hostilities there perished the last forlorn hope that this might after all turn out to be the best of all possible worlds. Now it seemed that if society did not drown in the Malthusian swamp, it would tear itself to pieces on David Ricardo's treacherous moving stairs." (WP p. 82)

Theory of Value

"Ricardo's most famous work is his *Principles of Political Economy and Taxation* [1817]. It was usually understood that he advanced a *labor theory of value* in this book. Indeed, in the heading of Chapter 1, section I, we read this sentence:

> ***The value of a commodity, or the quantity of any other commodity for which it will exchange, depends on the relative quantity of labor, which is necessary for its production, and not on the greater or less compensation, which is paid for that labor.***

However, it is now interpreted that Ricardo stated for an easiness of understanding this simple, strong case at the beginning of his theory and his real intention is what is now termed *cost of production theory of value*. Simplest evidence for this fact is given by Ricardo's note to Section VI, which reads as follows:

> ***Mr. Malthus appears to think that it is a part of my doctrine, that the cost and value of a thing be the same; ...it is, if he means by cost, 'cost of production' including profits.***

This note clearly contradicts the labor theory of value interpretation." (W David Ricardo)

The Role of the Landlord

"But so far, save for the lack of realistic detail, it is not a world too far removed from that of Adam Smith. It was when Ricardo came to the landlord that things were different.

For Ricardo saw the landlord as a unique beneficiary in the organization of society. The worker worked and for this he was paid a wage; the capitalist ran the show, and for this he gained a profit. But the landlord benefited from the powers of the soil, and his income – rent – was not held in line either by competition or by the power of population. In fact, he gained at everyone else's expense.

We must pause for a moment to understand how Ricardo came to this conclusion, for his bleak outlook for society hangs on his definition of the landlord's rent. Rent, to Ricardo, was not just the price one paid for the use of the soil, much as interest was the price of capital, and wages the price of labor. Rent was a very special kind of return that had its origin in the demonstrable fact that not all land was equally productive.

Suppose, says Ricardo, there are two neighboring landlords. On one landlord's fields the soil is fertile, and with the labor of a hundred men and a given amount of equipment he can raise fifteen hundred bushels of grain. On the second landlord's fields the soil is less fecund; the same men and their equipment will raise only one thousand bushels. This is merely a fact of nature, but it has an economic consequence: grain will be cheaper, per bushel, on the fortunate landlord's estate. Obviously since both landlords must pay out the same wages and capital expenses, there will be an advantage in cost to the man who secures five hundred more bushels than his competitor." (WP p. 96)

Economic Rent - Definitions

"David Ricardo had been the first to formulate and develop the consequences of the law of rent. His definition of it, however, was unfortunately limited:

> ***Rent is that portion of the produce of the earth that is paid to the landlord for the use of the original and indestructible powers of the soil.***

By citing the natural fertility of land as the prime example of such powers, Ricardo's definition drew attention away from the many other '*powers*' attached to land, especially those that fall under the general heading of location. The American economist, Henry George….[was] well aware that location was considerably more important than fertility in giving rise to rent, but George had been intellectually ostracized by the academic establishment….

We may formulate the law of rent as:

> ***Rent arises as the potential excess of production on a particular piece of land over and above the potential production from the same effort on land of equal area, which is the least productive in use.***

…Every site is unique, and has unique qualities, which endow work on that site with special advantages and disadvantages. This is by no means a matter of purely natural aspects, like soil, minerals, topography or climate, though these are of great importance. The presence of a settled community, its population distribution, law and order, infrastructure – roads, railways, bridges and municipal facilities – existing economic development in industry, commerce and finance, public utilities like water, gas and electricity, social amenities for culture, entertainment and sport, the whole host of opportunities available in a developed society, all of these contribute a part in making the application of labor, with capital, more or less productive in one place than in another. Any businessman, or any house buyer deciding on a location, knows this without a doubt. Everyone knows it. Yet economists neglect it!" (NEM pp. 72-73)

The Landlord's Advantage

"What a different conclusion from Adam Smith's great pageant of progress! In Smith's world everybody gradually became better off as the division of labor increased and made the community wealthier. We can now see that this conclusion hinged on Smith's failure to perceive land as a bottleneck to progress. In Smith's vision there is no shortage of fertile soil, hence no margin behind which rents would rise along with population.

By way of contrast, in Ricardo's world *only* the landlord stood to gain. The worker was forever condemned to subsistence for he chased after every wage rise with a flock of children and thereby competed most of his gains away. The capitalist, who worked and saved and invested, found that all his trouble was for nothing; his wage costs were higher and his profits smaller. As for the landlord who did nothing but collect his rents – he sat back and watched them increase." (WP p. 98)

Tax on the Land Rent

"Ricardo concluded that a tax on land value, equivalent to a tax on the land rent, minus the improvements, was the only form of taxation that would not lead to price increases. Land itself has no cost of production, because it is not produced by humans. Thus, the price is not determined by the cost, but only by the best available rent-free alternative, not by the tax burdens of the person claiming exclusive use." (W David Ricardo)

Comparative Advantage and Free Trade

"Between 1500 and 1750 most economists advocated Mercantilism which promoted the idea of international trade for the purpose of earning bullion by running a trade surplus with other countries. Ricardo challenged the idea that the purpose of trade was merely to accumulate gold or silver. With 'comparative advantage' Ricardo argued in favour of industry specialisation and free trade. He suggested that industry specialization combined with free international trade always produces positive results. This theory expanded on the concept of absolute advantage.

Ricardo suggested that there is mutual national benefit from trade even if one country is more competitive in every area than its trading counterpart and that a nation should concentrate resources only in industries where it has a comparative advantage, that is in those industries in which it has the greatest competitive edge. Ricardo suggested that national industries which were, in fact, profitable and internationally competitive should be jettisoned in favor of the most competitive industries, the assumption being that subsequent economic growth would more than offset any economic dislocation which would result from closing profitable and competitive national industries.

Ricardo attempted to prove theoretically that international trade is always beneficial. Paul Samuelson called the numbers used in Ricardo's example dealing with trade between England and Portugal the 'four magic numbers'. '*In spite of the fact that the Portuguese could produce both cloth and wine with less amount of labor, Ricardo suggested that both countries would benefit from trade with each other.*'" (W David Ricardo)

Protectionism

"Like Adam Smith, Ricardo was an opponent of protectionism for national economies, especially for agriculture. He believed that the British 'Corn Laws' – tariffs on agricultural products – ensured that less-productive domestic land would be harvested and rents would be driven up. Thus, profits would be directed toward landlords and away from the emerging industrial capitalists. Ricardo believed landlords tended to squander their wealth on luxuries, rather than invest. He believed the Corn Laws were leading to the stagnatiion of the British economy." (W David Ricardo)

Joan Robinson's Criticism of Free Trade

"As Joan Robinson pointed out following the opening of free trade with England, Portugal endured centuries of economic underdevelopment: '*the imposition of free trade on Portugal killed off a promising textile industry and left her with a slow-growing export market for wine, while for England, exports of cotton cloth led to accumulation, mechanization and the whole spiralling growth of the industrial revolution*'. Robinson argued tha Ricardo's example requred that economies were in static euilibrium positions with full employment and that there could not be a trade deficit or a trade surplus. These conditions, she wrote, were not relevant to the real world. She also argued that Ricardo's math did not take into account that some countries may be at different levels of development and that this raised the prospect of 'unequal exchange' which might hamper a country's development, as we saw in the case of Portugal." (W David Ricardo)

Development Economist Ha-Joon Chang Challenges the Argument that Free Trade Benefits Every Country

"Ricardo's theory is absolutely right – within its narrow confines. His theory correctly says that, *accepting their current levels of technology as given*, it is better for countries to

specialize in things that they are relatively better at. One cannot argue with that. His theory fails when a country wants to acquire more advanced technologies – that is, when it wants to develop its economy. It takes time and experience to absorb new technologies, so technologically backward producers need a period of protection from international competition during this period of learning. Such protection is costly, because the country is giving up the chance to import better and cheaper products. However, it is a price that has to be paid if it wants to develop advanced industries. Ricardo's theory is, thus seen, for those who accept the *status quo* but not for those who want to change it." (W David Ricardo)

Ricardo's Influence and Intellectual Legacy

"David Ricardo's ideas had a tremendous influence on later developments in economics. U.S. economists rank Ricardo as the second most influential economic thinker, behind Adam Smith, prior to the twentieth century.

Ricardo became the theoretical father of classical political economy. However, Schumpeter coined an expression *Ricardian Vice*, which indicates that rigorous logic does not provide a good economic theory. This criticism applies also to most neoclassical theories, which make heavy use of mathematics, but are, according to him, theoretically unsound, because the conclusion being drawn does not logically follow from the theories used to defend it." (W David Ricardo)

Ricardian Vice

"Ricardo's gift to the world was plain. Here was a world stripped to its essentials and laid open for everyone to examine: the watchworks were exposed. In its very unreality lay its strength, for not only did the bare structure of a greatly simplified world reveal the laws of rent, but it elucidated as well vital questions of foreign trade, money, taxation, and economic policy. By building a model world, Ricardo gave the powerful tool of abstraction to economics – a tool that is essential if the distraction of everyday life is to be pierced and its underlying mechanism understood. To be sure, as some observers said in his own day, the tool of abstraction could also be used to ignore awkward facts – a use that has become known as the Ricardian Vice. Nonetheless, it is to Ricardo's gift for simplification that we owe the claim of economics to be considered as a science. Perhaps it is to his penchant for oversimplification that we also owe its rather spotty record as a science." (WP p. 102-103)

Ricardo's Relevance to Today's Economic Debates

Ricardo's gloomy picture of economic stagnation is relevant to a modern debate: how the rise of the financial sector in recent decades and the massive rents it earned from speculative activity have created disincentives for industrial production. Some heterodox economists today argue that growth will fall if finance becomes too big relative to the rest of the economy (industry) because real profits come from the production of new goods and services rather than from simple transfer of money earned from those goods and services. To

'rebalance' **the economy, the argument runs, we must allow genuine profits from production to win over rents – which, as we can see here, is exactly the argument Ricardo made 200 years ago, and John Maynard Keynes was to make 100 years later." (VE p. 44)**