

35. History of Economic Thought

Mercantilism

Arguments **in favour of state involvement** in society

- Based on '**Bullionism**' Economic health of a nation measured stores of gold/silver in reserve
- Link between **wealth and trade** – As Exports > Imports = Building up gold/silver reserves (prosperity)
- Trade only where it benefits your exports. Ignore **principle of comparative advantage**
- Gov should **reduce imports** via tariffs, subsidies and granting exclusive rights (National advantage and imperative to run a trade surplus i.e. money gold/silver must flow in)
- **Import substitution/Economic self sufficiency** vital (via domestic manufacturing)
- **Strong political authority** vital (at the expense of individual liberty) to coordinate economy and solve conflict
- State would **aggressively seek to expand its position** as with great wealth comes great political power
- **Key Industry:** Manufacturing (but agriculture needs to be encouraged)
- **Colonies should be exploited** as a source of raw materials and a market for manufactured goods

Physiocrats

'Government of nature',
Rely on 'rule of nature' **not state involvement**. Maximum freedom of the individual

Francois Quesnay

- Allow economy to follow 'natural order'
- Role of state is to **uphold 'natural order'** and **preserve private property**
- **Key Industry:** Agriculture (all wealth derives from the soil)
- **3 Economic Sectors**
 1. **Proprietary Class** (Landowners)
 2. **Productive Class** (Agricultural Labourers)
 3. **Sterile Class** (Artisans and Merchants)
- **Free trade with no protectionism** – 'laissez faire' (leave it alone)

Classical School (Capitalism)

Rely on 'rule of nature' **not state involvement**. Maximum freedom of the individual.
Labour is the source of value (**Labour Theory of Value**) + **Profit Motive**

Adam Smith

- **Major Work:** 'The Wealth of Nations' (1776)
- Advanced '**laissez faire**' system of natural liberty + specialisation of ones labour (new Political/Social order)
- Everyone should be free to pursue own '**self interest**' + **Free International Trade**
- **Trade = Zero Sum** (Everyone gains!)
- Selfish interests benefits society as, **unobstructed by government**, the '**invisible hand**' of markets will guide markets to their most efficient uses and determine prices
- **Key Industry:** Manufacturing (Rejected Physiocrats view)
- **State role:** national defence, legal system, public works (via taxation)

David Ricardo

- **Major Work:** 'Principles of Political Economy and Taxation' (1817)
- Pessimistic 'Theory on Rent': **Small population (POP) = supply food domestically** via best land + low rent = High output/Profits
- **Demand for food ↑, Wages ↑, POP ↑, Demand for land ↑, Use of less quality land ↑, Rents ↑, Landowning Profits ↑**
- Bad thing for industrial productivity
- Also, **Theory of Comparative Advantage** in Trade

Thomas Malthus

- **Major Work:** Pessimistic work 'Essay on the Principle of Population.' (1798)
- **Population growth = Geometric growth** but **food supply growth = Arithmetic growth** (poverty and starvation is inevitable)
- This leads to a low standard of living for all (fuelled by '**Iron Law of Wages**' i.e. ↑Wages ↓Population ↓SOL ↓Wages)
- Only checks on pop growth 'misery', 'vice' and 'moral restraint'

John Baptiste Say

- **Major Work:** 'Treatise on Political Economy' (1803)
- **Law of Markets (Says Law)** = Supply creates its own demand
- People work to buy goods/services (demand) and exchange their **own surplus goods for the surplus goods of others**. So, no overproduction!
- **Income** can be saved, **interest rates** would fall, **demand** would rise

JS Mill

- **Major Work:** 'Principles of Political Society' (1848)
- **State role:** Gov can tax excess earnings (landowners) and wealth spread
- **Overproduction** is impossible (Says Law)
- **Increasing returns** to scale for large scale firms
- **Trade unions** have a role in countering employer power
- Accepted **subsistence theory of wages** (Iron Law)

16th and 17th Century

18th Century

18th and 19th Century

TIME



TIME

19th Century

Early/Mid 20th Century

Late 20th Century

Socialism

Much social and political change (after Industrial Revolution and Railway Mania of mid 1800s)

Karl Marx

- **Major Work:** Communist Manifesto (1848)
- **Labour Theory of Value** (like Classical writers) : **Value of good** = Labour needed to produce it
- **No invisible hand**
- Capitalists exploit wealth (created by Labour)
- Capitalists want **↑Profit** so they demand more labour, **↑ Wages** (above subsistence)
- Capitalists don't want to pay **↑Wages** (hits profitability)
- Replace workers with technology, new methods of production (less labour intensive) = Unemployment
- In the drive for **↑Profit, Wages** eventually **↓**
- But **only Labour can generate profits.** Unemployment = Reduced demand (Vicious cycle)
- Workers become 'deskilled' as mere 'cogs in a machine' for profit (**Alienated**)
- Provokes **profitable firms to merge** – centralises power in fewer and fewer capitalists
- Poverty, oppression, exploitation and enslavement ensues

Rebirth of Classical School

(Neo-Classical)

The '**Paradox of Value**': How do we judge the value of a good?

- Smith, Marx and Ricardo all believed in the **Labour Theory of Value** (it's the cost of labour that determines price of a good). If its easy to acquire or plentiful) and easy to produce, it will be cheap.
- Birth of a **new idea:** Value is instead based on '**Utility**' or consumer satisfaction
- **Marginal Utility** (of consuming additional units) determines price. High MU = High Price

(Neo Classical) Keynesianism

Lessons of 1930s Great Depression

Recessions a major problem. Says Law wrong? Unemployment can persist because wages can remain high. Interest rates can be ineffective to spur economic growth

John Maynard Keynes

- **Major Work:** The General Theory of Employment, Interest and Money (1936)
- **Idea: **Damage Management****
- **Unemployment** is caused by **insufficient demand** for goods/services in the economy and the economy can settle with high unemployment for a long period. Afterfall 'in the Long Run, we're all dead' so action needs to be short run
- **Wages aren't always flexible downwards** (can't be cut – provokes industrial/social unrest') aka 'Sticky Wages'
- **Level of investment** in economy (in recession) **insufficient.** Supply > Demand and unemployment follows
- **Fiscal Policy** of a state can prevent unemployment and economic recession
- **State plays a role (regulates the economy when needed)** raise aggregate demand itself by stimulus spending (by borrowing and investing i.e. by running budget deficits **IF** it means coming the economy healthy)
- State spending smooths out the bumps caused by market cycle (**Boom-Bust**)
- This creates **employment** (and **prevents unemployment**)

Monetarism

Monetary Policy **not** Fiscal Policy should be key to economic management (Keynesianism doesn't help with inflation)

Milton Friedman

- **↑Money Supply = ↑Inflation** (**↓Competitiveness** of exports)...:so...:increasing public spending will only increase prices (not output)
- **Control Money Supply** (via interest rates, limiting loans and public spending) = **Control inflation**
- **Idea: **Supply side policies**** (anything that attempts to influence labour supply or supply of goods and services)
- **1.** Cut income tax
- **2.** Encourage market competition
- **3.** Reduce role of trade unions in the labour market
- **Minimise state role in economy** return to laissez faire (back to Smith's 'invisible hand') via privatisation of state assets and encouraging business growth
- **Price stability MOST important goal** (not full employment as in Keynesianism)