

Economic Theories (Schools)

Classical School - Adam Smith (1723 - 1790)

Adam Smith Wrote an Inquiry into the Nature and Causes of the **Wealth of Nations**, published in 1776. Smith sought to convince people that "the wealth of a nation would be promoted with vastly greater effectiveness by the 'obvious and simple system of **natural liberty**' than by national planning of the mercantilist sort." Smith's belief that a society composed of individuals acting in pursuit of their own interests would result in a stable, free and more prosperous society than one regimented and planned by the state. Smith took **Isaac Newton's** vision of a universe running by itself according to **natural laws** and applied it to society as a whole and to economic activity in particular. **Laissez-faire** is an economic system in which transactions between private parties are free from government interference such as regulations, privileges, tariffs, and subsidies.

Capitalism needs **Land, Labor** and **Capital** to function and grow. **Fixed capital** is derived from and must be constantly maintained by circulating capital. The ultimate purpose of both is to create consumables. The ultimate source of circulating capital is natural resources like land, mines and fisheries. The exploitation of nature also requires both fixed and circulating capital. **Land:** Rent may be divided between "gross rent" and "net rent." Rent, being the revenue of land, is profit to the landlord after taxes and other charges. If the land is improved - if there is capital invested in the land - then a portion of the rent is the revenue of that capital, divided between maintenance, taxes and other charges, and profit. **Human capital:** Similarly, wages are the revenue of human capital, and may be divided between maintenance and profit (and now, taxes). **Capital stock:** The accumulation of capital to finance construction and maintenance of facilities and employment of labor and purchase of supplies is another key factor in the increase of productivity and prosperity. The division of labor depends on this factor as much as on the existence of markets. It is profit incentives that drive the accumulation of capital and the most efficient management of its use. **Economic growth** is good and is achieved by the ever-widening application of the **division of labor**, which is organized within markets and driven by rational self-interest. Those nations that allow market forces to generate such growth will become wealthier, in Smith's view, than those that follow the mercantile model of managed trade. In his writings on policy issues in *Wealth of Nations*, Smith lays out the proper role for state activity. Thus, it is the inherent incompetence of government management that would doom all socialist experiments and undermine all government-administered initiatives. He maintains that there are three areas for legitimate governmental activity in society: defense against external and internal security threats, the formation of laws that prevent individuals from oppressing one another and the provision of public goods that the market would not supply. Smith's greatest achievement was to "put into the center of economics the systematic analysis of the behavior of individuals pursuing their self-interest (**Self-Betterment**) under conditions of competition. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. Through Self-interest and an Invisible hand then would regulate the economy. **invisible hand**, also known as the **invisible hand of the market**, the term economists use to describe the self-regulating nature of the marketplace. if each consumer is allowed to choose freely what to buy and each producer is allowed to choose freely what to sell and how to produce it, the market will settle on a product distribution and prices that are beneficial to all

the individual members of a community, and hence to the community as a whole. The reason for this is that **self-interest** will drive actors to beneficial behavior. Efficient methods of production will be adopted in order to maximize profits. Low prices will be charged in order to maximize revenue through gain in market share by undercutting competitors. Investors will invest in those industries that are most urgently needed to maximize returns, and withdraw capital from those that are less efficient in creating value. And all these effects will take place dynamically and automatically.

Division of labor: The value of labor is determined by the "skill, dexterity, and judgment" with which it is supplied. Adam Smith sets forth his justly famous explanation of the advantages of division of labor. he explains how 10 men each doing one or two or three procedures - can turn out "upwards of 48,000 pins in a day," even though each one, if working on his own, "could not each of them have made 20, perhaps not one pin in a day." **Specialization** improves dexterity and reduces time lost shifting from one operation to another. It also stimulates **invention**, since individual workers contrive labor-saving techniques and machines for the particular operations with which they are intimately familiar.

Karl Marx (1818-1883) Marxist School

History of Class Struggle: The Communist Manifesto begins with Marx's famous generalization that "the history of all hitherto existing society is the history of **class struggles**". Marx describes these classes in terms of binary oppositions, with one party as oppressor, the other as oppressed. society is increasingly splitting into only two classes: **Bourgeoisie (Owners) and Proletariat (Workers)**.

Historical (Dialectical) Materialism: Marx believed that human history unfolds according to a distinct series of historical stages (**class struggles**), each necessarily following the other. These stages ultimately lead to a prescribed **Utopian** endpoint, after which there will be no more change, an end to history.

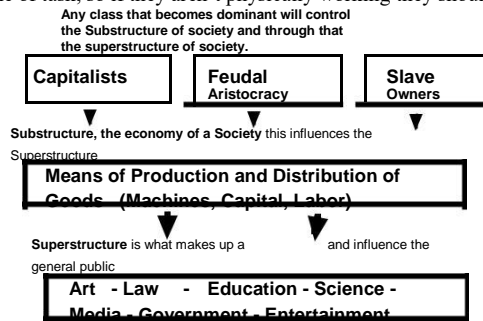
- 1. Primitive Communism:** Early tribal societies, Villages of hunters and gatherers.
- 2. Feudal:** Aristocracy exploiting serfs
- 3. Slave Owner:** Slave owners exploiting slaves
- 4. Capitalism:** Business(bourgeois) owners exploiting Workers(proletariat)
- 5. Socialism:** government of the people is here to facilitate the transformation to Self-control and not to perpetuate itself indefinitely.

Communism (The Final Stage): The state will wither away after the proletariat succeeds in fully revolutionizing society, no government, no money, people work for the common good of society, public store houses where people only take what they need.

Marx's Class Structured Society (Economics in History)

More specifically, it is crucial to note the central role that economics plays in Marx's view. While we might be inclined to view the progress of history-if we believe in progress at all-in terms of revolutionary ideas, i.e. Renaissance humanism, the scientific revolution, the Enlightenment, etc., Marx viewed the progress of history in decidedly materialistic terms. The grand ideas by which we characterize societies are always the reflection of underlying economic realities. In Marxist language, the **superstructure** (laws, morality, religion, politics, aesthetics: in short, culture) is always determined by the **infrastructure / substructure** (the methods of economic production and exchange); people's thoughts and behaviors are always determined by their social environments. What we think of as cultural revolutions, even great

political ones such as the French Revolution, are really the product of deeper economic issues expressed through class antagonism. This may not be immediately apparent as infrastructure always develops faster than superstructure. Every so often, though, the superstructure has to slingshot forward in order to catch up with the infrastructure. It is these great leaps forwards that we commonly misperceive as revolutions in ideas. **The labor theory of value:** (LTV) is a theory in economics and political economy concerning a market-oriented society: the theory equates the "value" of an exchangeable good or service (i.e., a commodity) with the amount of labor required to produce it. Literal meaning is workers actual time of task, so if they aren't physically working they shouldn't be paid.



David Ricardo (1772–1823)

For the problem of wages he proposed the “**iron law of wages**,” according to which wages tend to stabilize around the subsistence level. Any rise in wage rates above subsistence will cause the working population to increase to the point that heightened competition among the glut of laborers will merely cause their wages to fall back to the subsistence level. As far as value was concerned, Ricardo stated that the **value of almost any good was, essentially, a function of the labor needed to produce it**. For Ricardo saw the landlord as the unique beneficiary in the organization of society. The worker worked, and for this was paid a wage. The landlord gained at everyone else's expense. In Ricardo's world only the landlord stood to gain. The workers were forever condemned to subsistence, for he chased after every wage rise with a flock of children and thereby competed most of his gains away. As for the landlord, who did nothing but collect his rents - he sat back and watched them increase. Ricardo saw, “the escalator worked with different effects on different classes, that some rode triumphantly to the top, while others were carried up a few steps and then kicked down to the bottom. Worse yet, those who kept the escalator moving were not those who rose with its motion, and those who got the full benefit of the ride did nothing to earn their reward.”

Thomas Malthus (1766-1834)

Malthus was a political economist who was concerned about, what he saw as, the **decline of living conditions in nineteenth century England**. He blamed this decline on three elements: The overproduction of young; the inability of resources to keep up with the rising human population; and the irresponsibility of the lower classes. To combat this, Malthus suggested the family size of the lower class ought to be regulated such that poor families do not produce more children than they can support. Malthus believed that natural rates of human

reproduction, when unchecked, would lead to **geometric** increases in population: population would grow in a ratio of 2, 4, 8, 16, 32, 64 and so on. However, he believed that food production increased only in **arithmetic** progression: 2, 4, 6, 8, 10. It seemed obvious to him that something had to keep the population in check to prevent wholesale starvation. He said that there were two general kinds of checks that limited population growth: preventative checks and positive checks. Preventative checks reduced the birth rate; positive checks increased the death rate. Malthus believed that the positive checks were famine, misery, plague and war; because preventative checks had not limited the numbers of the poor, Malthus thought that positive checks were essential to do that job. If positive checks were unsuccessful, then inevitably (he said), famine would be the resulting way of keeping the population down. Before starvation set in, Malthus advised that steps be taken to help the positive checks to do their work. In Malthus' opinion, the **masses were incapable of exercising moral restraint**, which was the only real remedy for the population problem. They were therefore doomed to live always at bare subsistence level. If all income and wealth were distributed among them, it would be totally wasted within one generation because of profligate behavior and population growth, and they would be as poor and destitute as ever. **Paternalistic attempts to help the poor were therefore highly likely to fail**. Also, they were a positive evil because they drained wealth and income from the higher (and therefore more moral) ranks of society. These people were responsible - either in person or through patronage - for all the great achievements of society: art, music, philosophy, literature and so on owed their existence to the good taste and generosity of these people. Taking money from them to help the poor would deprive the world of culture. The projected population increase was expected to lead to a glut in the supply of labor and hence a fall in the price paid to that labor. At the same time, the growing demand for food and other provisions would surely raise the cost of survival. Malthus expected that forces such as war, pestilence, famine and plague would operate as checks on a swelling population.

Questions - Answer Journal Left Side

1. Explain the following Adam Smith

Concepts Capitalism
Self Interest
Laissez-Faire
Division of
Labor Markets
Invisible Hand (prices)

2. Explain the following Karl Marx

Concepts: Class Struggle:
Historical / Dialectical
Materialism: Substructure and
Superstructure: Labor Theory:

3. Explain the following David Ricardo

Concepts Iron law of wages
Escalator (metaphor)

4. Explain the following Thomas Malthus

Concepts Population: (Dismal Science)
View of helping the poor

Research 3 other economists from history and in 5 sentences each explain their major contributions to the field