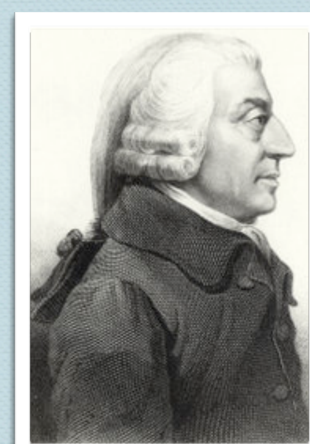
History of Economic Thought

Classical Economics

Classical economics refers to the school of economic thought that arose in Great Britain in the latter part of the eighteenth century. In the year 1776, David Hume died while Jacques Turgot and Marquis de Condorcet left their government posts. In that same year, though, the intellectual revolution they had contributed to, the Enlightenment, began to bear its principal fruit. It was a year of grand treatises. Adam Smith published his Wealth of Nations, the Abbé de Condillac his Commerce et le Gouvernement, Jeremy Bentham his Fragments on Government, and Tom Paine his Common Sense.
Essentially this approach places total reliance on markets, and anything that prevent markets clearing properly should be done away with. The earlier belief that agriculture was the chief determinant of economic health was also rejected in favor of the development of manufacturing, and the importance of labor productivity was stressed. The theories put forward by the classical economists still influence economics to this day. The classical economists strongly believed that the government should not intervene to try to correct this as it would only make things worse and so the only way to encourage growth was to allow free trade and free markets. Much of Adam Smith's early work was on this theme, and he introduced the notion of an "invisible hand" that guided economic activity and led to the optimum equilibrium.

Classical economics is widely regarded as the first modern school of economic thought. The term "classical" refers to work done by a group of economists in the eighteenth and nineteenth centuries. Its major developers include Adam Smith, David Ricardo, Thomas Malthus and John Stuart Mill. Much of their work was developing theories about the way markets and market economies work. Coming at a time when Mercantilism held sway, emphasizing the maximizing of exports and minimizing imports, classical economists promoted a radically different approach. They essentially regarded the economy as able to maintain its own equilibrium through market forces, and that government intervention in the form of artificial tariffs or other barriers that disrupted the free flow of goods and services were harmful to the economy.
Classical economics was a major intellectual achievement. While new techniques of analysis were required to address new questions, giving rise to the mathematical formulations of the neoclassicals and others, and advances in technology and changes in social awareness appear to have transformed the economic landscape, economic theory today still rests in many areas, monetary and trade theory to name but two, upon the foundations laid by classical economists.



Adam Smith (1723-1790)

was a Scottish political economist, lecturer, and essayist. His An Inquiry in to the Cause of the Wealth of Nations (1776) represents a highly critical commentary on mercantilism, the prevailing economic system of Smith's day. Mercantilism emphasized the maximizing of exports and the minimizing of imports. In Wealth of Nations Smith argued that everyone benefits from the removal of tariffs and other barriers to trade. Because of supply and demand, production will increase as demand increases. This may lead to new employment opportunities for the workforce and to collateral industries emerging in response to new demands. For example, an increase in France's wine production would also lead to an increased demand for bottles, for barrels, for cork, and an increase in shipping, thus leading to a variety of new employment opportunities.
Adam Smith was convinced that the free market would stimulate development, improve living conditions, reduce social strife, and create an atmosphere that was conducive to peace and human cooperation. In his view, a balance had to exist between self interest and sympathy, with sympathy being the guiding moral imperative. Competition would emerge and serve as a check to profiteering and unfair pricing. Smith made compelling arguments for the free market and his economic and moral writings remain relevant today. Wealth of Nations serves as one of the most elegant explanations for the rapid economic growth experienced by the United States and other industrial powers in the nineteenth and twentieth centuries.

Thomas Robert Malthus (1766-1834)

believed in strict government abstention from social ills. In his work, An Essay on the Principle of Population (1798), he argued that intervention was impossible because of two factors. "Food is necessary to the existence of man," wrote Malthus. "The passion between the sexes is necessary and will remain nearly in its present state," he added, meaning that the "power of the population is infinitely greater than the power in the Earth to produce subsistence for man." Nevertheless growth in population is checked by "misery and vice." Any increase in wages for the masses would cause only a temporary growth in population, which given the constraints in the supply of the Earth's produce would lead to misery, vice and a corresponding readjustment to the original population. However more labor could mean more economic growth, either one of which was able to be produced by an accumulation of capital. Malthus devoted the last chapter of his Principles of Political Economy (1820) to rebutting Say's law, and argued that the economy could stagnate with a lack of "effectual demand." In other words, wages less than the total costs of production cannot purchase the total output of industry and this would cause prices to fall. Price falls cause incentives to invest, and the spiral could continue indefinitely.

David Ricardo (1772-1823)

was born in London, and by the age of 26 had become a wealthy stock market trader. He bought himself a constituency seat in Ireland to gain a platform in the House of Commons in the Parliament of the United Kingdom. Ricardo's best known work is his Principles of Political Economy and Taxation (1817, 1821), which contains his critique of barriers to international trade.
Economics for Ricardo was all about the relationship between the three "factors of production" - land, labor, and capital. He demonstrated mathematically that the gains from trade would outweigh the perceived advantages of protectionist policy. His theory of comparative advantage suggested that even if one country is inferior at producing all of its goods than another, it may still benefit from opening its borders since the inflow of goods produced more cheaply than at home produces a gain for domestic consumers. For example, in two days an average worker in England produces a bushel of wheat and in one day a yard of cloth, while the average French worker can do either in just a day. If England exchanges the wheat it produces (one day's production) for French cloth (while English cloth takes two days) then both sides can strike a bargain between the margin that is mutually beneficial. England by selling its wheat can get its cloth in a day, rather than two days, and France can get an extra bushel of wheat for selling its more efficiently produced cloth. This would lead to a shift in prices so that eventually England would be producing the goods in which its comparative advantages were the highest. His thinking was instrumental in the repeal of the Corn Laws.

Classical theories revolved mainly around the role of markets in the economy. If markets worked freely and nothing prevented their rapid clearing then the economy would prosper. Any imperfections in the market that prevented this process should be dealt with by government. On the other hand, government interventions that inhibit the free flow of goods and services are detrimental. The main roles of government are therefore to ensure the free workings of markets using "supply-side policies" and to ensure a balanced budget.

Free market theory

Classical economists assumed that if the economy was left to itself, then it would tend to full employment equilibrium. This would happen if the labor market worked properly. If there was any unemployment, then the following would happen:

Scale effect

As the wage rate rises, the scale effect involves the following chain of effects:
- *higher wages result in higher average and marginal costs of production,*
- *higher average and marginal average costs result in an increase in the equilibrium price of the product,*
- *as the price of the product rises, the equilibrium quantity of the product demanded declines (a reduction in the "scale" of production), and*
- *the reduction in output results in a reduction in the quantity of all inputs used to produce this product (including this category of labor).*

Hence, classical economists were of the view that the economy is self-adjusting. In fact, in their view, because the economy tends to full-employment, there is no need for government to actively intervene. In fact, intervention may simply be destabilizing and inflationary. The key to long-term stable economic growth is therefore to:
- *ensure free markets with no imperfections (through supply-side policies); and*
- *control the growth of the money supply to ensure low inflation.*

Supply-side policies as we have said are ones that reduce market imperfections. They may include:
- *Improving education and training to make the work-force more occupationally mobile,*
- *reducing the level of benefits to increase the incentive for people to work,*
- *reducing taxation to encourage enterprise and encourage hard work,*
- *policies to make people more geographically mobile (ending rent controls, simplifying house buying, and so forth),*
- *reducing the power of trade unions to allow wages to be more flexible,*
- *removing any capital controls, and*
- *removing unnecessary regulations.*

Say's Law

Jean-Baptiste Say was adamant in his opposition to government intervention into the economy. Most succinctly stated, he declared that self-interest and the search for profits will push entrepreneurs toward satisfying consumer demand: "the nature of the products is always regulated by the wants of society," therefore "legislative interference is superfluous altogether" .
It was in his Treatise that Say outlined his famous law: Say's Law claims that total demand in an economy cannot exceed or fall below total supply in that economy or, as James Mill restated it, "production of commodities creates, and is the one and universal cause which creates a market for the commodities produced." In Say's language, "products are paid for with products" or "a glut can take place only when there are too many means of production applied to one kind of product and not enough to another" . Say argued against claims that business was suffering because people did not have enough money and more money should be printed. Say argued that the power to purchase could be increased only by more production.
It is important to note that Say himself never used many of the later short definitions of Say's Law, including John Maynard Keynes' somewhat inaccurate version, "supply creates its own demand." Say's Law actually developed due to the work of many of his contemporaries and those who came after him. The work of James Mill, David Ricardo, John Stuart Mill, and others developed it into what is sometimes called the "law of markets" which was the framework of macroeconomics from the mid-1800s until the 1930s.

Quantity theory of money

Classical economists ascribe one other important role to the government: to control monetary growth. In this way, as predicted by the Quantity theory of money (QTM), they would be able to maintain low inflation.
The Quantity theory of money states that there is a direct relationship between the quantity of money in an economy and the level of prices of goods and services sold. According to QTM, if the amount of money in an economy doubles, price levels also double, causing inflation (the percentage rate at which the level of prices is rising in an economy). The consumer therefore pays twice as much for the same amount of the good or service.
This idea was first promoted in the seventeenth century by John Locke and David Hume. The original proposition was to refute Mercantilism's equation of money with wealth, and based on shrewd observation of the impact of the influx of precious metals from the New World. With the advent of fiat money (bank notes and other non-metallic forms) the possibility of hoarding money as wealth, which reduced the quantity effect, was lost. John Stuart Mill noted this in his development of the QTM, making clear that the medium-of-exchange function of money is essential to the effect. His work also laid the foundation for this theory to play a significant role in twentieth century economics, long after new theories of economics had replaced the classical tradition.

The rationality principle

Ricardian notions such as comparative advantage in international trade rest on the idea that people are rational (Ricardo, 1951). In other words, it is implied that traders produce goods that they can trade, and they sell to those who offer the highest price:
If one of the wine sellers were offering only four quarts for a bushel, the owner of the wheat will not give it to this wine seller if he knows that another will give him six or eight quarts for the same bushel
This type of thinking is neatly illustrated by the saga of the British Corn Laws, import tariffs designed to protect British corn against competition from cheaper foreign imports, and their eventual repealing thirty years later. The Corn Laws were adopted by the Tories who represented the landed class and greatly benefited from agricultural protections, and were designed to keep prices high after the Napoleonic Wars. They feared that a drop in prices due to foreign imports would harm them financially. The Whigs, on the other hand, were business owners. Following David Ricardo's economic views they believed a decrease in the price of grain would allow them to lower wages and through that increase their profits.
The Corn Laws had been passed in 1815, setting a fluctuating system of tariffs to stabilize the price of wheat in the domestic market. Ricardo argued that raising tariffs, despite being intended to benefit the incomes of farmers, would merely produce a rise in the prices of rents that went into the pockets of landowners. Furthermore, extra labor would be employed leading to an increase in the cost of wages across the board, and therefore reducing exports and profits coming from overseas business. In 1841, Sir Robert Peel became Conservative Prime Minister and Richard Cobden, a leading free trader, was elected for the first time. With Cobden's support Peel was persuaded to the position of the classical economists, and in 1846, the Corn Laws were repealed.