EVOLUTION OF ECONOMIC DOCTRINES

M. A. Economics First Year

Semester – I, Paper-IV

Director, I/c

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104EC21: EVOLUTION OF ECONOMIC DOCTRINES

1. The Early Period:

Ancient Doctrines: The Old Testament; Greek Philosophers; Plato and Aristotle; Roman Empire and Christianity; Middle Ages; The Doctrine of the Church; Modern Period; Mercantilism; Physiocracy

2. The Classical Period

The Classical School- Adam Smith; Ricardo; Mallthus; Say's Law of Markets; Muller; Socialists; Sismond; Marx.

3. The Later Period:

Founders of Modern Economics: Gossen, Jevons, Menger Walras, other writers: Pareto, Fisher- Basic Doctrines of Marshall.

4. Post Marshall Doctrines:

Pigou, Keynes and Schumpeter; Basic Doctrines; Veblen Institutionalism.

5. The Indian Doctrines:

Ancient to Modern Periods: Kautilya; Vlluvar; Medieval Thought – Nauroji, Ranade, R.C.Dutt; M.N. Roy (Democratic Decentralization); Gandhi: Sarvodaya, Full Employment, Khadi and Village Industries, Cooperation.

<u>Books Recommended:</u>

1. Back House, R.(1985), A History of Modern Economic Analysis, Basil Blackwell, Oxford.
2. Blaug.M.(1978),Economic Theory in Retrospect, Cambridge University Press, Cambridge.
3. Dasgupta, A.K.(1985), Epochs of Economic Theory, Oxford university Press Delhi.
4. Ekelund, R.B. and R. Herbett (1983), A Hisotry Economic Theory and Method. Mc Graw Hill, London.
5. Gide, Cand G. Rst(1956)m, A History of Economics Doctrines George G,. Harrap and Co., London.
6. Hajela, T.N.(1980), History of Economic Thought Shivalal Agarwala and Co., Agra
7. Gray, A(1978), Development of Economic Doctrine, Longman Group, London
8. Rima, I.H.(1979)Development of Economic Analysis, Richard D Irvin, Homewood.
9. Roll E. (1973) A History of Economic Thought, Fabre, London.
10. Babatosh Datta, Indian Economic Though, Twentieth Century Perspectives, 199-50
11. Gandhi, K.K. (1938), Economics of village industries, , Navivan Publishing House Ahmedabad.
12. Gandhi, K.K. (1974) India of My Dreams, Navjivan Publishing House Ahmedabad.
13. Ganguli, B.N. (1977, Indian Economic thought a nineteenth century perspective, Tata, MacGraw- Hill, New Delhi.
14. Gupta, J.N.ed.,(1971), R.C.Dutt-Life and works, London.
15. Kautilya(1951), Arthaqshastra tr. By R. Shayama Sastry, Rernond Priniting Press, Mysore
16. Roy, M.N. (1964), Memoirs, Allied Publisher, Bombay

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LESSON 1/UNIT-1

ANCIENT ECONOMIC DOCTRINES*

1.0. OBJECTIVE OF THE LESSON

In this lesson, it is proposed to provide a detailed account of ancient economic thought. While going into the subject matter, a student is in a position to understand the following concepts well.

1. Meaning of History of Economic Thought
2. Ancient Economic Thought
   A. The Hebrew Economic Thought
   B. The Greek Economic Thought
   C. The Roman Economic Thought

STRUCTURE OF THE LESSON

1.1. MEANING OF ECONOMIC THOUGHT

History of Economic Thought is largely a product of economic ideas and the concurrent environment in a society. Since the time immemorial, men do possess economic ideas as civilization progresses followed by the multiplication of wants. It is the development of the system of 'value and exchange' that necessitated the need for the development of economic ideas. These ideas are culminated into the development of economic theories by the great thinkers, philosophers, economists, physicians, statesmen, and so on and so forth. Therefore the subject deals with the 'origin and development of economic ideas and their interrelations'.

The subject is a chronological arrangement of highly subjective, opinionated and personal economic ideas of great economists. But these ideas are a mixture of politics, economics, religion, ethics, and philosophy. This is particularly upto the 18th century. Depending on their current situation, viewpoints are expressed by the economists. Hence, environment has a greater say in the moulding of economic ideas. In many of the cases these ideas may not be absolute ideas. In exact sciences like physical sciences, physical theories are absolute facts irrespective of time and space. The best example is Newton's laws of motion. However, many of the economic theories of Adam Smith are absolute theories. As such, public policies on different economic issues are suggested at a given time and place. The views or statements expressed at one time and place may not be valid at other times and spaces. However, it is rightly pointed out by Alexander Gray that old doctrines never die, they only fade away to come back again in an appropriate environment. The policy issues taken up by the Great Thinkers include Production, Distribution, Value, Money and Prices, Economic Development, etc. We can find a sea of change between different writers. The subject so developed is studied by the later generations and is interpreted by them as per their current situation and environment. History of economic thought is a systematic compilation of economic ideas of human beings which aim at analyzing some economic problems or explaining the origin and mechanism of some economic institutions. In ancient times, the institution of barter was used to make exchanges and as such the writings of economists were influenced by the economic institution. The same is the case with the institution of slavery. Schumpeter says that Economic Thought is "the sum total of all the opinions and desires concerning economic subjects, especially concerning public policy bearing upon these subjects that any given time and place, float in the public mind". In the words of Prof. Haney, "The subject, the History of Economic Thought, may be defined as a critical account of the development of economic ideas, searching into their origin, interrelations and manifestations". Therefore, history of economic thought is a systematic, chronological and critical study of the economic ideas and sources of such ideas.

It is very important to note that History of Economic Thought is different from Economic History and History of Economics. As we know that History of Economic Thought is about the development of economic ideas, whereas Economic History deals with industrial development of a country during a past period. Nevertheless, there is a close correlation between the two subjects as the development of economic ideas is intertwined with the then economic institutions or the environment. For example, the institution of slavery at that time influenced the writings of many Greek Philosophers like Plato and Aristotle. Also Karl Marx's ideas were influenced by the development of 'class struggle' in the advent of Industrial revolution during the early 19th century. On the other hand, History of Economics provides an account of economic analysis. As we know that the subject matter of Economics is an exact science like physical sciences, since it is presented as a systematized knowledge. The development of this subject was started from the 18th century. Though Economics started its paradigm in 1776 with Wealth of Nations of Adam Smith, the subject came to me known as 'science' since Marginalist Revolution of led by Alfred Marshall. That was the time when Economics could be freed from the shackles of politics and religion and given the status of science. The best examples of this mixture of politics, religion, ethics, and philosophy in Economics are Plato's 'Republic', Aristotle's 'Politics' and Kautilya's 'Arthasastra'. Hence, History of Economic Thought is quite older in terms of its existence compared to History of Economics. Therefore, the three subjects, History of Economic Thought, Economic History and History of Economics are separate branches of study, though there are definite interrelationships between them.

The scope of History of Economic Thought is very broad since it is a record of economic thinking of different thinkers from the ancient times to the present day. It is explained that the subject is a compilation of economic ideas of the contemporary economic situations. Economists can be said possess a knowledge of any doctrine, or to understand it, until one knows something of its history (Gide & Rist). Therefore, History of Economic Thought provides a basis for the study of economic analysis.

1.2. NATURE OF ANCIENT ECONOMIC THOUGHT

The Ancient Economic Thought, as the present topic aims to explain, is mostly haphazard and scattered lying here and there in an unorganized manner. Most of the ancient economic ideas is a mixture of philosophy and ethics particularly by the great ancient thinkers like Plato and Aristotle. Hence, the opinions expressed by the thinkers lack scientific analysis and clear division between economics and other subjects. In the words of Alexander Gray, “there was more speculation about morals than economic life. Ancient philosophy in its social aspects was simple, the political, economic and ethical values being little differentiated and under the circumstances, the whole was pervaded by a moral tone”.

The developments of Ancient Economic Thought can be studied under the following divisions:

1. Hebrew Economic Thought (2500 B.C – 150 B.C.)
2. Greek Economic Thought (427 BC -322 BC)
3. Roman Economic Thought
4. Medieval Economic Thought

In this lesson, we discuss the first three divisions and the 4th one will be taken up in the next lesson.

1.3. THE HEBREW ECONOMIC THOUGHT (2500 BC – 150 BC)

The Hebrew Economic ideas are enshrined in the Old Testament. Going into the details, the Hebrew civilization dates back to 2500 B.C. and it is one of the ancient civilizations in the world. It is said that the seeds of western civilization are sown in the Hebrew civilization of biblical times. Their ideas are based on metaphysical and ethical ideas that are beyond the purview of economics. For the economic ideas, the writings of Hebrew Prophets and their code of conduct as laid in Old Testament are the source.

1.3.1. FEATURES OF THE PERIOD

A simple society guided by the Code of Conduct is an important feature of the period.. The ideas prevailing in the society are a mixture of economics, politics, ethics, religion and philosophy. But religion dominated the scene. The priests had a greater say in the society and their conduct was not conducive for economic development. In those days, human wants are simple and limited that didn’t demand cumbersome process as is evident in the modern times. The property was owned by the community and the means of exchange was barter. Food, clothing and shelter are the corpus of wants to stimulate economic effort. As a result, economic effort was at low ebb. Life was governed by customs and traditional rather than pecuniary motives. Economic order was more or less static. The performance of religious rituals occupied the major portion of the leisure activity of the people.

During the Hebrew period, agriculture was given the most important place in the society as it was the primary occupation and industry was relegated to background. In Agriculture, traditional methods of production were employed. There was indifference towards wealth and a great degree of passivity and fatalism used to exist. All this made industrial revolution impossibility. There were two classes in the society – privileged and underprivileged. Slavery also existed at that time. It was sanctioned by the Moasaic Law. At the same time, there was dignity of labour. Land was the main form of property. The family system was patriarchal in nature. The society was based on the concept of justice. Corruption was punishable and honesty was rewarded. Speculative activities were discouraged. Money came into vogue and transacted in the form of bullion. Trade and commerce were not developed. Women in the society were experts in weaving and spinning. No tax system existed. There was poor relief. The services of labourers were used to be commissioned by the King for public works.

1.3.2. SPECIFIC ECONOMIC IDEAS of HEBREWS

The economic ideas of Hebrew Prophets were used to express in commands and laws. They used to possess specific economic ideas regarding interest (Usury), agriculture, monopoly, property rights, taxation, etc. They are explained hereunder.

i. USURY (Interest)

The Hebrew Prophets condemned anything accepted in return was more in value than what was given to the borrower because it was the act of usury. No place for interest in the Hebrew literature. It was considered unethical to charge usury. The Mosaic Law prohibited "Usury of money, Usury of Victuals, Usury of anything that is lent upon usury". This law was applied to only fellow Hebrews. For others, it was allowed. The Hebrews were asked to show mercy to the loans given to the poor because they used to raise loans for consumption purposes. The rule of 'no usury' was relaxed in times of the King Solomon when charging of interest at low rates was allowed. It is to be noted that in regard to usury, the ideas of Hebrews were more or less to those expressed by the Hindu ancient thinkers.

ii. COMMERCE AND JUST PRICE

The Hebrew Prophets exercised great care in designing laws against false and weights and measures and adulteration of consumption items. The rules for curbing monopoly and speculation activity were used to be very strict. There were no middlemen in the commercial activity. Essential foods items were forbidden to be exported. Hoarding was prohibited in times of scarcity and famine. Also , there was a ceiling on the margin of profit in case of retailers. These measures were used to safeguard the interests of the poor. In all, Hebrews developed the concept of 'just price' in its primitive form.

iii. LABOUR

The Hebrew Prophets recognized 'the dignity of labour', but place of pride was given to agricultural labour. This is because agriculture was the main occupation of the people. Payments to labour were made in kind. There were no laws governing the relations between labourers and employers. However, they devised some laws to protect the interests of labourers.

iv. AGRICULTURE AND INDUSTRY

Agriculture was held in high esteem in the Hebrew society. Trade was looked down. According to the Hebrew ideology, "He that tilleth the soil shall have plenty of bread". In the Jewish Encyclopedia, agriculture was the basis of the national life of the Israelites, state and Church, both being founded upon it. The

Jews held the mercantile community in utter disregard. The Hebrews also did not encourage the manufacturing of goods and commerce to any considerable extent.

v. THE SEVENTH YEAR

The Seventh or Sabbatical Year was observed by the Hebrews after tilling the land for six consecutive years by leaving their land fallow in the seventh year in order to conserve its fertility. The Hebrews used to extend the institution of the seventh year to slaves and loans. The slaves of Israelite race, after serving for six years, were freed in the seventh year with their wives. The liberated slaves were provided with food and other goods that would enable them to start out on a life of their own. Also, the seventh year, required that all debts should be cancelled.

vi. THE JUBILEE YEAR

The Jubilee year of the Hebrews was the 50th year. The sale of land was considered to be a 'lease' under this provision, when a land sold to somebody was to revert back to its original owner in the 50th year. Land was the main form of wealth in those days. By this measure, the concentration of wealth in a few hands was averted. With the institution of the Seventh and Jubilee years, the lawgiver desired to prevent inequality in wealth, to preserve family and tribal property, and to keep his people attached to their country. Therefore, the law giver tried to prevent the permanent alienation of land from the original possessor.

vii. MONEY

The Hebrews recognized money and its use. Money and its different forms were referred by the Old Testament. The payments during the period were made in the form of bullion, ingots, rings, etc. The Hebrews were not used to stamp money. The stamping of money in the form of coins was started during 700 BC.

viii. SABBATH

The Sabbath was referred to as weekly rest, relaxation and good living. It was biblical social legislation at that time. The weekly holiday was enjoyed by everybody in the society, namely, master of a house, family members, maid servants, slaves, etc. The institution of weekly rest was a social invention and there was no parallel in the civilizations of Greeks, Romans or other ancient cultures.

The other features include the following viewpoints. The organization of society was tribal in nature. They were in the initial stages of civilization. The se everyday life of the people was minutely regulated by the Code of Conduct and rules designed by the priests of the day. There was lack of individualism and materialism combined with ethico-religious ideology that made little scope for industrial development. There was the fixity of ideas. The general aim of social regulation was to maintain the social equilibrium. Hence static ideals dominated. During the period, the seeds of 'socialism' were sown with the efforts of Moses who tried to prevent inequality of wealth. In the Bible, there were provisions to protect the poor from the exploitation and permanent debt. The prophets were used to attack injustice and exploitation of the poor by the rich community.

Finally, to conclude in the words of Eric Roll, "the views of Hebrews Prophets, set in the ethical and metaphysical system of patriarchal society may appear extremely primitive to a modern economist; but their power to influence men's minds is not necessarily inferior to that of many a refined and scientific theory; indeed it is often greater. The system of philosophy, of which such isolated economic statements formed part, continues to live".

1.4. THE GREEK ECONOMIC THOUGHT (427-322 BC)

The Greek Philosophy centered around city-state. Much of the productive work was done by the slaves and resident foreigners. There was high degree of division of labour. Money was also in use. The society is divided into different classes and ruled by the landed gentry. There was democracy in the city-states, but the real power was in the hands of land owners and a hereditary ruling class.

The Greeks were the first to develop economic theory, but it was made subservient to ethics. religion and politics. There was no line of demarcation between politics and religion. The religion was developed under the patronage of city-state. The relationship between economics and ethics can be better understood by referring to the viewpoint of Alexander Gray. According him, "Economics was not merely attendant and handmaid of ethics; she was crushed and blotted out by her more prosperous and pampered sister, and later excavators, in search of the origins of economic theory, can only dig out disconnected fragments and mangled remains". The Greeks were interested in things like 'good life', 'the just state' and the 'happy man'. The word 'economics' is of Greek origin and literally means "**management of the household**". As per the Greek ideology, economics refers to two things. Firstly, it is the science of 'home management' and secondly, it is an art of 'wealth getting' and 'wealth spending'. The Greeks called the home management as **'Oeconomicus'** and the second purpose as '**Chrematistics'.** The Greeks mixed economic reasoning with the management of the state and society. Under the Greek thinkers, the credit for paying some attention to the economic aspects of social organization goes to Plato. Although he regarded economics no more than a branch of ethics and politics, Plato attempted to offer a systematic exposition of principles of society and of the origin of city-state, as well as a plan for the ideal social structure. The Greek philosopher, who really laid the foundation of economics as a science, was Aristotle.

The Greek economic e Greek economic thought was developed mainly by three thinkers: Plato, Aristotle and Xenophon.

1.4.1. PLATO (427-347 BC)

Plato was born in Athens and he was an aristocrat. He was the disciple of Socrates. In his times, there was too much commercialism and a new commercial class was coming up to power. He led a spiritual revolt against the excess of commercialism. His economic teachings are incidental to the theories of politics and ethics at that time. His important works are "Republic" and "The Laws". These works are the sources of his economic thought. As explained in the earlier para, Plato was the first person to offer a systematic explanation of the principles of society and the origin of city-state. He gave a plan for the ideal social structure. All these views are found in the above two works.

i.ORIGIN OF THE CITY-STATE AND DIVISION OF LABOUR

According to Plato, the origin of city-state was found in the economic considerations of the people. To him, "a state arises out of the needs of mankind, no one is self-sufficing, but all of us have many wants". He based his theory on the fact that everybody has wants and he cannot satisfy all his wants by himself, because his wants are complementary. Hence, a person produces a particular good and exchanges it for another, so that he could satisfy all his wants. Taking into account these wants of the people, Plato arrives at a conclusion, that the city arises because of division of labour. The division of labour is caused due to the differences in nature and aptitude of human beings. There are "diversities of natures among us which are adapted to different occupations". As a result of division of labour all things are produced plentifully and easily, and of a better quality. One man takes up one thing which is natural to him and at the right time leaving other things to some other person. The origin of 'Say's Law of Markets' can be found remotely in this explanation. Adam Smith had borrowed the concept of division of labour from Plato. Of course, there are difference in the content between Adam Smith and Plato.

Ii.THE IDEAL STATE AND COMMUNISM

Plato's ideal state is a city-state with a fixed population of 5040. Such a state can be easily administered by the rulers. Not only population constant, but also wealth must be more or less stationary. The ruler is also an ideal person and free from all motives of exploitation and must stand to the rigorous tests of conduct.

In the society, there are two classes –rulers and the ruled. The rulers are guardians and auxiliaries. The ruled class consists of artisans. The rulers are the members of a ruling class. The members will be isolated from their very childhood and they are given rigorous training in the art of warfare, governance, philosophy, etc. At the age of thirty, the skills of the members will be tested and if they pass the test, they will be rewarded to rule the state. These members will be called philosopher kings. Those who fail in the test will be recruited in the army as soldiers. These are called Auxiliaries. On the other hand, artisans are engaged in menial occupations of production and exchange of wealth and they will not have the ability to run the state.

In Plato's writings, there was a reference to communism, of course not in the strict sense of the term. He believed in the rule by the elite class. He suggested that this elite group must lead a communistic way of life. They must lead a spartan life. They should not acquire wealth in the form of houses, lands, or in any other form of property beyond what is needed. If they acquire disproportionate wealth, they will lose the status of guardians and they become housekeepers and husbandmen. Therefore, upper classes shall not have any private property and family. They live together and share common meal along with soldiers and they even share women. Therefore, there is communism in respect of goods and women. This communism is prescribed only to the guardian class only, who are to live in a semi-military life. (Alexander Gray). Therefore, Plato suggested communism only to the upper classes in the society. But, Plato's Constitution does not exclude private property excepting the guardians. Even though Plato referred the concept of Communism in his writings, one cannot label him as communist or socialist or a forerunner of present day communism or socialism.

iii. MONEY, INTEREST AND TRADE

Plato's views on the nature of money were not specific. But he recognized the use of money as a 'medium of exchange'. Plato did not favour the idea of allowing gold and silver to be possessed by the common man. Instead, he suggested the use of domestic coins for payment of wages and other transactions by the common man. Also, he suggested that state should have a common 'Hellenic currency' to be used by the ambassadors, travelers, visitors, etc. Thus, citizens are not permitted to accumulate wealth in the form of full bodied money. Also, it is very important to remember that Plato was the first exponent of fundamental theory of money which says that ‘value of money is independent of material used in a coin-money’. Plato considered value as a inherent quality of the product, though his views were not specific. According to him, a man should not attempt to raise the price, but simply ask its ‘value’.

Regarding interest, Plato was against collecting interest on loans. Plato thought that neither interest should be given nor principal nor loan repaid. A ceiling was imposed on the amount of permissible wealth only to reduce inequalities in the society. There is no incentive for the accumulation of wealth. Thus, there was no place for interest in the Greek economic thinking.

Now coming to the trade, Plato suggested that trade should be handled by the resident foreigners only. The citizens are forbidden to take up trade and crafts. On the other hand, these resident foreigners, being emigrants from a foreign nation, are not allowed to own land and houses in the city-state. In the trade, only those goods which are not needed by the citizens are allowed to be exported. Only, necessities are permitted to be imported. The retail trade is not permitted.

Iv.INHERITANCE AND POPULATON

Plato’s views on inheritance and population are quite interesting. Regarding inheritance, in his ideal state each man was to be given an inalienable plot of land with the right to choose a single heir, either by birth or adoption. Plato believed in the predominance of the interests of the state and hence Plato was not in favour free disposal or transference of property. Therefore, the right to inheritance was limited in the Greek society.

Regarding population, Plato felt that his ideal state should consist of limited number of citizens numbering to 5040. Population remains stationary in the ideal state. This means that there was a strict regulation of population in the ideal state. The state was to encourage population through prizes and other incentives when the number fell short of the benchmark of 5040. On the other hand, when the number exceeded the standard norm, the additional population would be sent to new colonies to be set up separately.

The other views of Plato are explained in the following lines. Plato favoured agriculture sector like the Hebrew economic thought. Plato decried riches as well as poverty. To him, riches made a man indolent and careless, while poverty led to inefficiency. Plato did not question the institution of slavery as they formed one third of the population and performed most of the economic activities. He was a sympathizer of aristocrats. His political ideas are authoritarian in nature. But he was a lover of peace and against fascism. Though his ideal state was an utopia, many thinkers of 19^{th} century had inspired from his writings. Lastly Plato made an important contribution to economic science.

1.4.2. ARISTOTLE (384-322 B.C.)

Aristotle was born at Stagira and a pupil of Plato. He was a thinker of extra.ordinary power and there were no parallels to him to this day. Aristotle was a tutor of Alexander, the Great. His thinking was not in line with his teacher, Plato. He differed with him in respect of his ideal state, communal versus private property, etc. Aristotle was not an aristocrat unlike his teacher Plato that made all the difference between the two. He was the first analytical economist in the ancient economic thought. His economic ideas are available in his famous books, **"Politics"** and **"Ethics".** Let us go into the details.

i.ORIGIN OF STATE

Unlike Plato, Aristotle explained that the origin of state was to be interpreted not in terms of economic needs and their satisfaction, but in terms of the natural instinct of man to associate himself with his fellow beings. This is because man is a social animal and the state is a creation of nature. According to Aristotle, there were three stages in the development of a state. Firstly, people organized themselves in a household which is an association naturally formed for the supply of wants. Secondly, the village grew out of the number of households formed. Thirdly, a state came into existence out of the number of villages formed. The goal of the state was full independence of the state in all respects. Under Aristotle, a state was a product of natural growth, whereas Plato explained exaggerated idealism.

Ii.CRITICISM OF PLATO'S COMMUNISM

As we know that Plato advocated communism in respect of upper classes or rulers in the state. But Aristotle didn't fall in line with Plato regarding communism with respect to property and wives and children. Therefore, Aristotle made a frontal attack on the communism of Plato. His attack was based on 'incentive argument'. According to him, that common ownership of property doesn't provide incentive to economic development.

When a person has a feeling of ownership of a property, it provides immense satisfaction to him which results in accumulation of wealth. In fact, having a ownership title is drawn from his natural instinct. Therefore, any attempt to nationalize a piece of property results resistance from the people because such an act will take away their fruits of labour. Considering these points, Aristotle found out a new course of action for the maximization of wealth. While he was not subscribing to extreme individualism of the Greeks, he was, in fact, modified Plato's communism by advocating private property with a common use of it. So, more and more goods will be produced under the common use without affecting private property rights. In the words of Aristotle, "It is clearly better that property should be private, but the use of it common, and the special business of the legislator is to create in men this benevolent disposition". Thus, a modified version of communism is found in Aristotle's book 'Politics'.

Iii. ABOUT PRIVATE PROPERTY

Aristotle says that communal property will not be looked after well as carefully as private property. Aristotle also says that private property is superior to communal property on five grounds: (a) Progress, (b) Peace, (3) Pleasure, (4) Practice, and (5) Philanthropy. Firstly, progress points that private property is more productive than communal property. No adequate care will be taken by the people when a property is commonly owned. In the words of Aristotle, "property should be in a certain sense common, but as a general rule, private; for when everyone has a distinct interest, men will not complain one another, and they will make more progress because everyone will be attending to his own business".

Secondly, peace in the society will be affected badly. Under communal property, quarrels are bound arise particularly in respect of the slogan, "equal pay for equal work". This means that under collective ownership of property, some people perform more and better work receiving small remunerations and there are some who perform less and low quality work getting higher wages. Hence, peace is affected thereby productivity. Thirdly, private ownership gives immense pleasure and satisfaction to a person who owns it because the person feels that something is mine and nobody would touch it. This is, in fact, an engine of growth. Fourthly, since good olden days, private ownership of property was adjudged as the best practice. On the other hand, practicability of communal property did not stand to the tests of time. Therefore, common ownership of property is not a workable solution. Lastly, the private ownership of property facilitates moral goodness among the people. In fact, it promotes philanthropy. A person keeps a part of his wealth for himself and something to be used for common purpose or at least used among his friends. Therefore, private property is supreme to the communal property.

iv. CLASS DISTINCTION

Just as in the case of Plato, Aristotle also explained the existence of two classes – rulers and ruled. The rulers are military class, statesmen, magistrates, and the priests. Depending on their age, they perform different tasks of the state. For example, if rulers are young and energetic, they will work as soldiers. When they are in their prime age, they will act as magistrates and when they are at their senior ages, they will act as priests. On the other hand, the ruled class consists of farmers, craftsmen and the labourers.

v. SLAVERY

Slavery was a salient features of Greeks. Hence, Aristotle was also in line with Plato regarding views on slavery. Aristotle justified slavery by saying that some people were slaves by nature. But in his times, there were some slaves who were not slaves by nature but they were made slaves under law. Of which, some of them were Greeks. Therefore, Aristotle suggested that Greeks should never enslave Greeks.

vi. SCOPE OF ECONOMICS

While writing about household management, Aristotle tried to develop a theory of economics. The subject matter was divided into **'Oeconomicus'** and **Chrematistics'.** The former concerned with consumption of wealth in the satisfaction of wants and the latter with the art of acquiring wealth either by money making or by exchange. Chrematistics is divided into two branches – natural branch and unnatural branch. The natural form of exchange is merely an extension of the management of the household and meant for the satisfaction of man's natural wants. For example, barter system of exchange is natural branch of chrematistics, whereas trade and money exchange are unnatural branches of chrematistics. The unnatural form of exchange of money aims at monetary gain and hence unnatural. According to him, natural branch should not be included in Economics or household management. There are natural and unnatural uses. For example, when a good is used for consumption, it is a natural use. It refers to satisfaction of natural wants. On the other hand, a good is used for trade or exchange, it is an unnatural use. To Aristotle, exchange is an unnatural way of money making and a man could not reach the point of satiety. All exchanges for monetary gain are categorized as unnatural uses. An important path breaking finding of Aristotle was "value-in-use" and "value-in-exchange".

According to Aristotle, value of a commodity depends upon its utility. Under this theory, the greater the intensity of want of a person, the higher the value and he is willing to pay a higher price. Therefore, theory of value is subjective in nature. Also, Aristotle tried to solve the problem of value from angle of ethics. Under his value theory, Aristotle implicitly referred the 'rule of justice' in pricing of a commodity. He stated that a sort of equivalence between what a people pays and utility receives. In the words of Haney, "an exchange is just when each gets exactly as much as he gives the other; yet this equality does not mean equal costs, but equal wants".

vii. MONEY AND INTEREST

Plato recognized only one function to money, i.e. 'medium of exchange'. On the other hand, Aristotle referred two more functions of money – 'store of value' and 'measure of value'. Store of value refers that one can store up money; whereas measure of value refers that money acts as a unit of account. This means that value of a commodity can be expressed in terms of monetary units. Therefore, according to Aristotle, "money is what money does". Aristotle said, "as the benefits of commerce were more widely extended……….the use of currency was an indispensable device". Regarding value of money, he opined that it varied like other commodities, but had a tendency to remain constant.

Regarding interest, Aristotle also fell in line with his predecessors with respect to condemning interest on loans. In the words of Haney, "A piece of money cannot beget another piece, was the doctrine of Aristotle, and no economic idea of his had more lasting effect. The obvious conclusion was that interest was unjust". According to Aristotle, Payment of interest is unnatural and leads to unnatural accumulation. Hence, it is unjust. In those days of Greeks, money was borrowed by the poor from rich community for consumption purposes for satisfying their wants. Hence, Aristotle thought that levying interest on loans was unjust. But in modern days, money is used for productive purposes. As such, levying interest on loans is justified.

Regarding other ideas, Aristotle condemned Monopoly. Aristotle's ideas on division of labour, inheritance, and population were more or less in line with .Plato. Aristotle preferred agriculture and stock–raising because they were the natural arts. He opposed too much concentration of wealth. Like Plato, Aristotle believed that poverty was the breeding ground of revolution and crime. He wanted to reduce the gap between rich and poor.

Viii. CONCLUDING REMARKS ON ARISTOTLE

Aristotle has made a path breaking analysis of many a subject which includes economics, politics, ethics, philosophy, etc. He made a lasting impression among the economic thinkers of various times. Most of the ideas are valid even today particularly with reference economics. In fact, he laid foundations of science of economics. Also, he was known as the first analytical economist.

For example, he was the first exponent of value-in-use and value-in-exchange. Today, we know that money has the functions like medium of exchange, store of value and unit of account. Such an analysis was given by Aristotle 2000 years ago. That was his thinking spread to future times. The views on private property stand good in the present times. Aristotle's view that property should be private and a part of it may be put to common use is a golden principle to solve the problem of inequalities of wealth. This view has led to the concept of socialism of the present times. This is an important contribution of Aristotle. Another important contribution of Aristotle was evolution of development from agriculture to commerce and trade. This implies gradual growth of an economy in a phased manner, but not in a discrete manner.

Normally, concurrent environment has a strong bearing on any of the thinkers' ideas. For example, Aristotle accepted and justified slavery because it was the order of the day at that time.

On the other side of the coin, there seems to be a contradiction in the analysis of Aristotle. At one side, Aristotle desired to maximize wealth by means of allowing private property and on the other side, he wished to restrict accumulation of wealth via condemning interest payment.

1.4.3. XENOPHON (440-355 B.C.)

He was the third and the last of the Greek thinkers. He wrote several books. His economic ideas are found in '**Economicus',** and '**Ways and Means to increase the Revenues of Athens'**. His views on division of labour can be traced from '**Cyropaedia'.**

Primarily Xenophon was agricultural writer. He declared that, "when husbandry flourishes, all the other arts are in good fettle, but whenever land is compelled to lie waste, the other arts of landsmen and miners alike well nigh perish". His love for agriculture did not deter him to approve manufacturers, and traders for enhancing the revenues of the state of Athens. In addition, he explained that state should build ships for transportation. He considered merchants and ship-owners were considered highly valuable citizens because they brought wealth to the state. He also advocated silver mining for increasing the revenues. For this, he advocated for the organization of 'joint stock companies'. Also, he explained that there were only two factors of production, namely, land and labour. In the words of Xenophon, "agriculture supplies good things in plenty, but she suffers them not to be won without toil". Xenophon was an inventor of 'laws of return'. He held that agriculture was an industry that subject to law of diminishing returns, while silver mining yielded increasing returns. Xenophon marked a definite advance over Plato's idea that division of labour arose from differences in the 'innate abilities' of men. The roots of modern theory of division of labour can be found in Xenophon's idea. Finally, He advocated large population for the prosperity of Athens.

1.5. THE ROMAN EMPIRE AND CHRISTIANITY

The contribution made by the Romans was meager, if not nil. They borrowed their economic ideas from the Greeks. The reason is that most of them are warriors and empire builders.. The great Roman Empire, by the side of which the Greek city state looks a small unit, was incapable of producing great social thinkers. It is not until the decline of imperial splendour that there is some concern with economic questions. Even then, Greek doctrine holds the field. A desire for a return to the more primitive conditions like a high agriculture regard for agriculture, condemning newer forms of money-making, and attack on **'latifundia** ' (meaning large domain/estates) are some of the recurrent elements of Roman economic thought.

The Roman kingdom started with small agricultural communities with very little trade and rigid division of social classes. But with the expansion of the Roman Empire, the problem of impoverishment of farmers was solved. This resulted in larger and more complex social structure. On the negative side, there was economic dislocation and an intensified opposition of interests between poor and rich. Later after consolidating the gains and finances, tensions were eased by reducing the tax burden on the farmers and the gap between poor and rich had been reduced.

The perceptible deviation of Romans from the Greek philosophers was their view on slavery. They started to question whether slavery was a natural phenomenon. They also regarded that slave labour, particularly on larger **latifundia** was less productive than hired labour (Collumella). To them, slave labour is an uneconomic form of labour. After the end of conquests, slave labour was ceased to exist. The whole economic basis of slavery on the land was destroyed. This led to the gradual rise of class of **'freedmen'.** Thus, While the Greek writers justified the institution of slavery, Romans observed that slavery was ceased to exist.

Let us go into the views expressed by some of the Roman philosophers in regard to their economic thinking.

i. CICERO

Basically, Romans were the lovers of agriculture. They preferred cultivation of small plots of land, but not large scale farming. An important Roman philosopher, namely**, Cicero** explained that "of all occupations by which gain is secured, none is better than agriculture, none more profitable, none more delightful, none more becoming to a freeman". He regarded many an occupation as vulgar excepting agricultural occupation. Since he considered occupation of money lenders as vulgar, Cicero regarded money lending as big a crime as murder. Also, vulgar.

ii. SENECA

Seneca believed in the existence of 'natural order'. This is perhaps the source from which the Physiocrats borrowed the concept of natural order. He considered money as the root cause of all evils. He also recognized the importance of utility for the determination of exchange value of a commodity.

Seneca had faith in the division of labour. Also, he had an idea about trade between states and the principle of comparative advantage.

iii. PLINY

Pliny believed in the use of money and its importance in the development of a state. He was in favour of using gold as money. He explained about the superiority of gold as a medium of exchange.

iv. CATO, COLLUMELLA AND VERRO

The other writers include **Cato, Collumella** and **Verro**. Cato explained that agriculture was most important occupation in the Roman State. Collumella was in favour of small scale farming. He also expressed that free labour was more superior in terms of their productivity to slave labour. Use of slave labour in agriculture was the root cause of decline of agriculture. Verro was an 'industrial economist'. He advocated reward and punishment in the process of manufacturing. Also, he preferred 'hired labour' rather than slave labour due to low productivity of the latter. Also, the hired labour should be provided with incentives for the maximization of industrial production.

v. ROMAN LAW

During the peak its power, Romans evolved a body of laws which has had the most profound influence on later legal institutions. This is known as Roman Law. This law led later to the idea of the natural law which had a considerable influence on the evolution of economic thought (Eric Roll). It plays an important role in the history of economic analysis. Under the Law, regarding economic thought, Roman jurists evolved for the regulation of economic relations. The jurists sanctioned almost unlimited rights to private property guaranteed freedom of contract. . The Law made the right to private property as absolute right and also provided a right to dispose it. Under it, there was a freedom of contract. By evolving the law, Romans developed the mechanism of modern commerce.The law provided for the separation of assets of a company from the assets of its owners. The same provision is carried forward to the present day. The Law had also provided definitions of economic concepts like price, money, and purchase and sale. This has provided a starting point for later economic analysis.

We can find a difference between Aristotle's view and the view of Roman law regarding private property. Aristotle's view had strong ethical element restricting the rights of private property, whereas the Roman law upheld unrestricted power of individualism over private property. Therefore, the Roman law becomes the basis for the legal doctrines and institutions of capitalism.

On the other hand, the Roman law did not work well over the evils of Rome's social order. We know the fact that Rome was the birth place of the greatest movement of revolt of antiquity. Christianity caused for the social upheaval by which Jesus as the Messiah became the emancipator of the poor and oppressed. The teachings of Christ are different from the Greek philosophers, Plato and Aristotle. Economic doctrines of the latter derived from their aristocratic opposition to the evils of wealth making, whereas Christ preaches complete change in human relations. Also, Christ preaches universal love and brotherhood which is against slavery. Therefore, there is no place for slavery in Christ's teachings. On the other hand, Plato and Aristotle justified slavery. Finally, Christianity was more revolutionary and at the same it was more Utopian.

. To conclude in the words of Haney, "Though the Romans did not directly develop economic theory, a knowledge of their writings is essential to an understanding of the continuity of the history of economic thought".

1.6. SUMMARY

History of economic thought refers to the origin and development of economic ideas and their interrelationships. The origin of economic ideas is as old as human civilization itself. These ideas are the offspring of the needs of men which arose due to the multiplicity of wants and the need to satisfy them. Therefore, economic ideas have a long history. The economic ideas are expressed by the great thinkers of the ancient times. The great thinkers like Plato and Aristotle expressed several path breaking ideas in terms of economics, politics, philosophy, ethics, etc. Of course, their ideas are a mixture of philosophy, ethics, politics and economics. Hence, an ardent student of economics is required to gather all those scattered economic ideas of the great thinkers and synthesize them into an economic analysis. Hence, a study of history of economic thought is proved to be an important instrument for future scientific development.

The ancient economic thought is classified into three divisions, namely, the Hebrew economic thought, the Greek economic thought and the Roman economic thought. The ancient economic ideas are not only scattered but also haphazard and unorganized. These also lack scientific analysis. A high dose morals and ethics are attached to the thinking. Therefore, it is said that economics is an attendant and handmaid of ethics. Most of the ideas are based on the concurrent environment.

The Hebrew economic thought is mostly ethical and based on metaphysical aspects. The Hebrews preferred agriculture and condemned all other activities. They were against usury. They accepted the institution of slavery. Also, there was a dignity of labour. There was common ownership of property and the means of exchange was barter. There was little economic effort.

Plato and Aristotle were the great thinkers of the Greek times. Aristotle was in fact the torch-bearer of economic thinking for years to come. Aristotle laid the foundation for economics as a scientific analysis. The Greeks stated that economics has two functions, namely, home management; and wealth getting and spending. The two thinkers explained the functions of money. In particular, Aristotle laid the foundation for the theory of value. On the other hand, Plato explained the fundamental theory of money. Both condemned interest payment. Plato preferred communal ownership of property, whereas Aristotle favoured private property. Both preferred agriculture because it was the natural activity. To Plato, the origin of state was the creation of wants of the people. On the other hand, it was a natural phenomenon. Both believed in stationary population. Plato and Aristotle accepted the institution of slavery which was the order the day.

The contribution of the Romans to the history of economic thought was meager, since they were the empire builders. However, the thinkers like

Cicero, Seneca, Pliny, and Verro expressed certain ideas. The most important idea was small scale farming, since agriculture occupation was a preferred occupation. Also, though slave labour was in use, they preferred hired labour for maximization of productivity. The Roman Law was an important contribution of the Romans.

1.7. TECHNICAL TERMS

1. Metaphysical ideas
2. Usury
3. Mosaic Law
4. Just Price
5. Dignity of Labour
6. 7th Year
7. Jubilee Year
8. Sabbath
9. Oeconomicus
10. Chrematistics
11. Republic
12. City-State
13. Division of Labour
14. Communism
15. Medium of Exchange
16. Store of Value
17. Unit of Account

18. Hellenic Currency
19. Politics
20. Ethics
21. Economicus
22. Cyropaedia
23. Elite Class
24. Value-in-use
25. Value-in-Exchange
26. Barter System
27. Money System
28. Joint Stock Company
29. Laws of Return
30. Roman Law
31. Latifundia

1.8. SELF-ASSESSMENT QUESTIONS

1. "Economics is an attendant and handmaid of ethics". Explain.
2. What are the salient features of ancient economic thought? Enumerate the economic ideas of Hebrews.
3. "A state arises out of the needs of mankind, no one is self sufficing, but all of us have many wants". Assess Plato's economic ideas.
4. "No Usury….No Accumulation". Justify your answer with Aristotle's views.

5. “He that tilleth the soil shall have plenty of bread” (Jewish Encyclopedia). Explain the importance of agriculture in the ancient economic thought.
6. “The foundation for scientific analysis of Economics is laid by Aristotle”. Assess.
7. What do you mean by ‘communism’ in the ancient economic thought? Distinguish between the views of Plato and Aristotle
8. Define the term ‘History of Economic Thought’. Compare and Contrast different economic ideas of Hebrews, Greeks, and Romans.

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M.A.ECONOMICS:EVOLUTION OF ECONOMIC DOCTRINES

LESSON 2/UNIT-1

MEDIEVAL ECONOMIC THOUGHT

CONTENTS

M.A.ECONOMICS: EVOLUTION OF ECONOMIC DOCTRINES

LESSON 2/UNIT-1

MEDIEVAL ECONOMIC THOUGHT

2.0. OBJECTIVE OF THE LESSON

In this lesson, it is proposed present a detailed discussion on the history of economic thought during the medieval period from 5th century AD to 15 century AD. A student of History of Economic Thought is going to understand the discussion on (i) Features of the period, and (ii) Contributions made by St.Thomas Aquinas and Nicole Oresme.

STRUCTURE OF THE LESSON

2.1. INTRODUCTION

The Middle Ages or the Medieval Period came to be known as 'Dark Age' as there is no concrete contribution by the thinkers of the time regarding economic thinking. The thinking of the medieval period is dominated by the Greek ideology mostly. There is profound influence of the Church, the Bible and Aristotle on the life and thought of the Middle Ages. Also, there is considerable controversy regarding the period in between which the ideas of thinkers of Medieval Ages prevailed. There is no unanimity over the subject among the historians. Keeping aside the point of controversy, as it is of no use to the student of History of Economic Thought, we can say with some confidence that the medieval period started with the downfall of the Roman Empire. The period from 476 A.D. to 1453 A.D., spreading over 1000 years, is considered as the medieval period. The 1000 year period is coincided with the fall of Rome and the fall of Constantinople into the hands of Turks. So the period between 5th Century AD and 15th century AD is roughly the period of middle ages. The Medieval period ends with the writings of Nicolas Oresme and his student, Gabriel Biel, who is the last medieval thinker, in the latter part of the 15th century. The point here is to remember that the period indicates the length of time during which a certain type of society and ideology existed.

A student of Economics derives immense knowledge of economic thought, while undergoing the study of ideas of the thinkers of the medieval period. The student's curiosity gets aroused because the economic thinking has moved slowly compared to the rapid progress made by the subject during the Greek period. But things have started changing after the 10th Century AD. We can cite here the name of St. Thomas Aquinas. The medieval period can be divided in two periods on the basis of developments in the thinking process. The first period starts from 470 AD to 1200 AD and the rest of the period in between 1200 AD to 1500 AD is the second period. During the former period the 'Christian Theology' which opposed the Roman philosophy, and the customs and traditions of Germany have dominated the early medieval society. During the latter period, the medieval thinking is stabilized reaching a peak stage. The Christian dogmas have started retreat from its original position of rigidities and lost control over the economy. In the second period, as part of the German customs, feudalism dominated the society and Thomas Aquinas is behind the development of 'Scholasticism'. The writings of Thomas Aquinas have played a crucial role in making the thinking of the medieval period to reach the peak level. So the second period has witnessed development of medieval thinking to its fullest form. The Medieval philosophers have expressed their views on money, interest and price which are quite similar to the Greek philosophers in the early period. Compromising attitude on the part of the church out of compulsions of the situation is an important development during the latter period.

2.2. FEATURES OF THE MEDIEVAL PERIOD

For a detailed study of medieval economic thought, it is necessary to go into the features of its society during the early medieval period. The essential features of the early medieval society have their origin in the latter period of the Roman Empire.

2.2.1. COMMUNITY LIFE

During the first stage of development of medieval thought, i.e. up to the end of 1200 AD, economic ideas were moulded on the lines of customs and traditions of German society. Feudal system was prevailing in the society. In this system, society was bonded together by 'village communities' or 'Genossenschaft'. This community was the economic unit with families as the self-reliant sub-units. "In all directions medieval life was communal and cooperative in character". The community was worked on mutual cooperation and services. There was complete freedom of opinion. There was the spirit of brotherhood among the sub-units of the community.

The community was given the right over cultivable land to decide on the cultivation to be taken up by the community members. The community members did not have the individual right over agricultural land.

To explain further, the village communities possess 4 types of properties at their disposal—residential land, estates, cultivable lands, and waste lands. In respect of the first two types of properties, there is individual property right and in the case of cultivable agricultural lands, the community's word is final. It has a right over the agricultural lands. It will decide what to produce, when to produce and what not to be produced. Regarding the waste lands, nobody enjoys the right. They are known as common lands. Therefore, right over property is determined by the type of property considered in question.

2.2.2. CLASS DIVISION – A UNIFYING FORCE

There was a difference between Romans and Germans regarding rights over private property. The Roman law stipulated overwhelming rights over private property to the citizens, whereas Germans made the right transferable between the individuals and the village community. In the early medieval period, Germans had given greater weight age to personal rights and privileges, over the property rights, basing on which rigid class divisions were created. Basing on which status of landed gentry is fixed in the society. These personal rights were determined by the landed property a person holds. It was taken for granted that this division was itself a foundation of society. Inequality of men was an accepted notion. There was no 'atomic individualism'. The activities of every individual were conditioned by his status in the society. Therefore, the class division with its rights and privileges became a unifying force in the medieval period.

2.2.3. ROLE OF THE CHURCH IN UNIFICATION

In this period, the Church, the Bible and Aristotle made an indelible mark on the thinking process of the medieval society. After the fall of the Roman Empire, the Church had become increasingly institutionalized and had added greatly to its spiritual and material power (Eric Roll). At that time, there was no unifying force making it very difficult to visualize a nationalist union. The reason was that feudal lordships were scattered lacking any links of nationalist elements.
. During the period, there was no national cohesion regarding the scattered feudal lordships. The Church had got a doctrinal unity which gave it a universal power. This resulted in complete harmony between the doctrines of Church and feudal society. In these circumstances, the Church was a great unifying force during the medieval period.

The Church tried to regulate the lives of men. It tried to preach people that their present life on earth was only an instrument for eternal salvation. The Church used to dictate terms in the society because of its overwhelming influence. Church became the spiritual and material power. In fact, the Church was the landlord of landlords in the light of its ownership of landed property. With this power in its hand, the Church tried to improve the lives of the citizens. Thus, class divisions and the doctrine of Church are the unifying forces in the medieval society.

2.2.4. TEACHINGS OF CHRISTANITY

Christianity preached (a) universal brotherhood, (b) equality of rights, (c) abolition of slavery,(d) dignity labour, (f) purity of family life, (g) charity to the needy, (h) communal ownership of property, etc. There was a difference between what the Church and Christianity did to the people.

Christianity had a profound influence on the life and thought of medieval period. The new religion appealed to the poor and oppressed. Christianity mainly preached ‘universal brotherhood’ referring to one Father, the God. This principle was struck at the very roots of class divisions in the society in the medieval period. It pleaded that all citizens were equal. So the institution of slavery was broken down as it was considered as sin. Christianity established that slaves have also a place in the Kingdom of Heaven as all men are equal. Hence, slaves were advised to take Christianity as their religion. Therefore, people should try for salvation of the present birth having no place for hatred.

Christianity spelt about property right. Under it, the right to property should be common, i.e. common ownership of property. Citizens should have common rights over goods and other property. The rights and privileges were common to all the citizens. Christianity also recognized dignity of labour. All economic activities were equally dignified. Nothing was superior to any other activity. This is in contrast to the Greek philosophy that labour was to be carried out by slaves and menial workers. But the New Testament advised people to work with their own hands.

Christianity upheld ‘charity’ to the poor and downtrodden which was one of the instruments of eternal salvation. According to the preaching, people should have a ‘sensitive and sorrowful heart’ towards the poor. In those days, it was said that charity should be taken up as a responsibility. Also, purity of family was an important essence of Christianity. It was said that family members should be faithful to each other. Then only family life would be permanent, peaceful and long lasting.

In short, Christianity during medieval period gave greater importance to ‘personal rights and privileges’ of an individual. In course of time, ethical and humanistic tendencies had imposed limits over personal rights and privileges. However, these rights were continued to grow in the period.

Christianity and the German customs moved hand in hand in the medieval period. Both these ideologies expressed their views about rights of citizens emphasizing responsibilities. There was an important reference to this ideology in the period. As we have pointed out earlier, there were two classes – landlords and serfs in the medieval period. In this period, it was recognized that the rights of the serfs were the responsibilities of the landlords. This implies that landlords were supposed to look after the welfare of the serfs. Then the class divisions did not result in conflicts and there was peace and harmony in the state.

During the latter medieval period, the ethical values taught by Christianity had undergone rapid changes. In course of the period, for instance, the masterpiece of the teachings of Christianity, equality was replaced by property rights and personal rights and privileges. The medieval society was drawn back to the Roman times. The other important development is that universal brotherhood was an important teaching of Christianity. In course time, the preaching was compromised by permitting inequalities in wealth. Also, Christianity had given way to the institution of slavery in one form or other in its preaching in the latter part of the medieval period. The institution of slavery had not been removed even until 10th century. The other form of slavery, serfdom, tying the tiller to the land, was happened to be on the scene even up to modern period, i.e. 19th century.

2.2.5. THE CANONISTS

The teachings of Canonists, the preachers, recognized the difference between Aristotle's 'natural economy of household' and the unnatural form of money making. Certain rules were framed the Christian Theology (Canon Law), which are akin to Aristotle for ensuring good administration of economic activities. Hence, material advancements are undermined for the benefit of salvation of mortal life. The Church was sometimes capable of condemning worldly pleasures which increased inequalities and exploitation and sometimes taught indifference towards worldly miseries. The teachings of Gospels and Christian Fathers have overwhelmingly opposed the material pleasures. The Fathers viewed that trade turned men from the search for God. Therefore, the early Christian Fathers strictly opposed worldly goods or material welfare. This phenomenon was common in the early medieval period.

But, there was radical transformation in the ideology of superiority of ethics over economic interests under the Canon law in the latter medieval period particularly so when the economy development was picking up.

2.2.6. FEUDALISM AND SERFDOM

During the initial years of the medieval period, feudalism started with the class division between landlords and 'serfs'. This feature was brought about by the 'latifundia' of Romans. The medieval society witnessed the scarcity of slaves and as such there was a change that had taken place in the administration of large estates. The landlords began to let out their landed property domain to slaves or to 'free tenants' charging a 'rent' in kind and money. Therefore, tenancy system started appearing on the scene. Also, a new form of slavery or a new system of bondage was came into being, in the 4th century, in that the free tenant was tied to the piece of land given on rent. The downfall of Roman Empire converted the landlord and his estate into a new economic and political unit giving more and more administrative powers. This was the forerunner of the medieval manor. The Germans evolved 'manorial system' under which land was seized by the conquerors who in turn gave it to their supporters creating feudal lordships. This created a rigid division of different social classes with different rights and obligations (Eric Roll).

2.2.7. ECONOMIC IDEAS

Economic ideas were part of the moral teachings of Christianity. The medieval society could not give up the ethical quality of its doctrines without losing its spiritual character. Considering the economic conditions of its feudal society, the period witnessed a combination of teachings of Gospels and of early Christian Fathers and those of Aristotle. So there is a mixture of economic ideas and ethical values. This is not a new thing. The medieval society just brought forward the philosophy from Greeks. Thus there was a union between the economic ethic, which had been part of the Christian preaching, and the existing institutions with its imperfections (Eric Roll). In course of time, this union was broken down under the influence of new economic forces.

2.2.7(i). PRIVATE PROPERTY

The views on property were more pronounced with the development of economic situation in the towns and cities. Trade once again gained momentum. There are certain 'schoolmen' who continued to condemn trade. On the other hand, Saint Thomas Aquinas attempted reconciliation between 'theological dogmas' of the Church and conditions of economic life (Eric Roll). But he was against unrestricted rights on property unlike the Roman law. He also opined that it was not the institution of property but the manner of using it determined whether it was good or evil. If somebody uses property, say, land for the benefit of the community, it can be regarded as good and desirable. Or if it is used for one's own benefit of worldly pleasures, it is not appreciated for the salvation of mortal life.

2.2.7(ii).PRODUCTION OF GOODS

Regarding economic thinking in the medieval period, there is almost nothing new in this period. The Greek economic ideas were carried forward and moral values dominated the scene. The Church was interested only in the preaching of the principles of Christianity. Since there was widespread acceptance of moral values in the society, nobody concentrated on luxurious ways of living. So they had given less importance to manufacturing sector. Of course, the society felt that it was not against God to encourage the production of goods. They used to say that material welfare was an obstacle for the salvation of the individual soul. So long as the goods that were produced used for the promotion of welfare of the fellow citizens, the Church permitted such production as an acceptable way of life. But, they considered commerce as an unethical activity. Just as in the case of Greeks, agriculture was considered as the primary economic activity.

2.2.7(iii). NATURAL ECONOMY

Moreover, we have to note that medieval economy was a 'natural economy'. This is because the economy is an agrarian economy. The economy is very close to the nature. Also, whatever we say about the development of trade and industry, there is very little that can be expected of from the two sectors due to scarcity of money and transport facilities. Hence, the economy in the medieval period can rightly be described as natural economy.

2.2.7(iv).TRADE AND COMMERCE

Trade and commerce, though limited in scope, were brought forward into the medieval period from Romans. This was the basis for the development of trade in the medieval Italian cities. In addition, there was large trade developed in the Eastern Empire. A class of merchants was created out of the warrior class. In the medieval period, oriental trade was extended to the Asian countries including India. On the other hand, industrial development was confined to the production of goods for local purposes only. In some cases, a few goods of outstanding importance had also been produced for long distance trade. In the medieval period, industry was also getting into the hands of voluntary associations such as merchant guilds just as in the case of Romans. These are known as friendly associations or monopoly association for the protection of their mutual interests. With the spread of trade and commerce particularly in the 11^{th} and 12^{th} centuries through the new sea routes discovered, industrial development began to appear as new and new markets were found out.

Development picked up in the 11^{th} century. Trade and commerce, handicrafts, use of money for exchange, etc., were developed. Also, the book written by Aristotle, 'Politics,' was translated into Latin language. These developments witnessed the dawn of a new era.

2.2.7(v).OTHER FEATURES

Regarding place of 'value' in medieval society, the thinkers of the period declared that value of a commodity was independent of its price. According to them, the value was determined by demand. In such a situation, exchange takes place only when their values are equal. In the medieval thinking, there is no place for labour theory of value.

The early Fathers also stipulated the principle of 'just price' which was also appreciated by Thomas Aquinas. The principle connotes that whether the exchange of good is just. This means that which is given and that which is received is of equal value. Anything above or below that price is an infringement upon the moral conduct.

In respect of usury, the Church was out- rightly condemned the payment of interest because the amount of interest was over and above what was given as loan. They were therefore, against it. With the development of trade and commerce in the later medieval period, there were increasing opportunities for monetary transactions. As a result, the lending of money on interest began to rise even in the light of the prohibition of the Church.

The concept of 'bimetallism' was the invention of Oresme in that gold and silver were to be used as coin money for transactions.

Thus, the medieval economic ideas are again a mixture of moral values up to the 12^{th} century AD. During the latter part of the medieval period, gradually the Canon Law gives way to dilution of its principles as economic development picks up. As a result, many of the economic institutions of the modern world begin to be accepted as the order of the day.

In the medieval period, the thinking process regarding economic ideology was found prominently in the writings of St.Thomas Aquinas (1225-1274 AD), and Nicole Oresme (1320-1382 AD). Let us go into the details of their writings in the following paragraphs.

2.3. St.THOMAS AQUINAS (1225-1274 AD)

St. Thomas Aquinas was the most renowned 'scholastic philosopher'. He can rightly be called as the prince of scholastics. St. Thomas Aquinas economic ideas were found in his famous book, namely, **'Summa Theologica'.** This book is a complete and **authoritative** work on medieval economic thought. Regarding his education, he carried out his early education in 'Benedictine Monastery' of Monte Casino. He continued his university education in the University of Naples. Later, he went to Paris and Cologne for completing his educational career. He was a disciple of Albert, the Great. He became professor of theology and philosophy. He received his doctoral degree in 1257 AD from Sor Borne University. He wrote many books numbering 60. The ideas of St.Thomas were influenced by the Bible, Canonists and Aristotle. His economic ideas include the institution of private property, usury, and just price. On many an occasion, St.Thomas more or less repeats the views of Aristotle. He had a distinct tendency to reconcile theological dogma with the existing conditions of economic life. Most of his economic ideas are centered on religious and moral issues.

2.3.1. DEFINITION OF SCHOLASTICISM

Scholasticism refers to a system of thought which combines the teachings of the Bible, the Church and the views of Aristotle. It is considered as a happy and ingenuous association. In this blended union, we find only theological teachings and rules of conduct of the Church and their application to the concurrent situation. No one could find something related economic phenomenon. Therefore, St. Thomas Aquinas was a famous scholastic or schoolman of the medieval period. He tried to attempt unification of medieval thinking process with the help of his ideas under the influence of the Bible, the Church and Aristotle.

2.3.2. ON PRIVATE PROPERTY

St. Thomas Aquinas did not uphold the exclusive and unrestricted rights on property as stipulated by Roman law. In this context, he adopted Aristotle's line of thinking. In this context, he mentioned Aristotle's two aspects of property, namely, firstly, the power of acquisition and administration, and secondly, the mode of its use. The former confers rights on the individual and the latter put an obligation upon the individual in the interests of the community. Therefore, he stated that it is not the institution but the manner of using it determined whether it was good or evil. Suppose the property is used by an individual for the benefit of the community, it is considered as good, and if it is used for self, it is an evil. What is that mattered is the conduct on this earth which is to be judged in the light of ultimate salvation. St Thomas believes that the institution of property is in accord with the law of nature. He did not regard that wealth was natural or good in itself because it was subject to inevitability of imperfections of mortal world. Hence, he suggested that wealth should be made as good. This implies that property has to be used for the benefit of fellow citizens. Then such property can be regarded as natural or good. In essence, like Aristotle, St.Thomas Aquinas suggested that "property should be private in possession, but common in use".

While advocating the restriction of rights over property, St. Thomas Aquinas justified theft by the needy. According to him, theft is permissible in the case of extreme necessity. He advocates the giving of alms, but it does not endanger the giver's or his family's status in society. The giver should not be made to live below his status in the society. Therefore, he was well aware of the implications of status in the medieval society, while advocating charity to the needy.

2.3.3. ON TRADE

St. Thomas Aquinas follows the line of thinking of Canonists regarding his views on trade. Following Aristotle, he regards trade as unnatural. But this evil was inevitable due to the imperfections in the world. Therefore, trade could be justified only when it attempted to satisfy the needs of his household and when the object of trade was good of the society. He justified trade if it was done therefore as a service to the public by providing goods. St. Thomas also justified a measure of profit on the grounds of support, charity or public service. The profit received was nothing but the reward for labour.

2.3.4. ON JUST PRICE

There was another justification given by St. Thomas for trade. This was whether the exchange was just. This can be understood with reference to 'just price'. While exchanging goods, their exchange value must be justified. There should be an element of justice in the transaction. No party should be at loss of value. The value of what is given and that of what is received must be the same. This is referred to as 'just price'. It was indirectly referred by Aristotle while explaining the concept of 'exchange value'. Early Christian Fathers also, though they were against trade, stipulated the principle of just price. According to them, that price was objective and inherent in the values of goods in exchange. Any deviation from this objective price was an infringement of moral code of conduct.

This price was determined by the cost of production which includes labour. According to Aristotle, goods containing the same amount of labour and expense should be exchanged. While estimating the cost of labour, the social status of the labourer was to be taken into account. Therefore, in order to estimate the cost of labour, they had fixed rules regarding the standard of living for each status. St.Thomas also has in mind a vague cost of production theory of to exchange value. The cost of production is determined by the principle of justice. So it has an ethical character. The concept of just price connotes value and usefulness of a good. The value thus fixed was not necessarily the price which prevailed in the market. It was just and was to be determined by law. It may be remembered that during the medieval ages there was, therefore, price regulation. This regulated price was the just price.

During the medieval period, the markets in the towns and cities were not adequately integrated and as a result there was no free play of supply was permitted oscillations round the 'just price' according to some market fluctuations. He also justified taking of a higher price where the seller would otherwise likely to incur loss. Also, he held that a seller can lawfully charge higher, "either because he has improved the article in some respect, or because the price of the article has been changed on account of the danger to which he exposes himself in transferring the article from place to place or in causing it to be transferred". Therefore, students are required to understand the distinction between 'just price' and 'market price'.

2.3.5. ON USURY

St.Thomas Aquinas adopted the line of thinking of Aristotle and the Bible regarding usury. The teachings of Christ and Gospels unmistakably condemned the receipt of interest on lending. In the words of Jesus, "lend freely hoping nothing thereby". To them, enriching through lending of money at interest was regarded as the very worst form of the pursuit of gain. The Hebrews had also done the same. With the growth of money economy and with the expanding opportunities for profitable investment of money the concept of usury has underwent gradual change in the thinking process. The development of trade and commerce and opportunities for monetary transactions in the latter medieval period, two tendencies were fast developing, first increasing justification for lending of money on interest, and secondly, the Church became more strict and loud in its general condemnation of taking interest.

St. Thomas Aquinas based his doctrine against usury as much if not more on Aristotle's argument as on Scripture. Aristotle condemned usury because he regarded money as barren. To develop his argument he made use of Roman law. Under the law, goods were of two kinds – consumptibles and non-consumptibles or **'fungibles'.** The former goods are those which are consumed in use and the latter goods are those which are not consumed in use. He and Canonists put money in the first category and concluded that "to demand interest in addition to the return of the loan was to seek an unnatural and unjust gain" (Eric Roll). St. Thomas Aquinas allowed certain exceptions to this rule. St. Thomas opined that under certain circumstances interest could be charged on loans given. Firstly, where a lender was suffering a loss by means of a delay in the repayment, then the lender was entitled to exact a penalty as compensation. The Church opined that there was a bonafide loss on the part of lender due to the genuine delay. The arguments opened the doors to the charging of interest. Secondly, where a person has lost the chance of getting a gain via lending money, there was a justification for receiving interest. Thirdly, if a lender suffered any damage because of having parted with his funds, he could charge interest. Lastly, if there was any risk involved, interest could be charged. Some of the thinkers of the medieval period went so far to say that a merchant who borrowed money might justly be expected to pay 5 percent rate of interest. After the close of the medieval period, the Scholastic doctrine gradually approved of interest on loans.

2.3.6. ON DIVISION OF LABOUR

St.Thomas Aquinas agreed with Aristotle regarding the division of labour. The Schoolmen did not agree with the ignobility of certain forms of labour unlike Greeks. Any type of labour was considered as noble. But the condition is that labour must lead to some kind of service to the citizens. The Schoolmen laid great emphasis on the use of anything, including labour, which is then regarded as natural and desirable. But to Greeks, only agriculture labour was natural and therefore productive.

2.3.7. ON ECONOMIC FUNCTIONS OF THE STATE

The medieval state was likened to a private economy. The office of the state was regarded as private property. This was the case particularly in 12^{th} and 13^{th} centuries. The head of the state received its income from estates under its jurisdiction, properties of resident foreigners, royalty on land sales, rights over purchase of lands, rights of purveyance, properties of diseased persons, national treasures and from the ruler's inherited rights of property. Almost the tax system was absent. The functions of the state included maintenance of population, provision to the poor, the establishment of safe and free roads, of weights and measures, and special coinage. The establishment of an exact and unchanging system of coinage was the most important duty of the ruler. St.Thomas Aquinas opined that by money the king could buy food for his people in times of war. Also, the king had the power to control and regulate the monetary system and to make laws for the prevention of counterfeiting of coins. This power enabled the king to stabilize the prices.

The medieval rulers were mostly inefficient administrators and lacked human touch. Also, the working of the legislative measures taken up was not up to the mark. The administrative machinery used to be highly corruptive.

2.4. NICOLE ORESME (1320—1382 A.D.)

Nicole Oresme, educated in Paris, was one of the great thinkers of later medieval period. He wrote many books of logical and mathematical nature. Nicole Oresme wrote a book on **Traictie de la Premiere Invention des Monnoies** (Treatise on the First Invention of Money) in 1360 in French. In this book, he develops a theory of money which reveals a very different approach to economic problems from Buridan. Already Buridan developed the foundation of money basing on which Nicole Oresme built his treatise on money.

2.4.1. ON MONEY

Nicole Oresme started his book with a detailed account of the origin of money following line of Aristotle. In that, he devoted much attention to the qualities of goods which make them suitable for use as money. For the purpose of using certain goods as money, he observed the use of precious metals. He advocated the use of gold and silver, the precious metals, as money in the form of coins. This is known as bi-metalism'. He was in favour of bimetallism in which the proportion of the market value of the two metals should determine their monetary values. It implies that the value of money is ultimately derived from the value of the money good. Therefore, he was the forerunner of the later monetary theorists.

Nicole Oresme held that the right to coinage should rest with the prince. He also explained that the prince should act as a representative of the community which has greatest prestige and authority. Also, the prince is not or ought not to be the lord of the money in circulation in the country. This is because that money is a legal instrument for exchanging natural Riches among men. Therefore, money really belongs to those who own such natural Riches. Oresme opposed the debasement of coinage basing on the idea regarding the functions of monetary authority. The prince has no authority over tampering wealth of the citizens by effecting changes in the coins. He noted that the rulers at his time restored to debasement of coinage on the large scale. Debasement refers to deliberate reduction in the value of the coins by bringing alterations in terms of weight, content of material, and proportion of coins. He called the policy of debasing coinage as a tyrannical and fraudulent practice and described it as a 'violent theft'. To Oresme, gain from debasement was worse than usury. Debasement is a tax in disguise on the public. It will adversely affect trade and lead to impoverishment. Oresme here anticipated Gresham's Law when gold and silver coins are debased they will be taken to a location where their value is higher. It will reduce the monetary value of the coins in the other location.

The thinking process of Oresme is ahead of his time. In his period, trade is taken for granted. Oresme put emphasis on the problems of merchants at that time. As such he advocated protection of commercial class from the oppressive practices of the price.

2.5. SUMMARY

The medieval period was considered as 'dark age' in terms of development of history of economic thought. Apart from repeating everything from the Greek economic thought, nothing concrete economic thought was developed by the thinkers of the medieval period. Nevertheless, the writings of St. Thomas Aquinas and Nicole Oresme were regarded as significant. In fact, "it a period of 'adjustment and fusion' and a period of transition" because there are divergent philosophies and systems of thought. These include Roman philosophy of individualism and materialism, Christian idealism, Germans democratic individualism, and Aristotle's restricted individualism which were all fused and combined by the schoolmen of the medieval period. This fusion resulted in a systematic body of knowledge governing rights and duties of the classes of men and forms and functions of the government.

The period between 5th and 15th century AD came to be classified as the medieval period. The period was divided into 2 phases -- 5th to 12th century was the first phase and the balance of the period was categorized as the second phase. In the first phase, the Church dominated the scene with its rules of the game. In the second phase, there was a retreat by the Church in dictating the terms and there was a complete deviation from the earlier thought. For example, previously usury was condemned by all the thinkers alike on the lines of Canonists, but in the later period, it was justified with the development of trade and commerce. The medieval period was an instance of transition. Therefore, the influence of the Church was waned and this resulted in the separation of economics from ethics and philosophy.

St. Thomas Aquinas was at the forefront proposing scholasticism by following the line of thinking of Aristotle. Just as Aristotle, he also advocated restricted property rights. He further explained the concepts of usury, just price, etc. Regarding Nicole Oresme, he was proponent of theory of money and advocated the use of precious metals gold and silver as money. Also, Oresme fought for the protection of merchant class from oppressive activities of the prince.

To conclude, “the whole economic philosophy of the middle ages might be summed up in the doctrine of just price, which aimed to protect buyer and borrower from exploitation by subjecting economic motives to ethical appraisal under a sort of system of ‘rate regulation’. Such regulation was directed toward enforcing ideals of duty, for the most part formulated and enforced by religious authority, but influenced by racial or local custom and occasional political upheavals” (Haney).

2.6. TECHNICAL TERMS

1. Dark Age
2. Christian Theology
3. Canon Law
4. Village Communities
5. Class Division
6. Atomic Individualism
7. Doctrine of Church
8. Universal Brotherhood
9. Dignity of Labour
10. Equality of Rights
11. Common Ownership of Property
12. Feudalism
13. Serfdom

14. Natural Economy
15. Latifundia
16. Free Tenants
17. Tenancy System
18. Manorial System
19. Scholasticism
20. Schoolmen
21. Medieval Usury
22. Just Price
23. Bimetalism
24. Exchange Value
25. Consumptibles
26. Fungibles
27. Violent Theft
28. Circulation of wealth
29. Mint Ratio
30. Debasement
31. Democratic Individualism
32. Natural Equality
33. Merchant Guilds
34. Crusades
35. Capitalism

2.7. SELF-ASSESSMENT QUESTIONS

1. Ascertain the origin and extent of the Medieval Period. Examine in detail the feature of the period.

2. Define Christian Theology . Assess the role of the Church in the medieval economic thought.

3. What is Canon Law? Examine the blending of economic ideas with the Doctrine of Church and what is its effect on the economic development of medieval towns and cities.

4.”Property should be private in possession, but common in use”. Elucidate with the contribution of St.Thomas Aquinas.

5. “The proportion of the market value of gold and silver should determine their monetary values” (Nicole Oresme). Assess.

6.”The value of what is given and that of what is received must be the same” (St.Thomas Aquinas). Examine.

7. Evaluate the influence of Aristotle on the economic thinking of in the medieval period.

8. Why a compromise is necessitated by the Christian rigidities in the latter part of the medieval period?

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M.A.ECONOMICS: EVOLUTION OF ECONOMIC DOCTRINES

LESSON 3/UNIT-1

MERCANTILISM - A SYSTEM OF COMMERCIAL CAPITALISM (1500-1750 A.D.)

CONTENTS

M.A.ECONOMICS: EVOLUTION OF ECONOMIC DOCTRINES

LESSON 3/UNIT-1

MERCANTILISM - A SYSTEM OF COMMERCIAL CAPITALISM (1500-1750 A.D.)

3.1. OBJECTIVE OF THE LESSON

In this lesson, it is proposed to provide a discussion on the meaning and origin of Mercantilism, and contributions made by the some of the important representatives of mercantilist economic thought.

STRUCTURE OF THE LESSON

3.2. INTRODUCTION

Economic Thought in its dynamic form was witnessed in the Western Europe during the period between the beginning of 15th century and the middle of 18th century in the wake of rapid development of economic and commercial activities. Feudalism had given way to commercial capitalism which is otherwise called as mercantilism. People began to realize the significance of economic aspects of their day to day problems. In the political sphere, national government and absolute monarchy gained momentum in the place of local feudal-lordships. The nationalist government started to take policies in the economic sphere for the nation's wealth and prosperity. It can be regarded as the economic counterpart of political nationalism (Whittaker). Trade and commerce began to appear on the scene as engines of growth. A new class known as merchant class was began to emerge.

The rise of absolute monarchy and merchant class replaced the medieval ideas and institutions and streamlined the development of the system of mercantilism. The mercantilist theoreticians were the 'spiritual predecessors of the science of economics' and their ideas were modern in character. The mercantilism was the economic counterpart of political nationalism. Mercantilism had emphasized 'protectionism' in the commercial field and a strong nation in the sense of increasing gold and silver stocks in the national exchequer even at the cost of other nations. Therefore, mercantilism can be regarded as a force which gave birth to the system of political economy.

3.3. PEROID OF MERCANTILISM

Mercantilism, politically, grew with the onset of absolute monarchy and died out with its extinction. In economic philosophy, it came into existence with the development of foreign trade which is regarded as solely helpful to promote wealth and welfare of the country. Mercantilism is a system of commercial capitalism or merchant capitalism which was introduced in various countries during the period between 1500 AD and 1750 AD. From good olden days, many cities in Europe had followed mercantilist ideology, as trade and commerce were developed. As an instance, the ideas of Machiavelli (1469-1527) and Jean Bodin (1520-1596) were staunch supporters of a strong national government for the maximization of the national well-being. This idea was part of the mercantilism. Cannon has asserted that mercantilism proper appeared only in the 17th century and he has grouped the ideas which prevailed during 14th and 15th centuries under the head 'Bullionism'. He has thus drawn a distinction between bullionism and mercantilism. It was only in Italy that Serra developed it systematically as a doctrine during 1613. In fact, it was in the 17th century that maximum number of mercantilist writings appeared. The foundations of mercantilism could be found in Europe firstly, in the development of 'monetary economy' and secondly, the emergence of nations.

The economic views prevailed during the "period falling roughly between the end of the Middle Ages and the beginning of the American Revolution" have been named as the commercial or mercantile system by Adam Smith (Newman). The Mercantilist views were continued roughly up to the period when Adam Smith published his "Wealth of Nations" in 1776. The mercantilist theorists were spread throughout the Europe. In the words of Eric Roll, "what has made it possible to speak of mercantilism is the presence in a number of countries of a set of theories which explained or underplay the practices of statesmen for a considerable time".

Since the period covered by the mercantilist ideology was very long, there were several variations in the thought. The term mercantilism vaguely sums up and represents a set of ideas and policy prescriptions which were prevalent in the Western European countries and had certain common features. Mercantilist ideas appeared in almost all the European countries such as Germany, France, Austria, England, Italy, Holland, Spain, Scotland, and Russia. For over 3 centuries, the mercantilist ideology was established as a strong driving force in synthesizing economic thinking process in the European countries.

3.4. MEANING

Divergent views about mercantilism implied that the term would be basically a group of ideas and politics. The term was mainly used as a term of approbation lacking clear cut meaning and an expression coined merely for scientific purposes. The term mercantilism is also one of those abstract terms which vaguely sums up and represents a set of ideas and policy prescriptions which were prevalent in the Western European countries and had certain common features. The term indicates the economic policy and economic ideas which became gradually dominant. These included an absorbing interest in foreign trade and through which the acquisition of the precious metals which in turn led to military strength of a country and the power of the state. The term was mainly popularized by Adam Smith. Mercantilism, as the term implies, is closely associated with trade and commercial activities of an economy. Mercantilism refers to, that the wealth of a nation can be increased through trade and commerce particularly by export trade.

There were many facets of the term mercantilism. Machiavelli and Bodin described it as a strong national government for the maximization of national well-being. On the other hand, Gustav Schmoller described it as ‘state making’. According to him, it was the national unity, but not the national strength, which was the prime motive of mercantilists. Another thinker, namely, Bacon, explained that ‘state power’ as the primary objective of mercantilists. The essence of mercantilism was to make one’s own state stronger at the expense of other state even by waging a war against another state. According to it, one state is gaining at the cost of the other. So, a situation of international anarchy was the thought of mercantilists during the period. If mercantilism connotes state power, it will give a misguiding view to a student of history of economic thought. But we are saying that it means trade and commerce. Therefore, controversy surrounds the term mercantilism.

Leaving the controversy aside, for the present we accept it as to mean trade and commerce. The mercantilist ideology was closely connected to other economic activities in an economy and as such the mercantilist thinking was extended to many other economic activities. The concept mercantilism describes the economic policy and economic ideas which became gradually dominant. The mercantilism was basically exhibiting the aspirations of the merchant capitalists to whom a strong state appeared necessary for their own protection and to whom an abundant supply of money was important for carrying out business and trade activities smoothly. It refers to a "restrictive system" as the state imposes restrictions on the movement of goods. This was to maintain favourable balance of trade. This is a system of 'protectionism' or it is a system of 'restrictive trade practices'.

Mercantilist philosophy, doctrines, and practices extended to vast aspects other than trade and commerce. Hence, mercantilism is a fluid concept by its very nature and accordingly it has been preferred by other names as well. In Germany, it was called **"Cameralism",** in France it was known as **"Colbertism**", and in England, it was termed as "**Mercantilism".** It was also called as "**Bullionism**" by the early mercantilists meaning that the wealth of a nation consisted in the amount of gold and silver possessed by it. As a result, they advocated ways and means of increasing the stock of gold and silver in a country. Under Colbertism in France, there were far more restrictions than in England. The industry in France was unduly regulated. State enterprises were established. Restrictions were imposed on. , and foreign trade was regulated through customs duties and import restrictions. The state used to provide social overhead capital in the form of roads, canals, and ship-building. The term Cameralism in Germany refers to 'treasure chamber' of the ruler and thus cameralism was essentially a science of public finance. In Germany and Austria, most of the mercantilist writings were pieces of advice to benevolent monarchs in the conduct of their affairs.

In England it appeared in the form of pamphlets and small booklets upholding or criticizing the state policies on particular questions. The concept of mercantilism reaches its peak during the reign of Queen Elizabeth-I and Stuart Kings. Also, it was subject to changes on the basis of the concurrent situation.

3.5. THE ORIGIN OF MERCANTILISM

The quality and role of mercantilism can be better understood by taking into account the historical background. This is because the writings of the mercantilists were greatly influenced by the concurrent situation of their times. According to Keynes, it follows that the theories of the past cannot be properly understood or their validity fairly estimated unless they are taken in connection with the actual phenomenon. Therefore, it is pertinent to take up a study of social, political, economic, religious, and other factors that gave rise to mercantilist philosophy during the 13th and 14th centuries.

3.5.1. RENAISSANCE

The Renaissance movement was against the dictates of medieval theology. During the close of the medieval period, nationalism became a strong force in Europe. As such, the countries were undergoing sharp change. It gave rise to a new light and learning among the people. Reasoning and Skepticism were the order of the day in the place of blind obedience of certain given ideas. This led to a freedom of the leaders of the society from obscurantism. The age of reasoning dawned upon the people of Europe. They used to accept an issue on the basis of adequate logical reasoning. No place for blind following. This resulted in increasing inquisitiveness regarding materialistic aspects of life. People began to understand that life on earth was more important than the life on the immortal world such as heaven. Emphasis was laid on creative human activities, acquisition of wealth, and trade and commerce. In fact, mercantilism was a reaction against the moral and idealistic attitude of the medieval period. These ideas were inscribed in the literary and art works of the time. For example, the artists like

Leonardo da vinci, and Michelangelo, and philosophers, namely, Erasmus and Bacon were the torch bearers in the spreading the new line of thinking in Europe. Therefore, money came to occupy a place of pride in human relations and materialism started gaining strength day by day.

3.5.2. PROTESTANTISM

With the development of skepticism among the people of the Western Europe, the tendency of questioning was developed as a mass movement and the intellectuals of the society leading to ‘Reformation Movement’. The Reformation Movement raised its voice against the supremacy of the Roman Catholic Church and its dictates through the authority of Pope in religious and political matters. This development was associated with the rise of Protestantism, as a new religion. This new religion was led by Martin Luther. This led to the weakening of loyal and blind obedience and gave way to more reasoned arguments. The Protestantism had given a rational meaning to Christianity and accepted the acquisition of material goods and property. It laid stress on the importance of money, economic effort and thrift in man’s life unlike the Christianity, which taught complete detachment of man from material things. Also, the new religion favoured complete liberty and individual freedom. The Protestantism believed in a strong nation. Political Economy became a reality with the fall of feudalism and the dictatorial authority of the Roman Catholic Church.

In course of time, the new religion became very strong and embraced by the kings and merchants. These sections of the society broke away from the clutches of the Roman Catholic Church and started their own Churches under the new religion. For example, the King of England, Henry VIII established the Church of England under the new religion. The power and popularity of the Catholic Church was declined.

3.5.3. CHANGES ON THE ECONOMIC AND POLITICAL FRONT

At the close of the 15th century, several changes had taken place in various countries of Europe in both economic and political front as well. In this period, feudalism was replaced by ‘commercial capitalism’. Foreign trade and commerce became the sources of profits to the traders. Self-sufficient domestic economy with limited exchange gave way to the 'exchange economy'. Agriculture was receded to background and it gave birth to manufacturing economy. In England, a good deal of interaction between commercial capitalism and agriculture took place and it gave way to capitalism in the country. With the invention of new farming methods of production, feudalistic methods of production were lost their dominance. Having been replaced from their feudal lordships, landlords converted themselves into merchant class and engaged themselves in trade and commerce. In view of the growing importance attached to the manufacturing sector, a new class, known as, 'labouring classes' was emerged. Competition among various manufacturing industries became the order of the day. Increased specialization together with increasing exchange and trade, the importance of money increased all the more. The benefit for all this was increase in the foreign trade. Also, the discovery of the new World like America increased the flow of gold and silver in to the Europe causing the rise in the price level. With the increased price level, the governments had failed to manage their increasing expenses due to low receipts from their estates and from other sources. The governments then resorted to the imposition of heavy taxation. The development of industry and trade felicitated such changes. There was widespread 'debasement' of coin currency by which prices had increased much. The price increase led to the onset of 'speculation'. At that time, the kings used to believe in the strength of wealth to wage a war rather on the strength of the army. All this led to increased importance to money.

Further, Increased security resulted in the encouragement of saving and banking habit. As a result, Bank of England was established by the close of this period.

On the political side, to mercantilists the objective of a state was not to increase wealth, but to increase strength and authority. It was pointed out that mercantilists were not basically 'nationalists' whose nationalism was the product of 'romanticism' (Heckscher). Even by keeping the wage level of labour low, a strong state could be built up leaving the labour poor. Therefore, the state has the “authority of authorities”. So, the state must keep in mind the objective of gaining power. A state therefore had to be strong enough both internally and externally.

According to mercantilists, the strength was an end in itself and economic policy had to be planned accordingly. So at any time, when a state was called upon to wage a war, it must get ready with the required strength to wage a war. The political organization, which was loose in the past due to scattered centres of power of feudal lordships, came to be replaced, thus, by a strong nation state. A strong nation state headed by a strong king was the norm. Some of the strong kings were Tudor King and Louis XIV. Therefore, shift in emphasis was, therefore, on the development of nationalist state with a centralized government. These ideas were explained by Machiavelli’s “**The Prince”** and Jean Bodin’s “**Six Livres de la republique**”.

The mercantilists recognized that to achieve political unity economic unity was also required. These two are mutually complementary. So, power lies in wealth. For instance, in order to be strong and powerful a king required money and wealth which could only be acquired by trade and commerce. Thus, there emerged a compatibility of economic interests of the merchant classes and the political interests of the state. The state was interested in capitalism as a continuously increasing source of revenue for the ever-hungry state. Money revenue was the goal of the economic activities which the state engaged in or suggested to the private businessmen (Heckscher). Similarly, without the strength of the state, the commercial interests of the state could not be protected and colonies established could not serve as marketing zones for the home trader. The key to mercantilist prosperity was in the strength of the state. The mercantilists therefore explained the strength of the state and state-making.

Most of the mercantilist thinking was carried out by merchant price of a nation state. Thus, the role of merchant class had increased in the political sphere due to the rise of labour class and fall of feudal lordships.

On the other hand, competition was intensified among the nation states in the sphere of foreign trade. The principal reason in extending foreign trade was to acquire gold and silver. To gain an upper hand in the international sphere and to get more stocks of gold and silver, nation states intensified their efforts to build strong ocean fleets and admiralties and extended trade to every corner of the globe with the discovery maritime routes. This led to the prolonged hostilities between nations. England and Portugal were at logger heads during the 17^{th} century. Therefore, mercantilists emphasized the role of international trade in state making.

3.5.4. OTHER DEVELOPMENTS

The thinking process of mercantilists was influenced by many discoveries and inventions of the period. These include discovery of maritime routes to America (1492 by Columbus) and India (1498), and inventions like mariner's compass, printing press, etc. Inventions of Galileo and Kepler dispelled the centuries old beliefs and taboos and demolished the supremacy of the Christian theology. All these developments led to significant changes in trade and commerce. Marketing avenues were developed with the establishment of colonies in Asia, Africa and America.

All the above explained developments came to be taken as the genesis of the birth of mercantilism. In brief, it was a reaction against the medieval thought and the dictates of the Christian theology.

3.6. THE SYSTEM OF MERCANTILISM

The mercantilist thought was centered on the strength of the state and state-making. Some consider it as national unity and certain other people think it as the wealth of the nation. Both, state's power and wealth, should co-exist and mutually interdependent. If one is absent, the other cannot be expected. In this context, mercantilists explained the **end and means** of national economic policy. The end objective of economic policy is the state's power itself and the means for achieving the state's power is creation of wealth in the form of precious metals like gold and silver.

The end objective of national economic policy is the power of the state itself. The strength of a state can be observed from its sound economic situation. So a wealthy state can only be called a strong state. A strong state could only protect the interests of its subjects from internal and external aggressions. The strength of a state can be increased with the help of a strong armed forces and navy. Then only it would protect its countrymen from external aggression and protect its colonies in the outer world. Only a country possessing a strong financial position, in the sense of having large stocks of gold and silver could think of maintaining a strong army. In addition, with the spread and expansion of monetization, state administration demands additional sources of revenue which can only be obtained from increased inflows of gold and silver. With the increased flows of gold, domestic prices would go up which implied additional revenue needs of the government. Thus, increasing state activities are also another reason for the attraction of gold inflows into state.

Mercantilists found increased sources of wealth in the form of inflows of gold and silver into the country. For this purpose, they advocated foreign trade as a viable instrument of economic policy for maximization of wealth and prosperity of a country. So, the strength of the state and the economic means by which the state's power is enhanced, are the cornerstones of the thought of mercantilists. The state's power and economic means went hand in hand and reinforced each other during the period of mercantilism.

There is also another important view regarding the objective of mercantilism. According to some, it is not the strength of the state that is important, but the important thing is the means applied to make the nation strong. Here means is wealth. Mercantilists believed in the creation of an integrated and well regulated economy to achieve the norm of maximization of wealth. According to Schmoller, mercantilism was essentially a policy of economic unity. The creation of 'national customs system' was found to be necessary by the Heckscher. Such a national policy could create a consistent national system or regulation of internal trade and industry for the benefit of the entire state. So mercantilists advocated a regulated and integrated economy for the prosperity of the nation. The group of free-traders including Adam Smith thought that the end objective was state power, but they observed that it to come only from wealth and productive power of the nation. Therefore, mercantilists viewed that for a state to be strong, they must secure enough wealth in the form of gold and silver stocks by creating a national customs system. Heavy stocks of gold and silver can be had from foreign trade or from mines. Foreign trade must be conducted and regulated in such a way that precious metals particularly gold may come into the country. This didn't mean that mercantilists were bullionists. The bullionists wanted to prohibit the outflow of bullion, i.e. gold, whereas the mercantilists brought forward a theory of balance of trade. In order that a country may have more bullion, there must be a 'favourable balance of trade'. There should be excess of exports over imports. The typical mercantilist's primary principle was to maximize exports, while minimizing imports (Alexander Gray).

Therefore, lure for gold and expansion of foreign trade are two important phenomenon of mercantilist philosophy. The mercantilism is a new order of materialism unlike the case of medieval idealism and morality. Let us go into the details of the system.

3.6.1. ROLE OF THE STATE

Many writers explained that mercantilism was a national policy and emphasized the state's role in the growth and development of economies of Europe. Schmoller has rightly pointed out that the object of mercantilism is 'state-making'. The role of the state lies in the total transformation of society and its organization including its institutions. By which there is a replacement of local economic policy by that of a national state (Schmoller). The mercantilists emphasized national strength and prosperity. This in other words referred to as 'nationalism'. The mercantilists believed that state intervention was necessary for the proper management of society's economic affairs. In the period, there was much of state regulation of economic activities in England. According to a noted economic historian, E.Lipson, mercantilists experienced their first 'planned economy' in England.

As a part of its regulatory activities, the government used to impose heavy import duties to restrict imports of foreign goods and introduced several concessions to the export oriented industries to pave the way for reaching the goal of maximization of exports and minimization of imports.

In England, government issued patents of monopoly as and when new methods of production were introduced by the industries. For the establishment of a new industry, foreign workers were allowed to be imported. Wages and prices were fixed by the government to encourage production. Also, shipping and navigation laws were promulgated to encourage large fleets for purposes of trade. England also established colonies in various parts of the world for the supply of raw materials. Around 1600, England established East India Company in India. Therefore, there was a policy of perpetual governmental activity.

In the words of Heckscher, mercantilism was chiefly a phase in the history of economic policy. In the process of state making, various monetary, protectionist and other economic devices were regarded as necessary. Mercantilist writers were basically belonged to the merchant class and as such they had created divergent individual trading interests. This resulted a situation where in the merchant class looked to the state to implement their theories and protect them from their rival merchants. This necessitated the creation of a strong central government to maintain cohesion in the country. Therefore, there was interplay of economic conditions and political institutions which necessitated the attention of the mercantilists.

3.6.2. THE ROLE OF MONEY

The mercantilists believed that money in the form of precious metals, gold and silver, was considered to be most important role to play in determining the economic well-being of a nation. So, they liked unlimited accumulation of gold and silver for the prosperity and strength of the nation. The mercantilists had drawn the inspiration for this from Greeks and Romans for whom the real power was accumulation of wealth in the form of treasure or metallic hoards. The commercial policy was advocated only for this purpose. In the words of

Columbus, “gold is a wonderful thing; whoever possesses it is master of everything he desires. With gold one can get souls into paradise”. Also, William Petty says that the great and ultimate effect of trade is not wealth at large, but abundance of gold, silver and jewels which are not perishable are wealth at all times and places. The mercantilists paid a lot of attention to the accumulation of precious metals. Gold and silver were universally accepted as ‘medium of exchange’. Hence, gold and silver were considered as commodity money. The mercantilists explained that gold and silver possessed ‘store of value’ function of money. On some occasions, they emphasized ‘circulation of money’ function to the metals. They believed that there was a specific relationship between production and the quantity of money in circulation. Moreover, in those days, government used to impose taxation to regulate trade. For this purpose, the government needed common measure of value which is available in gold and silver. Mercantilists believed that the increase in the supply of money would help in increasing production and export of manufactures. So, they thought of ways and means of increasing the stock of precious metals. Finally, for conducting wars on large scale at the country level against another country, the kings required large stocks of gold and silver metals. Therefore, mercantilists had a highest regard for gold and silver. It has been said that mercantilists grossly confused money and wealth (capital). But some of the mercantilists really recognized the importance of money as a means of augmenting national welfare. J.M.Keynes opined that mercantilists were much ahead of their times in analyzing the role of money in the economic system.

3.6.3. RATE OF INTEREST

Among mercantilists, one group led by Thomas Mun advocated the imposition of interest, while the other group led by Davenant opposed the charge. According to Thomas Mun, money lending on interest was beneficial to the poor merchants with the provision of necessary capital and was useful for channelizing the savings for development purposes. His view point was supported by many thinkers. On the other hand, the writer Davenant opposed the idea because he considered it as an unearned income. He suggested even to impose a tax on the money lenders for having charged interest. In majority of cases, mercantilists advocated the levy of interest.

Also, they said that on economic grounds a low rate of interest should be charged. The mercantilists believed that economic development could proceed effectively when the rate of interest was low. Only when the money supply was adequate, rate of interest would be low. So, they explained that accumulation of precious metals would help reduce the rate of interest and increase the availability of funds. The increased inflows of precious metals bound to have beneficial effect on trade and commerce. The writers like Child, Thomas Culpeper and Nicholas Barbon advocated for the issue of legislation for establishing a low rate of interest. Moreover, at one time, England and Holland suffered from scarcity of money. Naturally, mercantilists thought of increasing the supply of money by way of increasing the inflows of gold and silver. According to Sir Josiah Child, "Low interest is the Natural Mother of Frugality, Industry and Arts". The mercantilists believed that greater money supply ensured a low rate of interest which in turn conducive for expansion of trade and commerce.

But an increase in the money supply results in not only a fall in the rate of interest but also it affects badly economic development with falling prices. The mercantilists observed that abundance of money supply coupled with low rate of interest was essential for economic development to proceed effectively. Therefore, they opposed any policy leading to a fall in the prices. It seems that mercantilists never bothered about the side effects of falling rate of interest on the economy. They were mainly concerned with the funds required for trade and commerce and for that additional money supply was needed. They preferred a low rate of interest, but they showed aversion to a falling price level. According to mercantilists, a rising price level was a lesser evil than a falling price level. In the words of Bert F.Hoselitz, "Aversion to falling prices, rather than attainment of rising prices was emphasized". Therefore, a low rate of interest was considered to be an instrument economic development by the mercantilists.

3.6.4. THE BALANCE OF TRADE

The central theme of mercantilism was “balance of trade”. For the purpose of increasing wealth and treasure of a country, it was believed that foreign trade was the only way out. Only through foreign trade, the flow of precious metals was secured. To have increased inflows of precious metals, the mercantilists advocated ‘favourable balance of trade’. This implies maximization of exports and minimization of imports. To be more specific, it means that exports are in excess of imports. This is by way of selling more and purchasing less in the international markets and thereby getting paid for the surplus exports in terms of precious metals. The surplus in the current account balance is known as ‘export surplus’ which is going to be received by the exporting country in the form of gold and silver. The mercantilists believed that state intervention was necessary to promote favourable balance of trade.

Some earlier mercantilist writers were used to oppose the outflow of gold and silver to foreign countries. These writers were called as ‘bullionists’. The bullionist philosophy would not permit any export of gold and silver even for the purposes of trade and even for getting still more favourable balance of trade. Also, they were against the import of goods. On the other hand, during the latter mercantilist period, there was a change in the thinking process regarding outflows of gold and silver. The mercantilists began to understand the need for payments in gold and silver for raw material imports which were used for the export of manufactured goods of higher value thereby getting surplus of gold and silver for the domestic economy. This was the mercantilist thought proper.

The mercantilist philosophy of achieving favourable balance of trade was not a universally applicable philosophy. This is because every country could not have an export surplus. We should keep one point in mind that mercantilists were not pure economists, but they were basically merchant statesmen and therefore they wished only their nation’s good and nothing else. The mercantilist philosophy of balance of trade was based on a premise that world resources were limited. Hence, theirs was a static approach.

In order to get a favourable balance of trade, the mercantilists followed a policy of discrimination, regulation and protection in trade. When the countries practice trade restrictions in a successful manner, then the distribution of precious metals between countries need not conform to the free trade norms. To Adam Smith, the distribution of precious metals over the world was guided by their supplies relative to the supplies of goods under free trade. By encouraging exports and discouraging imports, more stocks of gold can be retained by a country. So the country must implement the corresponding economic policies within the country to suit the policy of restricting imports.

For getting the export surplus, it is said that the value of exports should be as high as possible. In addition, volume of exports should also be more. As such, export of manufactures was favoured and raw material and agricultural exports were discouraged. The sale of machines and emigration of skilled labour were regarded as injurious to the economy. The mercantilists gave top priority for commodities with high labour content in their scheme of exports because there was an abundant supply of unskilled labour. On the other hand, imports should be limited to raw materials but finished goods should not be imported. Mercantilists advocated a policy of protection and encouragement to export oriented industries.

3.6.5. DOMESTIC ECONOMIC POLICIES

To have a successful foreign trade policy regime, suitable economic policies within the country were the need of the hour. So, mercantilists designed certain economic policies to make them compatible with the objective of export surplus. In this case, insurance and freight charges are the best examples. Mercantilists insisted that cargo should be carried only in those ships which flew the national flag of the country. The example is British Navigation Acts.

Secondly, during the days of mercantilists, production was carried out by labour intensive methods of production due to abundant labour supply. They believed that cheap and abundant labour supply would help in keeping the cost of production low, thus enabling the home country to compete effectively in the international market. Mercantilists advocated a policy of low wages to the labour for making them to work for more number of hours. Mercantilists were thought of giving competitive edge to the domestic exporters by advocating a policy of importation or immigration of skilled labour and artisans for the purpose of producing goods cheaply and qualitatively. They didn't have the fear about Malthusian Theory of Overpopulation which they considered it as a remote chance. In fact, Nicholas Barbon points out that "the people are the strength of the country". An increment in population meant both an addition to the armed forces and productive workers of the country. So, mercantilists advocated measures to encourage matrimony and parenthood.

Thirdly, regarding taxation policy, mercantilists were most scientific in the sense that they are ahead of their times. In this context, we can cite the names of Petty and Hobbes who are proved to be great source of inspiration to Adam Smith (18^{th} century) and Kaldor (20^{th} century). Mercantilists favoured a multiple tax system. The basic principle of a tax is 'payment according to the benefit received' from the government. This is known as 'benefit principle of taxation'. Hobbes opined that people should pay taxes in accordance with the expenditure incurred. He considered that a tax on expenditure is the most equitable. Basing on which, Kaldor advocated a policy of levying expenditure tax. Mercantilists preferred 'equality' as cannon of taxation. Finally, they introduced customs duties, excise duties and a tax on interest.

3.7. CONTRIBUTIONS OF INDIVIDUAL MERCANTILISTS

Let us delve into the 'contributions made by some of the important individual mercantilists.

3.7.1. Sir Thomas Mun (1571-1641)

Sir Thomas Mun was an Englishman and born in 1571. He was a prominent British mercantilist writer of his times. He served on the Board of East India Company. A merchant by profession, he was greatly responsible for shaping trade policies of England. His two important works are **'A Discourse of Trade, from England unto the East Indies (1621)'** and a posthumous publication in 1664 though written in 1630 entitled **'England's Treasure by Foreign Trade or The Balance of our Foreign Trade is the Rule of our Treasure'.** This book contained valuable instructions for his son. In this book, he has clearly enunciated the theory of balance of trade. This work is "the most famous exposition of Mercantilist principles" (Munroe). As a perfect mercantilist, Thomas Mun emphasized surplus balance of trade and not the restriction on exportation of gold. He has started the theory of balance of trade in the following words: "The ordinary means to increase our wealth and treasure is by foreign trade, wherein we must ever observe this rule: **to sell more to strangers yearly than we consume of in value".** This results in export surplus. Thomas Mun says that accumulation of treasure could be possible only by chopping off imports and encouraging exports. For this he advocated heavy import duties on goods meant for consumption within the country and moderate duties on goods meant for exports. But unlimited accumulation of money within the country has an adverse effect on balance of trade via increase in the domestic price level making exports costly. Hence, Thomas Mun did not favour limitless expansion in money in the domestic economy. Thomas Mun in Chapter 3 of his book, England's Treasure by Foreign Trade, explained 12 methods by which a country could have a favourable balance of trade making it rich with increased treasure.

1. Cultivation of Waste lands for the production of agricultural products for saving imports of tobacco, hemp, and flax.
2. Reduction on domestic consumption of imported goods resulting in export surplus.
3. Judge the needs of the England's neighbours so as to gain so much of manufacture as we can and to sell them dear. For instance, if the good exported by England is a necessity to its neighbour, a higher price will be charged on the good. In respect of other goods, suppose England faces tough competition from other countries, it must sell the goods exported at cheaper rates instead of losing the foreign market.
4. Regarding invisible items of the balance of trade, i.e. service charges like insurance and freight, Mun advocated that England should insist its traders to ship their goods only through English ships.
5. Export of finished products must be allowed and not of raw materials. This is only to increase the net worth of exports.

6. England should exploit her own natural resources. Instead of importing fish, better learn how to catch a fish from its own waters.

7. England should be made entry-point so that it would increase shipping, trade and customs.
8. Mun regarded trade with distant lands is more profitable.
9. Export of money should not be permitted except in trade. He argued that ‘money begets trade and trade increases money’.

10. Export duties on goods made out of the imported raw material should be removed. For example, goods manufactured in England from foreign raw materials such as velvets and silks should be allowed to be exported free.

11. High customs duties on native goods should be removed.

12. England should, as far as possible, be self-sufficient.

To go into the other views of Mun, he praised industry and condemned idleness and luxury. In this context, he praised industrious Dutch and deplored idleness of Englishmen. Mun does not even want to allow all kinds of luxury to be avoided. This is because that he was afraid that if Englishmen did not use foreign goods, then who would buy theirs? What would happen to their ships?

Mun advocated the export of money (treasure) for purposes of augmenting trade and commerce. He asserted that it was not a desirable policy to insist on the receipt of money always by every exporter from trade. Only unfavourable balance of trade makes a country to lose precious metals. What he meant is that he is talking about general (overall) balance of trade, but not particular. Therefore, trade must result in overall balance of trade.

Mun also contributed to the theory of money and interest. He advocated for the extension of lending activities. He also pleaded for a long-term taxation policy to promote the economic interests of the country.

3.7.2. ANTONIO SERRA (1580-1650)

Antonio Serra was an Italian mercantilist who was born in 1580. He was the first mercantilist writer who gave a systematic version of mercantilism in pamphlet, **"A Brief Treatise on the Causes Which Can Make Gold and Silver Abound in Kingdoms Where There Are No Mines, 1613".** Serra explained the causes which would bring about abundance of gold and silver. He said that these precious metals were very important and helpful to trade and people. According to him, there were two sources for acquiring these metals. Firstly, a country should be blessed with its own gold and silver mines. Secondly, there were other countries in whose case certain factors would enable them to acquire these metals. He classified these factors as '**collateral factors'.** These collateral factors were again divided into **'particular factors'** and **'common factors'**. The particular factors were applicable to particular countries where there were surplus of products over the needs of a country. So the surplus goods would be transported to those countries where they were lacking. This was the export surplus resulting in inflows of gold and silver. Also basing on the geographical location of a trading area of a country, a country might be put it in an advantageous position compared with other countries resulting in inflows of gold and silver.

On the other hand, common factors were applicable universally to any country. The common factors included **"quantity of industry, quality of population, extensive trading operations, and regulations of the sovereign".**

Firstly, Serra believes that industry is more productive than agriculture in generating inflows of gold and silver. The artisan is more certain of a profit by working at his trade than is the peasant. The peasant depends on uncertain weather conditions resulting in loss. Secondly, it is possible to expand the scale of production in the industry to get more profit, whereas it is not possible in respect of agricultural produce. Therefore, the law of increasing returns is applicable to industry. Thirdly, agricultural commodities are comparatively perishable and the industry is sure of market and more stable. Fourthly, industry is more profitable than agriculture.

Regarding quality of population, he explained that people of a country must be industrious and hardworking. Also, people should be zealous and anxious to development trade, both internal and external trade. In respect of state regulations, he is indecisive because there are several causes which made the arrangement of regulations very difficult.

Just as in the case of Thomas Mun, Serra also allowed the export of money due to its benefits on certain occasions. He declared that "if money is exported for any purpose whatever, it must return with a profit into the kingdom from which it was sent". Therefore, export of money is not in itself harmful, so long as there would an export surplus.

3.7.3. JEAN BODIN (1530-1596)

Jean Bodin was French lawyer and he wrote many books and of which the important was "Republicque (1576)". He mainly discussed public finance issues in his book, Republique. In another book, "Discourse of the Common Weal", he provided a discussion on economic problems. In his book named, "Response", he dealt with inflationary rise in the price level. He explained that the main reason for the rise in the prices was debasement of coin and prices rose more than the debasement of the coin which was due to the inflow of additional money into the country. So, production and foreign trade over time expanded the quantity of money in the country. The result is increase in the money supply and price level. Also, some Kings at that time encouraged a policy of borrowing at high interest rates which attracted foreigners resulting in increased inflows of gold and silver into France. Bodin concluded that additional money supply was the reason for the rise in the price level rather than the debasement of coin. However, Bodin agreed to the mercantilists' view that a country should acquire gold and silver through export surplus leaving aside the effects of increased money supply.

3.7.4. CAMERALISTS (or GERMAN MERCANTILISTS)

The German counterparts of mercantilists were the "cameralists". The ideas of cameralists were spread over 300 years in Austria and other German states. The word Cameralism refers to 'filling the chamber or treasure of the price". These cameralists should ensure that the fertility of the sources of revenue never declined. Hence, they advocated for the prosperity of the people of a state because in whose hands the prosperity of the prince depended. So, the ultimate objective of Cameralism was to fill the public treasury. Like mercantilists, cameralists viewed that it was not the absolute power or richness that mattered, but the country's position relative to the position of others. Therefore, Cameralism was concerned with broader economic policies of the country. The cameralists had a great faith in the government regulation of the affairs of the economy. They also believed in the diligent and hardworking population which included traders, skilled people and artisans. They preferred dense population and an abundant supply of money which are essential for the prosperity of the nation. Cameralists believed in the state regulation of all kinds, but this did not mean that they are against free market activities. Finally, cameralists gave less importance to balance of trade and more to the royal revenues.

Philipp Von Hornick (1638-1712) was an Austrian pamphleteer. He was born at Mainz in Austria in 1638. He was lawyer by profession. His main work was "Austria Above All, If Only She Will", 1684. He explained the ways and means of achieving self-sufficiency. According to him, "the might and excellence of the land consists in its over-surplus of gold and silver". All other things requisite or convenient for its sustenance in so far as is possible should be derived from its own resources attending by proper care, use and application. Austria is known for its natural resources and by their proper exploitation excluding some foreign products; the country can overwhelm its neighbours in power and wealth. Hornick believes that for human existence two things are necessary: firstly, gold and silver; and secondly, other things required for nourishment, clothes, shelter, etc.

For the accumulation of gold and silver, he suggested certain methods. They are:

1. Discover gold and silver mines in the country and the land resources should be exploited to the maximum possible.
2. Domestic production of commodities should be encouraged. “All the goods which occur in a country and which are not used in their raw state should be worked up in that country as far as possible”.
3. Encourage population numbers. They should be trained in skills and activities and should be made to adopt useful occupations.
4. Gold and silver must be allowed to be in circulation within the country and should not be permitted to go out of the country.
5. People should be encouraged to be content with domestically produced goods and they should be done away with the foreign goods especially luxuries.
6. In case of imports of foreign goods are necessary, they must be paid in kind with the exports of goods. Finished goods should not be imported. Only Raw material imports must be allowed into the country.
7. If a good is available plenty in the country, imports of such a good should be banned, even if the good produced domestically is that of inferior quality and of higher price.
8. Exports of the country should be encouraged as far as possible.

The other important writers under the category of cameralists are **Johannes Heinrich Gottlob Von Justi** (1717-1771) and **Joachim George Daries.** The cameralists, Justi published his book, “Political Economy, 1755”. He explained in this book cameralist theories and policies in a systematic manner. He distinguished between economic science and cameral science. The former deals private sector economics and latter takes up the affairs of the government.

The ideas of George Daries come very close to the views of Adam Smith

3.75. JEAN BAPTISTE COLBERT (1619-1683): COLBERTISM OF FRANCE

Mercantilism used to be famous in France as “Colbertism”. It is named after Jean Baptiste Colbert, the Finance Minister of Louis XIV (1661-1683) of France. He was the greatest of 17^{th} century French mercantilists. His policies are aimed at making the country France strong and self-sufficient. He was the architect behind the development of several economic policies only to make the King strong and powerful. He developed a wide network of roads and canals for the development of industries in the country. Probably it was in France under him that the policy of State regulation was carried to the extreme. There was absolute state control over everything in the country. In France, mercantilism was out rightly a restrictive policy. He levied restrictions on the export of grains. He imposed detailed controls over production of goods. He was a nationalist and wanted France to be free from foreign goods. He even permitted the immigration of skilled workers and offered several concessions to the producers. But, he was against any restriction on trade between countries. He was in favour of free trade between nations. Also, he made the country as the great naval power by building a strong merchant fleet. Colbert was also responsible for the expansion of colonial empire of France. He was also the person behind the establishment of trading companies in the colonies. Finally, he considered money as the only objective of trade and commerce and an instrument of making the country strong and powerful.

3.7.6. Sir Josiah Child (1630-1699)

Child was an English merchant, economist and governor of East India Company. His works include “Discourse of Trade, 1660” and a revised edition of “A New Discourse of Trade, 1675”. Like all the mercantilists, Child also believed in the export surplus leading to favourable balance of trade. He also permitted the export of gold because it eventually results in increase in the inflows of gold. Child favoured general (overall) balance of trade but not specific balance of trade. Regarding his contribution to the thought, he advocated charging of low interest rates for the development of trade and national prosperity. Child also explained colonial economy as a source of employment to the home country.

3.7.7. OTHERS

William Petty (1623-1687) was a mercantilist, but was more liberal in thought than others of his group. He was mainly concerned with taxation. In all other matters he was like an orthodox mercantilist believing in the value of exports and favourable balance of trade and a large stock of gold and silver. Also, he believed in state sovereignty. His works include "A Treatise on Taxes and Contributions, 1662", "A Tract Concerning Money, 1682", and "Discourses on Political Arithmetic, 1660". By profession he was a physician. Basing on his writings he was considered to be forerunner to many future economists like Adam Smith, Karl Marx, etc.

Sir John Law (1671-1729) believed in the abundance of money because it was helpful to trade and commerce. He explained his views on money in his book, "Money and Trade Considered; with a Proposal for Supplying the Nation with Money", 1705. He initiated a plan for the establishment of a 'note-issuing bank' and it was in France and after some initial help to the economy, it failed on being no limit to the issuing of notes. On the other hand, the suggestion led to the establishment of Bank of England and it was a success.

Charles Davenant (1656-1714) was an English economist. He was also a famous mercantilist. He gained rich experience in the field of taxation and foreign trade due to his various positions held. His works include "Essay on East Indian Trade, 1696" and "Essay on the Probable Means of Making People Gainers in the Balance of Trade, 1699". By imposing restrictions on imports and a reduction in the cost of production within the country, Davenant felt that exports would rise. To him, the value of money was not dependent on gold and silver, but on scarcity. In his opinion, when the gold and silver are not used properly, it would become a surfeiting meal to a nation. He favoured the payment of subsistence wages to the population only to get an increase in the wealth of a country.

3.8. CRITICAL APPRAISAL

From the foregoing analysis of mercantilist thought, it mainly concerned with the strength of the state and state making. For which the mercantilists favoured the development of trade and commerce. By which, they aim at favourable balance of trade in the form of inflows of gold and silver into the coffers of the state. With the increased inflows of gold and silver, mercantilists believed that a strong and powerful state could be built up. While considering the favourable balance of trade, they have taken into account individual state's benefits. This implies that they have taken into account a static view of the situation. They have failed to consider a global view. When one state gets an export surplus, another country must loose. All countries cannot have a surplus balance simultaneously. Of course, the mercantilists never claimed this belief and they did not generalize. They have mainly concentrated on certain issues and have taken their typical stand on them mainly on the national interests. The mercantilists are basically merchants believing in the accumulation of wealth. They are not economists in a true sense. Therefore, they have failed to develop a scientific system of economic thought.

It is argued that time and space is to be considered before commenting on mercantilism. When considered with reference to the problems of the time in which mercantilism flourished, it is difficult, if not impossible, to find fault with the system. Mercantilism in essence was an economic policy combined with political concept of nationalism.

As pointed out before, mercantilists were only propagating the objective of merchant class of getting more wealth by means of more merchant power. This merchant power can be enhanced by making the state strong and powerful. In a way to settle their end, they are making the state powerful. Heimann disapproved this view and said that mercantilism was the ideological justification of commercial capitalism. But in order to settle their merchant class objectives, the mercantilists discussed about wages which was to cut down the cost of production by way of paying low wages. A cut in the cost of production could increase exports thereby export surplus.

The views of mercantilists are lacking inadequate understanding of economic phenomenon causing insistent policy prescriptions. For instance, having insufficient knowledge about the quantity theory of money led to the idea that they wanted more money and higher prices, so that exports could be sold at favourable prices. But it should have led them to think that higher price level would lower exports and increase imports. Therefore, they failed to understand the relationship between quantity of money, price levels, and exchange rates, though their main concern was foreign trade.

The Mercantilists as a merchant class needed money for expanding trading activities. It was right on the part of them to have more money. As a result, they disregarded the inflationary tendencies in the economy. On two counts, prescription of low wages and undermining inflationary situations, mercantilists were against the welfare of the poor people, though beneficial to the trading community.

Adam Smith viewed that economic ideas of the mercantilists were 'little better than nonsense'. He opined that the mercantilists confused money and wealth. Adam Smith's 'Wealth of Nations', 1776 is a challenge to mercantilism. He is a free-trader, whereas mercantilists are for protection and restricting imports Their approach was static in the sense that "the most misleading doctrine of the mercantilists was the oft-repeated proposition that a country can get rich only at the expense of the other countries" (Edward Heimann).

The mercantilist system was not an academic system and therefore it lacked any scientific cohesion. In the words of Haney, "they were laying down the principles of a national political economy, not a cosmopolitan one. War was the normal thing and a large degree of self-sufficiency a practical necessity". England, France, Germany and Spain became strong nations under the mercantilist regime. For example, the famous Navigation Acts passed during the regime were of great help to England. The subject developed by them had an immense practical value even for today's times. It is rightly pointed out, "it is the mercantilists, and not Adam Smith who are the spiritual predecessors of modern economics". Some of the modern theories of money, interest and employment are based on the mercantilist ideas. The Mercantilists developed a macroeconomic view of their ideas.

3.9. Decline of Mercantilism

Towards the end of the 18th century, the decline of mercantilist ideology was started in England and all over Europe. In England, the downfall was due to the publication of book of "Wealth of Nations, 1776" of Adam Smith and the 'policy of plenty' replaced the 'policy of power'. The gold and silver have lost their charm with the development of banking system. In addition, other forms wealth has begun to be recognized by the public in various countries. Also, in England, Industrial Revolution had taken place which completely revamped the industrial structure of the countries of the world. Finally, regulations of erstwhile mercantilist Europe were liberalized completely. Laissez faire principles with their emphasis on individualism, unfettered competition and free trade began to replace the mercantilist doctrines. Thus, the mercantilism has lost its existence in the world.

4.0 SUMMARY

Mercantilism is a system of commercial capitalism or merchant capitalism which was prevailed in various countries during the period between 1500 AD and 1750 AD. It is a system of politico-nationalism which believes in the strength of the state and in state-making. The mercantilist thought is a great unifying force with the downfall of medieval institutions such as slavery, feudal-lordships, supremacy of the Christian Theology, etc. In addition, the spread of skepticism, development of economic institutions, trade and commerce are behind the development mercantilist doctrines. The main theme of mercantilist ideology is the promotion of favourable balance of trade only to get export surplus in the form of inflows of gold and silver. The objective of this policy is to make the state strong and powerful. For this purpose, the mercantilists prescribed several economic policies like regulation of trade, protectionism, imposition of import duties, payment of low wages to labour, etc. The mercantilists allowed the export of gold and silver in trade only with an intention to get more inflows of the precious metal. The mercantilists are basically merchant-statesmen, and as such they are interested in their immediate gain, i.e. accumulation of wealth. For this purpose, they need a strong and prosperous state by which the merchant class wanted to get the needed capital for the expansion of their trade and commerce. While advocating the export surplus, they mentioned 'overall' balance of trade. The mercantilists also concerned about their state's welfare only while advocating export surplus in the form of gold and silver. Thus, in mercantilism economic policies are mixed with nationalism.

The system of mercantilism was called as 'bullionism' in England, 'Cameralism' in Germany, and 'Colbertism' in France. The important representatives of mercantilist thought are Sir Thomas Mun, Serra, Jean Bodin, Phillip Von Hornick, Jean Baptiste Colbert, Sir Josiah Child, William Petty, Sir John Law and Charles Davenant.

The mercantilist system of thought was limited to a particular time and space. Therefore, one cannot draw generalizations from mercantilist economic doctrines. Though mercantilists were considered as predecessors of modern economic thought in explaining the concepts of quantity theory of money, balance of trade, interest, prices, etc., the mercantilists failed to develop a scientific system of economic thought. The mercantilist economic ideology has come an end with the publication of 'Wealth of Nations', 1776 of Adam Smith and with the onset of Industrial Revolution in England.

5.0 Technical Terms

1. Political Nationalism

2. Colbertism

3. Bullionism

4. Cameralism

5. Laissez Faire

6. State-Making

7. Restrictive Trade Practices

8. Treasure Chamber

9, Skepticism

10. Christian Theology

11. Protectionism

12. Reformation Movement

13. Commercial Capitalism

14. Merchant Capitalism

15. Exchange Economy

16. Feudal Lordships

17. Debasement

18. Nationalists

19. Romanticism

20. Authority of Authorities

21. Favourable Balance of Trade

22. Free Trade

23. Export Surplus

24. National Customs System

25. Metallic Hoards

26. Protectionism

27. Circulation of Money

28. Store of Value

29. Labour Intensive Methods of Production

30. Benefit Principle of Taxation

31. Cannons of Taxation

32. Invisible Items of Trade

33. Collateral Factors

34. Common Factors

35. Merchant Prince

36. Subsistence Theory of Wages

37. Quasi-Absolute State

38. Absolute Monarchy

6.0 Self-Assessment Questions

1. Define Mercantilism. Explain the basic tenets of Mercantilism by tracing its foot-prints in modern economic policies.

2. Explain the situational factors that caused the development of doctrines of mercantilism.

3. Evaluate the 'system of mercantilism' and asses the views of mercantilists on various political and economic phenomenon.

4. "The ordinary means to increase our wealth and treasure is by foreign trade, wherein we must ever observe this rule: to sell more to strangers yearly than we consume of in value". Explain the views of Sir Thoman Mun.

5. Define Cameralism. Examine the contribution made by some of the Cameralists.

6. Evaluate the contribution made by Jean Baptiste Colbert to the mercantilist doctrines.

7. “Mercantilism, in essence was an economic policy and an economic doctrine bound up with the political doctrine of nationalism”. Elucidate.

8. “The objective of mercantilist thought was achieving a favourable balance of trade”. Critically examine the concept with reference to its consequences within and outside a country.

9. How do you explain the export of bullion results in more inflows of the precious metal?

10. It is the mercantilists and not Adam Smith who are the spiritual predecessors of modern economics”. Discuss.

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M.A.ECONOMICS: EVOLUTION OF ECONOMIC DOCTRINES

LESSON-4/UNIT-1

THE PHYSIOCRATS (1756-1778)

CONTENTS

M.A.ECONOMICS: EVOLUTION OF ECONOMIC DOCTRINES

LESSON-4/UNIT-1

THE PHYSIOCRATS (1756-1778)

4.1. OBJECTIVE OF THE LESSON

This lesson deals with the economic doctrines of the physiocrats. In this lesson, a student can have an in depth analysis of the contributions made by the physiocrat school to the History of Economic Doctrines. The lesson covers the factors responsible for the emergence of the doctrines, their ideas and theories, and the contributions of important representatives of the physiocrat school like Francois Quesnay, Turgot and others. In the end, an analysis of critical appraisal assessing the positive and negative points of the doctrines is provided.

4.2 INTRODUCTION

With the decline of mercantilist economic theory and philosophy, the commercial capitalism began to be replaced by a more coherent and systematic thought in the Western Europe, especially in France. As a reaction against mercantilism with its stern regulations of trade and commerce, a new system economic thought, which is considered to be more mature and dynamic, was developed by a group of Frenchmen called 'physiocrats' in the 18^{th} century. The new system was called 'physiocracy' bringing the economic philosophy closer to the 'nature'. Physiocracy means 'the rule of Nature'. It is regarded as 'rationalization of certain political aims'. The physiocrats believed in some natural power which is responsible for human happiness and prosperity. Adam Smith considered the philosophy as 'a school of agriculture' or Agricultural System in contrast with the Mercantilist System. On the other hand, mercantilist thought was away from the nature. The new system of philosophy and as a thought was short-lived, but had a profound influence during the 18th century. The physiocrats developed an alternative political and social system compared to the mercantilist ideas. So, they are regarded as founders of ‘political economy’. The main objective of physiocrats was to develop economic policies and principles by which they could get the country, France, developed. They are regarded as the ‘precursors of the French Revolution’. As a group, physiocrats comprises of intellectuals from different walks of life, say, men of letters, physicians, historians, philosophers, statesmen, and administrators. The physiocrats considered themselves as ‘economists’ **(Les Economistes**). But conventionally the term ‘physiocracts’ is reserved for the special group of economists who are originated from France. Francois Quesnay, Turgot, Mirabeau, and Dupont are the chief representatives of the physiocrats. In spite of the theoretical advancements of the physiocracts, the economic and social system was unable to stand the test of time and was soon discredited and abandoned.

4.3. PHYSIOCRACY- A REACTION AGAINST MERCANTILISM

The physiocrats developed the doctrine stating that agriculture was the sole source of all wealth, and it was the only productive occupation. The manufacture was sterile. As per the mercantilist thought, the primary source of wealth was international trade. The physiocrats opined that “the inordinate fostering of sterile manufacture at the expense of agriculture, striving for a monetary balance of trade, restrictive regulations on trade and commerce, and restrictions on the marketing and export of food grains formed the source of all the misery of the people of France and ultimate cause of all social evils and destructive warfare between nations”. So they viewed that these policies of the Mercantilists had played the spoil sport in the lives of the people and the nations. Therefore, the physiocracy is a reaction against the mercantilism. On the other hand, the physiocracts believed in the panacea of all social and economic evils in agriculture as a chief productive occupation and in the restoration of natural justice and liberty by doing away with all the governmental regulations, controls, and restrictions. Therefore, permitting the Nature to rule in accordance with the Providence is the main theme of the physiocracts.

Though the physiocrats believed in agriculture, it must be noted that physiocracy is not an agricultural system. Adam Smith opined that labour is all the source of wealth. But that doesn't mean that Adam Smith's system is 'labour system'. Since physiocrats developed a complete system of political economy, their system was a social order comprising of production of wealth, labourers, manufacturers, merchants, farmers, owners of estates, and sovereigns (Haney).The ultimate objective of the mercantilists was favourable balance of trade and remained as a static system. On the other hand, physiocracy was a complete social system even though physiocrats emphasized agriculture as a source of surplus value. The contradictions, between the two thoughts, are given hereunder:

- Mercantilists were in favour of state intervention and strict regulations of trade and commerce, whereas the physiocrats advocated 'laissez faire' and free trade.
- Mercantilists aimed at production of wealth, but physiocrats concentrated on the distributional aspect.
- Mercantilists made a lasting contribution to the theories of money and trade. Physiocrats developed a systematic economic analysis using 'general equilibrium'.
- Mercantilists opined that industry is the productive occupation so as to create export surplus. On the other hand, physiocrats viewed that agriculture is only productive occupation facilitating the creation of surplus value.
- Mercantilists believed that money is wealth, whereas physiocrats argued that only the tangible goods are the real wealth.

4.4. FACTORS RESPONSIBLE FOR THE DEVELOPMENT OF PHYSIOCRATIC THOUGHT

The situational environment in France in 1750s was prone to the development of physiocratic economic thought. The situation was inherent in the oppressive mercantilist ideas prevailing in France at that time. The need for a thorough reform of the social and economic system of the country had been felt for long and quite intensively in France. Let us take the details of the situation in France in the following paragraphs.

4.4.1. PHYSIOCRACY – A REVOLT AGAINST COLBERTISM

Firstly, as we know that physiocracy was a revolt against mercantilism, the politics of mercantilism were carried to the extreme degree causing underdevelopment of many a sector of the economy. As a result, the agricultural sector in France was subject to utter neglect for quite a long time. Colbert, the Finance Minister of France was responsible for all the problems faced by the country. Under the instructions of the Finance Minister, investments were diverted from agriculture to the industry causing low demand for agricultural products. So, capital accumulation in the sector was almost stopped. Therefore, agriculture sector was badly affected. At this juncture, a group of intellectuals had surfaced in the country to provide a theoretical basis to disprove mercantilist thought. This group consisted of farmers and landlords who opposed the mercantilist thought of neglecting the agriculture. One among the group was Quesnay being a landlord. They also got encouraged from the developments of agriculture revolution in England through the writings of Mirabeau and Montesquieu. In England, large scale farming became a success. They thought a similar agricultural revolution can be brought about in France. So, they wanted to restructure the economy by encouraging a large-scale farming. In fact, Quesnay adopted new methods of cultivation in his own estate. All these developments shook the very roots of mercantilist economic thought. A new system of socio-economic order was emerged in France in the name of ‘physiocracy’.

4.4.2. BANKRUPTCY OF THE STATE EXCHEQUER

Secondly, in the 18th century, there was absolute monarchy in France. The kings such as Louis XV and Louis XVI were the dictators of the country who were under the influence of the maxim, "I am the State". This led to a steep deterioration in socio-economic conditions in France. The life of the administrators including the king was very luxurious and corrupt. There was extravagant and wasteful public expenditure. This led to the heavy indebtedness of the state leading to bankruptcy. The government had levied extra taxes to finance the public expenditure causing heavy tax burden on the population. Frequent wars particularly with Holland under the reigns of Louis XIV and Louis XV added fuel to fire to the situation absorbing the finances of the exchequer. All these miserable conditions led to a new thinking by the intellectuals of the time like Boisguillebert and Marshall Vauban. It came to be transformed in the name of physiocracy.

4.4.3. OPPRESSIVE AND REGRESSIVE TAXATION

The manner of tax collection was highly inefficient, arbitrary, unjust and corrupt. The taxes imposed by the state were inequitable and unjust resulting in regressive taxation. The nobility and clergy who owned 2/3rds of the land in the country were almost exempted from taxation. On the other hand, the poor peasants were being crushed under all sorts of levies, besides the extortionist land rents. The collection of taxes was given on contract at fixed prices to 'farmers of the revenues'. The surplus, if any, of tax collection was retained by the contracting farmers. But farmers were hardly left with any surplus. The taxes like salt tax, the worst of all taxes; poll tax; the tithe, i.e. a small tax on the tenth part of a tax base; and the like were some of the oppressive taxes levied in France. Under the Salt tax (**Gabelle)**, all the population above the age of 7 was required to buy 7 lbs. of inferior salt per year from the government establishments for cooking purposes. They were not allowed to use it for any other purpose. In southern France, the taxes were levied on agricultural lands and houses and in the rest of the country the wealth of the people was subject to a tax. The commerce and trade were adversely affected with all types of levies including those on the movement of commodities from one province to another. This resulted in the reduction in the value of the farm produce. These included a tax on commodities known as 'aides' and customs duties. These two taxes caused an increase in the price of the commodities. In the total amount of taxes collected, only 1/3rd portion of the revenue was deposited in the treasury and the rest was appropriated by the king.

4.4.4. STAGNATION

After the death of Lois XIV, the people of France got sufficient freedom to revolt against the injustice meted by the miserable conditions in the country. So, they demanded natural justice. Also, the economic situation was such that the economy was not meeting the requirements of capital accumulation and productive capacity. The economy of France was like a factory without making any allowance for depreciation of capital stock which implies depletion of natural resources (Haney). For the French economy, the agriculture was the main source of revenue to the exchequer, but it was in a state of utter neglect and remained stagnant. On the other hand, England had reaped the benefits from agricultural revolution. Therefore, the economy was under a state of stagnation.

4.4.5. TIRADE AGAINST THE POLICIES OF FRANCE

The people of France started vehement opposition to the policies of the King Louis XIV and after his death the people got sufficient liberty to express their opinion. The French thought was beginning to break from the established policies, politics and religion. The process of change in the system was affected at a great speed towards the middle of the 18th century, for the people wanted something more rational, simpler, and more practical and above all, something based on natural justice. In this change, the influence of English thought was more widely felt.

4.4.6. THE ONSET OF PHYSIOCRACY

All these miserable state of affairs in France led to a new way of thinking in which the revival of the economy was the main target. The intellectuals of the time felt that revival of agriculture was the key to economic development of the country. Therefore, replacing the erstwhile mercantilist concept of 'merchant capitalism' with 'capitalist agriculture' was thought to be the most appropriate way for the achieving the objective. The change had given rise to the creation of a new school of thought, known as ‘physiocracy’ which believed in the ‘rule of nature’ and the ‘natural order’. The leader of the new school of thought was Francois Quesnay (1694-1744). The others important writers were Turgot (1721-1781), Dupont (1739-1817), Riviere (1720-1793), Mirabeau, and Condillac, etc. But the new philosophy did not develop into a complete system all of a sudden. There was a time wherein some thinkers developed incoherent ideas against the Colbertism. The thinkers of this category include Marshall Vauban and Boisguillebert. According to Vauban, agricultural labour is the most productive. The physiocrats modified the view as land is the most productive. On the other hand, Boisguillebert recommended for tax reform giving weightage to equity. He also believed in the ‘rule of the nature’ which became the basis for the development of physiocratic thought. After these initial developments, in the middle of the 18th century, many thinkers put forward their coherent ideas as a remedy against the ills of the society in France. The efforts of Quesnay and Mirabeau reached the climax in the physiocratic thought. These thinkers are known as ‘physiocrats’.

4.5. IDEAS OF PHYSIOCRATS

The ideas of physiocrats can be grouped into two parts – the first part consists of ‘central economic hypotheses’ and the second part deals with the practical economic aspects. In the first part, three aspects are placed.

Natural Order
Net Product
Circulation of Wealth

The second part takes up the following ideas:

Functions of the State

Trade and Laissez Faire
Taxation
Wages
Population
Money and Interest

4.5.1. NATURAL ORDER

The most fundamental basis of physiocracy was the natural order. Quesnay developed the whole system of physiocracy on the basis of the natural order. Dupont defines the term physiocracy as “the science of natural order” (Gide and Rist, p.25). To the physiocratic school, the natural order is an ideal order provided by God. In this system, society is governed by the laws of Nature and is superior to the man-made materialistic system which is considered to be imperfect. According to the physiocrats, such a Natural Order is an ideal order. In this society governed by the laws of Nature, people would develop the right kind of moral and social attitudes and behavior having inherent faith in the existence of an Almighty God. So that, the system of Nature and the faculties of human beings, as created by the God, go hand in hand in harmony with each other. Then everybody would work in accordance with the demands of the Nature. It gives happiness to the mankind. The physiocrats revealed the idea that all social classes were interdependent and in turn depended on nature through the system of natural order. Thus, it is a system of natural-scientific, ethical, and social-scientific natural laws designed by the God. In the words of Dupont, “natural order is merely the physical constitution which God himself has given the universe”. It is divine in its origin it is universal in its scope.

The system explained by the physiocrats is eternal and an unchanging phenomenon and human beings perform their tasks in conformity with the rules of the Nature. Then, there would be heaven on this earth. This concept might have been brought from the medieval concept of natural justice. The natural order prescribes certain laws, which are normative in character, for governing the behavior of human beings on an ideal basis. Therefore, the natural order is the ideal order of things.

Now let us study the characteristic features of the natural order. At first, the natural order prescribes certain rules which stand in contrast to the man-made materialistic social order. One must remember that the Natural order doesn't mean that it is same as the state of nature. It is the duty of the human beings to first understand the natural order, appreciate its implications and then try to bring their lives in conformity with the natural order. The natural order is able to secure for the individual and the society the greatest amount of pleasure and happiness. It includes the elements of a civil life. They are: property, security and liberty which constitute the whole of the natural order. Paradoxically, the physiocrats were not interested in the concept of equality. In this natural order, different sections of the society were interdependent and must act and cooperate both for their self interests and for the common benefit.

Now the question is that what does the natural order mean? Physiocrats tried to answer it by saying that the content is self-evident. The content includes the institution of private property, landed classes, peasants, and an absolute though enlightened monarchy. The natural order also requires authority. The other component of the natural order is a programme of laissez faire and removal of all restrictions. This indicates that the monarch should have minimum functions such as maintaining internal and external protection, arranging public education, and provide and maintain roads, bridges, and other public works. The essential aspects of natural order were the right to enjoy the benefits of property, to exercise one's labour and to have such freedom as was consistent with the freedom of others to follow their self-interest (Eric Roll, p.137-8). Since the natural order was ordained by God, the physiocrats were so optimistic about the order that they sung limitless praises of it. The order was able to secure greatest amount of pleasure with the least amount of sacrifice for everyone. There was a perfect harmony in the society as the individual interests were identical with the interests of the society. Therefore, the physiocrats were more optimistic about their system of natural order.

The physiocrats believed that the natural order is governed by the natural laws. These laws are the guaranteed natural rights to the individual in the society. These laws govern human actions as much as they govern the rest of the nature. Hence, these laws are supreme in nature which pre-supposes freedom of action by the individual in particular and society in general. Such a system was existed in the ancient times and due to the development of greed and lust among humans, the society was converted into a materialistic society. The physiocrats are therefore believed in the development of a society governed by the rule of the nature as is existed in the good olden days. The physiocrats preferred to live closer to the nature and as such they advocated agriculture as the prime source of development since it possesses certain special features such as the power of engendering the forces of life. However, their philosophy is a theoretical abstraction of ‘savage society’.

On the other side of the coin, the concept of natural order is metaphysical in nature which makes it less scientific and more subjective. The eternity of the natural order appears to indicate the static nature of the system of thought. However, the physiocrats made an attempt to bring about an ideal order of things on the basis of the medieval concept of natural justice. Thus, the philosophy of natural order is against the philosophy of mercantilist thought of rigid control of economic life.

4.5.2. THE NET PRODUCT

The concept of ‘net product (produit net)’ had played a fundamental role in physiocratic doctrine of thought. As explained earlier, physiocrats held agriculture supreme among all occupations since it was the source of all wealth. In agriculture, both nature and man works together to deliver the farm produce. But mercantilists believed that the main source of wealth consisted in the favourable balance of trade in bullion. Thus, all wealth lay in agriculture which consisted of real (farm) produce.

Let us go into the meaning of net product as per the physiocrats. In their search for the source of wealth, the physiocrats found a source which could be easily seen in physical terms. This is output in agriculture. According to their finding, the output in agriculture was more than the corresponding inputs of seeds plus the subsistence of the farmers. That is,

Net Product (surplus) = Agriculture Output *minus* Cost of Inputs *plus* Subsistence needs of Farmers

They strongly believed in this 'truth'. The term net product refers to 'surplus which is over and above what is used up in the process of producing farm output'. It is the difference between farm-output produced and the farm-output consumed in the process of production. The surplus arises because agriculture produces much more, due to the bounty of nature, than what is required to satisfy the needs of the farmers. The excess produce is the wealth of the economy which meets the needs of those working in industry and other occupations.

In the words of physiocratic writer Le Tronse, "labour applied anywhere except to land is absolutely sterile, for man is not a creator". The surplus so remained after meeting the expenses including wages of the farmers is a pure gift given to the peasants by the Nature's bounty. The physiocrats believed that this type of surplus was not available in industry and trade so they were considered sterile or unproductive. This doesn't mean that they are useless. The physiocrats believed that the non-agricultural sectors could not produce surplus, but it can simply replace, modify and transfer wealth which is already created by the agricultural sector.

The size of the net product reflects the welfare of the people. When the surplus is high, the welfare of the people would also be high. The generation of higher amount of surplus depends on the capacity of the farmer to invest. When he invests more, there is higher amount of surplus. To physiocrats, farm investments are of three kinds: firstly, ground advances for making the soil fit for cultivation; secondly, primitive advances by which farmer makes investments of durable nature; and thirdly, annual advances by which farmer meets recurring expenditure in cultivation such as labour expenses, etc. After meeting all these three types of expenses, farmer keeps a part for his sustenance and the rest is regarded as net product. The physiocrats categorized the society into three classes – the proprietors, the farmers, and the sterile class. The net product generated is paid to the proprietors being the owners of the land. The sterile class is unproductive class which is not capable of creating a surplus. This class is employed in commerce and manufacturing which are regarded, therefore, as unproductive occupations. Hence, the agriculture sector is the sole productive sector of the economy since it delivers net product to the country.

Industry, trade and commerce are incapable of creating any surplus. This is because that the amount of output generated in these sectors is equal to the amount of expenditure incurred in producing that amount of output. The difference between the output and input is equal to zero. Hence, they are unproductive sectors. The classes who are depending on these sectors do not add anything extra to the stock of wealth. It doesn't mean that they are useless sectors. In this context, Baudeau opined that "far from being useless, these are the arts that supply the luxuries as well as necessaries of life and upon that mankind is dependent both for its preservation and for its well being".

How the net product is valued? To the physiocrats, production does not aim at the creation of utility, but at making surplus. Production is not the creation of utility, but it is the creation of matter. The net product is valued either in value terms or in physical terms. In spite of the fact that the realization of net product is somehow connected with the market valuation of produce, to the physiocrats surplus meant primarily a 'material surplus'. The material surplus can be created by the help of God or Nature alone, since the power of creating something new was in the hands of God and man cannot create anything. To value the produce, market price enters into the picture. Then the amount of surplus depends on market price. When the market price is high, net product will also be high and when the price falls, net product will be vanished. In these circumstances, the concept of net product is questionable. According to the physiocrats, when the market is under competitive conditions, competitive price, known as 'Bon-Prix' (a high price which is higher than the cost of production) will prevail. This Bon-Prix is such that it generates excess of output over input. Then net product will not vanish. So long as the Bon-Prix is dearer, surplus is generated. To get the Bon-prix for the produce, they advocated free trade policy.

APPRAISALOF NET PRODUCT

Let us consider the contradictions connected with the concept. Since many of the physiocratic writers were themselves landlords, they wanted to show that agriculture alone is productive. They felt, therefore, that landlord class was productive and rent was just a payment for the use of land. Hence, the idea was based on a political consideration.

Secondly, it appeared doubtful that all the physiocratic writers regarded mining as a productive sector along with agriculture. According to the physiocrats, land produces surplus repeatedly with each operation, but the same could not be said in a very definitive manner with regard to mines. This is because we only take up something which is already stored there. In the words of Turgot, "the land produces fruit annually, but a mine produces no fruit. The mine itself is the garnered fruit". Hence, he held that mines give no net product.

Thirdly, the physiocrats opined that all natural products were influenced by the market conditions. As such, with a fall in the prices, the net product might vanish. If that is the case, no sector can produce net product. But the physiocrats believed that the normal effect of the natural order was the Bon-Prix, the price which is over and above the cost of production giving way to the generation of net product. In case the market price falls below the cost of production, the natural order would be destroyed. In this context, Quesnay said, "abundance and cheapness are not wealth, scarcity and dearness are misery, abundance and dearness are opulence" (Gide and Rist, p.35). Thus, a dearer Bon-Prix generates net product.

Fourthly, the physiocrats did not have a satisfactory theory of value, since the analysis of net product was connected with theory of pricing. To explain further, if the bon-prix was the difference between the value of the commodity and its cost of production, net product would be created in any sector of the economy, whether it is agriculture or industry. Hence, it could be said with certainty that the product of the earth differed in any essential respect from the product of industry (Gide and Rist, p.34-35). One can say now that even the non-agricultural sector is also capable to creating net product. This follows that non-agricultural occupations are not sterile or unproductive. According to Adam Smith, all classes of people are capable of producing net product. On the other hand, Marx explained that labour alone could produce net product, whereas physiocrats explained that land alone was capable of producing the net product. Ricardo, though supporting the concept of net product for developing the theory of rent, held that the net product is not necessarily due to the bounty of Nature, but it is due to the sterility of land. According to Gide and Rist, "the net product was an illusion. The essence of production is not the creation of matter, but simply the accretion of value". Therefore, the validity of the concept of net product is questionable.

In spite of all its weaknesses, one can say that the concept of net product had enjoyed the popularity among the intellectuals of the time. The concept was an open challenge to mercantilists by which the physiocrats were able to eliminate the misconception about the real of source of wealth in the economy. The mercantilist philosophy could yield a policy of exploitation of other countries for the benefit of the home country. Physiocratic concept of net product implied the worthlessness of any such policy. In fact, the physiocrats advocated a 'free trade policy' contrary to the policy of rigid controls of mercantilists. Therefore, the physiocratic doctrine has its own significance.

4.5.3. THE CIRCULATION OF WEALTH (TABLEAU ECONOMIQUE)

The physiocrats were at first attempted measurement of national income in a crude form. This is by way of analyzing, in a systematic way, the 'circulation of wealth' in an economy. Among the physiocrats, Francois Quesnay was credited with the development of this analysis at first in his famous work, 'Tableau Economique, 1758'. The book provides a graphic representation of circulation of wealth. By profession, Quesnay was a physician. He, therefore, extended Harvey's theory of blood circulation to the field of economics. He regarded the circulation of wealth was like the circulation of blood in a human body. In the words of Turgot, "circulation of wealth constituted the very life of the body politic just as the circulation of blood did of the physical". Quesnay provided a synthesis of production and distribution in his work to unveil a significant landmark in the History of Economics. Dupont opined that the Tableau Economique attempted to make Economics an 'exact science' (Alexander Gray, p.107).

The concept of circulation of wealth is a macro-economic concept dealing with the entire economy as a whole. Through this concept, the physiocrats explained how the national product was distributed among different sections of the society. Quesnay presupposes a realm in which the King leads the nation as per the rule of Nature assisted by a group of councilors, who interpret the physical and moral laws. In this realm, agriculture forms the basis of social life which aims to secure maximum gains to the whole realm. Quesnay has divided the society into three classes, namely, proprietors of land, cultivators of land, and 'artificers, manufacturers and merchants'.

Firstly, the proprietors of land include owners of land and the King. The king was regarded as the co-proprietor of the net product. These landed gentry live like parasites on the net product generated in agriculture. The net product is paid to the proprietors as rent. This class forms less than a quarter of the population. Though the proprietors are different from the productive farmers and though their income is the annual payment paid to them in the form of net product (or rent), Quesnay regarded them as also productive class along with farmers, for they are bearing the responsibility of caring the soil. In fact, the proprietors make ‘ground advances’ in the form of investment to make the land fit for cultivation. For all these efforts, they are paid net product. Of the amount of net product received, the proprietors retain $4/7^{th}$ part for their maintenance, $2/7^{th}$ part paid as single tax to the King, and the remaining $1/7^{th}$ goes as ‘tithe’ (i.e. $1/10^{th}$ of the produce paid to the King).

Secondly, the cultivators of land or peasants are the only productive class in the society because they generate net product by tilling the land. They extract wealth from the soil and the higher the labour, the higher the wealth. For them, machinery, implements, and livestock used for cultivation are the fixed capital. This fixed capital amounts to 10 Milliard Livers. The next thing is the ‘annual circulating capital’ in the form of seeds, subsistence of farmers, etc. This is known ‘annual cost of production’. This amounts to 2 milliard livers. Both the fixed and circulating capital consist only in kind.

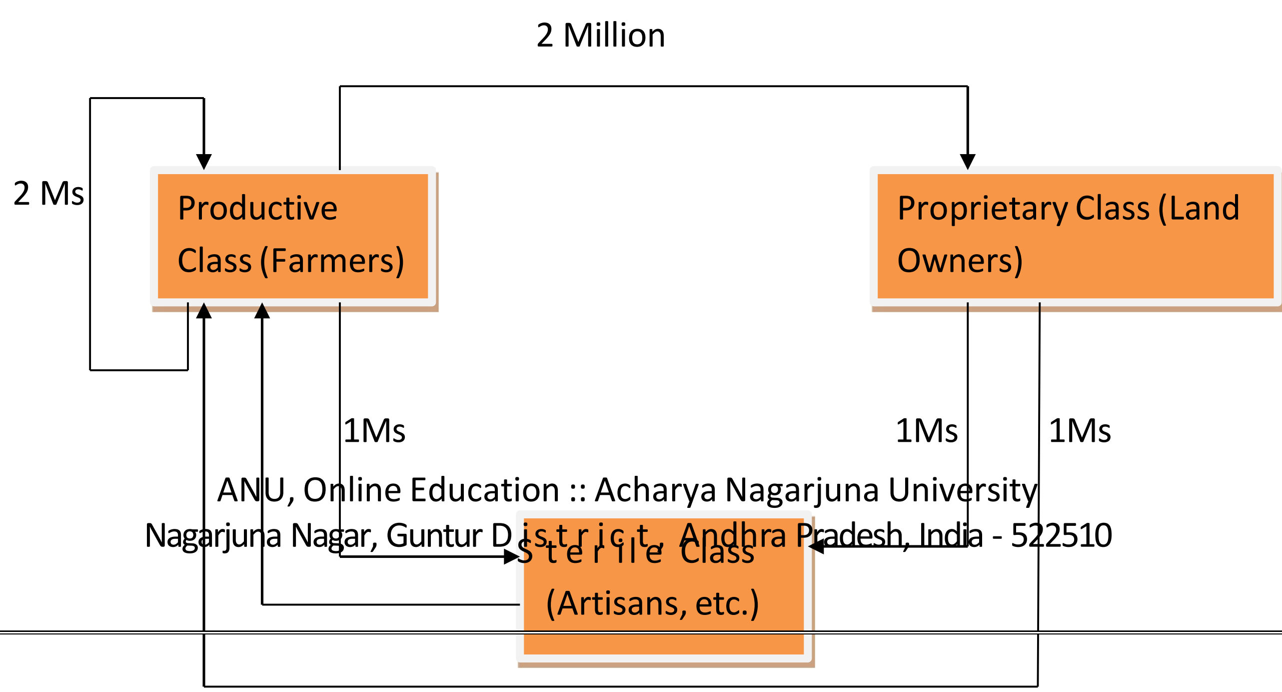
Thirdly, the last category which includes artisans, manufacturers and merchants is a sterile class and therefore unable to produce the net product. The physiocrats did not consider the sterile class as useless. This unproductive class

The Tableau Economique explains the process of circular flow of wealth in between the three classes of society. At first, landowners supply the necessary investment for making the land fit for cultivation. Basing on the improvement of land, the cultivators in turn are able to deliver surplus over and above what is invested on land. This surplus goes to the landowners. Later, landowners make fresh advances to the cultivators for the improvement of land. This again paves the way for the generation of surplus in the next production cycle. This is a continuous process until the total amount of surplus generated return to the cultivators. The process is that landowners divide their receipts of rental income from the cultivators by spending on manufactured goods and on food items from agriculture. In turn, industrial sector divides its income receipt by spending on food items from agriculture keeping a part for its own use. Finally, agricultural sector obtains receipts from the landowners and industrial sector. The cycle completes.

To take a numerical example, let us consider that an amount of 5 million francs is produced in a year. Of this an amount of 2 million francs is kept for their sustenance and as such this amount is away from the circulation. The balance amount of 3 million francs will enter into the picture of circulation. Of this amount, 2 million francs will be paid to the landowners and the government in the form of rent and taxes respectively. The remaining amount of 1 million francs will be used for buying manufactured products from the industrial sector or the sterile class. With the receipt of 2 million francs, the landowners divide their income into two parts – 1 million francs are used for buying food from the agricultural sector and the balance will be spent on industrial products from the industrial sector. On the other hand, the industrial sector spends its receipt of 2 million francs on the purchase of food items from the agricultural sector. The sterile class is an unproductive class and hence produces nothing. Therefore, at first an amount of 3 million francs are released into the circulation (2 million to the landowners + 1 million to the industry) from the agricultural sector and the same amount is returned back (1 million from the landowners + 2 million from the industry sector). Then, agriculture sector secures 5 million francs once again. Therefore, the cycle completes. Again, the process of generating the net product once again resumes. This will continue in an unending process.

The following chart shows how circulation of wealth is taking place in a typical economy as per Tableau Economique.

CIRCULATION OF WEALTH (In Francs)



2Ms

The Chart given above is self-explanatory. If any one finds it difficult to understand, he can go through the following details:

1. Landowners: Receipts: 2 million francs by way of rent.
   Expenditure: 1 million francs on food &
   1 million francs on industrial products
2. Industry: Receipts: 1 million francs from agriculture from the sale of industrial products &
   1 million francs from landowners from sale of industrial products
   Expenditure: 2 million francs spent on food and raw materials from agriculture.

3. Agriculture Sector:
   Receipts: 1 million francs from landowners for the sale of food &
   2 million francs from industry for the sale of food and raw materials.
   Expenditure: 2 million francs in the form of rent to landowners.
   1 million francs to industry for finished products. &
   2 million used for its own maintenance.

The above explanation of circulation of wealth can also be understood with the help of a matrix table given below. There is a similarity between Quesnay's Table and Leontief's input-output table. Quesnay was the forerunner to many of the modern economic concepts.

QUESNAY'S INPUT-OUTPUT TABLE (in millions)

SECTOR	FARMERS	LANDOWNERS	ARTISANS	TOTAL OUTPUT
FARMERS	2	1	2	5
LANDOWNERS	2	0	0	2
ARTISANS	1	1	0	2
TOTAL PURCHASES	5	2	2	9

A matrix table is one in which totals of rows and columns are equal. For example, totals of the first row and first column are equal to 5 millions. Not only that, totals of all rows (9 million) and all columns (9 millions) are the same. We can repeat the process with respect to other rows and columns. Now coming to the explanation of the input-output table, rows indicate production of output or it can also be taken as total sales of output to the different sectors. On the other hand, columns refer total purchases made by different sectors. In our explanation, there are 3 sectors in the economy, viz., farmers (productive class), landowner class, and artisan class (sterile one). This is the Quesnay's scheme of things regarding the circulation of wealth. Let us take the 'first row'. This row explains about the quantum of sales to the other sectors. In this row, keeping 2 million worth of output for their maintenance, farmers have sold 1 million worth of output to the landowner class and 2 million worth of output to the artisan class. Total sales of output come to 5 millions livers. Regarding the 'first column', to manufacture 5 million worth of output, farmers have used 2 million worth of their labour services, 2 million worth of output from landowners, and 1 million worth of output from artisans. So, to produce 5 million worth of output, the farming community have used in the process of production 5 million worth of output purchased from different sectors. This shows that all the sectors of the economy are interdependent and mutually co-existing. You can read the other columns and rows.

APPRAISAL

The physiocratic doctrine of circulation of wealth marks an enormous advance in economic theory. It gives us that agriculture sector is capable of accumulating capital stock provided the sector is devoid of taxes. Not only that, agriculture sector should be free from all sorts of impositions from the state. The doctrine of circulation of wealth presupposes a particular type of society having two classes, feudal lords and farmers. It lacks, therefore, universal application. The physiocrats suggested capitalist agriculture in which the landowners are interested in maximum gain in the form of rent at the expense of cultivators, who are getting only subsistence living. Also, the physiocrats showered praises on the landowners who are even considered as productive class, since they spend everything they receive. But Turgot, also a physiocratic writer, did not believe in the usefulness of landed gentry. For the success of the cycle to complete, they supposed unrestricted and uninterrupted circulation of all types of commodities, both agricultural and industrial. But they failed to consider the fluctuations in agriculture due to the nature or otherwise, which might disturb the smooth functioning of the cycle. So, their analysis of circulation of wealth is static in nature because the cycle repeats itself year after year without any disturbance. In this scheme of things, farmers are the worst sufferers because they do not have any share in the net product generated and they are supposed to content with what they have in the form of subsistence living. According to them, labour was not the creator of wealth. This defect was removed by Adam Smith, who considered that labour was alone the source of all wealth. Moreover, physiocrats believed in laissez faire policy and hence they didn’t given any place to the government sector in their scheme of things. But the government does have certain functions to perform for which it needs to impose taxes on the people. Of course, on certain occasions, they referred tax reform. Their analyses represent France of 18th century in which rich farmers used to pay rent to landlords. Therefore, the physiocrats have an 'agrarian bias'.

4.5.4. FUNCTIONS OF THE STATE

The physiocrats are the staunch supporters of laissez faire philosophy and as such they advocated minimum functions to the state. They have opposed all legislation and authority of the state to the barest minimum. However, they preferred certain essential legislations for the preservation of the natural order. In the words of Baudeau, "remove all useless, unjust, contradictory, and absurd laws, and there will not be much legislative machinery left after that" (Gide & Rist, p.52). The legislations that remain after that are to be the copies of the laws of nature. The state must be a law-giver, but not the law-maker. What they wanted to see was the minimum of legislation with a maximum of authority. According to Quesnay, government should be centralized in a single person who should be guided by the laws of nature. The physiocrats were not in favour of a democratic government. They preferred not even a parliamentary regime. The best form of government was a single centralized authority, a hereditary monarchy. The monarch's chief function was preservation of the natural order and to protect private property. The other function of the despot was imparting instruction and educating public opinion. This is to make the people to unders tand the natural order and to make them to live under the laws of nature. The last function includes that of construction and maintenance of public works by the state.

4.5.5. TRADE AND LAISSEZ FAIRE

The physiocrats thought that all exchange was sterile and unproductive in the sense that exchange implied a transfer of equal values. According to Le Tronse, exchange is a contract of equality and equal value being given in exchange for equal value. This doesn't create any wealth. In this sense, trade and industry are unproductive because they do not create any surplus. Even the fate of the foreign trade is the same under the physiocratic thought. So the doctrine of mercantilism giving importance to foreign trade was lost its importance under the regime of physiocrats. The physiocrats were not entirely against foreign trade, for they held that a country must get from other countries those goods which it could not produce by itself and those which are in excess of its own consumption. Hence, the trade is a necessary evil. In this context, they attacked the mercantilists' view of favourable balance of trade which makes a country to gain at the expense of others. Therefore, they favoured 'free trade', which implies gains to all the countries.

The advocacy of free trade was in consistence with their basic policy of laissez faire. Under the policy, no restrictions are imposed on the movement of goods from one place to another. The natural order implied each trader would be the free to buy or sell wherever he choose, within or without the country. Not only that, any hindrance to the movement of goods would come in the way of realizing the 'bon-prix' by the farmers for their produce. In order to produce enough amount of net product, a high price required a free play of competitive forces in the market and an absence of all restrictions on trade. According to the physiocrats, the natural order was given by God and as a result no state intervention was needed to implement the order. The free movement of goods and the overall laissez faire policy are part and parcel of the natural order.

4.5.6. TAXATION

The physiocratic theory of taxation was centered on the net product. Their main thrust was on a 'single tax' (impot unique) which should be levied on the net product of land. They pointed out that all the expenditure of the government should be met only from this tax. Their philosophy of levying a single tax was followed from their desire to bring about the natural order. The physiocrats thought that the establishment of natural order would bring an all-round harmony of interests and the concept of net product made them to prefer a single direct tax. In the light of their philosophy of laissez faire, limited functions were advocated by the physiocrats to the state and hence the demands for revenue should not be exorbitant. But the question from which source the revenue is to be collected? Regarding the source from where the money should be paid to the state, the physiocrats held that the only available fund was the net product. Farmers and artisans are making both ends meet on subsistence living. If at all a tax is imposed on them, the burden of tax will be passed on to the net product. Hence, they must be left free of any tax. Hence, a tax has to be levied on the net product directly and should be paid out of it. Therefore, the incidence of taxation should be solely on the net product. Naturally, the burden of paying the tax falls on the landowners, since the product goes to the proprietors. Baudeau, a physiocratic writer, recommended that this tax rate should be 20 per cent of the net product. The landowners were not used to pay taxes almost to the state at that time and as such they resented the introduction of this tax. The other thing is that the physiocrats had given greater importance to the landowner class in the society along with the farming community. Even in such a scheme of things, the physiocrats recommended a tax rate of 30 per cent which appeared to be very high at that time.

In this single direct taxation, the entire burden falls on one class of the society, that is, landowners. In this context, the objection raised was that it was unjust to levy such a tax upon a single class and the burden should be equally distributed. Instead of distributing it equally among all classes, the physiocrats replied that the sovereign's ideal was not equal taxation, but the complete abolition of all taxation, which could only be achieved by taxing the net product. Excepting the landowner class, the other two classes are left with only subsistence wages, that is, 'iron law of wages'. Hence, the scope of taxation lies only with the landowners. Since the tax is a direct tax, it is easier and inexpensive to collect. Moreover, another objection was that a single tax was unable to meet all the requirements of the sovereign. The physiocrats replied that by the application of tax reforms the net product would increase to such an extent that the tax receipts would go up in a progressive manner. Thus, the net product is an important source of tax revenue to the state.

4.5.7. WAGES

In this description of net product, the physiocrats subscribed to the idea of subsistence theory of wages or iron law of wages. By subsistence wage we mean that the amount of wage is just sufficient to keep the body and soul together. In their analysis, the farmers and artisans were to get only the subsistence wages because they would be ready to work at this wage. They did not explain anything about why they are paid the subsistence wage. So, the lower limit of wages in their analysis is subsistence wage since it cannot go down any further. In this situation, a rational employer would like to pay even less than the subsistence wage, if workers were available. The physiocrats had failed to provide a complete picture of demand for and supply of labour. So the theory of wages is incomplete. The merit of their analysis lies in simplifying the estimation of net product on the basis of the given subsistence wage.

4.5.8. MONEY AND INTEREST

The contribution of physiocrats regarding money and interest was not much. They believed that money was not equivalent to wealth. They referred money while analyzing the concept circulation of wealth. In their scheme of things, all circulation of wealth was through the medium of money. They believed that supply of money was automatically adjusted with the help of foreign trade. Moreover, the physiocrats made a distinction between money and capital, which is absent in the case of mercantilists who considered that money was also capital. According to the physiocrats, capital refers to advances to agriculture for making the land fit for cultivation.

Regarding interest, the physiocrats opined that interest should be allowed on the capital invested in agriculture and they would allow interest on the capital invested in the industry, because of its sterility. There is a place for interest in agriculture because the sector generates net product. Turgot opposed this viewpoint that interest was allowed in agriculture. He opined that if interest was allowed in agriculture, money would be withdrawn from other sectors and invested in the agriculture sector. In general, loans sought by the traders were more risky and therefore the investor would demand higher interest which would be higher than what was prevailing in the agricultural sector. Francois Quesnay regarded interest as a 'replacement fund' and it was not 'net income'. On occasions of wear and tear of machinery, they are required to be replaced by new machines for which replacement fund is needed.

4.5.9. ON POPULATION

The physiocrats believed that multiplication of population was a natural corollary to the natural order. They opined that the growth of population was dependent on the net product. When the net product was high, population would also be high. Some physiocratic writers were optimistic and favoured the increase in population and some who were afraid of over population.

4.6. REPRESENTATIVES OF THE PHYSIOCRATIC SCHOOL

In France, physiocratic doctrine was a revolt against Colbertism in particular and mercantilism in general. The physiocracy was a movement of laissez faire philosophy. The important physiocrats behind this movement were Francois Quesnay (1694-1774) and Turgot (1727-1781). These writers were spoken about the natural order and net product proper. The faith in these concepts was carried out by the students of Quesnay such as Riviere, Mirabeau, Le Tronse, Dupont and Baudeau.

4.6.1. QUESNAY

Quesnay was the founder and the leader of the physiocratic school of thought. By profession, he was a physician at the Court of the King Louis XV. At the age of 62, he made a path breaking contribution to the History of Economics, viz., 'Tableau Economique' during the period 1753-1758. The other works include, 'Farmers' in 1756 and 'Grains' in 1757. At first, he investigated about how the wealth of France be increased? In this connection, he believed in the agriculture as an important source of wealth of the country. He opposed the rigid-control regime of Colbert and as such he preferred laissez faire economy. He advocated freedom of trade and industry. Quesnay developed the concept of 'net product' by which he introduced the concept of 'rent' which became a guide to the classical economists like David Ricardo. He also made a distinction between land and other factors of production in his analysis. In his famous book, Tableau Economique, he developed the concept of estimating national income in crude form, while introducing the concept 'circulation of wealth'. His analysis of net product and all that led to the concept of 'stationary state'. There was a profound influence on Karl Marx who also developed the 'Table' in 1878 on the lines of Quesnay. Also, there was a similarity between Quesnay's Table and Leontief's 'input-output table'.

4.6.2. TURGOT

Turgot occupied a place of prominence among the chief physiocrats. He was never completely followed the physiocratic doctrines, though a student of Quesnay. In the words of Gide and Rist, "he was never a thorough-going physiocrat". But basing on his writings regarding labour, Turgot secured a place in the physiocratic school. According to him, the effort of labour alone was the reason for the creation of net product in agriculture. Turgot developed many a concept which was considered to be much more scientific in nature compared to the other physiocrats. His main ideas were found in his work, 'Reflections' (1769). This book paved the way for the publication of 'Wealth of Nations' of Adam Smith during the later years. He was appointed as Minister of Navy in 1774 and later he became the Finance Minister to Louis XVI.

Regarding his main ideas, Turgot was an advocate of laissez faire. He believed in self-interest of an individual. He preferred complete freedom to the individual in the economy. He stressed the importance of agriculture in the national economy. Though emphasized the term 'sterility', he recognized the services of unproductive classes too. He opposed the physioratic idea that the landed property is a divine institution. Turgot had a better idea of the relation of saving to capital formation. He defended freedom to lend and borrow at interest. He was opposed to the system of political autocracy which Quesnay favoured. Also, he was also known for his ideas regarding theory of value, theory of distribution, and theory of capital. He realized the subjective character of value. Thus, Turgot was a non-physiocrat with physiocrat sympathies (Schumpeter).

4.6.3. CONDILLAC

The ideas of Condillac were far more developed than those of other physiocrats. He was the only one who regarded the value as the basis for Economics. Like Turgot, he also linked value to utility. Condillac viewed that value is not an attribute of matter, but represents its usefulness; this utility is relative to our need; and utility grows or diminishes according to our need expands or contracts. Therefore, he is the founder of the 'psychological theory of value'. He also explained that value increases with scarcity and diminishes with free availability. Therefore, he had sown the seeds of 'marginal utility theories'.

Regarding production, his views are specific and different from those of other physiocrats. According to him, production means giving a new form to matter. Also, he says that there was no difference between production of agriculture sector and industrial sector, since both the sectors engaged in the transformation of already existing material.

In respect of Wages, Condillac for opposed the view point of other physiocrats. Physiocrats subscribed to the theory of subsistence wages. Even Turgot says that 'the worker's wage is only equal to what is necessary for his subsistence' (Iron Law of Wages). But Condillac opined that wages form the share of the produce due to the worker as co-partner. He mentioned that the wages were determined by the demand and supply forces. Condillac believed in the charging of interest like Turgot.

4.6.4. MIRABEAU

After the death of Quesnay, Mirabeau became the head of the physiocrat school. He is a close lieutenant of Quesnay what Angels is to Karl Marx.

His works include Friend of Mankind (1756), The Theory of Taxation (1760) and Rural Philosophy (1768). Mirabeau explained Quesnay's economic table in his book, Friend of Mankind. In this book, he mentioned the invention of three things, namely, writing, money, and Tableau Economique, have benefitted the future generations remarkably. He was jailed for his adverse comments on tax system of France and later he was exiled.

4.7. APPRAISAL OF PHYSIOCRATS' IDEAS

In the words of Haney, 'physiocracy was a revolt of the French against mercantilism'. Apart from its limitations and merits, the physiocrats laid the foundation for a systematic economic thought leading to the development of modern economic theories. Eric Roll said that 'the physiocrats established proper links with modern economics which went into three directions: national income analysis, general equilibrium analysis and econometrics. The physiocrats made an in depth analysis of theory of taxation. The physiocrat period was a transition between feudalism and capitalism. Adam Smith had all praise for Quesnay and his followers formed a sect and written number of books on their doctrine but without any relevance to political economy proper and mostly dealt with civil government. Adam Smith also noted that physiocracy with all its imperfections is perhaps the nearest approximation to the truth that has yet been published in the subject of political economy.

Regarding their contribution, the physiocrats emphasized that wealth is not equivalent to money and according to them it is material wealth in real form. This contention is a positive stand compared to the mercantilists who considered that wealth is in the form of a surplus of trade balance. To physiocrats wealth consists in the generation of net produce in agriculture which is considered as an engine of development of France. The view of the physiocrats is macroeconomic in nature by which they have considered the economy as a whole while explaining their path breaking analysis of circulation of wealth. This analysis explains how different sectors are dependent on one another. This laid the foundation for national income analysis through input-output analysis. To them, economy is a free private enterprise economy with limited functions to the government. On the other mercantilists believed in rigid controls and active intervention by the government. Though physiocrats put economics on scientific footings, it is not without weaknesses. According to the physiocrats, land alone can produce net product or wealth. There is a case for wealth generation in respect of other sectors particularly the manufacturing sector. Trade and industry are, therefore, equally productive as agriculture. So, their version is absurd. With this version in mind, they suggested a single direct tax on net product. Also, they argued that production was not the creation of utility, but the creation of matter. In modern economics by production, we mean creation of utilities. The reason is that they have failed to visualize the theory of value and price. Moreover, they are weak at the theory of distribution. To them, rent is a free gift of Nature's bounty. But David Ricardo retorted that rent arises not because Nature is bountiful but because it is niggardly.

4.8. SUMMARY

The physiocratic doctrines are a revolt against Colbert, Finance Minister of France, in particular and mercantilists in general. The socio-economic and political situation was miserable in France. The politics of mercantilism are carried to the extreme degree causing underdevelopment of many a sector of the economy. As a result, the agricultural sector in France was subject to utter neglect for quite a long time. So Economic development was at its low ebb and the state imposed severe restricts on trade and industry. In these circumstances people started voicing their concerns through Renaissance movement. The supreme authority of the Church came to an end and a liberal form of Christianity in the form of Protestantism came into being. In this scheme of things, a school of men called physiocrats emerged under the leadership of Francois Quesnay for whom the immediate task was to make France a developed country. Then the policies which were hither to been followed and implemented in the name of Colbertism or mercantilism began to crumble. Agriculture began to come to the centre stage in the preaching of physiocrats. They strongly believed in the Natural Order and its laws. Under the rules of the Nature, man enjoys perfect freedom to do whatever he likes and nobody is going to restrain his freedom. This is because the natural order is provided by God. The rules of the nature provide a man maximum gain with minimum effort. In this, the state has a limited role. Accordingly, they considered agriculture as the key to the development of the country, since they believed that agriculture sector can alone generate the net product due to Nature's bounty, the surplus over and above what is consumed. They wrote that agriculture alone was a productive sector in the economy and all others, trade and industry were unproductive. To them, trade and industry could not generate net product and these sectors are doing just transforming the product produced in agriculture. Hence, they are considered as sterile sector. According to the physiocrats, wealth is not money, but wealth consists in the form of net product.

Quesnay, the leader of the group, had propounded a path breaking concept of circulation of wealth through his Tableau Economique. The table laid the foundation for the development modern economic concepts. According to his, the circulation of wealth takes place among the three classes of the society, farmers, landowners and artisans. Whatever released into the economy in the form of net product by the farmers would eventually return back to them.

They advocated laissez faire system by which the government is given limited functions. For the sake of maintaining these functions, they advocated a single direct tax on the net product received by the landowners. Also, the physiocrats subscribed to the iron law of wages. They allowed charging of interest only in respect of investment in agriculture because it generates net product. In respect of theories of value and prices, their contribution was very little, if not nil. This is because they considered that production is the creation of matter, but not utility. After Quesnay, Turgot made a mark of his own in the doctrines.

Though the doctrines of the physiocrats laid the foundation for many modern economic analyses like national income analysis, general equilibrium analysis, and econometrics, the influence of these doctrines began to fade away with the publication of Adam Smith's Wealth of Nations in 1776.

4.9. TECHNICAL TERMS

1. Capitalist Agriculture
2. Natural Order
3. Sterile Class
4. Natural Laws
5. Gabelle
6. Aides
7. Stagnation
8. Merchant Capitalism
9. Rules of Nature
10. Produit net
11. Tableau Economique
12. Circulation of Wealth
13. Laissez Faire
14. Subsistence Wage
15. Savage Society
16. Ground Advances
17. Primitive Advances
18. Annual Advances
19. Material Surplus
20. Bon-Prix
21. Exact Science

22. Input-Output Table

23. Impot Unique

24. Iron Law of Wages

25. Replacement Fund

27. Stationary State

28. Psychological Theory of Value

29. Economic Liberalism

30. Absolutism

31. Self Interest

4.10. SELF ASSESSMENT QUESTIONS

1. **Physiocracy has been described as "the science of the natural order". Explain.**
2. "Circulation of wealth constituted the very life of the body politic just as the circulation of blood did of the physical", said Turgot. Elucidate.
3. Who are the physiocrats? What is their contribution to the Evolution of Economic Doctrines?
4. Distinguish the differences between the doctrines of physiocrats and mercantilist. How the physiocrats do made a mark in the scientific analysis of economics?
5. Explain the following chief propositions of the physiocrats:
   a. Natural Order
   b. Net Product
   c. Circulation of Wealth
6. Why do we consider the physiocracy is a revolt against Colbertism in France?
7. What are the contributions of the main representatives of the physiocrat school of thought?

8. How can you explain the relevance of physiocracy to the development of modern economic concepts?

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M.A. ECONOMICS:: EVOLUTION OF ECONOMIC DOCTRINES

LESSON-5/UNIT-2

CLASSICAL ECONOMISTS – ADAM SMITH AND DAVID RICARDO

CONTENTS

M.A. ECONOMICS:: EVOLUTION OF ECONOMIC DOCTRINES

LESSON-5/UNIT-2

CLASSICAL ECONOMISTS – ADAM SMITH AND DAVID RICARDO

5.1. OBJECTIVE OF THE LESSON

In this lesson, it is proposed to take up classical economists proper. In this context, the lesson provides an account of two important classical economists, namely, Adam Smith and David Ricardo. The lesson is divided into two sections. Adam Smith is taken in the first section. In this Section, an in-depth analysis covering Smith's propositions such as Naturalism and Optimism, Division of Labour, Theory of Value, Theory of Distribution and Economic Growth. In the other Section, David Ricardo is explained delving Theory of value, Theory of distribution, Theory of Money, Theory of Comparative cost, and Stationary state.

SECTION 1: ADAM SMITH (1723-1790)

5.2. INTRODUCTION

With the publication of his masterpiece work, "An Inquiry into the Nature and Causes of the Wealth of Nations, 1776", Adam Smith came to be regarded as an institution par excellence in the History of Economic Thought. It is not an exaggeration that his contribution to the development of science of economics has made a lasting impression on the future economic thought and policy. Adam Smith laid the foundation for many of the later developments in economics in his classic work, Wealth of Nations. He was responsible for the introduction of a new paradigm in economics, which is known as the classical paradigm by unifying the scattered ideas and loose theories of his time. So, he regarded as the founder of economic science in spite of the originality and vigour shown by the physiocrats before him (Gide and Rist, p.68). Though the ideas presented in this book are already known, Adam Smith hardly acknowledged the sources of his inspiration from many a writer earlier to him. So, none of the features of the book are original, thought it is surely a classic of great historical interest.

Smith's book is a vast storehouse of facts which make it so authentic that one cannot bypass it. It covers several theoretical concepts including production, distribution, value, trade, development, capital, etc. Adam Smith presented the ideas in a systematic and analytical manner in his voluminous book. Therefore, it is said that "The Wealth of Nations is the outpouring not only of a great mind, but of a whole epoch".

The earlier schools of thought particularly the physiocrats had a profound influence on him in his philosophical and analytical scheme of things. For what all he did to the economic science, he came to be called as 'Father of Political Economy'. His work Wealth of Nations is regarded as the starting point of classical school of economic thought and as such he can be taken as 'founder of the classical school'. Here we refer him as a classical economist and the term classical economist was at first used by Karl Marx.

Adam Smith was mainly guided by one universal principle that of self-interest by which each individual has the desire to better his own interest. According to him, the human conduct is guided by self-love, sympathy, desire to be free, a sense of propriety, a habit of labour and propensity to satisfy his wants with the help of others. Each person is the best judge of his own interest. Every one acts according to his self interest, but that itself leads to the benefit of both the individual and the society. A person satisfying his self interest indirectly, though not intentionally, is benefiting the society. In this context, Smith had an occasion to see the presence of an 'invisible hand', a guiding force.

Adam Smith was born in Kircaldy, Scotland in 1723. He was educated at the universities of Glasgow and Oxford. He became Professor at first Logic and later of Moral Philosophy at Glasgow. While travelling extensively, Smith met leading physiocrats of the day like Quesnay and Turgot who had exercised profound influence on him. In fact, Smith praised the physiocratic system. In 1778, he was appointed as commissioner of customs in Edinburgh and he held the post till his end. He died in 1790.

Regarding his publications, Smith published the Theory of Moral Sentiments in 1759. Later on, Smith concentrated more on jurisprudence and political economy and less on ethical doctrines. In 1776, he published his classic work 'An Inquiry in to the Nature and Causes of Wealth of Nations'. The book was a challenge to mercantilism. The book emphasizes the importance of labour as the source of the wealth of a nation. The wealth of a nation can be increased with the application of division of labour. In his book, Wealth of Nations, philosophy and economic content are intertwined.

5.3. PROPOSITIONS OF THE WEALTH OF NATIONS

In his book, Smith's philosophy and economic content are found interrelated. The book can be studied in two aspects- first the underlying philosophy and secondly, the economic content Smith wanted propose. Although the philosophical elements are nowhere explicit in his analysis, we can understand the underlying philosophy that occupies the whole book. Let us take up the details.

5.3.1. SMITH'S PHILOSOPHY - NATURALISM AND OPTIMISM

While extensively travelling the European continent, Adam Smith happened to meet some of the leading physiocrats like Quesnay and Turgot. These two physiocrat writers made a lasting impression on the mind of Smith. In fact, Smith showered praises upon them. Taking into account this background, Smith had borrowed some of the ideas of the physiocrats such as Natural Order, etc. Smith changed the name of his natural order as 'Naturalism'. The economic order as conceived by Adam Smith consists of two fundamental ideas. These are 'Naturalism and Optimism' which are the logical offshoots of his philosophical framework. His philosophy was emphasized in his famous book, Theory of Moral Sentiment.

Naturalism means the spontaneous and natural origin of economic institutions. On the other hand, optimism indicates that the naturally created institutions are based on the influence of self interest and common natural instinct. The economic institutions which are spontaneously created are beneficial in their effects. For Smith, spontaneity and beneficence are closely connected. Presence of one implied the presence of the other also. Smith had followed the physiocratic tradition of natural order and being the divine origin, it was certainly the best possible. Smith opined that there are certain motives and instincts which guided the human behavior. To Smith, human actions as guided by their selfish interests were bound to result in social good. The book, 'Theory of Moral Sentiment' explains about Smith's stand regarding the human conduct which was actuated by six motives. These include 'self-love, sympathy, the desire to be free, a sense of propriety, a habit of labour, and the propensity to truck, barter and exchange one thing for another'.

Basing the features of human conduct, Smith explained that everyone is bound to act on his self-interest. This type of behavior is given a name of 'rationality'. To try to serve his interest is to act rationally. Smith mentioned the role of invisible hand in moulding the human behavior. Smith says that a man always tries to further his economic interests by behaving selfishly. He further says that every man is a best judge of his own interests. This presupposes that a man must be completely left free to judge his own interests. Nobody shall restrain his freedom. Also, the interests of different individuals are mutually co-existing. That implies that different economics units do not conflict with each other. There is complete harmony of interests. In this context, we can cite the famous saying of Smith which says that "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". Smith pointed out that unless individuals were selfishly motivated, the very process of economic progress would come to an end. The butcher and baker, in the promotion of their self interest, further those of the society also. In this connection, the invisible hand plays a crucial role in furthering the interests of the society. Also, as we said earlier that the interests of different individuals are so carefully balanced that the benefit of one individual could not conflict with those of others so long as the society is free of restrictions or regulations. Being led by the invisible hand, the individual while promoting his own interest, he promotes the end which is no part of his intension. Therefore, the Smith's philosophy insists on a kind 'individualism' in which individual instincts, self interest and decision making must be given a free play.

Smith's idea of the spontaneous origin of economic institutions and their beneficent character is briefly his naturalism and optimism. Smith opined that all economic institutions are created by human beings and have come into existence spontaneously, i.e. naturally. These institutions include division of labour, money, capital, the theory of demand and supply, etc which are all beneficial to the mankind. The institution of money is a spontaneous institution and it removed the difficulties of barter system of exchange and paves the way for trade, exchange and commerce. Money is the result of the collective instinct of people guided personal motives. The same position is with capital. According to Smith, capital was the true source of economic life. While capital fertilizes the earth, the labour of man simply leaves it a weary waste. Capital is the simultaneous efforts of all the individuals who spontaneously inspired to save something out of their income only transform it as productive investment. To Smith, division of labour is "not originally the effect of any human wisdom, which foresees and intends that general opulence to which it gives occasion". To satisfy the instinct of barter and exchange, men resort to specialization and division of labour. Smith shows that division of labour gives rise to opulence and is hence beneficial. They theory of demand and supply is the best example of spontaneous origin and it does a great service to the market economy by adjusting supply and demand to the price level. Similarly, Smith's theory of population is also an extension of demand and supply theory of labour. Smith explains that variation of wage rate regulates the supply of labour through a variation in population. In case wage exceeds subsistence, more children of the working class families manage to reach maturity. When wages are very low, poverty and misery cause the death of many of them.

Smith wanted to establish that all aspects of the economy are interlinked and mutually interdependent. Also, a person generally 'indeed neither intends to promote the public interest nor knows how much he is promoting it. He intends only his security and furtherance of his material progress. The invisible hand is behind the behavior of the mankind and guarantees harmony of interests of all the individuals.

The inalienable character of naturalism and optimism leads the mankind, via their self-interest, to the creation and maintenance of economic institutions, and also makes the nation progresses towards greater wealth and prosperity.

APPRAISAL

Smith's optimism is not absolute and universally applicable to all the aspects of the economy. It seems to be correct in respect of production through which increasing opulence is to be achieved. There is hardly any scope for optimism and harmony of interests in the case of distribution. Smith recognized that there were possibilities of traders and merchants joining hands for the exploitation of consumers. Also, he realized that with the progress of the economy, income distribution would result in greater inequalities. There are increasing chances of unrest between labour and capital.

Though the beneficial effect of some institutions like the division of labour can be proved beyond doubt, but the spontaneity of certain human instincts cannot be established. For instance, the man's propensity to 'truck, barter and exchange' is one example of such nature. Nevertheless, Adam Smith was an optimist and he did not lose faith in the compatibility between individual and social interests. Smith had a trust in the working of the invisible hand.

5.3.2. SMITH'S ECONOMIC CONTENT – DIVISION OF LABOUR

As an opening statement of his book, Wealth of Nations, Smith said that "The annual labour of every nation is the fund which originally supplies it with all 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". A nation's material well being will depend upon the percapita income. Smith tried to find out the origin of national wealth which lies not in foreign trade or in land, but in labour and the nation's wealth constitutes the produce of labour. The amount of wealth that a nation is capable of acquiring determines the current degree of wealthiness or opulence. It is not the money value of the wealth produced, but the 'real' value of wealth that is important. Though Smith had given importance to the factor labour, he did not undermine the role played by nature in production. Here Smith considered that labour is a variable factor, given the physical environment. The wealth of a nation varies with the variations in the factor labour. Therefore, Smith opined that labour is the source of all wealth.

After explaining the importance of labour in the national economy, Adam Smith explained the technique of division of labour in the maximization of nation's output. The instinct of a man to truck, barter and exchange makes him to think in terms of creation of surplus in production. In the search of ways and means, man has found the institution of division of labour. Therefore, division of labour is a natural outcome of a natural behavior. It is a system of social cooperation in the production process where every individual is given a job according to his specialization. Acquired skills and talents emerge or get strengthened through this institution. The immediate benefit of this institution is maximization of labour productivity at a lesser time than before the application of the technique.

This can be explained with the help the illustration of pin making industry given by Smith. Let us suppose the production process is divisible into a number of different sub processes. At the process of making a pin will be divided into several distinct sub processes and each is given to a different labourer. For instance, one man draws out the wire; another straightens it; a third cuts it; a fourth points it; a fifth grinds it at the top for receiving the head of the pin; to make the head requires two or three distinct processes; to put it on is a peculiar business; and the important business of making a pin is in this manner divided into about 18 distinct operations. If one man performed all the above operations, that is, if there was no division of labour, he would produce just one pin or so in a day. On the other hand, if division of labour is introduced in the factory, the average production of each labourer was 4800 pins. Therefore, output will be maximized.

Regarding the merits of division of labour, we have already mentioned that it maximizes labour productivity. Smith ascribes the increased labour efficiency to three factors. Firstly, a labourer doing the same task again and again in a repeated manner, his skill in performing the task will get improved. So the adage – practice make a man perfect. Secondly, the labourer saves time while doing the task. The labourer can work on the task continuously without any interruption or disturbance from his fellow workers for want of tools. On the other hand, if a worker is performing a number of tasks in sequence, some time will be lost in shifting from one job to the other including the time lost in changing tools. Thirdly, the most important merit is that division of labour increases the chances of invention and increases the use of machinery. There is a chance for the labourer to invent short-cut methods of production because of his constant repetitions of the same task.

On the other side of the coin the technique has its own limitations. Firstly, doing the same task again and again, a labourer feels monotonous in doing the task. Then labour productivity comes down because he will lose pleasure and interest in the job given. Secondly, if a worker confined himself to a few very simple operations all through his life, it would make him as 'stupid and ignorant as it is possible for a human creature to become'. Thirdly, it leads to the immobility of labour because he doesn't know any other work. In times of bad trade, he will be in trouble of losing employment.

LIMITATIONS

Firstly, though division of labour maximizes labour productivity very much, the technique is limited by the size of the market. The increased output has to find the necessary demand for it. Only if there is a wide demand for the good, it will be produced on a large scale and there will be lot of scope for the application of division of labour. Anybody can apply this technique only in the manufacturing sector. This limitation of division of labour provided a basis for the development of increasing returns to scale by Alfred Marshall in the later period. But here Smith's contention was free trade which enlarges the scope for division of labour. Secondly, division of labour is limited by the quantity of capital available. When greater amount of capital is available, there is a possibility of taking up finer subdivisions of operations. Therefore, when capital stock is sufficient and markets are expanding, division of labour should be undertaken to increase productivity and national income.

Thus, Adam Smith dethroned the physiocratic system by showing that labour was productive and that by division of labour, its productivity could be increased further, though labour productivity depends on certain circumstances.

5.3.3. SMITH'S ECONOMIC CONTENT – THEORY OF VALUE

The theory of value of Smith was part of the analysis of economic system as a whole. His main concern was not mainly of value, but an inquiry into the nature and wealth of nations. In his analysis, the components of price include wages, rent and profits and his theory of value explains about the determination of 'natural rates' of the three components of price. The theory of value of Smith gets significance on the basis of market mechanism through which a natural harmony is secured in the operation of the laissez faire economic system. The price mechanism determines the decisions regarding the production and allocation of resources. Smith's theory of value appears to be confusing because he had referred many a concept of value on different occasions.

Smith opened his version of theory of value by introducing a distinction between 'value-in-use' and 'value-in-exchange'. The former refers to utility aspect and the later deals with power of purchasing other goods. Take the example water and in this case we can say that nothing is more useful than water but it has little value-in-exchange. On the other hand, in the case of diamonds, there is little value-in-use, but it has great value-in-exchange. So, the use-value and exchange-value need not go together as is seen above in the 'water-diamond paradox'. Smith in this context failed to establish some relation between the two values. Here Alfred Marshall provided the answer in the form of Marginal Utility analysis by which Marshall uses marginal utility as a regulator of demand in relation to the market price. So, Smith had lost the chance of linking utility with market price because he assumed that demand side of the market is given.

LABOUR-EMBODIED THEORY OF VALUE

Adam Smith has a labour theory of value in mind. In order to understand the real measure of value, Smith made a distinction between real price and nominal price. Nominal price refers to money price, i.e., quantity of a good multiplied by its price. When the price is assumed to be constant, money price becomes real price. Real price tells about purchasing power of money. So, in the search of this real exchangeable value, Smith finds labour. Accordingly, he says that "labour, therefore, is the real measure of the exchangeable value of all commodities". This implies that the exchangeable value of a commodity is determined by the amount of labour embodied in the commodity produced. According to him, "the real price of everything, what everything really costs to the man who wants to acquire it, is toil and trouble of acquiring it". Smith explained that it was natural that an article the making of which required two days' of labour should have double the value of another that was the result of only one day's labour. So, labour is both the origin and measure of the exchange value. This is his famous 'Labour Theory of Value'. It is curious that it was the same theory that was used by Karl Marx in his attack upon capitalism (Guide and Rist).

Smith also made a distinction between market price and natural price. The natural price is a long term price. "When the price just covers the ordinary rate of rent, wages, and profits expended in preparing and marketing the commodity it sells at its 'natural price'. The natural price is exactly equal to the 'labour command value' as determined by 'natural' rates of its components, namely, rent, wages and profits. In addition to the labour cost, wages, there are other costs incurred in the production process which include rent to the landlords and profits to the entrepreneurs. All these costs put together determine the natural price of a commodity in the long run. On the other hand, the actual price at which any commodity is sold is called its market price. The market price may either be above, or below or exactly the same with its natural price. The market price is determined by the supply on the one hand and by the 'effectual demand' on the other. The effectual demand refers to the demand of those who are willing to pay the natural price. In the short run, the price prevailing in the short run is the market price. A process of adjustment mechanism takes place in between demand and supply forces in the market which determines the market price and this price fluctuates up and down so as to ultimately settle at the level of natural price. This mechanism is guided by the invisible hand. The market price will be higher than the natural price, when the demand exceeds that of supply at a given price. The competition among the potential buyers will be intensified for the limited supply. As a result, the price will increase higher and higher till it equals the natural price. But opposite sequence will happen and the market price will be declined lower than the natural price and falls lower and lower until it reaches the natural price. In the cases of market price exceeds the natural price, or fall short of it, some component of the natural price, i.e. wages and profits, either gains or losses. This means that fluctuations in the market price tend to have its effects on the wage rate and profit rate before affecting the natural price of a commodity. Thus the natural price becomes "the central price to which the prices of all commodities are continually gravitating".

The natural price is not an absolute one in the sense that it is not fixed for every. It may change as per the changes in the general circumstances of the society, their riches or poverty, and their advancing, stationary, or declining condition. The other thing is that the relative natural prices of goods are proportional to the amounts of labour-cost of production.

The theory of value of Smith touches too many strands at the same time without explaining anyone in a scientific manner. There is the difficulty of measuring labour cost of production and Smith used time as his measuring rod. But not all workers are equally efficient and less skilled may take longer time than the skilled workers over a particular task. Also, at first Smith had given greater importance to labour as a source of wealth and at a later time with the progress of industrial revolution in his surroundings, he changed his mind and said that capital was also important. Then, he included the factor capital and land as components of natural price. But he is not successful in integrating them with labour theory of value.

5.3.4. SMITH'S ECONOMIC CONTENT - THEORY OF DISTRIBUTION

Adam Smith basically had no interest in the theory of distribution. He referred the theory as a passing reference while analyzing the components of price, namely, rent, wages, and profit. Smith's theory of distribution, therefore, follows from his analysis of natural price. To him, there are natural prices of labour, capital and land. These prices determine the natural price of a commodity. Smith distinguished between 'labour-cost' and 'labour-command' factors in determining the natural price of a commodity. With the advancement of society, the labour has to share its produce in terms of its value with the suppliers of land and capital. Smith's analysis of shares of labour, land and capital run in terms of the institution of private property and money.

a. THEORY OF WAGES

To Smith, the produce of labour constitutes the natural recompense or wages of labour. In a primitive society, the whole produce of labour belongs to the labour because he has neither landlord nor master to share with him. As society advances, the labour has to share the produce with landlord and capitalist because rent and capital come into the picture. Smith distinguished between the 'gross' produce of labour and 'net' produce of labour, when labour is no longer the only factor and when there is private property in land and capital. To Smith, wages were dependent on and were determined by contract between the employers and workers. The employers as a group always try to reduce the wage rate. There is a weak bargaining power in the case of workers.

In addition, Smith explained the influence of a fund, which destined for the payment of wages. Smith has developed the concept of wages-fund theory. Apart from the theory of wages, the wages-fund theory also provides a theory of capital. Labour is employed so long as capital accumulates by which wages fund also gets increased. So, more labour will be demanded. Smith did not consider the absolute size of the fund as a determinant of wage rate. But he considered variations in the fund by which he established the relationship between wage rate and population. If the wages are above subsistence level, population would go up. This increase in population would be proportional to the demand for labour. As a result, a population increase will not result in the reduction of wage rate to the subsistence level. This will depend on the economic situation in the economy. For instance, to keep a high wage rate that is above the subsistence level, it is essential to have an expanding economy. Smith was not against high wages. To him, high wages were advantageous to the society. The actual wage rate fluctuates around the subsistence wage as per the changes in the economic situation. In the long run, the wage rate is equal to the subsistence level. Then, the labour supply curve becomes perfectly elastic in the long run, i.e. horizontal to the X-axis. It is to be noted here that in Smith's mind, subsistence is not a fixed entity. A subsistence wage is one which keeps the body and soul together. Any wage lower than this would mean increase in the mortality rates.

Smith also analyzed difference in the wages on account of nature of employment include the agreeableness of employment, the relative difficulty of learning them, the degree of regularity of employment, the relative trust imposed on those employed and the relative possibility of success.

b. THEORY OF RENT

Adam Smith did not provide a systematic analysis of rent theory. Mostly, he based his analysis on the physiocrats. He differed with the physiocrats by mentioning that the whole of the rent was not due to the investment of capital on land. At one time, he called rent as 'Monopoly price' and another time he included rent in the cost of production to determine the price of a commodity. Still at other times, he referred that rent is determined by price. So he expressed more than one opinion and his analysis of rent runs on the basis of (1) monopoly, (2) differential fertility and location of land, and (3) the bounty of nature. Smith started with the assumption that land is a private property. As population increases, the demand for land goes up and less and less fertile lands and less accessible lands will be brought under plough. Then landowners in their capacity as appropriators of all land can have the capacity to withhold the supply of land unless they are paid rent. The rent is not related to their efforts. Hence, it is a monopoly price. Therefore, given the institution of private property and given the demand for land, the rent of land is determined by the excess of the agricultural produce which is over and above the cost of production. In the words of Smith, “rent, considered as the price paid for the use of land, is naturally the highest which the tenant can afford to pay in the actual circumstances of the land”. The farmer is left with wages and profit after meeting the natural rate of rent.

Regarding fertility differences, rent will be different due to differences in fertility. The land with higher fertility will get higher rent and a land with lower fertility will be charged at lower rent. A less fertile land produces yield of low value and therefore gets low rent. To Smith, rent is determined by the price. Also, rent enters in to the composition of the price of commodities. Therefore, rent arises on account of differences in the market price and the cost of production. Finally, the Nature’s bounty also influences the rent paid to the landlord. Nature also toils along with farmer in a number of ways to deliver the farm output. The rent may be considered as the produce of those powers of nature the use of which the landlords lends to the farmer.

c. PROFITS AND INTEREST

Smith did not clearly make a distinction between profit and interest. In the days of Smith, entrepreneurs used to employ their own funds. Hence, there was no distinction between entrepreneur and the capitalist. In modern times, these two are distinct. According to him, return on capital is profit, if capital is invested. On the other hand, if the capital is lent to someone else, the earning on capital is interest. Smith says that the reason for the collection of profit is because capitalist supplies capital. To explain further, capitalist maintains workers during the process of producing the commodities before its sale. This implies that he is taking the risk of maintaining the workers prior to commodities taken to the market for sale. Here, Smith indirectly makes a indirect reference to the roles of a capitalist and entrepreneurs proper. In this context, the entrepreneur is entitled to a share in the sale proceeds due to supply of his specialized entrepreneurial skills. On the other hand, capitalist maintains the labour during the process of production by supplying capital in the form of advances. Hence, the capitalist has a share in the produce of the labour. So, a particular institutional arrangement is the cause of profit, but not that of capital and its employment. Capital also plays a crucial role in the increase in output via the application of division of labour.

In the words of Smith, “profit is so very fluctuating, that the person who carries on a particular trade cannot always tell himself what is the average of his annual profit”. Smith also opined that rate of profit moves together with rate of interest. They do not bear definite proportion to each other. But profit moves in opposite direction with wages. In a progressive economy, wages rise and profits would fall. It is said that, “the increase in stock, which raises wages, tends to lower profit”. Increasing competition among the capitalists and increasing demand for labour cause increase in wages. When the economy moves from progressive state to stationary state, rate of profit goes on declining and ultimately, at the level of stationary state, it becomes zero. Like profit, rate of interest also falls in the long run.

Lastly, Smith has failed to have an integrated theory of distribution. In the view of Gide and Rist, his theory of distribution is least original of all his works.

d. THEORY OF CAPITAL

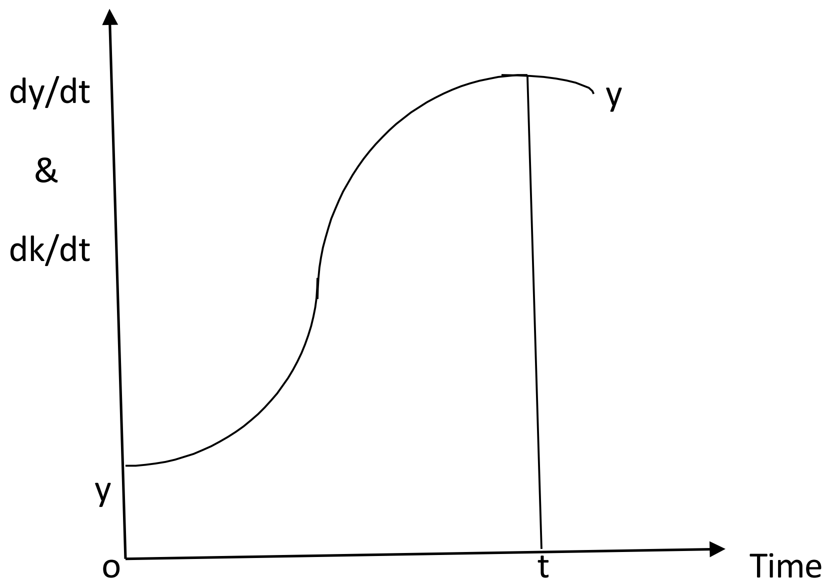
To Smith, capital is necessary to increase labour productivity. Capital and division of labour mutually feed each other. Therefore, “Capital limits industry”. Smith defined capital as “that portion of the stock of an individual or of a society which yields revenue, as contrasted with that portion of the stock which is used for immediate consumption. So, he distinguished between two types of capital, namely (a) circulating capital, and (b) fixed capital. Circulating capital refers to working capital which is needed for the purchase of raw material, goods-in-process, finished goods, money, etc. It is employed “in raising, manufacturing or purchasing goods, and selling them again with a profit”. It yields revenue by circulating or changing hands. On the other hand, fixed capital refers to capital invested on land, machinery, plant, etc. The fixed capital is “employed in the improvement of land, in the purchase of useful machines and instruments of trade. It yields of a revenue or profit without changing masters or circulating any further. Whether it is circulating or fixed, capital has the feature of providing addition to income or revenue of the society. Every industry, agriculture, mines and fisheries require both these types of capital.

Smith emphasizes the role of productive labour in the accumulation of capital. These two move together. Smith also recognized the role of saving in capital accumulation. While advocating increasing rate of saving, Smith held that, “capitals are increased by parsimony, and diminished by prodigality and misconduct”. So, the immediate source of capital accumulation is not the increasing in national income, but a frugality in consumption. Further, Smith’s implicit assumption is that supply of capital is increasing faster than its demand. As a result, there is a fall in the rate of profit. As quantity of capital grows the rate of interest falls. To Smith, therefore, increasing quantity of money is not the cause of a fall in the rate of interest. Smith is in favour of labour-intensive methods of production and naturally he prefers investment in agriculture.

5.3.5. ON FALLING RATE OF PROFIT & STATIONARY STATE

In the Smith’s theory of development, capital accumulation plays a highly crucial role. As per his scheme of analysis, capital accumulation and division of labour are mutually interdependent and as such they produce a chain mechanism in the economy leading to the increase in national income via increases in labour productivity. Again, capital stock increases in succeeding periods by increased doses of investment. Labour employment will increase. Due to the increased demand for labour, wage rate goes up. These factors reinforcing each other to accelerate the pace of development until such time that the economy’s capital stock grows large enough to eliminate profits. At this stage, stationary state sets in. In this stationary state, everything comes to a standstill position. Up to the stationary state, the economy moves to higher levels and once stationary state reaches, the growth process stops. At this level, the stationary state is featured by growth rates of population, output, and profits become equal to zero. The wage rate is at the subsistence level. Smith did not suggest any remedies to this ‘dull’ state of affairs. Of course, an economy in the stationary state finds itself at the highest level prosperity consistent with its natural resources. Only rate of growth stops and the economy is at a high level of development.

Smith's Growth Process & Stationary State



The above diagram explains about Smith's economic growth process. Y-axis measures the rate of growth of output (dy/dt) and the rate of growth of capital (dk/dt). X-axis measures time. The curve 'yy' represents growth of output curve. After reaching the maximum growth of output level, the output line starts falling due to the contradictions in the growth process. At time t, stationary state sets in at which the slope of the output line becomes zero. At this level, output reaches the peak level (maximum level). Hence it is the stage of riches or economic bliss.

SECTION 2: DAVID RICARDO (1772-1823)

5.4. INTRODUCTION

David Ricardo is the greatest name in the classical school of economics followed by Adam Smith. Also, he is the last representative of the English Classical School and he has been one of the most controversial figures in the domain of economic thought. He became the leader of the classical school. Ricardo was a formidable logician and a terribly abstract writer. Ricardo's influence in shaping the future course of economic thought has been so profound that none can rival him in his respect.

The best example of his abstract writing is his book, "Principles of Political Economy and Taxation, 1817". Ricardo was interested in analyzing the problems of political economy rather than in its wealth and progress. In a letter to Malthus, Ricardo wrote, "Political Economy, you think, is an inquiry in to the nature and causes of wealth: I think it should rather be called an inquiry into the laws which determine the division of the produce of industry amongst the classes who concur in its formation". He opined that a tolerably correct law can be laid down in respect of proportional shares of the produce and it is the true object of science. Therefore, Ricardo was chiefly concerned with the theory of distribution.

In the history of economic thought, Ricardo and Malthus are known as pessimists, whereas Adam Smith was an optimist. The prevailing economic situation during the times of Ricardo was completely different from that of Smith. Industrial Revolution had already taken deep roots in England with its attendant evils. Economic development was fast picking up. There was the factory system and the growth of population and poverty of the working masses. The prices of grains increased which was caused by depreciation of money and increased urban population. Less fertile lands were brought into cultivation and land rents were up. There was large employment of capital and the English economy was under capitalistic system. Due to the rise in the prices of food grins, 'Corn Laws' became a subject of intense controversy. This resulted in conflict between landowners and manufacturers. This situation greatly influenced the Ricardo's analysis of economic thought.

Regarding his methodology, Ricardo adopted deductive reasoning for his analysis. Just like Smith, he also a believer of laissez faire economy. Regarding value, he considered labour theory of value. He approached the theory of value from cost of production side. He incorporated many a theory of Malthus in respect of population and food supply. His famous rent theory is based on the law of diminishing returns. Finally, his main attention was the theory of value and distribution.

5.5. THEORY OF VALUE

Ricardo's theory of value contains many of the legacies of Smith. His theory was essentially a 'labour theory of value'. Ricardo distinguished between the exchange value and use value. The use value represents utility of the good in question. He recognized that use value is essential for exchange value. Then utility is not a measure of exchangeable value, although it is absolutely essential to it. Commodities possessing utility desire their exchange value from two sources: (1) scarcity and (2) quantity of labour require procuring them. In respect rare non-reproducible commodities, such as rare paintings, which are scarce, value is determined by the intensity of demand. In respect of ordinary reproducible commodities, value depends on the amount of labour necessary to produce them.

Also, Ricardo distinguished between 'natural price' and market price. Natural price is a long run price, whereas the market price is a short-run one. Market price fluctuates around the natural price. The long run price depends on cost of production and the short run price is determined by supply and demand forces. When the market price is above the natural price, profits will be pushed up and investment would be raised. On the other hand, when the market price is lower than the natural price, profits would fall and investment would flow out of the industry. So, in the long run, natural price confirms to the cost of production and normal profits would prevail.

While Smith applied labour theory of value to the primitive societies, Ricardo applied it to capitalistic society as well. If a commodity is produced by labour and capital, value would ultimately depend on the amount of labour expended in producing the commodity, since capital can be converted into labour. When a commodity is produced with land, labour and capital, value is determined by the cost of labour embodied + the cost of labour which represents the cost of capital after conversion of capital to labour. To Ricardo, rent doesn't enter into price. Ricardo accuses Smith of confusion between labour-cost and labour-command measures of value. Ricardo used the 'labour-cost' measure of value only, because it is to this that the relative long-term value (natural price) of a commodity gravitates and because it is a stable measure. Therefore, Ricardo sticks to the proposition that irrespective of the stage of economic development, it is labour-cost which determines the relative value of commodities.

There are two important problems faced by Ricardo in respect of labour. Firstly, labour cost of production would increase if labour is used inefficiently. Secondly, there are many kinds of labour. To answer the first question, he said that it is the 'necessary' or 'customary' quantity of labour which should be considered in analyzing the relative value of a good. Secondly, Ricardo knows well that different types of labour are paid at different rates. He opined that this is no cause of variation in the relative value of commodities. Thirdly, Ricardo did not find any difficulty with the inclusion of capital in the determination of price of a commodity. He recognized two forms of capital, firstly, circulating capital and fixed capital. To him, circulating capital was meant for maintenance of labour and fixed capital in the form of machinery and equipment was nothing but 'stored up' labour and could be expressed in labour terms. According to Stigler, in the Ricardian Theory of value, labour cost constitutes 93 percent of the total cost, whereas the capital cost in the form of profit accounts for the remaining 7 per cent. Therefore, Stigler regarded the Ricardian theory of value as 93 percent labour theory of value. With this labour-content measure of value, Ricardo could proceed in measuring the behavior the relative factor shares in a multi-sector framework. Though Ricardo confirms the labour-cost approach, he is not able to solve as to how the labour equivalent of different capital inputs would be estimated.

The theory of value of Ricardo became a powerful tool in the hands of Karl Marx to demonstrate that there was labour exploitation in a capitalist economy. On the basis of the labour theory of value, Marx asserted that the worker was entitled to the entire fruit of his labour. But there is no hint of exploitation in the analysis of Ricardo.

5.6. THEORY OF DISTRIBUTION

The primary objective of his book ‘Political Economy’ is determination of distributive shares. Ricardo’s theory of distribution laid great stress on the distribution of national income and on the extension of theory of value to the field of distribution. Though Ricardo is clear in putting forth commendable job in analyzing the theory of distribution compared to Adam Smith, he does not bring interest as a specific category of income distribution in his analysis and he aims at ‘factoral distribution’, i.e., shares of wages, profit and rent in the national product at the macro level. In this analysis, Ricardo said that ‘rent does not enter into the cost of production’, so that only wages and profits required to be determined to solve the problem of distribution. In addition to the determination of distributive shares, Ricardo also explains how these shares are affected in the long run. This unveils the foundation for socialist ideas.

a. THEORY OF RENT

Ricardo’s contribution to the History of Economic Thought was his theory of rent. Ricardo’s effort in the development of theory was by far ‘fullest and complete’. Hence, his name was mainly associated with the theory of rent. The theory of rent was based on two principles: firstly, marginal principle and secondly, surplus principle. Ricardo used the ‘law of diminishing returns in agriculture’ under the marginal principle. This principle emphasizes the share of rent in the total income. On the other hand, the surplus principle explains the division of surplus over and above cost of farm output between wages and profits. The theory covers two phases: firstly, cultivation of lands of inferior quality or extensive cultivation; and secondly, the law of diminishing returns and the intensive cultivation phase. Both these phases were gained significance with the Corn Laws. The Corn Laws controversy made this rent theory more widely known. The idea of diminishing returns was not of the origin of Ricardo.

Regarding the definition of rent, “rent is that portion of the produce of the earth which is paid to the landlord for the use of the original and indestructible powers of the soil”. It implies that rent is the reward for the use of the services of land. Ricardo also looked at rent in the form of a differential rent arising out of niggardliness of nature. James Anderson (1739-1808) has made an analysis of differential rent as lands are of differential fertility. Therefore, rent is differential surplus.

While analyzing the theory, Ricardo considered the following assumptions. Firstly, land is inelastic in nature that is, fixed in supply. This is a peculiar feature of the land. All lands are not of uniform fertility. Only those lands which are more fertile than others will get rent. Secondly, land has some original and indestructible powers. Thirdly, land is subject to the law of diminishing returns. Lastly, classical economic thought runs in terms of laissez faire which presupposes the existence of perfect competition.

Ricardo's analysis of his rent theory is explained in the following lines with a hypothetical example of a colonization of a new country. Let us suppose that some people go to this country and settle down there. In the new country land is plenty and the people are going to cultivate the best possible lands. The land is also free for them. So, no rent is to be paid. After some time, a new batch will start moving to the new country to settle. Then the demand for agricultural produce would go up. In course of time, the first grade lands, though cultivated intensively, alone cannot produce the needed food grains to the increasing population. This is due to the operation of the law of diminishing returns. So the second grade lands will be brought under cultivation. Then the supply of corn increases, but each additional supply is obtained at higher marginal cost. In the market, all corn sells at the same price due to perfect completion. The corn of both the grades of land has to be sold at the same price. The price of corn is just sufficient enough to meet the cost of production in the second grade lands. Then the market conditions together with diminishing returns are able to create an economic surplus. The economic surplus is rent and is appropriated by the landowners by virtue of their property rights on land. The economic surplus will be earned by the first grade land because of its superior fertility over the second grade land. The second grade land covers only the expenses basing on the 'prevailing' market price of corn.

If population increases further in this new country, third grade lands, which are less fertile compared to the second grade lands, will be brought under cultivation. Then the second grade land will begin to yield rent and rent on the first grade land will increase further. No-rent land or marginal land refers to those lands in whose case its cost of production is just equal to the price of corn. Rent indicates the differential advantage of the superior land over the marginal land. Therefore, rent arises on account of differences in the fertility of the soil. But Ricardo fails to bring in the locational aspect of rent theory which was filled by the German economist Von Thunen in 1826. It is thus proved that differential distance from the market affects rent in the same way as differential fertility.

It is to be noted that rent is not a part of the cost of production, since marginal doses of capital and labour do not yield rent. This is because increasing demand for corn leads to extensive cultivation using marginal lands. Ricardo shows that with increasing difficulty in cultivation, land rent goes up, because the cost of cultivation at the margin goes up and the market price of corn must cover the marginal cost of cultivation. Ricardo says that rent, therefore, is price-determined because the marginal lands do not get any rent at all.

Rent, therefore, is defined as economic surplus caused by diminishing returns and market forces. But Ricardo defined it as that portion of the earth which is paid to the landowner for the original and indestructible powers of the soil. So, rent is made as institution- bound phenomenon revealing that landowners are able to get it because land has fertility and they would not allow cultivation unless they are paid rent. Both Ricardo and Smith are closer to the saying that rent is extortion by the landlords on account of their property rights and demand for land exceeds its supply.

CRITICAL APPRAISAL

Though Ricardo developed a systematic analysis of theory of rent and accepted by many economists including Malthus, the theory is not without defects. Firstly, in the words of Ricardo, "the most fertile and most favorably situated land will be first cultivated". But Ricardo has himself explained that if all lands were of equal fertility, there would be no rent unless there was a difference in the conditions of situation. Though fertile, certain lands are suitable for certain crops only. Secondly, not all the produce of different lands is sold at the same price. Ricardo missed the point that a particular agricultural product can be of different quality depending upon the soil composition and other factors. Thirdly, Ricardo opined that land has ‘original and indestructible powers’. With the repeated cultivation of crops on a fertile land, fertility goes down. So, there are no original powers and these powers are not indestructible. Fourthly, Ricardo’s theory of rent comes into conflict with his theory of value. According to Ricardo, relative values are determined by relative labour costs, but in the theory of rent, price of corn is determined by the marginal labour cost. Fifthly, Ricardo deals with differential rent and did not explain the scarcity rent. Finally, Ricardo overemphasized the role of diminishing returns. This theory is valid under constant technological conditions. Historically improvements in agriculture have resulted in increasing returns in advanced countries.

b. THEORY OF WAGES

After determining the share of the landowners in the national income, Ricardo proceeded to explain the theory of wages. The Ricardian theory of wages is a combination of Smith’s subsistence theory of wages and Malthusian theory of population. Wages are the price of labour. The price is divided into market wage and natural wage. Market wage is a short run price and is determined by the fluctuations in the demand and supply of labour. On the other hand, natural wage of labour is a long-run phenomenon and the wage is adjusted towards the subsistence wage. To Ricardo, the natural price of labour is “that price which is necessary to enable the labourers, one with another, to subsist and to perpetuate their race, without either increase or diminution”. It depends on the price of necessities required by a typical labour and his family. The natural wage is directly related to the cost of necessities of life. This is known as subsistence theory of wages or ‘iron law of wages’. He also defined the market price as, “the price which is really paid for it, from the natural operation of the proportion of the supply to demand”. In the long run, market price and natural price of labour are equal. But in the short run they vary due to the fluctuations in the market.

In his analysis of wages, Ricardo treated labour as a commodity. This means that the determination of wage of labour is the same as the determination of price of a commodity. Suppose if the market wage is moving at a higher level compared to the natural wage, labourers will be happy because they command a greater proportion of necessities and enjoyments of life. Then, population would go up. In due course, money wage rate falls to the level of natural wage where the labourers would get subsistence wage. At times, the money wage will fall below the natural wage and in that case there would be increase in the mortality rates. So the lower limit for the wage is, normally, subsistence wage at which population growth remains constant. In this context, Ricardo used the Malthusian theory of population.

c. THEORY OF PROFIT AND INTEREST

Ricardo's theory of profit and interest is the most unsatisfactory part of his Political Economy. He has failed to provide a clear cut distinction between profits and interest. Ricardo firmly believed that wages would rise at the expense of profits. So, wages and profits are diametrically opposed to each other. This leads to class conflict between workers and employers. In the long run, there is a tendency on the part of profits to fall. Regarding interest, Ricardo adopted the path of Adam Smith that interest is paid on borrowed capital and profit is earned on one's own capital. During the times of Ricardo, profit was regarded as a combination of interest, wages of managerial labour and the return for entrepreneurship. But he did not split the profit income into its components. Since the entrepreneur adds the service of saving and investment to the value of the product produced, the value of the product includes 'labour-cost plus profit'. This implies that profits are included in the cost of production. Under perfect competition, normal profits are included in the cost of production.

Moreover, Ricardo treats profits as residual income received by the entrepreneur. After meeting the claims of rent and wages from the cost of production, the residual amount would be profits. In respect of marginal or no-rent lands, the total produce is divided into wages and profits only and profit would vary in the opposite direction to the one in which wages would vary.

Therefore, Ricardo says that with the progress of the economy, profits would tend to fall in the backdrop of an increase in money wages. This has been mitigated by improvements in machinery and discoveries in the science of agriculture.

Increased population culminates in the increased demand for corn. Then marginal land cultivation will be increased leading to increase in the cost of production at the margin. Corn prices and wages would go up, since subsistence required by the workers would increase. Such wage increase is at the cost of profits. So a fall in the profit rate in agriculture leads to fall in the profit rate in other employments of capital also. The entrepreneurs will stop the service of saving and investment because of no-profit situation, the economy would be moved to the stationary state. Also, Ricardo believed that 'profits must be sufficient to afford an adequate compensation for their trouble and the risk'. So Ricardo says there must definitely be a minimum limit to profits.

5.7. THEORY OF MONEY

Ricardo made a significant contribution to the principles of money that should govern the issue of paper currency, since he was interested in the urgent currency problems of his times. Ricardo witnessed the upheavals that took place in the currency system of England. Ricardo opined that The High Price of Bullion, a Proof of the Depreciation of Bank Notes 1809, was the chief cause of these upheavals. The main reason he explicitly stated was over-issue of paper currency leading to the depreciation of value. In this context, Ricardo developed the quantity theory of money. Ricardo was of the view that paper currency was useful for commerce and trade, and advancement over previous system of metallic money, the bullion, which was advancement over the barter system. The main task before him is to arrest the depreciation of paper money as people at that time rushed to encash Bank Notes in 1797. For this purpose, Ricardo advocated the use of 'regulation of the supply of money'. Also, Ricardo advocated a 'gold bullion standard' to the Bank of England. In this gold standard, only bank notes are in circulation. He believed that gold standard by acting as a check on the over-issue of currency would curb inflation. England accepted the recommendation and introduced gold standard in 1821. The gold standard remained the dominant monetary standard in Britain and many other countries for over a century.

Ricardo believed in the quantity theory of money which tells that the level of prices in the economy is proportional to the quantity of money in the economy. It may be pointed out that the analysis of money was inconsistent in terms of his theory of value. To Ricardo, the value of precious metals, gold and silver, was determined by the amount of labour required to obtain them. Given the values of these precious metals, the quantity of currency in a country will be determined by the sum of all commodities that enter into exchange. The precious metals may be substituted by paper currency and the quantity of which will be determined by the value of precious metals. Basing on the value of available gold and silver, paper currency will be issued by a central bank. Then, the quantity of currency in a country depends upon prices and the prices are determined by the quantity of money as per Ricardo's quantity theory of money. So, a rise or fall in the price level is due to an excess or deficiency of the amount of currency in circulation. Ricardo also says that purchasing power of money depends upon the supply of money. Ricardo advised the banking authorities to regulate the note issue in a country in accordance with the international movement of gold. The value of precious metals cannot be reduced by the home country because, "the value of gold as a commodity must be regulated by the quantity of goods which must be given to foreigners in exchange of it". Therefore, like mercantilists, Ricardo had forgotten that he was giving the same importance to precious metals.

5.8. THEORY OF COMPARATIVE COST

Ricardo's theory of comparative cost is a major contribution to the theory of international trade. Adam Smith developed the international trade theory based on differences in absolute costs allowing free competition. Accordingly, every country would try to buy in the cheapest market. On the other hand, Ricardo has shown that international trade can take place even when a country is able to produce all commodities cheaply than its foreign counterpart. The comparative cost theory says that," under competitive conditions a country tends to specialize in those commodities in the production of which it has the greatest comparative advantage". Ricardo stated that the more efficient country should export those commodities whose comparative cost is the lowest, and it should import those whose comparative cost is highest. Ricardo ran his theory of international in terms of labour cost of production and barter exchange ratios between different goods. Basing on this theory, Ricardo advocated free trade policy.

Regarding the terms of trade, Ricardo believed that balance of trade gets adjusted automatically through the operation of quantity theory of money. Suppose a country gets favourable balance of trade by which gold inflows will come into the home country. As a result, prices in the home country would rise. Prices would go down in the gold exporting country. The price variations would reduce exports and increase imports, thereby, surplus in the balance of trade would be wiped out. The reverse sequence would be the result, when there is unfavourable balance of trade situation. In either way, there is automatic adjustment.

5.9. STATIONARY STATE

In the initial period, only best lands are cultivated. Population is also very small. Income is going to be distributed between wages and profits. The portion of rent is very small. In the second period, profits are invested. Capital accumulation begins. This leads to increasing demand for labour leading to increase in wages above subsistence level. Then population would increase. So, inferior quality lands will be brought under cultivation to feed the numbers. Rents would increase and diminishing returns start working. The relative shares of wages and profits would go up. In the third phase, rents would rise further and wages and profits fall. The pressure mounts up on the land. Population becomes larger and larger. Then, wages touch the subsistence level. Profits would fall to a dead bottom level following which capitalists stop accumulating the capital. The economy is said to be at the level of 'stationary state'. At this stage, all growth would be stopped. Please remember that this level is not an underdevelopment level, but the economy is at a highest level of development. Therefore, Ricardo made a significant contribution by bringing together under one head the problems of production, distribution and economic growth.

5.10. SUMMARY OF CLASSICAL ECONOMISTS

Smith's Wealth of Nations has become the corner stone of science of economics. His book is a voluminous one having covered a large number of fields. The ideas of Smith lack originality and therefore sans scientific treatment. In the words of Schumpeter, "The Wealth of Nations does not contain a single analytic idea, principle, or method that was entirely new in 1776". Though he borrowed ideas from physiocrats and others, he never cared to acknowledge them. He is only a synthesizer of scattered and known ideas at his times. But the way in which he has written the book is highly lucid and convincing. Smith's approach is essentially materialistic. To him, production and wealth manifest only materialistic form. Ignoring social and moral values, Smith concentrated mainly on individualism. His individual is too much of an economic man dominated by self-love and self-interest. Smith's main attention is always on the production of wealth. He also says that consumption is the sole end purpose of all production. Due to his preoccupation with wealth, Smith neglected the question of welfare. Therefore, though he is a forerunner to many later developments in economics, he has considered too many concepts at a time, but left nothing scientific.

Adam Smith's main propositions are naturalism and optimism, division of labour, labour embodied theory of value. But his efforts in respect of the theory of distribution are not in good stead.

David Ricardo has made a significant contribution to the History of Economic Thought, though he is the supreme example of abstract reasoning. He will be remembered as the master of deductive method in economics. He was more consistent and logical in his approach compared to Smith. But he was too much materialistic in his approach to various economic activities. The demerit of his analysis is that he used to proceed on the basis of laws and institutions of England, and draw conclusions claiming their universal application. Ricardo covered a narrow field than Adam Smith does. But his treatment was more rigorous and made economic analysis more scientific. He was used to be called as pessimist along with Malthus, because he presented a gloomy picture regarding population.

Regarding the works of Ricardo, the theory of value and distribution are the chief works of Ricardo. By emphasizing the labour-cost theory of value and by giving an account of conflicts of interest among different classes of the society, Ricardo laid the foundation for the socialist economics. The interests of landlords were opposite to those of other classes in the society. With increasing population, landowners would like marginal cost of cultivation to go up. The paradox is that the landowners did not like advancements in agriculture science. Basing on his analysis of conflicts of interests of various classes, Karl Marx used his analysis of labour theory of value as the basis for his 'labour exploitation theory' and class conflict. Also, the Ricardian theory of rent has become a powerful tool for every Marxian in his general attack on private property.

The Classical Economists, Adam Smith and Ricardo are pioneers for many a concept in economics and in fact the subject of economics was born in their hands. The later developments in economics are almost based on the foundations provided by these great economists in their contributions. Their ideas, relevant even today, are drawn from their absolutism.

5.11. TECHNICAL TERM

1. Invisible hand
2. Naturalism
3. Optimism
4. Rationality
5. Spontaneity
6. Division of Labour
7. Natural Price

8. Natural Wage
9. Subsistence Wage
10. Iron Law of Wages
11. Value-in-use
12. Value-in-use
13. Water-Diamond Paradox
14. Effectual Demand
15. Labour-cost Value
16. Labour-command Vaue
17. Wages Fund
18. Monopoly Price
19. Circulating Capital
20. Fixed Capital
21. Stationary State
22. Capital Accumulation
23. Deductive Reasoning
24. Factoral Distribution
25. Diminishing Returns

5.12. SELF-ASSESSMENT QUESTIONS

1. Smith opined that “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”. Explain the spontaneity of economic institutions.

2. “Rent does not enter into price”. Elucidate Ricardo’s viewpoint.

3. The cumulative growth process reaches a point wherein capital accumulation stops and stationary state sets in. Explain Smith’s viewpoint.

4. Explain the following propositions of Adam Smith:

a. Naturalism and Optimism; b. Division of Labour; c. Theory of Value

5. Bring out the contribution of Ricardo in integrating the theory of distribution of factoral shares in national income with that of his theory of value.

6. Examine Ricardo’s views regarding the monetary economics and theory of international trade.

7. Distinguish between Adam Smith and Ricardo regarding the theory of value.

8. “Landlord is interested in the extension of cultivation to the marginal lands thereby he accentuates the fall in the rate of profit leading to stationary state”. How can you substantiate the view of Ricardo?

9. “Smith’s Labour Theory of Value has far reaching effects on the later developments in economics”. Do you agree?

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M.A.ECONOMICS: EVOLUTION OF ECONOMIC DOCTRINES

LESSON-6/UNIT-2

CLASSICAL ECONOMISTS - THOMAS ROBERT MALTHUS (1766-1834)

CONTENTS

M.A.ECONOMICS: EVOLUTION OF ECONOMIC DOCTRINES

LESSON-6/UNIT-2

CLASSICAL ECONOMISTS - THOMAS ROBERT MALTHUS (1766-1834)

6.1. OBJECTIVE OF THE LESSON

In this lesson, the ideas of Thomas Robert Malthus are discussed. He is mainly known for his significant contribution to the theory of population. A student of economics is able to understand the intricacies of the theory of population. After that, a detailed analysis is provided regarding the Malthusian version of 'theory of overproduction or glut' and how far he is successful in setting aside the Say's Law of Markets.

6.2. INTRODUCTION

Thomas Robert Malthus was a son of Daniel Malthus and born in 1766 in Rockery in England. He was educated at Cambridge and proficient in philosophy, mathematics, and theology. In 1805, he was appointed as Professor of History and Political Economy in the college near London by the East India Company and worked in the college until his death in 1834. He was the first 'Professor of Political Economy' anywhere in the world. He was a close friend of David Ricardo. In the History of Economic Thought, both were regarded as pessimists because both of them interpreted a gloomy picture about population and other theories.

There was no systematic theory of population before Malthus. Malthus was the first economist who developed a treatise on population, knitting the scattered ideas. He was able to synthesize the relationship between population and means of subsistence in quantifiable terms. The circumstances prevailing during the times of Malthus prompted him to do so. At that time, he felt sorrow regarding the plight of the poor people. By the end of the 18th century the peak level agricultural prosperity had come down to a situation of shortage of food and rising prices. Added fuel to fire, the ill-effects of industrial revolution like unemployment, poverty, unrest, etc were come to the light. He found that there was an imbalance between population increase and means of subsistence. He also felt that there was a need to solve the problem of shortage of effective demand.

Therefore, Malthus propounded two important contributions, namely, on 'theory of population' and 'the theory of economic crisis' to the History of Economic Thought. But here one things we must remember that Malthus was well known only with respect to the theory of population. Though he contributed his own ideas regarding others like rent, value, etc, his theory of population has overshadowed these developments. His first contribution is found in his main work, "An Essay on the Principles of Population as it Affects the Future Improvements of the Society", 1798. The later contribution is taken up in his other work, "Principles of Political Economy" (1820).

6.3. MALTHUSIAN THEORY OF POPULATION

a. GENESIS OF THE THEORY

Prior to Malthus, it was believed that there was a correlation between dense population and economic prosperity. So a rapidly growth population necessarily led to economic prosperity and the wealthiest and the strongest countries were often the most populous. During Malthus's times also governments and employers preferred a dense population. Adam Smith opined that human population conforms to the rule of subsistence. Adam Smith also believes that the law of population applies only to the poorer sections. Malthus agreed to this view of Adam Smith. The views on population can be categorized into two strands. They are pessimistic view and optimistic view. Regarding the pessimistic view, the laboring class could not hope to better their lives beyond subsistence. In case any increase in wage rate beyond subsistence level, population would go up. Then wage level again comes down to the level of subsistence. In the words of Cantillon, "men multiply like mice in a barn if they have unlimited means of subsistence". On the other hand, richer communities were not used to be influenced by the subsistence because their incomes were higher than the subsistence. This view failed to give any idea regarding what determined the subsistence. The optimistic view was that that most people believed in ‘golden future for mankind’. This belief was based on the production potentialities of man. These potentialities were increasingly realized by better and complex division of labour and by the use of better machines and other techniques.

William Godwin (1758-1836) was a believer in golden future of human race. Malthus’s father, Daniel Malthus was in fact believed in the optimistic philosophy of Godwin. Godwin published his work on, “An Inquiry Concerning Political Justice and Its Influence on General Virtue and Happiness”, in 1793. Godwin believed in the perfectibility of human race. Being the perfect people, they would develop a behavior pattern suited for their individual and social welfare. He opined that men were ultimately guided by the rule of reason. To Godwin, the main obstacles to progress are: the institution of private property; economic and political inequalities; and the coercive state. The institution of private property propagates the ills in the society in the form of socio-economic conflicts between haves and have-nots. The state works on the side of the haves to coerce the have-nots. The have-nots are denied of ‘natural justice’. Godwin felt that the institution of private property and the attendant evils of exploitation and confrontation was to be abolished to promote the welfare of the society. This results in ‘fraternal equality’ in the society. He also believed that $3/4^{th}$ of the earth’s habitable surface was still uncultivated, and there was no reason to believe that earth would ever be overpopulated. In his view social reform would be ushered in the place of over-population. Therefore, Godwin was an optimist.

On similar lines, Condorcet (1743-1794) held the same view as that of Godwin. He was a pacifist and an optimist. Condorcet believed that the natural order tended towards economic equality, but the existing laws and institutions encouraged inequalities. Equality would pave the way for man’s perfection. Condorcet also believed in human capacity to achieve complete happiness with the help of science. On the question of population, Condorcet opined that as a result of beneficent reforms, population would increase, but food supply would increase more rapidly. He recommended birth control in case population growth exceeds the food supply.

Malthus did not agree with any of the views expressed by the Godwin, Condorcet and other optimists. He refuted the optimism of Godwin who said that either the population growth would be counterbalanced by a corresponding increase in the means of subsistence or reason would prevail to check the growth rate. Godwin wrote: “There is a principle in human society, by which population is perpetually kept down to the level of the means of subsistence. Thus among the wandering tribes of America and Asia we never find through a lapse of ages that population has increased as to render necessary the cultivation of the earth”. Malthus rejected the opinion of Godwin and sarcastically remarked,” this principle, which Mr. Godwin thus mentions as some mysterious and occult source… will be found to be grinding law of necessity, misery and the fear of misery”. Malthus, however, reached this view on the basis of two postulates: firstly, “that food is necessary to the existence of man”, and secondly, “that the passion between sexes is necessary and will remain nearly in its present state”.

Therefore, the power of population is infinitely greater than the power in the earth to produce subsistence for man.

Malthus viewed that there was something like natural law which pushed the population growth rate at a rate faster than the increase in the means of subsistence. Therefore, Malthus opined that poverty and misery were caused by the fecundity of human race. So the strong sexual desire of human beings must be curtailed through moral restraint, otherwise it results in a high rate of human procreation. Due to niggardliness of the land, food supply, the means of subsistence, cannot be increased at a fast rate. Therefore, there is an imbalance between population and food supply.

b. THE THEORY

The Malthusian theory of population discusses the relationship between population and food supply. The theory is based on the law of diminishing returns. The two fundamental assumption of the theory mentioned, in the preceding paragraphs, are: firstly, food is necessary to the human existence; and secondly, the passion between sexes is necessary and will remain more or less stable. Also, population has greater power in procreating numbers than the power in the earth in producing the means of subsistence, that is, food. Then we can say that 'population is necessarily limited by the means of subsistence'. According to Malthus, population goes on doubling itself every 25 years or increases in a 'geometric ratio', that is, at the rate of 1, 2, 4, 8, 16, 32…. and so on. Basing on the Malthusian view that population invariably increases more than the means of subsistence, we can deduce that food supply will increase at an 'arithmetic ratio', that is, at the rate of 1, 2, 3, 4, 5…..and so on. So, food supply cannot increase as fast as population on account of influence of the law of diminishing returns on land. Malthus says that, "in proportion as cultivation is extended, the additions that can yearly be made to the former average produce must be gradually and regularly diminishing".

As long as population and food supply conformed to their respective geometric and arithmetic progression, population was bound to outstrip the food supply. Therefore, the growth of population has to be checked. In case the cultivation of new lands and emigration are not sufficient to counteract the superior powers of population then it would be checked by natural forces, which would limit the supply of food. These checks include war, disease, famines, death, and other natural disasters. These checks are known as 'positive checks' by Malthus. Malthus had also suggested certain other checks which are known as 'preventive checks'. The preventive checks refer to the steps adopted by man himself to avert the oncoming gloomy situation of population outstripping the food supply. These steps include late marriages, celibacy, and moral restraint within marriage. Being a clergyman, he did not suggest modern 'birth control' techniques as are generally advocated by the neo-Malthusians. He was, therefore, not in favour of artificial methods of birth control.

The above two checks will facilitate a fall in the population. Malthus was of the view that if man failed to use preventive checks, population would be reduced by the positive checks. Thus, Malthus presents a gloomy and pessimistic picture about the future of mankind.

Malthus confused between the sexual and reproductive instincts. These two are different. The sexual instinct may be satisfied without necessarily increasing population. According to him, even within marriage, sexual instinct should be subject to moral restraint and be contended only in pursuance of the need to procreate. Malthus was against satisfying the sexual instinct out of the marriage.

Malthus, in his later days of writing his Essay, confirmed the actual reproduction rate may not be associated with its biological maximum even though there is enough food. Also, he agreed to the Smith's view that poor women beget a large number of children whereas rich women, who can afford a large family, may not do so. In the words of Adam Smith, "A half-starved Highland woman frequently bears more twenty children, while a pampered fine lady is often incapable to bearing any, and is generally exhausted by two or three". The same is true in respect of wage increases which induce large families only among the workers and it is untrue in respect of an increase in rental income which may increase the consumption of landowners, but not population. Therefore, the availability of more subsistence or food encourages large families and population only in the poorer communities. All this implies two things, an increase in population leads to a state of poverty and poverty is the cause of population increase.

c. APPRAISAL OFTHE THEORY

The Malthusian theory of population was evoked a great interest for over a century. But this interest was in the nature of criticism and disagreement. However, many governments used the theory as the basis for policy formulation. He was the instrumental in introducing the English census system in 1801. Darwin himself acknowledged his indebtedness to the work of Malthus saying that the population theory is the most celebrated scientific doctrine of the 19^{th} century. Darwin also said that Malthusian theory emphasizes "the conception of the struggle for existence and the survival of the fittest as one of the mainsprings of progress”.

What all Malthus tried to say was nature had the harsh method of allowing the food supply to increase quite slowly, while inducing man to procreate faster. This creates a gap between population and means of subsistence. If man fails to check the growth of population, nature will come to the rescue of the society by wiping out the excess population through natural calamities, famines, diseases, etc. Also Malthus advocated the repeal of ‘Poor Laws’ which are used to help the poor. If aid is given to the poor, population problem will be aggravated. Accordingly, these laws were abolished in 1834.

As against the Malthusian theory of population, the critics regarded that population has a tendency not to increase beyond the food supply. Hence, the problem of excess population doesn’t arise. Godwin said that, in many cases, population had not increased at the rate expected by Malthus. Godwin had given the examples of quick increases in food supply in his work, “Of Population: An Inquiry concerning the power of increase in the Numbers of Mankind, being an Answer to Mr. Malthus’s Essay on that Subject”. According to William Thompson (1783-1833), with the improvement of the means of subsistence, the tendency of ‘improvident breeding’ decreases due to improvement in human knowledge.

Ricardo endorsed the view of Malthus regarding population saying that under favourable conditions population may be doubled in 25 years, but under the same favourable conditions capital stock might possibly doubled in a shorter period. So with a better division of labour, population increase paves the way for higher capacity production. To substantiate, we can use the words of Cannon who said that “a baby comes to the world not only with a mouth and stomach, but also with a pair of hands”. Prof. Seligman opined that the problem of population as a whole is not one of mere size, but of efficient production and equitable distribution. Thus, it is not a problem not of numbers alone but of wealth.

The Malthusian theory of population states that increasing population outstrips the increase in food supply. This view is based on the operation of the law of diminishing returns. But Malthus failed to visualize the technical advancements that can arrest the operation of the law of diminishing returns so that food supply can be matched with the increasing population leading to the salvation of population tangle. With these developments, increasing food supply is going to feed a large number of mouths than before. In many modern developing economies, food supply has increased much faster than in arithmetical progression.

Malthus and the writers mentioned above relied mostly on the population control through the 'voluntary decisions' of the people disregarding the actions of the state in the form of education or compulsions. In a modern developed society, people would like to limit the numbers voluntarily without any government compulsions in order to enjoy the fruits of economic development. In this context, people prefer a car rather than a baby. So, population will not grow as fast as food supply. Dupont has shown in his 'Social Capillarity Thesis' that with an increase in 'percapita income' the desire to have more children to supplement parental income declines. France, an advanced industrialized country, has been suffering from the problem of 'zero population growth'. The French government is taking several policy measures to encourage the population growth. But in a backward economy, there is the danger of overpopulation. Hence, the state action in terms of necessary education and compulsions would be needed to arrest population growth. Therefore, the problem of overpopulation is imminent in less developed or developing countries. As a result, the government of India has adopted a policy of 'family planning' to contain the population growth since 1960s.

If a man fails in arresting the population growth, positive checks like natural calamities will take its recourse to wipe out the excess population, so that a balance is maintained always in between the population and food supplies. We must remember here one fact that the natural calamities are not peculiar to overpopulated countries. These natural calamities are also found in under-populated countries. Also, there is a biological maximum in respect of population growth which is around 3 to 4 per cent per annum and population could not rise beyond that level.

It is quite injustice meted out to Malthus by criticizing his theory of population by quoting instances of population not increasing as rapidly as stated by him or by giving examples of unprecedented increases in food supply or showing certain countries which are still sparsely populated. Within the considered assumptions, Malthus's theory is still applicable. It is aptly applicable to the underdeveloped countries of the world. Malthus's theory has some force even today. If we consider the total population and food supply of the world, taken together, there will be shortage of food supplies in the world after some time, unless certain checks are implemented for the control of population growth. So birth control methods are being adopted by many countries. But the theory is not applicable to the country for which it was developed, i.e., England. From this analysis, one thing is certain to be noted, that is, if rapid population is not checked human prosperity will suffer. Therefore, Malthus must be remembered as an economist, but not as a mathematician or statistician.

6.4. MALTHUS'S THEORY OF OVER PRODUCTION (GLUT)

The theory of over production or glut is propounded by Malthus as an analysis of capitalist economy. This Malthusian theory had proved to be a foundation to the Keynesian theory of effective demand. We know that aggregate supply must be equal to aggregate demand to have equilibrium in the economy as a whole. Whenever aggregate supply exceeds that of demand, the problem of overproduction arises. So, overproduction is created when all the goods produced are not sold in the market. In this context, theory of glut has gained importance in the macroeconomic analysis. Malthus viewed that the level output at any time depended on the effective demand. Malthus defined effective demand as a situation in which the demand must be high enough to sustain a continual supply of goods. This is the macroeconomic equilibrium position. This effective demand enables the producer, supplying goods to the market, to cover cost of production plus profit.

We can trace the genesis of this equilibrium between supply and demand in one of the significant contributions of Jean Baptiste Say (1767-1832) who developed the famous idea of 'Say's Law of Markets', i.e. 'supply creates its own demand'. According to it, the very act of producing a commodity is the creation of demand for it. Unless there is production, there will be no demand. As per this idea, there can never be a question of overproduction or glut or demand crisis in the market. Such a situation was witnessed by J.B.Say in the market after the Napoleonic Wars. We must remember that it is a 'long-term phenomenon'. In the short run, there might be oscillations between demand and supply resulting either in overproduction or underproduction. Therefore, in the short run, there is partial glut or scarcity. This implies that the demand for and supply of individual commodities may be in disequilibrium, though total demand and supply may be equal. This indicates that a particular commodity may be in short supply while another commodity is in abundant supply. Moreover, demand and supply will undergo adjustment mechanism in the long run to get macroeconomic equilibrium. This means, in the long run, producers are able to adjust their supplies in accordance with the market demand situation. Also, the producers, who sell their goods, should necessarily use the sale proceeds for the creation of demand for other goods. The sale proceeds of a period must have to be spent within that period on other goods. Then only total sales must be equal to total demand. In this scheme of things, money is used as a medium of exchange and therefore, it is neutral.

David Ricardo also did not agree with the theory of overproduction, thereby crisis. To him, general overproduction is impossible. He based his belief on the Say's Law. He opined that there was the operation of automatic adjustment mechanism by which the economy adjusts itself to the changing demand. Hence, the problem of 'crisis', as a long term tendency, does not arise, he believed. His argument is as follows: the total national income is divided into 'unproductive consumption' and 'saving', the productive consumption. The unproductive consumption leads to the employment of unproductive labour. On the other hand, savings are used for investment on productive enterprises. So, these enterprises would employ productive labour. The productive labour generates surplus to the employers. Therefore, the productive consumption would never cause overproduction in the market. With the accumulation of capital, the demand for productive labour increases leading to the increase in the wage rate. This results a decline in the rate of profit. A stage comes in which people's desire to save and invest will be curtailed with the fall in the profit rate. So further investment will be stopped and stationary state sets in.

Regarding Malthus's view on the glut, he did not agree with Ricardo's version, though both of them were close friends. He recognized the problem of overproduction at every stage of production. He felt that this is due to the inherent tendencies of capitalism and its malfunctioning. For his analysis, Malthus considered the 'labour-command theory of value'. According to which, the price of a commodity consists of cost of production plus normal profit, so that the production of which would be profitable to the producer. The sale price of a good produced must exceed the cost price by an amount equal to the normal profit. We should understand from where the employer is going to realize the profits. The argument is as follows: the productive labour, with their low wages, cannot consume the total output produced. Their demand is inadequate to match the effective demand. This is because the workers are receiving only a part of the sale price of the output. Here Malthus opined that labour would be exploited by the capitalists by paying low wages. On the other hand, producers are interested in saving and accumulation of capital. Their actual habits and mode of living do not permit them to indulge in unproductive consumption on a sufficient scale. Hence, they cannot make up the effective demand. Therefore, overproduction or deficiency of aggregate demand will be caused.

Malthus has found out the solution, as a dependable source of demand, in the unproductive consumption of certain unproductive classes such as landlords, army men, clergymen, etc., in the society. These sections of the society will not add anything productive to the economy. This source of demand paves the employers to realize their profits. Malthus said that "It is absolutely necessary that a country with great powers of production should possess a body of unproductive consumers". As capital accumulation advances with the development of the economy, Malthus suggested the retention and expansion of unproductive consumers.

Malthus, therefore, believed that the economy was not a self-adjusting one as was thought of by David Ricardo. In fact, there was chronic deficiency of effective demand, he opined. He found a remedy for this malfunctioning of capitalistic form of society in the class of unproductive consumers. In his analysis, Malthus, thus, emphasized the exploitative nature of capitalism. He also vehemently opposed the stimulation of demand through increasing the wages or by way of poor laws. On the other hand, Malthus tried to support the capitalist system which permits a happy compromise between feudalistic interests of landlords and productive powers of capitalism. Also, he supported the class of landlords as a providential benevolence of capitalism.

Karl Marx employed the labour theory of value for developing the 'theory of surplus value' or the 'theory of labour exploitation' as referred by Malthus. Thus, Malthus can be regarded as a forerunner to the many later developments in economics.

6.5. MALTHUS'S VIEWS ON RENT

Though well known for his theory of population, Malthus's views on rent are not quite significant. He dealt with his views on rent in his work, namely, "An Inquiry into the Nature and Progress of Rent", 1815. In his analysis of rent, Malthus opined that rent is a surplus caused by the Nature's bounty. On the other hand, David Ricardo held that rent is caused by niggardliness of the nature. To Malthus, rent is difference between the price and cost of production of the produce. Hence, the surplus over the cost of production is the origin of rent. Malthus listed the following reasons for creation of rent: firstly, scarcity fertile lands; secondly, cultivation of inferior lands; and thirdly, the produce is sold at natural or necessary price. The price of the produce is just equal to the cost of production on land of the poorest quality used for cultivation. Lands with superior quality will receive rent. Malthus, more or less, anticipated theory of rent of David Ricardo.

6.6. SUMMARY

Malthus was one among the trio of Classical Economists and the other two are Adam Smith and David Ricardo. Their contribution is the basis for modern economic thought. Malthus acquired a unique place in the history of economic thought and his ideas have become the foundation to many later developments in economics. He is quite well known for his theory on population. Basing on his population theory, he became the founder of modern demography. The theory of population facilitates the emergence of the theory of Natural Selection of Darwin. Of course, he is an economist, but not a mathematician or statistician. Apart from its several defects, his population theory has stressed the importance of population in the national economies of the world. While explaining the capitalist production, Malthus opposed the views of David Ricardo. He said that due to the malfunctioning of the capitalist system, deficiency in effective demand is the result. This can be removed by encouraging unproductive consumption. As such, he has become the forerunner of many under-consumption theories of trade cycle. Finally, Malthus is a pessimist due to the presentation of gloomy picture regarding the population theory.

6.7. TECHNICAL TERMS

1. Geometric Progression
2. Arithmetic Progression
3. Economic Crisis
4. Economic Equality
5. Diminishing Returns
6. Positive Checks
7. Preventive Checks
8. Reproduction Rate
9. Biological Maximum

10. Poor Laws

11. Zero Population Growth

12. Family Planning

13. Glut

14. Macroeconomic equilibrium

15. Effective Demand

16. Unproductive Consumption

17. Unproductive Labour

18. Labour Command Theory of Value

19. Self-Adjusting Mechanism

20. Capitalism

21. Labour Exploitation

22. Cost plus price

6.8. SELF-ASSESSMENT QUESTIONS

1. "Men multiply like mice in a barn if they have unlimited means of subsistence" (Cantillon). Examine the Malthusian sequence of the theory of population.

2. "There is a principle in human society, by which population is perpetually kept down to the level of the means of subsistence"(William Godwin). Critically examine the theory of population.

3. How did Malthus repudiate the Say's Law of Markets in his theory of overproduction?

4. Why did Malthus present a gloomy and pessimistic view with respect to his economic doctrines?

5. Malthus viewed that "there was something like natural law which pushed the population growth rate at a rate faster than the increase in the means of subsistence". Do you agree with the view?

6. What are the ways and means of checking the population growth as suggested by Malthus? Why he didn't touch the birth control techniques to solve the population tangle?

7. "It is absolutely necessary that a country with great powers of production should possess a body of unproductive consumers" (Malthus). Discuss.

8. What contribution made Malthus to be regarded as 'founder of the science of demography?

6.9. BOOKS FOR STUDY

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LESSON-7/UNIT-2

SOCIALISTS- JEAN CHARLES LEONARD SISMONDI & KARL MARX

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7.17. Falling rate of profit and Economic Crisis

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LESSON-7/UNIT-2

SOCIALISTS- JEAN CHARLES LEONARD SISMONDI & KARL MARX

7.1. OBJECTIVE OF THE LESSON

In this lesson, a detailed discussion of socialistic economic thought is provided. Two significant contributors of socialistic school of thought, namely, Jean Charles Leonard Sismondi and Karl Marx are explained in detail. The discussion is provided in two sections. The first section is devoted to the ideas of Sismondi, and the following section is dealt with Karl Marx.

SECTION 1: JEAN CHARLES LEONARD SISMONDI (1773-1842)

7.2. BACKGROUND AND WORKS

Sismondi was born in Switzerland in 1773. He secured a special position in the history of economic thought by being a bitter critique of the classical doctrines. Initially, he was a liberal economist and ardent admirer of classical doctrines, but later he became a severe critique of Adam Smith. In course of time he had developed socialist leanings in his writings. In spite of his lacking a clear cut idea, Sismondi was able to explain the conflict in capitalist system of production and distribution. Sismondi got the necessary inputs for his writing from the consequences of depression caused by the ill-effects of the Napoleonic Wars, Industrial Revolution, etc. He witnessed the evils of wage-slavery and factory system. Since 1815, economic crisis, i.e., business fluctuations became a common feature in England. Therefore, he got the necessary inputs for his socialist ideas. His ideas are found in books, “Commercial Wealth or Principles of Political Economy, 1803”; and “New Principles of Political Economy, 1819”. The former book is devoted for his admiration of Adam Smith and lacks originality. The latest book brought him name and fame as an economist.

7.3. METHOD OF POLITICAL ECONOMY

While praising Adam Smith for his method of conclusions based on historical data, Sismondi criticized thoroughly the abstractness of Ricardo. In Ricardo, the concern for human happiness and welfare was missing. Sismondi prefers human happiness and welfare in his Political Economy. Sismondi also praised Malthus for his habit of meticulous study of facts. Agreeing with Smith, Sismondi opined that economic science should be based upon the historical facts because economic and institutional framework is dynamic in nature and never have they remained static or uniform. So, Sismondi started the ground work for German Historical School. Moreover, most of the classical writers were at fault in enunciating a few general principles and they had forgotten the practical side of the problem. But Sismondi wanted immediate reform to the practical problems which are linked to the well-being of the mankind.

To Sismondi, political economy is a moral science which should look after the well being of the people. In the words of Gide and Rist, "But the real object of the science should be man, or at least the physical well-being of man". Ethical considerations dominated the ideas of Sismondi. Sismondi opined that Political Economy is not concerned with wealth as such, but wealth in relations to man. The classical political economy was concerned with wealth. Sismondi argued that the real purpose of political economy should be man and his well being. Classical economists had taught only how to increase the national wealth, but they failed to teach how to increase national happiness. Therefore, political economy is a study of economic activity in relation to human welfare. This definition is more or less akin to the one given by Marshall. Sismondi's definition of political economy provided greater emphasis on distribution rather than production. Therefore, Sismondi devoted much in his writings to the problem of divorce of labour from capital and land leading to inadequate livelihood and distributive shares.

7.4. THEORY OF OVERPRODUCTION

The theory of overproduction is the major contribution of Sismondi. His criticism against the classical doctrines is targeted mainly on the undue emphasis on production, doctrine of harmony of interests and laissez faire. Sismondi felt that there is something fundamentally wrong in the conditions of capitalistic production. To Sismondi, the main issue here is economic crisis due to the separation between labour and property ownership. As capitalism progresses there is a separation of interests between workers and capitalists leading to class conflict. Sismondi felt that labourers were not able to get enough income to buy the produce. This is the origin of economic crisis under the analysis of Sismondi. While rejecting the Malthusian theory of population, Sismondi said that "egoism and calculation" would act as checks on the population growth.

The classical economists believed in the part play by the 'invisible hand' in getting spontaneous changes in the economy to correct any macroeconomic disequilibrium. The classical writers believed in the existence of full employment equilibrium and its spontaneous correction mechanism. On the other hand, Sismondi observed that the ill-effects of capitalism were aggravated by the aftermath of Napoleon Wars. Sismondi felt that there was no automatic adjustment mechanism to correct the ill-effects of capitalism. So, Sismondi warns, "Let us beware of this dangerous theory of equilibrium which is supposed to be automatically established. A certain kind of equilibrium, if it is true, is re-established in the long run, but it is only after a frightful amount of suffering". Sismondi opined that over production is not an impossibility considering the exigencies in the business decisions and income distribution. An entrepreneur must have to estimate the needs of the consumers before embarking upon production. Next, the demand of the consumers must be backed up by the capacity to buy. Therefore, Sismondi has listed the following causes for overproduction: (a) competitive character of the economy; (b) capital requirements; and (c) the separation of labour and ownership of the means of production, i.e., capital.

In the first case, it is very difficult for the producer to know the exact size of the market demand for the product in question. It leads to difficulties in obtaining quick labour supplies to adjust with the changing demand conditions. Labour is not in a position to move from one employment to the other due to the involvement of time and expenses of training and education. There is also a problem of shifting capital from one employment to the other on the part of the entrepreneurs. Even if a given size of output is produced, there will be no guarantee for the tastes to remain constant. These errors were also admitted by the classical writers, but they brushed them aside due to their abstract analysis. So producers are unable to judge the future demand movements accurately. Secondly, the size of the capital at the disposal of an entrepreneur determines the production. A capitalist always tries to invest on the basis of profitability. Sale proceeds which are over and above the cost of production are profits. Therefore, Sismondi argues that overproduction takes place because production is carried on not according to demand, but according to the availability of capital.

Finally, overproduction is the result of separation of interests between workers and capitalists. Sismondi opined that 'the distribution of purchasing power is not in accordance with the volume of output'. This implies a gap between the capacity to pay on the part of workers and the total output produced using capital intensive methods of production. Since the workers have a weak bargaining power, they are forced to accept low wages. This widens the gap between workers and capitalists resulting in class conflict proceeding ultimately to the stage of 'economic crisis'. In their urge to secure more profits, capitalists increase the production by employing more capital stock. An increase in the application of capital results in increased output, but it will not correspondingly add to the purchase power of the workers. This will add to the misery of the workers by throwing out of the employment with intensification of the capital intensive methods of production. Then markets are not completely cleared leading to overproduction. Therefore, Sismondi had anticipated the later development of 'capitalist crisis' by Karl Marx.

Sismondi, therefore, suggested that there must be balance between production and consumption to remove economic crisis. Also, he pleaded for state intervention in the matters of income distribution. Sismondi preferred organized trade unions for both the workers and capitalists. But he rejected communism and feudalism.

7.5. CLASS-CONFLICT

From the discussion made above, Sismondi believed in overproduction and economic crisis. Basing on this idea, Sismondi invented a significant concept of conflict of interests between workers and capitalists. So Sismondi found class conflict in the society. Karl Marx was greatly indebted to Sismondi regarding the idea of class conflict. This is a problem of distributive shares of national income in between the two classes. Sismondi was interested in the problem of distribution because the society was interested not in the production of wealth but in the happiness and well being of the people. He said that increased application of machinery should result not only an increase in the productive capacity of the nation, but also it should result in the equitable distribution of that output. In fact, the workers are not able to get any share in the increasing productivity of the economy. On the other hand, the workers' face recurring unemployment and increasing concentration of wealth in a few hands. At the same time, Sismondi accepted the fact that capital is necessary for economic development.

The immediate effect of the capital intensity is to throw some of the workers out of employment. As capital intensity progresses, increased number of workers would be added to the 'pool of unemployed workers'. Karl Marx termed this pool as 'industrial reserve army'. In this context, profits may represent only the exploitation of the working man (Phillip Charles Newman). This would cut the wage rate because labour supply is greater than demand. Ultimately, this leads to slackening of demand. There is overproduction and economic crisis. On account of recurring crises, the situation in the society leads to increasing immiserisation of masses. This crisis is caused by three factors: firstly, unplanned production and excess competition; secondly, production is not based on demand but is based on the growth of capital; and thirdly, separation of labour and owners of means of production. Sismondi believed that under capitalistic system of production, there is an inherent tendency to widen the chasm between production and consumption. Therefore, Sismondi opined that an increasing proportion of national income had been received by the owners of land and capital leading to the exploitation of the poor.

7.6. ON POPULATION

As we said earlier in this lesson, Sismondi did not believe in the Malthusian theory of population. The theory is based on the assumption that population is limited by the means of subsistence. Sismondi opined that people are not devoid of basic intelligence and therefore their "egoism and calculations" would keep the population under control. So, population would not increase at a faster rate than that of food supply. Sismondi said that population is dependent on 'revenue' that a worker is getting. Under the system of capitalist production, workers are at the mercy of the capitalists and in order to live they must have to work at any wage offered by the employers. Then, the labour supply is dependent on the demand for labour from the capitalists. The worker has no control over the revenue. Therefore, a worker determines when to marry and beget children gauzing his revenue estimation. He would not like to marry and procreate unless he has means of providing livelihood for their families. The capitalists are indirectly controlling the size of the population by means of their control over revenue. As per the will of the capitalists, population may either grow or diminish. When the demand for labour increases, population would increase, and when the demand diminishes, population would come down.

7.7. ON SOCIALISM

From the earlier discussion, we might venture into the idea that Sismondi was a socialist. Prof. Knies, one of the founders of the earlier Historical School, described him as a socialist. But some say that Sismondi was a bitter critique of capitalist system of production. It is no doubt true that Sismondi has given some of the most important inputs which found expression in the writings of socialists in the latter part of the 19th century. His ideas regarding formation of trade unions for both workers and capitalists; declaration of Sunday as a holiday; reducing number of hours of work; insurance against illness and old age of workers;

prohibition of child labour; and government intervention in the distribution matters are some of his views that may well secure him a place in the galaxy of socialists. Also, Sismondi was the first writer to plead for factory legislation in France. He has his sympathies with labour and poor and he spoke against labour exploitation. In spite of all these socialist leanings, he could hardly be called as a socialist. As per the opinion of Haney, though Sismondi's influence was felt by socialists, he was not a socialist. Though he was against the big capitalists and concentration of wealth, he was not against capitalism. He praised capitalism for its productive powers, but despised its crises and class conflict. At the same time, he disregarded socialism because Sismondi believed in the beneficial effects of private property. Sismondi was interested in reforming capitalistic system, but not its outright removal. Despite his asking a guarantee from the capitalists to protect the workers in times illness or old age, Sismondi did not hold the society responsible for the welfare of the workers. Therefore, he is not a socialist in spite of his influence on the socialists.

7.8. SISMONDI'S REFORMS

Sismondi wished an ideal society wherein there is harmony of interests between population and wealth of the nation having equitable distribution of income. Such a system alone can promote human happiness and well being of the society. Then economic crises become a rarity. **Firstly,** this can be achieved through the bringing together of both workers and owners of the means of production. **Secondly**, Sismondi was not in favour of abolition of private property. He considered it necessary and legitimate for the development of the nation. **Thirdly**, for bringing together workers and means of production, Sismondi did not suggest 'joint ownership of the means of production'. Neither had he suggested for the state ownership of means of production. The state ownership would result in harming the private interest in the property. In this regard, he suggested for the revival of independent producer, the small farmer and the artisan. This would remove the problem of under-consumption. In this context, the state has a role to protect the distributive shares**. Fourthly**, the government should see that workers are given to right to combine themselves into an organized labour union to show tough resistance to the low wages and to improve their bargaining power. **Fifthly**, a system of social security; abolition of child labour; reduction in the long working hours; and holiday on Sunday are to be guaranteed to the workers to do away with the exploitation of labour. **Sixthly,** Sismondi advocated slow progress by way of reducing the rate of growth of output. This is only to avoid overproduction. In this regard, he also suggested the government to put a brake on the invention. **Seventhly**, In respect of farm land, he suggested for the splitting farm lands into small sizes to revive peasant proprietorship. **Eighthly**, Sismondi suggested for a "professional guarantee" from the capitalists to the workers as a means of social security against ill health, accident, and old age. Such an arrangement would automatically force them not to reduce the wages continuously and too much. They would be more cautious about introducing machinery. **Lastly**, Sismondi was against the state aid to the poor in the form of Poor Laws because the employers would not be deterred to reduce the wages of workers.

7.9. APPRAISAL

Sismondi has occupied a place of prominence in the history of economic doctrines. He is a bitter critique of individualism, emphasis on production, harmony of interests and others of classical economists. But he is an admirer of Adam Smith. Though he praised capitalistic form of production, he is interested in the distributive shares of factors of production in the national income. Under capitalist production, he observed that there is divorce of labour and means of production leading to conflict. He recommended for active state intervention in protecting the rightful share of the workers. He is also against state capitalism because of his interest in private property. So, he pleaded for equitable distribution of income to promote the happiness and well being of the people. Though he has socialist leanings, he is not considered as a socialist.

SECTION 2: KARL HEINRICH MARX (1818-1883)

7.10. BACKGROUND

Karl Heinrich Marx is one of the greatest thinkers of all ages and of all schools and without whom the history of economic thought is incomplete. He was the founder of scientific socialism, though he was essentially a classical economist. Marx was a student of Ricardo. It is rightly said that “Marxism is simply a branch grafted on the classical trunk” (Gide and Rist). It was he who coined the term ‘classical economics’. To Marx, the objective of scientific socialism is to demonstrate socialism as a necessary product of historical development. The socialism is expected to come out from the ruins of capitalism itself and it is the result of natural historical process. So, the birth of socialism is inevitable consequence of the evolutionary process from which capitalism had given way to a new social order, just as serfdom had given way to capitalism. Like Adam Smith, Karl Marx’s writing has a philosophical touch. His writing was mainly focused on the critical analysis of capitalist development and to its transition to a new development, namely, socialism.

Karl Marx was born in Treves, Germany in a middle class Jewish family. He received his degree of doctor of philosophy from the University of Jena in 1841 at the age of 23. Marx happened to come in touch with socialist writers in Paris such as Proudhon and Cabot, while he was in Paris after his banishment from Brussels in 1848. Then he started thinking in terms of socialism. Friedrich Engels, 1820-1895, was a close friend of Marx. Engels supported Marx financially and otherwise to get through the problems which Marx could never be able to solve. Marx, in collaboration with Engels, wrote “Communist Manifesto” in January, 1848. This book was came out on the eve of 1848 Revolution, when Marx was banished from Brussels and ultimately settled in England from 1850 onwards until his last breath. In England, Marx had an occasion to read political economy intensively. As an attack on Proudhon’s book, “The Philosophy of Poverty”, Marx wrote, “The Poverty of Philosophy”. In 1859, he published “The Critique of Political Economy”. Karl Marx published his major work, “Das Capital” whose first volume was appeared in 1867. After Marx’s death, Engel published his second and third volumes of Das Capital respectively in 1884 and 1894. The last volume was published after the death of Engels in 1910 by a German Socialist, Karl Kautsky. This publication appeared as “Theories of Surplus Value”. After the publication of this book, Marx was came to be known as "Marx, the Prophet" basing on the number of his followers believing in his book, Das Capital. Thus, the book began to be called as the Bible of scientific socialism.

7.11. PHILOSOPHY OF MARX

Karl Marx was a product of his environment in the sense that his ideas were shaped by the economic and political conditions of Germany. During his times, Germany was a backward and autocratic country compared to France and England. In addition, his revolutionary zeal and poverty also influenced his writings. In England, Capitalist production was in a full blooming stage with its attendant evils like class conflicts, economic crises, and exploitation of labour. He also drew inspiration from England's industrialization and trade unionism and the French post-Revolution political struggle. Not only that, he was greatly influenced by the socialist thinkers of France. Marx wanted to reconstitute the economic system in one way or other basing on his belief of peaceful transition from capitalism to socialism.

7.12. MARX'S DIALECTICALMATERIALISM/MATERIALISTIC INTERPRETATION OF HISTORY

Marx's main attention was to bring it into limelight the process of historical change in successive stages of development of a society regarding its institutional framework. Marx believed that institutional framework is subject to laws of evolution. The objective of Marxian doctrine is to discover these laws. In other words, Marx wanted to find out laws by which the society moves from one historical stage to another. Therefore, his method of analysis is an excellent blend of historical, deductive and institutional methods.

According to Hegel, a German philosopher, the society is always dynamic and change from one situation to another which is based on conflict. Hegel had given the role of primary importance to the ideas in getting a motion in the society from one stage to another. According to Hegel, there are certain ideas called 'theses'. The ideas opposite to the 'theses' are called 'anti-theses'. A reaction takes place between 'theses' and 'anti-theses' in the society and the result is 'syntheses' or new ideas. This again attracts anti-theses. This process will continuously happen without an end. In the process of change, new ideas did not so much eliminate some of the old ones. Some of the older ideas persist in the new stage of development of society. In this, a new phase is advancement over the old phase. Hegel called this as "dialectic". Marx did not consider ideas as prime movers unlike Hegel. The material conditions in a society are given the role of prime movers by Marx in his analysis. Marx used the Hegelian dialectics by including those economic factors which he considered as the sole determinants of social change. Therefore, Marx put Hegel's dialectic on a materialistic basis and made social evolution, a matter of economic forces.

Dialectical materialism is nothing but how changes in society take place. Change gives rise to development which takes place in different phases. Each phase is higher than the old one. The process of change takes place continuously without an end. Hence, the institutional framework in the society is dynamic in nature, but not static as classical writers put it. So everything is subject to change. For instance, feudalism, a medieval institution, was replaced by capitalism. To Marx, the institution of capitalism must have to give way to a new order, say, socialism.

In his analysis, Marx explained the relationship between forces of production (social production) and relations of production as an influencing factor in historical change. In a society material production necessitates creation of relations of production in the form of workers and capitalists. These production relations are based on property relationships leading to segregation of society into different classes. Accordingly, exchange and distributions patterns are also determined. These relations of production are the basis for other political, legal and intellectual life. A society's relations of production correspond to a definite stage of development productive forces. As productive powers or forces of society develop the existing and economic and political institutions should change for they are no longer appropriate. For instance, in ancient times, the relations of production are between masters and slaves. This system corresponds to a pre-capitalistic form of production. Immediately after the medieval period, the relations of production are between wage earners and capitalists which correspond to capitalistic form of production. Hence, the relations of production and forces of production are subject to continuous change.

The process of dialectical materialism by which society changes from one stage to another includes the following three propositions: firstly, unity of opposites; secondly, rule of negation of negation; and thirdly, society experiences change of quantity to quality. Under the first proposition, two opposite elements, say, capitalists and workers co-exist in the society under capitalistic system initially. In respect of the second case, the institutional framework is dynamic in nature, but not static. One system gives way to another. For instance, feudalism of the medieval period was replaced by capitalism. The change won't stop here and it will take to a new stage, say, socialism. The change will take place unendingly. In respect of changes of quantity into quality, the initial effect of the exploitation of workers would be misery only. If the exploitation persists with capitalist development, there will be qualitative changes in the form of workers' reaction. It will lead to a revolt against the capitalist order and soon a class-less society, i.e. a workers' proletariat is established. This is socialism which is the result of historical change in the society.

7.13. MARX'S THEORY OF VALUE

Marx developed his theory of value from 'Ricardian labour theory of value'. Marx said that a thing can have value only if it is a product of human labour. Here human labour refers to 'socially necessary labour'. A wasteful labour cannot increase value of a commodity. According to Marx, a commodity contains use value and well as exchange value. Use-value is essential for a commodity to have an exchange value. A good having an exchange value means that it is a commodity. For a commodity to be exchanged, it should be produced with human labour.

A commodity is produced by land, labour and capital. Then the determination of value will become cumbersome. The amount of labour embodied in a commodity is an essential condition to arrive at the value. What about the other two? From the earlier lesson of Ricardo, we have learnt that land does not enter into the value measurement because its contribution is nothing to the value of a commodity. Therefore it is passive factor in the value analysis. In respect of capital, there are two categories: constant capital and variable capital. Constant capital or fixed capital is in other words known as 'stored-up labour'. So, the labour imbibed in the constant capital enters into the value of a commodity. Marx said that the means of production can never add more value than they themselves lose in the process of production. This is known as depreciation. The value of the machinery and plant is transferred to the product which is equal to their wear and tear, i.e. depreciation. The machinery and plant do not create value. They merely transfer the value already created by labour. Secondly, variable capital, the second part of capital, is used for maintaining labour for manufacturing a commodity. This involves labour time expended in the production of the commodity. The variable capital produces an equivalent of its own value and, not only that, it also produces an excess, an additional value or surplus value. Therefore, a commodity is produced by labour power. The value of labour power is determined by the average labour time necessary for the production and reproduction, i.e. sustenance of labour. The average labour time is known as 'socially necessary labour'. The socially necessary labour is determined by historical conditions of production and techniques of production. This average labour time expended both on fixed capital and variable capital is the value of the commodity. This is known as socially necessary labour cost. The relative cost of production represented by average (socially necessary) labour cost determines the exchange value of commodities. So, socially necessary labour in the form of average labour time embodied in the commodity is very important to determine the exchange value of the commodity in the market.

MARX'S LABOUR TIME Vs. LABOUR POWER

Karl Marx also makes a distinction between 'labour time' and 'labour power'. Labour power refers to both mental and physical capacity existing in human being to produce a use-value of a commodity. The use-value of labour power is the amount of labour time embodied in a commodity. To explain further, when a labourer is employed in a factory, the labourer has agreed to provide the use-value of his labour power to the capitalist for a given length of time. In return to the use-value of labour power, the capitalist provides the labourer a payment (wage) equal to the cost of production of the labourer's labour power. The labour power determines the exchange value of labour in the market. So, labour time is one part of the labour power. This value (payment) of labour power is determined by the labour-time necessary for the production and reproduction of the labour power. In this context, Marx explained that human being possesses a special characteristic. Suppose a worker is able to work for a certain length of time. The amount of subsistence needed to create the labour power to work that long as agreed by the worker, can itself be produced in a short period of time. To take a numerical example, suppose a worker is agreed to offer his labour power to work for 12 hours in a day. But the amount of labour power needed to produce that labour power to work for 12 hours can be producible in only 8 hours. These 8 hours of work is going to determine the exchange value of labour in the market. This in other words refers to the subsistence wage equal to 8 hours of work. The exchange value of labour or the wage rate is determined by the socially necessary labour or the average labour time needed to produce the subsistence required for producing the labour power. The subsistence level is determined historically and therefore it is not static. This subsistence wage includes the maintenance of the worker himself along with his family members. This is necessary for the maintenance of labour supply in the economy. It is to be remembered that a capitalist is not going to purchase the labour as such but he purchases only the labour power and pays a wage for this labour power.

Karl Marx adopted a traditional approach to the theory of value. While explaining the theory, he has taken the supply side and proceeds to the cost of production as an explanation of value. It has been criticized by many that Marxian labour embodied theory of value is fallacious. Demand is an important factor in the determination of value. It is said that 'there is no direct proof that value expresses the amount of labour concealed in a commodity'. Marx ignored the concept of price in the first volume of his book and introduced in the third volume. We note that value is monetary expression of the amount of labour embodied in a commodity, whereas price is the monetary expression of exchange value. He failed to explain anything about the price level and fluctuations thereof.

7.14. MARX'S THEORY OF SURPLUS VALUE

From the above analysis of theory of value, Karl Marx deduced the theory of surplus value. We have explained in the preceding paragraph that labour has a special characteristic feature. Suppose a worker is able to work for a certain length of time. The amount of subsistence needed to create the labour power to work that length of time as agreed by the worker, can itself be produced in a short period of time. This situation had been the result of capitalist mode of production. By which, there is the existence of private property in the hands of capitalists. On the other hand, workers do not have anything of their own in the form of property. They depend on the capitalists for their livelihood. So capitalists purchase the labour for its use-value for the production of commodities. In return to their services, capitalists pay the value which is equivalent to the exchange value I of the labour power in the market. The surplus value refers to the additional labour time which the capitalist is able to get embodied in the production of commodities. The example given in the last paragraph regarding the additional or extra time which the capitalist is able to get imbibed is 4 hours (12 hours length of work- 8 hours of work sufficient for their sustenance). The 4 hours of work is the surplus value which is going to be appropriated by the capitalist because the product is the property of the capitalist and not that of the labourer. So, 8 hours of socially necessary labour is required to create the necessary labour power by which the workers are able to work for 12 hours. The capitalists are going to pay the workers a wage equivalent to the 8 hours of socially necessary labour. So a subsistence wage equal to 8 hours of socially necessary labour is required to generate a labour power equivalent to 12 hours. The balance is surplus value of labour power equal to 4 hours. So, the activity of labour power not only reproduces its own value in the form of subsistence wage, but also produces extra value which is over and above this reproduction. The surplus value is therefore is the difference between the value of the product and the value consumed in the process of production. The former refers to the means of production (machinery and plant) and the latter means labour power.

In this analysis of surplus value, there lies the important factor of 'super-productivity of human labour'. If it is untrue, there would be no increase in population, no saving of capital, and no progress of civilization. To Marx, it is an axiomatic truth. He explained the concept further in simple process of the circulation of commodities. It is given in a symbolic form:

C – M – C, where C refers to Commodity and M refers to Money.

The sequence is as follows: a commodity is sold for money and money is exchanged against another commodity. The cycle completes. In this cycle, the objective of exchange is give up a commodity of less use-value and obtain another commodity which has a greater use-value. But under the capitalist mode of production, the circulation takes the following form:

M – C – M

The starting point is money. Money is used to buy commodities. These are again sold for money. This sequence has no rationale because the objective is to get benefit or profit. So, the above symbolic form can be converted into the following:

M –C – M', where M' is greater than M

This is as follows: the initial purchase of commodities includes the purchase of labour power also. The labour power so purchased is used to put in much larger labour time in the production of commodities. These commodities are sold for a greater sum of money so that the capitalist makes a profit of **M' – M**. Marx calls this as surplus value. In the words of Eric Roll, "The capitalist who has bought labour power consumes it in the process of production of commodities, that is, in the production of exchange-value and of surplus value". It is possible for the capitalist to make profit because labour power has the peculiar property of being able to create more value than is needed for its own production. According to Marx, profits are 'legalized robbery'. The working day of a labourer may be divided into two parts, during one of which the worker works for himself and the other for the capitalist. The ratio between the two is called the 'rate of exploitation'. According to Marx, the rate of surplus value is therefore an exact expression for the degree of exploitation of labour power by capital, or of labourer by the capitalist. In a symbolic form, it may be written as

Rate of Exploitation = S/V, where S refers to surplus value and

V means variable capital

To arrive at the value of a commodity, we shall go to the explanation given by Marx regarding capital. He has divided capital into: 'constant capital and variable capital'. Constant capital accounts for machinery and plant and it is a fixed capital. On the other hand, variable capital refers to the amount used for purchasing the labour power. The capital which does not alter the value of the commodity in the process of production is constant capital, while that which alters its value is variable capital. Constant capital is nothing but congealed past labour and its contribution to the creation of exchange value is equal to the past labour embodied in it. So variable capital alone can reproduce its own exchange value and also produces a surplus value. So V alone can produce a surplus value. Taking C to stand as constant capital, we can arrive at the total value of output as **C + V + S.**

METHODS OF INCREASING THE SURPLUS VALUE

The capitalist is in a position to increase the surplus value. There are different ways. Firstly, he can do so by lengthening the working day. Secondly, he can also get the same benefit by shortening the length of the time required to produce his subsistence. The capitalists prefer the first method to the second because the labourers resist the second method. Given the rate of surplus value, capitalists increase the total surplus value by employing more variable capital and therefore more workers. Now we are required to refer organic composition of capital which has a close connection with the surplus value. This can be written as C**/C + V.** This is the proportion of capital stock to the total capital stock employed. The capitalists also increase the organic composition of capital to get a higher total surplus value because *'the organic composition of capital and the surplus value are directly related'*. This encourages every capitalist to increase the organic composition of capital.

With every increase in the organic composition of capital, the capitalist is able to produce the commodity at a lower cost in terms of labour time required. The increase in the capital via new technology promotes the productivity of the labourers. To explain further the point, Marx used the distinction between 'price of production' and value. We know that value is determined by the amount of labour time embodied in the commodity. On the other hand, price of production refers to 'the cost price plus average rate of profit'. With the increase in the organic composition of capital through improvements in technology, the capitalist is able to reduce the price of production of the portion of the commodity produced by him. The price of production of that commodity produced by other capitalists in the industry remains the same as before. This means that the other producers in the industry have not introduced any improvements in the technology. In respect of our individual capitalist, the value of the commodity or the socially necessary labour time required to produce the commodity falls much less than the reduction in the price of production because our capitalist has increased the organic composition of capital. The other capitalists sell their commodities at the rate determined by socially necessary labour. So our individual capitalist who introduced improvements in technology through increases in organic composition of capital gets an extra profit. Therefore, every capitalist is tempted to increase the organic composition of capital to get more surplus value.

7.15. CLASS STRUGGLE

Marx's one of the significant contributions is the invention of class-struggle. Marx believed that the basic disparity between the evolving powers of production and outdated institutions would express itself in 'class struggle'. We know that classical writers are believed in harmony of interests. This belief was broken down in Germany and elsewhere with the ill-effects of post-industrialization, Napoleonic wars, poverty of the masses, autarky and lawlessness, etc. So, Marx felt that class conflict has become a dominant feature of social life. In his Communist Manifesto, Marx opined that "all history is the history of class struggles". In ancient times, there was the struggle between master and the slave. In the medieval period, there was the struggle between feudal land lords and serfs. The struggles are carried forward as struggles between oppressors and oppressed. Under modern capitalistic system, the struggle is between the capitalists and workers. One system is an improvement over the past system. For example, when slavery was replaced by serfdom, the serfs welcomed it an improvement over the slavery. Afterwards, capitalism becomes an improvement over the serfdom. What about the next stage? The capitalism is replaced by the state ownership of means of production. Therefore, the production relations determine the social, political and legal superstructure of the society and if these production relations come into conflict with each other, the old production relations will be replaced by new relations.

To Marx, class is an economic class which strives to secure its economic interests. The people whose economic interests are affected in the same manner belong to one class. The working class is an economic class whose economic interests are affected in the society in the same manner. Hence, they are the affected class. The genesis of class struggle lies in the recognition of private property. In the capitalistic mode of production, capitalists own the means of production by virtue of their ownership of property. But workers lack anything of their own in terms of property. So, they have to depend on the capitalists for their livelihood. In view of their large supply, they are at a receiving end. Therefore, capitalists have got the opportunity to make the labourers to work for more number of hours by paying low wages. In view of their objective of maximizing profits, workers are subject to exploitation by making them to work for longer hours and paying only their subsistence wages. They are made to work to earn their livelihood and in addition to earn a profit in the form of surplus value to the capitalists. Therefore, exploitation is inherent in the capitalist mode of production. This exploitation results in polarization of the society into working class (proletariat) and capitalist class. With the intensification of exploitation, the conditions in the society become ripe for the overthrow of capitalism by the united proletariat. In fact, capitalism collapses under its own dead-weight. A new mode of production came into being in the society and the system of capitalism becomes outdated. This paves the way for the dawn of socialism, a system of workers' proletariat. The right to property has become a past memory. A classless society is established with collective ownership of means of production.

7.16. CONCENTRATION OF CAPITAL

According to Marx, capital was a mere harmless factor of production and not 'engine of exploitation' prior to the 16th century. Under capitalist mode of production, it is an engine of exploitation. Not only that, there were no separation of interests between different classes in the ancient times. A person is both a master and a worker as well. Under capitalism, there is separation of interest and the interests are conflicting interests. As capital accumulation takes place, competition among the capitalists will be further intensified to maximize surplus value. This leads to economic crises after a certain period. As a result, some capitalists go bankrupt and concentration of capital increases among the few large capitalists remained. The enterprises remained became large scale organizations. The creation of such organization has not swallowed the small independent producers and also medium sized industrialists. As a result, these small and medium industrialists would be converted into wage-earners. The wage-earners as a class are the cause ruin of the capitalists. As capital accumulation is speeded up, supply of commodities is not matched with the available purchasing power leading to overproduction. A stage comes where the production is stopped for some time causing the labourers to be thrown out of employment. This situation causes an increase in the ranks of unemployed workers giving way to the creation of ‘industrial reserve army’, a pool of unemployed workers. As caused by the relative surplus population, the crucial function of industrial reserve army is to facilitate a rapid movement of capital among old branches of production and into new pursuits. In addition, the size of industrial reserve army also governs the magnitude of money wages through its influence upon the bargaining power of labour. Then, the capitalists are free to draw upon this army at their sweet will and as demand slackens, they will be thrown out of employment again. In due course, the concentration of capital reaches the extreme levels. Marx says, “What the bourgeoisie produce above all, therefore, are its own grave-diggers”. All this process ultimately moves to the stage where capitalists are expropriated from the means of production and socialism is established.

7.17. FALLING RATE OF PROFIT LEADING TO ECONOMIC CRISIS

In Marxian analysis, theory of growth gives greater importance to the accumulation of capital. According to him, capital accumulation is a necessary evil under capitalist mode of production. To him, accumulation is the Moses and Prophets in capitalism. It is the capitalization of surplus value. There is an urge among the capitalists to increase the surplus value as much as possible. This gives momentum to capitalist mode of production. So, there is an inherent tendency of dynamism in capitalism. It is also sustained by the intense competition among the capitalists.

The urge to get more surplus value leads the capitalist to investigate the sources by which they can increase the same. In this context, they resort to all sorts of tactics including lengthening the working hours, employment of women and children, etc. After having exhausting all the sources, they go for the greater use of ‘variable capital’ which is the only source of surplus value. If one capitalist adopts this method, the other capitalists also follow suit. So employment more labour with an increase in the variable capital would be intensified causing the surplus value to be wiped out via increase in the wages. But under the Marxian system, the capitalists can draw upon from the Industrial Reserve Army as much labour as needed without the fear of increasing the wages. This is possible till the industrial reverse army is exhausted. Then only the wage rate starts moving up. At this stage, the capitalists use the increasing doses of the organic composition of capital for reaping additional surplus value.

After reaching the full employment level, the surplus value starts going down due to the exhaustion of industrial reserve army. This results in a falling rate of profit via increase in the wage rate. This follows 'economic crisis'. The crisis is caused by the excess of aggregate supply over aggregate demand. The purchasing power on the part of labour is insufficient to clear of the markets. Under the capitalist mode of production, production relations are such that capitalists are appropriating the surplus. Had it been given to the workers, it would have been spent by the workers leaving no scope for deficiency of aggregate demand. In a way to overcome the situation of crisis, capitalists try to increase the organic composition of capital to increase the surplus value. Not all the capitalists do the same because some of capitalists fall behind in the race of competition. So, the capitalists who have fallen aback may start winding up the business. These bankrupt capitalists have to join the ranks of industrial reserve army. Then, the situation gives rise to concentration of capital in a few capitalists who remained in the business. The rate of profit will continuously plunge downwards until it is reduced to zero when the capitalists are expropriated from the means of production.

The sequence of falling rate of profit is explained hereunder: In symbolic form, rate of profit can be written as

$\mathbf{r = S/C+V}$, Where 'r' is rate of profit.

This can be written as, $= \mathbf{SV/V(C+V)}$

To simplify it: $= \mathbf{SC + SV - SC / V (C + V)}$

$= \mathbf{S (C + V) - SC / V (C + V)}$

$= \mathbf{S (C + V)/V (C +V) = SC / V (C + V)}$

$$= \mathbf{S/V - S/V. C/ (C + V)}$$

Since S/V is surplus value and is denoted by**'s'** and C/(C+ V) is organic composition of capital and is denoted by **'c'**. Then the equation for rate of profit is as follows:

$$\mathbf{r = s - s.\ c}$$

$$\mathbf{r = s\ (1 - c)}$$

The equation indicates that an increase in the organic composition of capital (c) causes a fall in the rate of profit (r), given the surplus value (s). Here Marx assumed a constant rate of exploitation, 's'. The falling tendency of the rate of profit is the crucial explanation for the economic crisis of Marx. When the rate of profit falls, investment will lag behind triggering a crisis. So, new capital formation is checked and thus causes a threat to the development of capitalist production. In the words of Marx, "It breeds overproduction, speculation, crisis and surplus capital alongside surplus population".

The critics claim that a rising organic composition of capital would offset the fall in the rate of profit through a raise in the surplus value. According to Marx, a rise in the surplus value is not enough to counteract the fall in the rate of profit. A fall in the rate of profit will be counterbalanced only when the increasing organic composition of capital causes a fall in the 'capital-output ratio', i.e. capital stock per unit of output. Therefore, as per the Marxian model of crisis, there is a tendency for the rate of profit to fall so long as the rising organic composition of capital is accompanied by a rise in the capital-output ratio.

The process of crisis deepens when the capitalists try to increase the surplus value via increasing the organic composition of capital with latest techniques of production. This results in unemployment increasing the ranks of industrial reserve army. The wages go down to the level of subsistence and consequently the rate of surplus value would be increased. The capitalists add continuously increasing doses of organic composition of capital leading to additional employment of labour. This completes one capitalist development cycle. In the second cycle, the same process repeats with additional doses of organic composition of capital. Then, the ranks of the industrial reserve army would get exhausted leading to a hike in the wage rate. There is intensification of competition for labour. Then aggregate supply exceeds aggregate demand resulting in deficiency of effective demand. The crisis starts appearing with a fall in the rate of profit. The ranks of industrial reserve army expand. But total profit expands. Marx says that "A fall in the rate of profit hastens the concentration of capital and its centralization through the expropriation of the smaller capitalists, the expropriation of the last survivors of the direct producers who still have anything to give up". Falling rate of profit is accompanied by the higher wages, higher organic composition of capital, technical progress, the substitution of capital for labour and the concentration of industrial capital proceeds at an accelerated pace. This all leads to economic crisis. Then industrial capital is increasingly concentrated among a few capitalists. The capitalist mode of production crumbles under its own weight. All this happens because of 'internal contradictions from the very nature of capitalist production and of the capitalist spirit. The most serious of them is that production is motivated primarily by the desire to accumulate more capital rather than by social needs and wants and that the ownership of the means of production is in private hands. These contradictions lead to disturbances in the economy in the form of periodic economic crises.

The capitalists, then, are expropriated from their means of production and a classless society, known as workers' proletariat is established with collective ownership of the means of production. This is known as 'socialism. Therefore, under the dynamic process of change, a new set of economic institutions began to appear on the scene contradicting the old institutions, wherein capitalism is given way to socialism.

7.18. APPRAISAL

Karl Marx was much more than an economist in the sense that he analyzed a combination of social and economic influences working in a society. Using the historical method, Marx provided an in depth analysis of dynamic process of capitalist mode of production. He found that development takes place in phases making the economy proceeds from one type of institutions to a new set of institutions and believed that nothing is permanent. From his historical study, we know that slavery gives way to serfdom under feudalism and feudalism gives way to capitalism. Marx observed that capitalism is subject to dead weight loss leading to the establishment of socialism. In his analysis he used dialectical materialism. Marx has made significant contribution in the fields of theory of value, surplus value and historical evolution. He is a philosopher and expositor of a new society by which he had commanded wide popularity. His views have been used to prove him a devil incarnate or a savior of mankind. He propounded a religion which is even more powerful than that of Christ or Mohammad. His notable works, in collaboration with Engels, are Communist Manifesto and Das Capital.

Regarding the negative points, there is nothing remarkable in the economic theories of Marx. Firstly, the labour theory of value was considered outmoded even during the Marx's times. Even if we agree with the fact that value depends on cost of production, all costs cannot be reduced in terms of labour. He failed to elaborate on utility. Secondly, when the labour theory of value is outmoded, the theory of surplus value would lose its significance in the Marxian analysis. Though Marx provided a penetrating analysis to understand the capitalist development and exploitation of labour, Marx failed to provide a concrete explanation that with the rising of organic composition of capital the rate of surplus value is not in a position to counteract the falling rate of profit. Thirdly, regarding historical evolution, Marx's analysis was proved wrong. For instance, capitalism tries to take the form of imperialism before it collapses. Also, slavery is not the result of historical evolution, but it is considered as a more efficient mode of production. Fourthly, in respect of internal contradictions of capitalism, Marx failed to visualize the way in which the capitalism could change its character and solve internal contradictions. By means of government intervention and trade unions movement, the internal contradictions of capitalism can be solved. Also, by directing the production of goods of mass consumption, the effective demand can be increased. Therefore, he failed predict the future course of events correctly. The socialist revolution did not start with the industrially advanced countries. So, Marx was successful in explaining the past events failing to do the same for future. Finally, Marx is a forerunner to some of the theories of modern economic thought. For instance, in his analysis, he developed the theory of trade cycles. From his analysis of concentration of wealth and means of production, Marx paved the way for the later development of imperfect completion by the modern economists. Therefore, he is a spiritual kinsman of modern economists.

7.19. TECHNICAL TERMS

1. Wage-Slavery; 2. Serfdom; 3. Egoism and Calculation; 4. Separation of interests; 5. Economic Crisis; 6. Capitalist Crisis; 7. Industrial Reserve Army; 8. Professional Guarantee; 9. Dialectical Materialism; 10. Historical Method; 11. Relations of Production; 12. Capitalist Mode of Production; 13. Dead Weight Loss; 14. Socialism; 15. Labour Power; 16. Labour Time; 17. Socially Necessary Labour; 18. Depreciation; 19. Constant Capital; 20. Variable Capital; 21. Surplus Value; 22. Labour Embodied Theory of Value; 23. Production & Reproduction; 24. Legalized Robbery; 25. Organic Composition of Capital; 26. Class Struggle; 27. Concentration of Capital; 28. Capital Accumulation; 29. Falling Rate of Profit; and 30. Workers' Proletariat.

7.20. SELF ASSESSMENT QUESTIONS

1. "Though Sismondi's influence was felt by socialists, he was not a socialist" (Haney). Do you agree with the idea?

2. Compare and contrast Marx's theory of surplus value and Physiocrats' concept of net product.

3. "Let us beware of the dangerous theory of equilibrium which is supposed to be automatically established. A certain kind of equilibrium, if it is true, is re-

established in the long run, but it is only after a frightful amount of suffering” (Sismondi). Explain.

4. Define Dialectical Materialism or Materialistic Interpretation of History. Do you agree that dynamic process of development of socio economic institutions leads to the crumbling of capitalistic mode of production?

5. Distinguish between ‘labour time and labour power’. Assess their role in determining the exchange value of labour in the market.

6. Examine the statement that ‘as organic composition of capital increases, rate of profit would fall, given the rate of surplus value’.

7. “Marxism is simply a branch grafted on the classical trunk” (Gide and Rist). Elucidate.

8. Discuss the Marxian theory of economic crisis. What does its role in the dynamic analysis of Marx?

9. Explain the following concepts:

1. Theory of Value of Marx; 2. Criticism against Marx; 3. Falling rate of profit

4. Industrial reserve army; 5.Sismondi’s Class Struggle; 6. Theory of exploitation.

7. Historical Method; 8. Labour Theory of Value.

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M.A.ECONOMICS: EVOLUTION OF ECONOMIC DOCTRINES

LESSON-8/UNIT-2

OTHER CONTRIBUTIONS- J.B.SAY, VON THUNEN, NASSOU WILLION SENIOR, COURNOT, J.S.MILL, ADAM MULLER & HISTORICAL SCHOOL

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8.1. OBJECTIVE OF THE LESSON

In this lesson, a detailed analysis of ideas developed by the economists of classical tradition. These include J.B.Say, Von Thunen, N.W.Senior, Cournot, and J.S.Mill. Also an account of the contribution made by Adam Muller, a romanticist is explained. Considering the chronological order of its origin, the views of the Historical School are given at the end.

8.2. JEAN BAPTISTE SAY (1767-1832)

8.2.1. INTRODUCTION

Jean Baptiste Say, born in 1767, is a French economist who is regarded as an exponent of Adam Smith's idea on the Continent. J.B.Say made a significant contribution to the political economy and secured a place of pride in the history of economic thought. He can be regarded as founder of French Classical School. He is not only an expositor of Smithian economics, but also he is instrumental in making the Smithian economics more popular by introducing necessary modifications. He preferred to make economics as an exact science with a set of fundamental principles that are universal in nature. Say's ideas are contained in his book, "A Treatise on Political Economy, 1803". Though he is greatly influenced by Smith's book, Wealth of Nations, Say felt that Smith's book is a vast chaos of just ideas, jumbled with positive knowledge.

Regarding the scope of political economy, Say regarded the political economy as a study of the laws governing wealth. He considered that it is a study of production, distribution and consumption of wealth. Say opined that political economy is purely a theoretical and descriptive science. To him, the duty of an economist is “to observe, to analyze, and to describe”, but not to give advice. Say wrote to Malthus saying that “he must be content to remain an impartial spectator”. Say, therefore, tried to segregate politics from political economy.

Say is against the government interference in the harmonious and spontaneous working of the economic system. He regarded that economics to be an exact science like physics. The laws of physics are not the work of men, but it is the work of the nature and hence applicable universally. Similarly, the laws of political economy are also derived from nature and hence they have universal validity. Thus, Say had broken the tradition of mercantilists, physiocrats and Adam Smith in mixing the economics with politics paving the way for theoretical analysis of economics.

8.2.2. SAY’S LAW OF MARKETS

Say’s Law of Markets is a significant contribution of Jean Baptiste Say and through which he had secured a permanent place among the galaxy of economists. During those days of Say, several economists thought that general overproduction and unemployment were the common features. J.B.Say through his analysis of the law proved it to be wrong.

The law of markets states that “supply creates its own demand” by which the economy is always under equilibrium in the sense of balance between aggregate demand and aggregate supply. So, overproduction and the consequent unemployment are ruled out. Of course, this happens only in the long run. The law of markets tells us that ‘the very act of producing a commodity is the creation of demand for another’. That is, a mere circumstance of the creation of one product immediately opens a vent for other products. In the words of Say, “….a product is no sooner created, than it, from that instant, affords a market for other products to the to the full extent of its own value…..the only way of getting of money (received for selling the commodity produced) is in the purchase of some product or other". In other words, whatever is produced represents the demand for another product. So, additional supply creates additional demand.

Say's law of markets, at the first instance, is valid in a barter system of exchange where goods are exchanged for goods. When a product is produced, it offers a market for other products. This is because a man needs many a commodity at the same time. The reason for a man to engage himself in the act of producing a commodity is to offer market for other products which are going to satisfy his multiple wants. The man manufacturing a commodity brings the surplus of it to the market for sale only to buy other commodities. Apart from the ratio of exchange, the barter system paves the way for the smooth functioning of the exchange of goods. To take Smith's example, a man is manufacturing a given quantity of shoes and after keeping some pairs for his use, the person takes the surplus to market for exchanging the same for other goods, say, bread, clothing, food, etc. An additional supply of shoes gives rise to additional demand for food, etc. As a result, macroeconomic equilibrium is always maintained and there is no question of overproduction or underproduction.

Now let us try to understand the situation when money is introduced in the economy. The conclusions of the law are equally valid in a money economy. In this money economy, goods are exchanged for money. The producers will receive money from the sale of the goods produced and with the help of this money they are going to buy other goods. Here in this scheme, price enters into the system. Basing on the relative prices, exchange will take place. In this context, money acts as a medium of exchange. That is, money is paid and received while undertaking transactions in goods. The role money in these transactions is 'neutral'. The entire money that is received from the sale would be used for purchasing other goods. Nothing can be kept away from the transactions. However, changes in the money supply will result in changes in the price level. Referring the previous shoe example, in case producers of other goods, food and clothing, may not want to buy additional shoes produced at the existing price. This means that the relative price of shoes would come down. The relative prices of other goods have risen.

As a result, the producer of shoes will reduce production in the next production cycle. The producers of other goods will increase the production in the following year. This example shows that there is the situation of partial overproduction or deficiency of aggregate demand which is the effect of producing what is not exactly wanted. The situation of partial overproduction can be corrected by shifting the resources to the profitable enterprises.

This doesn't mean that the society is in the habit of saving. The people do save a part of their income. But this saving will find its way to productive investment or buying of capital goods. Total demand consisting of demand for consumer goods and capital goods remains always equal to total supply comprising of supply of consumer goods and capital goods. In the classical system, the rate of interest mechanism could ensure the conversion of saving into investment. There is, therefore, equilibrium between aggregate supply and demand.

8.2.3. . APPRAISAL

Since total demand for goods is always equal to total supply of goods, it can be said that the Say's Law can be regarded as an identity of statement. The identity is valid in both the barter and money economies. The law also states that there is no overproduction which means that there is no general unemployment in the economy. A perfectly competitive economy has aninherent tendency towards full employment equilibrium through wage-price flexibility. In the economy, there is automatic adjustment mechanism by which equilibrium is always restored even if there is disequilibrium. This also indicates 'static equilibrium analyses.

In the Say's law of markets, there was nothing much new. Whatever stated by his predecessors is repeated in some form or other. For instance, the statement that goods are exchanged for goods is not a new thing to be given by Say. Also, money received through sale proceeds is meant for buying other goods is also not new. But Say's effort lies in explaining a universally applicable barter system of exchange. While saying that there is no overproduction, he said that partial overproduction is possible, but it is temporary. Say did not rule out the habit of saving. Even if some income is saved, aggregate equilibrium won't be disturbed. This is because saving will find its way into productive investment.

Malthus did not agree with Say regarding ruling out of general overproduction or glut. Malthus opined that there is the possibility of overproduction due to the exigencies of capitalistic system under which labour is paid low wages. Say also ignored the role of money in regulating the flow of demand.

Whatever the criticism against the Say's law, Say has made an outstanding contribution to the economic theory thereby making the Wealth of Nations more popular.

8.3. VON THUNEN (1783-1850)

8.3.1. INTRODUCTION

The book, Wealth of Nations has not received much attention in Germany either from the side German thinkers or from the ruling elite. There was some recognition to the writings of Adam Smith once the book was translated into the German language in 1778 and 1794. The book had a profound influenced on the writings of some German economists. The prominent among them is Von Thunen who was an agriculturist by profession, being the son of a landed proprietor. He was born in Oldenburg in 1783. Von Thunen may be regarded as Ricardo of Germany. He was staunch follower of Adam Smith. He was interested in the development of theoretical economics. He is famous for his book, namely, 'The Isolated State'. He has developed several original works which include the concepts of rent, theory of distribution, diminishing returns and so on. He is the forerunner in the development of location theory. His book has been regarded as one of the most remarkable books in economic literature. Though he is a follower of Smith, Thunen criticized that Smith for having confused on various concepts such as profits, interest and rent and he was incomplete in many respects.

Regarding the method of analysis, Von Thunen has used the abstract deductive reasoning for his analysis of economics. He has undertaken a scientific investigation method in the book considering the relationship between theory and facts. He also made an attempt to undertake empirical study. He also utilized marginal analysis for developing the theory of distribution. To understand the shares of factors of production, he used imputation method. Therefore, the book is full of mathematical formulae.

8.3.2. THE THEORY OF RENT

At first, Thunen has defined certain assumptions for his analysis. He has taken up the definitions of these unrealities or imaginary things given in his book,' The Isolated State'. He has taken a large town in a fruitful plain with no navigable canals or rivers. This plain consists of cultivable land. All lands are of equal quality and all labourers are equally productive. This large town assumed supplies all the manufactures to the plain and in return obtains its sustenance from the surrounding country. This is the assumption considered by Von Thunen, being an agriculturist.

After taking into account the assumption, he proceeded to explain the way the land would be cultivated and the effect of distance on agriculture. Then he reduced the problem of cultivation to the cost of transport basing on his experience of farm management. In this hypothetical state, cultivation is arranged in concentric circles round the town according to the cost of transport of the commodity and the ratio in which its value stands to its bulk and weight. After taking into consideration the cost of transport, Thunen presented diminishing scales of value for commodities produced at different distances from the town.

Beyond a certain distance from the town, the grain becomes valueless. That is, the greater the distance from the town, the lesser the value of the grain. For far of lands, transport costs are high to deliver the farm output to the market place. Therefore, cultivation is impossible at far off distances from the town centre, even if the commodities are produced at free of cost. This point takes Von Thunen to the concept of 'rent'. While determining the rent component from the income derived from the land, he said that a farm land is provided with capital equipment which is a separate cost on land. Interest cost on capital equipment used on land is to be considered for arriving at the rental income. So, the income derived from the farm is not only the result of the soil, but also includes the interest on capital used. The amount of rent can be arrived at by deducting the interest cost from income derived from the farm land. After meeting the interest cost from the farm income, the balance remained is called rent.

Thunen said: “The rent of a farm arises from the advantages which it possesses over the worst farm, whether in situation or soil, the production of which is necessary for the satisfaction of demand”. It is the distance that makes all the difference in getting a higher or lower rent. He also said that rent is the “amount of the landlord’s income which, after deducting interest on the value of the buildings, woods, and all valuable objects which can be separated from the land, remains and so belongs to the land as such”. Rent is the net income after deducting the interest cost on capital.

In view of important role played by the transport cost in the Thunen analysis of rent, he suggested that it is better to produce perishable goods like fresh vegetables near the town centre to transport them quickly. In view of the relatively high rents near the town area, he recommended not to lay a crop which requires a large amount of labour. As one move farther away from the town centre, rent on farm land goes on declining, but the transport costs increase because the farm output is to be carried to greater distances to reach the town.
So, the successively remote lands are used at first to forestry, then to crop rotation, then to grains and stock farming. Von Thunen was the first economist to analyze the factor distance and its influence on the cultivation. Thunen said that production cannot be taken up beyond a distance from the town centre where the net return to the farmer is zero. In his theory of rent, he analyzed the least cost location of cultivation for each crop within the isolated state.

Regarding the price of corn, Von Thunen explained a general law saying that “the price of corn must be so high, that the rent of the farm, whose cost of production and delivery is highest, whose cultivation is at the same time necessary for the satisfaction of the demand for grain, shall not fall below zero”. Thunen said that purchasers of grain are indifferent whether the grain is produced at a far off land or on a land which is nearer to the town. The grain from both the areas is of equal value to the purchasers. But the distance makes all thedifferent to the producers. The producer of grain nearest to the town gets a high gain in the form of rent compared to the one at a far off area.

8.3.3. ON WAGES, CAPITAL AND INTEREST

Thunen also referred the concept of margin, though it is a later development in economics, in his analysis of rent. For instance, on a farm land, every additional worker will produce smaller addition to the output. Therefore, number of workers will be successively increased until a point where the value of additional output produced by the additional worker is equal to the additional wage he receives. The same conclusion is drawn from the 'marginal productivity theory of wages', which is a later development in economics. We must note the point that Von Thunen had anticipated the marginal productivity theory of wages well in advance. Von Thunen has based his analysis on the law of diminishing returns and on the marginal analysis of distribution. He said that the wages received by the last worker must act as a norm for all workers, since an equal wage is paid for the same work.

Regarding the rate of interest and capital, Thunen explained that successive doses of capital will provide less and less output due to the 'diminishing effectiveness of capital leading to a fall in the rate of interest. The rate of interest fall to a level as the least profitable employment can afford to pay. Therefore, the rate of interest is determined by last amount of capital used.

Von Thunen was used to worry about the plight of labour because of their low wages. The labour was not given the needed concern at that time. The reason is that of high population and workers did not receive the 'school knowledge'. This implies that mostly labourers are illiterate. In this context, Thunen held that workers can be relieved of this situation by means of late marriages and imparting education.

Moreover, a labour works on the farm land for which he is not able to appropriate the entire value of the rent. Hence, he is receiving low wages. Even without doing any work on the land, a landowner is receiving rent. To Thunen, the plight of labour is because of either of the natural factors or because of labour oppression.

Since there is no rent on the marginal lands, the proceeds on the marginal lands go to the labour. In this context, productivity of capital will be reduced to the productivity of labour, on the plea that capital is regarded as 'stored-up labour'. Also, Thunen said that labour can be divided into capital producing and subsistence producing and both are given the same wage due to competition among the labour. As we have pointed out in earlier paragraphs, the successive doses of labour and capital would provide lesser and lesser outputs. So, the earlier units of labour and capital earn surplus over the last units. But the surplus will be appropriated by the capital. Therefore, Thunen said that wages are low because the capital has retained more than its share.

Thunen opined that the earlier investments of labour and capital get surplus over the later investments on the same. This is due to the operation of diminishing returns. We know that the subsistence wage is the minimum limit which a labour should get in the form of wage. Though subsistence is the minimum limit, labour should get a share in the progress in the form of a higher wage compared to the subsistence level. Thunen provided a formula by which the share of the labour can be determined. The formula is "square root of the joint product of the two factors, labour and capital". It can be written symbolically as

Natural Wage = $\sqrt{ap}$ (square root of a and p)

Where 'a' refers to subsistence, and

'p' represents productivity of the labour

Von Thunen was very much bewitched of the above formula that he wished to get it engraved on his tomb. He realized the fact it is impossible to have a distinction between the value of the product of the earlier units and later units. But it should be noted that the view that earlier units of labour and capital will get surplus over the later units, is neither empirically verified nor practicable.
However, Von Thunen provided humanitarian ethical approach to the problems

of labour in his book, ‘The Isolated State’. Further, Von Thunen was the first economist to apply the law of diminishing returns to all the factors of production.

8.3.4. PRICE DETERMINATION

The price of products produced by the labourers on the farm land is determined by the expenditures incurred on food, etc., during the process of production and on raw materials. If the raw materials are obtained from the town centre, the price of the products is determined to a lesser extent by the local (town) price of grain. On the other hand, if the raw materials are procured on the farm land itself by means of producing them, the price of the finished product is determined to a greater extent by the price of grain. The reason is that the farmers would buy some commodities from the town exchanging money for.

Von Thunen recognized the role played by the demand and supply forces in the determination of price. For instance, as demand for products increases, the price would go up leading to intensive and extensive cultivation of land. This increase of cultivation ultimately leads to equilibrium between production and consumption. Also, he said that the price of grain depends on the income level. The higher the income level, the higher the demand, and eventually the higher price level in the market. In this price analysis, Thunen provided a long term analysis. For this purpose, he distinguished between ‘market price and average price’. The average price of Thunen resembles the ‘natural price’ of classical economists. Thunen opined that market price would never equal to the average price, but hovers around the average price. Thunen mainly concerned about the determination of the average price in the long run.

8.3.5. ON TRADE

In the beginning, Thunen was a staunch supporter of free trade, but later he changed his view when he observed that free trade is not an absolute good. In this context, he discussed about the nationalist view and the Smith’s cosmopolitan view. From national point of view Thunen explained that the relative strengths of the countries are important. In this view, money considerations are the strength of the nation. On the other hand, in a cosmopolitan approach, absolute strengths are the aim. But this view takes into account the welfare of the people. While saying that free trade is not an absolute good, Thunen opined that protection may be necessary for the growth of domestic industries. Even in the case of Smith, though favoured cosmopolitan approach, there were instances of supporting the nationalist point of view. So, there is a similarity here in the views of Smith and Thunen regarding his nationalist point of view. Also, Thunen agreed to the views of Smith on the rationalism of economic man who knows well what is best for him leading to economic harmony in the society. Thunen accepted the view of Smith that all this activity is carried out by the spontaneous nature of human behavior. Therefore, both national and cosmopolitan approaches are valid for trade, as per the views of Thunen.

8.3.6. APPRAISAL

Von Thunen was a great follower of Adam Smith. He used the deductive method of reasoning in his famous contribution, The Isolated State. In addition, he was the first economist to apply the law of diminishing returns to all the factors of production. Regarding his contribution, he is known for his theory of rent in that he considered the contributions of both labour and capital. In the theory of rent, he used the variable distance in the determination of the value of the grain. He felt sad regarding the plight of labour in not getting adequate wages to their efforts. For the first time, he attempted to find out the shares of labour and capital by providing a formula which he wished to engrave it on his tombstone. Like Smith, he also explained about the average price, a corollary of natural price, for the determination of value of a product. Finally, his ideas have sown the seeds for the development modern economic theories.

8.4. NASSAU WILLIAM SENIOR (1790-1864)

Nassau William Senior is one of the important representatives of the classical school. It is pointed out that he belongs to the school of Ricardo, thought not completely. Senior’s effort lies in introducing modifications in the labour theory of value, as compared to the Ricardian theory. He is not only a supporter of classical thought, but also introduced certain modifications. The important task for the economists at the time when he was writing was to analyze the conflicting interests between labour and capital. Therefore, a modification to the labour theory of value was the outcome at the hands of Senior. Italian writer, Cossa regarded him as the ablest of English economists from Ricardo to J.S.Mill.

He was born in England in 1790 and was educated at the University of Edinburg. After completing his M.A. in 1815, he was called to the bar in 1819. Later he was twice Professor of Political Economy at Oxford. Also, he worked at King's College, London. Senior's principal work is "An Outline of the Science of Political Economy, 1836".

8.4.1. SCOPE AND METHOD OF POLITICAL ECONOMY

To Senior, the subject matter of economics is not happiness but wealth. It is the science which deals with the nature, the production and the distribution of wealth without any implication of morality and welfare. He divides the economic laws into two types anticipating Mill. Firstly, the economic laws are universal for all the economies. This category includes the laws of production. Secondly, the economic laws are affected by the peculiar institutions of particular countries. This category includes the laws of distribution. He regarded economics as an abstract and deductive science. He opined that practical questions are no more part of the political economy. Also, he said that an economist should not indulge himself in giving even a single piece of advice. To him, the business of an economist is neither to recommend nor to dissuade, but solely to state general principles.

According to Senior, Political Economy is based on four basic propositions. Firstly, each man desires to get additional wealth with least sacrifice. It is the assumption of economic rationality, i.e., the economic unit acts with the aim of self-interest. This is known as hedonistic principle. Secondly, population of the world is limited only by moral or physical evil, or by fear of deficiency of food articles. This in other words refers to Malthusian Theory of Population. Thirdly, the powers of labour may be indefinitely increased by using their products as the means of further production. This indicates the concept of 'Increasing returns to scale in industry'. Under this, capital can add more to the total production compared to its labour cost of production. Increased use of capital paves the way for better use of both labour and capital. Fourthly, agricultural skill remaining the same, additional labour employed on the land produces in general a less proportionate return. This implies the law of diminishing returns in agriculture.

8.4.2. ON VALUE

(a) THE CONCEPT OF UTILITY

As we said earlier, Senior was successful in modifying Ricardian labour theory of value. The utility analysis is used in Senior's version of value theory. Walrus credited him for the idea of marginal utility. Senior defines value as "that quality in anything which fits to be given and received in exchange". Thus, value is determined by the demand and supply of one commodity and the demand and supply of that commodity for which it is exchanged. According to Senior, three things go into the determination of value. These are transferability or marketability, relative scarcity, and utility. Firstly, a good must have to be sold or marketed before it is considered for exchange value in the market. Secondly, value is determined by the relative scarcity of a good. The good available in abundance is expected to be less valuable and a scarce good is expected to get more value. Whether a good is scarce or abundant in supply, the judgment is to be given basing on its demand. Thirdly, a good must possess utility before it is sold in the market. Utility means want satisfying power.

While saying that demand is determined by utility, Senior referred the concept of diminishing marginal utility analysis. But Senior did not give prominent place to the utility analysis in his writings. According to him, value is that "quality in anything which fits to be given and received in exchange or, in other words, to be lent or sold, hired or purchased". On the other hand, in his value analysis, Senior devoted much attention to the supply side of the problem. According to him, limitations associated with the supply determine the value of a commodity. So, value is caused because the supply is less than demand. As long as there is utility, the addition of labour to the production of a commodity gives rise to value.

(b) COST OF PRODUCTION THEORY OF VALUE

While discussing the limitations of supply, Senior classified the 'means of production' as (a) human labour, (b) the spontaneous agency of nature or land, and (c) abstinence. According to Senior, land was freely available to all. On the other hand, abstinence is different from land and labour. The term abstinence refers to postpone of present consumption to a future date. That is, a consumer is abstaining from present consumption leading to saving. The saving turns into investment resulting in capital accumulation. Capital accumulation promotes labour productivity. So, the concurrence of abstinence is necessary to capital. Therefore, abstinence is the source of capital supply.

Therefore, the supply of a commodity is limited by the sum of the labour and abstinence necessary to production, given the land. This is called as the 'cost of production'. This in other words refers to as the cost of production theory of value. Senior has tried to alter the Ricardian theory of value. In this theory, labour and capital constitutes the cost of production. Like labour, capital also productive and hence Senior justifies a payment to capital. Senior was successful in bringing together the total cost of production and the demand in terms of utility in his value analysis. According to him, cost of production determines price only when there is free competition. The price is a long term price which is going to deviate from the short-run market price.

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Senior felt that in practice free competition does not always exist. An element of monopoly is present in the market. According to Senior, there are 4 types of monopoly existing in a market. Firstly, a producer may be enjoying certain exclusive facilities as a producer. By using these facilities he is in a position to increase production indefinitely. But other producers can also produce the good but at a higher cost. We can cite the example of a patent right. A patent holder enjoys special rights in the manufacture of a product and others do not have same privileges. In such cases, the monopoly producer can earn a larger absolute profit provided he is enjoying an elastic demand for the commodity and also enjoying economies of scale. In this case of monopoly, market price is very close to the cost of production. Secondly, in the second case, a monopolist enjoys complete control over production, but he cannot increase the size of the output. In this case, price cannot fall below the cost of production, but the upper limit for the price is determined by the demand conditions. Thirdly, in this case, a monopolist producer has absolute control over supply and he can also increase the production. For example, a book publishing company having a copy right or patent can increase production. Here market price is equal to the cost of production, but there is no upper limit to the price. Fourthly, in this case of monopoly, the producer is not only the producer, but has peculiar facilities which diminish and ultimately disappear as the size of the output increases. This applies to the case of a monopoly of land. Using a factor of production of different qualities on a piece of land causes differential rent. Therefore, Senior's analysis of monopoly explains about the differential control over supply. This idea leads to the notion of 'market imperfections' and value is determined by a different combination of demand and supply in markets with different degrees of imperfections.

8.4.3. THEORY OF WAGES

Senior did not contribute much to the theory of wages. The reason is that he is linked to the wages fund theory of his classical predecessors. According to him, wages depend on "the extent of the fund for the maintenance of the labourers, compared with the number of labourers to be maintained". Senior failed to consider population as a source of labour supply. Also, he did not like to develop a cost of production theory of wages. He was in a confusion regarding the suggestions made for a wages fund and productivity theory of on the other. Also, he failed in his analysis in considering that one of the determining factors of wages fund is labour productivity.

8.4.4. LAISSEZ FAIRE

We know that Senior has said that capital is also productive through his abstinence theory. Also, we know that he has developed the cost of production theory combining the productivities of labour and capital. Viewing from this angle, it can be said that Senior was an advocate of laissez faire. It is commented that Senior was not a rigid advocate of laissez faire. Senior suggested that it was the duty of the government to remove the distress of the workers. He was prepared to advocate government intervention so long as it did not unduly interfere in the free working of the economic laws. Also, Senior deviated from his earlier version in practice that economists have no role in giving policy suggestions.

8.4.5. APPRAISAL

Senior was a great economist of classical tradition. Senior was content enough with the earlier economic theories and he was well aware of their defects because of his familiarity with facts of economic life. Senior emphasized the subjective elements. He has given greater importance to utility and abstinence which are subjective in nature. But he does not grasp the concept of marginal utility. The critical powers of Senior were remarkable, but he did not formulate any significant theories in economics though he was on the verge of stating the law of diminishing utility and the law of increasing returns. Therefore, he placed economics on a more scientific and abstract footing.

8.5 AUGUSTINE COURNOT (1801-1877)

8.5.1. COURNOT'S WORKS

Augustine Cournot was French mathematician. He was proficient in probability theory and was also a philosopher. In 1838, he published his famous book on “Mathematical Principles of the Theory of Wealth”. Though the book included many a concept of economics, the book was not sold even a single copy. In 1863, he wrote another book, “Principles of the Theory of Wealth” and in 1876 he published another book, “Review Summary of Economic Doctrines. He also contributed extensively to the theory of political economy.

8.5.2. COURNOT'S CONTRIBUTION

Cournot emphasized the importance of mathematical method in economics in his various contributions. According to him, the task of mathematics is to simply handle the numerical data and also establishing functional relationships between different variables. Basing on this, he developed the demand function which is found to be a function of price. In a symbolic form, it can be written as

D = f (P), where D stands for demand and P for Price.

He rejected the idea that utility as the foundation of demand analysis. While dealing with exchange of goods, he reiterated that 'running expenses' meaning variable costs enter the determination of price. He explained that an increase in the running expenses (marginal costs) would lead to an increase in the price in a monopoly case. Cournot is famous for his solution to the problem of 'duopoly', a case of two sellers facing many consumers. In this, Cournot made certain unrealistic assumptions. The individual seller proceeds on the assumption that his rival seller's output remains constant. And the rival will not react to the actions of our seller. In this context, Cournot explained that the equilibrium price is higher than the price in a perfectly competitive market and lower than the simple monopolist's price. Under the duopoly, two sellers charge the same price in equilibrium. If the two sellers under duopoly collude, it is a case of monopoly.
According to Cournot, the output under duopoly will be 2/3rds of the output produced under perfect competition.

The credit of developing a general supply curve goes to Cournot. He explained that the price is determined by the intersection of the general supply curve and general demand curve.

8.5.3. APPRAISAL

Cournot was credited with the mathematical analysis of economics establishing functional relationships between variables. He provided theoretical foundation to many concepts of economics. Whatever the contribution, Cournot is known for his contribution to determination of price under duopoly. But many of his assumptions were changed by the later economists to make his contribution more realistic. He was considered as a path-finder to many later developments in economics. Nevertheless, economic historians did not pay adequate attention to the theoretical foundations laid down by Cournot.

8.6. JOHN STUART MILL (1806-1873)

8.6.1. LIFE AND WORKS

J.S.Mill heralded the end of the era of classical economists. He systematized the popularized the whole body of the classical economic thought. In his book, “Principles of Political Economy, 1848”, we find the classical doctrines in their final crystalline form. He made some significant original contributions to the political economy. Mill is not only a gifted popular writer, but also a significant contributor of economic thought. Mill on several occasions deviated from the main ideas developed by the classical trinity, Smith-Ricardo-Malthus. During times, classical economics reached its apex and also witnessed its downfall. It is said that, “with him classical economics may be said in some way to have attained its perfection and with him begin its decay” (Gide & Rist).

Mill was the son of James Mill, an economist, who encouraged Ricardo to write on economics. He received extraordinary education under the guidance of James Mill. He was not only an economist, but also a logician, reformer and a champion of liberty. Apart from his book on Principles of Political Economy, he wrote number of books, namely, System of Logic (1843), On Liberty (1853), Subjection of Women (1869), Unsettled Questions of Political Economy (1844), and Autobiography (1873).

8.6.2. SCOPE OF THE POLITICAL ECONOMY

Mill’s ideas are basically derived from Adam Smith and Ricardo. His economic thinking is the result of the developments that had taken place in economic and social scenario since the days of Smith and Ricardo. Mill was in a society which was experiencing the fruits of industrial development in England. There were fundamental changes in the social and economic situation in the country. The after-effects of industrial capitalism resulted in a situation of class war between workers and capitalists.

a) DEFINITION OF POLITICAL ECONOMY

Taking into account the overall picture of the political economy, Mill defined political economy as a science which deals with “the nature of Wealth, and the laws of its production and distribution: including directly or indirectly, the operation of all the causes by which the condition of mankind is made prosperous or the reverse”. Mill’s definition of political economy comes very close to the one given by Marshall, who defined economics as a study of the ordinary business of life. So the nature of wealth is the central theme of Mill’s analysis. Following the English tradition, Mill divided the subject matter of the Political Economy into 5 Books: “Production, Distribution, Exchange, Influence and Progress of Society on Production and Distribution, and The Influence of Government”. Mill denied a distinct place to consumption. He has not only studied the laws governing the production and distribution of wealth, which were used to be the subjects of his predecessors, but he has also included all those causes by the operation of which society is made prosperous or reverse. The scope of the book, Political economy is much wider than that covered by his predecessors.

b) MILL’S ECONOMIC AND SOCIAL PHILOSOPHY

According to Mill, economics is both a science and an art. It is science in the senses that it studies the working of the economy and it is an art in the sense that it cannot be separated from social and moral philosophy. Mill subscribes to the Utilitarianism. For instance, human actions are guided by motives other than self-interest also. The economic life of man is one of the many shades of man’s individual and social life.

The early classical writers did not believe in offering advice but Mill was a social reformer. He was interested in the application of economic principles to the problems of the society. Mill was more concerned with the practical side of political economy. Mill’s concern for social and economic reforms caused him to distinguish between the laws of production and the law of distribution. Though

Mill restated classical doctrines, he made an original contribution by saying that the law of production was different from the law of distribution. On the other hand, the whole of the conduct of man is not covered by the Political Economy. It covers only an economic man who is desirous of pursuing wealth. It considers the phenomenon of the social state that results from as a consequence of the pursuit of wealth.

8.6.3. LAWS OF PRODUCTION

To Mill, production is the result of the cooperation between the nature or natural agents and labour. Labour refers to mental or physical effort of human beings in a particular occupation. On the other hand, natural agents are which "exist or grow up spontaneously, of a kind suited to the supply of human wants". Production is carried out by the constant efforts of both labour and nature. Mill opined that "labour…is always and solely employed in putting objects in motion; the properties of matter, the law of nature do the rest". Following J.B.Say, Mill said that the function of labour is that of creating 'utilities'. According to Mill, labour creates three types of utilities, namely, firstly, those which are fixed and embodied in outward objects; secondly, those which fixed and embodied in human beings; and thirdly, those which are not fixed or embodied in any object, but consisting in a mere service rendered to any person. Under the first category, the employment of labour may lead to the production of material objects. The second category refers to the creation of 'human capital'. The last category refers to the creation of 'service'. Mill said that the first two categories add to the productive capacity of the nation and the last adds nothing. The third category of 'service' also facilitates the production of wealth. But Mill failed to realize that consumption of a service leads to the production of wealth. Mill opined that labour is instrumental indirectly in certain fields of production which include" (a) extraction industries, (b) making of tools and implements, (c) protection of industries, (d) taking the existing available supplies to the consumers, and (e) inventions of industrial processes.

Basing on the concepts of production and wealth, Mill also distinguished between productive and unproductive labour. To Mill, labour is considered as productive when it adds to the productive capacity of the nation. This includes human capital also. But production of service is not the productive labour, even if it is exchanged in the market. He says that society cannot grow with the help of unproductive labour. There is the case of unproductive consumers. These are those individuals who consume, but add nothing directly or indirectly to the production. Such category of individuals is known as unproductive consumers. This category includes the consumption by children, the old people and the infirm. Here we must remember that a part of the consumption of the productive labour can be considered as unproductive consumption. For instance, what is consumed in pleasure or luxury, whether by the idle or the industrious, is called unproductive consumption.

While referring to the supply of labour, he dealt with the theory of population as a source of labour supply. Mill believed that there is no obstacle to the augmentation of labour supply, since he is a firm believer of Malthusian theory of population. He also recognized the dangers of population increase. In this context, he said that, “The new mouths require as much food as the old ones and the hands do not produce as much”. Mill opined that to improve the well being of the labour, the labour should limit their numbers. A large family appeared to him as disgusting as drunkenness. Mill became one of the early supporters of the birth control movement, which sought to spread the knowledge and use of contraceptives and make planned parenthood universal”. There Mill was a great advocate of population control.

Mill also recognized the importance of capital as a factor of production in addition to labour and natural agent. According to him, the former is given a secondary place in the production process, the primary position being labour and natural agents. He defines capital as the accumulated stock resulting from industry which is devoted to reproductive employment. He listed the following four fundamental features of capital: (a) that industry is limited by capital; (b) that it is the result of saving; (c) it is used for further production; and (d) that capital supports labour and employs it. Mill also said that every increase of capital leads to the expansion of industry and provides employment. To Mill, capital does not possess any productive powers as possessed by labour and natural agents. The only function of capital is to feed and maintain labour in the process of production. He included saving as part of consumption along with other expenditure. He also said that as capital accumulates, the rate of increase in production tend to decline due to increasing depreciation requirements which are going to be met from savings out of the current income.

The productive efficiency of labour is also determined by the energy, skill and knowledge of labourers and cooperation with each other. Thus, to Mill, the nature of industrial organization depends on the degree of productive efficiency of labour, capital and natural agents.

8.6.4. MILL'S THEORY OF VALUE

According to Mill, there is nothing new that can be explained with reference to the theory of value which is more or less a settled problem. Mill's task remained here is to restate the Ricardian theory of value. Like Ricardo, Mill attempted to distinguish between value-in-use and value-in-exchange. His concentration is mainly on the latter. He said that value of a commodity is determined by the amount of labour embodied in it. At a later stage, Mill settled at cost of production theory of value. In this, profits and wages enter into the cost of production. This determines the price.

While explaining the concept of value in exchange, Mill furnished three types of situations. Firstly, there are goods in whose case supply is absolutely fixed. Since supply is fixed, price is determined by the demand in the market. Secondly, there are goods which are absolutely elastic in supply. In this case, the price is determined by the cost of production. This is a long-run phenomenon. In the short run, demand and supply forces determine the price. Thirdly, there are goods which are relatively elastic in supply. In this case, supply can be increased only with the increase in cost. In this case, increased supply increases cost and therefore an increased supply is offered at an increasing price. But Mill failed to elaborate on this aspect.

Mill has made an important contribution to economics by modifying the law of demand and supply by saying that price is fixed at a margin where the quantity offered is equal to the quantity demanded. The law of demand and supply explains only the variations of value, but does not explain the conception of value itself. In this context, Mill developed a cost of production theory of value.

Mill opined that the law of supply and demand can equally be applied to money also. He distinguished between temporary value and natural value of money. The temporary value of money is determined by its supply, i.e. quantity in circulation and demand for exchange purposes. On the other hand, Mill believed in the natural value of money which is determined by the cost of production of precious metals. He also extended the law to the field of international trade by using Ricardo's comparative cost theory. While accepting Ricardo's version of trade, Mill developed the theory of 'reciprocal demand'. The trade depends on the 'proportion at which the demand of the two countries for each other's products will exactly correspond'. The supply and demand are another form of expression for reciprocal demand. Marshall had taken up the task of further developing the Mill's theory of reciprocal demand.

8.6.5. MILL'S THEORY OF WAGES

Regarding the theory of wages, Mill adopted the wages fund theory, though not completely. He first started with the wages fund theory and later he discarded it. Mill divided the capital into that part which is used for the payment of wages and that which is not. So wages are determined by the part of the capital meant for payment of wages. Next comes the ratio between the population of labour class and capital determines the wage rate. Here capital refers to circulating capital and not even the whole of that, but the part which is expended in the direct purchase of labour. Mill opined that wages can increase only with an increase in the aggregate fund meant for hiring of labour. Also, wages can decrease with either an increase in population or a decline in the funds. He suggested that number should be limited only to increase the well being of labour. He also referred the famous statement that: "wages are high, when trade is good"; and that "high prices make high wages". In this context, he indirectly used the statement of Ricardo that: "wages vary with the price of food".

8.6.6. MILL'S THEORY OF RENT

Mill accepted the theory of differential rent of his predecessors like Ricardo and Malthus. Mill opined that rent arises due to differences in fertility of land. Therefore, the pre-margin lands will yield rent. The produce of the inferior lands only pays back the expenditure incurred on its use. To Mill, the payment of rent is the result of the institution of private property in land. This leads to a kind of monopoly. Land is a commodity which many want it, but no one can obtain it but from the landlords. Without doing any productive work, landlord will receive remuneration in the form of rent, being the possessors of land. In Smith's words, rent is a monopoly price.

8.6.7. MILLS THEORY OF PROFIT

Mill borrowed the concept of profit from Nassau William Senior. Senior considered that profit is a reward for abstinence, that is, postponement of current consumption to a future date. This in other words refers to as 'saving', which is another form of consumption. Therefore, profit is the reward for abstinence and risk. Since supply of capital is determined by abstinence, the abstinence or waiting requires compensation. This compensation is known as profit. He also explained three elements for the ascertainment of profit, namely, "abstinence, risk, and exertion". For the three elements respectively require "profit, insurance and wages for superintendence". But he failed to provide a concrete idea regarding profit. Basing on Ricardo, Mill said that "the rate of profit depends upon wages; rising as wages fall, and falling as wages rise". Like Ricardo, Mill also believed in the falling rate of profit. He said that wages and profit varies inversely.

8.6.8. MILL'S STATIONARY STATE

Like his predecessors, Mill also described the stationary state. Once the rate of profit reaches the minimum, the economy reaches its stationary state. After achieving the peak level of growth in output and wealth, the growth rate begins

to fall and reaches to a stage stationary state with the rapid fall in the rate of profit. A fall in the rate of profit is the result of an increase in the share of labour in the form of wages in the total output. The share of wages increases due to the accumulation of capital which gives rise to intensification of competition. With the improvement of living standards, population growth would be checked. The employers would face the scarcity of labour as a result of which wage rate goes up and profit comes down. The stationary state provides vast scope for improving the quality of life on account of the stability of capital and population. In this state, there would be no competitive struggle and wealth is evenly distributed.
Mill called this state as the blissful equilibrium. Therefore, Mill thought that the stationary state works towards “improving and elevating the universal lot”.

8.6.9. MILL’S SOCIALIST PROGRAMME

As we said earlier in the preceding paragraphs, Mill was not only a political economist, but also a social reformer. The social question stems from the utilitarianism of Mill. This means that the need to secure greatest good for the greatest number. This idea was encouraged by the deficiencies of laissez faire philosophy. Therefore, Mill was a supporter of working class movement. He borrowed his socialist ideas from Saint Simon, Sismondi, and others. Mill believed that a day would come when labourers and capitalists would become partners in a cooperative enterprise. He preferred communism to the state of sufferings and injustices. Though Mill was attracted towards socialism, he remained faithful to the liberal economy. Basing on his individualism, free competition and laissez faire philosophy, Mill’s socialist programme can rightly be called as “individualist socialist programme”.

8.6.10. APPRAISAL

Mill’s contribution to the theory of economic thought is the end of era classism. In the initial years of writing, Mill appears to be a perfect classist and in the later years, he appears to be a perfect idealist. Mill did for Ricardo what J.B.Say did for Adam Smith, a job of systematization and popularization (Newman). He is not only a political economist, but also a social reformer. Mill was a liberal economist with socialist leanings. However, his ideas are not without defects. In his earlier works, he adopted deductive method and in the later period, he used a combination of both deductive and inductive method of analysis.

8.7. ADAM HEINRICH MULLER (1779-1829)

(A ROMANTICIST)

8.7.1. BACKGROUND

Adam H. Mueller belongs to the school of 'romanticism', a spirit of nationalism. The school of romanticism was developed in Germany. This school fundamentally opposes the classical school. He is a nationalistic critique of classism. This romanticism is an ideal in which cultural, mystical and religious values are manifested in the spirit of the nation. The school opposed the individualism and economic rationalism of the classical school. A Romanticist represents economic nationalism and mysticism. The school stresses the importance of cultural values in economic life. The school was founded by George Wilhelm Friedrich Hegel (1770-1831) and others.

The nationalists consisted of two schools of thought, firstly philosophic nationalists and the protectionists. Muller was the prominent among the first group and Friedrich List represented the second group. This school failed to last long in Germany due to its inbuilt limitations. But this school gives rise to historical method of economics.

8.7.2. WORKS OF MULLER

Coming to Adam Muller, he has born in Berlin in 1779. With law degree, he entered into the government service. Also, he lectured for some time at the University of Gottingen. In 1808, he started lecturing on the 'entire political science' and his lectures were published as "The Elements of Politics, 1809". His other works include: "The Management of State Finances, 1812; An Essay on a New Theory of Money, 1816; and On the Necessity of a Theological Foundation for all the Political Sciences, 1819". His writings are often mystical, catholic, and reactionary. His writings are in fact a reaction against philosophy of the French Revolution. In his writings, he presented a totality of the state picture rather than individuals.

8.7.3. .MULLER'S CRITICISM OF ADAM SMITH

He was against the cosmopolitan approach of Adam Smith. We know that individual in Smith's analysis is supreme in taking decisions of his choice basing on his self interest. Smith is also known for his laissez faire philosophy. Muller criticized Smith by giving paramount importance to the Nation and individual is not important. Muller is not interested in the behavior of economic man because a man is influenced by more than one motive. Muller criticized that Adam Smith's contribution is nothing but a theory of individual property and private interest. There is no connection between the individual and the cultural history of the past and present in the Smith's analysis.

Also, Muller said that Smith's version of British experience is not suitable to other nations. So, Smith's absolutism doesn't work with respect to other nations. Smith has completely forgotten the altruism and religion in the man's thinking process and the set of economic activities. Muller said: "Without religion, economic activity loses its ultimate purpose". Muller highlighted the nationalism in which economic laws are not universal in character, but differ from one nation to the other and even within nation depending on the stage of their evolution. Therefore, Muller preferred national interests and linking of economic activity with religion and cultural history. In view of his views having philosophical overtones, Muller is considered to be one of the prominent thinkers of 'philosophic nationalists'.

8.7.4. MULLER'S CONTRIBUTION

Muller said. "Man is not to be thought of, outside the state". He emphasized the organic character of the state criticizing the individualism of Adam Smith. To Muller, the state comes first, and the individual has only significance in relation to the state. Hence, he was the supporter of a strong and wealth state. This view is similar to the views of mercantilists. This means that he was interested in increasing the 'wealth of his nation and not wealth of nations'.

Basing on his views on religion, Muller opined that production should not be considered as an activity to meet the requirements of the market and for earning a profit. On the same line of thinking, Muller considered that labour is not the sole source of produce. Hence, production should be treated as an activity meeting the requirements of the nation. Money also is a social thing. Muller advocated the use of paper currency rather than the use of gold and silver. The latter is of cosmopolitan in character. On the other hand, paper money promotes nationality. Muller opined that capital did not mean only material things as Adam Smith held, but also 'spiritual capital' like commerce, experienced armies, citizens, laws, religion, etc. Moreover, Muller was against the free trade policy of Adam Smith and in turn he suggested for imposing import and export duties. At the beginning of the 19th century, there was a lot of inequality among nations in their industrial development. So the school suggested protective tariffs for the industrial development. In this context, the views of the school resemble mercantilists. He preferred protectionism.

Muller considered money, Roman institutions and material luxuries as corruptors of mankind. Also he opposed the freedom of contract and concept of absolute property as given by Roman law. Muller was not interested in change and felt that institutions must be of permanent character. Muller was also interested in feudal set up because he thought that the poorer sections were better off than in the money economy.

Muller also preferred wars because the state and the national as a whole would come into prominence. He opined that there is no question of perpetual peace in politics and the peace and war should supplement each other. These views of Muller encouraged Nazis to be war friendly.

8.7.5. APPRAISAL

Though Muller criticized Smith of absolutism, he had all admiration for him saying that Smith was the incomparable scholar and the greatest of politicoeconomic writers of all times. To conclude, Muller is an exponent of nationalism in which he stated that economic laws are not universal in character Therefore, Muller, with his writings linking economic activity with religion and cultural history has sown the seeds of historical method of economics.

8.8. IDEAS OF HISTORICAL SCHOOL (1843-1883)

8.8.1. GENESIS OF HISTORICAL SCHOOL

The initial beginnings of the historical school were found in Germany and it was in fact dominant in the second half of the 19th century. It was founded by William Roscher, a Gottingen Professor. The school was a revolt against the classical school of thought. The school developed the 'historical method of analysis'. Basing on the ideas of the school, the Historical School is classified into (a) the older Historical School, and (b) the younger or new Historical School. William Roscher (1817-1894), B.Hildebrand (1812-1878), and Karl Knies (1821-1898) are all belonged to the older school. The new school is represented by Gustav Schmoller (1838-1917).

The Historical School refers to three things. Firstly, the school emphasizes the relativity of laws and institutions. Secondly, the school uses the inductive method of reasoning basing on concrete historical data. Thirdly, it studies interrelations among human motives and among the social sciences.

The school grew at a time when Germany economy was backward and undergoing change towards economic development. The Napoleonic invasions instilled a sense of patriotism and nationalism among the Germans. The soil was virgin in Germany for the development of indigenous economic doctrines. There was no scope for the application of classical doctrines in Germany. There was a need to have a new theoretical foundation. Therefore, the Germans would like to attach more importance to nationality and history in economic thought.

8.8.2. IDEAS OF THE SCHOOL

The Historical School is against the classical doctrines such as individualism, freedom, laissez faire philosophy, too much materialism, universal application of laws, and reductionism. On the other hand, the historical school has given importance to the environment and society. So, individual actions are to be viewed in terms of its effects on the society. Hence, the school opined that without the study of social organizations and institutions, the study is incomplete. The organic view of the society is considered by the Historical School. The school emphasized the study of economic phenomenon with reference to the social facts. The school opined that the classical abstract reasoning is useless and only the historical study leads to important policy formulations. The school advocated the importance of state in the economic activity of a nation and they disliked the philosophy of laissez faire. On the other side of the coin, the historical study is not always useful for scientific study. Also, the school likes empiricism, but the empiricism must be based on some theoretical background. The school's ideas are based on relativism, by which it is meant that everything is relative in character. In this sense, the school failed to consider capitalistic system as a passing phase. Therefore, many economists did not consider the ideas of the Historical School as complete replacement to the classical theory.

William Roscher is known for his famous book, "Principles of Political Economy". He recommended for the application of historical method in economic research. His book deals with the laws of development of economic national life. He believed that economic laws are not absolute truths. They are relative in nature. Their application varies with time and space. Roscher tried to investigate the laws of socio-economic development. Roscher failed to evolve any law of historical development finally.

Bruno Hildebrand, another representative of the school, published his book, "National Economy of the Present and Future, 1848". Hildebrand is against the absolutism of Smith. To him, a man, as a social being, is always a child of civilization and a product of history. Hildebrand proposed a stage theory of development based on historical evolution. According to him, historical development takes place in three phases: natural economy, money economy and credit economy. He is primarily interested in finding out the "historical law of development". But he could not do it.

Karl Knies was thoroughly successful in developing the historical method. Knies published his book: "Political Economy from the Standpoint of the Historical Method, 1853". He believed that historical studies are the basis of economic analysis. He also said that the economic system passes through a number of various phases which are dependent on the stage of civilization. He remarked that no economic system is final and one system gives way to another. Hence, nothing is absolute. The universal validity of economic laws is impossible to happen. Also, Knies argued that self-interest comes into conflict with social interest often. Ultimately, social interests prevail.

Gustav Schmoller was the chief architect of the new Historical School. Schmoller emphasized on historical research in his book, "Political Economy and its Method, 1894". He said that the historical sciences provide empirical material and data which transform the scholar from a mere beggar into a rich man as far as knowledge of the reality is concerned. Schmoller presented a dynamic view of economic life in his writings. Schmoller advocated social reform by which a more equitable distribution of income should be the guiding principle. Unlike the older school, Schmoller is in favour of both deductive and inductive methods of analysis. Schmoller said: "Induction and deduction are both necessary for the science just as the right and left foot are both needed for walking". Schmoller pleaded for much more historical study only to establish an empirical basis for national economic theory.

8.8.3. APPRAISAL

The Historical School is in favour of nationalist ideas and social reform. The school applied the historical method for the formulation of national economic theory. Their contribution lies in the stimulation of research in economic history.

8.9. TECHNICAL TERMS

1. Deductive Method; 2. Inductive Method; 3. Barter System of Exchange; 4. Money Economy; 5. Glut or Overproduction; 6. Stationary Equilibrium; 7. Perfectly Competitive Economy; 8. Full Employment; 9. Marginal Productivity Theory of Wages; 10. Diminishing Effectiveness of Capital; 11. Stored-up Labour;

12. Average Price; 13. Increasing Returns to Scale; 14. Abstinence; 15. Wages Fund Theory; 16. Laissez Faire; 17. Running Expenses; 18. Duopoly; 19. Human Capital; 20. Unproductive Consumption; 21. Value-in-use and Value-in-Exchange; 22. Labour Embodied Theory of Value; 23. Natural Value of Money; 24. Reciprocal Demand; 25. Circulating Capital; 26. Monopoly Rent; 27. Romanticism; 28. Spiritual Capital; 29. Historical Method; 30. Organic View of the Society; 31. Relativism.

8.10. SELF-ASSESSMENT QUESTIONS

1. 'The very act of producing a commodity is the creation of demand for another'. Elucidate.

2. To Von Thunen, "Distance from the town centre generates rent". Explain the role of transportation costs in the determination of rent.

3. Assess the contribution made by Nassau William Senior to the history of economic thought.

4. "With him (Mill) classical economics may be said in some way to have attained its perfection and with him begin its decay" (Gide & Rist). Explain the contribution of J.S.Mill.

5. Muller said. "Man is not to be thought of, outside the state". Do you agree that Muller is a bitter critique of Adam Smith?

6. "The historical study is not always useful for scientific study because the empiricism must be based on some theoretical background". Explain.

7. "Von Thunen had anticipated the marginal productivity theory of wages well in advance". Explain the theory of distribution.

8. "Mill's concern for social and economic reforms caused him to distinguish between the laws of production and the law of distribution". Explain the laws of production and distribution.

9. To Say, “General overproduction is an impossibility, but partial overproduction is possible”. Explain.

10. “The task of mathematics is to simply handle the numerical data and also establishing functional relationships between different variables”. Explain the contribution of Cournot.

8.11. BOOKS FOR STUDY

1. Haney, Lewis, H., “History of Economic Thought”, Macmillan, 1949,

2. Roll, Eric. A, “A History of Economic Thought”, Oxford Univ. Press, 1980.

3. Gray, Alexander, “The Development of Economic Doctrines, Longmans, Green & Co., New York, 1933.

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6. Hajela, T.N., “History of Economic Thought”, Konark Publishers Pvt.Ltd. 1995.

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8. Gide Charles & Rist Charles, “A History of Economic Thought”, George G. Harrap & Co., 1948.

9. Bhatia, H.L., “History of Economic Thought, Vikas Publishing House, 1993, New Delhi.

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Unit-3/ Lesson-9

FOUNDERS OF MODERN ECONOMICS: ECONOMIC IDEAS OF GOSSEN

Contents:

9.0. Objectives:

The main objective of this lesson is to analyze the important aspects relating to founders of modern economics as well as different schools of economic thought. An attempt is also made to explain the important contributions made by the famous economist Gossen to the development of economic doctrines.

9.1. Founders of Modern Economics:

From the earlier lessons we can notice that modern economic thought is usually considered to have begun with Adam Smith in the late 18th century, although earlier thinkers such as the Spanish Scholastics and the physiocrats made important contributions. The physiocrats were soon overshadowed by Adam Smith's Wealth of Nations, published in 1776. Today it is customary to consider Smith the founder of economic theory - and the classical economics that developed after him to be the beginnings of formal economic study. The central idea promoted by Smith was that the competition between various suppliers and buyers would produce the best possible distribution of goods and services, because it would encourage individuals to specialize and improve their capital, so as to produce more value with the same labor. Smith's thesis rests on the belief that large systems can be self-regulating by the activity of their parts, without specific direction. Smith's formulation is called the "invisible hand" and is still the centerpiece of market economics, and capitalism in particular.

In the 19th century, Karl Marx synthesized a variety of schools of thought involving the social distribution of resources, including the work of Adam Smith, as well as socialism and egalitarianism, and used the systematic approach to logic taken from philosopher Hegel to produce "Das Kapital". His work was the most widely adhered-to critique of market economics during much of the 19th and 20th centuries. The Marxist paradigm of economics is not generally held in high regard by market economists, though some concepts from his work are occasionally used in mainstream contexts, particularly in labor economics and in political economy. The term Marxian is in some contexts used to describe work which accepts concepts from his work but does not necessarily subscribe to the political thrust of Marxist thought.

Throughout the history of economic thought, different political ideas have often been associated with different schools of thought about how economies operate. For example, Adam Smith used his theories of trade and of the division of labor to argue for laissez-faire government economic policies, particularly against mercantilism. Similarly, Marx developed his theories, which focus on production and labor, to advocate socialism and communism. An example of another economic system which has recently been advocated is the participatory economics model. This uses neither market methods nor centralized methods for allocation, but incorporates many local positive and negative feedback loops in order to respond to the most positive human values. The participatory economics model is neither communist nor capitalist. One example of this school of thought is the Post Autistic Economics movement.

9.2. **Features of Modern Economics**:

The late 19th century also saw the "marginal revolution" or neo-classical economics, which altered the basis of economic reasoning to include concepts such as marginalism and opportunity cost. In addition to Marshall, the work of Carl Menger was influential in disseminating the framework of economics as the opportunity cost of decisions made at the margins of economic activity. In the early 20th century, economics became increasingly statistical, and the study of econometrics became increasingly important. Statistical treatment of price, unemployment, money supply and other variables, as well as the compiling of these statistics, became more and more central to economic writing and disputes within the field of economics.

Macroeconomics diverged from microeconomics with Keynes in the 1920s, and was codified in the 1930s by Keynes and others, particularly John Hicks. It grew in popularity as a reaction to the Great Depression. Keynes had been an influential exponent of the importance of central banking and government involvement in economic affairs, as well as a critic of the political economy of the post World War I period. His "General Theory" encapsulated both criticisms of classical theory that had been leveled by Thorstein Veblen and others, as well a method for economic management of aggregate demand. For an overview of a number of competing schools.

Many economists use a combination of Neoclassical microeconomics and Keynesian macroeconomics. This combination, sometimes known as the Neoclassical synthesis, was dominant in Western teaching and public policy in the years following World War II and up to the late 1970s. The neoclassical school was challenged by monetarism, formulated in the late 1940's and early 1950's by Milton Friedman and associated with the University of Chicago and also by supply-side economics.

In principle, economics can be applied to any type of economic organization. However, the majority of economic theory centers around systems where goods are exchanged in the market where buyers and sellers seek to maximize their results by trading. The dominant form of market economics focuses on societies where property is owned by individuals, money has a rational basis, and profit comes from utilizing labor and capital to produce goods to be sold in the market or capitalism. However, economic theory is also applied to markets where the control of capital is in the hands of the state or society, which include socialism and mercantilism, and to societies where the allocation of resources is not through the market, but through political mechanisms, generally referred to as command economies, which includes communism and forms of totalitarianism. Many economists assert that it is impossible to avoid the "Invisible Hand" of the Market, and hence all societies can be modeled through market dynamics, though this viewpoint has vehement opponents across the political spectrum.

The development of economics as a field of study is closely related to the rise of capital as the primary determining factor of production and trading, hence its most detailed and precise work has dealt with the institutions belonging to market societies, and most specifically to capitalist and socialist societies. To what extent economics must be adjusted to be applied to earlier forms of social organization has been the source of discussion. Generally, mainstream economists mostly feel that the basic framework of economics is relevant and flexible enough to be applied to virtually any form of society. Marxist economics asserts that history is divided into eras which are determined by which two classes, which are struggling to control the means of production - that is slaves and masters, peasants and royalty, wage workers and capitalists - and that mainstream economics only applies to those societies which are "objectively" industrial, that is to say, societies which are capable of industrial production based on their own knowledge and resources. In the late 20th Century three of the areas of study which are producing change in economic thinking are: risk based rather than price based models, imperfect economic actors, and treating economics as a biological science, based on evolutionary norms rather than abstract exchange.

The study of risk has been influential, which viewed variations in price over time as more important than actual price. This particularly applies to financial economics where risk-return tradeoffs are the crucial decisions to be made. The most important area of growth has been in the study of information and decision. Examples of this school include the work of Joseph Stiglitz. Problems of asymmetric information and moral hazard, both based around information economics, profoundly affect modern economic dilemmas like executive stock options, insurance markets, and third-world debt relief.

9.3. **Different Schools of Economic Thought:**

The history of the various schools of thought in economics can be loosely categorized as follows:

- Schoolmen, mercantilism, physiocrats, utilitarianism
- Classical economics, developed by David Ricardo, Thomas Malthus and John Stuart Mill in the 19th century.
- Neoclassical economics, arising from the Neoclassical Revolution which incorporated the marginal theory of value in the late 19th century. It is associated with e.g. Alfred Marshall
- Marxist economics is usually classified as a variant of classical economics and is based on the writings of Karl Marx, Friedrich Engels and others.
- The Austrian school, with its stress on Economic subjectivism and its rejection of economic modeling, developed by Carl Menger, Friedrich Hayek and Ludwig von Mises.
- German Historical School and institutuionalists, mainly American (Thorstein Veblen, Commons, Mitchell and followers;)
- Keynesian economics
- Monetarism
- New classical economics
- New Keynesian economics
- Supply-side economics

Contemporary alternative schools outside the mainstream of economic thought include:

- Post-Keynesian economics, which regards neoclassical economics as fundamentally flawed and develops a radically different analysis.
- Green economists, a loose group of theories associated with feminism, postmodernism, and the ecology movement.
- Modern variants of Marxist economics, such as Marxian and Post Marxist economics.

9.4. The Economic Ideas of Hermann Heinrich Gossen:

Hermann Heinrich Gossen is considered as economist belongs to first generation Marginal School because he had laid foundations to Marginal School with his important Economic Laws. Gossen is a German writer on economics, was born at Duren in the Rhineland in 1810 and died at Cologne in 1858. His claim to fame is based on a single publication: in 1854 he published a book " Development of Laws of Exchange among Men" in which he developed economic ideas with the help of mathematics and with a comprehensive theory of the hedonistic calculus. In his work Gossen postulated the principle of diminishing marginal utility and from this derived the following theorem: to maximize utility, a given quantity of a good must be divided among different uses in such a manner that the marginal utilities are equal in all uses. In the Continental literature the postulate is usually referred to as Gossen's First Law and the theorem as his Second Law. Gossen pioneered in the development of the subjective theory of value on the basis of the marginal principle, but his work was neglected during his life, and he died a disappointed man, having withdrawn the unsold copies of his book from the publisher. The reasons for the almost complete neglect of Gossen's work for a quarter of a century are not difficult to trace. His book was the work of a lone outsider, unknown in academic circles.

9.4.1. Gossen's Laws of Utility:

Although many (young) economists are not familiar with the name of Hermann Heinrich Gossen (1810–1858), they all are acquainted with some versions of his first and second law. Gossen's first law states that the marginal utility of some enjoyment decreases while uninterruptedly continuing it. According to the most known version of the second law, an individual with a certain income will distribute this income over the various enjoyments such that for each of them the quotient of marginal utility and price is the same. In his only published work, Gossen said it as follows.. Gossen's laws did not escape Occam's razor. The first evolved into the theorem that for utility maximization under the condition of a budget constraint, the upper con- tour-sets should be convex. In the more modern approaches, the second law has made place for the requirement that for such a utility maximization, the first derivatives of the problem's Lagrangian should be zero provided the utility functions are differentiable.

The magnitude (intensity) of pleasure decreases continuously if we continue to satisfy one and the same enjoyment without interruption until satiety is ultimately reached. Man obtains the maximum of life pleasure if he allocates all his earned money between the various pleasures in such a way that the last atom of money spent for each pleasure offers the same amount of pleasure . One might call this the "law of increasing relative satiation" because it means that a person possessing a certain good and wanting to exchange some of it against one unit of another good while keeping his utility at the same level has to give up the more of the first good the more he initially possessed.

Right from the first sentence, it is evident that Gossen's orientation is utilitarian. Man wants to enjoy life and make it his goal to increase pleasures enjoyed throughout life to the highest possible level .This literature are as follows: What is the motivation of Man's behavior?. How should society be organized and how should Man behave in this society? The answers are largely based on the following principles, which can be found in this literature: During his lifetime, Man maximizes his utility, which depends on his pleasures and his pains. Individual behavior of Man must be based on good instruction and on adequate legislation. The ultimate goal of Society is the maximization of the total happiness of all people together. It can found all these, somewhat incoherent, elements in Gossen's book. The conception of utilitarianism as a broad system with a positive and a normative part is widely adhered to in economic circles.

9.4.2. Issues relating to Human Behavior:

Gossen used geometrical tools to analyze Man's behavior. The magnitude of pleasure an individual derives from a certain matter during a certain period is represented by the area of a triangle or part of a triangle. Gossen uses the expression "the magnitude of pleasure" here in a meaning we now express by the word "utility", which word I shall mainly use in this chapter. Gossen uses the same expression to indicate what we now call "marginal utility". From the context, however, it is always clear what he is talking about; he never makes a mistake. Gossen started with the analysis of the thing that is scarce to everybody, namely time. If Gossen's work were not totally neglected by the profession but received as a basic, generally accepted piece of theory, right from its publication, economists perhaps would have dealt differently with the notion of time as they actually did. Gossen first applies the above idea to a situation in which some person has the choice between two pleasures and disposes only of a limited period E of time to Optimal allocation of time over two enjoyments spend on these pleasures.

In modern terms, marginal utilities should be equal. Apparently, Gossen assumed intra-personal cardinality of utility. The result is simply demonstrated, Gossen correctly says, by observing that any allocation of E deviating from the just mentioned one would yield a lower sum of the utilities. Individual obtains maximum pleasure if he spends time ad on the first activity and on the second. His total pleasure is then measured by the sum of the surfaces of the two trapeziums. Goods can only be obtained by more or less considerable labor by the person who wants to benefit from them. Gossen analyzed this in exactly the same way as Jevons.

Gossen considered the period in question as consisting of a large number of "atoms of time" and supposed that each atom of a good is consumed in exactly one atom of time. This "permitted" him to "generalize" figures. Fortunately, he did not go till the dead end of this dubious path of antiquated atomism and found a better basis for making goods comparable, namely labor time, as will be set out below. The individual cannot simultaneously fulfill these two requirements on his own. This, Gossen explains, is why there was always exchange. Therefore, he goes on to analyze actions and inter- actions of two or more persons. It appears that Gossen was puzzled a little by this extension and confused the notions of maximum individual utility and maximum collective utility.

9.4.3. Maximization of Utility:

In exchange, each individual involved should benefit personally, Gossen pro- claims as a preliminary condition. He starts with the simple case of two exchangers, one possessing a quantity of a certain good and the other some of another good. Again, making use of geometrical tools, he makes clear that it may be advantageous to both persons to exchange a part of their good for some quantity of the other good . The quite reasonable prerequisite that all exchangers should profit personally from an exchange is a too broad criterion for its unambiguous explanation. Therefore, Gossen needed a "workable" criterion whose application leads to a clear result. He found such a criterion, but, unfortunately, at the cost of the prerequisite, as we shall see. This criterion, to be fulfilled by a "correctly accomplished" exchange, is as follows.. exchange should bring about the highest total utility of all participating people together. Here, he introduces without warning the notion of collective utility over and above individual utilities; apparently, he supposes utility to be cardinal.

Gossen continued his investigations with the question "which factors determine the magnitude of the area of the triangle?". He judged talent for enjoying things, on one hand, and, on the other hand, ability to work as the two most important factors. Both factors can be enlarged by education in general and instruction in particular. Hence, Gossen's plea for good instruction, for boys as well as for girls, will not come as a surprise. Each person living in isolation faces two contradictory prescriptions to increase total happiness. The first one is specialization, which leads to greater productivity but a smaller number of goods, and the second is extension of the number of goods. For a nice alternative presentation of Gossen's mathematics of utility and disutility.

In order that a maximum of value be achieved through exchange, it is necessary that after its completion, each commodity be distributed among all individuals in such a way that the last atom of each commodity received by every individual will create for him the same pleasure as the last atom of the same commodity received by every other individual. Given that the individuals do not have all the same, linear utility function.

The maximization problem discussed above (maximization of total utility of all individuals together) should now be resolved for the more advanced situation, where money is the means of exchange. Gossen arrives at the untenable conclusion that the afore- mentioned maximum of social utility will be attained together with the simultaneous attainment of maximum lifetime utility of all individuals separately . From this it follows that, in Gossen's view, the solution of one of the two maximization problems has been found, once the other has been solved. In the more general case, with money as a means of exchange, the problem of individual utility maximization seems to be the simplest of the two. Its solution has been formulated in what would become known as Gossen's second law, repeated here because of its importance.

It is a necessary condition for individual utility maximization given prices and income as, indeed, Gossen said in his own words, but it is not true that it has something to do with the maximization of social utility, as is likewise his assertion. Hence, something went wrong in Gossen's reasoning. Gossen used his algebra for illustrative purposes only and not as an analytical tool. If he only had written out his results in mathematical symbols, he would have detected his mistake. For the maximization of the sum of all individual utilities together, the following relations should hold good.

Criticism on Gossen's Economic Ideas :

Walras argued, the ensuing individual amounts of utility do not necessarily coincide with maximum utility for each individual personally, given the quantity of goods with which he entered into the exchange. It may even be possible that somebody's utility will decrease in an exchange à la Gossen. This can be made clear by the following, somewhat extreme example. Let there be a number of persons who all possess only a little of one of a number of goods and let there be one single person possessing all these goods in large quantities.

If all these persons entered into an exchange where Gossen's criterion is applied, then after the exchange, the latter individual would have less of everything than he possessed before. Nevertheless, the sum of all the individual utilities taken together would be considerably greater than before, because the poor people's high marginal utilities taken together will certainly exceed the rich man's marginal utilities, which are, because of Gossen's first law, considerably lower.

It escaped Gossen that his criterion does not guarantee that all goods will be exchanged in fixed proportions against each other; in other words, Gossen does not notice that there are no exchange ratios equal for everybody. His rule may be a matter of course when friends have a party where people bring in dishes of food and bottles of beverages to put together and to be consumed freely.

The marginal utility of good (A) for individual 1 and so forth. usual to exchange all goods against some specific one acceptable to anybody, which therefore can be used to obtain other goods. This good, Gossen explained, is called money and the goods are exchanged for money in proportions fixed for everybody most people buy goods by means of money earned by selling their labor force. In other words, there is a price system. How all this comes into being remains vague. This is not amazing if one considers his misconception of the notion of exchange.

9.5. Summary:

The analysis relating to founders of modern economics reveal that during late 19th century also saw the "Marginal revolution" or neo-classical economics, which altered the basis of economic reasoning to include concepts such as marginalism and opportunity cost. In the early 20th century, economics became increasingly statistical, and the study of econometrics became increasingly important. Macroeconomics diverged from microeconomics with Keynes in the 1920s, and was codified in the 1930s by Keynes and others, particularly John Hicks. It grew in popularity as a reaction to the Great Depression. His "General Theory" encapsulated both criticisms of classical theory that had been leveled by Thorstein Veblen and others, as well a method for economic management of aggregate demand. Another dimension of modern economics is that many economists use a combination of Neoclassical microeconomics and Keynesian macroeconomics. This combination, sometimes known as the Neoclassical synthesis, was dominant in Western teaching and public policy. The neoclassical school was challenged by monetarism, formulated in the late 1940's and early 1950's by Milton Friedman and associated with the University of Chicago and also by supply-side economics.

Relating to the contributions made by Gossen for the development of economic doctrines is concerned, he is considered as economist belongs to first generation Marginal School because he had laid foundations to Marginal School with his important Economic Laws. Gossen published a book in 1854, that develops, with the help of mathematics, a comprehensive theory of the hedonistic calculus. In this work Gossen postulated the principle of diminishing marginal utility and from this derived the following theorem: to maximize utility, a given quantity of a good must be divided among different uses in such a manner that the marginal utilities are equal in all uses. In the Continental literature the postulate is usually referred to as Gossen’s First Law and the theorem as his Second Law. Gossen pioneered in the development of the subjective theory of value on the basis of the marginal principle. His Laws of Utility, fundamental issues relating to human behavior and the principles relating to maximization of utility became more popular. Most of his economic principles are condemned by the prominent economists belongs to Marginal School. However, Gossen can be considered as the economists belongs to the first generation economist belongs to Marginal School, because many of his ideas became the basis for the important theories developed by the economists belongs to Marginal School.

9.6. Glossary:

Utility

Human Behavior

Subjective Aspects

Law of Diminishing Marginal Utility

Principle of Equi marginal utility

Maximisation of utility

9.7. Preparatory Questions:

1. Examine the basic features of Modern Economics
2. Briefly outline about the founders of Modern Economics
3. Write about the important contributions made by Gossen towards the development of Economic Doctrines.
4. How can you consider Gossen as the economist belongs to first generation Marginal School.
5. Critically analyze the economic ideas of Gossen.

9.8. Books for further Study:

1. Blaug,M. , Economic theory in Retrospect.
2. Newman, P., The Theory of Exchange .
3. L.H. Haney., History of Economic Thought
4. Eric Roll: A History of Economic Thought.
5. Gide & Rist: History of Economic Doctrines.

Unit 3 /Lesson-10

FORERUNNERS OF MARGINAL ANALYSIS: JEVONS, MENGER AND WALRAS

10.0. Objectives:

The main objective of this lesson is to analyze about the important contributions made by the economists belongs to Marginal School for the development of modern economic doctrines. The marginalism is considered as a dividing line between classism and neo-classism. Marginalism paved the way for the development of neo-classism on modern lines

10.1. Emergence of Marginalism:

Classical economics did not become neoclassical economics overnight; the recasting of perspectives and theoretical structure occurred gradually. In this nineteenth century, a host of minor writers had had a clear conception of the principle that as an increasing quantity of a good is consumed, the good will yield diminishing marginal utility to the consumer. None of these writers, however, had been able to elaborate in full the concept of diminishing marginal utility or to apply it to the solution of economic problems. Between 1871 and 1874, Jevons, Menger, and Walras all published books that influenced the development of orthodox economic theory. Their influence was not immediate, but it developed over the last quarter of the century as their followers, the second generation of marginal utility theorists, fought for, and slowly gained, acceptance for some of the new ideas. The positions of Jevons, Menger, and Walras on the forces determining the value, or price, of final products are similar enough that we may examine them by subject rather than treating them individually. There were, among these developers of marginal analysis, some very important differ on the proper methodology for economics. In particular, they had different views on Austrians claim him as their intellectual source. However, Walras's general equilibrium analysis, as well as his integration of marginal concepts into general equilibrium theory, were unique because of their subsequent importance in modern microeconomic theory.

10.2. Marginalist's Criticism against Classical theory of Value:

All three of these economists, working independently of one another, were convinced that they had developed a unique, revolutionary analysis of the forces explaining the determination of relative prices. Jevons stated this most succinctly: Repeated reflection and inquiry have led me to the somewhat novel opinion, that value depends entirely upon utility. Prevailing opinions make labour rather than utility the origin of value and there are even those who distinctly assert that labour is the cause of value. Menger's statement was more personally modest, although nationalistic: Walras, noted for his general equilibrium analysis, also believed in the originality and uniqueness of his contribution: Are Jevons, Menger, and Walras justified in claiming that their work was both original and revolutionary? On this issue we must clearly separate the contributions of each. Jevons's contribution to economic theory was largely in the application of marginal analysis to demand. Menger's contribution was in the application of marginal analysis to both demand and supply, although paying little attention to supply. Walras's was in the application of marginal analysis to both demand and supply, also paying little attention to supply, *and* in the formulation of a general equilibrium model of an economy. Yes, they were original, in as much as their ideas influenced the subsequent development of economic theory in a way that the ideas of previous writers using marginal analysis did not . But to what extent their work is revolutionary can be determined only by comparing their views with previous classical theory and against the subsequent development of neoclassical micro- economic theory.

All three writers found the classical theory of value inadequate to explain the forces determining prices. Their principal criticism was that the cost of production theory of value lacked generality, because there were a number of goods whose prices could not be analyzed within the classical framework. They criticized Ricardo's labor theory of value and Senior's and Mill's cost of production theories because those theories required a separate explanation for the prices of goods of which there was a fixed supply. The problem these three writers were addressing, therefore, was whether value was produced in final goods by the factors of production (as the classical value theory held), or whether final goods determined the values of the factors of production. The marginal utility school asserted that factors of production were valuable but that the extent of their value was determined by the marginal utility received from consuming the final products produced by these factors. However, factors of production, or intermediate goods, do not value. Another fundamental flaw in pre classical and classical economic theory, according to the marginal utility writers, was its failure to recognize that the significant element in price determination is not total or average utility, but marginal utility. According to the marginal utility writers, the failure of the classical writers to recognize the importance of this principle in explaining prices was one of the major reasons why they were unable to develop a correct theory of prices. The price of diamonds is greater than the price of water because it is marginal utility that determines consumer choice, and hence price.

10.3. Economic Ideas of Marginalists:

There are three important contributors for the development of marginal school, they are William Stanley Jevons from England, Carl Menger from Austria and Leon Walras from Switzerland. These three economists are considered as Marginalist Trio. At the outset an attempt is made to explain their economic ideas independently.

10.4. Important Theories of William Stanley Jevons (1835–82):

William Stanley Jevons is known for developing a theory of relative prices, or exchange values, based upon the notion of marginal utility. In contrast to early nineteenth century classical economists, who held that the costs of production determined relative prices, Jevons argued that relative prices depend upon subjective assessments by people of the satisfaction to be gained from purchasing different goods. Jevons also made contributions to growth theory and business cycle theory. Jevons was born into an upper middle class family in Liverpool, England, in 1835. His father was an iron merchant and his mother came from a prosperous family of bankers and lawyers. The first book that Jevons published, The Coal Question (1865), was alarmist and Malthusian.

10.4.1. Utility Analysis:

Jevons's lasting claim to fame, however, stems not from his fears about energy shortages, but from his efforts to bring utility analysis into economics. Jevons, J. B. Clark, and Menger, each independently, discovered the notion of subjective utility and the principle of diminishing marginal utility. These were both important discoveries, as they brought consumers and consumer behavior into economic analysis for the first time. But Jevons went even further than Menger by drawing out the implications and possible applications of utility analysis. The discovery of the principle of diminishing marginal utility appears to have taken place in the late 1850s while Jevons was working in Australia. This idea is simply and concisely encapsulated in a letter of 1860 that he wrote to his brother: ‘‘One of the most important axioms is, that as the quantity of any commodity, for instance, plain food, which a man has to consume, increases, so the utility or benefit derived from the last portion used decreases in degree’’.

Several years later Jevons (1871) set forth the important distinction between total utility and marginal utility. This distinction led to the development of the modern theory of consumer behavior. Jevons noted that, as people consume more and more of any good, the total utility they get from consuming that good generally increases. But, as people consume more and more, the utility they get from each additional quantity, or the good's marginal utility, declines. Thus, the first glass of water to a thirsty man provides more satisfaction than the second or third glass. By the fifth or sixth glass, the man derives little additional utility from consuming more water. As we consume more and more water, our total utility goes up, but the extra utility that we get from the last glass falls.

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According to Jevons, consumers will buy those goods that provide them with the greatest satisfaction. Whenever the consumer can freely switch purchases, buying more things that give him a lot of utility and reducing his spending on goods that provide little utility, the consumer will be better off. Going even further, Jevons argued that each consumer would alter his purchases so that they reach a state where no further spending could increase total utility. This doctrine forms the foundation of laissez-faire policies that keep the government from regulating or taxing the goods and services that consumers buy. The unrestricted availability of goods, without taxes and without any government regulations, raises the utility of each consumer and increases national well-being.

10.4.2. Utility to Labor:

Jevons next applied the notion of utility to labor. By so doing, he helped show how wages are determined and how labor markets work. Jevons assumed that labor was disagreeable and therefore involved negative utility or disutility for the worker. On the other hand, labor also yields positive utility, since workers are paid for their efforts and can use this income to buy goods. Individuals have to balance the disutility of work against the utility of the goods that could be bought with the fruits of one’s labor. As long as the utility of consumption exceeded the disutility of work, people would continue to work. At the point where the disutility of work exceeded the utility of consumption, people would stop working and enjoy leisure time instead.

This application of utility analysis to the labor market had several important consequences. First, the distinction between productive and unproductive labor, as originally set forth by Quesnay, was shown to be mistaken. All labor was productive in the sense that it yielded utility to individual workers, who could take their pay packet and buy goods with it. Second, employing utility theory to study labor casts doubt on the classical theory of wages. Humans were not at the mercy of a subsistence wage; rather, the labor supply depended upon the going wage. If wages got too low, workers would withdraw from the market and enjoy leisure. Third, in contrast to Ricardo and Marx, for Jevons there is no opposition between labor and capital. Labor makes its own decisions about whether or not to work, carefully balancing the gains and the losses from employment. Capitalists also make similar decisions when deciding whether or not to invest and hire more workers.

10.4.3. Theory of Business Cycles:

Finally, no accounting of the economic thought of Jevons would be complete without mentioning his theory of the business cycle. While doing extensive research on economic growth, Jevons (1884) noted a close relationship between sunspot activity and economic activity. Between 1721 and 1878 business cycles had an average duration of 10.46 years, while sunspot activity showed a periodicity of 10.45 years. Jevons felt that this relationship was too close to be accidental. He even set forth a few creative explanations for this similarity. If sunspot activity affected the weather, and the weather affected British harvests, then sunspot activity should be correlated with grain prices.

A good harvest would increase the supply of grain and lower its price, while bad harvests would lead to higher grain prices. Jevons also looked to foreign trade to explain the similar solar and economic cycles. A more active sun, according to Jevons, influenced the rice harvest in India. A good harvest in India led to high demand for British manufactured goods. This in turn caused the British economy to expand. In contrast, less sunspot activity meant poor Indian harvests, little demand by India for British goods, and a slumping British economy.

Few contemporaries of Jevons, and few subsequent economists, have taken the sunspot theory of business cycles seriously. In addition, more recent data cast doubt on the figures Jevons used; astronomers have increased the solar sunspot cycle to 11.1 years, while economists have reduced the length of the business cycle to 7 or 8 years. And, in contrast to Jevons, most contemporary economists look towards the economy itself, rather than outside forces, as the cause of periodic turns in prosperity and depression. Nevertheless, Jevons deserves recognition as one of the originators of business cycle theory. Despite his linkages to the future through worries about the depletion of energy resources, and despite his linkages to the past as a business cycle historian, the major contribution of Jevons to economics remains his development of marginal utility theory and his use of this theory to explain consumption and work decisions. In all his work, Jevons was a pioneer, and the many advances due to Jevons make him one of the three or four most important nineteenth century economists.

10.5. Important Theories of Carl Menger (1840–1921):

Carl Menger is regarded as the founding father of the Austrian School of Economics. This is because he is responsible for developing two pillars of Austrian economics. First, Menger helped to establish a subjective theory of value. Second, he argued that economic knowledge can come only from deducing the consequences of assumptions that are known to be true. Menger was born in 1840 in Neu Sandec, Galicia. After graduating, Menger worked first as a financial journalist for the leading Viennese newspaper. It was during this time that he worked on the Principles of Economics (Menger 1985).

10.5.1. Subjective Theory of Value:

Menger made two important contributions to economics. One involved value theory and the other concerned economic methodology. Menger was one of the first economists to discover the marginal utility theory of value and the principle of diminishing marginal utility, and he was one of the earliest advocates of a subjective theory of value. Menger was also involved in a heated debate over the nature of economics and the proper way to do economic analysis. During the late nineteenth century, classical economics was held in low esteem on the European continent. Especially dissatisfying was the highly abstract and theoretical nature of British economics. Menger sought to bring economics back to the real world. His starting point in this endeavor was a recognition that goods have value because they meet human needs.

In contrast to the classical British economists, Menger argued that value was determined by subjective factors (utility or the beliefs of people about what gives them pleasure) rather than by objective factor (the costs of production). For Menger, value did not exist objectively within goods themselves. Rather, value arises because people make judgments about the worth of particular goods. Diamonds and gold are not valuable in and of themselves. They have value only because human beings desire them and find them useful. Value, for Menger, thus comes from the satisfaction of human needs. Human needs create a demand for goods; they also become the driving force for the development of institutions such as private property and money that help them to meet their needs.

Finally, human needs result in economic exchange and help determine prices. Furthermore, Menger argued that, since human needs were greater than the goods available to satisfy these needs, people would choose rationally among all alternative goods made available to them. Goods must satisfy the subjective needs of consumers, according to Menger, and consumers must recognize this fact if goods are to have any value. Menger also recognized that, as one purchases greater and greater quantities of a good, each succeeding quantity purchased will yield less satisfaction to the consumer. That is, people experience diminishing marginal utility when they consume more of any good. One important consequence of this theory of value is that all activities yielding subjective satisfaction are productive activities. In contrast to the British classical economists, trade was productive according to Menger because people would not trade unless they felt the goods that they received would give them more utility than the goods they gave up. And in contrast to Quesnay, agriculture and manufacturing could both be productive activities because the goods produced by each of these economic sectors yield satisfaction to consumers.

10.5.2. Theory of Factors of Production:

Another implication of the subjective theory of value is that the classical labor theory of value had to be wrong. As Menger noted “The determining factor in the value of a good, then, is neither the quantity of labor or other goods necessary for its production nor the quantity necessary for its reproduction, but rather the magnitude of importance of these satisfactions with respect to which we are conscious. Since value comes from the individual, according to Menger, economic analysis must begin with studying the individual. This position has come to be known as methodological individualism. Menger also recognized that factors of production have value because they satisfy wants indirectly; these factors are needed to produce the goods that people directly desire. To find the actual value of a factor of production, Menger thought that we should withdraw one unit of the factor (say one worker) and observe the loss in output. The value of this output is the value added by that worker. It represents the consumer satisfaction produced by that worker. The value created by each factor of production thus depended upon its marginal productivity; and the return or payment to each factor used in producing goods should depend on the anticipated value created by that factor.

10.5.3. Methodological Issues:

The theory development took precedence over data accumulation for Menger. Menger thought that proper scientific method involved the search for essential characteristics of economic phenomena, or necessary connections between economic variables. Historical or empirical economics could not do this, since sometimes prices fall and people expect further price declines, so they buy less now. Consequently, historical economics could not yield definitive results. Only introspection yields absolute and necessary truths, according to Menger. Trying to refute laws of economics by pointing to contrary real-world evidence was like trying to refute the laws of geometry by measuring the angles of a triangle to see if they equaled 180¯ even the attempt to do this shows a fundamental misunderstanding of geometry. Menger’s Investigations into the Method of Social Sciences (1883) sought to put economics on firm theoretical and methodological foundations. In so doing, Menger defended his method of doing economics and argued against the method of the Historical School.

Menger strongly emphasized the individualistic method of analysis and the fact that economic knowledge is derived a priori, or before the experience of real-world economies. Studying economics for Menger involved studying individual preferences (or demand) and explaining how these lead to observable phenomena like different prices for different goods. Menger's method became the accepted method of doing economics, although there have been many prominent critics of this methodology. The major effect of the debate has probably been to give economic methodology, a study of the methods used to obtain economic knowledge, a bad reputation.

10.6. Important Theories of Leon Walras (1834–1910):

Leon Walras is known primarily for developing general equilibrium analysis. He took a very abstract and theoretical problem about how all markets in an economy are related, applied sophisticated mathematics to the problem, and arrived at a solution. His solution showed that all the markets in the economy could simultaneously achieve equilibrium. Walras was born in France in 1834. His father, a teacher and an economist, stressed that mathematics would come to be used increasingly in the social sciences. Walras wrote articles for economics journals, but all he had to show for his efforts was a pile of rejection letters. None the less, Walras learned more mathematics and he continued to praise the virtues of making economics more quantitative.

Walras made several important contributions to economics. Along with Jevons and Menger, he was one of several independent discoverers of the notion of marginal utility. He was one of the first and strongest advocates of methodological individualism, the belief that all explanations of economic phenomena should be based upon individual acts of choice. But Walras is best known for constructing a general equilibrium economic model, which views the economic system as a set of interrelated mathematical equations. Walras then explained how to solve this set of equations for all prices and quantities.

10.6.1. Market Equilibrium:

The notion that different sectors of an economy are related to each other has a long history in economics; the idea goes back at least as far as Cantillon and Quesnay. Walras added two important things to this vision – a mathematical representation of how all markets were interrelated, and an argument that economies would move towards equilibrium in all markets. Walras recognized that whenever one market moved towards equilibrium, or whenever one market was affected by outside forces, these changes would upset the markets for other goods.

10.6.2. General Equilibrium Analysis:

The question raised by the notion of general equilibrium is whether all these changes tend to slow down and stabilize at some point, so that all markets reach a point where there are no more forces of change affecting any good or input. Walras answered this question with an unqualified yes. To support this answer he set up a series of mathematical equations representing the market for every good and for every input in the economy. There were four sets of equations in his economic model. The first set showed the quantity of each good that consumers demanded. Consumer demand was based upon individual preferences and the price of every good that consumers could purchase. Each good sold to consumers could be represented by a mathematical equation that related the amount of the good consumers wanted to their income and to the price of every good.

A second set of equations described what determines the price of every good bought by households. Walras assumed that all markets were competitive and that firms could not charge high prices based upon their monopoly power. This enabled him to set the price of each good equal to its cost of production . These first two sets of equations dealt only with product markets, or goods sold to consumers. But another set of markets operates in all economies. These are factor or input markets. They are where remuneration is determined for the factors of production – the wages received by workers, the rental payments received by landlords, and the profits received by owners of capital.

Factor markets contribute two more sets of equations. One set shows the quantity of inputs or factors offered to help produce goods. Owners of factor inputs determine the quantity of factors they wish to supply. This decision will be based upon how disagreeable it is to work or supply their input into the production process, and also on how much can be bought with the income received from helping to produce goods. The reward for working, in turn, depends on the price of goods and the income received from working. A final set of equations shows the quantity of inputs or factors that businesses want to buy. This depends on the final demand for goods, on production technology, and on the cost of all inputs.

So far we have four sets of equations – one showing the quantity of goods demanded, one relating price to cost of production, one showing the quantity of inputs supplied, and one showing the quantity of inputs demanded. We also have four sets of unknowns that we need to solve, for: the price of each good; the quantity of each final good bought and sold; the price of each factor of production and the quantity of each factor supplied and bought by business firms. But Walras adds one more equation to his mathematical system. This equation stipulates that all the money received by various factors of production must be used to buy something. This can be done either directly, by each household spending all their income, or indirectly, by some households saving money and then lending this money to other households.

This extra equation created a difficult problem for Walras. As all students of algebra learn, to solve a set of mathematical equations it is necessary that the number of equations equals the number of unknowns. Walras now had one more equation than the number of unknowns. To deal with this problem Walras selected one good, G1, arbitrarily; the prices of all other goods would be determined relative to G1. The price of G1 thus would be a standard of comparison, or numeraire. Mathematically, the number of unknowns would now equal the number of equations in the general equilibrium representation of the economy. The system could thus be solved for the price of all goods relative to G1. The solution could not explain the absolute level of prices, or why a gallon of milk cost $2 rather than $1 or $4.

But it could explain why a gallon of milk costs twice as much as a dozen eggs and three times as much as the daily news paper.

This vision of the economic system as a set of equations is quite abstract. One question that naturally arises after working through a mathematical proof for the existence of general equilibrium is ‘‘what, if anything, does this have to do with the real world?’’ After all, in the real world things change all the time; and in the real world there is no master economist who solves a large set of equations in order to determine the price of each good and the wage received by each worker. Walras believed that his mathematical solution to the system of equations would be the same solution reached by markets in the real world. But how could the real world achieve equilibrium without a master economist to solve the many mathematical equations?

Walras devised an answer which he felt showed that his abstract model and his mathematical equations were good depictions of actual reality. His answer was twofold. First, Walras held that all traders wanted to maximize utility, and that utility maximization and competition moved the whole economy to the set of equilibrium prices ground out by his equations. Second, Walras introduced the notions of the auctioneer and the tenant process. Imagine a big auction, where producers bring their goods to sell and where consumers come to buy goods. Producers set prices for their goods and these prices are called out by the auctioneer. Of course, at some prices, some goods will have too many buyers and other goods will have too few buyers. The auctioneer then notes these cases of too many buyers and too few buyers, and raises prices in the former case while lowering prices in the latter case. Buyers and sellers would then revise their offers to buy and sell goods. Again, there may be shortages of some goods while other goods will find too few buyers. The auctioneer would take this new information into account and again revise prices accordingly. Through successive iterations of this process, Walras argued, the auctioneer would grope towards the set of equilibrium prices for the whole auction. Only then would exchange take place and, at this set of equilibrium prices, all markets would clear. Walras thought that market prices naturally behaved the way that the mythical auctioneer did. Market prices do rise when there are more buyers than sellers, and they do fall whenever there are more sellers than buyers. In this way, the market system gropes its way to a position of general equilibrium.

10.7. Common Ideas of the Marginalists:

The marginal utility writers followed orthodox classical economic theory in assuming that individuals are rational and calculating. In making buying decisions, consumers or households consider the marginal utility they expect to enjoy from the consumption of goods. This raises two questions: what is utility, and how is it measured? Jevons, Menger, and Walras were almost identical in their approaches to these issues: they did not directly engage them at all. None used the term marginal utility; Menger did not even use the word utility, preferring to speak of the "importance of satisfactions." All three simply assumed that utility existed and that individual introspection would disclose the varying utilities of different final goods. Thus, without clearly explaining the nature of the utility concept, Jevons, Menger, and Walras assumed what is now known as the principle of diminishing marginal utility, which states that as the consumption of a good increases, its marginal utility decreases. This is based on the assumption that whatever marginal utility is, it can be measured. Menger and Walras did not discuss measurability. Jevons stated that although we are presently unable to measure utility, further developments may permit such measurement in the future. From the examples given in their writings, however, it is clear that all three assumed the cardinal measurability of utility.

Jevons and Walras, using mathematical presentations of utility functions, assumed as a first approximation that both the quantity of goods consumed and the quantity of utility were continuously divisible. Both recognized the unreality of this assumption and made allowance in their presentations for non divisibility, which would give rise to discontinuous functions. Because Menger's approach made no use of mathematics other than arithmetic tables, all his functions were discontinuous. If the utility functions are continuous (with smooth curves), small variations in quantity and utility can occur and the equality will still be satisfied. However, if the utility functions are discontinuous, then the consumer may be at a maximum without the equality's being satisfied. Assuming that utility can be measured, another series of questions arises. All three writers assumed, without examining the issue, that an individual was capable of making comparisons between the utilities of different commodities. Thus, the marginal utility of another glass of beer can be compared to the marginal utility of another pair of shoes. A more important issue is involved in the making of interpersonal comparisons of utility.

Although Jevons, Menger, and Walras did not explicitly examine the exact form and nature of utility functions, Jevons and Walras did write out equations relating total utility to the quantities of goods consumed, and Menger's verbal and arithmetical examples indicate that his conception of the total utility function was the same as that of Jevons and Walras. The utility an individual receives from consuming a good depends, according to these writers, exclusively on the quantity of that good consumed. It does not depend on the quantities of other goods consumed.

What set Jevons, Menger, and Walras apart from their predecessors, with the exception of Gossen, is that they not only postulated the principle of diminishing marginal utility but also attempted to determine the conditions that would hold when a consumer is maximizing utility, and to develop a theory of exchange. Jevons and Walras went so far as to investigate the relationship between utility and demand. Because of Walras's greater mathematical ability, he was the most successful of the three in these endeavours. Although he was less concerned about the concept of diminishing marginal utility, he had a much more sophisticated understanding of the interrelatedness of the various sectors of an economy. Although both Menger and Jevons established the essence of this proposition (Menger with verbal explanations and crude arithmetic examples, Jevons with more sophisticated mathematical notation), it remained for Walras, in his justly famous Lesson 8, to derive mathematically the equations that hold when a consumer is maximizing utility.

All three pioneers attempted to show the relationships between marginal utility, maximization of consumer satisfaction, and the exchange of goods in a market. Menger was the least successful. Jevons was able to show these relationships in a simple market of two goods and two individuals. If individual G owns corn and individual H owns beef, and they barter, the final position of equilibrium can be concisely stated: "The ratio of exchange of any two commodities will be the reciprocal of the ratio of the final degrees of utility of the quantities of commodity available for consumption after the exchange is completed." Jevons's statement can be translated into the following equation: Walras was able to demonstrate the relationship between marginal utility, maximization of consumer satisfaction, and exchange in a much more thorough and generalized manner than either Jevons or Menger. Thus, Jevons and Menger treated the causal relationship between a final good and its factors of production in a partial equilibrium framework. Because Walras formulated his consideration of value in his general equilibrium analysis, he understood the issue much more fully than did Jevons or Menger and saw the causal relationships as more complex.

The proposition can be criticized on several grounds. First, Jevons offered no theory of cost or supply. Furthermore, the proposition suggests that a chain of causation runs from cost of production to value, or price. If such a chain of causation did exist, it would be possible to omit the middle part of the chain and conclude that cost of production determines value. Jevons and Menger erred in trying to find a simple one-way, cause-and-effect demand, and price are interdependent and mutually determine each other. relationship between marginal utility and price. They did not perceive that cost, supply,

10.8. Summary:

The above mentioned contributions made by the marginalists reveal that, through their contributions to marginal analysis, Jevons, Menger, and Walras began neoclassical economics. Jevons and Menger believed they were revolutionizing economic theory by replacing a supply-oriented cost of production theory of value with a demand-oriented marginal utility theory of value. Their hopes were not realized, however, because their exclusive emphasis on the demand side was as deficient as the classical stress on the supply side. Jevons's and Menger's conception of the value problem was, in fact, fundamentally unsound, as they looked for a simple cause-and-effect relationship between marginal utility and price. Whereas the classical economists had in essence assumed that demand was given and concluded that supply determined price, Jevons and Menger assumed that supply was given and concluded that demand determined price. Walras had a much clearer understanding of the value problem in that he recognized the mutual interdependence of the parts of an economy. The three writers made five lasting contributions to economic theory. Their emphasis on marginal utility and the role of demand caused subsequent economists to pay greater attention to this part of value theory. Their use of marginal analysis led to a recognition of the more general applicability of this technique, a recognition that was to have important consequences for the development of economic theory. By 1890 marginal analysis had been extended to cover not only the household demand side and the supply side of the firm but also the demand side of the firm for factors of production. Jevons's and Walras's use of mathematics in economic theorizing made economists more aware of the power of this type of analysis and ultimately led to the present dominance of mathematical models in economic thinking. Walras's general equilibrium model was seminal in providing insight into the interrelatedness of the sectors of a market economy and furnishing a basis for subsequent theoretical work. Jevons's use and endorsement of statistics was another important step toward the emergence of the testing of theory with econometric techniques.

10.9. Glossary:

Additive function
Diminishing Marginal Utility
Partial Equilibrium Analysis
General Equilibrium Analysis
Factors of production
Interpersonal comparisons of utility
Marginal utility
Price-determination
Utility maximization

10.10. Self Assessment Questions:

1. . What difference does it make whether one can make interpersonal comparisons of utility?
2. . Contrast the scope and method of economics according to Jevons, Menger, and Walras.
3. Examine the nature of Marginalism and how it differs from Classical School
4. Explain the contributions made by the Marginalists for the development of Economic Doctrines.

5. Analyze the significance of Walrasian General Equilibrium Analysis.

6. Briefly explain the Marginal Utility Theory of value.

10.11. Books for further Study:

1. Blaug,M. , Economic theory in Retrospect.
2. Newman, P., The Theory of Exchange .
3. L.H. Haney., History of Economic Thought
4. Eric Roll: A History of Economic Thought.
5. Gide & Rist: History of Economic Doctrines.

- **Prof M Sundara Rao.**

Unit-3 /Lesson-11

The Economic Ideas of Pareto and Fisher

11.0. Objectives:

The main objective of this lesson is to explain the important economic ideas developed by Pareto and Fisher. These economic ideas of these two economists helped to transmit the marginalst theories into neo classical economic ideas and helped Marshall in framing the Neo-Classical economics on the lines of modern economics.

11. 1. Important Theories of Vilfredo Pareto (1848–1923):

Vilfredo Pareto is remembered by economists primarily as one of the fathers of mathematical economics. Pareto was born in Paris in 1848.After receiving his degree, Pareto worked as a civil engineer. The success of the British government in promoting a free market, and the beneficial effects of this laissez-faire policy, were especially striking. As a result, Pareto joined the Adam Smith Society and became an active member of the society in the 1870s and 1880s. Pareto also put his training in mathematics and engineering to good use by translating economic theories from verbal, declarative sentences into mathematical equations. Despite his success, Pareto became troubled by the increasing narrowness of mathematical economics and did an about-face. He argued that, to understand real economies, one needed to understand the cultural and political con- text in which economic events took place. Pareto also attempted to incorporate sociological, political, and psychological factors into his analysis of how economies change.

11. 1.1. Law of Income Distribution :

In addition to making economics more mathematical, Pareto made three substantive contributions to economics – he developed a law of income distribution that still bears his name, he was responsible for switching the focus of economists from cardinal to ordinal utility, and he developed a test of whether economic outcomes could be improved. Pareto became interested in income distribution, and he began to study income inequality in various nations. These studies led to the discovery of a simple pattern governing income distribution. Pareto found that if you were to rank order families in one country by their income level, and then recorded family income levels, you would find that income does not increase proportionately or arithmetically Rather, Pareto found that income increases geometrically as we move along our rank ordering from the poorest to the wealthiest family. When income increases proportionately, if a family at the thirtieth percentile makes 20 per- cent more than a family at the twentieth percentile, a family at the fortieth percentile would make 20 percent more than a family at the thirtieth percentile and a family at the hundredth percentile would make 20 percent more than a family at the ninetieth percentile. When income increases geometrically, income disparities grow as one moves along the ordered list of incomes. For example, if a family at the thirtieth percentile makes 10 percent more than a family at the twentieth percentile, a family at the fiftieth percentile may make 40 percent more than a family at the fortieth percentile and a family at the hundredth percentile may make twice as much as a family at the ninetieth percentile .

Examining income statistics from the US and numerous European countries, Pareto found the pattern of income distribution to be pretty much the same everywhere. As a result, he called this pattern a law of income distribution. Because he found income distribution to be rigid and invariant, some economists have criticized Pareto for justifying existing patterns of income inequality. But other explanations of the remarkably similar income patterns found everywhere are possible. For example, Pareto believed that the rich will try to protect what they have, and that they usually have the power to do so. Programs to redistribute income and reduce inequality will thus fail due to the political clout of the wealthy – a universal phenomenon.

Despite the great controversy it generated, Pareto's work on income distribution marked a major advance in economics. Pareto was the first economist to seriously study income distribution data from around the world. He was thus a pioneer in this area. Pareto also made a major contribution by suggesting how income inequality could be measured. In this way, his work was path-breaking. Finally, the suggestion that income distribution might display some law-like order raises intriguing economic, social, and political questions which have been ignored by most subsequent economists.

11.1.2. Ordinal Utility Analysis:

Pareto made another important contribution to economics when he argued that ordinal utility rather than cardinal utility should form the basis of economic analysis. Measured in ordinal terms, the individual consumer is assumed to know that good A is preferred to good B.

Measured in cardinal terms, the consumer is assumed to know not only that good A is preferred to good B, but also by how much good A is preferred to good B. Shifting the focus from cardinal to ordinal utility reduces the demands that economists made of each consumer. Consumers need to know only that they prefer peaches to plums. This is something most consumers do actually know. It is also something that most consumers reveal through their everyday expenditures. Consumers, however, are not likely to know that they want peaches twice as much as plums or three times as much as plums. The shift to ordinal utility thus made economics more realistic in the way it described human behavior.

Also, by moving from cardinal to ordinal utility, it was no longer necessary to worry about how utility could be measured or how it was possible to compare the utility of different people. Since the times of Bentham and Mill, utilitarianism had been plagued by these problems. With ordinal utility, rather than cardinal utility, a measuring rod was no longer needed. The fact that two people traded with each other demonstrated that they preferred the goods they received to the goods they traded away. Likewise, interpersonal utility comparisons no longer had to be made. Ordinal utility could guarantee that total utility would rise as a result of any trade because utility for each party to the exchange had to be greater; if one person was not made better off by the trade, they would not have made such a trade.

11.1.3. Pareto Optimality:

A third contribution made by Pareto was the introduction of the notion of an optimal state of economic affairs, now called ''Pareto Optimality.'' Pareto himself called such a state ''ophelimite,'' from the Greek ''ophelimos.'' His goal was to argue that certain economic out-comes could not be improved upon. Pareto Optimal outcomes are situations where making one person better off requires that someone else be made worse off. Thus, no clear overall improvement is possible; the Pareto Optimal condition is the best that we can do Pareto began by noting that two individuals in a market will trade only if each of them gains something from the exchange. If one party gains and the other loses there will be no trading. If the two parties are unwilling to trade on their own, any attempt to redistribute goods between these people will make one person better off but the other worse off. Whenever a country allows free exchange in the market, the outcome for the nation will have to be Pareto Optimal.

The notion of Pareto Optimality can also be used to evaluate proposed policy changes. Tax cuts for the wealthy may increase investment and spur economic growth. If those with low incomes gain as a result of greater growth, this tax policy would lead to a Pareto Superior result. But if the tax cuts do not generate sufficient income growth, those with low incomes wind up worse off (because these tax cuts will have to be paid for by someone). In this case, the current tax system would be Pareto Optimal. In the 1930s, many economists thought that the notion of Pareto Optimality could help evaluate economic performance without resorting to value judgments. This, they thought, would give economics a more scientific grounding. As a result, economists spent a great deal of effort trying to prove theorems about the existence of Pareto Optimality under certain conditions, and to determine whether Pareto Optimal situations were stable or likely to change. The main finding of this work is that competitive capitalism leads to an out- come that is both Pareto Optimal and stable.

11.1. 4. Criticism on Pareto Optimality:

However, this work has more recently received a good deal of criticism. First, all Pareto Optimal situations are based upon an initial distribution of income or resources. If we were to begin with other initial distributions, we would reach very different results. These outcomes would be Pareto Optimal also, and there is no way to decide among the various possible Pareto Optimal outcomes. Second, as Sen (1982) has pointed out, Pareto Optimality does not really yield a value-free or scientific welfare economics. It assumes that, if a change makes every individual in society better off, the society as a whole is better off. While this may very well be true, Sen points out it is still an individual opinion rather than a scientific truth. Finally, Sen (1987) has also argued that there is really nothing great about Pareto Optimal situations, since famines could be Pareto Optimal, while government redistribution to prevent mass starvation would not.

Despite his many important substantive contributions, Pareto is best known for introducing mathematical forms of reasoning and analysis into economics. However, later in his life, Pareto grew dissatisfied with mathematical formalization and with abstract economic theory. Important questions about economic growth and overall economic performance, he thought, could only be understood within an historical and sociopolitical context. Pareto then sought to incorporate these factors into a theory of the business cycle. He noted that social factors influenced decisions to save, work, and consume, and thus the overall state of the economy.

11.1.5. Sociological Theory of Economic Growth:

Pareto developed a sociological theory of economic growth and stagnation. Economic growth, according to Pareto, required hard work and a willingness to delay gratification. Social norms of hard work, frugality, and professional commitment contribute to these behaviors; economic growth tends to soften and relax them. When their incomes rise, people become more hedonistic – they borrow and spend, and they engage in speculative activities to make money quickly. At some point, Pareto thought, excessive consumer debt would reduce consumer confidence and spending.

This would slow down economic growth, but it would also lay the foundation for future growth by reinvigorating social norms and by providing more saving for future investment. It is somewhat ironic that Pareto is remembered for contributing to the mathematical economics that he came to criticize and reject. But it is hardly surprising that a discipline which has become increasingly mathematical would praise the mathematical Pareto and ignore the sociological Pareto. None the less, for his many contributions to so many different areas within economics, and for his pioneering efforts to make economics more mathematical and scientific, as well as more historical and sociological, Pareto must be regarded among the dozen or so most important figures in the history of economics.

11.2. Important Economic Ideas of Irving Fisher (1867–1947):

Irving Fisher spent his career studying questions about money and the economy – how money affects interest rates, how money affects inflation, and the impact of money on overall economic activity. For this work, he is regarded as the father of monetary economics. Fisher was born in 1867 in Saugerties, New York. Graduating first in his class, Fisher remained at Yale to do graduate work in both mathematics and economics. During the 1920s Fisher applied his knowledge of economics and financial markets to Wall Street. Speculating heavily in stocks, he soon became a multimillionaire. But Fisher lost half his net worth in the crash of 1929. Believing that stocks were a good bargain following the crash, Fisher borrowed heavily to buy more stock. When the market continued to fall, Fisher lost his entire fortune and then some. He remained heavily in debt for the rest of his life and lived the simple lifestyle that comes with such indebtedness. Fisher devoted his life to many causes and wrote many popular books advocating those causes.

11.2.1. Monetay Theory:

Classical and neoclassical theorists maintained an interest in at least one macro-economic question: what determines the general level of prices? They addressed this economic question by utilizing the supply-and-demand approach developed in microeconomic theory. The supply of money was assumed to be determined by the monetary authorities, so some orthodox economists contended that the basic issues to be analyzed were on the side of demand. The household and firm are assumed to be rational and to have a demand for money to be used for various purposes. Walras, Menger, and others developed a supply-and-demand analysis to explain the value of money, but the most famous of these theories is probably the one developed by Marshall, which has become known as the Cambridge cash-balance version of the quantity theory of money.

In contrast to his policy proposals, Fisher's theoretical work earned him the reputation of being a first-rate economist. His main interests were monetary theory – money, interest rates, prices, and how they were all related. His main contributions were to explain monetary concepts and how money affected the economy. It was Fisher who first defined precisely the notions of income, capital, and wealth. To understand these terms requires knowledge of the differences between stocks and flows. Fisher used this distinction to clarify several economic notions. He defined capital as a stock of wealth at one point in time, analogous to a stock of water in a pool at the bottom of a mountain. Out of current income would come a flow of savings which, like the water cascading down the Swiss mountain, adds to our stock of wealth.

11.2.2. The Concept of Money Illusion:

Too much spending would cause a flow out of current wealth, thus reducing the stock of wealth. Fisher also distinguished real interest rates from nominal interest rates and he coined the term ‘‘money illusion’’ to refer to an inability to distinguish a dollar from the purchasing power of the dollar (or what the dollar could buy after inflation). Interest rates on bank deposits provide one good example of money illusion. When the rates on certificates of deposit fall, people generally complain about the low returns they are getting. Yet these people may have been doing worse with higher nominal interest rates and higher inflation. Money illusion also frequently occurs when workers get pay increases. Since wages are a major component of business costs, higher wages usually lead to higher prices. Workers suffering from money illusion will be happy with a bigger pay check even though their bigger check can buy fewer things.

For Fisher, money illusion was a prevalent phenomenon. He also thought it was responsible for the business cycle. Businesses, believing that real interest rates are high during times of inflation and high nominal interest rates, stop borrowing and investing. This slows down economic activity. Then, when a slowing economy reduces nominal rates, businesses mistake this for a cut in real rates and increase their borrowing and investment. As the economy expands, money illusion eventually brings the expansion to a halt. As the expanding economy generates inflationary pressures, banks must raise nominal rates to maintain the real rate of interest they make on their loans. Again, businesses mistake this for higher real rates and investment falls. According to Fisher, economic expansion and contraction follow one another continually as a result of this process.

11.2.3. Measurement of Inflation:

Fisher also tackled the difficult problem of how to measure inflation for the entire economy. Inflation is simply the change in prices faced by a typical family. Since each family purchases a diverse set of goods, and since the goods it buys change regularly, developing a single number to represent the average change in prices becomes a complex problem. The simple solution to this problem of measuring inflation is to measure the price change for a set of goods that the typical family buys at one point in time. One problem with this method is that, when prices change for some good, people buy less of that good. Today all nations use the set of goods bought by people before prices change when calculating inflation. Nations have adopted this method for practical reasons more than anything else. It is both expensive and time-consuming to take regular surveys of consumer purchases. Surveys therefore are only taken every few years. But this decision has important consequences for our measurement of inflation; it implicitly assumes that consumers will not change their spending patterns when prices change. Fisher recognized that using original purchases would overstate the actual inflation rate because it assumes that people are buying large quantities of the good that increases most in price. He also recognized that taking the opposite approach, and using quantities bought by families after the price change, would underestimate the loss in purchasing power to the family when some good rises in price by a large amount. Fisher suggested that an ideal index number, or inflation measure, should employ the average of quantities bought before the price change and quantities bought after the price change.

11.2.4. Factors Determine Interest Rates and Inflation:

While Fisher devoted a great deal of effort and energy to clarifying economic notions, he did more than just help define concepts. His main contributions to economics involved analyzing what factors determined interest rates and what factors caused inflation. Fisher’s theory of the rate of interest is still taught to most economics students today, and is regarded by most economists as a correct analysis of what determines interest rates for a particular economy. Fisher proposed that interest should be viewed as an income flow that comes from using anything in production. In particular, interest is the income flowing to someone who allows their stock of wealth to be used in producing goods. When wealth gets used in the production process, someone lends money to a business firm and does not spend it. Interest was thus a reward for not consuming things today, and so Fisher’s theory is usually referred to as a time-preference theory of interest. Because most people desire to consume things now, they have to be paid to wait until next year or the year after to consume goods. Interest is thus a bribe to keep people from spending everything now.

Two forces determine interest rates, according to Fisher. On the supply side, the key is the preferences of individuals for present consumption versus future consumption. If people look toward the future, and are worried about how they will support themselves in old age, they will accept low interest rates to save rather than spend. On the other hand, if people only think about enjoying life now, they will not save unless they are paid grandly to do so. On the demand side, interest rates depend upon available investment opportunities and the productivity of capital. Greater productivity will lead to greater demand for borrowed money. With greater productivity, profits increase and business owners will want to expand more. To do this they will need to borrow or will demand more money. The equilibrium rate of interest is the rate of interest at which the quantity of funds that borrowers want to lend equals the quantity of funds that lenders are willing to give up. Fisher made it clear that the forces affecting both supply and demand were unstable. Moreover, in addition to economic factors, supply and demand were also affected by social and psychological factors such as the habits, intelligence, self-control, and foresight of both borrowers and lenders.

11.2.5. Quantity Theory of Money:

The first clear statement of the quantity theory of money was made by David Hume in 1752. This theory, as it came down through the literature, held that the general level of prices depended upon the quantity of money in circulation. Marshall's version of the quantity theory was an attempt to give microeconomic underpinnings to the macroeconomic theory that prices and the quantity of money varied directly. He did this by elaborating a theory of household and firm behaviour to explain the demand for money. Marshall reasoned that households and firms would desire to hold in cash balances a fraction of their money income. If M is money (currency plus demand deposits), PY is money income, and k is the proportion of their income that households and firms desire to hold in the form of money, then the fundamental cash-balance equation is

$$M = kPY$$

Because Marshall accepted Say's Law, full employment is assumed. An increase in the quantity of money, assuming k remains constant, will lead to an increase in money income, PY. Because full employment is assumed, an increase in the quantity of money will result in higher prices and a consequent increase in money income; real income, however, will not change. Decreases in the quantity of money will result in a fall in money income as prices fall; real income again will remain constant. We shall not examine the many different aspects of Marshall's formulation; the important point is that Marshall's version of the quantity theory made an attempt to integrate the microeconomic behavior of maximizing firms and households with the macroeconomic question of the general level of prices.

A group of economists, the most prominent being the American Irving Fisher (1869-1947), developed another form of the quantity theory known as the transactions version. However, they showed little interest in finding a microeconomic foundation for the macroeconomic analysis of the general level of prices. In this version,

$$MV = PT$$

Where M is the quantity of money, V is the velocity of money, P is a measure of the price level, and T is the volume of transactions.

Although these two approaches have important differences, they have one element in common: they were both designed to explain the forces that determine the general price level. They were not used to explain the level of real income, which was assumed to be at full employment and fixed by nonmonetary forces in the economy. Fisher set forth the now-famous equation of exchange, and he used it to identify the causes of price inflation. The equation, MV=PQ, says that the money supply (M) times its velocity (V, the number of times a unit of money is used during a year to purchase goods and services) must equal the output of goods and services (P times Q). This equality must be true as a result of the definitions of the various terms. If the British economy has a money supply of 1 trillion pounds, and if each pound is used seven times during the year to purchase things, then 7 trillion pounds worth of goods and services will be purchased during the year. This is the national output or gross domestic product of the British economy. This output, in turn, can be further divided into price (P) and quantity (Q) components. The quantity represents real things that are produced, while the price component measures how much each thing costs on average. Using this equation Fisher was able to explain the three potential causes of inflation. First, if V and Q are both constant, prices will vary with changes in the money supply; that is, inflation will be due to too much money in the economy. Second, if M and Q are constant, prices will vary with changes in velocity. In this case, inflation stems from people trying to spend their money too quickly, or trying to buy more goods than the economic system can produce. Finally, if M and V are constant, prices go up if quantities go down. Here, a shortage of goods leads to inflation.

Taking his analysis one step further, Fisher analyzed the factors that affect M, V, and Q. Most important was his explanation of how the spending habits of individuals, and the means by which people get paid, affect the velocity of money. To keep things simple, suppose all workers get paid at the beginning of every month. During the month they will normally use just about all their pay to buy goods and services. By the end of the month, then, all money is again held by employers and can be used to pay next month's wages. In this case, each British pound will be used 12 times during the year to purchase goods (once each month), and the velocity of money will be 12. On the other hand, if British workers were paid two times a month, the same process of wage payments followed by spending would occur 24 times a year, and the velocity of money would be 24 instead of 12. Because the frequency with which people are paid is relatively constant, the velocity of money should also be relatively constant. This leaves changes in the money supply (M) as the main cause of economic fluctuations. For Fisher, changes in M could affect either prices or real output. Contemporary monetary economists tend to follow Friedman, rather than Fisher, and contend that changes in the money supply affect only prices in the long run.

11.3. Summary:

Despite his many important substantive contributions, Pareto is best known for introducing mathematical forms of reasoning and analysis into economics. However, later in his life, Pareto grew dissatisfied with mathematical formalization and with abstract economic theory. Important questions about economic growth and overall economic performance, he thought, could only be understood within an historical and sociopolitical context. Pareto then sought to incorporate these factors into a theory of the business cycle. He noted that social factors influenced decisions to save, work, and consume, and thus the overall state of the economy.

While Fisher devoted a great deal of effort and energy to clarifying economic notions, he did more than just help define concepts. His main contributions to economics involved analyzing what factors determined interest rates and what factors caused inflation. Fisher's theory of the rate of interest is still taught to most economics students today, and is regarded by most economists as a correct analysis of what determines interest rates for a particular economy. Fisher proposed that interest should be viewed as an income flow that comes from using anything in production. In particular, interest is the income flowing to someone who allows their stock of wealth to be used in producing goods. When wealth gets used in the production process, someone lends money to a business firm and does not spend it. Interest was thus a reward for not consuming things today, and so Fisher's theory is usually referred to as a time-preference theory of interest. Because most people desire to consume things now, they have to be paid to wait until next year or the year after to consume goods. Interest is thus a bribe to keep people from spending everything now.

11.3. Glossary:

Ordinal utility

Income Distribution

Pareto Optimality

Sociological Theory of Economic Growth:

Monetary Theory:

Money Illusion:

Measurement of Inflation

Factors Determine Interest Rates and Inflation:

Quantity Theory of Money:

11.4. Self Assessment Questions:

1. Critically examine the conditions relating to Pareto Optimality
2. Write about the Sociological theory of Economic Development
3. Briefly analyze the important economic ideas of Pareto

4. Examine the Fishers concept of Money illusion

5 Analyze the basic features of Fisher's Quantity theory of Money.

6. Outline the contributions of Irving Fisher.

11.5. **Books for further Study:**

1. Blaug,M. , Economic theory in Retrospect.
2. Alexander Gray, Evolution of Economic Doctrines.
3. L.H. Haney., History of Economic Thought
4. Eric Roll: A History of Economic Thought.
5. Gide & Rist: History of Economic Doctrines.

- **Prof M Sundara Rao.**

Unit -3/Lesson 12

BASIC DOCTRINES OF MARSHALL

12.0. Objectives of the Lesson:

In this lesson an attempt is made to explain the important economic ideas of Marshall who is generally considered as the founder of Neo-Classical school of Economic thought. Marshall is one of the greatest figures in English economics, was undoubtedly superior to the contemporary neoclassical economists in his clarity of vision, originality and profundity of thought and consistency of exposition.

About the works of Marshall:

Marshall started teaching economics in 1885, he became professor of economics at Cambridge the post which he held until his retirement. He came to economics from mathematics for which he had a passion. Disillusioned from mathematics, Marshall turned to ethics. He showed a great concern over the existing conditions of inequality and poverty in the country and made up his mind to find solutions to these problems. Marshall was gifted with the rare combination of qualities. He had varied interests and was a serious student a number of subjects like mathematics, history, philosophy, theology and economics. Marshall's important works are: Economics of Industry (1879), Principles of Economics (1880), Industry and Trade (1919) and Money Credit and Commerce (1924).

12. 1. Nature and Scope of Economics:

The neoclassical economists had before them the following task : First, they had the task of completing the main theoretical structure. Jevoim, Walras and Menger provided theoretical explanation for consumer's behavior in the utility theory of value. Similarly, economists like Wicksteed, Marshall and Clark developed the productivity theory of distribution. The task of the neoclassical economists was to isolate the scientific from personal preferences. They considered Economics as 'not a concrete truths, but engine for discovery of concrete truths.' The tools of analysis as well as the conclusions were ethically neutral. In order to fully appreciate the nature and contribution of neoclassical ideas, it is necessary to understand the fundamental features of the system

Neoclassical economics is based on the argument that not labour alone, but other factors of production too were productive and shared in the final value of the product. It puts forward the view that it is possible to reverse the traditional chain of causation which explained the value of a commodity in terms of the value of factors of production was derived from the value of ultimate product. it is based on abstract reasoning which means a tendency not to view production and distribution objectively as social facts to be explained either in terms of social laws or historically. It explained economic and social phenomena as a result of individual behavior.

Marshall was the great interpreter of the partial equilibrium method of analysis. According to this method, we select a few variables and study their relationship, while keeping all other forces at rest. Marshall considered both induction and deduction as useful for economic investigation. According to Marshall economics is practical economics and the basic issue is that of poverty. Poverty can be removed not by maximizing output but through optimum distribution. While formulating an economic policy, both economic and non-economic factors are to be taken into consideration. Marshall did not consider the doctrine of maximum satisfaction based on the assumption of perfect competition as a universal rule for economic policy. In certain cases, government intervention may increase social welfare.

Marshall stated that the growth of economic science is slow and continuous. The theories of the past writers are not antagonistic but supplementary to those of the present writers. The distinction between various economic terms, i.e., between normal action and abnormal action, between normal values and current values, between rent and interest, between floating capital and sunk capital, etc., are not absolute but relative. According to him , the theory of distribution is essentially a theory of factor pricing. Like all other commodities, the prices of the productive services are also determined by the forces of demand and supply. On the demand side, a factor price is governed by the marginal productivity of that factor and, on the supply side, it is governed by the supply of that factor .Along with partial equilibrium and welfare analysis Marshall broadly outlined the scope of economics in to four parts, they are consumption, production, exchange and distribution.

Though, Marshall's own theory of distribution was marginal productivity theory, yet. he was aware of the difficulties that come in the way of measuring marginal productivity of a factor of production.. Marshall was not only a great system builder but also a great tool maker. He devised a number of analytical tools. They are : consumer's surplus. elasticity, internal and external economies, substitution, short run and long run, prime and supplementary costs, representative firm and quasi- rent.

12.2. Substance, Method and Application of Economics:

Marshall's Principles opens with a statement on the subject-matter and scope of economics : 'Political Economy or Economics is a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of well-being. With this statement, Marshall makes it clear that economics is primarily concerned with man and his activities; wealth is of secondary importance. Economics deals with the material welfare of man. Again the man, whose actions form the substance of economics, is not an imaginary- or 'economic man' but an average man of 'flesh and blood'. This average man is influenced by the egoistic motives of ordinary business of life and is neither, above vanity and recklessness, nor below the love of a virtuous life.

Marshall raised economics to the status of science. 'Economic science is but the working of common sense aided by appliances of organized analysis and general reasoning, which facilitate the task of collecting, arranging, and drawing inferences from particular facts. There are good reasons for treating economics as a separate science. First, it deals with those activities of man which are under the control of measurable motives. We do not measure motives, but only the moving force and money provides a fairly good measure of the moving force ot the motives. *Second,* the economic problems, because they relate specially to man's actions are controlled by motives that have much in common and form a fairly homogeneous group. There is no one method of analysis which can be properly called the method of economics. Marshall considered both induction and deduction *an* useful for economics. Though both these methods of investigation serve different ends and are employed in different proportions, yet they are complementary Economic laws are the statements of economic tendencies and thus, arc essentially hypothetical. They study the effect of certain causes subject to the condition that other things remain the same so that the causes are able to produce effect undisturbed. Since, economic laws deal with man's actions which are numerous and uncertain, they 'are to be compared with the laws of tides.

It is the applied aspect of economics that Marshall was ultimately concerned with. Pure theory and mathematical constructions were for him a child's play. He was, in fact interested in the intricate problems of the real world, i.e., the problems relating to practical business and to the life of the working classes. The basic issue before Marshall was that of poverty, i.e., how to get rid of such evils in society as arise from a lack of material wealth.

The problem of poverty was a problem of optimum distribution and not of maximum production. Unlike Ricardo, whose emphasis was on the allocation of wealth and resources with a view to maximize production. Marshall aimed at the optimum allocation of wealth and resources that would maximize social welfare. Maximum happiness and general well-being of the society was Marshall's objective of economic policies. But, like Adam Smith and J.S. Mill, Marshall also did not like the emphasis on the economic elements in isolation from the non-economic elements of welfare in the formulation of economic policies.

12.3. Marshall's Economic Ideas relating to Consumption:

Marshall's important views relating to consumption are briefly discussed here

12.3.1. Utility and Demand:

Price of a commodity is determined not by supply alone (as the classical economists believed) and not by demand alone (as the utility theorists believed) but by the intersection of demand and supply curves. Marshall, first of all, takes up the theory of demand which was almost neglected by the classical economists. Demand theory is based on the study of consumer's behavior. A rational consumer aims at maximizing satisfaction from his purchases. The amount of satisfaction from a commodity is closely related to the quantity of that commodity acquired by the consumer. The law of diminishing marginal utility highlights the fundamental tendency of human nature that 'the additional benefit which a person derives from a given increase of the stock of a thing, diminishes with every increase in the stock that he already has.

By demand, Marshall means the quantity of a commodity demanded at a certain price, other things remaining the same. The individual demand curve which represents different quantities demanded at various prices, can be directly derived from the tendency of diminishing marginal utility. As the satisfaction from the additional units of a commodity diminishes, the price we are going to offer for these addition units will also fall, assuming the marginal utility of money as constant. Or, in the other words, the demand price for a commodity will fall, as more and more of it is acquired. Thus, like that of the marginal utility curve the slope of demand curve is also negative. The negative slope of demand curve can also be mathematically explained. The condition for equilibrium of the individual consumer depends on a constant marginal utility of money and a declining marginal utility of *x* will give a negatively sloping demand curve which represents that an increase in *x* decreases the rate at which a consumer is willing to pay for the additional unit of it.

The next step is that these individual demand curves arc added up to arrive at the market demand curve. The market demand curve, which represents the total demand of all the individual consumers for a commodity at various prices, is constructed on the basis of following assumptions : constant tastes preferences, and customs of the consumers; constant money income; constant purchasing power of money; constant prices of other commodities. Given these conditions, the general law of demand states that 'the amount demanded increases with a fall in price, and diminishes with a rise in price.

12.3.2. The Concept of Elasticity:

One of Marshall's most important contributions to economics was his formulation of the notion of elasticity. Virtually all economic relationships are cause-and-effect relationships. The notion of elasticity attempts to ascertain how much of an effect a given cause has. If some cause has a large effect, the relationship is said to be elastic; if the cause has a small effect, the relationship is inelastic. Marshall also developed a mathematical formula to measure exactly how elastic or inelastic any economic relationship was. The price elasticity of demand concerns how much a given change in price alters the amount of a good consumers would purchase.. Marshall identified several factors that determined whether the demand for a particular good was likely to be elastic or inelastic. One important factor was the ease of substitution. If goods were necessities and there were few alternatives, then demand for the good was likely to be price inelastic; consumers would have to keep buying the good when its price increased because they had no alternatives.

Marshall also explained why price itself was an important determinant of demand elasticity. For a container of salt, whose price is very low, a large percentage change in price would have little effect on consumption because the extra money spent on salt due to a large price increase would be rather trivial. In contrast, when expensive items increase in price by a large percentage, consumers must spend a good deal more of their income to buy these goods. Thus they are less likely to purchase them. Consequently, demand for expensive goods tends to be elastic and demand for inexpensive goods tends to be inelastic. Finally, Marshall stressed that time was an important factor in determining the elasticity of demand, with demand becoming more elastic over time. Marshall also applied the notion of price elasticity to the supply relationship. The price elasticity of supply measured how much more businesses would produce and seek to sell in response to a given change in price. Here, too, time was an important factor.

Although Marshall did not originate the concept of elasticity, yet it was he who clearly stated and popularized. Marshall's introduction of the notion 'elasticity of demand was responsible for the revolutionary advance in the theory of value and distribution He defined elasticity of demand in the following words: "The elasticity of demand in a market is great or small according as the amount demanded increases much or little for a given fall in price, and diminishes much or little for a given rise in price. The elasticity of demand is expressed as the percentage change in quantity demanded divided by the percentage change in price. Marshall also extended the application of the concept of elasticity to the fields of supply and factor demand.

12.3.3 .Consumer's Surplus:

Consumer's surplus is an operational concept—a tool of practical use It gives a rough estimate of 'the benefit which a person derives from his environment or his conjuncture.'[1] Marshall defines consumer's surplus as 'the excess of the price which he would be willing to pay rather than go without the thing, over that which he actually does pay. Marshall's numerical example explaining the concept of consumer's surplus explains that a consumer's demand schedule. Marshall takes an unimportant commodity, lea, to ensure that it accounts for a very small portion of his total expenditure. Marginal utility of lea is measured by the price that a consumer is willing to pay for a pound of tea. Total utility is derived by adding the marginal utilities of the successive increments of the purchase of tea.

Marshall has given an estimate of consumer's surplus with the help of an individual demand schedule, then Marshall attempted to determine consumer's surplus on the basis of the market demand schedule. To know, consumers' surplus for the market, we have to sum up the individual surpluses which requires an adding up of individual demand functions. For this purpose, we have to ignore the 'fact that the same sum of money represents different amounts of pleasure to different people'. Thus, the individual surpluses cannot be easily aggregated to arrive at (he consumers' surplus. Marshall's measure of consumer's surplus is not satisfactory. Consumer's surplus is in fact a utility surplus, but Marshall expressed it in terms of money. For this purpose, he assumed the marginal utility of money to be constant throughout the demand schedule. But, the fact is that as the price falls, the purchasing power of money increases and, due to the law of diminishing utility, the marginal utility of money decreases. To avoid this difficulty, Marshall selected an unimportant commodity for which the real income changes will be negligibly small. In this way, Marshall retained his assumption of constant marginal utility of money and proceeded with his money measure. Theoretically, the problem of measuring consumer's surplus may seem to be solved, but. in reality, where important commodities also exist, the problem remains. Whatever the difficulties may be in the way of estimating the consumer's surplus, the fact that consumer's surplus exists in the real world cannot be ignored. Moreover, the concept itself is useful in analyzing the problems of monopoly.

12.3.4. Determination of Consumer's Equilibrium:

The consumer is in equilibrium when he gels maximum satisfaction out of his limited income and has no tendency to make any change in the existing expenditure pattern. When the consumer spends his limited income on different commodities, he compares marginal utility per unit of money from each commodity in order to reach the position of equilibrium. He will be in equilibrium when he follows the law of equi-marginal utility, i.e., when the last unit of money spent on each community gives him the same marginal utility.

12.4. Marshall’s views on Production:

Marshall’s important views relating to production are discussed here.

12.4.1. Supply and Cost Analysis:

Marshall developed his theory of supply on the lines similar to his analysis of demand. Just as the consumers obtain utilities or satisfaction from the consumption of commodities, the producers suffer disutility because the production of commodities involves costs. Just as the marginal utility as a consumer increases consumption of a commodity, the marginal costs rise (in accordance with the law of diminishing returns) as the production of a commodity expands. Just as a rational consumer aims at maximizing his satisfaction, a rational producer aims at minimizing his costs. Again the same equi- marginal principle guides the producer in matters of resource allocation. Like the consumer, the producer loll 'has so to distribute his resources that they have the same marginal utility III each use: he has to weigh the loss that would result from taking away the expenditure here, with the gain that would result from adding a little there.

Marshall distinguished between real and money cost of production. Ural cost of production refers to the efforts and sacrifices involved in making a commodity. Real costs include the exertion of labor and waiting for saving Money cost of production or the expenses of production indicate 'the sums of money that have to be paid for these efforts and sacrifices'. While a businessman is interested in the money costs, the concept of real costs is useful when we are considering the costs from the social point of view. Money cost of production also indicates the supply price of a commodity because it includes the prices required to call forth an adequate supply of the efforts and sacrifices necessary for producing a commodity. The prices that constitute the supply price of a commodity are: the price of raw materials, wear-and-tear and depreciation of the buildings, machinery and other fixed capital, interest and insurance on all the capital, the wages of those who work in the factories, and the gross earnings of management, of those who undertake the risks, who engineer and superintend the working. By estimating the supply price of a commodity, we obtain a firm's supply schedule which, when graphically presented, gives tin- supply curve of the firm. This supply curve slopes upward to the right depending upon the tendency of the marginal cost to rise as the output of a commodity increases. Market supply curve or the supply curve of the industry is derived by aggregating the supply curves comprising the industry.

12.4.2. The Theory of Representative Firm:

While explaining the long-run equilibrium of an industry, Marshall maintained that the supply price of an industry in the long-run is determined by the minimum average costs of the marginal firm, including normal profits Marginal firm is the least efficient firm in the industry. The equilibrium position is defined as that in which the marginal firm must earn normal profits. Under the conditions of perfect competition, all firms in the industry tend to earn only normal profits in the long-run and the industry is in equilibrium. Here arises one difficulty. If the firms enjoy internal economics, they will grow at the rate the industry grows and there is no problem. But, if there are external economies then the larger firms (especially, new entrants) will certainly do better than the marginal firm. In this case, the equilibrium condition that all firms earn only normal profits has no meaning.

Marshall was able to get out of this difficulty by replacing the idea of marginal firm by a representative firm. The representative firm is neither a new firm just struggling into the business, nor an exceptionally efficient and well- established firm, but is an average firm, with a normal access to internal and external economies. Marshall defined the representative firm as 'one which has had a fairly long life, which is managed with normal ability, and which has normal access to the economies, external and internal, which belong to that aggregate volume of production. Now the equilibrium situation is that in which the representative firm earns just normal profits. The industry is in equilibrium because the increase in output from the firms that are growing and being balanced by the decrease in output from the firms that are declining and dying.

12.4.3. Internal and External Economies:

Economies of scale are vital to Marshall's theory of production. Production is governed by two tendencies—diminishing returns and increasing returns. The tendency to diminishing returns is due to natural limitations (e.g., land scarcity), while the tendency to increasing returns is explained by the economies of scale or improvements of the organization of production and efficiency of factors of production as a result of large-scale production. As Marshall puts it : 'while the part which nature plays in production shows a tendency to diminishing return, the part which man plays shows a tendency to increasing return. In those industries, which are engaged in producing raw-materials (i.e., agriculture), the tendency to diminishing return more than offsets the tendency to increasing return : in manufacturing industries, on the other hand, the tendency to increasing return more than offsets, any tendency to diminishing return; the industries, in which both the tendencies balance each other, operate under the law of constant returns.

Economies of scale are of two types, internal and external. Internal economies are those which are 'dependent on the resources of the individual houses of business engaged in it, on their organization and the efficiency of their management.'[2] Internal economies arise within a firm when its production increases. External economies are external to a firm and accrue to it when the size of the industry expands. These economics are important in understanding the nature of long-run supply curve of an industry.

The important internal economies mentioned by Marshall are: Economy of materials or the utilization of byproducts. Economy of machinery: In a large establishment, there are often many expensive machines, which a small manufacturer cannot afford to use. (ii) Larger machines are more efficient. Small manufacturers are sometimes ignorant of the best types of machinery to rise in their business. Small manufacturers cannot undertake expensive experiments. Economy in bulk buying and selling and larger firms secure discounts for purchasing in huge quantity. Larger firm pays low freights and saves on carriage in many ways. It is cheaper to sell in large quantities. Each man can be assigned to the task for which he is best fitted and thereby can acquire additional proficiency by repetition. High grade managerial ability can be concerned exclusively with problems of policy, leaving routine details to subordinates. Economy of finance: Larger firms secure credit on easier terms. Owing to these internal economies, the long-run average costs fall as output rises. But, after a certain level of output, average costs must rise due to growing managerial inefficiencies and marketing difficulties. Thus, internal economies and diseconomies explain why the long-run average cost curve is U-shaped.

As regards the external economies, Marshall discussed two general types: Economies of localization; such as, cross fertilization of ideas, the development of auxiliary and subsidiary industries, and the availability of skilled labor. The growth of knowledge and progress of arts. But here we encounter a number of analytical difficulties. External economies appropriate to Marshall's partial equilibrium analysis are those which are external to the firm but internal to the industry. The downward-sloping industry's supply curve, which is the result of these economies, is drawn up on the assumption of constant technology because technological change causes a shift in the curve. This is a static analysis. But when we go through Marshall's discussion of external economies, it is surprising to note that in no case are they confined to single industries. All the examples involve, in some way or the other, technological change, which requires a dynamic analysis.

In fact, Marshall failed to distinguish between reversible and irreversible external economics. Reversible economies, static phenomenon are destroyed when the output of the industry falls, while irreversible or technological economic dynamic phenomenon are retained even when output of the industry tail, the economies in the industry arc due lo technological advances and thus arc irreversible; reversible economies are very rare. How i nit then a downward-sloping industry's supply curve, drawn in a partial equilibrium analysis with the assumption of constant technology and exhibiting reversible economies, face the reality.

External economies or decreasing costs are also not compatible with Marshall's assumption of perfect competition. This difficulty led to the development of the theory of imperfect competition in the 20th century. When the firms of an industry are producing under decreasing cost conditions as a result of external economics, any single firm will have a strong desire lo monopolies all the firms of the industry. In that case, external economics will be competitive firms of the industry.

12.4.4. Determination of Producer's Equilibrium:

A producer (or a firm) is in equilibrium when he has no tendency to reach the level of output. He needs neither expansion nor contraction. In the condition of equilibrium, the producer earns maximum profits by satisfying the following two conditions : Marginal cost (MC) = Marginal revenue (MR). MC curve cuts MR curve from below.

12.5. Value Analysis:

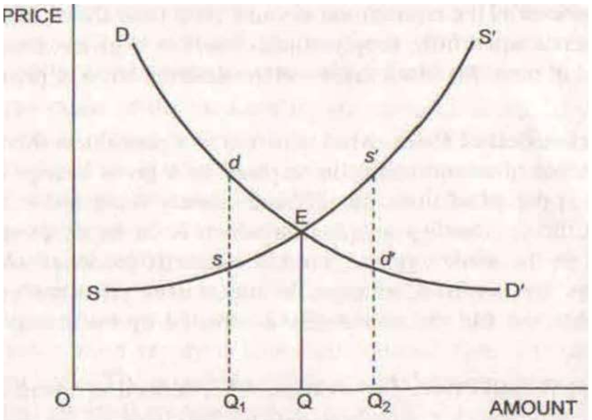
However important, practical economics was to Marshall, his greatness as an economist lay in pure theory and not in policy. In theoretical economics, his contribution was two-fold; he was a system builder as well as a tool maker. In this section, we will grasp Marshall's theoretical system and, in the next, we will acquaint ourselves with his analytical tools. Along with Jevons, Menger, and Walras, Marshall also discovered the utility theory of value independently. He has made it clear that the term 'marginal' was suggested to him, as a result of studying von Thunen, before Jevons's book appeared. But Marshall's claim of originality remained subjective because of the delayed publication of his ideas. The delay, however, was not due to any weakness on the part of Marshall. It, on the other hand, spoke of the author's profundity of thought and scientific genius.

12.5.1. Consumer and Producer Behavior:

So far we were concerned with consumer's behavior with regard to only one commodity. In practical life, the consumer has to choose between more than one commodity. The rational consumer will adjust his spending on various commodities in such a way that his total satisfaction is maximized. For achieving this aim, the equi-marginal principle will help him. He will go on substituting between various commodities at the margin and comparing the marginal utilities from each line of expenditure till 'the marginal utility of a Shilling's worth of goods on each line shall be the same. The neoclassical utility analysis has rendered certain classical conceptual distinctions baseless and unscientific. First of all, the distinction between the material and non-material things is unnecessary. It is said that while a cabin- maker produces material things (i.e., furniture), the furniture dealer simply sells what is already produced. The neoclassical economists made it clear that, 'they both produce utilities, and neither of them can do more. Similarly, the classical distinction between productive and unproductive labor has been found useless. It would be best to regard all labor as productive except that which failed to promote the aim towards which it was directed, and so produced no utility. The producer behavior is analyzed by Marshall as higging and the consumer behavior as bargaining. These behavioral aspects of both the producer and consumer according to Marshall paves the way for the determination of equilibrium price in the market.

12.5.2.. Equilibrium Price:

Equilibrium price is determined by the point of intersection between mark demand curve and market supply curve. This point shows equality of the demand price and the supply price. At the equilibrium price, the amount produced is equal to the amount demanded and there is no tendency for the former to



increase or decrease. Such an equilibrium is stable equilibrium, i.e., the price, it deviates a little from its equilibrium level, tends to return to it. The condition for stable equilibrium is that 'demand price is greater than the supply price for amounts just less than the equilibrium amount, and vice versa. EQ is the equilibrium price and OQ is the equilibrium amount. Here the demand price is equal to the supply price and the amount produced has no tendency cither to be increased or to be decreased. If the amount produced is less than the equilibrium amount (i.e., OQ|), the demand price will be more than the supply price (</Q, > .vQ|). This will tend to increase the amount. On the other hand, at an amount more than the equilibrium *(i.e.,* OQ_2), the demand price will be less than the supply price (d,Q_2 < .*|Q) and the amount will have the tendency to decrease.

Thus, the dispute whether cost or utility governs value is useless because both arc equally important elements in the determination of value. A> Marshall says : 'We might as reasonably dispute whether it is the upper or the under blade of a pair of scissors that cuts a piece of paper, as whether value is governed by utility or cost of production. It is true that when one blade is held still, and the cutting is effected by moving the other, we may say with careless brevity that the culling is done by the second; but the statement is not strictly accurate, and is to be excused only so long as it claims to be merely a popular and not a strictly scientific account of what happens.

12.5.3. Importance of Time Element:

The forces of demand and supply that determine the equilibrium price themselves change with the passage of time and every change in them alters the equilibrium price and the equilibrium amount. How time affects the determination of price depends upon how supply adjusts itself to a given change in demand over a period of time. Marshall discussed the determination of price in three time periods: Marshall explained the market period price, by analyzing market period is a period too short to allow any change in output of a commodity in response to a given change in demand. In this very short period of time, supply is absolutely fixed and is taken to mean the stock of the commodity in question which is on hand, or at all events in sight. Since, in the market period, no new output is produced and, as a result**,** no new costs are involved, changes in the market price are entirely due to changes in demand and are completely unaffected by the changes in the cost of production.

In explaining short term price Marshall stated that the short period is defined as a period long enough to permit the adjustment of supply to demand by changing the output within the limits set by the existing capacity of the industry, but not long enough to permit **a**ny change in the capacity. Supply in the short period means what can be produced with the existing productive capacity of the industry. The supply will increase according to the law of increasing costs.

Since plant and equipment do not change in the short period, there are certain costs which remain fixed during this period whatever the level of output may be. These costs are called supplementary or fixed costs. But, since the output can change within the productive capacity of the firms, all costs are not fixed. Some costs vary with output. These are termed as prime or variable costs. Although prime and supplementary costs exhaust the total costs of production, yet, in the short period, prime costs alone enter into the supply price of a commodity. As long as, the price is such that the prime costs are covered, the producers will go on with their production by equalizing marginal revenue and marginal cost, even if there are losses. This is because even if they stop producing, they will have to pay the supplementary costs. They will, of course, suspend production if the price falls too much to enable the producers to cover their supplementary costs,

Marshall analyzed the long term price while stating that in the long period, the productive capacity can also be changed in order to meet the changed demand. The distinction between prime and supplementary costs disappears; all factors become variable. The supply of a commodity can be increased in three ways: if the existing firms produce more with their old plants, if they build larger plants and if new firms enter the industry, thus since, in the long-run. Firms have sufficient time to fully adjust their supply to demand, it is supply and not demand that has great influence on price. In the long period, the prices cover costs, including normal profits, and all the firms are in equilibrium.

Firms expand and new firms enter the industry. Similarly, if the demand falls so much that the costs are not covered, the inefficient firms exit the industry and the remaining firms will be able to earn only normal profits. Marshall sums up his discussion on value in the following words: Thus we may conclude that, as a general rule, the shorter the period which we are considering, the greater must be the share of our attention which is given to the influence of demand on value; and the longer the period, the more important will be the influence of cost of production on value.'"

12.6. Marshall's Economic Ideas on Theory of Distribution:

To Marshall, the theory of distribution is essentially a theory of factor pricing like all other commodities, the pricing of productive services has two aspects: demand and supply. 'The normal value of everything, be a particular kind of labour or capital or anything else, rests, like the keys to of an arch, balanced in equilibrium between the contending pressures of its two opposing sides; the forces of demand press on the one side, and those of supply on the other. The demand for a factor of production is a derived demand and depends upon its marginal productivity. It is regulated by two forces: the demand for the product it produces, and the means at the command of the producer who employs it. A producer, who aims at the most profitable application of his resources, will go on making marginal shifts in the employment of factum of production in accordance with the principle of substitution and will employ each factor up to that margin or limit at which 'its cost is proportionate to the additional net product resulting from its use.

Marshall's theory of distribution was marginal productivity theory of distribution. This is clear from the following statement: In each case tin- income lends to equal the value of the marginal net product. Marshall also accepted Wicksteed's argument about the exhaustion of product. But Marshall's acceptance of the marginal productivity was not unconditional. To overcome Hobson's objection that a single factor cannot be varied without affecting the amounts employed of other factors, Marshall used the term marginal net product He was also aware of the difficulty of measuring marginal productivity arising out of the failure of the law of substitution.

Marshall also admits that the marginal productivity theory is not a complete theory of factor pricing; it throws light on the one aspect of the problem. The other side that requires investigation is the supply side. The effective supply of a factor of production at any time, according to Marshall, depend - firstly on the stock of it in existence, and secondly on the willingness of those, in whose charge it is, to apply it in production. The equilibrium price of a factor of production is determined by the interaction of demand and supply forces.

12.6.1. Views on Rent:

Marshall's theory of distribution provides a good example of his law of continuity. Continuity is an essential feature of economic life. No doubt, the difference between wages, interest, profit and rent is fundamental, but it is not absolute. First of all, 'wages and other earnings of effort have much in common with interest on capital'. The causes that determine the supply price of material and personal capital are generally the same. For example, the motives which induce a man to accumulate personal capital for his son's education and training arc identical to those which determine his accumulation of material capital for his son. Similarly, rent of land is 'not a thing by itself, but the leading species of a larger genus'. The income from land which is generally called rent is not true rent but contains elements of interest and wages. Almost all lands require initial efforts and improvements before it is ready for cultivation. Again, true rent does not arise on land alone; returns of other factors too contain an element of rent. Like land, durable capital goods are also fixed in supply which is the cause of rent. The rent which durable capital goods earn is termed by Marshall as quasi-rent; it will vanish in the long- run when no investment remains fixed.

12.6.2. The Concept of Quasi-Rent:

The concept of quasi-rent explains the return from fixed investment on durable capital goods. Marshall defined quasi rent as 'the Income derived from machines and other appliances for production made by man. Land and other free gifts of nature are permanently fixed in supply. Therefore, their earnings are called rent. But there are manmade appliances whose supply is fixed only temporarily. The income derived from such appliances is also of the nature of rent. But because such earning will not remain forever and will disappear when in the long-run the supply of these appliances is fully adjusted by its demand. Marshall called it quasi-rent. Thus, through quasi-rent, Marshall was able to extend the classical theory of rent to the incomes of fixed investments.

Like rent, quasi-rent is price determined and not price determining. In the short-run, price is determined by the variable costs and the income of the fixed factors is a surplus over and above the necessary cost of production. On the contrary, it is the price of the product as influenced by the market demand that determines income of the fixed factors. But, there is a difference between the rent of land and quasi-rent of fixed investment. Quasi-rents are price determined for both the entrepreneur and society, while the rent on land is price determined only for the economy as a whole.

12.6.3. Views on of Wages:

Wages are the reward for labour. Labour is defined 'as any exertion of mind or body undergone partly or wholly with a view to some good other than the pleasure derived directly from the work. The determination of wages has been explained by the law of demand and supply. 'Wages tend to equal the net product of labour; its marginal productivity rules the demand-price for it; and, on the other side, wages tend to retain a close though indirect and intricate relation with the cost of rearing, training and sustaining the energy of efficient labor. Marshall here attempted to combine the marginal productivity theory of relative wages with the Malthusian subsistence theory of the level of average aggregate wages.

The demand for labour arises because labour is productive and all labour is productive that produces utilities. The forces governing the supply of labour vary in different market periods. The short-run theory of labour supply has been developed on the lines of Jevons's analysis. That is, the supply of labour is determined at the level where the marginal disutility of labour equals the marginal utility of labour. The chief force governing the long-run supply of labour is the cost of producing labour. Wages must be high enough to maintain the physical and mental powers of the laborer, or, in other words, they must cover the worker's expenditures for bare necessaries, for conventional necessaries and for habitual comfort. Both the short-run and long-run supply curves are, in general, positively sloped. Marshall also mentioned various peculiarities of labour as a factor of production. The worker sells his work, but he himself remains his own property. When a person sells his services, he has to present himself where they are delivered, Labor is perishable. The sellers of labour are often at a disadvantage in bargaining. Great length of time is required for providing additional supplies «>1 skilled labour.

12.6.4. Views on Interest:

Marshall defined capital as anything other than land that yields income through time and interest, the return on capital, as the reward for waiting. The rate of interest is determined, on the supply side, by prospective or time preference and, on the demand side, on the productiveness. The demand lot capital arises generally from its productiveness, from the services it renders it is subject to diminishing returns. The supply of capital, on the other hand, depends upon the fact that in order to accumulate capital, we must save, wall and sacrifice the present to the future. In the short-run, given the stock of capital, the rate of interest is mainly governed by the marginal productivity theory, but in the long-run, the cost of producing capital determines its return. Marshall, however, ignored some other problems closely related to the theory of interest, such as, the cumulative nature of interest and the effects of saving on invention.

12.6.5. Views on Profits:

Marshall gave to organization the status of fourth factor of production and made profits the reward for organization or the earnings of management Organization involves risk-bearing, business connection, and exceptional abilities of the entrepreneurs. In the long-run, the profits are determined by the cost of production of the entrepreneurial ability.

12.7. Partial Equilibrium Analysis and Welfare Maximization:

Marshall studied individual markets in isolation, pretty much ignoring the impact that one market has on other markets and that these other markets, in turn, have on every market. This made Marshall the founder of partial equilibrium analysis. In contrast, Leon Walras studied the many interrelationships among all markets in the economy, or general equilibrium analysis. While neither as complete nor as comprehensive as general equilibrium analysis, partial equilibrium analysis has the advantage of focusing on the practical problems facing a particular firm and industry. In order to study individual markets, Marshall developed the tools of supply and demand analysis.

Marshall was the great interpreter of the Method of Partial Equilibrium with the help of one-at-a-time principle. In actual life, the forces influencing an economics phenomenon are so numerous that it not possible to analyze all of them simultaneously in order to arrive at a complete explanation of the phenomenon. The best method is to isolate a few forces and to study their influences on the phenomenon. "We reduce to inaction all other forces by the phrase "other things being equal": we do not suppose that they are inert, but for the time we ignore their activity". Marshall in his Principles applied this method. In the analysis of price determination, he, while keeping all other forces at rest, isolated the primary relations between supply, demand and price of a particular commodity. It is this Ceteris Paribus method which enables us to obtain a clear and precise analysis and it is this method 'by which, consciously or unconsciously, sensible men have dealt from time immemorial with every difficult problem of ordinary life.

Marshall's noteworthy contribution to the theory of economic policy is his critical review of the doctrine of maximum satisfaction. The doctrine of maximum satisfaction states 'that the free pursuit by each individual of his own immediate interest, will lead producers to turn their capital and labor, and consumers to turn their expenditure into such courses as are most conducive to the interests. In other words, the stable equilibrium position achieved by the interaction of demand and supply forces under free exchange is also the position of maximum satisfaction. But, according to Marshall this proposition is not universally true and has only limited applicability. He pointed out two qualifications to the doctrine of maximum satisfaction. Firstly, it assumes equal marginal utility of money for all and thus ignores the differences of wealth between different individuals. Secondly, it is applicable only under the condition of increasing costs and neglects the fact that a fall in price due to improvements in industrial organization benefits consumers without injuring the interests of producers. When we give due consideration to these qualification the following conclusions arc obtained which may serve as a useful guide in formulating an economic Policy.

When we take into account the differences of wealth and income, it may be concluded that total happiness can be increased through re distribution of income. If an individual spends his income in such a way as to increase the demand for the services of the poor and to increase their incomes, he adds something more to the total happiness than if he adds an equal amount to the income of the rich, simply because the happiness which an additional shilling brings to a poor man is much more than that which it brings to a rich man. Recognition of the fact of improvements leads to the conclusion that happiness also depends upon the manner in which an individual spends his income. In so far as an individual spends his income on commodities which obey the law of diminishing returns, he makes those commodities more difficult to be obtained by his neighbors, and thus lowers the real purchasing power of their incomes; while in so far as he spends his income on commodities which obey the law of increasing returns, he makes those commodities more easy of attainment to others, and thus increases the real purchasing power of their income. Thus, it is clear that the doctrine of maximum satisfaction has limited applicability and cannot be regarded as the universal rule for formulating an economic policy.

12.8. Conclusion:

Marshall's Principles cannot be considered a complete and satisfactory work on economies. One finds a number of inadequacies and inconsistencies in Marshall's analysis, He relegated diagrams and mathematical analysis to the appendices or footnotes, and he concentrated his attention on the static micro-theory and avoided the dynamic macro-economic problems. He completely neglected monetary theory in his Principles, His analysis was partial, and not general, equilibrium analysis, His concepts of normal, representative firm and consumer's surplus were vague and imaginary. His assumption of perfect competition was unrealistic.

In spite of these weaknesses, Marshall is ranked with the most influential economists and his authority in the subject remains unchallenged. In fact, Marshall's greatness as an economist lay not in his specific analytical contributions to economics, but in his efforts to solve the old problems and to create the new issues for coming generations. On the one hand, grasped and synthesized the conflicting, ideas of the earlier writers and solved the age-old dispute. After covering the above discussion, the question still remained unanswered: What is the basic explanation of the occurrence of the marginal revolution in the third quarter of 19th century.

12.9. Technical Terms:

Scope of Economics

Method of Economics

Utility and Demand:

Elasticity

Consumer's Surplus

Consumer's Equilibrium

Cost Analysis

Representative Firm:

Economies of Scale

Producer's Equilibrium

Value Analysis

Producer Behavior

Equilibrium Price:

Time Element

Quasi-Rent

Partial Equilibrium

Welfare Maximization

12.10. Self Assessment Questions:

1. Write about the Nature, Method and Scope of Economics
2. Briefly outline Marshall’s Economic Theories on Consumption
3. Examine the Marshillian concepts of Production
4. Analyze the Importance of Time Element
5. Discuss Marshall’s Economic Ideas on Theory of Distribution
6. Elucidate Marshall’s Partial Equilibrium Analysis and Welfare Maximization

12.11. Reference Books:

1. Blaug, *M.* , Economic theory in Retrospect.
2. Alexander Gray, Evolution of Economic Doctrines.
3. L.H. Haney., History of Economic Thought

4. Eric Roll: A History of Economic Thought.

5. Gide & Rist: History of Economic Doctrines.

--Prof M Sundara Rao.

Unit-4/Lesson 13

A.C. Pigou and Welfare Economics

13.0. Objectives of the Lesson:

The important economic ideas of A.C. Pigou who contributed much towards development of welfare economics are presented briefly in this lesson.

About the Works of Pigou.

A. C. Pigou is known as the father of modern welfare economics, which studies how to make economies operate more efficiently as well as the trade-offs between efficiency and equity. Pigou is also one of the founders of modern public fi nance. This work developed the means to analyze how taxes impact the economy and the justification for government intervention in economic affairs. He began studying history at Cambridge; but in his third year he came under the influence of Alfred Marshall and Henry Sidgwick, who convinced him to study political economy. Like Marshall, Pigou was attracted to economics for its practical value. When Marshall retired from Cambridge in 1908, Pigou succeeded him in the Chair of Political Economy. From then until his retirement in 1943, Pigou was the main expositor of Marshallian economics at Cambridge.

13.1. Externalities –Modern Public Finance:

The main economic contributions of Pigou fall into two broad categories. First, his analysis of externalities provides the foundation for modern public fi nance, environmental economics and welfare economics. Second, Pigou was the first major opponent of the macroeconomic revolution started by Keynes. Pigou's first works in economics were on industrial relations and import duties. These studies led to an interest in how government policy could increase national wellbeing. Pigou raised this general question, and then spent most of his life trying to answer it. In so doing, he invented a good deal of modern public finance, especially the arguments and rationale for government intervention in the economy.

The divergences between private costs and social costs are called ''externalities,'' ''spillover effects,'' and ''third-party effects.'' Pigou stressed that in the presence of externalities the market system is inefficient, and that this might justify government intervention into the market place. Whenever there are large positive externalities, people gain whether or not they pay anything. This ability to obtain the benefits of some good or service without having to pay for it gives rise to what is called ''the free rider problem.'' Each person, looking at things from their own individual point of view, will recognize that if they do not contribute money towards the national defense, a defense system will be built anyway and they will still reap the benefits of greater defense spending.

The problem here is that, when everyone reasons in this manner, no money gets spent on defense and everyone is worse off. The solution to this problem is for the government to improve upon market based outcomes. The government must develop a defense system and must tax all beneficiaries for the cost of its construction. In many cases the government can remedy problems that stem from externalities through taxes and subsidies. But sometimes legal remedies are sufficient to solve the problem. Private and social benefits would thus no longer diverge, and externalities would be internalized, or become part of the cost of transporting goods via rail.

13.2. Social cost-Benefit Analysis:

For some goods, all production costs are borne by the fi rm and passed on to the consumer via the price of the good. Pigou showed that the production costs to a firm may not reflect all the social costs of production. When producers manufacture a good they take into account only their private costs the labor, the raw materials, and the capital that they have to purchase. But production inevitably pollutes the environment, and these costs are paid for by third parties who neither produce nor consume the good. Here the social costs of production exceed the private costs; the firm and the consumer get others to pay part of the cost of producing that good. Market outcomes are not the best possible outcomes in this situation. We get too many goods that pollute the environment; and firms tend to use technology that creates excessive pollution since the costs of pollution are imposed on third parties but are free to the firm. As a result, the market system produces too much polluted air and water, as well as excessive noise and congestion in urban areas.

On the other hand, production can yield benefits to society greater than the benefits received by those consumers who purchase it. Other examples of this sort include police and fire protection, national defense, and spending on health care and education. The individual who purchases a cold remedy benefits because he feels better as a result of taking this medication. But if this medication also makes it less likely that others will be infected, there are greater social benefits than private benefits.

In some cases no government intervention is justified to remedy the problems stemming from externalities. When the costs imposed on third parties are small and the costs of any remedy are large, cost–benefit analysis leads to the conclusion that externalities should be allowed to persist. Pigou asserted that one job of the economist was to identify externalities, and to help eliminate them by showing how and when government action would improve upon market outcomes. He even thought that economists had a moral responsibility to identify externalities. But Pigou was not only interested in eliminating externalities. His main concern was how to increase the economic well-being of a nation. This, he noted, depended on both the size of the economic pie and its distribution.

Pigou's treatment of the distribution of the national dividend is developed, in which the goal of improving distributive fairness is considered from two general perspectives. First, and most indirectly, the potential to alter income distribution through variations in the wage rate is reviewed. Second, the potential to 'directly' alter income distribution through the transfer of funds, from the rich to the poor, is discussed. Specifically, the national minimum provides for redistribution in cash and services to the point where the poor's marginal benefit from the last dollar of redistribution received is equal to the marginal cost from the last dollar of the national income given up to fund the national minimum.

13.3. Views on Welfare Economics:

Pigou set out to examine, first, the full conditions of maximum satisfaction; second, the conditions under which private and social product might be different, so that the maximum would not be achieved under a system of private enterprise; and third, the measures which might be taken to bring the two into equality. In one important respect Pigou's work was fundamentally different from that of his successors in the field of welfare theory. He was primarily concerned with fruit rather than light: with writing a theory of welfare that was applicable in practice. Pigou's definition of maximum economic welfare made it dependent on the average volume, the distribution, and the variability of the national dividend. Any course, he argued, which without compulsion increased efficiency and the volume of the dividend or which increased the proportion of the dividend which was received by poor persons or which diminished the variability of the dividend would increase economic welfare.

The subsequent discussions of welfare theory have started with the problem of the meaning and measurability of utility and that of the validity of interpersonal comparisons and have inevitably led to the difficulties of measuring the national income in welfare terms and defining the circumstances in which it can be said to have increased. In particular, ingenious attempts have been made to identify the cases in which, without any interpersonal comparisons and thus without ambiguity, welfare can be said to have been increased. But even with the addition of the compensation principle, these discussions have tended to leave untouched a large number of real cases in which the poorer may be supposed to benefit at the expense of the richer who will suffer some loss; even the compensation principle does not provide a complete and satisfactory solution.

In this final summing up of his thinking, Pigou argued, first, that satisfactions are not in principle incomparable, even if they are not directly measurable. One can thus attach meaning to marginal changes. But he conceded that one cannot hope to establish absolute magnitudes of total utility or to be able to answer the question whether a tax proportioned to total income will inflict equal sacrifice upon everyone, whatever the size of his income. Second, he turned to interpersonal comparisons and argued that "the utilities enjoyed by different people are not in their nature incomparable. Pigou believed that the economics of policy making was a serious academic study and not merely a politically loaded exercise. Even in the direct area of welfare economics and policy, Pigou's work became more nuanced with the identification of possible corrections of market failure extending to a range of areas beyond fiscal instruments.

More output would increase general welfare, since people desire to have things, and the more things they have the better off they are. Redistributive economic policies would likewise increase general welfare. This conclusion followed from Pigou's belief that the satisfaction derived from money declines as one has more and more money. Another few hundred dollars means little to rich man who is fabulously wealthy, but to someone who is unemployed this extra money may make the difference between life and death. Consequently, the loss of welfare from taxing the rich must be less than the gain in economic welfare from giving that money to the poor. Progressive taxation and transfer programs to aid the poor could thus be justified as improving the overall well-being of the nation. Pigou did recognize that progressive taxes and transfers might reduce the size of the economic pie, and that there could be a trade- off between growth and equity. When there was no trade-off the implications were clear. Anything that increased national output, but did not make the poor worse off, increased national welfare. And anything that increased the share of national output going to the poor, but did not reduce the total size of the output, also increased well-being.

However, when these two criteria clashed the situation was quite different. Judgments would be required about how much output to give up in order to improve the position of the poor. Transfers from the rich to the poor are always made with a leaky bucket, which will lose some of its contents as it redistributes income. The leaking water represents the inefficiencies or the reduced national output due to these transfers. Pigou was not quite as precise, but he did state that sacrificing a little output was worth the gains that come from greater equity.

13.4. Basic Issues relating to Wealth and Welfare:

Wealth and Welfare was the first major book on economics that A. C. Pigou wrote after succeeding Alfred Marshall to the Chair of Political Economy in the University of Cambridge. In the first place Pigou explained the differences between social and private marginal net products arising from imperfect divisibility, to elements of monopoly and similar factors, and to the methods of controlling monopoly and otherwise correcting these divergences; second, it considered methods of remunerating labor and the practicability and desirability of interference to raise the wages of poorer workers. Wealth and Welfare treated rather scantily the whole question of taxation as it involves transfers from the relatively rich to the relatively poor, which later editions of Economics of Welfare treated more fully and systematically. Much of Pigou's work, as far as it relates to monopoly, to pricing policies of public activities, and to wage bargaining, for example, has been so thoroughly absorbed into the present corpus of economic doctrine that it has long ceased to be identified consciously with his name. Antipathy to his conclusions has been much keener and much more continued with regard to his argument that measures to equalize incomes would increase economic welfare. In later editions Pigou slightly modified his actual presentation of the argument for increased welfare with less inequality of income, but the essentials remained the same. He began by assuming that individuals are of similar temperament and anticipating the potential criticism that at present rich and poor are temperamentally different, argued that there is evidence that with greater income equality and with time any differences of temperament and taste would disappear. He satisfied himself, by appeal to evidence based on social inquiries, that the assumption he proposed was a plausible one.

13.4.1. A Framework towards Wealth in relation to Welfare:

Wealth and Welfare is not simply a treatise on the neoclassical approach to welfare economics. Rather, it is a work prepared by a scholar schooled in the moral sciences, with Henry Sidgwick, the Cambridge philosopher and ethicist (and economist), coming to influence Pigou in significant ways as did the British idealism associated with T. E. Green. Firstly Pigou discussed about welfare and the national dividend. He discusses the general relationship between wealth and welfare. Pigou argued that the same is true of welfare, though, notwithstanding this, he asserts that ethics has something to say about what things belong to welfare and writes two general propositions about 'welfare' and the purpose of Wealth and Welfare. First, welfare includes states of consciousness only. Second, welfare can be considered by categories such as 'greater or lesser'. Pigou then presents his taxonomy of what is 'good' by prescribing 'economic welfare' as just one part of 'welfare', the part that directly concerns the 'national dividend' and its allocation. 'Welfare' and 'economic welfare' are broadly correlated, but they are not synchronized to the point where a change in 'economic welfare' necessarily yields an equal change in 'welfare'.

Within that context, Pigou defines economic welfare with reference to social changes which, other things being equal, increase economic welfare in a probabilistic sense. The three social changes that he associates with an increase economic welfare are 'an increase in the size of the national dividend' an increase in the absolute share of the national dividend accruing to the poor and a 'diminution in the variability of the national income, especially of the part accruing to the poor'. The general introductory discussion of the relationship between wealth and welfare makes it clear that a fundamental issue in welfare economics concerns the respective 'harmony' and 'disharmony' between each of the three goals above. Economic welfare is enhanced, at least in a probabilistic sense, when an outcome enhances one or more of these three goals and there is no disharmony with the other goals. For example, economic welfare would be increased if an improvement in distributive fairness has no adverse impact on either wealth-efficiency or macroeconomic stability. But, very significantly, Pigou does not rule out the possibility of an economic welfare improving even in the face of 'disharmony', such as when disharmony is only evident in the short run, all of which complicates the assessment of economic welfare significantly.

13.4.2. Market Failures:

Having noted the potential for disharmony between the various goals of welfare economics, Pigou mainly considers the wealth-efficiency issue in isolation. The analysis is predicated on 'money' being a cardinal indicator of economic welfare. In that context, Pigou relates the greatest magnitude of the national dividend to equality of marginal net products, with his most significant analysis directed towards the investigation of 'hindrances' to that equality. Pigou's notion of 'hindrances' suggests that there will be 'maladjustments' in the movement towards efficient market equilibrium, which have the same general meaning as the modern phrase 'market failures'.

The most enduring contribution of Wealth and Welfare to the study of market failure within a competitive environment concerns Pigou's investigation of 'hindrances' to investment, which introduces the distinction between 'marginal private net product' and 'marginal social net product'. The resulting analysis provided the basis for subsequent analysis in welfare economics concerning the relationship between investment and what became known as 'externalities', which Pigou effectively "made a centerpiece of his Wealth and Welfare". Nevertheless, the theoretical foundation for that analysis derives from his Economic Journal article 'Producers' and Consumers' Surplus', which treats the issue in a more general framework. Specifically, the prominence of the 'net' products from investment in Wealth and Welfare is replaced by a more general emphasis on the market, with the supply price considered with reference to a distinction between 'private marginal supply price' and 'collective marginal supply price', and, the demand price considered with reference to a distinction between 'private marginal demand prices' and 'collective marginal demand price'. In terms of Pigou's more enduring influence on welfare economics, however, it is the specific focus on investment presented in Wealth and Welfare that proved to be the most influential, perhaps because the concept of externalities is more typically considered with reference to supply side market failures – and the associated consequence for over, or under, investment. His prior discussion of externalities caused by demand side market failures was to prove less influential.

The next most discussed 'hindrance' that Pigou addressed in Wealth and Welfare concerns the topic of competition and increasing returns. As in the case of 'hindrance' due to the potential inequality between 'marginal private net products' and 'marginal social net products', Pigou's analysis of 'hindrance' to investment due to competition and increasing returns also derives from his article, 'Producers' and Consumers' Surplus'. Indeed, both these 'hindrances' are analyzed using common tools: Pigou framed supply decisions within a static context to contrast the decisions of an individual supplier with the aggregate industry supply of a good. While this proved effective in isolating 'externalities', in modern parlance, it proved problematic in dealing with goods produced in industries that do not exhibit constant returns to scale.

Pigou gave most attention to the case of industries that exhibit increasing returns but his analysis also extended to diminishing returns. When calculating the supply price, he examines changes in the total supply of the industry, which, as Allyn Young (1913) has demonstrated, had the effect of attributing rents that firms realize from increasing returns to the marginal net product of resource. On that basis, Pigou concluded that taxes and bounties could be considered for industries that do not exhibit constant returns to scale, but the appropriateness of such a policy prescription has not been widely accepted among economist.

Other 'hindrances' to equality between marginal net products under simple competition are also discussed. These include imperfections in the mobility of labour, and differences in the relative variability of labour and 'waiting' in different industries. In addition to the earlier mentioned 'hindrances' to the promotion of wealth-efficiency in a competitive context, Pigou's discussion of the potential to diminish the net national dividend extends to other cases of goods being produced 'by one set of people and sold to another set' such as 'simple monopoly', 'discriminating monopoly', 'monopolistic competition' and 'purchasers' associations'. It should perhaps be stressed, however, that Pigou's discussion of 'monopolistic competition' is not a strict precursor of the seminal work of Edward Chamberlin. Pigou's notion of 'monopolistic competition' concerns predatory pricing. Specifically, in the case of two or more firms, with substantial shares of the market, Pigou reflects on whether or not each of the firms will consider engaging in 'cut-throat' price warfare with a view to eliminating the competition from the market. Specific chapters on special cases are also included, such as public operation of railways and 'purchaser organizations'. He concluded that delimit the potential for public intervention to enhance the wealth-efficiency goal.

13.4.3. Distributive Fairness and Macro-economic Fluctuations:

Pigou's treatment of the distribution of the national dividend analyzes the goal of improving distributive fairness is considered from two general perspectives. First, and most indirectly, the potential to alter income distribution through variations in the wage rate is reviewed. Second, the potential to 'directly' alter income distribution through the transfer of funds, from the rich to the poor, is discussed. The analysis on the 'national minimum' which brings together the earlier analysis of both wealth-efficiency and distributional fairness based on a late utilitarian view of collective wellbeing. Specifically, the national minimum provides for redistribution in cash and services to the point where the poor's marginal benefit from the last dollar of redistribution received is equal to the marginal cost from the last dollar of the national income given up to fund the national minimum.

The treatment of the variability in the national dividend is largely concerned with the effects of macroeconomic fluctuations on wages and wage rates. It is not, in large part, a macroeconomic study, although it includes discussion of some elements of macroeconomics. Rather, it presents a study of the welfare effects of macro-economic fluctuation on the poor, partly achieved by direct consideration of wages income in aggregate. It also includes consideration of the interdependence between variability in the consumption of the poor, which declines during down turns, variability in the employment of labor, with reduced hours of work or complete loss of employment increasing during downturns, and the increases in insecurity and uncertainty that fluctuations engender. But before systematically investigating the above relations, Pigou raised two contextual issues in separate chapters: one being a practical matter – working person's insurance and consideration of whether it should be voluntary or compulsory, the other being a theoretical matter, monetary theory in relation to the 'variability of general prices'. This discussion of monetary theory focuses on the quantity theory of money and price adjustments rather than variations in economic output. General prices are considered in the light of issues like of the supply of 'money', the supply of 'money proper', the elasticity of money supply and the demand for money.

Pigou analyzed how economic fluctuations may alter resources available for the purchase of labor. He also outlined his proposition that variability in the income of the working class is magnified beyond that of the rest of the community because goods consumed by the working class tend to be especially variable in supply. This is complemented by an investigation of economic fluctuations and the effects on the movement of aggregate wages relative to the movement in the wage of the representative working person when the mobility of labor between different locations is limited. Pigou stated about the variability of error in business forecasts', which focuses on forecasting errors that are related to financial activities. Such variations were important to Pigou because they altered expectations and influence investment decisions. "Experience suggests that, apart altogether from the financial ties, by which different business men are bound together, there exists among them a certain measure of psychological interdependence. A change of tone in one part of the business world diffuses itself, in a quite unreasoning manner, over the other and wholly disconnected parts. There comes into play a quasi-hypnotic system of mutual suggestion". To better understand these influences, Pigou reflected on the character of modern industry, the personal qualities of forecasters, the reaction to different forecasts from different forecasters and the 'reproductive power' of errors.

13.5. On Wages and Wage Policy:

The theory of wages and employment is treated extensively across a number of chapters. His objectives and analysis of labor economics here draws significantly from the Principles and Methods of Industrial Peace (Pigou 1905), both of which consider whether an 'artificial' rise in the wage rate beyond its natural level can result in a transfer of resources from the rich to the poor. After reflecting on issues related to the elasticity of demand for labor and the presence, or absence, of differentiated wages for heterogeneous labor within an industry, Pigou's general probabilistic conclusion is that it is unlikely that distributive fairness will be enhanced by altering wage rates, mainly because of the importance of exchange to the economic process. Nevertheless, he does not rule it out altogether. On a related issue, Pigou considers whether high 'artificial' wages are likely to act against the wealth-efficiency goal. Again, in general, he finds this to be the case, especially in the long run, but nevertheless he insists that it is still possible to defend increases in the wage rate for the lowest classes of labor. Having pointed to the significant limits of using wages policy to effect income redistribution, Pigou then considered the possibility of achieving the same end by using direct transfer measures, either by philanthropists or the State. One chapter is devoted to introducing the problem, mainly to remind readers of the interdependence between the goals of wealth-efficiency and distributive fairness. The chapters that follow consider the effects of direct transfer measures on the rich (i.e. the incentive effects of taxation) and the poor.

Despite his many contributions to welfare economics and to public finance, Pigou has probably attained greatest notoriety as an opponent of the Keynesian Revolution that began at Cambridge during the 1930s. Pigou published a popular work entitled. Unemployment which argued that in the long run unemployment was due to inflexible and high wages. Many years later, he argued that reduced demand by businesses for workers would lead to higher unemployment, but that this problem could be remedied if workers let their real wages fall. In the Theory of Unemployment Pigou argued that, if wage levels were greater than the marginal productivity of workers, businesses would not hire anyone since the cost of doing so would exceed the benefits of hiring that worker. Although Pigou never actively advocated wage cuts, in all these cases the solution to the unemployment problem seemed to be a reduction in wages. And it was for this reason that Keynes criticized Pigou.

13.6. Real Balance –Pigou Effect:

Pigou was deeply offended by the General Theory, both for its attacks on himself and its attacks on the Marshallian tradition at Cambridge. Reviewing the General Theory, Pigou accused Keynes of misrepresenting his views, and claimed there was nothing at all of merit in the book. He argued that in his previous work he recognized that expansionary policies could increase prices, thereby reducing real wages and increasing employment in the short run. Pigou later developed his own criticisms of Keynesian economics. He formulated the real balance or Pigou Effect, which described one way that the problem of high unemployment would tend to be self-correcting and not require Keynesian economic policies. Pigou pointed out that prices generally fall during periods of high unemployment because firms cannot sell goods otherwise. As a result, real wealth, or the purchasing power of prior savings, increases during a recession. Being wealthier, people tend to spend more. This additional spending will then spur production, and businesses will hire more workers. Unemployment would thus end automatically and macroeconomic policy was unnecessary.

13.7. Conclusion:

Pigou spent most of his career within the shadows of two giant Cambridge economists, Marshall and Keynes. For this reason, his contributions have seemed small by comparison. While not achieving the stature of either Keynes or Marshall, the influence of Pigou remains large. The way that economists analyze and justify government intervention in economic affairs stems from Pigou. It is for this reason that Pigou became the father of modern public fi nance and modern welfare theory. It is also for this reason that the field of environmental economics rests squarely upon his shoulders. It is not easy to place Pigou in the theogony of economists. Outside the field of welfare economics, one does not instantaneously associate him with any of the major instruments of economic analysis that one uses daily. Modern economics would have been very different without Pigou. Marshall was almost certainly right in thinking that Pigou was the proper successor to create a new disciplined and professional school of analytical economics in Cambridge. Pigouvian economics came from the brain of Pigou and from his reading of published material.

13.8. Technical Terms:

Social Costs

Social Benefits

Externalities

Cost-Benefit Analysis

Welfare Economics

Wealth

Welfare

Efficiency

Distributive Fairness

Macro-economic Stability

Macro Economic Fluctuations:

Wage Policy

Real Balances

Pigou Effect

Market Failures

13.9. Self Assessment Questions:

1. Write about Externalities and Market Failure
2. Examine the importance of Social Cost-Benefit Analysis
3. Discuss the Pigou's Views on Welfare Economics
4. Explain the Basic Issues relating to Wealth and Welfare
5. Analyze the concepts of Macro-economic Stability and Fluctuations
6. Briefly mention Pigou's views on Wages and Wage Policy

13.10. Reference Books:

1. Blaug, M., Economic theory in Retrospect.
2. Alexander Gray, Evolution of Economic Doctrines.
3. L.H. Haney., History of Economic Thought
4. Eric Roll: A History of Economic Thought.
5. Gide & Rist: History of Economic Doctrines.
6. Grenchy, A.G., Modern Economic Thought.
7. Newman, P.C.,The Development of Economic Thought.

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Unit4/Lesson14

J.M.Keynes-The Father of Modern Economics

14.1. Objectives of the Lesson:

About the works of J.M. Keynes

With Adam Smith and Karl Marx, John Maynard Keynes stands as one of three giant figures in the history of economics. Keynes can be viewed as the pragmatic savior of capitalism. Recognizing both the benefits and the flaws of capitalism, Keynes looked to economic policy as a means of mitigating the problems that arise in a capitalist economy. Intelligent government policy could save capitalism, he thought, allowing us to reap its benefits without experiencing its dark side. J.M. Keynes (1883-1946) was the product and pride of Cambridge. After his graduation in 1905, Keynes joined India Office but, after serving there for two years, he returned to Cambridge. Like Ricardo, Keynes, too, gifted with rare combination of qualities of abstraction and realism; he was a pure theorist as well as a practical economist. True to the tradition till the Cambridge School.

Keynes's important works are*:* Indian Currency and Finance (1912), The Economic Consequences of the Peace (1919); Tract on Money Reform. The Economic Consequences of Mr. Churchill (1925); Can Lloyd George (1929); A Treatise on Money (1930); The General Theory of Employment Interest and Money (1936); How to Pay for the War (1940); Of all these the General Theory of Employment, Interest and Money is the most scientific and revolutionary work.

14.2. Macro Economic Approach:

At the theoretical level Keynes developed macro- economic analysis, and macroeconomics as it is taught in colleges and universities today still relies on the concepts and modes of analysis developed by Keynes. Even contemporary macroeconomists opposed to the ideas of Keynes find it necessary to start with Keynes, and then explain the limitations and problems with his theory. At the policy level, the many tools employed by central banks and central governments to help control the business cycle, and the international mechanisms that exist to deal with trade imbalances and financial problems, are primarily due to Keynes.

Keynes's analysis was aggregative analysis. Though Keynes was not inventor of macro-economic method, he recognized the importance of and government stimulus to this method at the time when economists were primarily interested in microeconomics. As an econometrician, Keynes realized that for who wants to solve the problems of mankind, the use of macro concepts is essential. That is why, he developed his analysis in aggregative terms.

Keynes' analysis contains all the steps of an econometric model. They are, the choice of the variables, the choice of the relations assumed between the variables, the determination of the numerical values of the coefficients in the relations between the variables, the solution of the system of equations obtained in the foregoing stages. Keynes gave stimulus to the methodological approach of building verifiable models of economic behavior As a result of Keynes' contribution, econometrics has now become, an inseparable part of modern economics. As Keynes was practical economist, he did not pay much attention to logical niceties and mathematical accuracies.

14.3. Fundamental Economic Ideas of Keynes:

Keynes greatest contribution to economics is his theory of employment which he developed in his General theory. Here is the outline of the theory. Employment = Output = Income. As employment increases, output and income increase proportionately. Volume of employment depends upon effective demand which in turn is determined by aggregate supply function and aggregate demand function. Keynes assumed aggregate supply function to be given in the short period. Aggregate demand function is governed by consumption expenditure and investment expenditure. Consumption expenditure depends upon size of income and propensity to consume. Consumption expenditure is fairly stable in the short-period because propensity to consume does not change quickly. Investment expenditure is governed by marginal efficiency of capital and the rate of interest. Unlike consumption expenditure, investment expenditure is highly unstable. The marginal efficiency of capital is determined by the supply price of capital assets on the one hand and the prospective yield on the other. Prospective yield in turn depends upon future expectations. This explains why the marginal efficiency of capital and hence investment expenditure fluctuates. Rate of interest is a monetary phenomenon and is determined by the demand for money and the quantity of money. Liquidity preference depends upon three motives, they are: transaction motive, precautionary motive and speculative motive.

14.4. Basic Features of Keynesian Theory of Employment:

Keynes begins The General Theory by attacking Say's Law, the view that ‘‘supply creates its own demand.’’ According to this dictum, unemployment was not possible because whatever the existing supply of workers , there will be a demand for these workers. Keynes then proceeded to turn Say's Law on its head, arguing that aggregate or total demand determined the supply of output and level of employment. Whenever demand was high, economies would prosper, businesses would expand and hire more workers, and unemployment would cease to be a problem. But when demand was low, firms would be unable to sell their goods and they would be forced to cut back on production and hiring. If things got very bad, there would be massive layoffs, high unemployment, and a depression. For obvious reasons, Keynes turned next to study aggregate demand and the causes of changes in aggregate demand. Analyzing the two most important components of demand, Keynes developed the modern theories of consumer spending and business investment .

The General Theory of Employment, Interest and Money is Keynes' magnum opus. It is this hook that has effected a revolution in economic thinking. The 'Keynesian Revolution' is not limited to the theoretical economics but also has brought economic policy within its fold. In fact, the immediate purpose of the book was to find a solution to the burning problem of the day. So deep-rooted and wide- ranged is the impact of the 'new economics' that hardly any economic writing or public policy is to be found since the publication of the General Theory that has not been directly or indirectly influenced by Keynes' ideas. Undoubtedly, Keynes' General Theory is one of those few works on economics which has given the subject a new direction.

Keynes was the first to develop a systematic theory of employment. The classical and the neoclassical economists almost neglected the problem of unemployment. They regarded unemployment as a temporary phenomenon and assumed that there is always a tendency towards full employment. No doubt, a number of pre-Keynesian attempts were made to repudiate the unrealistic assumptions of the orthodox economics, but all these attempts were fragmentary and inadequate. It was Keynes who led a vigorous and systematic attack on the traditional theory of employment and replaced it with a more general and more realistic theory.

Keynes' theory of employment is called the effective demand theory of employment because, according to this theory, unemployment arises due to the deficiency of effective demand and the method to remove unemployment is to raise effective demand. Keynes was concerned with the short-run problem of unemployment as he believed that in the long-run, there is no problem; in the long-run, we are all dead. Income and output are the functions of employment and, in the short-run, the three move in the same direction so closely that Keynes, in his analysis, assumed them identical. That is, employment = output = income. With this preliminary background, we now turn to the discussion of Keynes' theory of employment.

14.4.1. The Theory of Effective Demand:

The central problem of the General Theory is : what determines the level of employment ? Keynes' answer is : effective demand. Effective demand is the logical starting point of Keynes' theory of employment. Effective demand simply means desire plus ability and willingness to buy. Effective demand depends upon aggregate demand function and aggregate supply function. Aggregate demand function represents different amounts of money which the entrepreneurs expect to get from the sale of output at varying levels of employment. Or, to put it differently, aggregate demand function reveals planned or intended expenditure at different levels of income. Aggregate demand comprises consumption demand and investment demand. Consumption demand is a function of income, i.e., $C = f(Y)$. As income increases, consumption expenditure increases and as income falls, consumption expenditure falls.

For obvious reasons, Keynes analyzed the causes of changes in aggregate demand. Analyzing the two most important components of demand, Keynes developed the modern theories of consumer spending and business investment Keynes identified two broad determinants of consumer spending subjective factors and objective factors. The subjective or psychological factors affecting consumption were uncertainty regarding the future, the desire to bequeath a fortune, and a desire to enjoy independence and power. Greater fears about one's economic future, a greater desire to leave money to one's children, or a greater desire for independence, would lead to more saving and less spending.

Conversely, a secure economic future, no heirs, and indifference to one's economic independence would reduce savings and increase spending. The objective factors affecting consumption were economic variables like interest rates, taxes, the distribution of income and wealth, expected future income and – most important of all – current income. When interest rates rose, consumers would become reluctant to borrow money in order to buy homes, new cars, and other goods on credit. Conversely, with low interest rates, consumers would freely incur debt and spend money. Likewise, when wealth, current income, or expected future income went up, people would spend more and save less; and with less wealth, less current income, and lower expected income in the future, people would spend less and save more.

Aggregate supply function represents different amounts of money which the entrepreneurs must get from the sale of output at varying levels of employment. Or, stated in a different way, aggregate supply function represents different levels of income which the entrepreneurs will supply at different levels of expenditures (C + I). The aggregate supply schedule indicates that at a given level of expected total expenditure (C + I), exactly equal level of total income will be offered.

The level of effective demand is determined by the intersection of the aggregate demand and aggregate supply functions. Here, two points are to be noted. First, the equilibrium level of income (Y_0) as represented by the condition Y = C + I does not necessarily indicate a full employment level of national income and output. Keynes' main contribution is the

demonstration that less-than-full employment is possible and, in a capitalist economy, this is a normal feature. In such an economy, investment is generally inadequate to fill the gap between income and consumption. Second, Aggregate supply function cannot be manipulated and thus is not of much practical significance in Keynes' economics. Thus, the theory of employment may be more properly called the theory of aggregate demand.

14.4.2. Keynesian Psychological Law of Consumption:

Consumption function simply represents the relationship between income (Y) and consumption (C) and is expressed as C = /(Y), i.e., C is a function of Y. Now, what kind of relationship is there between consumption and income. Keynes gives the reply to this question in his Psychological Law of Consumption, which states : 'The psychology of the community is such that when aggregate real income is increased aggregate consumption is increased, but not by so much as income. This Psychological Law of Consumption contains the following three interrelated propositions : when aggregate income increases, aggregate consumption also increases, but by a somewhat smaller amount; an increment of income will be divided in some ratio between saving and consumption; and both saving and consumption will increase as a result of an increase in income.

Three technical attributes of Keynes' consumption function are to be understood. The first one is Marginal Propensity to Consume (MPC) refers to the ratio of a small change in consumption to a small change in AC , where A denotes a small change. Marginal propensity to consume gives the slope of the consumption curve ? Keynes also referred to the fact that the marginal propensity to consume of the poor is greater as compared to the marginal propensity to consume of the rich. Keynes stated the second important attribute as Marginal Propensity to Save. Marginal propensity to save (MPS) is the complement of the marginal propensity to consume, so that MPC + MPS = I.

Marginal propensity to save is expressed as the ratio of a small change in saving in income as a result of a small change in income over consumption and a change in saving is equal to a change in income minus a change in consumption, marginal propensity to save will be equal to one minus marginal propensity to consume. The third attribute advocated by Kens is Average Propensity to Consume (APC). It is the ratio of absolute consumption to absolute income (C/Y). It tells the level of consumption at a given level of income. Based on the three attributes Keynes' Psychological Law of Consumption technically states that, the MPC is positive but less than unity.

14.4.3. The Concept of Multiplier:

The size of the marginal propensity to consume is a key to the size of the multiplier, another important concept in Keynes' theory of employment. The multiplier tells us how many times the income increases as a result of an initial increase in investment. Given the MPC, the multiplier establishes a quantitative relationship between aggregate income and the investment The multiplier is expressed as K. Thus, if we know either the MPC or the MPS, we can know the size of the multiplier. Greater the MPC, higher the size of the multiplier and lesser the MPC. lower the size of the multiplier. Since, according to the Psychological Law of Consumption, the value of the MPC lies between zero and one, it follows that the size of the multiplier can never be unity or infinity, but remains between these two limits. The working of the multiplier can be understood.

14.4.4. Investment Function:

In contrast to the many factors affecting consumption, business investment depends on just two factors according to Keynes the expected return on investment, and the rate of interest. The former constitutes the benefits from investing in new plant and equipment; the latter constitutes the cost of obtaining funds to purchase the plant and equipment. If the expected rate of return on investment exceeded the interest rate, business films will expand, building new plants and filling them with machinery to produce goods. However, if interest rates exceeded the expected rate of return on investment, that investment will not take place.

Changes in expectations and changes in interest rates lead to changes in business investment. When business owners are optimistic about the economy, they will expect high rates of return on money used to build new plants and equipment. However, when pessimism sets in, business decision-makers expect fewer sales to consumers and think that only if they offer goods at low prices will consumers purchase these goods. In this case, expectations are for meager rates of return on new investment, and little new plant is built.

Keynes next explained determinants interest rates. The interest rate was determined, according to Keynes, in money markets where people and businesses demand money and where central banks control the money supply. The demand for money came from port- folio decisions made by people and businesses they could hold money or they could hold their wealth in the form of stocks, bonds and other assets. By necessity, the supply of money existing in the economy must be held by someone. When central banks increase the money supply they buy government bonds. A bond is merely a promise to pay the person who owns the bond a fixed sum of money at some point in the future. To keep things simple, consider a bond that promises to pay its owner $1,000 one year from today.

Consequently, bond prices and interest rates are inversely related – as one goes up, the other goes down, and vice versa. When central banks buy bonds, this drives up the price of bonds and lowers the rate of return on these assets. On the other hand, when central banks want to reduce the money supply, they must sell bonds. To get people to hold these bonds the central bank must offer them at a low price. Those buying the bonds will thus be receiving a good rate of return on their money, or interest rates will rise.

Private investment, according to Keynes, depends, on the one hand, on the marginal efficiency of capital (MEC), i.e., the return on the capital and, on the other hand, on the rate of interest, i.e.. the cost of investment. If the MEC is greater than the rate of interest, investment will increase; if the MEC is less than the rate of interest, investment will fall; if the MEC is equal to the rate of interest, investment will stop.

According to Keynes the MEC refers to the expected rate of return over cost from the employment of a brand new capital asset. In simple terms, the MEC means the expected rate of profit of a capital asset. The MEC, in turn, depends upon prospective yield from the capital asset, and the supply price of the capital asset. The supply price refers to the cost of producing a new capital asset. The supply price is not the market price at which the capital asset is purchased, but is 'the price which would just induce a manufacturer newly to produce an additional unit of such assets, i.e., what is sometimes called its replacement cost'." The prospective yield means the total returns which an entrepreneur expects to obtain from selling the output of the capital asset over its life-time.

Running expenses are to be deducted from these returns. Thus, the entrepreneur compares the prospective yield with the supply price in order to get an estimate of the MEC. Keynes defined the MEC as follows, define the marginal efficiency of capital as being equal to that rate of discount which would make the present value of the series of annuities given by the return expected from the capital asset during its life just equal to its supply price. In other words, the MEC is the rate at which the prospective yield is to be discounted to make it equal to the supply price.

The schedule of the MEC or the investment demand function represents a functional relationship between the volume of investment and the MEC. The schedule of the MEC is a negatively sloping curve showing that as investment increases, the MEC decreases. Two factors arc responsible for this inverse relationship. If investment increases in a particular capital asset, the prospective yield will fall due to an increase in the supply of that capital asset, and the supply price of that capital asset increases because of the pressure on the resources for the production of that asset.

The above analysis reveal that , the volume of employment depends upon the propensity to consume and the inducement to invest. The propensity to consume is more or less stable. Thus, fluctuations in employment depend upon the inducement to investment. Now, inducement to invest depends upon the MEC and the rate of interest. The rate of interest being relatively sticky, fluctuations in the inducement to invest are mainly due to the variations in the MEC. Of the two determinate of the MEC, i.e., the prospective yield and the supply price, the latter is relatively stable in the short-run. Hence, the ultimate cause of the instability in a capitalist economy is the unstable nature of the prospective yield. The instability of the prospective yield is due to the fact that it depends upon the future expectations which are unpredictable and uncertain.

14.4.5. Keynesian Theory of Interest:

Keynes has developed a monetary theory of interest as opposed to the classical real theory of interest. According to Keynes, interest is a monetary phenomenon and is determined by the demand for and the supply of money. Demand for money means the desire of the people to hold their wealth in liquid form. People have desire for liquidity and interest is a reward for parting with liquidity. The emphasis in Keynes' theory is on the desire for liquidity and not on the actual liquidity. The stronger the liquidity preference, the higher the rate of interest and the weaker the liquidity preference the lower the rate of interest.

The question is : Why do people want to keep cash ? Keynes gave three reasons for holding cash. The first one is Transaction motive which implies that People want to keep cash for their day-to-day purchases. The second one is precautionary motive under which People need ready cash for meeting unforeseen contingencies, such as, illness, accidents, etc. How much amount will be kept in cash for transaction and precautionary motives ? It depends upon the level of income and has nothing to do with the rate of interest.

The third important motive advocated by Keynes was Speculative Motive. Demand for money for speculative motive is directly related with the rate of interest and bond prices. People desire to have money in order to take advantages from knowing better than others about the future changes in the rate of interest . If people feel that the current rate of interest is low and it is expected to rise in future, then they will borrow money at a lower rate of interest and keep cash in hand with a view to lend it in future at a higher rate of interest. Thus, the demand for money for speculative motive will rise. Similarly, if people feel that in future the rate of interest is going to fall, they will reduce the demand for money meant for speculative purpose.

Thus, to conclude, given the level of income, the liquidity preference and the current rate of interest are inversely related. As the rate of interest uses, the liquidity preference decreases and as the rate of interest falls, the liquidity preference increases. An important feature of the LP schedule is that if the rate of interest falls to a very low level (say r), the LP schedule becomes perfectly elastic. It means that at this extremely low rate of interest, people have no desire to lend money and will keep the whole money with them. It further implies that the rate of interest cannot be lowered any more. This feature of the LP schedule has been called the 'liquidity trap.

Supply of money is determined and controlled by the banking system of a country and is interest inelastic. It is influenced by political and not by economic factors. The rate of interest is determined by the intersection between the LP schedule and the supply of money schedule. To sum up Keynes' theory of interest: given the liquidity preference, the rate of interest falls as the supply of money increases and rises as the supply of money decreases, given the supply of money, the rate of interest rises as the liquidity preference increases and falls as the liquidity preference decreases and the rate of interest cannot be reduced beyond the lower limit set by the liquidity trap.

14.5. Theory of Business Cycles

Keynes stated that the relationships between money, prices, and unemployment which singled out the saving–investment relationship as the main cause of economic fluctuations. According to Keynes, when people attempted to save more than businesses wanted to invest, businesses would soon find themselves with excess capacity to produce goods and too few buyers for the goods they produced. On the other hand, when investment exceeded saving, there would be too much spending taking place in the economy. Consumers would be spending rather than saving, and businesses would demand more workers to produce goods and more workers to build plants and equipment. All this spending would bid up wages as well as other costs of production, and also increase the price of all consumer goods. Inflation would be the natural outcome.

The problem, Keynes stressed, was that savings decisions and investment decisions were made by different groups of individuals. As a result, there was no guarantee that the two would be equal. Keynes then argued that it was the responsibility of the central bank to keep these two variables equal to one another, and thus the responsibility of the central bank to prevent inflation and recessions. If savings exceeded investment, the central bank would need to lower interest rates, thus both reducing savings and stimulating borrowing. On the other hand, if investment exceeded savings, the central bank would need to raise interest rates, thus increasing savings and reducing borrowing for investment purposes.

Keynes did not develop a theory of business cycle. His theory of employment provides a general explanation of the cyclical nature of the changes in employment. According to Keynes, the real cause of the business cycle lies in the variations in the rate of investment which, in turn, are caused by the fluctuations in the MEC. Future expectations play an important role in explaining why the MEC is subject to violent fluctuations. The multiplier accounts for the cumulative nature of expansion and contraction and the Psychological Law of Consumption explains the turning points of the cycle. The first phase of business cycle is mentioned as Expansionary phase. In the expansionary phase, the atmosphere of optimism prevails, expectations of profits are bright, and the MEC is rising. Under such an optimistic atmosphere, investment increases rapidly. This expansionary movement becomes cumulative because of the operation of the multiplier. Soon the economy reaches the peak of boom. At this stage, certain unfavorable forces emerge, leading to a fall in the MEC. During the expansionary phase, the costs of production begin to rise due to the scarcities and bottlenecks of labor and materials. Increasing abundance of output tends to lower the returns below expectations.

As a result of these two forces, the MEC falls and a the second phase of the business cycle contraction movement starts, which soon becomes cumulative because of the reverse working of the multiplier. But the phase of contraction will not go on forever. There also appeal certain economic forces which cause the MEC to revive. The wearing out and obsolescence of the existing machinery raises the demand for new machinery. The excess stock of other goods also get exhausted as time paws. During the third phase, which is stated by Keynes as the state of depression, the prices and labor costs also fall. All these forces tend to raise the MEC and promote business activity. In this way, the upward movement begins.

Keynes' most important contribution to the theory of business cycle is the explanation of the turning points of the cycle. Keynes attributed the upper turning point to the fact that consumption expenditure does not increase us last as income. Similarly, the lower turning point is explained by the fact that as income falls, consumption falls less than proportionately. Thus, the MPC less unity sets the lower limits to the downward movement of output and employment.

14.6. Keynesian Economic Policies:

Keynes' General Theory has two objectives, The first one is theoretical and the other one is practical. The theoretical objective is to demonstrate the possibility of less-than- full employment situation, the practical objective is to suggest a line of action to deal with such a situation. Keynes regarded unemployment as a great social evil and unemployed people as a national liability. He pointed out that in a capitalist economy, unemployment, and not full employment was a normal situation. But, as a remedial measure, Keynes did not suggest a complete reconstruction of the capitalist society on socialist pattern. The difference between Marx and Keynes is that while the former intended to replace capitalism by socialism, the latter wanted to preserve and reform capitalism. Keynes only wanted that the evils of capitalism and not capitalism itself, should go. Keynes' theory of employment indicates the following practical program for solving the problem of unemployment.

14.6.1. Monetary Policy:

Keynes views on Monetary Reform warned of the dangers of inflation. It looked to central bank control of the money supply as a means of stabilizing the price level and keeping inflation under control. This work also contained Keynes's famous and misunderstood dictum ‘‘in the long run we are all dead.’’ Many have taken this phrase to mean that Keynes was willing to sacrifice long-term economic performance for short-term economic benefits. Yet this is not at all what Keynes was driving at. Keynes meant to criticize others who believed that the problem of inflation would eventually remedy itself, without any active government involvement. To the contrary, Keynes felt that, rather than waiting for inflationary problems to correct themselves in the distant future, it would be better to employ economic policy and improve things now. His point was that there was no reason to wait for elusive future gains, when more rapid progress could be made solving economic problems by intelligently employing economic policies.

Keynes turned his attention to these new problems. A Treatise on Money examined in detail the relationships between money, prices, and unemployment. Keynes singled out the saving–investment relationship as the main cause of economic fluctuations. According to Keynes, when people attempted to save more than businesses wanted to invest, businesses would soon find themselves with excess capacity to pro- duce goods and too few buyers for the goods they produced. On the other hand, when investment exceeded saving, there would be too much spending taking place in the economy. Consumers would be spending rather than saving, and businesses would demand more workers to produce goods and more workers to build plants and equipment. All this spending would bid up wages as well as other costs of production, and also increase the price of all consumer goods. Inflation would be the natural outcome.

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Second component of aggregate demand is investment. From the discussion of Keynes' investment function it becomes clear that not much can be done either to raise or to stabilize private investment. Private investment may be increased by raising the MEC or by reducing the rate of interest. It is difficult to predict or control MEC because it depends upon future expectations. In fact, the uncertainties in the MEC are responsible for fluctuations in private investment, which, in turn, causes fluctuations in employment. So much depends upon lowering the rate of interest. Rate of interest is determined, on the demand side, by liquidity preference and, on the supply side, by the quantity of money the banking authorities of a country. The banking authorities can fix of interest by increasing the supply of money. This will promote private motive and thus increase employment.

But Keynes did not consider the cheap money policy a reliable one. A tall in the rate of interest will be ineffective if the MEC is too low. After all, the monetary authorities can only make money available to a businessman at a cheaper rate, but cannot compel him to increase investment if he is pessimistic about the future prospects of the business.

14.6.2. Taxation Policy:

Since the problem of unemployment is due to the deficiency of effective demand, the remedy lies in raising effective demand. Effective demand depends upon aggregate demand and aggregate supply. Aggregate supply being given in the short-period, the only way to increase employment is by increasing aggregate demand. Given the economy's total income, its consumption expenditure can be increased by increasing its propensity to consume. Now, Keynes suggested that propensity to consume can be raised by redistribution of income from the rich to the poor. Such a re-distribution of income can be achieved through progressive taxation.

14.6.3. Policy of Public Investment:

This is especially surprising since Keynes was interested first and foremost in economic policy. He supported both monetary policy and fiscal policy. Keynes writes about the need for more houses, hospitals, schools, and roads. But he notes that many people are likely to object to such ‘‘wasteful’’ government spending. The approach of money creation was therefore necessary. Keynes calls for ‘‘a somewhat comprehensive socialization of investment.’’ While many have taken him to be advocating government control of all business investment decisions, what Keynes really advanced was government spending policies to stabilize the aggregate level of investment in the national economy .

Keynes believed that consumer spending was relatively stable, and changed little from year to year. Changes in business confidence or expectations about the future of the economy would change the level of investment and would have a major impact on the economy. Moreover, self fulfilling prophesies were likely to be at work. When businesses were confident about the economy, they would invest more and the economy would expand. This boom would reinforce expectations about profits, and lead to even greater optimism and investment. On the other hand, expectations about a poorly performing economy would lower investment, slow economic activity, and reinforce and strengthen business pessimism about future profits. As a result of all this, when optimism took hold the economy would boom, but when pessimism set in there would be dramatic declines in investment and massive unemployment.

Keynes' solution was to have government stabilize the level of investment. When private investment was low, the government should borrow money and engage in public investments such as building new roads and bridges as well as spending more money on schools and better education. This would expand the economy as well as improve expectations. In contrast, when business investment was high due to great optimism, government should stop borrowing, repay its past loans and cut back on its public investment. The 1940s found Keynes again working for the British government. He also returned to policy issues surrounding the war effort.

Keynes laid maximum emphasis on public investment because of the unstable nature of private investment. He suggested that government can remove unemployment by starting public works and utilizing the unemployed there. Employment in this case will increase many times because of the operation of the multiplier. But the method of increasing employment is also not without qualifications. Public expenditure will increase income and employment by multiple times only if it is a new expenditure if this new expenditure has no adverse effects on the existing expenditure; and if there are no changes in leakages and in the size of the multiplier. So, great care has to be taken in financing the public works.

From the above discussion, one may get the impression that Keynes was a depression economist; that Keynes' economics provides solution to the problem of unemployment and has nothing to do with inflationary conditions. But such a view is wrong and misleading. Keynes' General Theory is applicable to all kinds of situations depression as well as inflation. If, in depression, the problem is to raise aggregate demand, in inflation, the problem is to reduce aggregate demand. The measures to fight inflation are: to redistribute income in favor of the rich; to raise the rate of interest through dear money policy and to reduce public expenditure.

14.7. Conclusion:

The General Theory of Employment, Interest and Money of Keynes has been responsible for the development of a whole branch of macro economics. It was the most referenced and debated work in economics during the twentieth century. The work itself is both an attack on the predecessors of Keynes, and a theory of what determines the amount of production and employment in a country. Although the book says very little about economic policy, it provided the theoretical foundation for government policy action to end the Depression that was plaguing virtually every country in the 1930s.

The revolution in economic policy was not that Keynes' recommendations were new, nor that they had universal application, but that they originate from a consistent macro economic theory. The practical conclusions of this theory are. Due to inherent flaws of capitalism, a competitive economy cannot automatically attain full employment level. State has to play an important and active role if the objective of full employment is to be achieved. Keynes' practical advice is that if capitalism is to be saved, then the existing system of inequalities must be replaced by a more egalitarian system through 'a somewhat comprehensive socialization of investment'.

14.8. Glossary

Macro Economics

Employment

Effective Demand

Psychological Law of Consumption

Multiplier

Investment Function

Interest

Business Cycles

Monetary Policy

Fiscal Policy

Taxation

Public Investment

14.9. Self Assessment Questions

1. Explain the Fundamental Economic Ideas of Keynes
2. Discuss Basic Features of Keynesian Theory of Employment
3. Write about Keynesian Psychological Law of Consumption
4. Analyze the importance of Keynesian Investment Function
5. Examine the Keynesian Theory of Money and Interest
6. Briefly mention about the Keynesian Economic Policies

14.10. Books for further Study:

1. Blaug, *M.* , Economic theory in Retrospect.

2. Alexander Gray, Evolution of Economic Doctrines.

3. L.H. Haney., History of Economic Thought

4. Eric Roll: A History of Economic Thought.

5. Gide & Rist: History of Economic Doctrines.

--Prof. M. Sundara Rao.

Unit-4/Lesson-15

Economic Doctrines of Joseph Schumpeter

15.0. Introduction:

Schumpeter born in 1883, started his career as a theoretical economist and then moved to economic sociology and historical studies in later life. From the beginning of his academic life Schumpeter had a wide range of interests in history, sociology, and economic theory. He had already begun sociological studies in 1912, when he published his theoretical work on economic development. Schumpeter immigrated to the United States to become a professor at Harvard University, where he remained until his death in 1950. In his American period, Schumpeter wrote his later trilogy: Business Cycles (1939), Capitalism, Socialism and Democracy (1942), and History of Economic Analysis (1954a). Having developed the pure theories of statics and dynamics, his next tasks were, first, to analyze the historical process of capitalist economic development, and, second, to diagnose the future trend of the economic, social, and cultural system of capitalism.

Schumpeter is regarded as one of the greatest economists of the twentieth century, ranking with John Maynard Keynes, who was born in the same year. As economists and sometimes as rivals, they were equally concerned with the instability of capitalism, such as inflation and deflation, business cycles, and unemployment, in the early 1900s. Neoclassical economics, the mainstream economics of the day could not explain business cycles and unemployment because it addressed static equilibrium with full utilization of economic resources. To solve the problems of that period a new theory had to be constructed on a new basis. Hence Schumpeter shown the growing interest in the long-tem development of capitalism has drawn attention to technological innovations, institutionalism, and evolutionism. His rich vision of the long-term and wider perspective has certainly given a stimulus to broadening the scope of economics.

15.1. Pure theory of Statics and Dynamics:

Insofar as society is seen as composed of individuals and their interactions, we must start with some conceptions of individuals. The conception of the agent as a rational utility maximizer based on fixed preferences has occupied a central place in mainstream neoclassical economic theory and is often labeled as economic man. Various criticisms have been raised of the notion of economic man: for example, holism against individualism, altruism against egoism, and irrationalism against rationalism. But, from the viewpoint of instrumentalist methodology, the realism of the assumptions should not matter; the conception of man should depend on what problems are to be addressed. Schumpeter's problem was to explore a new horizon of dynamic economics vis-à-vis static economics. For this purpose, he proposed to define the dynamic man in contradistinction to the static man in such a way that the dynamic man was innovative, whereas the static man was adaptive to given conditions. He called the static man "hedonistic" and the dynamic man "energetic." This is the most orthodox approach to methodological individualism in view of other dynamic approaches to saving-investment relations, monetary disturbances, period analysis, disequilibrium analysis, and expectations.

Schumpeter's idea of the dynamic man has some affinity with contemporary sociological thought. Schumpeter's originality was twofold: first, he applied the sociological dichotomy to the basic assumptions of the static vs. dynamic system by the rhetoric of *antithesis*, and second, he applied the dichotomy not only to economic area but also to all other areas by the rhetoric of analogy. For Schumpeter, a general equilibrium in economic statics was not a fiction but the logic of an economy that formulates the consequences of the adaptive behavior of ordinary economic agents responding to their exogenously given circumstances. He regarded economic statics as the Magna Carta of economic theory in the sense that economics should be established as an exact and autonomous science on the basis of economic statics. Economic statics is applied to the process of circular flow, in which the economy repeats itself year after year, with its size and structure remaining constant under given conditions. According to Schumpeter, economic growth based on an increase in population and capital can also be explained by economic statics because these changes are exogenous.

By an analogy with economic equilibrium, he assumed the presence of static order in other areas of social life such as politics, science, art, and morality and explained static states by reference to the adaptive behavior of ordinary people. His unique view was that the dynamic phenomenon in the economic process is brought about by a destruction of the previous equilibrium by forces from within the economy, i.e., by the innovations of entrepreneurs. He also argued, using an analogy with economic dynamics that such dynamic phenomena occur in other areas of social life, also by innovators' destruction of the existing order. If innovators succeed in introducing a new way of life to specific areas, the direction in which the general public will follow is set, and they become the leaders in these areas. Adaptive behavior is to statics what innovative behavior is to dynamics; just as a static state in any area is characterized by the average man following conventions and customs, so is a dynamic state marked by a leader who has enough energy and will, foresight and creativity to introduce innovations. The entrepreneur in the economic area is a special kind of leader.

15.2. Ideas Relating to Social Evolution through Interactions:

Schumpeter's second fundamental idea was the evolutionary development of society through interactions between various social areas. This was his response to the Marxian challenge of historical materialism, which viewed historical processes as unilateral relations from production processes as the substructure of society to political, social, and cultural processes as the superstructure of society through the pivotal position of the class structure of capital and labor. For Schumpeter, social class also occupied an important place in evolutionary development as a whole, but his conception of social class was not confined to the economic area but consisted of more open social dynamics derived from leadership formation in various social areas. Although he mentioned the notion of comprehensive socio-cultural development, his actual work was confined to the two social areas; economic and noneconomic, the latter referring to a way of thinking, social values, and the *Zeitgeist.* This division of the two areas preserved the Marxian influence of the super- and substructure concepts. The basic idea of Capitalism, Socialism and Democracy is that capitalist economic development driven by the innovation of entrepreneurs will make the Zeitgeist of society anticapitalistic and this in turn will gradually create a social atmosphere in which it is more difficult for innovations to occur.

If it were possible to analyze comprehensive socio cultural developments comprising various social areas, more important results would be obtained from the Schumpeterian apparatus. Social class has the function of weighing and integrating various social areas, in which successful leaders ascend to the top of a society. In the past, such areas as economy, politics, religion, and the military played important social roles, according to which a hierarchy was established among the social classes of the various areas to create a social order. The determinant of the hierarchy is called "social value," meaning the aptitude for fulfilling socially necessary functions in a specific historical situation. Social values, which weigh and integrate social classes into a hierarchical system, and the Zeitgeist, which is the ideological expression of the hierarchy, characterize the nature of a society as a whole. It is possible that social values and the Zeitgeist will conflict: Schumpeter's famous thesis on the fall of capitalism is reduced to the argument that the social values demanded by capitalism and the Zeitgeist produced by capitalism may collide. This collision, in turn, is reduced to the antinomy between heroism and rationalism, each being derived from the definition of the dynamic and static man, respectively. If an analysis could be extended to specific interactions between major social areas such as the economic, political, religious, intellectual, and military spheres, one would address the prospect of changing social values and of shifting the locus of innovative human resources after the fall of capitalism or the system of economic dominance.

15.3. Importance of Economic theory and History:

Now let us turn to the third basic idea of Schumpeter's research program: the notion that institution is intended to achieve the synthesis of theory and history. This was his response to the Methodenstreit between theory and history and opened a new frontier to the theoretical analysis of history. Schumpeter believed that history is much more important than theory because "the subject matter of economics is essentially a unique process in historic time". The concept of institution is a means of generalizing historical events, but it is generally limited due to its historical relativity. Thus, it can be conceived of as a compromise between the generality meant by theory and the individuality meant by history. Both economic sociology and the sociology of science, with their focus on the concept of institutions, lump together all factors exogenous to the proper areas of economy and science in a convenient grab bag of institutions.

It is the core proposition of institutional economics that institutions and individuals constitute an action-information loop. Institutions are social norms, consisting of laws, morality, and customs. Institutions offer information on normative rules to individuals, and actions of individuals, in turn, provides institutions with habitual behaviors. Schumpeter sometimes called the institutional totality simply the Zeitgeist that exists outside the economy. Therefore, the action-information loop between institutions and individuals presents another picture of the interactions between economic and noneconomic areas. Institutional economics and economic sociology provide complementary approaches to the goal of a comprehensive sociology.

It is generally recognized that Schumpeter accomplished excellent work on the history of economics, but his system of metatheory, which comprises the history of economics as a part, is little known. I find in Schumpeter's writings a set of metatheories with three layers that can be regarded as the counterpart of his set of substantive theories on the economy. Metatheory is a theory about theory. Just as his economic studies contain three layers, i.e., economic statics, economic dynamics, and economic sociology, his studies on science have three parallel layers, i.e., statics of science, dynamics of science, and sociology of science. In the common usage, the first one is called the methodology of science, which is concerned with the static structure and rules of science; the second, the history of science, which deals with the dynamic development of science; and the third, the sociology of science, which views scientific activities as social phenomena. It is natural that a strong structural parallelism exists between the systems of substantive theory and metatheory because the same methods of observation are applied to the two areas of social life, i.e., economy and science; the same methods will permit analysis of static equilibrium, dynamic development, and interactions with other social areas, respectively.

Schumpeter's methodology of science was developed in his first book itself. Since his contribution to economics is considered to be in the realm of dynamic theory, his no-less-important work on static theory has not received the attention it deserves. Even the fact that this book is about methodology is not generally known. Schumpeter ingeniously applied to economics the instrumentalist methodology and phenomenalist epistemology developed at the end of nineteenth century by natural scientists such as Ernst Mach, Henri Poincare, and Pierre Duhem. Instrumentalism is the view that theories are not descriptions but instruments for deriving useful results and are neither true nor false. Unlike the present-day narrow view of instrumentalism, useful results of theories, for Schumpeter, should be interpreted broadly to include not only the generation of predictions but also the classification, organization, and explanation of observable phenomena and guides for action. If theories are instruments in this sense, it is useless to ask whether they are true or false; it is only possible to ask whether they are useful for certain purposes. Therefore, the realism of assumptions in a corpus of theories does not matter.

The Methodenstreit was concerned with the explanatory primacy of historical vs. theoretical methods, or inductive vs. deductive methods. But this cannot be a genuine issue of debate because both methods are indispensable depending on the problems involved. The genuine issue was not methods but problems to be pursued. Whereas the Historical School focused on the economics of institutions and evolution, the Neoclassical School claimed the economics of utility and prices. In constructing a scenario on the historical development of economics, Schumpeter applied the same patterns of thought as established between statics and dynamics of the economy. He introduced the concept of the "classical situation" as a device of periodization in history; defining it as "the achievement of substantial agreement after a long period of struggle and controversy the consolidation of the fresh and original work which went before" later termed the same situation the establishment of a "normal science." Once the classical situation is established, scientists are engaged in the production of potential scientific results under a new paradigm; this is compared with a stationary economy that is repeating itself on a fixed channel with a constant scale and structure.

Dynamic phenomena in science involve a scientific revolution and its aftermath; parallel to innovative entrepreneurs in the economy, innovators in science challenge traditional paradigms by introducing new ideas and new theories. The formation of schools in science is compared to the clustering of imitators who follow the innovators. Revolution and synthesis are the two moments in scientific development. Developments in science, according to Schumpeter, do not proceed in a linear fashion in which the past achievements are carried over to the future so that scientific knowledge grows cumulatively. Important creative ideas are sometimes left behind the mainstream that gains power by caprice and chance. Thus, developments in science are not a logical process but a proper subject of the sociology of science, the third branch of metatheory. For Schumpeter, the subject of the sociology of science was twofold: schools and vision. The formation of schools is an important strategy in establishing the "classical situation."

Along with the concept of the classical situation, which concerns the mechanism of revolution and ensuing synthesis, Schumpeter put forward another concept of the filiations of scientific ideas, one that produces a theoretical reformulation of neglected ideas. Through discourses with past history, fragments left in the shadow of that history will revive as a vision to guide the formation of new theories. This form of filiations in history emerges from a combination of vision and theory that takes place over time.

Against the background of his fundamental ideas, it will be realized that Schumpeter's theory of economic development marks only the midpoint in his journey. But, at the same time, it should be remembered that this theory contains a core of the whole scheme. So let us examine its structure. There are three key words. The first is innovation, the cause of economic development. Innovation covers the introduction of a new product, a new method of production, the opening of a new market, the acquisition of a new source of supply, and the reorganization of an existing industry. The second key word is entrepreneur, the subject of economic development or the agent of innovation. Because innovation requires foresight and originality, resolution and action, innovators are rare. If one succeeds in introducing a change, he can get entrepreneurial profits. The third element is bank credit, the means by which the entrepreneur accomplishes innovation. In economic statics, there is no room for the essential role of money to command economic resources.

15.4. Schumpeter's Theory of Economic Growth:

Before Schumpeter was thirty years old, he had laid the foundation for his theory of economic growth in The Theory of Economic Development, first published in 1912 and translated into English in 1934. A brilliant conception, it has lain almost dormant because it is so broad based that it does not lend itself to the economic model building that has been the vogue in mainstream economics for some fifty years. Tobin comments that Schumpeter's theories of development and business cycles were difficult to incorporate into the style and method that came to dominate economics, especially American economics, over the past fifty years. Ironically, Schumpeter was a strong proponent of the greater use of mathematics in economics and econometric testing of hypotheses, the areas in which he was at a comparative disadvantage.

Schumpeter's explanation of the process of economic growth does not fit into the orthodox doctrines, because he stressed the noneconomic causes of growth. Though he examined some strictly economic factors, he insisted that the principal elements in the past growth of the system and the elements that will reduce growth in the future are noneconomic. He essentially accepted Say's Law, although he recognized and analyzed the fluctuations in economic activity under capitalism. To him depressions were self-correcting, and there could be no equilibrium at less than full employment. Where Marx had seen depressions as a manifestation of the contradictions in the system that lead to its ultimate collapse, Schumpeter considered depressions beneficial to the system; they were an integral part of the entire process of economic growth. Growth was tied to the prosperity stage of the cycle, because this phase represented the ultimate outcome of the introduction of new products and technology into the economy. But excesses develop as credit is over expanded and businesses overextend themselves. The resulting depression is beneficial in that it shakes out the economy, removing managed, efficient firms. The less efficient firms, and thereby prepares the way for a growing economy of healthy, well-

But the principal agents of economic growth are noneconomic, according to Schumpeter, and are to be found in the institutional structure of the society. Schumpeter attributed to the activities of what he called entrepreneurs the tremendous growth that took place in the industrialized world. An entrepreneur to Schumpeter is not just a businessperson or manager; this person is a unique individual who is by nature a taker of risks and who introduces innovative products and new technology into the economy. Schumpeter clearly distinguished between the process of invention and that of innovation. Only a few farsighted innovative businesspersons are able to grasp the potential of a new invention and exploit it for personal gain. But their gain is the economy's gain. After the introduction of a successful innovation by the entrepreneur, other businesspersons will follow suit and the new product or technology will spread throughout the economy. The real source of growth in the economy, therefore, is found in the activities of the innovative entrepreneur, not in the activities of the mass of the business community, who are risk-averting followers.

Therefore, economic growth is fostered by an institutional environment that rewards and encourages the activities of entrepreneurs; early capitalism, with its private property and laissez-faire government, was ideally suited to economic growth. Insofar as it stresses the importance of incentive and laissez-faire government, this part of Schumpeter's analysis is in theoretical and ideological accord with the classical theory of growth; but where classical theory stressed the economic factor of the size of capital accumulation, Schumpeter emphasized a noneconomic, cultural, sociological factor in his analysis of the role of the entrepreneur. The contrast between this view of growth and that of mainstream neoclassical economics was stated succinctly by Schumpeter: What we are about to consider is that kind of change arising from within the system which so displaces its equilibrium point that the new one cannot be reached from the old one by infinitesimal steps. Add successively as many mail coaches as you please, you will never get a railway thereby.

Still more novel are Schumpeter's observations about the future growth and development of capitalism. Where Marx had predicted that the demise of capitalism would proceed from its contradictions, Schumpeter speculated that its end would be the product of its success. He was an ideologically conservative economist who had a somewhat romantic vision of the growth of the economy as proceeding from the daring deeds of swashbuckling entrepreneurs. He wished to see the continuation of this process, yet he expected capitalism demise of the entrepreneur and, to a lesser extent, the greater role of the intellectual as the society became more affluent. The successful entrepreneur will promote the growth of a large firm that will eliminate by competition the less efficient, risk-averting firms in an industry. But the large firm will soon become risk-averting and cautious and will be run by bureaucratic committees, not by innovating entrepreneurs. The bureaucratized giant firm will then eliminate the entrepreneurs and replace them with "prudent" managers. As the hired managers replace the entrepreneurs, ownership of the large corporation will become an absentee ownership.

Schumpeter believed that once the giant firm has eliminated many of the small, owner operated firms; a large part of the political support for capitalism will have been removed. The success of capitalism will destroy, moreover, the old conception of private property and the willingness to fight for it, Schumpeter contended. Once the entrepreneur is gone, the paid manager and the stockholders will no longer defend the concept of private property. Their attitude will also prevail among the working class and public at large. "Eventually there will be nobody left who really cares to stand for it, nobody within and nobody without the precincts of the big concerns. Again, the success of capitalism will speed this process, for the increases in income and wealth produced by capitalism will permit the growth of an intellectual group in the society who wield the power of the spoken word and who have "no direct responsibility for practical affairs. The success of capitalism will permit these intellectuals to live off the fruits of the system but, at the same time, to criticize it. They will radicalize the labour movement; although they will not usually run for public office, they will work for and advise the politician. Occasionally, they will become part of the government bureaucracy, but most importantly, with the ever-increasing growth of mass communication, they will be able to disseminate throughout the society a discontent with and resentment of the institutions of capitalism.

Schumpeter envisioned the end of the system he loved approaching slowly but surely. He feared that with the demise of the entrepreneur and the end of laissez faire, government would intervene more and more in the economy. Some, like Keynes, welcomed this intervention as a way of saving capitalism, but to Schumpeter, it was a sign of the imminent end of capitalism. Because of what he called "Evaporation of the Substance of Property" and the end of the entrepreneur, Schumpeter predicted that the dynamic element in the economy that accounted for its past growth would disappear. Schumpeter received some acclaim, but not from significant mainstream economists. For Schumpeter, all capitalist economies had two prominent characteristics they were unstable, and they experienced rapid growth. Schumpeter sought to analyze and understand these features of capitalism.

15.5. Theory of Innovations and role of Entrepreneur:

Schumpeter saw invention and innovation as the driving force behind long-run cycles. In times of slow economic growth, businesses would not likely introduce new innovations. As a result, new discoveries and innovations would pile up for several decades. When rapid economic growth finally begins, the stockpile of innovations gets employed in the production process and economies grow rapidly. Schumpeter regarded the Industrial Revolution, which introduced the steam engine, the spinning jenny, and other discoveries, as the beginning of one long-term economic expansion. Railroad construction in the mid-nineteenth century began a second Kondratieff wave. In the early twentieth century, electricity, automobiles, and chemicals sparked a third Kondratieff wave.

In his early work, Schumpeter held that invention was determined by noneconomic forces and could not be understood through studying economics. In later work, Schumpeter held that innovation was shaped by economic forces inside the large firm. But throughout his life, Schumpeter refused to believe that innovation was a rational activity; instead he thought it was a creative activity that could neither be explained nor understood as the result of rational thinking processes. The agent of innovation and invention was the entrepreneur.

Unlike many of his contemporaries, Schumpeter did not believe that entrepreneurs merely hired resources in order to produce goods and meet consumer demand at minimum cost. Rather, like Cantillon, he thought that entrepreneurs were individuals willing to take risks. As such, they were the key force causing capitalist economies to grow. When there were many entrepreneurs, capitalism would thrive; on the other hand, if the entrepreneurial spirit was destroyed or severely hindered, capitalism would quietly transform itself into socialism. For entrepreneurs to succeed, Schumpeter held that they had to mold and shape consumer tastes. In contrast to other economists, who saw firms responding to consumer tastes, Schumpeter held that ‘‘the great majority of changes in commodities consumed has been forced by producers on consumers who, more often than not, have resisted the change and have had to be educated up by elaborate psycho techniques of advertising’’. Consumer preferences do not lead to production and innovation, rather, innovation leads to new goods and services that consumers either reject or develop tastes for.

Invention and innovation by the entrepreneur was the driving force behind long-run economic cycles, according to Schumpeter. Invention, backed by bank credit, leads to innovation and growing prosperity. This soon attracts imitators, and the original innovation leads to economic prosperity. But imitators are always less effective than innovators, and many arrive too late in the expansion cycle. Miscalculation and tighter credit will push some fi rms into bankruptcy, and lead to recession or depression. But these bankruptcies also weed out inefficient firms, thus correcting the errors of the past expansion. Inventions accumulate during the contraction, when entrepreneurs cannot find the funds to convert them into new products and processes. They remain dormant, but are available to start a new cycle of growth when the time is right and the economy begins to rebound.

In Capitalism, Socialism and Democracy, Schumpeter adopted an even broader perspective on economic change. Rather than examining the cyclical changes that a capitalist economy goes through, he examined the very future of capitalism.. In essence, he thought that Marx was right in believing that socialism would replace capitalism. However, rather than being destroyed by its failures, as Marx predicted, Schumpeter believed that capitalism would be destroyed by its many successes. Schumpeter thought that creative destruction was one main reason for the success of capitalism. Capitalism is not only about successful innovation, it is also about destroying old and inefficient processes and products. This replacement process makes capitalism dynamic and causes incomes to grow rapidly. Problems arise, however, because smaller firms are constantly being replaced by larger firms. Through this process, managerial bureaucrats, rather than innovative entrepreneurs, come to run the firm. These managers are employees rather than owners. They prefer a steady income and job security to innovation and risk-taking. As a result, capitalism loses its dynamic tendency towards innovation and its spirit of continual improvement and change.

Schumpeter also saw potential problems stemming from the fact that capitalism requires rational calculation and logical decision making from all participants. This leads people to develop a skeptical and critical frame of mind. In addition, because capitalism is so successful at increasing incomes, it can support a large number of middle class intellectuals. With much free time on their hands, these individuals will criticize the capitalist system and push for measures that enhance the economic role of government bureaucrats. Resentment against the income inequalities that make capitalism possible will also be strong among intellectuals, and they will push for measures that try to keep incomes equal. These actions also will reduce the incentive to take risks and innovate.

Finally, Schumpeter thought that capitalism undermines the family. Capitalism is all about satisfying individual wants, while the family requires sublimating one's desires and compromising. If everyone just focuses on satisfying their own wants, it is hard to see how long-term relationships can last. One such relationship, the family, is important for capitalism because it is a main reason for saving. Families save so that, if anything happens to the main breadwinner, other family members will be provided for. By under- mining the motivation to save, capitalism destroys its own foundation – the capital needed for future growth. Long-term economic growth has always been a central economic concern. The main contribution of Schumpeter has been to redirect the attention of economists to the issue of long term economic growth. In so doing, he stressed the importance of noneconomic factors like innovation and the entrepreneur for a healthy, thriving, and growing capitalism.

15.6. The Theory of Business Cycles:

Schumpeter was one of the fi rst economists to study business cycles, the regular fluctuations that economies experience. He identified three different cycles occurring simultaneously. First, there were short-run fluctuations of three to four years, which Schumpeter called ''Kitchin Cycles,'' after economist Joseph Kitchin who first discovered them. These cycles were due to changes in business inventories. For one to two years, businesses would expand their inventories in order to keep ahead of rising sales. But when the growth of sales slowed, inventories would begin to pile up in ware houses. As a result, businesses would cut back production for a year or so in order to reduce their inventory backlog. When inventories finally returned to more desirable levels, and sales picked up, businesses would again seek to expand their inventories.

A second cycle was associated with changes in business investment in new plant and equipment. These cycles lasted eight to eleven years, and Schumpeter called them ‘‘Juglar Cycles,’’ after Clement Juglar who first discovered them. Usually when people speak of ‘‘the business cycle,’’ they refer to these economic fluctuations. Expansions lasting four to five years, Schumpeter thought, were due to the desire of businesses to expand and modernize their capital equipment. But after most businesses have expanded and modernized, they have little need for new investment. Consequently, spending on plant and equipment is cut back during the next four or five years. Over this period, capital equipment becomes worn out and outdated, thus setting the stage for another investment boom of four to five years. Finally, there are long-run cycles, or Kondratieff waves, lasting 45 to 60 years. Schumpeter named these cycles after Russian economist Nikolai Kondratieff, who first noticed them but could not explain what caused them.

15.7. Conclusion:

Schumpeter had a grand vision of a universal social science and that his writing is characterized by broad rhetorical knowledge as distinct from scientific knowledge. Schumpeter argued the important relationship between theory and vision. In my view, it is impossible to recognize the nature of Schumpeter’s contributions to economics without paying attention to the rhetoric that was an instrument to express his imaginative vision. For Schumpeter economics was all about change. He studied both short-run economic fluctuations and the long-run tendencies of capitalism. In these studies he identified the phases and causes of business cycles. He also examined the factors contributing to the rise and decline of capitalism.

15.8. Glossary:

Statics

Dynamics

Social Evolution

Social Interactions

Economic theory

Economic History

Economic Growth

Capitalism

Socialism

Democracy

Institutionalism

Innovations

Entrepreneurs

Business Cycles

15.9. Self Assessment Questions:

1. Write about the pure theory of Statics and Dynamics
2. Examine the Ideas Relating to Social Evolution
3. Discuss the Importance of Economic theory and History
4. Briefly analyse the Schumpeter's Theory of Economic Growth
5. Explain the Schumpeter's Theory of Innovations
6. Analyze the features of Schumpeter's Theory of Business Cycles

15.10. Books for further Study:

1. Blaug, M., Economic theory in Retrospect.
2. Alexander Gray, Evolution of Economic Doctrines.
3. L.H. Haney., History of Economic Thought
4. Eric Roll: A History of Economic Thought.
5. Gide & Rist: History of Economic Doctrines.
6. Grenchy, A.G., Modern Economic Thought

- ---- Prof. M. Sundara Rao.

Unit-4/Lesson 16

Veblon's Institutionalism

16.0. Introduction:

Institutionalism as a system of thought, which is quite a recent phenomenon, developed only in the first half of the present century. The new system is purely of American origin and was founded by Veblen with the publication of his work. The Theory of Leisure Class (1899); it was further strengthened by the publication of his second book, Instinct of Workmanship and the State of Industrial Art (1914). Thorstein Veblen, was one of the sharpest and wittiest critics of orthodox economic theory. His criticism of traditional theory, and his own positive contribution to economics, stressed the impact that societal institutions have on individual behavior. Veblen saw behavior as driven by customs, by habit, by envy, and by other psychological dispositions, rather than seeing individuals as motivated by rational self-interest. Veblen then used these behavioral dispositions to explain the changes economies regularly undergo

16.1. Significance and Relevance of Institutionalism:

Institutional economics analyzes the role played by the institutional factors in economic life. Habits, customs and other social, cultural, economic and political arrangements all influence economic activities. According to institutional economists, economic problems must be studied with a broad social and political framework. They regard the economy as an open system and human action as basically dependent upon institutional arrangements which are continually changing. Thus, human behavior and economic system, along with its processes, such as, production and distribution, derive their purposes and principles from factors traditionally considers! exogenous and, therefore, excluded, from the enquiry.

Institutionalism has its impact on economic thought and also has greatly influenced economic policies of the modern world. Similarly, institutional economics can be of great help in analyzing and solving various contemporary problems, such as social inefficiencies and social costs of unused capacity and unemployment, increasing disparities between rich and poor countries, and the changing nature of international economic relations, etc. Institutional economics is essentially a movement against the orthodox economics and advances a body of theories which, in form and content, represents an antithesis of pure economies. According to the classical and neoclassical economists, human actions are guided by rational and enlightened self-interest, and economic activities are governed by universal laws. Nature was considered superior to man and the laws of nature to man made institutions.

The economists belonging to institutionalism believed that economic activities are governed by instincts, habits and institutions. According to them, economic problems arc actual problems related to the complexities of realities. Economic analysis, therefore, must not be based on the pure laws of economic n which work under a given institutional framework, but must maintain a close relation with the observable reality. Economic theory, according to unorthodox economists, is an ideal type theory derived rationally from a *prior* generalizations. On the contrary, according to them, economic theory is a real type and gestalt theory, it serves as a guiding principle designed in define the problems to be investigated, to determine the questions to In- asked, to ascertain the facts of the situation and to establish the scientific truth about causal relations. As against the concept of static equilibrium of the orthodox economists, the institutional economists recognize the existing maladjustments in the economic order and realize the necessity of efforts towards planned evolutionary rearrangement of economic life. While unorthodox economists were mere theorists, the institutional economists with reformers.

There are two schools of thought relating to institutional economists, who are categorized as older and younger. The older institutional school includes Veblen, Mitchell, while the younger institutional school is formed by the younger generation, like. W.E. Atkins, W.H. Hamilton and others. The older school is mainly concerned with the description and analysis of maladjustments of economic life; it is more critical. The younger school, on the other hand, is chiefly, concerned with adjustments of economic life through social institutions, it is more positive in approach.

16.2. Basic and Fundamental Ideas of Institutional Economics:

Institutional economics considers the socio-cultural framework, such as value orientations, customs, tastes, technology and techniques, and their obsolescence as well as the domestic and international distribution of power as true variables of strategic importance in social evolution, economic development, and social causation. Institutional economics considers conflict, coercion, individual or group domination, and public power as typical phenomena and directly relevant to the explanation of relative prices as well as aggregate price levels. Institutional economics, in harmony with its concept of the economy as an open system, views human action and motivation as typically dependent upon man's concrete socio-cultural environment. Institutional economics rejects as a false analogy the assumption of any basic tendency in economic affairs toward self-correction and stable equilibrium. Instead, it advances the hypothesis of cumulative social causation.

Institutional economics treats actual rates of economic development in different societies as socially conditioned by institutional arrangements concerning land use, pre-dominant value-orientation, and the market calculus, which determine the extent to which a country's disposable surplus is devoted to unproductive consumption or to productive investments. Institutional economics broadens such basic concepts as wealth, production, costs, and utility by including various social benefits and dis utilities which diffuse themselves throughout society at large, because they are not fully appreciable by individual producers and single consumers and hence, not exchangeable, and which remain inadequately accounted for in entrepreneurial accounts and private allocation and investment decisions.

Institutional economics estimates the performance of an economy in terms of objective criteria of social efficiency rather than standards of judgement in which indifferent forms of social organization tend to lustily their respective performances. Social efficiency. optimality, and social balance are judged in terms of pragmatic and social criteria rather than formal or subjective standards. Institutional economics considers it necessary and legitimate for the social scientist to appraise the quality of life and human relations which are characteristic or different forms of economic organization In this respect too, it continues in a tradition of critical dissent. Institutional economics differs from pure economics in its willingness to project past and present trends of social evolution into the future and to analyze the implications of such dynamic social forces as science, technology, conflict and coercion on economic life, and socio-political organization.

As a whole, institutional economics has two aspects, negative and positive. In its negative aspect, it is critical of the rational deductive approach of the classical and neoclassical economics. In its positive aspect, it emphasizes the importance of human instincts and habits in influencing the economic activities. Institutionalism has its impact not only on the economic thought, but also on the public policy.

16.3. Veblen’s Contributions towards Development of Institutionalism:

Veblen was one of the eminent critics of orthodox economic theory. His criticism of traditional theory, and his own positive contribution to economics, stressed the impact that societal institutions have on individual behavior. Veblen saw behavior as driven by customs, by habit, by envy, and by other psychological dispositions, rather than seeing individuals as motivated by rational self-interest. Veblen then used these behavioral dispositions to explain the changes economies regularly undergo. Veblen’s economics was nearly as quirky as his lifestyle. While other economists studied human behavior from their ivory towers, Veblen studied human behavior within the context of anthropology and other social sciences. For Veblen many forces influenced human behavior, and he brought these other forces into his economic analysis. As such, he sought to broaden and enrich economics with the insights from other disciplines.

Veblen is known as the father of institutional economics. In his ideas, he was an innovator and non-conformist. Using the insights from other social sciences, Veblen rejected the economic assumption that much behavior was rational and that people sought only their own pleasures. Instead, he saw people as behaving irrationally and following customs and habits rather than maximizing utility. In fact, Veblen turned traditional economic analysis upside down, arguing that human institu- tions and experience help determine what people believe to be pleasurable and painful. Veblen is best known for his first book, a work that instantly made him famous. The Theory of the Leisure Class (Veblen 1908) rejects the traditional view of consumption as a means to human happiness, and rejects the view that individuals look inside themselves to determine the happiness that they would receive from consuming different goods. In its place Veblen develops a cultural theory of consumption. Habit, convention, and superstitious irrationality all determine human consumption. His other works are : The Instinct of Workmanship and the State of the Industrial Arts (1914); Imperial Germany and the Industrial Revolution (1915), Inquiry into the Nature of Peace (1917), The Higher Learning in America (1919), The Vested Interests and the State of Industrial Arts (1919), The Engineers and the Price System (1921), Absentee Ownership and Business Enterprise in Recent Tunes, the Case of America (1923).

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16.4. Veblen’s Critical Ideas on Existing Schools of Economic Thought:

Veblen was highly critical of the existing economic theories, particularly developed by the classical, neoclassical and Marxian theories. His main points of criticism are: Veblen criticized the procedure, assumptions and contents of neoclassical economics. According to him, the neoclassical economics was too formal, too deductive and too static to provide answer to the problems that really mattered in economic life. The neoclassical economics is statistical in character. It provides no theory of a movement of any kind, since it basically deals with the adjustment of values to a given situation. It provides no explanation for the genesis, growth, sequence, change process, or the like in economic life. It neither gives the causes of change, nor unfolds the sequence of the phenomenon of economic life. The neo-classical economics not only accorded low priority to dynamic factors in economic life, but it was almost oblivious to the analysis of change. It is, in fact, not capable of dealing with the phenomenon of change, since it is teleological in character. The neoclassical economists do not admit arguments leading from cause to effect while forming their theories, and, as such, the neoclassical theory is not drawn in causal terms.

According to the neoclassical economic thought, man is considered as a rational human- being and he is an economic man. Human conduct is explained in terms of hedonistic calculus. Human-beings have been assumed to respond rationally to the stimulus of anticipated pleasure pain. Veblen, on the other hand, maintained that human action was more instinctive than reflective. In his interpretation, social conduct is influenced by two major drives: the instinct of workmanship and the instinct of emulation**.** The infirmity of the neoclassical theoretical system lies in its deductive system of analysis. Most of the neoclassical conclusions are derived rationally from the generalizations of naturalistic philosophy. The fundamental assumption of the neoclassical economics is the assumption of natural right of ownership. The neoclassical conclusions are drawn through the method of sufficient reason, whereas, Veblen's conclusions are derived from the method of efficient cases. The procedure of sufficient reason runs from the future to the present and it is solely of an intellectual, subjective, personal and Ideological character. The procedure of efficient cause runs from the present to the future, and is solely an objective, impersonal and materialistic character.

After condemning the validity and applicability of the assumptions and the procedures of the neoclassical economics, Veblen rejected all the basic propositions of neoclassical economics. For example, the neoclassical view was that the consumers would normally buy more of a commodity at lower price and less at a higher price. But, according to Veblen's view, the considerations of emulation and conspicuous consumption might, in some cases, produce opposite result; luxury goods, for example, considered as status symbol, might actually be purchased in less quantities when their prices fall. Similarly, the fundamental proposition of the neoclassical theory, was that labor involved disutility. Veblen held the opposite view that because of the instinct of workmanship man obtained positive satisfaction from productive effort.

Similarly, according to the neoclassical economists, the proper area of inquiry for the economic theorist was the formal analysis of the allocation of resources under the static equilibrium conditions. According to Veblen, on the contrary, the main aim of the economic theorist was the investigation of the destabilizing effects of changes in tastes and technology. Veblen considers neoclassical school at one with the classical economics and both suffering from the same defects. Both are teleological and neither can admit arguments from cause to effect. Neither can deal with phenomena of change. He criticized the classical political economy on the ground that it is founded on the philosophy of beneficial natural order. Its laws are based on the fundamental assumption that there is a tendency for the things "to work out what the instructed common sense of the time accepts as the adequate or worthy end of human effort."

Though Veblen was also critical of the Marxian economics, in spite of disagreements, both Marx and Veblen had certain similarities: Like Veblen, Marx also attacked the hedonistic and utilitarian foundations of classical economics. He too rejected the economic man as the basic dictum in the classical analysis of economic process. Both Marx and Veblen belongs to institutionalism, with the difference that while Marx's approach was materialistic, Veblen's basic concern was human motives. Veblen developed a theory that is primarily concerned with human motives and instincts. On the other hand, Marx never theorized on the subject of instincts and motives. He, on the contrary, developed a theory in which private property and its changing forms and the state and its changing forms are the main categories. Thus, although Veblen was the founder of institutional school, Marx's theory was truly institutional, and Veblen's theory was not.

Generally both Marx and Veblen were considered as economic determinists because both believed that social, cultural and economic institutions were determined by economic factors. Both maintained that non-economic forces greatly influence the economic life. Both Marx and Veblen recognized the existence of class conflict in the capitalist society. While Marx believed that exploitation arises in the form of profits of the capitalists when the workers produce over and above the cost of their existence. Veblen on the other hand, held the view that, owing to its wasteful tendencies, the capitalist system exploits the entire society. It is the ownership rights of the capitalist class in the commodities and materials, and not the commodities and materials themselves, that lead to exploitation.

16.5. Veblen's Positive Ideas and Contributions to Economic Thought:

Some of the positive contributions made by Veblen for the development of institutionalism are briefly presented in this part of the lesson.

16.5.1. Importance of Institutions:

The positive contribution of Veblen was his emphasis on the importance of the institutions in economic life and economic progress. He believes that the entire civilization as a scheme of the institutions. Veblen defined institutions in psychological or ideological terms as the habitual, conventional modes of human behavior. In other words, institutions are made up of the biological instincts and reflexes and they are the result of conditioning and habituation. According to Veblen, it is the human behavior that ultimately develops into institutions. The present institutions are the result of the continuous process of cultural development taking place for the last so many centuries. Thus Veblen was basically concerned with those phenomena which in Marxian terminology are religious, aesthetic, literary, etc. He was mainly interested in the processes which accompany the working of the present economy, in the rationalization of behavior which it produces and in the habits of thought in which it is enshrined.

Analyzing the capitalist system, Veblen points out that industry and business are the two fundamental institutions of capitalism. Around these two institutions, several other small institutions, like competition, private properly, banks, money, etc., have developed. All these institutions are developed on the basis of habit", of thought and followed the evolutionary process. Veblen believed that the evolutionary process of institutions would continue and the social institutions would change with the changing habits of the society. He, however, admits that besides thinking habits, factors, like population, idle curiosity, physical environment, race mixing, climatic conditions, etc. also influence the growth of institutions.

Veblen was highly critical of the institutions of pecuniary and opposed the wasteful behavior of the leisure class. Veblen's institutionalism and evolutionary economics, which rest on economic conflict and change, is more relevant to the problems of modern world rather than the theories of equilibrium economists. The greater relevancy of Veblen's institutional economics is derived from its central theories of economic conflict and change. Besides, closing the gap between theory and practice, Veblen's evolutionary economics gives a futuristic slant to economic thought.

16.5.2. The Theory of Business Enterprise:

Veblen's positive contribution to economic theory is found in his book The Theory of Business Enterprise. Here he discusses the conflict between two opposing forces, *i.e.,* between 'industry' and 'business'. By industry Veblen means machine process which includes the technical methods used in producing goods, the relations of these methods to each other in factories and the habit of thought which is formed while working with machines and directing their operations. Development of industry refers to developmental technology or the material improvement of the productive process. Through us reasoned procedures, standard measurements and intellectual arrangements, the machine process provides an outlet for the instinct of workmanship. As a result, cost of production falls and production becomes more efficient.

According to Veblen business or business enterprise means two ways of thinking of the business community which is far removed from the machine process. The businessmen have made pecuniary gains ;is their solo Him and lest everything by that criteria. They are interested not in making goods, but in making money. Their speculative activities lead to economic waste, unemployment and depressions. They are undesirable elements in the society because they live on the labors of others and indulge in anti-social activities.

Similarly Veblen stated that, the basic cause of class conflict lies in the cultural lag and not in the conflict between the forces of production and the social relations of production as believed by Marx. The development of technology, which is the result of efforts of inventors, engineers and workers, is the most potent cause of change in institutions. Technological improvements, by changing the way of performing the material operations of living, makes certain habits and modes of thought (institutions) out-of-date and stimulates the creation of new ones. Here lies the powerful cause of class conflict. Thus, class conflict in the modern times is manifested in the opposition between industry and business. Business represents the ways of thinking of the business community whose behavior is guided by pecuniary considerations, while industry represents the ways of thinking of the engineers, inventors and the workers whose behavior is guided by the instinct of workmanship.

16.5.3. Analysis of Trade Cycle:

According to Veblen, business activities were the root causes of the business cycle. Businessmen borrowed money based on their expectations of future profits. This borrowing increased economic activity and prices, leading to higher profits. With their expectations confirmed, businessmen would form even more optimistic views of future profits. And with things going so well, businesses could borrow more and make even more money. At some point, however, unease about continued profits would arise and some businessmen would see the possibility of making money in a contraction. Loans would be called in, small businesses would start to go under, and a recession would follow. Stagnation would then continue until businessmen saw enough opportunities for greater profit and were willing to borrow and expand their operations. In sharp contrast to other economists writing on business cycles in the early twentieth century, Veblen saw no tendency for the economic system to equilibrate. Rather, he saw unending instability and oscillation. Any analysis of how economies reached equilibrium was therefore unscientific, according to Veblen. For economic analysis to be scientific, it had to focus on the evolutionary changes of institutions over time rather than on the way an economy moves to a static equilibrium point.

Veblen stated that, business fluctuations are the result of business enterprise. The businessmen, in their effort to maximize profits tend to indulge in excessive use of loan credit and to adopt such measures which lead to the curtailment of production and reduction in efficiency. During prosperity, profits and prices are rising. The captains of industry borrow large amounts of money with a view to expand their business and thus to earn more and more profits. In the later stages of prosperity, profits decrease and prices cannot be increased further, while on the other hand, labor and material costs rise. All this makes it difficult for the businessmen to secure loans and they become uneasy and nervous. The pressure by the creditors on the businessmen for the return of loans gives the final blow. Consequently, the big businesses collapse and the crisis begins.

Veblen also stated that the businessmen not only produce economic crisis through their excessive use of loan credit in business, but also attempt to intensify and perpetuate the crisis by engaging in the capitalistic sabotage. In order to maximize their profits, the businessmen tend to fix the prices and control the supply, and, thereby, put restrictions on the efficiency of engineers and technicians. The engineers and technicians, guided by their natural impulse to produce, to create and to innovate, seek to expand output without limit. But, their efforts are frustrated by businessmen, who led by the fears of declining capital values, make all efforts to restrict output well below the technologically feasible levels.

16.6. Veblen's Prominent Theory of Leisure Class:

The Theory of the leisure Class was the Veblen's first and the most popular book which was published in 1899 and was reprinted in several editions. The main argument of Veblen's theory of the leisure class as a whole can be considered that as the society advances beyond its primitive stages and men accumulate a surplus beyond their immediate needs, they have the tendency to use this surplus not for living in a wise and intelligent manner, but for impressing their neighbors with the fact that they have a surplus. The capitalist society is divided into two classes, with conflicting interests. The first one is the leisure class belongs to the upper and superior ranks of the society. This class is aggressive and is made up of the owners of property. The behavior of this class is marked by the pecuniary culture. The leisure class is distinguished by its pecuniary emulation, conspicuous waste, conspicuous consumption and pecuniary canons of taste. Veblen criticizes the pecuniary considerations of the leisure class. The other class is the Working Class. The working class belongs to the lower and inferior ranks of the society. This class works hard to produce the necessities of life. The workers envy the leisure class and often strive to imitate its habits.

Veblen stated that the leisure class is distinguished by its pecuniary emulation. The main motive which leads the men of leisure class to accumulate wealth is the motive of pecuniary emulation or the desire to excel in pecuniary standing. In other words, the main incentive to acquisition and accumulation is the desire to rank high in comparison with the rest of the community in terms of pecuniary strength and so gain the esteem and envy of one's fellowmen. This desire of everyone in the leisure class to excel everyone else in pecuniary standing is chronic.

16.6.1. Distinctive Features of the Leisure Class:

Veblen analyzed that, the desire for accumulation of wealth has no end. If the motive to accumulate were the want of subsistence or of physical comfort, then the aggregate economic wants of the community might conceivably be satisfied at same point in the advance of industrial efficiency. But since the motive involves a struggle for reputability on the basis of an invidious comparison, there exists no method by which the definite attainment of such a motive is possible. The term individual comparison refers to the process of valuation of persons in respect of their worth. The invidious comparison can never become favorable to an individual he will rate himself usher relatively to his competitors in the struggle for pecuniary reputability. The invidious comparison thus, leads the individual to live in chronic dissatisfaction with the present lot.

Another distinctive feature of the leisure class is the preference for conspicuous leisure. The members of the leisure class abstain from productive labor and conspicuously lead a life of leisure before the eyes of others who are to be impressed by that spectacle of honorific leisure. The term 'leisure' as used by Veblen, does not mean indolence or quiescence. It means non-productive consumption of time. Time is consumed non-productively from a sense of unworthiness of productive work and as an evidence of pecuniary ability to afford a life of idleness.

According to Veblen, the pecuniary struggle has different effects on different groups of the society. It makes the ordinary lower classes industrious and frugal. This applies to the laboring classes whose ordinary means of acquiring goods is productive labor. The upper classes regard labor as a symbol of inferiority. Therefore, they tend to abstain from productive labor and prefer leisure. The individuals in these classes, no doubt, have incentive to diligence and thrift, but their actions are more guided by the secondary demands of pecuniary evolutions. From the very beginning, labor has been associated in men's habits of thought with weakness and subjection to the master. It is, therefore, considered as a mark of inferiority and comes to be accounted unworthy of superior men. As a result of this tradition, labor is felt to be debasing and this tradition still continues.

Veblen also stated that in order to gain esteem of men, it is not sufficient merely to possess wealth or power. The wealth or power must also be put in evidence because esteem is awarded only on evidence. The evidence of wealth, on the one hand, serves to impress one's importance on others, and, on the other hand, keeps his sense of importance alive and alert. A life of leisure and abstention from labor are the readiest and most conclusive evidence of pecuniary strength. Abstention from work is not only an honorific and meritorious act, but at present it has also become a requisite of decency. Greater degree of leisure has always been recognized by thoughtful men as a pre-requisite to a worthy or beautiful, or even a blameless, life.

According to Veblen, another characteristic feature of the leisure class is the conspicuous consumption as an evidence of wealth. According to the conventional scheme of consumption, the base and industrious class; should consume only what may be necessary for their subsistence. The leisure class, on the other hand, should use of luxury und comfort commodities. Since, the consumption of more excellent goods is an evidence of wealth, it becomes honorific. And, conversely, the failure to consume such items in due quantity and quality becomes a mark of inferiority and demerit.

Veblen pointed out that the growth of ceremonial differentiation of qualitative excellence in eating, drinking, etc., in modern times affects not only the manner of life, but also the training and intellectual activity of the gentlemen of leisure. He is no longer simply the successful, aggressive male, *i.e.,* the man of strength, resource and intrepidity. He must also cultivate his tastes. In other words, he must develop the aesthetic faculty in consumption, *i.e.,* he must learn to discriminate between the noble and the ignoble in consumption. Thus, closely related to the requirement that the gentleman must consume freely and the right kind of a good, there is the requirement that he must know how to consume them in good manner.

16.6.2. Issues relating to Conspicuous Consumption:

Another important purpose of consumption, according to Veblen, is to impress others. Veblen called this ''conspicuous consumption.'' He then went on to provide an historical account of this phenomenon. He demonstrated that in early, predatory cultures unproductive consumption was a mark of human prowess and dignity. In more modern cultures, conspicuous consumption involves various sorts of ostentation – giving valuable gifts to others, driving expensive sports cars, and arranging expensive and extravagant feasts. These acts provide evidence of one's wealth and importance. Even in lower economic classes, conspicuous consumption can be demonstrated through a spouse who stays at home and does no work for remuneration in the marketplace.

The doctrine of conspicuous consumption undermines the traditional view of economic man. Money is not spent because it yields utility to the individual consumer. Rather, the doctrine of conspicuous consumption holds that consumers spend money in order to make their friends and neighbors jealous, and to keep up with the spending of their friends and neighbors. Economy would move towards a stable equilibrium, Veblen attempted to understand and explain the changes he saw taking place in the real world. Towards this end, Veblen distinguished business activities from the machine process, and analogously the capitalist from the engineer. The business enterprise for Veblen was run by capitalists who were only interested in making profits. The capitalist was a predator, interested in making money rather than goods. Goods could be useless and of poor quality, but as long as money was being made nothing else was important.

Veblen stated that the serviceability of conspicuous consumption as a means of repute and decency is at its best in those portions of society where the human contact of the individual is widest and mobility of population is the greatest. This is the reason why, the conspicuous consumption claims a relatively larger portion of the income of the urban population. Consumption constitutes a larger element in the standard of living in the city than in the village.

While pointing the wasteful expenditure made by the leisure class, Veblen stated that the important implication of the conspicuous expenditure, whether of goods or of services or human life, is that it is an expenditure of superfluities or waste. In order to be reputable, the expenditure must be wasteful. The term 'waste', as used by Veblen in his analysis of conspicuous expenditure, should not be taken in an odious sense, implying an illegitimate expenditure. The expenditure made by the leisure class is no more or no less illegitimate expenditure than any other expenditure. This expenditure is called 'waste' because it does not serve human life or human well-being on the whole, and not because it is waste or misdirection of effort or expenditure as viewed from the standpoint of the individual consumer who chooses it.

From the viewpoint of the individual consumer, the question of wastefulness does not arise because whatever form of the expenditure he chooses and with whatever motive he makes this choice, it gives him utility simply by virtue of his own preference. The question of wastefulness is related to the welfare of the society as a whole; expenditure of the leisure class is wasteful because it does not serve directly to improve human life on the whole. Conspicuous leisure and conspicuous consumption both are conventionally accepted as equivalents in many ways. Both are methods of demonstrating the possession of wealth. Both are means of reputability to the gentlemen of leisure class. Both contain element of waste; in the case of conspicuous leisure, it is a waste of time and effort; in the case of conspicuous consumption, it is a waste of goods. Both the methods are equally effective and serve equally well during the early stages of social growth.

The leisure class is also distinctly characterized by pecuniary canons of taste. Their various canons of taste have been colored by the canons of pecuniary reputability. The members of the leisure class possess special taste for personal or feminine beauty and articles of aesthetic beauty in the objects of use. The articles used by the leisure class should not only be beautiful but also satisfy the sense of novelty, *i.e.,* these articles should show ingenuity of design and should puzzle the beholder. The canons of taste are primarily the canons of expensiveness. The members of the leisure class disapprove an inexpensive manner of living because it indicates their inability to spend much, and thereby, indicate a lack of pecuniary success. Cheap things are intrinsically dishonorable or unworthy because they are cheap.

16.7. Conclusion:

Veblen was one of two or three best known American economists in the early twentieth century. He attempted to give economics greater breadth by bringing to it the insights from other social sciences. More specifically, he showed how habits, culture, and institutions mould human behavior, and how changing human behavior affects the economy. As a result of this work, Veblen has become the intellectual father of the institutionalist school of economics.

16.8. Glossary

Institutionalism

Institutional Economics

Critical Ideas

Positive Ideas

Business Enterprise

Trade Cycle

Leisure Class

Working Class

Conspicuous Consumption

16.9. Self Assessment Questions

1. What is Institutionalism? Give the basic features of institutional economics
2. What are the critical ideas of Veblen on existing schools of Economic Thought?
3. Write about the Contributions of Veblen for the development of Institutionalism.
4. Examine Veblen's views on Leisure Class.
5. Discuss Veblen's analysis relating to conspicuous consumption.

16.10. Books for further Study:

1. Blaug, M. , Economic theory in Retrospect.
2. Alexander Gray, Evolution of Economic Doctrines.
3. L.H. Haney., History of Economic Thought
4. Eric Roll: A History of Economic Thought.

5. Gide & Rist: History of Economic Doctrines.
6. Grenchy, A.G., Modern Economic Thought.
7. Kapp, K.W. and Kapp, L.L., History of Economic Thought.
8. Newman, P.C., The Development of Economic Thought.
9. Veblen, T., The Theory of Leisure Class; The Theory of Business Enterprise

--Prof. M. Sundara Rao.

M.A. ECONOMICS: EVOLUTION OF ECONOMIC DOCTRINES

LESSON-1/UNIT-5

ECONOMIC THOUGHT IN ANCIENT AND MEDIEVAL INDIA

- KAUTILYA AND VALLUVAR

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M.A. ECONOMICS: EVOLUTION OF ECONOMIC DOCTRINES

LESSON-1/UNIT-5

ECONOMIC THOUGHT IN ANCIENT AND MEDIEVAL INDIA

- KAUTILYA AND VALLUVAR

1.1. OBJECTIVE OF THE LESSON

In this lesson, the economic thought in ancient and medieval India is taken up for discussion. In ancient India, the economic ideas provided in Kautilya's Arthasastra and Valluvar's Thirukkural are explained. After that, the medieval Indian economic thought is discussed.

1.2. INTRODUCTION

India is a country with rich cultural heritage since the time immemorial. India has a vast repository of knowledge in the form of Vedas, Upanishads, Brahmanas, Smrities, Neeti Sastras, Dharma Sastras, Epics and other ancient religious books. They are very comprehensive of par excellence having no parallels in the history of mankind. The history of economic thought of India can be gathered from these sources of knowledge. In these sources, politics and economics are blended together, just like ancient western economic thought. The socio-economic and political life was so intertwined that compartmentalization into different branches of study particularly of economic thought was made impossible. On the other hand, Literature in Sanskrit had enjoyed a greater patronage in ancient times in India. Though India was subject to frequent invasions by foreign powers starting from Alexander to Moghals and to the Europeans, the ancient Indian knowledge and cultural values were ever relegated to background. This is because the ancient knowledge is an ocean of economic ideas and the depth of which is fathomless. Not only is that, the Indians mostly habituated to non-materialistic ideas regarding the material prosperity. The economic ideas of ancient India were overshadowed by religion and philosophy, just like ancient western economic thought. These are guided by four principles of moral conduct, namely, Dharma, Artha, Kama and Moksha. The ethical and moral values have made the people not to think in terms of economic thought as a separate subject of study. The non-materialistic life of people of India also did not permit the development of systematic economic theories. The ancient thinkers of India were concerned with the practical economic problems and their solutions. As such, theoretical economics did not appear on the scene. However, Kautilya's 'Arthasastra' is the best recorded evidence of Indian economic thought which was written in the 4^{th}century B.C. It contains not only economic ideas, but also political diplomacy known as 'Chanukya Neeti'.

Economics as an intellectual discipline did not enjoy independent existence till the later part of the 19^{th} century. On the other hand, in Western Europe, the societies were under capitalistic mode of production which caused for the systematic inquiry into economic institutions leading to the development of economic theories. In this context, the British economists mostly held a sway in the theoretical development of economics. Therefore, the views of ancient Indian seers and sages, the philosophy of Manu, Sukra, Narada, Yagnavalkya, Vidura, and Kamandaka, and the practical philosophy of Kautilya all have tremendous influence on the socio-political and economic life of people of ancient India.

The Indian economy in ancient times was simple though it was far developed compared with contemporary economies of the world. Accordingly, the economic ideas could not attain the status of a science. Hence, it is an admixture of Dharmasastra and Arthasastra in Arthasastra. There was nothing like an inquiry into the rationale of existing economic system and institutions. The main concentration was on effective utilization of known resources without any wastage. In ancient India, the economic thought was culminated in four principles: the philosophy, political science (dandaneeti), Vedas and economics. Economics was considered as science of wealth, i.e. artha. Wealth is mainly coming from agriculture, crafts, cattle and trade. The ancient economic thought gave greater importance to a strong and prosperous economy, a precondition for political strength. In ancient India, people are given freedom to own a property and accumulate wealth. There is rigid stratification of people into 4-caste system leading to satisfaction of people's multiple wants. For all these views, Kautilya's Arthasastra provides an in depth analysis regarding the economic thought in ancient India.

1.3. KAUTILYA'S ARTHASASTRA

Kautilya's Arthasastra is a chief representative of ancient Indian economic thought. His work is a culmination of contemporary economic structure, economic aspirations of the people, and the related theoretical analysis. His original name was Vishnu Gupta, a well read and learned Brahmin. He is known for his expertise in diplomacy and a political and defense strategist of Maurya Chandra Gupta of Maghad Kingdom. Because of his versatile multi disciplinary genius, he is rightly referred as 'Chanukya'. His famous book, Arthasastra is by far the most important treatise on economics consisting of 15 large sections and 180 sub-sections covering about 430 pages. This is meant for streamlining economic and financial administration of the kingdom of Chandra Gupta Maurya. The book is a very comprehensive one covering many a concept such as agriculture, land, wealth, taxation, finance, distribution, labour, population, government administration, law courts, rights of women, maintenance of army and navy, and others. It covers almost every aspect of the theory and practice of economics. Kautilya has regarded economics as a continuous process. He has acknowledged his debt to Shukracharya and Brihaspati.

The economy at the time of Kautilya was predominantly rural and agricultural. The Kingdom was ruled by centralized administration with local self-governmental set up. These local governments were given the powers of trade and handicrafts. There was peasant agricultural system without having feudal lordships. Also, in Kautilya's times, there was the practice of doing economic activities by the state like cultivating Crown lands as state farms. These state farms were given to the tenant farmers. The King was supposed to act for the happiness and material prosperity of the citizens.

1.3.1. MEANING OF ECONOMICS

Kautilya refers 'Artha', i.e. wealth, as the root of all disciplines. According to him, it is one of the 'Chaturvidha Purusharthas, namely, Dharma, Artha, Kama, and Moksha in the ancient times. Artha, the material prosperity, is a means to achieve salvation or Moksha. During those days, citizens were free to earn a livelihood and accumulate wealth to the extent it was necessary for the satisfaction of one's wants and those of the members of his family. The economic power in the form of wealth gives strength, stability and political power to the state. So, it gives power to both individual citizens to enjoy freedom to earn a living, but also to the state. The term economics refers to want and welfare as per Kautilya. The meaning of economics is overshadowed by religious and moral philosophy. Regarding the methods of earning and acquiring wealth, the investment of capital and labour was the approved economic activities. The methods used in acquiring wealth must be in conformity with the main objectives of life. Kautilya has defined economic as a "collection of all the treatises promulgated by the early savants on the subject of acquiring and preserving or maintaining the earth".

1.3.2. STATE AND WEALTH

Wealth is the foundation for the power of the state. The power comes from 'power of valour' and 'power of knowledge'. The political power enhances the strength and power of a state. On the other hand, knowledge facilitates effective utilization of economic resources. So wealth is essential not only for the material prosperity, but also for political power of a state. We know that economic resources in the form of men and material available in a country collectively called as wealth of a state. Men in the form of labour are required to produce wealth. On the other hand, material resources such as arable land, minerals and other resources are necessary for the production of other goods. While dealing with land, he did not mention the law of diminishing returns, though he mentioned non-fertile and non-cultivable lands.

Kautilya's concept of wealth has a wide scope. Wealth is related to welfare. According to him, wealth includes domestic cattle such as cows, horses, etc. He also included in wealth the items such as money and commodities, private property, precious metals and other goods having a market value. He also said that wealth should possess transferability, reality, consumability, and power of appropriation. In addition, he included labour and forest produce as part of the wealth. He explained that patience is essential to acquire wealth, as it slowly and steadily increases. Kautilya opined that "wealth is to be acquired grain by grain, as learning is to be acquired every moment. Anyone who is anxious to acquire wealth or learning should not neglect either grain or moment. Acquisition of wealth is always beneficial if it is acquired for the sake (for the maintenance) of a good wife, a son or a friend or for giving away (charity)". Wealth must be acquired through proper and justified means. Wealth is not an end in itself, but it is a means to attain salvation. Kautilya justified the accumulation of wealth in a country with frequent occurrence of famines as it was a safe method to protect the people. Therefore, wealth is accumulated for protecting and strengthening the country.

1.3.3. VARTA

Varta refers to the science of national economy. The term Varta had been used by ancient seers and sages. Kautilya covered agriculture, animal husbandry and trade in Varta. The great ancient thinker Kamandaka said that if Varta was destroyed, the world would be lifeless. The king was given the knowledge of Varta by the experts appointed by the state. Kautilya finally replaced the term Varta with Arthasastra and included in the term economics, political affairs, military science, jurisprudence, etc.

1.3.4. LAND AND AGRICULTURE

Agriculture was given the place of pride in Arthasastra. This is because it provides grain, cattle, gold, forest produce and cheap labour. In this context, there is a similarity between Kautilya and the physiocrats. In those days, lands were gifted to Vedic scholars, spiritual masters, priests, and those people who perform sacrifices. They were also given tax exemptions. Lands are confiscated by the king from those who do not cultivate them. The methods of production employed in agriculture were the most modern methods. These methods include intensive and extensive cultivation, small and large scale farming, the use of fertilizers, and eradication of crop diseases. In the ancient period, land was meant for cultivation by Vaishyas and Shudras. Kautilya said that Brahmins can also take up cultivation, but they should not carry the plough. Tax payers are given the lands after having been prepared them for cultivation. The state supplies inputs to those farmers who promptly pay the taxes. The king also provides the necessary infrastructure such as roads, mining, exploiting timber and elephant forces, developing commerce and manufacturing, etc. The practice of using slave labour and prisoners of war for sowing the seeds on state farms is also used. The system of peasant farming is used during the Kautilya's period. This implies that there is no landed class. The state farms are given to the tenants. So tenancy farming is also in use. Though private property is recognized, the ultimate ownership title in respect of lands is in the hands of the king.

1.3.5. LABOUR AND WAGES

According to the ancient literature, a man should lead an active life for a period of 100 years of hard-labour. Basing on the productivity of labour, wage labour is determined, as per Kautilya. He also suggested penalties for not doing work on the part of a labour who has taken his wage. A penalty is also to be imposed on the producer for non-payment of wages. He has also described the basis for the determination of wages and the concept of minimum living wages to the workers. Kautilya has also dealt with the methods of regulation of wages and for the settlement of disputes between labourers and employers. He said that by sharing the work, women should help the men labour. Kautilya also recommended leave for workers. Kautilya was not in favour of slave-labour. He prepared the code of conduct for workers. The ancient thinkers regarded the labour as unproductive who failed to achieve the objective whether it is in agriculture, trade or industry. Kautilya accepted the dignity of labour. Moreover, regarding the social security of labour, Kautilya was in favour of providing social security. The king's basic duty was to provide employment to workers and poor relief to the poor.

Regarding the fixation of salaries of public servants, Kautilya laid down the following criteria: firstly, salary should be such as to enhance the loyalty of high officials; secondly, salary must commensurate with the status of the employee; and thirdly, salary should be such as to encourage the officials to put in best of their efficiency and effort. Kautilya cautioned that the total salary bill should not exceed $1/4^{th}$ of its total revenues.

1.3.6. TRADE

The ancient Indian thinkers approved both internal and external trade. Foreign trade was allowed by the ancient thinkers only when there are enough surpluses over and above what is needed for the domestic use. Trade was considered as a "vent for surplus". During the period of Kautilya, there was much attention paid to the regulation of trade. Regarding the fixation of price of commodities, Kautilya attached greater importance to the supply and demand forces. Regarding the value, it is said that "we should take the value of each commodity according to time and space, but there can be no value of that which is incapable of being exchanged". On the other hand, the great sage, Shukracharya opined that value (price) of a commodity must be equal to the cost of production, easiness with which it can be obtained and its inherent utility. So, Kautilya's Arthasastra has recognized the modern concepts of value.

Regarding the development of trade, it was the responsibility of the state to provide the necessary infrastructure for the promotion of the trade during the period of Kautilya. The state should also provide the needed facilities by the merchants such as building rest houses, store houses, etc. The merchant class has enjoyed many privileges during the period. In addition, various types of duties in the form of tolls and customs have also been imposed on trade. These duties are an important source of revenue to the state. The state also at times entered into the trade for earning revenue and for distributing certain commodities in a proper manner. In those days trade with restrictions was in vogue. However, the state used to prescribe trade regulations by which it can be concluded that commerce had reached then an advanced stage. For instance, the state used to have proper supervision of weights and measures. Therefore, trade was at a developed stage during the times of Kautilya.

1.3.7. PUBLIC FINANCE AND TAXATION

After the recognition of the importance of wealth in the derivation and retention of state power, the next comes in importance is the public revenue. Kautilya in his Arthasastra dealt with this concept extensively and elaborately. According to him, taxation was one of the important sources of revenue to the government. He called this as “raj kar”. The rates of taxation are fixed as per the Hindu religion. In the Epic, Mahabharata, it was stated that a tax is a payment for providing internal security to the people by the king. While taxing the people, the king must act like a bee which collects the nectar without harming the plant, the religious code explained.

In his Arthasastra, Kautilya used certain canons for policy prescriptions. Firstly, the state should recognize the fact that there are limits to the state’s power of taxation. The state should make a differentiation between a short-run requirement of tax revenue and long term possibilities of imposing taxes. In the former case, the state can increase the tax rates to meet any emergency situation created out of war. On the other hand, in the long run, the state could not levy taxation indiscretely without adversely affecting the economy. For instance, heavy taxation will encourage the tax payers to move to the neighbouring countries. Therefore the objective of the state’s budgetary policy should be to have a wealthy nation capable of getting large stable revenue.

Secondly, the other important canon is that a tax should not be burdensome to the people. Not only the state should get enough revenue to meet its requirements, but also the cost of collection of a tax should be as far as possible minimum. The state is required to spend the tax proceeds for the benefit of people in the form of providing 'social overhead capital' which increases the taxable capacity of the people. Through the instrument of tax exemptions, the state should promote the productive activities. In this context, during the Kautilya period, certain communities were exempted from taxation for the promotion of productive effort. In this regard, Brahmins were exempt from taxation which is in conformity with caste privileges sanctioned by the king.

Thirdly, Kautilya suggested that the rate of increase in tax must be graduated. This implies a progressive taxation, like the present day income tax, should be levied. So, the tax must be based on income or capacity of pay. This is known as ability to pay system of taxation. Therefore, Kautilya also used the modern concepts of taxation in his Arthasastra.

To Kautilya, there are three types of tax receipts. Tax revenue received from: (a) goods produced within the country; (b) goods produced within the capital; and(c) imports and exports. Regarding the taxes imposed on imports, Kautilya suggested a tax rate of 20 percent of the cost of the commodity imported. On imports of luxurious goods, a heavy tax rate is imposed only to discourage their consumption. On the precious stones, the rate of tax may be changed from time to time.

Kautilya suggested a surplus budget economy to maintain a larger stable revenue situation making the country a wealthy state. In times of deficit budget, he suggested forced borrowings on the part of the state.

Kautilya did not ignore the expenditure side of the finances. The public expenditure includes: (a) national defense; (b) public administration; (c) salaries of the ministries and expenditure on government departments; (d) expenditure on government storehouses, etc., (e) expenditure on the maintenance of national storehouse and granaries; (f) army expenditure; and (g) expenditure on obtaining gems, stones, and ornaments. The amount remained after meeting all these heads of expenditure would be deposited in the state treasury and 'war chest', as per Kautilya.

In Kautilya's Arthasastra, land revenue occupied a significant place in the tax revenues of the state. The rate of tax on land varies in between 8.5 percent and 33 percent of the total produce. The state has made elaborate arrangements for the maintenance of land revenue records, extent of private lands, etc. In addition to land revenue, there are many other types of tax revenues which include road tax, tax on trees, tax on commodities, tax on houses, etc. The merchandize which enters into the city limits would attract the toll tax. The rate of tax based on commodities that enter into the city and it is payable by merchants.

Kautilya was in favour of state's own sources of revenue from the surpluses generated from the industries owned by the government, instead of depending upon the tax revenues. Also, these industries are a good source of employment to the people. In this regard, there is a similarity in the views of Kautilya and the modern economist, John Maynard Keynes of Cambridge University. So, Arthasastra prescribes that the state should levy minimum number of taxes leading to the minimization of tax burden and maximization of happiness.

Finally, Kautilya has prescribed rules for the preparation of budgets of the state and also for laid down the mechanics of budget estimates. During this period, it appears that adult education reached an advanced stage. Kautilya also stated that those servants who put forth their energies for the increase in state revenues and are loyal are made permanent in employment in the King's court.

1.3.8. PRICING AND PRICE REGULATIONS

In Arthasastra, Kautilya has made an attempt to analyze the economic behavior of the market forces. In this context, he recognized the demand and supply forces in the determination of market price of a commodity. He admitted the influence of improvement in the means of transportation and communication on the price-pattern of a commodity. He also discussed in his master piece the role of market structure. For instance, in a competitive market, when the price level increases, supply would increase as an immediate response and afterwards, price and profit will be dampened. On the other hand, in a monopolistic market, suppliers of commodities would maintain higher level of profits along with higher level of prices. In a market, price is the creation of scarcity of supply relative to demand and as such this scarcity may be enhanced by the monopolistic producers in the market.

Kautilya has mentioned the medieval concept of 'just price'. The just price is nothing but the cost of production of a commodity to which a margin of profit is added. When the market price is higher than the just price, the difference should go to the state treasury. This is caused on account of the intensity of demand and the sudden drop in the supply. Kautilya was against the profits beyond a reasonable level. Kautilya warned that those who are appropriating abnormal profits should be penalized. Kautilya said that for administrative convenience, price regulation and collection of taxes are taken up at places where the goods are sold. In order to fix the price of a commodity, the superintendent of commerce was given the authority to ascertain the demand position. There is the practice of centralization of merchandize for the purpose of determining the price properly. So, price control was one of the important functions of the state during the time of Kautilya. The objective of price control was to protect the consumers against dishonest merchants. The trade in essential commodities such as food grains, etc., was conducted by the authorized agents of the state. The state stipulated that traders should charge a maximum rate of profit of 8 percent on domestic goods and 10 percent on the imported goods. The violations of this rule were sternly dealt with.

He limited his discussion of price determination only with respect to goods and services. Kautilya ignored the pricing of land and other tangible assets.

1.3.9. VIEWS ON POPULATION

A large population is an indication of prosperity of the economy. Kautilya considered population as a source of strength to the king. According to Vedic scriptures, 10 sons were considered to be just for a newly married couple. During the ancient times, it was believed that population could not grow beyond a limit due to frequent wars and increase in the death rates due to inadequate medical facilities. In this regard, Kautilya suggested that the king should establish separate colonies for encouraging immigration. In ancient times, foreigners were tempted to immigrate into a country.

1.3.10. VIEWS ON INTEREST

In ancient India, all thinkers alike approved of the charging of interest, but they were against charging of exorbitant rates of interest. The charging of interest was justified in those days on account of the productivity of capital. The rate of interest was determined on the basis of the purpose for which the loan was taken, the resultant profits, the economic resources of the borrowers, etc. No interest was allowed to be charged on the mortgage of property. The rate of interest varied from class to class. Kautilya suggested for the regulations of the rate of interest. Kautilya recommended a just charge of15 percent rate of interest, as a general rule. On the other hand, Kautilya justified the charging of higher rate of interest on money lent to traders and sea merchants. The grain loans were exempt from charging any interest. Also, Kautilya made a distinction between rate of interest and profits.

1.3.11. FUNCTIONS OF THE STATE

The functions of the state are subject to ethical and moral code of conduct. Kautilya's concept of state was of a welfare state. The aim of the welfare state was maximum good of the maximum number of people. The chief objective of the state was to promote economic welfare of the people. In this regard, each citizen was protected from starvation. There were no class conflicts, since wages were determined on the basis of equality and justice. Employers were no longer exploiting the labourers. In agriculture, peasant farming was the practice and as such there was no scope for serfdom. On purely entrepreneurial function, profits are claimed by the employers. Manu and Kautilya were against the charging of interest. All this proceeds towards the equitable distribution of wealth. It was the responsibility of the state to take care of social security and social welfare of the workers. It was the prime duty of the state to provide charitable institutions and poor houses for giving relief to the poor. The state used give importance to the people's caliber, character and aptitude in the public appointments. The king used to reward the honest people and punish the wrong-doers.

Regarding the state administration, the king is required to promote trade, agriculture, mining, etc., by granting subsidies. It was the duty of the state to make available the necessary money in the form of coins. In addition to the collection of 10 kinds of revenues from mines, both mining and commerce are the monopoly of the state. Industrial development was an important function of the state. Kautilya has laid down three important guiding principles for the state. Firstly, the state should establish those industries by which a self-sufficient and self-reliant economy could be achieved. These industries include gold, silver, diamonds, and other precious metals which should be in the ownership of the state. Secondly, the activities of farming, arts, crafts, weaving and spinning, livestock farming, etc., should be allowed to be owned by the individuals. Finally, the activities of production, distribution and consumption are undertaken as per rules laid by the king from time to time. The state formulated several procedures and regulations regarding the financial transactions, weights and measures, essential industries, currency and exchange, prevention of adulteration, usury, etc. In this scheme of things, the state has a dominant role which aims at promotion of social welfare of the people.

On the political administration side, the administration was fully democratic in nature and panchayats and municipalities were basic units of administration. The administration of justice was given to panchayats and guild courts.

1.4. ECONOMIC IDEAS OF THIRUVALLUVAR

In the ancient Indian economic thought, Thiruvalluvar occupied a place of prominence alongside Kautilya. Valluvar was a sage, thinker, a poet and a scholar, all moulded into one. He was a man concerned with the day to day conduct of man. Neither was he a law giver nor for that matter like that of Vedic law makers like Manu or Yagnavalkya. His ideas of contemporary ancient India were present in his famous classic work, namely, ‘Thirukkural’; a Tamil Sangam literature consisting of 1330 couplets or ‘kurals’. The book contains 133 chapters each consists of 10 couplets. These 133 chapters are grouped into 3 sections: righteousness (arathupaal), wealth (Poruthpaal) and love (kamathupaal). These in short refer to “virtue, wealth and love”. These are respectively known as Dharma, Artha, Kama and Moksha. The word Thirukkural is composed of two words, ‘Thiruk and Kural’ which means ‘Sacred’ and ‘Couplets’ respectively. The common English rendering of Thiruk-Kural is ‘Sacred Couplets’. This book is posterior to Arthasastra (between 250 B.C. and 150 A.D.). One cannot be certain regarding ascertaining the ancient period in which he made his mark known to the world. Scholars are divided in their opinion about the period of this great poet. In all probability, Valluvar would have lived during the period between 2^{nd} century A.D. and 4^{th} century A.D.

This book is an ethical work of par excellence. This book contains many ideas regarding the fundamentals of life. He talks of virtue, nobility, propriety, just governance, conduct, social obligations, self control, education, and knowledge. Many scholars consider that the 2^{nd} section in Thirukkural, Wealth, resembles a great deal to Chanakya’s Arthasastra and Niti Sastras. Also, many couplets in Thirukkural bear surprising resemblance to verses in Dharma Sastras like Manu Smriti. The Thirukkural also deals with miscellaneous topics like agriculture, rain and medicine. It is pointed out that Thirukkural deals with everything and there is nothing that it does not deal with.

1.4.1. VALLUVAR’S BASIC VIEWS

In his system of ethics, Valluvar’s believed in the existence of God, the Almighty. All his views are revolved around the spiritual point of view. In this context, he praised the glories of rain. Water and lives of mankind are closely correlated, he explained. According to him, water is life-sustaining and it is also spirit-giving. The economic life of man is determined by the water. The economics of man comes into life only after the guarantee given by spiritual or religious values. In this context, we can cite the example of the basic economic activity agriculture which is meeting the food requirements of the people. Since he considered land resources as part of water resources, we can conclude that Valluvar has provided a place of price to the natural resources. On the basis of these resources, a man thinks of taking an economic activity.

Secondly, Valluvar has given importance to 'spiritual leadership' as a basis for economic activity. The economic base of a society is stable and to ensure continued development, a strong spiritual leadership is necessary. By means of renunciation of worldly pleasures, a spiritual leader, a sage or a seer engages himself in preaching good things for the good of the society.

Thirdly, Valluvar deals with Dharma which means a moral code of permanent and universal validity. Dharma is an absolute truth and no man is above it. Therefore, his basic ideas include faith in God, natural resources, spiritual leadership and Dharma.

1.4.2. VALLUVAR'S ECONOMIC IDEAS

Valluvar's economic ideas are found in the 2nd section of his book, Thirukkural, namely, wealth. This section is almost similar to Arthasastra. But Valluvar's analysis is not that much elaborate as that of Kautilya. The intensity of spiritual linkage of ideas is much more in Valluvar's scheme of things than Arthasastra. In Tamil language, wealth is known as 'Poruthpaal' which means all material things in the form of tangible assets that can be acquired, enjoyed and lost and which a man requires in daily life for maintaining his family and for the fulfilling of his life's obligations. Like Arthasastra, in Valluvar's time also, economics had no independent existence of its own, but a part of the start craft. So, his economic ideas are part of political economy, just like Arthasastra and the ancient western economic thought. His economic ideas can be reduced to three principles: freedom from hunger, freedom from disease, and freedom from fear of external and internal aggression.

According to Valluvar, three things are needed by a typical economy to grow. Firstly, there should be adequate cultivable land to meet the food requirement of the people. Secondly, productive labour forces to convert natural resources into commodities. Thirdly, there must be adequate amount of capital in the economy. Valluvar considered wealth as a means, but an end in itself. He viewed that accumulation of wealth must be legally valid and proper. He viewed that wealth could not be accumulated through withholding money. It must be used for the benefit of the economy. A man who is hoarding money is a burden to the earth. This hoarding can rightly be called as profitless riches. Valluvar was not in favour of hoarding money in any form.

Valluvar had given importance to the industrious people in the economy. If a rich person is idle, he can be considered as really poor from social point of view. The stamina to perform a task is indicative of his achievements in life. For instance, the stem of a lotus is the measure of water's depth. An idle person could not achieve anything in terms of progress. To explain further, Valluvar analyzes three principles such as 'Absenteeism from Sloth', 'Manly Effort', and 'Courage in Crisis'. The word sloth refers to laziness. Laziness does bring in poverty, but only industry can accumulate wealth. The Goddess of Wealth runs after industry and enterprise, as per Valluvar. Therefore, economic progress can be achieved only through industrious work on the part of the people.

1.4.3 VALLUVAR'S VIEWS ON AGRICULTURE

Valluvar has given an important place to agriculture, as a lover of God. In his view, husbandmen are the axle-pin of the world. This is because the prosperity of the economy depends upon the prosperity of the farmers. Even if a man adopts other non-agricultural occupations, soon he would find himself landed in agricultural occupation. Therefore, the agriculture sector alone can be considered as primary occupation. The reason for this stand on agriculture is that Valluvar has shown concern for a well-developed agriculture and as such he has prescribed some important techniques for the development of the sector. These include: preparation of soil, manuring, weeding, and protecting the crop. Also, he was in favour of peasant proprietorship in the agriculture, just like the views of Kautilya. He resented the feudal lordships. So, there is no place for serfdom.

1.4.4. VIEWS ON PUBLIC FINANCE

Valluvar has recognized the importance of ‘fiscal policy’ in state’s economy. For this purpose, he classified the fiscal policy into four divisions. They are: revenue creation, revenue collection, management of revenues and public expenditure. Revenue creation refers to ‘taxation’. He was not in favour of taking the taxation to the extreme. If that is the case, the king may be likened to a highwayman, who robs the people of their valuables. The state should see that the yield from various sources of revenue increases naturally and automatically. This implies a continuous increase in the taxable capacity of the people. Regarding the budget, Valluvar advocated a balanced budget. There is neither a surplus nor a deficit in the budget. He also advocated a surplus budget if the circumstances permit, but he was totally against framing a deficit budget. Finally, the state should direct government expenditure to be channelized for socially useful activities.

1.4.5. FUNCTIONS OF THE STATE

Valluvar was staunch advocate of a welfare state. He opined that the king must be good administrator doing good to the maximum number of people. According to Valluvar, provision of education is an essential duty of the king in a progressive economy. Unless people are educated, one cannot think of productive labour. Therefore, the king was to take care of creation of knowledge base to advance the economy technologically. The knowledge brings in man wisdom to earn and spend wealth. This also acts as a social leveling force and a driving force for the development of the economy. Valluvar also explained about health of the people and its necessity to make the people work hard for the prosperity of the nation. A weak population cannot sustain the development process. In view of the importance of health, Valluvar devoted a full chapter to the ‘medicine’ by which he had given greater importance to preventive and nutritional aspects of health. Valluvar emphasized in his book the importance of ‘freedom from diseases’. He blatantly condemned several vices of man such as gambling, drinking, and prostitution. These vices would harm the health of the population worsening the productivity of the economy, he said. When the society is free from these evils, the economy would become self-sufficient and wealthy.

According to him, an ideal society must consists of freedom from disease, high standard of living, adequate food resources and wealth, a strong national defense, and freedom from hunger. In this ideal society, the role played by the individuals in the society was much more compared to the state. This indicates that there must be vigilant social consciousness. In the Valluvar's analysis of welfare state, individual action is given a place of significance which ultimately counts for the success of state action.

1.5. ECONOMIC IDEAS IN MEDIEVAL INDIA

In so far as the formation of economic ideas, the medieval period may be regarded as 'dark age' with an exception of stray incidents from the Muslim rule. The medieval period between 10^{th} century and the late 16^{th} century A.D., witnessed nothing concrete had had happened with respect to economic ideas. There were stray ideas of economic nature which would be collected from the works of the saint poets, namely, Kabir, Tulasi Das, Surdas, Meera Bai, Guru Nanak, etc. These ideas of these poet were more of social nature rather than economic in nature. However, the writings of Abul Fazal had the touch of economics explained in his famous book, "Ain-i-Akbari" during the period of Akbar. Excepting Abul Fazal, no other thinker was available to have an insight into the economic ideas during the medieval period. But certain tax-reforms were introduced by some Moghal kings by which one can understand a certain form of evolution of economic thought.

Society during the Moghals era was organized on a feudal basis and the head of the social system was the king. Agriculture was the mainstay of the people of India. Moghals as foreign invaders, following Timurian tradition, encouraged trade for which they used to give several concessions to foreigners. The Moghal kings were used to levy heavy taxation particularly on Hindus to maintain large armies and extravagant life of the king, nobles, etc. For instance, Aladdin Khilji (1296-1316) had imposed heavy taxation giving extensive powers to the provincial administrators. On Hindus, he levied 50 percent of proceeds of agriculture as tax. Mohammad Tughlaq (1325-1351) introduced gold, silver, and copper coins for the monetary transactions of the people. But the system had failed due to inbuilt deficiencies. The notorious 'Jizya tax' was introduced by Feroz Shah Tughlaq on Hindus to encourage conversions into Islam. But it was repealed by Akbar on account of the opposition from Hindus. The tax (Jizya) was again introduced by Aurangzeb in 1679. Though ruled for a short period, Sher Shah (1540-05) was well known for his reforms on Land Cess. He introduced the system of rent on land basing on its productivity. This idea is similar to the one expressed by the modern thinkers.

During the reign of Akbar (1556-1605), the economy began to grow to unprecedented levels because of his broad-minded economic reforms. The brain behind these reforms was the 'Muslim Chanukya', namely Abul Fazal, the architect of Akbar's rule. Abul Fazal, in his book, "Ain-i-Akbari", explained the economic situation of India. He mainly dealt with the revenue system of Todar Mal, who was the revenue minister of Akbar. During Akbar's time, land cess was regularized in the country taking the entire cultivated land into the king's hands. Also, Abul Fazal devoted attention to the discussion of relief to the agriculturists in the form of loans and remissions. Under the Islamic Code, the charging of interest was abolished, but introduced certain riders. According to Abul Fazal, government servants were allowed to take loans on interest. No interest was charged for the first year and interest would double in 10 years.

Summing the Moghal period, there are two types of taxes: central and local taxes. Land cess, Inheritance tax, and Monopolies tax are under the central jurisdiction. On the other hand, tax on merchants, house tax, excise taxes, tolls, etc., are under local category. Due to the levy of toll taxes, there was a rapid increase in the prices of commodities during the Moghal period. The Moghals used to levy taxes on milk, vegetables, and even on cow dung cakes. A major of portion of total revenue of the country come from Jizya tax and Land Cess.

1.6. APPRAISAL ANCIENT ANDMEDIEVAL THOUGHT

In ancient times, economic ideas are overshadowed by religious and moral code. These economic ideas are found in Vedas, Epics, Brahmanas, Upanishads, etc. Kautilya's Arthasastra is regarded as the first recorded evidence of ancient

Indians. Though there was a controversy regarding period in which Kautilya and Valluvar lived, we find a mixture of socio-economic and political views in their treatises, namely, Arthasastra and Thirukkural. In ancient India, economics did not attain an independent status because the thinkers presented a total situation of the economy comprising of socio-political and economic situation. The thinkers were not thought of the need for separating the subject matter of economics. Hence, the subject provided by ancient thinkers was not of pure economics. Kautilya, however, attempted a systematic presentation of his economic ideas along with political views. Valluvar was more concerned about the religious code of conduct or Chaturvidha Purusharthas, namely, Dharma, Artha, Kama, and Moksha because he was a sage.

The most important of contribution of Kautilya is public finance and taxation. He listed a large number of taxes to augment the revenue position of the state. In all his analysis, he has given a dominant role to the state in economic activities. In his Arthasastra, Kautilya had given several recommendations for strengthening the state both economically and politically. According to Kautilya, the main object of the state is to promote socio-economic welfare of the people. Most of his views are quite closer to the thinking of modern economists in matters like taxation, state control over the economy, budget preparation, maintenance of land revenue records, etc. Therefore, Arthasastra is a treatise of par excellence giving a detailed analysis of political economy of ancient India.

Valluvar, on the other hand, devoted one section of his work, Thirukkural for wealth which is similar in views as that of Arthasastra. But it is not as comprehensive as that of Kautilya's. The views are not systematically presented by Valluvar. He made wealth as part of the four Vedic principles, Dharma, Artha, Kama, and Moksha. He has given a significant role to the agriculture. Like Kautilya, he also advocated peasant proprietorship in agriculture. Compared to Kautilya, Valluvar is more attached to spiritualism. For instance, Kautilya tried to secure revenue by using coercion and intimidation, whereas Valluvar believed in taxation by consent. Basically, Kautilya is known for his Chanukya Neeti, a political dynamism. Valluvar has made several suggestions regarding education, health, and state administration. In his view of the welfare state, he has given greater role to the individuals' action facilitating vigilant social consciousness for the ultimate success of the state action.

Valluvar was neither an economic theorist nor a political thinker, but he was a great sage and a poet. On the other hand, Kautilya was a chief minister of Maurya Chandra Gupta. Therefore, there is a sea of dissimilarities in their thinking. On the whole, we can deduce certain common things in the views of both of these thinkers regarding the economic situation in ancient India.

During the Medieval period, there were only certain stray incidents of evolution of economic ideas which would be known from the writings of saint poets like Kabir Das, Tulasi Das, Sura Das, Guru Nanak, etc. Their ideas are mostly social in nature. So the economic thought had not been systematized. During the Akbar's rule, Abul Fazal explained certain ideas in the form of tax reforms. Therefore, the period may be declared as a dark age.

1.7. TECHNICAL TERMS

1. Varta,

2. Peasant Proprietorship

3. Social Overhead Capital

4. Progressive Taxation

5. Ability to Pay

6. War Chest

7. Just Price

8. Welfare State

9. Poruthpaal

10, Absenteeism from Sloth

11. Chaturvidha Purusharthas

12. Spiritual Leadership

13. Courage in Crisis.

14. Jizya Tax

15. Zakat Tax

1.8. SELF-ASSESSMENT QUESTIONS

1. Examine the main features of ancient Indian economic thought.

2. Explain Kautilya's Arthasastra and examine how far is it related to the modern economic doctrines?

3. Discuss Kautilya's views on the following:

    a. Public Finance and Taxation

    b. Views on Agriculture

    c. Functions of the State

4. Kautilya defined economics as "collection of all the treatises promulgated by the early savants on the subject of acquiring and preserving or maintaining the earth". Explain.

5. It is observed that "Valluvar's concept of wealth resembles Arthasastra of Kautilya". Elucidate.

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M.A. ECONOMICS: EVOLUTION OF ECONOMIC DOCTRINES

LESSON-2/UNIT-5

ECONOMIC THOUGHT IN MODERN INDIA - 1

-- DADABHAI NAOROJI AND MAHADEV GOVINDA RANADE

CONTENTS

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LESSON-2/UNIT-5

ECONOMIC THOUGHT IN MODERN INDIA - 1

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2.1. OBJECTIVE OF THE LESSON

It is proposed to discuss the economic thought in modern India. In this category the thinkers of 19th century and the early 20th century of modern India are included. The thinkers include Dadabhai Naoroji (1825-1913), Mahadev Govinda Ranade (1842-1901), Ramesh Chandra Dutt (1848-1909), Gopalakrishan Gokhale (1866-1915), M.N.Roy (1887-1954), and Mahatma Gandhi (1869-1948). In this lesson, the contributions made by the first two thinkers, namely, Naoroji and Ranade are included.

2.2. INTRODUCTION

As we have learnt from the earlier lesson of this unit, due to the preoccupation with non-materialistic thinking process dictated by the Hindu religious code, there was no significant advancement in the evolution of economic thought proper the early thinkers in India. A true beginning of economic thought in the sense of its modern context was started during the later part of 19th century in the country due to the exigencies of British rule. There were far reaching changes in the socio-economic life of the people caused under the influence of political administration, educational system, and economic policies of British Raj. A new line of economic thinking was begun to develop in the country mainly as a revolt against the British rule.

During the 19th century, India was subject to western influences in terms of their cultures and economies. As a result, the Indian economy was under great pressure causing its traditional model of economy to crumble under its pressure. As a result, Indian handicrafts and small industries are gradually collapsed on account of foreign trade leading to the break-up of self-sufficient village system and commercialization of agriculture to some degree. A new educational system catering to the needs of the administration of British India was started. Plantation and mining industries were encouraged. Therefore, the development of Indian economic thought is to be considered under this backdrop.

In the western countries, the policy which was hither to been followed was the market system. Its universal validity had been questioned by the thinkers of the world. It was thought that the imported policies were of no use to the countries like India. This is because India was subject to utter poverty, illiteracy and backwardness. In addition, the problem of drain of real resources from India to the U.K was causing concern. In these circumstances, it was thought that the government had to take care of the interests of the society by means of active state intervention in the economic activity as against the policy of free market system. The Indian thinkers began to be influenced by thinking in terms of government intervention. The Indian economic thinkers have therefore thought of the necessity of accelerated growth of the economy for which they desired of the effective government intervention. Their attention was on the issues of drain theory, causes of poverty and underemployment, and planned economic development as instruments of practical economic policy. So they considered the economic problems as a totality of the situation by the end of the 19th century. So, the studies were mostly empirical in nature. In the following century, there is some change in the Indian thinkers under which they begin to use abstract reasoning and started to develop economic models for economic analysis just like their counterparts elsewhere in the world.

During the period between the later part of the 19th century and the early part of the 20th century, the economic thought is pioneered by the celebrated trio, namely, Dadabhai Naoroji, Mahadev Govinda Ranade and Ramesh Chandra Dutt. Their work is mostly empirical in nature taking the economy as a whole. For instance, they have considered the economic facts for giving their analysis regarding poverty in India and the contribution made by the British Raj on Indian economy. These are followed by nationalists whose main concern is national importance in their economic thinking. The contributors of abstract reasoning follow next in the 20th century.

2.3. **DADABHAI NAOROJI (1825-1913)**

Dadabhai Naoroji, the grand old man of India and also a father of Indian economics, was born in 1825 in a Parsi family of Bombay. He was the first Indian to be appointed as Professor at Elphinstone College, Bombay. Also, he became Indian to become the member of House Commons, England. Also, there are several firsts to his record. The most important of all is that Naoroji was the first Indian to prepare National Income Estimates for India. Naoroji was the philosopher-trader and was greatly interested in the political fate of India. Therefore he was an ardent nationalist. He became the 'Father of Indian Nationalism".

Naoroji attempted to study the economic problems from their practical side using statistical tools. He attempted a colossal task of estimating National Income Estimates for India at a time there was paucity of organized empirical economic data. Even then, he was unrelenting in the daunting task of using the available data to suit his purpose and analysis mainly driven by his patriotism. The economic ideas of Naoroji are found in his book, "Poverty and Un-British Rule in India, 1901". He published a revised version in 1911. This aims at explaining the 'poverty of India' in his book. He contributed number of books on poverty in India and ill-effects of the British rule. His main contributions are explained hereunder in detail.

2.3.1. THE DRAIN THEORY

Dadabhai Naoroji was the first Indian economist to have discussed that the political and economic relations between India and Britain were leading to a heavy drain of real resources from India to England throwing India into a perpetual state of poverty. This is known as his famous Drain Theory. The main idea behind the writing of his book 'Poverty and Un-British Rule' was to demonstrate that the system of British administration in India was destructive for Indians and suicidal to British. Naoroji felt that India had the "lordliest and costliest administration in the world'. The extravagant cost of administration had proved disastrous to the Indians, he opined. The draining of real resources is an indication of unjust and forceful obstruction of Indian economic growth causing heavy foreign indebtedness aggravating the already appalling conditions of poverty and backwardness.

INTERNAL DRAIN

India is remotely ruled by the British Crown. The British have failed to recognize the specific characteristic features of socio-economic and political situation of Indian sub-continent because India is ruled from a distance. There are lot differences between the two. For instance, India is under the clutches of poverty, illiteracy, and backwardness. Also socio-political unification is not yet done. Because of the imperialistic tendencies of the British, military expenditure is very much heavy in terms of the British and European employees' salaries and other administrative expenses. In this context, India has to bear the brunt of the situation. The subsidizing of railways has added fuel to the fire to the increasing government expenditure. In railways, top jobs are occupied by the highly paid European officials and low paid jobs are received by Indians. Therefore, the government has resorted to heavy taxation on the people. This can be rightly termed as "internal drain".

Heavy taxation resulted in the depletion of surplus of income in the hands of farmers and the ability to invest would be reduced. Also, due to the primitive methods of production, fertility of land has deteriorated. There is deficiency of demand in the economy. As a result people's dependence on agriculture has gone up due to the population pressure. The tax revenue collected through heavy taxation did not meet the requirements of foreign debt. Then government is pushed further to increase the taxation due to the inadequacy of the existing taxation. But there is lack of ability to pay on the part of the people. All these happenings culminated into a 'vicious circle of perpetuating poverty'.

Naoroji also explained that there was also an internal drain in the form of transfer of purchasing power from the poor rural areas to the rich urban areas.

Due to the increasing trend of commercialization, imported goods have started flooding the markets. So, the consumption pattern of the people has changed. Gradually, works of skilled artisans of villages have started losing their employment converting themselves as agricultural labour. So a good deal of artistic skill and talent is lost. This is called drain of human resources.

EXTERNAL DRAIN

The resources which had gone out of the country did not return back to India. There is no scope for recouping the economy. Once lost, lost forever. Had they been returned back into the system, the taxable capacity would not have been that much deteriorated. Naoroji referred it as “external drain”. The British government in India is siphoning off the tax revenue collected out of the country to find its way to England. There are many routes for this way of draining of resources. Firstly, remittances are made on account of meeting the foreign debt. Secondly, remittances are sent towards the salaries and pensions of the European employees in India. Thirdly, remittances are made to meet the expenditure of British India. Fourthly, remittances are also sent to England on account of the profits of the British investments in India in railways, plantations, etc. These enterprises are in the hands of British so that even the earnings of foreign trade would go to England. The benefit of railways gone to the Britishers, but the burden of foreign debt was borne by India. The British, by bringing back the same capital which they have drained from India, have monopolized trade and industry. Fifthly, the government in India purchased its requirements of stores from the British producers and foreigners in India also purchased foreign goods mostly. For all these purchases remittances are made to England. The combined effect of all these transactions is draining of resources from the country and they would never come back home. The export surplus is the result of all factors through which resources were drained out. Normally, this export surplus would otherwise be helpful to meet foreign debts and to bring in foreign capital into the country facilitating the strengthening of the economy. But here the export surplus is lost forever causing perpetual indebtedness to the foreigners.

So, capital accumulation had become worsened due to the draining of resources. The source of the evil is, therefore, the official drains. Naoroji held that if the country's entire production is not employed in the country itself, the reproduction will be much more difficult. Using foreign capital in a country is different from invading it. Naoroji rightly said, "The former rulers were like butchers hacking here and there, but the English with their scientific scalpel cut to the very heart…..There is no wound to be seen, and soon the plaster of the high talk of civilization, progress and what not covers up the would". The draining of resources is a double-edged weapon. There is not only a continuous draining of capital, but also it is very difficult to maintain the existing rate of production in India.

In respect of the colonies of the British, the drain theory did not apply. These colonies have attracted the British capital resulting in the increasing in-flows of foreign capital into the colonies. With these inflows, import surplus has been generated in these colonies. That is inflows are greater than outflows. This made these colonies to increase their productive capacity in the form of increase in the national output by which they could get the chance of repaying the foreign debt. In the case of India, resources are drained out and they never come back. Therefore, the Indian economy is slowly bled to death. Everything is devised to the benefit of England at the expense of the Indian economy.

Regarding the estimates of the drain away resources in India, Naoroji had found that remittances resulted in the creation of export surplus in the British India's foreign trade. Imports were not significant due to the backwardness of the country. According to one estimate given by Naoroji, the extent of drain was to the tune of £350 million during 1814-1865. If interest had been calculated on the drained amount, the draining of resources would have been much more. The process of drain upon the resources continued unabated afterwards. Agricultural exports were the source through which the resources were drained out of the country. It is a black mark in the economic history of India because no country could bear such a large scale drain upon its resources.

On the other side of the coin, it is argued that there is overestimation of economic drain by Naoroji on economic terms. Of course, one cannot deny the economic drain occurred. At the same time, England also used to export capital in many forms to India. These factors are required to be taken into account to examine the extent of economic drain.

REMEDIES

Naoroji recommended the following measures to reduce the draining of resources from India. Firstly, India and England should meet all salaries of their people within their geographical boundaries. Regarding the Englishmen employed in India and Indians employed in England, the countries should agree to a mechanism of reasonable apportionment between the two countries. Secondly, exempt India from the payment of pensions to those foreigners who received reasonable salaries in India. Thirdly, since all the benefits from Indian Navy had gone to England, India should not be charged any portion of the expenditure incurred on Indian Navy.

2.3.2. NATIONAL INCOME ESTIMATES

Naoroji, as a nationalist, was not satisfied with the wrong estimation of national income of India by the British government. Naoroji wanted to make thorough investigations regarding a unified principle for explaining the economic phenomenon on a national basis. Therefore, he was the first person to estimate the National Income of India and factor-shares in it. During the later part of the 19th century, the recurring famines had caught the attention of the government. The British government found that the problem of famines was more of an even distribution of food supplies rather than of production itself. So, the government preferred to construct the railways in India to mitigate the problem of famines. In this context, Naoroji investigated the history of famines in 1868. The issues of poverty and famines made Naoroji to look into the productive resources and national income of the country. At that time, it was a herculean task to procure data to research the subject of national income estimates. Some data was available in a journal, namely, “The Indian Economist” edited by Robert Knight.

But the information provided in the journal is not of usable form. Naoroji wanted to have a reliable estimate of aggregate national and percapita income on a continuous basis. He felt that the percapita income estimates for the British India should be published every year. He was, therefore, interested in calculating realistically the total annual income, percapita income and 'the requirements of a labourer to live in working health and not as a starved beast of burden'.

Accordingly, for the year 1870-71, Naoroji's estimation of India's percapita income stood at Rs.20, whereas it was Rs.420 in the U.K. In this estimation, Naoroji adopted an indirect method of calculation. For instance, he estimated the Gross land tax at £21 million. He assumed that it was 1/8th of agriculture production by which he calculated the total agriculture production at £168 million. Adding the estimates of secondary sector at £132 million to the agriculture production, Naoroji's estimates constituted £300 million of National income and 40 shillings or Rs.20 of percapita income during 1870-71.

Naoroji's calculation of national income estimates was based on the bare minimum needs of the people to keep them in ordinary good health and decency. In this context, he considered the daily maintenance requirements of emigrant coolies, common agricultural labourers, lowest paid government servants and prisoners in Indian jails. Naoroji calculated that the requirement for meeting the bare needs of an ordinary Indian was about Rs.34 during 1870-71. He observed that the percapita income was much less than the percapita requirements of average Indian people. Naoroji opined that even for providing such food and clothing which was given to a criminal, the production even of a good season was not enough. His estimates revealed that rich and middle class got a much larger share in the national income and the poor masses did not even get enough for fulfilling their basic needs. In his estimates, Naoroji has equally apportioned the value of agriculture produce and manufactures among all people without exactly knowing the actual number of people working in agriculture and industry.

APPRAISAL OF NATIONAL INCOME ESTIMATES

Naoroji did a commendable job in attempting a herculean task in the light of haphazard, unscientific and unorganized availability of data. But on observing the method of estimates, one can immediately come to a conclusion that the estimates are unscientific. However, the service sector was left out by Naoroji considering only agriculture and industry. He did not take into account such items as railways, house property, government stock, foreign trade and so on. According to him, railways do not contribute anything to the wealth of the country. It just transfers the produce from one place to the other. Government stock does not increase wealth. House property also does the same. On the other hand, foreign trade does create wealth. But the entire proceeds drain out of the country to England. Though India's foreign trade does create wealth, the proceeds of trade are appropriated by England. Had the proceeds of trade been spent within the country, national income would have been increased. Since we have no use of these proceeds, foreign trade item is left by Naoroji. Also he ignored salaries, wages and pensions, professional income, and returns on investment. Regarding salaries and pensions, these are not part of the national income because the salaries and pensions are drained out to England in the form of remittances and no hope of their getting back. So, he left them out from the estimates of national income.

F.C.Denvers, an employee of India Office, had criticized Naoroji regarding the non-inclusion of certain items in the estimates of national income. Replying to the criticism of Danvers, Naoroji argued, "Suppose 100 maunds of wheat exists in Punjab, and its cost to the producers is say Rs.100…..Suppose that this wheat is carried by railways to Bombay, and its value at Bombay is Rs.125; does Mr. Danvers mean that this circumstance had added Rs.25 or anything at all, to the existing wealth of India?". Therefore, he was basically interested in the physical production and productive resources, and not the production of utility.

Naoroji, therefore, excluded the value of services in estimating the total production of the country. So, the utility of Naoroji's estimates was seriously impaired. Dr.V.K.R.V.Rao, a famous National Income statistician and educationist of India, pointed out that Naoroji's treatment of national income was based on “the physiocratic concept of the materiality of income” and, of course, supported Naoroji’s method of calculation of national income.

2.3.3. PUBLIC FINANCE AND FINANCIAL ADMINISTRATION

Naoroji attacked tooth and nail the British India administration in the House of Commons and pleaded for a due share for Indians in the administration of their country. He argued that the loss from the mismanagement of Indian affairs was suffered by Indians, but the benefits went to the Britishers. He contended that Indians were thrown into a state of perpetual poverty and foreign indebtedness. In this context, one should understand that the utter neglect of India’s economic problems emanate from the overall British policy towards India reduced to a state of dependence. Under the policy, all financial decisions were imposed from above. The mismanagement of the British rulers is in the realm of income and expenditure. The expenditure on civil and military expenditure was very much heavy with fat salaries of European employees. According to Gladstone, military expenditure in 1893 was indeed alarming. It is estimated that military expenditure constituted about 1/3rd of the total expenditure and exceeded corresponding expenditure by European monarchies. The expenses of ‘Indian war of Independence’ in 1857 were apportioned to India which was considered immoral on the part of the British Raj. Indians had no voice to protest this highhanded assignment of expenses. In fact, these expenses also served the interests of the Britishers in their imperialistic overtures. The British government in India at last constituted a Royal Commission under the chairmanship of Lord Wilby on May 24, 1895 to take up the reference of apportionment of expenses between India and England. Naoroji was also a member of this Commission. Naoroji recommended for the consideration of ‘relative paying capacity’ of the two countries as a guiding factor in the apportionment of expenses.

In the area of civil administration, there was misallocation of resources also along with the military expenditure. The European civil servants used to draw fat salaries leading to heavy remittances to England. Even after their retirement, India was forbidden to enjoy income generated from their pensions because they left India to settle in England immediately after their retirement. There was the absence of Indians working at the top positions in the civil administration. Indians did not enjoy the benefits from the railways. But, Indians bore the entire expenditure on the home establishment of the railway officials who were away from India living in England. As we have mentioned in earlier paragraphs, all top jobs in railways were held by the Europeans leaving the low paid and menial jobs to Indians. As a result of this mismanagement of public financial affairs, the interest charges on the public debt of British India were very much high. For instance, Naoroji estimated that public debt was accounted for £100 million in 1871.

Regarding the revenue and tax system in India, bulk of the revenue was collected from Indians through heavy taxation. Low income levels of the people and heavy taxation are juxtaposed. This results in regressive taxation. Tax rate will increase with every fall in the income level. This is an important feature of Indian tax system under the British rule. Had the collected revenue been spent in India for development purposes, the ability to pay of the people would have been increased. The best example for this type of tax was 'salt tax'. The rate tax imposed by the British government was 22 percent in India, whereas it was 8 percent in England. Even then, the British government was arguing that Indians were taxed lightly. According to the British government, the percapita incidence of tax was 5.6 shillings in India which was very low as compared with the corresponding figure of £2 and 10 shillings, On the other hand, Naoroji said that in terms of 'ability to pay'; Indians were being taxed too heavily. Another instance, in England, the tax payers were used to get some benefit in return to the tax payment from the government, But in India, there was no such 'quid pro quo' to the tax payers who were subject to heavy taxation. Naoroji believed that the government was not taxing but bleeding the Indian people.

Therefore, Naoroji declared in unequivocal terms that the British rule was perpetuating the crisis in India lacking financial prudence and misallocating the natural resources.

2.3.4. REMEDIES

In view of the disastrous effects of the British government, Naoroji felt the need for the state to play a positive role in different areas of economic activity such as education, trade, employment, public finance, and economic development. In this context, Naoroji suggested for the development necessary public works infrastructure importing foreign capital, but not foreign capitalists. Also, he recommended that the state should develop human capital formation in a poor country like India. These ideas of Naoroji imply that he was against the classical system of laissez faire philosophy. According to him, state's direct intervention is necessary to remove poverty from the country. The British used to manipulate the exchange rate against the Indian rupee favoring England's pound sterling. Naoroji argued that this type of manipulation should be immediately stopped by the British government. The other suggestions include: equitable distribution of financial relations between the two countries; Indianization of employment opportunities; minimization of public expenditure; ceiling on salaries and allowances; abolition of pensions to the non-Indian employees; and reducing the rate of interest on public debt.

2.3.5. APPRAISAL

Naoroji was considered as a great economist of India during the later part of the 19th century. The credit of estimating national income for the first time goes to him. He was not interested in individual welfare and utility analysis, but in the national income and poverty. He was rightly regarded as Father of Indian Nationalism. While doing so, he exhibited mastery in the collection of data and putting them into use. Naoroji is an empiricist taking the Indian economy as a whole. He analyzes the economic and political relationships of the Indian economy with England by which one can understand the genesis of poverty and underemployment. Basing on his drain theory, he declared that England was the real cause of ruin of India. Naoroji, in all his efforts in uprooting poverty from India, was guided by his patriotism and a sense of fairness. Though criticized by Danvers, Naoroji did complete a herculean task of estimating the national income and the job was commendable beyond doubt.

2.4. **MAHADEV GOVIND RANADE (1842-1901)**

Mahadev Govinda Ranade was born in Nasik in 1842. He received his M.A. degree from the University of Bombay. In 1883, he was appointed as Judge of Bombay High Court and continued in the post until his death in 1901. From 1867, he started studying economic conditions in the country. By 1877, he published his ‘Revenue Manual’ of the British India followed by a paper on the Famine Administration of Bombay Presidency. His most important works include: “Essays on Indian Political Economy, 1898” and “The Rise of Maratha Power, 1900”. His economic ideas consist of mainly three areas: (a) methodology of the study; (b) explanation of backwardness /poverty in India; and (c) development and industrialization of India and the role of the state.

2.4.1. METHOD AND SCOPE OF POLITICAL ECONOMY

Ranade was a staunch supporter of inductive or historical method for economic analysis. He completely rejected the classical system of universal applicability of economic laws irrespective of time and space. The classical idea refers to the ‘absolutism’ of economic laws. This view had long been challenged by social scientists. It was also opposed by Nationalists and representatives of the Historical School of thought. Ranade, as a nationalist, was against this view. Ranade was at first studied the economic system of European countries and come to the conclusion that economic laws were only relative in nature. That is, economic laws of one nation may not be suitable to another nation. So, Ranade thought that the historical method which takes the past into account in its forecast of the future is more appropriate than the deductive abstract classical method. In advocating the historical method, Ranade was influenced by the ideas of Friedrich List, a representative of the Nationalist School, who maintained that economic laws were relevant only with reference to a particular nation. Like the German economists, Ranade accepted the concept of state as an organic whole having its life and spirit and it was not an algebraic sum of economic units. So, he rejected the laws of economics derived on the basis of individual behaviour. Ranade was in full agreement with the view according to which economic problems and policies have a meaning only with reference to their specific circumstances. Depending on the time and space, economic laws change and therefore, universal applicability has lost its tenor and vigour, as per the critiques of classical method

Ranade argued that the traditional assumptions of economic theory are not applicable anywhere except in England. In the light of the situation in India, he overruled the application of the British classical school of thought. He recommended for a greater role to the state for developing the economy of India rejecting the laissez faire philosophy of the classical school.

Therefore, Ranade believed in the view that economic reasoning should be firmly based upon reality in which not the individual but the whole society should be the focal point. He recommended the study of theory and practice should go hand in hand. According to Ranade," the individual and his interests are not the centre round which the Theory should revolve, that true centre is the Body Politic of which that Individual is a Member". He said: "Theory is only enlarged practice and practice is theory studied in its relation to proximate causes". These two should be studied simultaneously facilitating scientific analysis of the subject matter of economics.

2.4.2. POVERTY IN INDIA

Ranade believed that poverty in India had been existed even before the advent of the Britishers. Of course, he agreed that poverty in India was intensified by the misrule of the British government. Ranade witnessed the transition which the Indian economy was passing under the influence of western economies. He felt that the transition was not quick enough due to the institutional hindrances in India. The institutional bottlenecks include: primary exports, collapse of traditional handicraft industries, backwardness gave rise to labour immobility, lack of modern industries and economic institutions, etc. In addition, there was the existence of imperfect markets and income and wealth distribution was done more by custom rather than by economic forces. All these hurdles make it impossible to get the Indian economy transformed into a modern economy.

Ranade listed several reasons for the increasing poverty in India. According to Ranade, the primary cause of poverty was increasing dependence on agriculture. India was a predominantly agricultural economy. India was a primary exporting country. India exports agriculture produce for which it imports manufactured goods. The policy of importing finished products without encouraging the Indian industries acted as a ruin of India. The productivity in agriculture was very low because of lack of mechanization. Secondly, alternative employment opportunities were lacking. There was no development of industries and at the same time crafts and art industries were collapsed due to the policy of the British government of encouraging the import of finished goods. These artisans were thrown out of their livelihood and converted into agricultural labour which added pressure on the already burdened agriculture sector. All this led to the creation of 'disguised unemployment', meaning unemployment in disguised form. Industries which exist, if any, were in a backward state owing to their inability to face stiff foreign competition leading to their closure. Thirdly, the literacy level was very much low making them unable to learn the technical skills of modern jobs. This made them to join in the ranks of unskilled workers. Lack of education had also promoted much structural rigidity among Indian labour making them immobile. Fourthly, low income levels were a major cause of concern for the low levels of living of the people. Fifthly, the credit system was highly disorganized and banking facilities were inadequate leading to the scarcity of capital and low entrepreneurship in the country. Finally, land policy of the British government was defective because the assessment of revenue was highly arbitrary.

Therefore, the main causes of India's poverty were primary production, backward industries, paucity of capital and defective land policy. Ranade denied the view of Naoroji that draining of India's resources by the British was the main cause of poverty of India. Ranade argued that poverty in India was caused by the increasing dependence on agriculture for livelihood. In a country like India, there was complete absence of landed gentry or wealthy middle class. Development of industries in India had become a problem. Ranade viewed that our laws and institutions favour a low standard of living and our religion condemns accumulation of wealth and power. So, he was struck by the abject poverty of the

Indian people. He said: Stagnation and dependence, depression and poverty – these are written in broad characters on the face of the land and its people".

2.4.3. STRATEGY FOR ECONOMIC DEVELOPMENT

Ranade observed that there was immediate necessity for the removal of poverty in India, thereby making India a modern developed economy. In this context, he suggested certain measures. These are provided in the following paragraphs.

(a) ON PROTECTION

The situation can be improved by means of discarding the laissez faire and free trade policy of the West. According to Ranade, a policy of protection, along with encouraging the entrepreneurs to start new enterprises, was the answer to covert the economy into an industrialized country. He suggested for the imposition of import duties on the foreign sugar. In those days, the best sugar from Austria and Germany were flooding the world markets leading to the closure of Indian sugar industries. So, heavy import tariffs were suggested by Ranade on sugar. He asked the British government to adopt a positive policy industrial development of India by protecting the domestic industries.

(b) ON TORRID ZONE DEVELOPMENT

He opposed the argument of the Britishers that torrid zones like India were meant for producing only raw materials. To this, Ranade said that India can very well specialize in the production as well as in the processing of raw materials. In this connection, he offered five arguments in India's favour. Firstly, in these torrid zones, industries should be established to start with. Secondly, industries should be located near to the raw material supplies and the markets for the products to save transport costs. Thirdly, the territorial division of labour had unduly favoured some countries at the expense of others. This advantage was mainly because of the use of machinery, iron and coal. These benefits were not their distinct advantages. The same might also be enjoyed by the underdeveloped countries of torrid zones like India. Fourthly, J.S.Mill favoured free trade only after a stage when industrialization of a country had passed the ‘infant stage’. On the other hand, Adam Smith allowed free trade only when it was beneficial to England. So, Ranade argued that India should adopt a policy of protection until Indian industries passed the test of infancy. Finally, Ranade opined that the type of territorial division of labour advocated by the classical economists would make the country to depend on agriculture only. Ranade said, agriculture in torrid zones is subject to uncertainties of rain and yields. Ranade firmly believed that agriculture alone could not promote development. There should be industrial base. He said that economic growth, industrialization and urbanization move together. Therefore, he suggested for a policy of industrialization for economic development of India. According to him, India has a distinct advantage in possessing huge amounts of natural resources including abundant supply of labour. Ranade was in the opinion of promoting labour intensive industries. Also, he was in favour of developing certain strategic industries such as iron and steel to make the people sustain themselves from recurring famines. Therefore, diversification of Indian economy was the only way out for rapid development of Indian economy.

(c) ON FARMING

He advocated state action to promote ‘large scale farming’. Ranade believed in a balanced and planned development of agriculture, industry and urbanization for promoting economic development of the country. Agriculture and industry are mutually interdependent. Agricultural growth should also be integrated with urbanization and industrialization. He advocated that India was required to transform the raw materials into finished goods for the purpose of export to foreign countries. Ranade recommended changes in land policy to serve the interests of the cultivators of the soil. He said that land should belong to the farmers. He said that the farmers might be permitted to pay their tax in kind. Ranade advocated a permanent ‘ryotwari land settlement’ at least for 20 to 30 years. For facilitating credit in the agricultural sector, he suggested institutional changes in the agriculture sector. The state should play an active role in this regard.

(d) ON REDISTRIBUTION OF POPULATION

Ranade advocated a balanced redistribution of population of India which must in conformity with the available productive resources in different parts of the country. He opined that an integral set of schemes were required for planning the internal migration of population. He recommended immigration of population from thickly populated and overpopulated regions to thinly populated areas. In this context, the state had to play its role for securing a faster rate of economic growth. This establishes perfect labour market in the country, so that wage rate stabilizes.

(e) INTEGRATION OF AGRICULTURE AND INDUSTRTY

According to Ranade, industry and agriculture are mutually interdependent. He opined that the state has an active role in the development of both the sectors which is essential for rapid economic development. For instance, a strong agriculture is needed to have a strong industrial base because the agriculture is supplying the necessary raw materials and food to the industry. On the other hand, a strong industry is needed to boost the production in agriculture via mechanization. Here Ranade was of the view that agricultural development did not imply mechanization in a country like India with surplus manpower. In his view, the surplus manpower should have to be solved by developing industries and a non-mechanized agriculture.

(f) ON STREAMLINING THE SUPPLY OF CAPITAL

Ranade also examined the need for capital accumulation in economic development. He observed that there was the availability of large amount of capital funds in the country. But there was no existence of proper mechanism by which these funds were made available to the industry. The private sector had failed to attract these funds. On the other hand, there was excess demand for government securities. The lacuna was not having suitable financial intermediaries for channeling the funds available with the public. Money lending activity was predominant in the country. Therefore, an institutional lending mechanism was the need of the hour for rapid growth of the economy. The banking system should have to be expanded as a remedy.

(g) ON STATE'S ACTIVE ROLE

Ranade suggested for the active intervention by the State in removing the poverty and in promoting the wealth of the country. The state had both a right and a responsibility to help the economy. In the words of Ranade, "the state should come forward with such measures as may prove helpful in the development of the economy of the country, to the maximum advantage of the people". His object was planned economy for India to establish a welfare state. As a part of the planned development of the country, Ranade suggested that the government "should try as an experiment the Policy of Cultural System". He implied that a policy of starting various public undertakings which could act as a catalyst of economic growth. According to Ranade, such a policy was adopted by the Dutch "in the East Indies with signal success". He argued that the Government had already helping the farmers and subsidizing the railways in the country. In the Ranade's opinion, such help would be available only initially, but in the long run, large scale joint stock companies must be developed in the country to face the stiff competition from foreigners.

According to Ranade, there was a wider scope for state's action and planning in the Indian economy. We have already mentioned that the state had to establish public enterprises to accelerate economic growth. In this scheme of things, he also recommended for protection for Indian industries. In addition, the state should adopt a policy of purchasing stores in favour of Indian products. Ranade felt that these forward steps would initiate the creation of demand for Indian products. Ranade believed that industrialization would have an urban bias. With a policy of urbanization, it would ensure an extensive market for Indian products. Ranade recommended that the state had to reorganize credit and financial system of the economy. Also, the state should encourage a policy of internal migration and emigration of excess population to get better utilization of

India's resources. Ranade advocated for the import of foreign technology and technical personnel in the initial stages of industrialization, but in the long run, he recommended a policy of Indianization of technical manpower.

According to Ranade, the ultimate aim is the removal of poverty from India, removal of total dependence on agriculture as the only source of income and secures a balanced growth.

2.4.4. APPRAISAL OF RANADE'S IDEAS

Ranade is known for his economic nationalism. Besides being an eminent economist and able historian, he is a nationalist and a great patriot. He adopted the historical method for his analysis of Indian economy. Though he is basically a man of jurisprudence, he thoroughly examined the appalling conditions of the Indian economy and recommended several remedies as a way out. Basing on his nationalist views, he recommended for a wider role for the state's action and planning correcting the miserable lives of the people. Accordingly, he advocated a policy of active state intervention by establishing public undertakings to accelerate the progress of the economy in the light of a weak private sector. Ranade fought hardly for economic justice for India in view of draining of resources by the British government. The primary aim of Ranade was to remove poverty and to remove increasing dependence on agriculture. He was right in saying that a balanced development of agriculture, industry and urbanization was the need of the hour. Ranade's tireless efforts for accelerating Indian economic progress left an indelible mark on Indian economic thought.

2.5. TECHNICAL TERMS

1. Drain Theory
2. Internal Drain
3. External Drain
4. Vicious Circle of Perpetuating Poverty
5. Factor Shares

6. Regressive Taxation

7. Salt Tax

8. Ability to Pay

9. Revenue Manual

10. Historical Method

11 Economic Nationalism

12. Immobility of Labour

13. Backwardness

14. Urbanization

15. Disguised Unemployment

16. Torrid Zone

17. Infant Stage

18. Ryotwari Land Settlement

19. Redistribution of Population

20. Policy of Cultural System

21. Policy of Protection

2.6. SELF-ASSESSMENT QUESTIONS

1. How can the Grand Old Man of India, Dadabhai Naoroji surmounted the formidable task of estimating National Income in view of the lack of organized data?
2. What is ‘drain theory’? In what way it adversely effect the Indian economy?
3. Mahadev Govind Ranade adopted the Historical method of analysis in economics. How does it come to aid his views on Indian economy?
4. Explain the following concepts.

a. Public Finance and Financial Administration of Naoroji.
b. Role of the State's action and planning of Ranade
c. Methodology and Scope of Political Economy of Ranade
d. Internal and external drain of Naoroji.

5. Define Economic Nationalism. Does it differ from Socialism or Communism?

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M.A. ECONOMICS: EVOLUTION OF ECONOMIC DOCTRINES

LESSON-4/UNIT-5: ECONOMIC THOUGHT IN MODERN INDIA- 2

-- MOHANDAS KARAMCHAND GANDHI (1869-1948)

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M.A. ECONOMICS: EVOLUTION OF ECONOMIC DOCTRINES

LESSON-4/UNIT-5: ECONOMIC THOUGHT IN MODERN INDIA- 3

-- MOHANDAS KARAMCHAND GANDHI (1869-1948)

4.1. OBJECTIVE OF THE LESSON

This lesson is exclusively dealt with contribution made by Mohandas Karamchand Gandhi, who is popularly known as Mahatma Gandhi, in the field of modern economic thought. In this lesson the views of Mahatma Gandhi regarding Village Industries. His views on economics are rightly called as „Gandhian Economics" are explained in detail.

4.2. INTRODUCTION

Mahatma Gandhi occupies an important place in the history of our independence movement. He is the first person in the world to use non-violence and satyagraha as weapons to the destruction of British hegemony in India and secure complete freedom from them. While doing so, he has created large scale awakening among the people of the country and he made them to participate voluntarily in the cause. He has a unique personality in that he first practices what all he said regarding his ideals and has shown the way to the people to follow suit. In short, he adopted a non-violent attitude based on the principle of „self-suffering" rather than making the adversary to suffer. Mahatma Gandhi appeared at a time when the national movement was gaining momentum. His presence has changed the shape and direction of the movement. Gandhi has led the people to achieve independence in 1947 leaving the sufferings of people over partition of the country.

Gandhi was born on October 2, 1868 at Porbander. At a young age of 18, Gandhi went to England to study law and joined in the Bar in 1891. During the period from 1893 to 1914, he did a yeoman service to the cause of racial racial equality in South Africa, which was colonized by the Britishers. In South Africa, Gandhi used the ideal of „passive resistance" to fight against the persecution of the Indians which won the hearts of even his opponents. Gandhiji returned to India in

1915 and actively engaged himself in the Indian freedom movement through Indian National Congress. His selfless service to the nation won the hearts of the Indians who rallied round him in the cause of overthrowing the British Raj. For the first time Gandhi offered Satyagraha against the Rowlett Act. In 1930, he started the Salt Satyagraha (Dandi March) and in 1930 launched the civil disobedience movement. In 1942, he launched the Quit India Movement. Gandhiji was arrested on a number of occasions during his political career, but never abandoned his chosen path for the cause of India. In all his life, Gandhiji believed in human dignity and freedom. On January 30, 1948, he was shot dead.

Gandhiji is neither an economist nor a politician. But he is a socialist. His ideas on economics are mixed with his philosophical, political and sociological ideals. Gandhiji"s ideology was greatly influenced by works of Tolstoy and Ruskin. Tolstoy"s book „The Kingdom of God is within you" and Ruskin"s „Unto the Last" had a far reaching influence on him. Gandhi owned to Tolstoy the concepts of egalitarianism, simplicity and asceticism, which were the cornerstones of his economic ideas. Tolstoy popularized the concept of „Bread Labour „from which Gandhi strengthened his conviction that machine should be done away with. From this bread labour concept, Gandhi was made to believe that a man who did not do body labour had no right to eat. Gandhi developed distaste for material progress. His views on the decentralization of political and economic power are derived from the ideas of the anarchists like Prince Kropotkin. The writings of Hindu saints and sages had also played their role in shaping the Gandhi"s ideas. Also, Gandhiji was a worshipper of Baghvad Geeta and Upanishads which also played a significant role on the derivation of Gandhiji"s economic ideas.

Regarding the writings of Gandhiji, we can trace out number of works for the purpose understanding his economic ideas. The writings include, "The Constructive Programme", "The Economics of Khadi", "Hind Swaraj", "Sarvodaya", "Towards Non-violent Socialism" and numerous articles published in Young India and Harijan. The other source available is that of J.C.Kumarappa: "Gandhian Economic Thought".

The foremost objective of Gandhiji is human dignity and freedom. For this purpose, he adopted non-violence, since violence was also a form of exploitation. To achieve human dignity, he said that economic emancipation is necessary. So, economic ideas in the Gandhian scheme of things do not stand in isolation from other from his other philosophy. Hence, Gandhian economics is to be studied in a totality of his views. For instance, as we said earlier that Gandhi mixed his economic ideas with his ideas of philosophy, politics and sociology. Gandhi is not concerned with economic theory, but it is a policy based upon his ideals of welfare and other philosophical ideals. Therefore, Gandhian economics is not a logical rigorous theory and it is part and parcel of his total thinking. This strikes a similarity with the Western economic thought.

4.3. SCOPE OF GANDHIAN ECONOMICS

In the Gandhian scheme of things, Gandhiji aimed to bring out the essential goodness in man regarding his ideal society. His views regarding man are different from the classical economic man. The classical economic man is a rational human being and it is a reality in the Western countries and even in the Eastern countries for that matter. But Gandhiji is believed in putting forth ethical values in respect of man‟ actions. He is interested in propounding the principle of what ought to be in respect of economic activities of man. Therefore, Gandhian economics is based on ethical considerations. Gandhian economics disregards economic progress in the material sense of the term. We can regard Gandhiji as a utilitarian because his economics is a special type of utilitarianism which cannot be estimated with the medium of money. Also, Gandhian economics is not based on pure hedonism of pain and pleasure. But it is based upon the human goodness and happiness caused by common welfare. Gandhiji believed in social welfare of the people by which the welfare of an individual is not independent of the welfare of the other members of the society. The welfare of the individual is in fact increased by the welfare of other members. Gandhian economic ideas are based on four cardinal principles: Truth, Non-Violence, and Dignity of labour and Simplicity. Gandhiji‟s life and philosophy: social and political, was governed by these principles. In the words of Huxley, “Gandhiji‟s social and economic ideas are based upon a realistic appraisal man‟s nature and nature of his position in the universe”.

The principle of „simple living and high thinking‟ drawn from Hindu philosophy and religion has played an important role in Gandhiji‟s life making him a practical idealist. In this principle, he found the remedy to solve all the modern ills of the society. Gandhiji opined that satisfaction and happiness are the metal conditions which act as restraint on the desire to satisfy multiple of wants. Simple living, according to Gandhiji, is a means to attain eternal bliss. Since Gandhiji was an apostle of non-violence, his economics may be regarded as economics of non-violence. It is on practicing this principle in practical life that the true democracy and the real growth human personality depend. According to him, exploitation of labour is a form of violence against human labour. Hence, he was against the modern capitalism. Gandhiji believed in the dignity of labour in that every individual must undergo physical labour to earn his living. This was the one of the important strongest pillars on which the Gandhian economy rests. Therefore, Gandhiji attached great significance to spiritual and moral values rather than to material and economic values to man.

Gandhiji‟s economic ideas are found scattered in short notes in the weeklies which he edited. His statements in these writings are often extempore. Gandhiji did not write any systematic book on the subject. So, one can notice contradictory views in his writings and speeches. Therefore, Gandhian economics is not a logically developed theory but it is part of an action plan of Gandhiji.

4.4. PRINCIPLES OF GANDHIAN ECONOMICS

Gandhian economics aims at a two-fold attack on the reduction of inequalities. The first one is increasing the incomes levels of the poor in the country. The second one is changing the attitude and motivation of the rich. Gandhiji declared that abject poverty should be removed. He observed that vast sections of the masses were not able to get the bare necessities of food, clothing, shelter and potable water. Gandhiji felt that there was the urgent necessity of meeting the basic needs of the people. Gandhi was against the state intervention in reducing inequalities of income.

Profit motive of the traditional economics has no place in Gandhian economics. In Gandhian scheme of things, individuals are not interested in their own material progress, but interested in the welfare of the society. Individual‟s welfare gets enhanced through the increase in the social welfare. Under Gandhian economics, individuals are not supposed to struggle for the accumulation of wealth. He considered that material progress is not an end in itself. On the other hand, a wealthy person is to consider himself as a trustee of the national wealth.

Large scale industries have no place in Gandhian economics. These large scale industries produce goods based on the market demand and therefore aim at profit. They fail to look after the needs of the common people. These industries are driven by profit motive. We have already said that Gandhiji was against profit motive. In Gandhian economics, material progress is not allowed to supersede the spiritual and moral progress. Also, under this profit motive, exploitation of human labour and dignity are involved. This leads to concentration of economic power and use of force. In this con text, he did not prefer replacement of private enterprises with public enterprises. These public enterprises are also working on profit motive and their operations are on large scale. On the other hand, he preferred village industries which absorb good amount of human labour. Gandhiji wanted the promotion of Khadi and Village industries which generate employment to the masses. Therefore, he believed in the production by the masses and not mass production by large scale industries.

Gandhian principles can be categorized into the following: Firstly, encouragement of village and Khadi industries keeping mechanization at bay. Secondly, Gandhian economics stresses the need for improving the rural small scale agriculture. Thirdly, Gandhiji indicated the establishment of self-sufficient and self-reliant Gram Swaraj. Fourthly, he suggested for the decentralization of the administrative and economic structure. Fifthly, Gandhian economics aims at reducing the income inequalities. Sixthly, Gandhiji stated that wealthy class must take the responsibility of the national wealth as trustees or „Dharma Kartas".

In Gandhian economics, the views expressed by Gandhiji are utopian in nature in which all kinds of ideal conditions are wished for and cannot be practicable in the modern world of human behaviour. For instance, no man can invest money on the basis of non-monetary considerations. Therefore, Gandhian economics is neither desirable nor feasible in the modern world.

4.5. VILLAGE REGENERATION OR VILLAGE SARVODAYA

According to Gandhi, India lives in villages. He was interested in making the villages as self sufficient and self reliant in all respects. Gandhiji opposed extensive application of machines in the production of goods. The large scale production of goods leads to increasing urbanization. The industrialization and urbanization leads to pauperization of villages and large scale unemployment in the country side. In his words, "Industrialization on a large scale necessarily lead to passive or active exploitation of the villages as the problems of marketing and competition come in". Gandhiji wanted the revival of old ancient village communities by emphasizing the fact that production was simultaneous with consumption and distribution and vicious circle of money was absent. He said further that production was for immediate use and not for distant markets. The whole structure of the society was founded on non-violence. Gandhiji wished these village communities to be self sufficient with prosperous agriculture, decentralized industry and small scale cooperative organizations. By self sufficiency he meant that nothing would be allowed to be produced by the cities which could equally well produced by villages. According to him, the proper function of cities is to serve as clearing houses for village products. Gandhiji wished that there should be participation of people at all levels of community organization in villages. He also said that real India was to be found in villages and not in the towns. His objective was that every Indian village should be converted into a little self-sufficient „Village Republics".

In the ideal Village Republics, he laid down certain conditions to reflect the true spirit of Village Sarvodaya. Gandhiji wanted to make agriculture productive making use of such techniques of production which will not deplete the quality of the soil. He was against the use of artificial fertilizers and favoured organic fertilizers to improve the soil fertility. Regarding irrigation facilities, Gandhiji preferred well irrigation instead of the irrigation by hydro-electric projects, as these will lead to exploitation. In respect of land ownership, he believed in the collective ownership of land for balanced cultivation rather than individual ownership and cultivation. Gandhiji did not favour peasant farming also. In this context, he wanted the abolition of the Zamindari system. The land should belong to the cultivators. The surplus produce on the land should be distributed to the rest of the members of the village community. The other features include: a. villages should have a „Dharmashala" and a small dispensary; b. villages should be self-sufficient in respect of food and clothing; c. roads and lanes should be kept clean; d. the places of worship should be beautiful and clean; e. the village should have a public hall, a school and a theatre hall; f. the village should have an efficient water supply; f. education up to the basic standard should be made compulsory in the village; g. rural activities should be organized on cooperative lines; h. village administration should be given to the village Panchayats consisting of five members duly elected every year by the adult villagers; i. the village panchayats should have judicial, legislative and executive powers; j. caste system should be abolished; k. the village should have a playground, cattle sheds, etc; l. the village should consist of adequate drainage system; and m. the village administration should protect the people and property from unlawful elements for which the system village guards should be established in the villages.

Gandhiji views on Village Sarvodaya are far from practicable and he himself knew that it was not simple and easy to establish such an ideal society in India. However, the ideal village described by him shows the way to the future generations in India.

4.6. GANDHI‟S VIEWS ON MACHINERY

Gandhiji opposed the use of machines in the production of goods. According to him using machine is „great sin‟. It should be looked down as an evil. His critics called him as a medieval mystic basing on his views on machinery. All his opposition to the use of machine is directed to the fact that machine causes exploitation of labour. But he failed to visualize that human progress will be lagged behind as a result of non-application of machinery. This is because a machine produces output at a faster rate than a man. The critics were in fact misunderstood his real attitude towards machinery. Gandhiji was not against the use of machinery in general. His objection was against the use of labour saving machinery. When labour saving machines are employed, human labour will be thrown out of employment and die of starvation. . So, he was not against the use of machines, when he knew that even this body is most delicate piece of machinery. In the words of Gandhi, "The spinning wheel itself is a machine, a little tooth pick is a machine, what I object to is the craze of a labour saving machinery. Men go on saving labour, till thousands are without work and thrown on the open streets to die of starvation. I want to save time and labour not for a fraction of mankind, but for all….Today machinery merely helps a few to ride on the backs of millions". Gandhiji was against the use of capital intensive technology in the industry replacing the labour. He said that made rush for wealth must cease and the labour must be assured not only of a living wage, but a daily task that is not a mere drudgery.

The problem is that India has plenty of human resources, but capital resources are poor. So, with a view to absorbing the surplus manpower, it was essential to adopt those methods of production which would be labour absorbing. Gandhiji welcomed such machinery that saved individual labour and lightened the burdens of millions of cottagers. Gandhiji was against the use of machinery of those goods which can as well produced by the villages without much difficulty. In 1934, Gandhi said, "Mechanization is good when the hands are too few for the work intended to be accomplished. It is an evil when there are more hands than required for the work, as is the case in India". What all Gandhiji wanted to explain is that the use of machinery results in technological unemployment in India in the light of its population. Therefore, he suggested for the application of labour intensive methods of production in view of the surplus labour situation in India.

4.7. INDUSTRIALIZATION & KHADI AND VILLAGE INDUSTRIES

Gandhiji opined that so long as the village communities are capable producing goods to meet the multiplicity of wants of the villages, the role played by the large scale industries is limited to the production of capital goods meant for future production. Gandhiji believed that industrialization is a curse on mankind. He was fully convinced that the large scale production was responsible for many socio-economic evils. Also, Gandhiji opined that large scale production of goods requires extensive markets and in a way to find out markets, the situation will lead to colonization. It will lead to wars and other forms turmoil. In this process, the position of the labourer will be reduced to a slave to the machine and he will lose his dignity and pride. Hence, Gandhi declared that industrialization is not necessary for India. He explained that repetition of the Western industrialization in India is an attempt at impossible because India has its own characteristics and individuality. In the words of Gandhi, "If we are to find out a true solution for her many ills, we shall have to take all the idiosyncrasies of her constitution into account and then prescribe a remedy". According to him, the immediate problem faced by India is the universal underemployment of the peasants. Hence, underemployment in villages is to be addressed first. In this connection, he suggested for the development of village industries. In the case of villages industries, goods are produced, distributed and consumed within the villages. In respect of cottage industries, goods are produced for the country as a whole and also for foreign markets. In this connection, Gandhi said that in cottage industries, there will be possibility of exploitation. But there is no such thing in the case of village industries. In addition, Gandhiji opined that khadi industries are based on truth and non-violence, though factory made products are cheaper than khadi products. According to Gandhiji, khadi industries are a symbol of "unity, freedom and equality". Promotion of these industries will encourage decentralization of production and distribution of the products. On the other hand, large scale production through the use of machinery involves the danger of violence and untruth. He said that class struggle between labour and capital is an offspring of industrialization. Gandhiji, therefore, did not favour such large scale industries.

Gandhiji was against large scale industrialization on the grounds of social justice. According to him, industrialization will encourage enrichment of a few people at the expense of the large sections of the society. Here the few refer to capitalists or employers of the industry. The labour community is the exploited lot and they are reduced wage-slaves. Not only that, the national wealth goes into the hands of the few capitalists by means of their monopoly power in the country leading to the concentration of wealth. This increases the gap between haves and have-nots. There is a co-existence of pauperization of the large sections of the society and the few enriched wealthy people on the other. All this violates the basic tenet of Gandhian economics.

Gandhi recommended for the development of Khadi industries as a remedy to the mass unemployment and underemployment in the country side until a better system of supplying work and adequate wages for every able bodied persons is found. In this connection, Gandhi provided a Khadi scheme which is as follows:

a. Compulsory introduction of spinning in all schools.
b. Encouragement of cotton cultivation in those areas where it is not grown.
c. Establishment of multipurpose cooperative societies to organize weaving.
d. All government employees at the local body level should necessarily pass a spinning test and in case anybody fails, he may be disqualified.
e. Imposing a ban on the use of mill cloth in areas where there is the availability of handmade cloth.

f. The old cotton textile industries should not be permitted to expand and no new mills are to be opened.
g. Impose ban on imports of foreign cloth or yarn.
h. Encourage the government departments to use the hand woven cloth.

4.8. GANDHI‟S VIEWS ON DECENTRALIZATION

Gandhi was opposed to an industrial economy because he thought that mill industries and the use of machines caused violence. Gandhi‟s life was based on the principle of non-violence. He was, therefore, in favour of decentralized pattern of development. Under this principle, Gandhiji felt that production should be organized at a large number of places at a small scale or production in the people‟s homes. Gandhiji believed not in the mass production of goods, but production by the masses. Decentralized industries can play an important role in the development of the country with lease disturbance and dislocation. In this Gandhian scheme, the small industries and village industries can serve the purpose of decentralization. Gandhiji wanted to revive the cottage industries because he thought that „production was simultaneous with consumption and distribution and the vicious circle of money economy was absent. Also, production of these village industries is meant for immediate use in the villages and not for distant markets. Therefore, Gandhi believed that the whole structure of society was founded on non-violence. The centralized industries are the large scale industries. These large scale industries are against the true principles of democracy. On the other hand, the village industries are truly democratic and there is no fight between labour and capital. The separation of interests between labour and capital in a small scale industry is more or less absent. Gandhiji‟s faith in decentralized economy was all the more strengthened because he thought that it was essential for the survival of democracy. He opined that the ideal constitution, say for India, must be based on the organization of well-knit and coordinated village communities with their positive and direct democracy, non-violent cottage economy and human contacts. Gandhiji also felt that decentralization was also essential for the establishment of a non-violent state. Such a state could not be established in a factory civilization, Gandhi believed.

Gandhiji realized that in respect of certain large scale industries which cannot be avoided in the light of economic development, he felt that there should be state control over such enterprises. He suggested nationalization of certain basic and key industries.

Therefore, Gandhiji did not believe in the establishment of large scale enterprises because they aim at material progress and violence and unrest. According to Gandhi, material progress is not an end in itself. He believed in „simple living and high thinking‟. Gandhi advocated the people to practice simple living and at eternal bliss. Accordingly, Gandhi advocated the decentralization of Indian economy to encourage people‟s participation in the process of economic development giving weightage to the village industries.

4.9. GANDHI‟S DOCTRINE OF TRUSTEESHIP

Gandhiji was against the concentration and misuse of wealth in a few hands. Gandhiji has developed the concept of trusteeship as an alternative to the Marxian Socialism. He disregarded the Marxian Socialism as a way out for mass poverty. In Gandhi‟s ideal social order, individual is at the centre stage and State is to protect the welfare of the individual. On the other hand, under Marxian socialism, individual is subordinate to the state. Gandhian socialistic order is based on non-violence. There is the involvement of violence in the Marxian socialistic order. Hence two views are different and opposite to one another.

Gandhiji is a believer of the „spirit of non-possession‟. According to him non-possession refers to „aparigraha‟. He said that when a person secured a big fortune or accumulated wealth by means of profits from industry and trade, the total amount that he earned did not belong to him, but to the entire society. The person who had accumulated wealth is entitled to a rightful share in that wealth to make a honourable living. The persons who accumulated wealth would keep for them only that much of wealth which is essential for a good standard of living (HARIJAN, AUG.1940). The rest of the amount should belong to the community as a whole and should be utilized on the welfare of the society. If any person dishonours this philosophy of aparigraha, he will be treated as a thief. According J.B.Kripalani, capitalist is likened to a thief. This is because he is appropriating the entire wealth accumulated by him for his own selfish use. This does not mean that Gandhi was against the capitalists as a class because the society would become poor in their absence. Gandhiji really wanted to correct the capitalists and to impress upon them that the wealth they had accumulated was not to be possessed by them, but to be held in trust. Gandhi made a distinction between „possession" and „possessiveness". According to him, the evil is not in possession as such but in the attitude of possessiveness. Gandhiji desired the capitalists to become trustees or Dharma Kartas of the nation by running their business with integrity and efficiency and for the welfare of the people. This means that they should appropriate for themselves no more than fair return for the services rendered and should surrender the rest to the society for its welfare. He opined that all social property should be held in trust. The capitalists as trustees of the social property are not only to take care of themselves but also of others in the society. In return to the trusteeship of capitalists, Gandhiji insisted that workers should have faith in the capitalists as their benefactors. Gandhiji believed that such a system would result in harmonious relations between labour and capitalists. Gandhiji has so great faith in the doctrine of trusteeship that it would lead to the establishment of a state of equality on earth. In such a situation, labour welfare would be maximized. Therefore, trusteeship is a means of transforming the capitalist order of society into a socialist state eliminating economic inequalities. The entire philosophy of trusteeship can be summarized in one phrase, namely, "a trustee has no heir but the public".

The salient features of Gandhian Doctrine of Trusteeship are given hereunder:

"Firstly, trusteeship provides a means of transforming the present capitalist order of society into an equalitarian one. It gives no quarter to capitalism, but gives the present owning class the chance of reforming itself. It is based on the faith that human nature is never beyond redemption.

Secondly, it does not recognize any right of private ownership of property except in as much as it may be permitted by society for its welfare.

Thirdly, it does not exclude legislative regulation of the ownership and the use of wealth.

Fourthly, under state-regulated trusteeship, an individual will not be free to hold or use his wealth for selfish satisfaction or in disregard of the interest of society.

Fifthly, just as it is proposed to fix a decent minimum living wage, even so, a limit should be fixed for the maximum income that could be allowed to any person in society. The difference between such minimum and maximum incomes should be reasonable and equitable and variable from time to time so much so that the tendency would be towards obliteration of the difference.

Sixthly, under the Gandhian economic order, the character of production will be determined by social necessity and not by personal whim or greed". (M.K.Gandhi, Sarvodaya).

It is argued that by means of the doctrine of trusteeship, Gandhiji was trying to give a new lease of life to the capitalist system halting the forces of revolution in the economic sphere. This is because capitalists could not be trusted to function as real trustees of their own free will without legislative compulsion. But the doctrine of trusteeship does not exclude legislative regulation of the ownership and the use of wealth. Gandhiji wanted to give a chance to the capitalists to reform themselves in the faith that human nature is never beyond redemption. On the basis of the doctrine of trusteeship, Gandhiji wished to establish an ideal form of society where everybody would work for the progress of the economy in a spirit of cooperation and trust.

4.10. GANDHI"S VIEWS ON BREAD LABOUR

Gandhiji believed in the dignity of human labour. He explained the idea that everyman must eat his daily bread by the sweat of his labour. Gandhiji used the term bread labour to mean manual labour. This applies to all types of labour. No one is entitled to have his food unless a man or woman performs labour. Gandhiji opined that man cannot develop his mind by simply writing and reading or making speeches all day long. By using the concept of bread labour, he tried to tell the people to use their idle hours to perform some task or other. The idle hours available in villages are equal to the working days of six months, he said. In this context, Gandhiji by himself practiced and preached the gospel of bread labour. The critics of Gandhiji considered him as a medieval mystic who was trying put back the clock of human progress regarding his emphasis on manual labour and opposition to machinery.

Gandhiji believed in the organized trade union movement of labour. He declared that the activities of the trade unions should be peaceful based on the principles of non-violence, arbitration and truth. Regarding strikes, Gandhiji favoured workers going on strikes that too based on a just cause. But it should be considered as a last resort, when all the methods of resolving the crisis have failed. Gandhiji also advocated that labour should be given an opportunity to participate in the management of the industry. This in other words refers to as „industrial democracy‟. The other views of Gandhiji regarding labour include: equal pay for equal work; shortening the hours of work, and economic equality in factories. Also, Gandhiji felt that the distinction between labour and capital should be eliminated to establish a much happier place to live in. What he wanted to say is cooperation and trust between labour and capital.

4.11. GANDHI‟S VIEWS ON THE FOOD PROBLEM

Gandhiji had experienced the worst ever famine during 1943-44 in the country. There was severe shortage food in the country. In 1943-44, Bengal suffered heavily due to the nationwide shortage of food grains. At first, Gandhiji had come to the conclusion that food shortage was due to artificial scarcity. After visiting several towns in the country like Madras, Bengal and Assam, Gandhiji arrived at the conclusion that food shortage was real and not artificial. Accordingly, he suggested some remedies to restore adequate food and pulses availability to all the regions of the country. Firstly, people should voluntarily reduce to the minimum the consumption of food grains and pulses by substituting vegetables, milk, fruits, etc. Secondly, flower gardens should be used for cultivation purposes. Thirdly, the consumption of food grains and pulses by the army should be economized. Fourthly, black marketing should be stopped strictly. Fifthly, the government should dug deep wells to provide irrigations facilities to the farmers. Sixthly, oil-seeds and oil cakes should not be allowed to be exported.

Gandhiji was against any sort of food control because it breeds artificial scarcity in the country. According to Gandhiji, people were made to depend on others as a result of the artificial scarcity. Gandhiji was of the opinion that control of food grains will lead to corruption and inflation. In November 1947, Gandhiji requested the government of India to introduce decontrol in food grains. Also, Gandhiji advised the business people not to resort to speculative activities in food grains.

12. ON POPULATION

Gandhiji has his own views regarding population. Gandhiji opposed the use of contraceptives to control the population in the country. Gandhiji was also against allowing vasectomy or tubectomy operations to control population. According to Gandhiji, the use of contraceptives would make the male population imbecile through the abuse of the creative function. He was in favour of birth control through brahmacharya or celibacy. Gandhiji felt that celibacy or self control was the infallible sovereign remedy for the population control. In order to overcome the sexual lust, Gandhiji wanted the introduction of sex education in the country. He did not believe in the opinion that food shortage was caused by the population problem. In this connection, Gandhiji opined that "by a proper land system, better agriculture and a supplementary industry, the country is capable of supporting twice as many people as there are today". Gandhiji also explained that everybody is working to earn his or her bread; there may not be any shortage of food and clothing. Therefore, he advised all the citizens of the country, whoever they may be, must undergo some sort of physical labour to earn their livelihood. Here we can add the example of Aurangzeb"s life. Though he is a king of vast Moghal Empire, he used to perform daily manual labour of making footwear to earn his living. What all Gandhiji wanted to tell the people is to perform manual labour to earn their bread in order to ward off the problem of over population.

4.13. ON PROHIBITION

Gandhiji advocated the total prohibition of the consumption of liquor. According to him, the consumption of liquor was a disease rather than a vice. Gandhiji declared that it was better for India to have a state of pauperism than to have thousands of drunkards on the streets. Gandhiji wrote on one occasion as, "If

I were a dictator of the country for at least one hour, I would have closed all the liquor shops without compensation and I compel the mill owners to start refreshment rooms to provide harmless drinks to the workmen (M.K.Gandhi, India of My Dreams)". He knows pretty well that the evil of drinking cannot be stopped by mere legislative action. Gandhiji did not agree with the fact that prohibiting liquor consumption would result in a steep fall in the revenue of the government making it unable to spend on social expenditure.

4.14. GANDHIAN SOCIALISM

As explained in the preceding pages, Gandhian socialism is different from Marxian socialism. In Gandhian socialism the individuals are at the centre stage, whereas in Marxism, the material prosperity is the supreme. The state is act according to the wishes of the individual under Gandhian socialism. All individuals are treated equally under Gandhian socialism, but man"s behaviour is controlled by the state under Marxian socialism. Under the Gandhian socialism, state is considered as an instrument of promoting the welfare of the individuals—spiritual, moral and economic. In so far as material point of view is considered, there is no difference between Gandhian socialism and Marxian socialism. What all that matters in Gandhian socialism is moral values. The moral philosophy is absent in Marxism. Under the Gandhian philosophy, individuals are free to approve or reject government policies. On the other hand, there is no such freedom under Marxism. Like Marxism, under the Gandhian philosophy regimentation is allowed, but it is voluntary. For example, to operate the philosophy of bread labour, the state tries to seek the cooperation of the people for the achievement of the ideal such as spinning Charka every day for one hour, as part of our discipline. In the Marxian socialism, we express everything in terms of material results. The Gandhian philosophy rejects the use of foreign goods because we did not know anything of the article and its quality. Therefore, Gandhian socialism attaches more importance to spiritual and moral values, i.e. truth and non-violence.

On the principles of truth and non-violence, Gandhiji introduced scheme of "Sarvodaya" under which an all-round development of the individual, community and the country are taken care of. Under the scheme of Sarvodaya, he insisted that poor people should get just and equitable share in the gifts of nature and should have freedom to enjoy the fruits of their labour. There is a similarity between Marx and Gandhiji in which both opposed the accumulation of capital. But Marx advocated the use of force, while Gandhi believed in non-violence. Whereas Gandhiji advocated the decentralization of economic and political power, Marx believed in the opposite. Gandhiji regarded himself as a great socialist because his socialism was long-lasting when the Western socialism would die soon. The difference between the two was individual freedom.

Gandhiji"s Sarvodaya advocates the emancipation and realization of the good of the human beings. According to him, the meaning includes (a) that the good of an individual lies in the good of the society; (b) that all individuals have the same right of earning their livelihood; and (c) that the life of the labourer or the tiller of the soil, and the handicraftsman is the worth living life. The philosophy is based on the values of "freedom, equality, justice and fraternity". In a society of universal brotherhood, the real "Swaraj" will be established where the people are free from sickness and disease, poverty, and cowardice. All citizens enjoy the same rights of living and freedom. Therefore, the objective of Sarvodaya scheme is the establishment of "Sarvodaya Social Order" leading to the development of a "Village Republic".

4.15. APPRAISAL OF GANDHIAN ECONOMICS

Gandhian economics has failed to provide a logical scientific theory and many economists view this subject as utopian in character in which all kinds of ideal conditions are wished for. To list out some of his utopian ideals, Gandhiji wished the people to change their hearts to lead a life of Dharma. In his scheme of things, man is considered supreme and should not be subject to exploitation by his fellow individuals or by the society. Gandhiji was against the misuse of private property and he desired cooperation to take the place of competition as social law. Gandhian economics considers economic activity as part of moral and ethical values. Therefore, it is questioned the Gandhian economics on the lines of its desirability.

Regarding the feasibility of the Gandhian economics, the inner strength and viability of the economy organized on Gandhian lines is considered weak. The economy prescribed by Gandhiji is a weak economy. In this economy, there is no scope for net capital accumulation because Gandhian economy runs on low labour productivity and the desire for improving the material conditions is absent. Gandhiji emphasized only spiritual and moral progress. Then, it is doubtful how come a village community becomes a Gram Swaraj in the light of the low percapita labour productivity with little, if not nil, net capital formation. So a village community cannot improve itself unless there is capital accumulation. For improving public health, road net work, and other basic amenities, the presence of capital is compulsory. Somehow, net economic surplus has to be generated for the development purposes whether it is through the exploitation of one section by the other or whether it is through the exploitation by the state or whether it is through improved labour productivity. Without having the surplus, the ideal village visualized by Gandhiji cannot be established. Also, India is predominantly agricultural country and in order to ward of famines and to improve its productivity, the agricultural sector needs irrigation facilities. To realize a developed agriculture in the country, a good industrial base is compulsory. Another problem is population. According to his version, if the people realize the need to limit their numbers and follow moral restraint, population problem can be solved. Gandhiji‟s ideas are medieval and unscientific. His insistence of bullock-cart economy undermining the scientific and technological advancements is not practicable. Therefore, it is doubtful whether a man can undertake decision-making solely on non-economic considerations.

Thus, Gandhian economics is neither desirable nor feasible in the light of the arguments explained. Though Gandhiji is a practical idealist, his ideals are far from being practicable in modern India. The ideal of Gram Swaraj cannot be successful as the villages were infested with politics and group rivalries.

On the other side of the coin, it is highly uncharitable to dismiss Gandhian economics as irrelevant to the modern India. Gandhiji had well understood the problems faced by India at that time. The problems include mass unemployment, scarcity of capital stock, population problem, poverty, and famines. There was a need to eradicate unemployment and in the process he suggested for the establishment of cottage and small scale industries in the light of capital shortage in the country. These cottage and small scale industries require only a small amount of capital. These industries may not lead to violence and the principle of non-violence is applicable to them. For a country like India, Gandhiji preferred production by masses rather than mass production. In a developing country like India, full employment of human resources depends on the production by the masses. Gandhiji was not against the use of machines. All that he meant that in India where capital was scarce and labour abundant. Gandhiji was afraid of the large scale use of the machinery because it labours saving devices, but at the same time, he would welcome the machine which lightens the burden of millions of people living in rural areas. Gandhiji was not opposed to the establishment of a few large scale key industries which are essential for the development of the country. He wanted to encourage those industries which produce consumer goods.

Gandhiji"s view of democratic decentralization giving adequate powers to the village governments is relevant today in terms of both political and economic development of the gross root level institutions. A decentralized economy will pave the way for the removal of unemployment, whether transitional, seasonal, frictional, and technological.

Therefore, a balanced view regarding Gandhian economics considering both positive and negative points is the need of the hour to send a true message to the world of students. As a towering personality, Mahatma Gandhi"s views have possessed a sign of permanence and they are relevant to the progress of economies as an ultimate solution to the miseries of the people.

4.16. TECHNICAL TERMS

1. Village Sarvodaya
2. Village Republic
3. Bread Labour
4. Zamindari System
5. Technological Unemployment
6. Capital Accumulation
7. Labour Saving Devices

8. Class Struggle
9. Industrial Democracy
10. Gandhian Socialism
11. Marxian Socialism
12. Communism
13. Trusteeship
14. Celibacy
15. Gandhian Economics

4.17. SELF-ASSESSMENT QUESTIONS

1. Enumerate the reasons for Gandhiji to recommend the village and cottage industries for India.
2. Why Gandhiji preferred labour intensive methods of production?
3. "Gandhian economics is neither desirable nor feasible in the present day economies". Discuss.
4. What is Gandhian Economics? Discuss its salient features.
5. Compare and contrast Gandhian Socialism and Marxian Socialism.
6. Write Notes on : a. Village Sarvodaya;
   b. Doctrine of Trusteeship
   c. Khadi and Village Industries
   d. Bread Labour

7. Why Gandhiji preferred labour to capital? Could it be possible to achieve progress of the economy without capital accumulation?

8. Examine the relevance of Gandhian Economics in the Indian context.

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