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History of Economic Thought

V. Classical Economics

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IV. The Classical School

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Key Characteristics of Classical Economics

- Devotion to *laissez faire* and free trade
- Production theory: the role of capital
- Distribution theory: the classical triad
- Population theory
- Monetary theory
 - But that's for next lecture!



1. Meanwhile in France...

- Richard Cantillon
- Physiocrats
- A. R. J. Turgot



Richard Cantillon

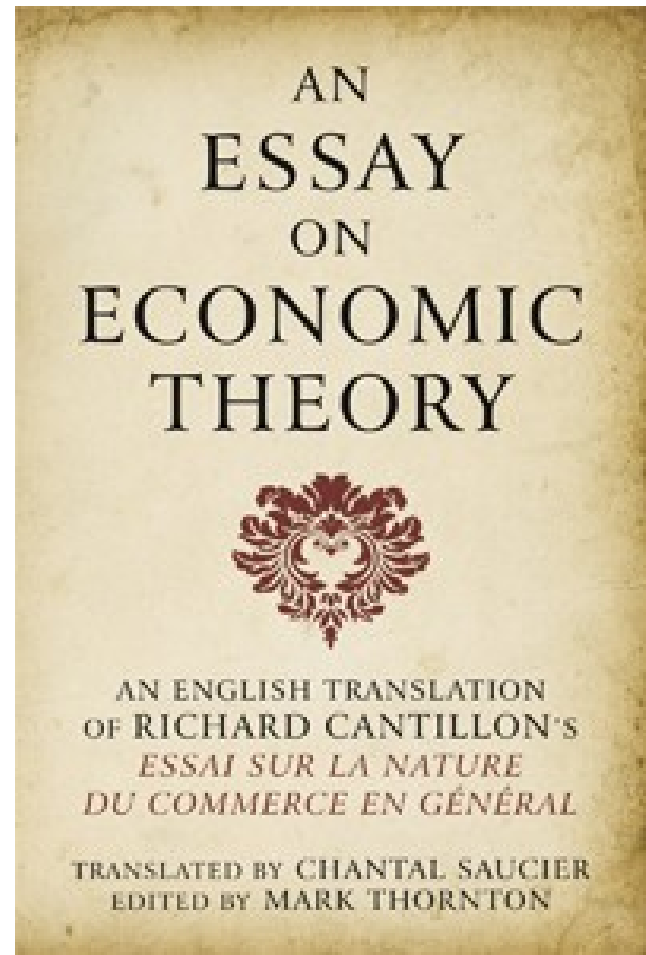


- C. 1680-1734
- Irish, family exiled after Cromwell's invasion of Ireland
- Banker in Paris, first working for cousin, then independently
- Became fabulously wealthy during the Mississippi Bubble 1717-20 – and got out in time
- Lived in various European cities afterwards
- Died mysteriously in London



The *Essai sur la nature du commerce en général*

- Written c. 1730, widely circulated in manuscript, published 1755
- General treatise on economics – unlike mercantilists
- Purely descriptive – unlike the scholastics, natural law philosophers
- Highly influential in his day, fell into oblivion after Smith





Land and Labour

- Land is the “matter” of production, earns rent
- Labour provides the “form” of production, earns wages

Entrepreneurs

- Distinction between salaried labour and entrepreneurs crucial:
 - Salaried people earn fixed, contractual wage
 - Entrepreneurs earn uncertain returns
- The entrepreneur faces uncertainty:
 - Fixed costs (contractual payments to workers and others)
 - Uncertain selling prices for final product
- The profits he earn result from his prudence, foresight
- Losses from his lack of prudence and erroneous judgement



The Theory of Wages and Population

- In the long run, wages depend on the supply of labour, i.e., on population size
- Equilibrium will be subsistence wages – but with compensating differentials
 - To attract people to jobs that require more training
 - To provide funds to train the next generation in the job
- Population growth determined by economic and cultural factors
- Increase in demand for land-intensive products lead to decline in demand for labour, lower wages, eventually lower population
- Increase in demand for labour-intensive products lead to increase in demand for labour, higher wages, eventually higher population



- First self-conscious school of economic thought, emerged mid-eighteenth century

Francois Quesnay (1694-1774)

- The founder: physician to Madame de Pompadour, Louis XV

Victor Riqueti, marquis de Mirabeau (1715-1789)

- Promoter of Quesnay: they meet July 1757, a school of thought is born



Quesnay and Mirabeau





Physiocracy

- The physiocrats originally called themselves simply “the economists”
- Physiocrats from their principle of physiocracy: the rule of nature

In Locke’s Footsteps

- Right to liberty implies right to property (Quesnay)
- There are natural laws governing social life
- Self-interest the mainspring of human action, leads to harmony if not artificially impeded

Policy

- The physiocrats cast aside all mercantilism
- For total free trade, domestic and internationally



Agriculture is the only productive sector

- Other activity may be useful, but not productive: it does not create matter
 - Perhaps influenced by Fleury and Fénélon?
- Single tax on land

The *Tableau économique*: the first circular flow model

- Depicts flow of expenditures from one class to the next
- Holistic: no mention of prices, price adjustment
- Savings bad: money leaks out, leading to reduction of expenditure

Individualist in their policies, holistic in their economics



Anne Robert Jacques Turgot, baron de l'Aulne (1727-1781)

- Brilliant but brief career in economics: really a side interest to him
- Wrote several essays, perhaps 150 pages total
- Born in Paris, studied for priesthood, but entered administration instead
- Intendant of Limoges for a decade, minister of commerce 1774-76





Self-made Economist

- A fellow-traveller of the physiocrats – but never part of their school
- First learned economics from his mentor, marquis de Gournay
 - Minister of commerce who advocated for laissez-faire

Self-interest the prime mover of economic life

- Individual interest always coincides with the general interest
- All exchange mutually advantageous
 - Freedom for domestic and foreign trade follows

Politics

- Exceptions for special interests harmful
- They turn political economy into a war of reciprocal oppression
- Therefore, commercial freedom must be universal



Subjective Utility

- Value is conferred on goods by the individual
 - He chooses between things, ranks goods on a scale
- The subjective utility of a good diminishes as its supply increases
 - Diminishing utility
 - Solves “value paradox”: since water is abundant, it is not considered very valuable

Exchange

- In an exchange, each person receives greater value than he gives up
- But the idea of equality of exchange persists: equal value will exchange for equal



Sources of Productivity

- Only agriculture productive
- Division of labour and trade greatly increases productivity

The Law of Diminishing Returns

- Double the input (advances of capital) will not lead to double the product
- After a point, all further advances useless
- There is a maximum point of returns: adding more beyond this will yield less and less
- Worked out in great detail, only graphical presentation missing



Original Capital Theory

- Capital comes from saving, consuming less than one earns
- Saving first in form of money
- Then invested in production
- Capitalists save and advance money to labourers while they work

Role of Time

- Production takes time: capitalists have to wait
- Labourers give up part of the product to benefit from capital
- Therefore, the capitalists earn a discount on the final product
- They also earn profits from uncertainty – like Cantillon



Equilibrium Returns

- Return on capital invested and interest on money will tend to be equal
- Capital owners will balance returns from different channels

Interest and Usury Laws

- Interest rates set by supply and demand
 - Many reasons to borrow
 - Two reasons to lend: security of capital and interest
- Turgot hard critic of usury laws: the contract is freely made, therefore mutually beneficial
- Money can always be invested, there are always opportunity costs to loans
- The physical quantity of loan not important but its present utility to borrower and lender

Capitalization

- The present value of land is the sum of rents discounted to the present



Turgot on Money

- Money is not a token, it is itself a commodity, a form of wealth
- Development and extension of monetary economy of crucial importance
 - Scope for commerce, capital accumulation greatly extended
 - Large sums of capital needed to develop production structure
 - Division of labour depends on monetary exchange
- There is no necessary connection between the quantity and value of money and the rate of interest
- Turgot overshadowed by Smith, but had large influence



Minister of commerce 1774-76

- Promised great effects from freeing trade
- Oversold it: too optimistic on short run gains
- Louis XVI then caved to pressure from other ministers

But is the problem overstated?

- Example of Cardinal Fleury 1723-43: moderately laissez-faire
- Gournay another example
- Real economic advance in France before the Revolution
- The real problem: the loss of faith in the *ancien régime*, partly from real and perceived failures of reform



2. Classical Economics Conquers the World

Scottish Enlightenment ends

- Presbyterian Revival
- Anti-Revolutionary Reaction

Dugald Stewart (1753-1828)

- Smithian apostle, professor of moral philosophy at Edinburgh
- Smithian since 1785, began teaching economics 1800 until retirement in 1810
- Influenced a generation of British economists/thinkers

Shift to England / London

- Still outside universities, key figures businessmen, civil servants
- *Political Economy Club* founded 1821



In France

- Physiocrats discredited following French Revolution
- *Wealth of Nations* translated by Germain Garnier
- Jean-Baptiste Say: Smith founded economics, I am merely the systematizer of Smith

In Italy

- *Wealth of Nations* translated already 1779
- Still strong native tradition: Pietro Verri (1728-1797) and others
- Smith came in more strongly with French troops in 1790s
- Displaced (c. 1810) by French: Destutt de Tracy and Say

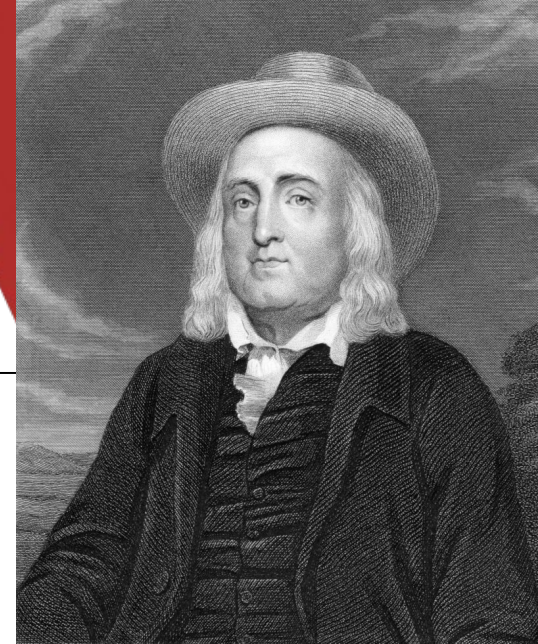


The British connection: the duchy/kingdom of Hanover

- University of Göttingen the key centre for economics
- Christian Jakob Kraus (1753-1807), professor at Königsberg
- Ludwig Heinrich von Jakob (1759-1827), professor at Halle
 - Smithian, incorporated JB Say's innovations
- Gottlieb Hufeland (1760-1817), mayor of Danzig, professor at Jena
 - Like von Jakob: turned to Say

In America

- Classical economics meant the French: Destutt de Tracy and JB Say
- The Jefferson connection: in Paris, translated de Tracy himself
- De Tracy, then JB Say's *Treatise*, the main textbook until after 1865



3. The Rise of Jeremy Bentham

- 1748-1832
- Independently wealthy: admitted to the bar but retired to focus on writing
- Devoted Smithian disciple from c. 1780
- *In Defence of Usury* 1787
- Utilitarian philosophy



Key premises

- Each person simply governed by his emotions, passions
- Role of reason: to serve as the tool of the passions
- Reason is only a means, it cannot establish ends of life

The Felicific Calculus

- All desire can be reduced to quantities of pleasure and pain
- Seven dimensions: intensity, duration, certainty, propinquity, fecundity, purity, extent
- Measure and multiply them, then you see net result of any action!
- Simple cost-benefit analysis for individual action



“The greatest happiness of the greatest number”

- Each person counts equally: simply add up the resulting gain in utility to evaluate policy
- Notice several assumptions:
 - Utility can be calculated
 - Only utility maximization is a valid ethical goal
 - Each individual counts as one in the social calculation
- These are all debatable (to put it mildly)

Influence of Bentham

- The “philosophical radicals” including Ricardo, James Mill and others
- Benthamite utilitarianism important for neoclassical theory



4. Thomas Malthus and Population



- 1766-1834
- Smithian, Anglican curate in Surrey
- 1805 appointed professor of history and political economy at EIC college in Haileybury
- Most famous work: *Essay on the Principle of Population as It Affects the Future Improvement of Society* (1798)



The Principle of Population

Malthus's Motive

- Malthus spurred on to write by errors of Utopian optimism
- Godwin the anarcho-communist: population growth will cease, since people will no longer be interested in reproduction

The Principle

- Population growth will always press on the means of subsistence, population only limited by
 - Positive checks: war, famine, pestilence
 - Negative check: starving women less fertile
- Mathematical precision: population growth follows a geometrical ratio, growth in food production an arithmetic ratio
- Enormously influential: virtually everyone became a Malthusian



Second edition 1803

- Much expanded, completely different conclusion
- Malthus had now studied the question in depth
- He added a new, powerful *preventive* check: moral restraint

Moral Restraint

- The decision of when to marry, how many children to have and so on
- Diffusion of luxury, higher standards of living would also induce the poor to restraint (e.g., through later marriage)
- But *Malthus never admitted the change!* He never explained that the first edition was wrong
- Everyone read the first edition



Certainly, the triumph of the Malthusian fallacy played an important role in the common view that the science of economics itself was and is cold, hardhearted, excessively rational, and opposed to the lives and welfare of people. The idea of economics being anti-human reached a bold and unforgettable expression in Dickens's Scrooge, the caricature of a Malthusian who cackled that poverty and starvation would be helpful in 'reducing the surplus population'.

Economic Thought before Adam Smith, p. 491



5. David Ricardo and his System

- 1772-1823
- Stockbroker of Portuguese/Spanish Jewish descent, born in London
- Quaker, became very wealthy, retired to private life and economics
- *Principles of Political Economy and Taxation* (1817)



Equilibrium

“I put those immediate and temporary effects quite aside, and fixed my whole attention on the permanent state of things which result from them.”

- Reliance on many (over-)simplifications

Aggregates

- Ricardo deals mainly in aggregates
 - Total output
 - Distribution of wages, rents and profits in the aggregate
- Ricardo not interested in individual wage rates, rents and so on
- Ricardo's key question: the distribution of national product



The Classical Triad

- labour, land and capital

Distribution the Key Question

- Four variables
 - Total output or income
 - Shares of income to landlords (rents), capitalists (profits), labourers (wages)
- National income = rent + profits + wages
- Total output assumed to be fixed

Conclusions

- Wages will tend toward subsistence
 - Ultra-Malthusian view
 - Labour assumed to be homogeneous
- The wage rate is fully determined by the price of corn – an aggregate representing all food
 - Corn price in turn determined by rent



Rent and Land

- Rent is paid for the “original and indestructible powers of the soil”
 - Income linked to productivity
- There are different grades of land, more and less fertile
 - Least fertile but yet useful land is *marginal* land, earning a zero rent
 - Supra-marginal land earns a rent based on the difference between its contribution to production and that of the marginal land

Differential Rent

- Rent payments come from the difference in fertility, not directly from the contribution of a plot of land to production



Population, Rent, and Land

- As population increases, demand for food increases
- More land needed: lower grades of land now enters production
 - The previously marginal land now earns a rent, based on the difference to the now-marginal land
 - All other rent differentials also increase

Labour, Rent, and Profits

- Since the marginal land is less fertile, the quantity of labour needed increases
- As population increases, total rent is always increasing
- But marginal rent is always zero
- Wages have to keep rising with subsistence cost, so profits have to keep falling
- When profits are zero, we have arrived at the final, stationary state



Value

- Ricardo focused on exchange value – price
 - Only of reproducible goods
- Cost determines price
- Rent, being zero on the margin, does not enter into cost
- Profits are uniform and fairly small, can be ignored
- Labour is uniform, and the price of the product (“corn”) ditto
- The quantity of labour cost on the marginal land determines the price of corn

Labour Theory of Value

- Value is determined by cost, cost is primarily quantity of labour → labour quantity determines value
- What about capital? In essence, “stored up labour”
- Capital will earn less and less as the economy nears the stationary state



Say's Law

- (We'll get back to that)

Comparative Advantage

- The law of comparative advantage only briefly mentioned by Ricardo, three paragraphs
- Developed by Robert Torrens and James Mill before (?) and after Ricardo

Implicit Class Conflict

- Between landlords and the other classes
- Between labour and capital

Quantity Theory of Money



The Law of Comparative Advantage

Foundation for International Trade

- Ricardo set out the law in 1817 in his *Principles*
- Illustrated by example
 - Portugal and England trade cloth and wine
 - Only labour input, Portugal more efficient at producing both

Hours of labour necessary to produce one unit		
	Cloth	Wine
England	100	120
Portugal	90	80



The Law of Comparative Advantage

Before Trade

- England needs 220 labour hours to produce 1 unit of each good
- Portugal needs 170 labour hours to produce 1 unit of each good

Opening Trade

- Portugal specializes in wine, imports cloth
- England specializes in cloth, imports wine

Greater Productivity

- Portugal produces 2.125 units of wine with 170 labour hours
- England produces 2.2 units of cloth with 220 labour hours



Ricardo's Popularity

- From his free trade arguments, being in tune with the *zeitgeist*, his follower James Mill indefatigable
- But Ricardian dominance a bit of a myth
- Robert Torrens addressing the Political Economy Club 1831: all the principles of the system now abandoned, especially concerning value, rent and profits

Attacks on the Ricardian System

- Samuel Bailey smashed the labour theory of value in 1825 (based on Say)
- Thomas Perronet Thompson (1783-1869) attacked Ricardian rent 1826
 - Ricardo got cause and effect precisely backwards:
 - Cultivation of inferior land does not cause the rise in price
 - The rise in price causes the cultivation of inferior land
- Robert Torrens also attacked Ricardo's rent theory
 - rent is from productivity, full stop; not from productivity compared to marginal land
- Nassau W. Senior in *Letters to Malthus* demolished Malthusianism



Mill reimposes Ricardian “orthodoxy”: *Principles of Political Economy* (1848)

- Restored labour theory of value – “last word on the theory of value for all time”
- Restored Ricardian theory of profit: dependent on and inversely related to wages
- Returned to Malthus on population, only difference Mill’s enthusiasm for birth control
- Orthodoxy until the marginal revolution

Mill’s other Accomplishments

- Son of James Mill, took over leadership of the Benthamite philosophical radicals
- Practical eclecticism and moderate utilitarianism
- The idea of *homo economicus* from Mill
 - Elaboration of earlier focus on self-interest, but more narrow conception of man
 - Paved the way for utility-maximizing models
- First to “concede” socialism the ideal social system, but practically unachievable



The Key Move

- Fundamental change in distribution theory
- Distribution and production inherently connected – Mill severs the link
- There is no necessary connection between the processes of production and the distribution of wealth
- “Society” is free to redistribute the product with no harm or consequences for the productive processes

Mill and Social Democracy

- Part of his more general move from classical liberalism to social liberalism
- Focus shifts from protection against the state to liberation from traditions, conventional morality, “outdated” social forms etc.
- Only a short step to see the state as the agent of social change and liberation



6. Jean-Baptiste Say and the French School

Shipwreck of the French Revolution

- Physiocrats had been supporters of absolute monarchy – not seen as smart in 1793 and later!
- Rebirth during the 1790s, 1800s: the ideologists
- A wider movement of social enquiry: Cabanis the intellectual leader

Antoine Louis Claude Destutt, comte de Tracy (1754-1836)

- The first economist among them
- *Eléments d'idéologie* (1801-15) in 5 volumes, vol. 4 *Traité de la volonté* his treatise on economics
- Destutt de Tracy followed French economically liberal tradition
- Argued against statistical and quantitative methods: the proper method in the social sciences the deduction of implicit properties contained in basic original truths
- Destutt de Tracy's fundamental axiom: man is a sensitive being, observation and deduction lead us to all human sciences



Jean-Baptiste Say (1767-1832)



- Born in Lyons, to family of Huguenot textile merchants
- Commercial education: first job at insurance company in Paris 1787
- Active as writer in revolution
- One of the founders of *La décade philosophique* 1794, the ideologists' organ
- Some political favour under Directory, early Napoleon, out of politics 1804 – for writing his *Treatise*
- Cotton manufacturer until Restoration, 1819 appointed professor of industrial economy at the *Conservatoire national des arts et metiers*



The Goal: Popularizing Economics

- To make political economy accessible to the general public
- Became a very popular textbook, in France and abroad going through numerous editions. Unfairly seen as simply a characterization of Smith's economics

An Original Treatise on Political Economy

- “Say's treatise is profundity parading as triviality” – Schumpeter
- It is well written and a pleasure to read, people assume there can be no real depth to it!
- Say continued the tradition of Cantillon and Turgot
- “the French tradition in Smithian clothing” – Rothbard



The Science of Wealth

- Political economy concerns its production, distribution and consumption
- Method of economics: identifying a few general facts and deducing the implications
- Political economy “is composed of a few fundamental principles and of a great number of corollaries or conclusions, drawn from these principles.”

Method

- Verbal deduction, since the data of economics, individual values, are “subject to the influence of the faculties, the wants and the desires of mankind, they are not susceptible of any rigorous appreciation, and cannot, therefore, furnish any data for absolute calculations.”
- No opposition between theory and practice: theory means knowledge of the laws connecting cause and effect, practice without theory is blind
- “Learning from experience” impossible, one cannot choose one’s economic theory based on historical experience
- In policy discussions, it is always a debate between theories – never the facts vs. the theory



- Say simply discarded the category of use value – so no value paradox!
- Value rests on acts of valuations by the consumers, always relative: one good to another
- Valuation depends on the wants and desires of man, physical and moral nature
 - These are given to the economist, not his job to be an ethical guide
 - What people *should* want can be left to ethical writers, practical men
- Say still insisted on equality in exchange



Production and Division of Labour

- Production is transformation of matter – every agent that transforms matter therefore productive
- Like Smith, the focus is on the division of labour
- Say went beyond the particular factory: division of labour ranges over the whole economy, it is the basis for all exchanges between producers
- Division of labour depends not only on the extent of the market, but also on the accumulation of capital
 - More capital goods essential in making labour more productive, lowering costs

Entrepreneurs

- Entrepreneurs reinstated in their central role, following Turgot
- They direct production, bear uncertainty of production
- They reap profits or suffer losses based on how well they perform



Time Structure of Production

- Goods are worked on over time
- They advance from stage to stage until reaching the consumers

Role of Capitalists

- Crucial in advancing payments at each stage of production
- Capitalists purchase the product of the previous stage from capitalists there
- They then fund work on the product during their stage until sold on to the next capitalists down the line

Example

- The iron miner extracts ore from the ground, is then paid by the iron founder
- The founder smelts the ore, refines it into steel, is then paid by the cutler, who thus repays the founders advance to the miner
- The cutler then makes razor blades, sells them to the public and is reimbursed for his capital advances and his own productive agency



Each successive producer makes the advance to his precursor of the then value of the product, including the labour already expended upon it. His successor in the order of production, reimburses him in turn, with the addition of such value as the product may have received in passing through his hands. Finally, the last producer, who is generally the retail dealer, is compensated by the consumer for the aggregate of all these advances, plus the concluding operation performed by himself upon the product.



The Classical Triad

- Land, capital, labour
- But these are not aggregates, they are kinds of “agents of production”
- Price of product and hence income depends on the productivity of the agent
 - Wages: payment for productive services of labour
 - Rent: payment for productive services of land
 - Interest/rate of profit: payment for productive services of capital

Confusion in the Triad

- Note the confusion between capital/capital goods in the classical triad!
- The distinction breaks down in Say’s analysis
 - He makes clear the kind of payment is really the same for all agents
 - Payment for “lending” one’s/its services to production



Interest Theory

- Despite confusion over capital, lucid on interest theory and loan market
- Interest rate on loans set by supply and demand
- Risk premia: for riskier borrowers and also for “innovative”, untried producers
- The quantity of money has no relation to the rate of interest

Entrepreneurs and Profits

- Entrepreneurs are owners of firms, intermediaries between buyers and sellers
- They must compare selling prices and costs: estimate uncertain future demand
- Success: profit, failure: loss
- Entrepreneurs serve an equilibrating and productive function



The Context

- Post-war depression led to great debate over “general glut” – overproduction and underconsumption
- Debate ended when depression over, 1823
- Originally a minor point, Say emphasized it as part of the debate

Say's Law

- Popular (mis-)statement: supply creates its own demand – wrong!
- Correct statement: the supply of one good constitutes a (partial) demand for other goods

Explanation

- Producers sell goods on market, then buy other products with income
 - Commodities exchange for commodities
- Prices are key: the “general glut” disappears if prices are allowed to change
- Say's law reigned supreme, unchallenged in mainstream of classical economics



Commodity Theory of Money

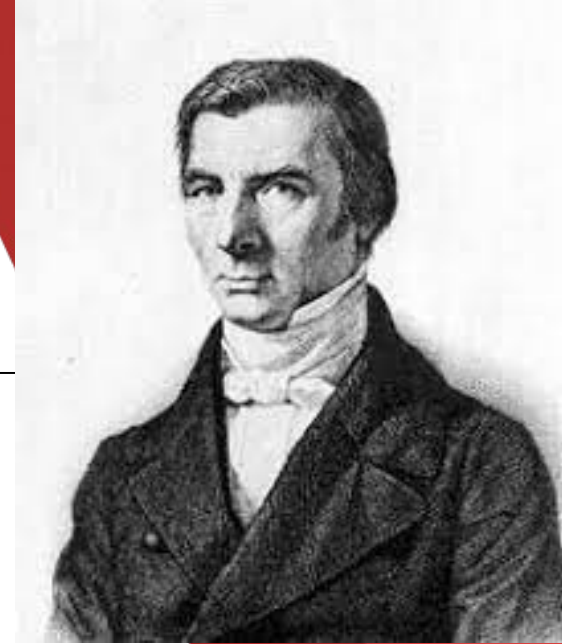
- In barter, people search for more marketable goods to facilitate exchanges
- Commodity chosen based on qualities: high value, divisible, portable, durable
- Role as money adds significantly to its value

Value of Money

- Determined by supply and demand
- Denominations should simply be units of weights, the commodity is the money
- Against bimetallism, a fixed exchange rate between gold and silver
 - Instead advocated a freely fluctuating rate

Paper Money and Banking

- Say critical of all paper money, bank notes
- Analysis of inflation: systematically injures creditors, helps debtors
- Against fractional reserve banking



7. Frédéric Bastiat (1801-50)

- Most famous of the French liberal economists
- Great reputation as a pamphleteer, popular writer
- Provoked into public life by the success of the English Anti-Corn Law League
- Famous debate with Proudhon on capital and interest
- Critic of socialism and interventionism



Key Ideas

- Free trade arguments: the *Candlemakers' Petition*
- The need for counterfactual reasoning in economics to dispel sophistries: *What is Seen and What is Not Seen*
- Focus on social harmony

The Positive Malthusian

- Bastiat read and understood Malthus's argument
- There is no problem of population, moral restraint will lead people toward “optimal” population growth: *Economic Harmonies*

Spoliation

- A government that goes beyond the protection of property and liberty invariably serves a narrow class to the detriment of the many
- Everyone is tempted into using it to plunder everyone else: *The Law*



Between a good and a bad economist this constitutes the whole difference – the one takes account of the visible effect; the other takes account both of the effects which are seen, and also of those which it is necessary to foresee. - *That Which Is Seen*

The state is the great fiction by which everyone tries to live at the expense of everyone else. - *The State*

In the state of isolation, our wants exceed our productive capacities. In society, our productive capacities exceed our wants. - *Economic Harmonies*