

Classical economics (1776 – 1890)

- Interested mainly in long-run economic processes (economic growth; distribution of income over time etc.)
- Optimistic about the workings of free markets (markets are in some sense optimal mechanisms)

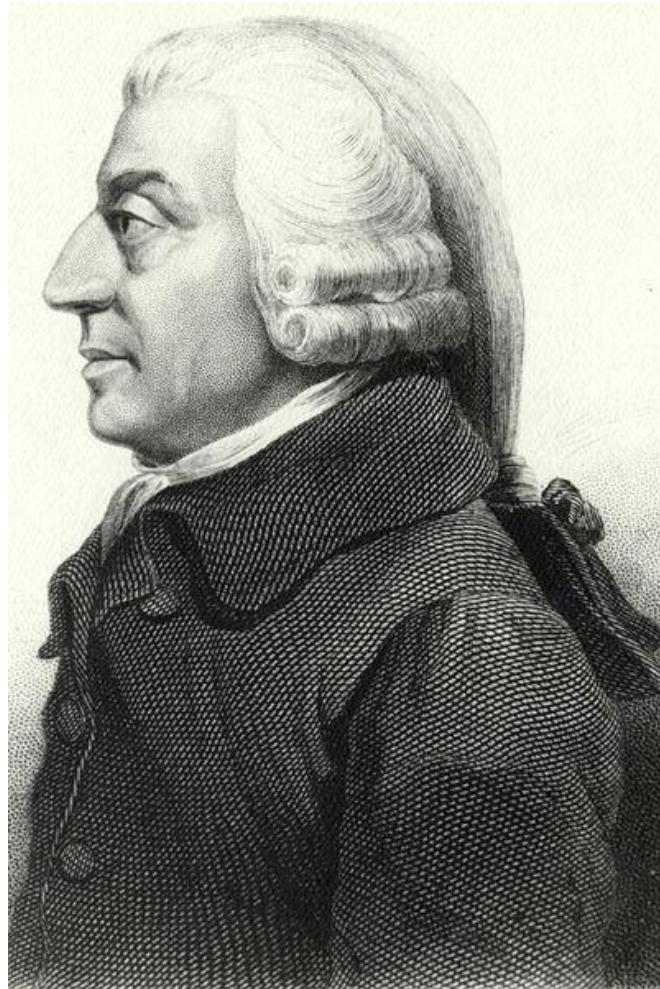
Main classical economists

- Adam Smith (1776-1790), *Wealth of Nations* 1776
- David Ricardo (1772-1823), *Principles of Political Economy and Taxation*, 1817
- John Stuart Mill (1806-1873), *Principles of Political Economy*, 1848

Economists related to classical economics

- Thomas Robert Malthus (1766-1834): demographic theory used by classicals
- Heterodoxy versus orthodoxy
- Karl Marx (1818-1883): borrowed some classical ideas, but rejected most of others

Adam Smith (1723-1790)



Adam Smith

- Scottish economist, philosopher, wrote also on law, rhetoric and even astronomy
- Professor of Moral Philosophy at Glasgow University from 1752 to 1764
- Interested in broad social questions, not only economic ones
- Influenced by his teacher Francis Hutcheson (1694-1746) and by his personal friend philosopher-economist David Hume (1711-1776)

Adam Smith

- Often called “the father of economics”, because he was able to synthesize his and previous achievements into one coherent, integrated system explaining:
 - how markets function (price determination),
 - how economic growth operates,
 - what policies accelerate economic growth,
 - how domestic economy interacts with others (international trade),
 - what is the appropriate role for the state in the economy, etc.
- Not a great theoretical economist (but advanced e.g. price theory, growth theory, trade theory, etc)
- Biggest impact in terms of promoting and popularizing the economic policy and economic worldview of **free market capitalism with very limited government interventionism (state as a night watchman, minimal state role in the economy)**
 - Direct and largest impact in Anglo-Saxon countries, but through Americanization of culture in the XX century also in other regions (e.g. in Poland)

Adam Smith

- Main economic work:

Inquiry into the Nature and Causes of the Wealth of Nations, 1776

- Wrote also on: rhetoric, the law, and even astronomy

Subject and methodology of the *Inquiry into the nature and causes Wealth of Nations*

- Main problem – causes of the national income, forces of the economic growth and policies for encouraging growth
- Methodology – deductive reasoning combined with historical description

Smith's economic policy

- Contextual economic policy – policy prescriptions are based not only on economic theory, but also on historical, political and institutional circumstances (prescriptions are contextual)
- Non-contextual economic policy – policy prescriptions based only on economic theory
- Ricardian vice (after David Ricardo) – tendency in modern economics to deduce policy conclusions only on the basis of highly abstract theoretical models

Smith's assumptions in matters of economic policy

- humans maximize their own interest (rationality)
- competitive markets exist (free movement of the factors of production, no government obstacles to that)

Smith's economic policy

- There is a natural process at work in the economy, which leads from private self-interest to the public good for society.
 - So a harmony emerges out of potentially conflicting self-interests
- The process is described as working through invisible hand (of markets)

Smith's invisible hand – a quotation from the Wealth of Nations

„As every individual, therefore, **endeavours as much as he can** both to employ his capital in the support of domestic industry, and so **to direct that industry that its produce may be of the greatest value**; every individual necessarily labours to render the annual revenue of the society as great as he can.

He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it.

By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, **and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.**

Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes interest of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good”. (*emphasis added*)

Reconstruction of 'invisible hand' idea in modern terms (based on the whole book, not only on the quotation)

- Economic agents are self-interested (not interested in social goals)
- Agents maximize their objectives (e.g. profits)
- In international trade they prefer investing home than abroad (for security reasons) if rates of return are similar
- There is a free international trade
- *Invisible hand mechanism leads to a good (or even optimal) situation for the whole society, understood as:*
 - 1) the greatest possible stock of capital is accumulated (engine of economic growth)
 - 2) prices of consumer goods are the lowest possible
 - 3) consumers' preferences are satisfied.

What is the invisible hand mechanism?

- Invisible hand = process of market competition
- Competition among capitalists result in commodities being produced at the minimal cost covering opportunity costs of the factors of production (the lowest feasible cost).
- If profits above a normal rate of return exist in any sector of the economy, other firms will enter these industries and profits will fall to zero (improved allocation of resources between sectors); supply will rise pushing down prices to those covering only costs of production
- Capitalists driven by the profit motive produce commodities that are desired by consumers.
- Capitalists accumulate capital and the rate of economic growth is high.

Smith's arguments for laissez-faire

- The phrase *laissez-faire* is French and literally means "let [them] do", but it broadly implies "let it be," "let them do as they will," or "leave it alone".
- So it implies a free market based economy with no or minimal state interventionism (regulations, coercion, restrictions, taxes, etc.)
- Did not prove rigorously that markets without (or with little) interventionism (a system of **laissez-faire**) lead to the best possible economic order
- For example, did not prove that producers employ the optimal (the most efficient) combination of factors of production or that consumers buy the optimal (maximizing satisfaction) bundle of commodities
- But pointed to (and analyzed informally) some steps in such a reasoning (low prices, high growth)
- Opposed monopoly – realized that monopoly prices are higher than competitive prices
- Reviewed past mercantilist regulations and analyzed their inefficiency

Smith's view on the role of the government („night-watchman state”, minimal state)

- Adam Smith advocated only qualified (not complete) laissez-faire policy; he saw some exceptions from laissez-faire:
 - system of justice;
 - national defence;
 - provision of quasi-public goods (roads, bridges, navigable canals, post-office, basic education etc.):

„... last duty of the sovereign or commonwealth is that of erecting and maintaining those public institutions and those public works which though they may be in the highest degree advantageous to a great society are, however, of such a nature that the profits could never repay the expenses to any individual or small number of individuals, and which it therefore cannot be expected that any individual or small number of individuals should erect."

Smith's impact on economic policy

- Provided a detailed analysis and understanding of benefits of free markets and the process of competition
- Supported laissez-faire policy
- Influenced the theory and practice of economic policy in England and the whole industrialized world from 19th century on, especially in the US
- Laissez-faire policy as an economic worldview of the American society.
- Promoted also all around the world
- The power of economic ideas: compare advantages and disadvantages of the American vs Scandinavian economies

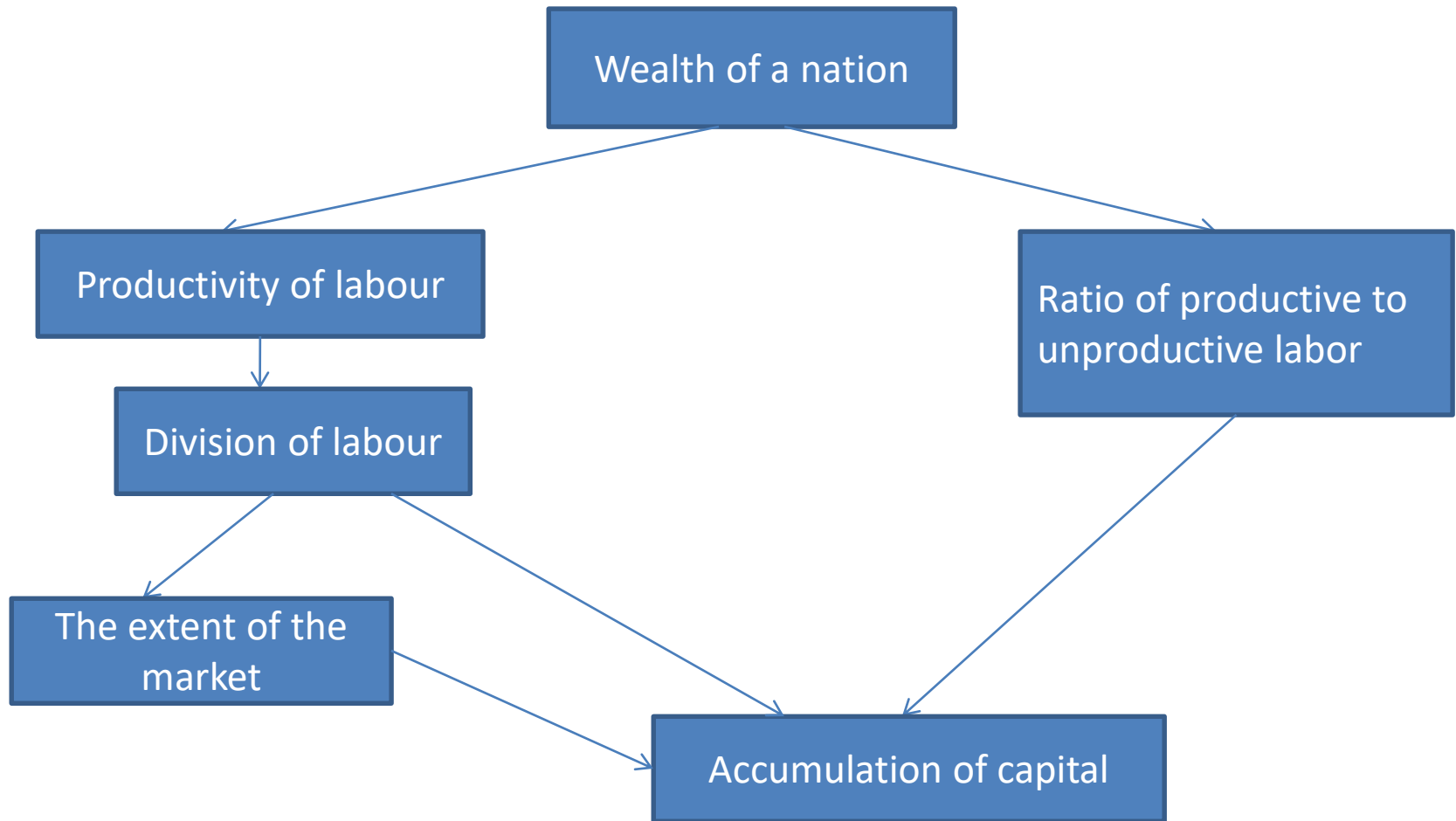
Theoretical achievements of A. Smith

- Theory of economic growth
- Theory of international trade
- Value theory (theory of relative prices)
- Distribution theory

Smith's theory of economic growth

- Wealth of a nation = an annual flow of material goods (services not included, unproductive labor)
- Consumption, not production is the ultimate end of economic activity
- Wealth of nations should be measured in *per capita* terms

What are the causes of the wealth of nations?



- What is missing in this theory?

GPT	Spillover Effects	Date	Classification
Domestication of plants	Neolithic Agricultural Revolution	9000-8000 BC	Process
Domestication of animals ****	Neolithic Agricultural Revolution , Working animals	8500-7500 BC	Process
Smelting of ore	Early metal tools	8000-7000 BC	Process
Wheel	Mechanization , Potter's wheel	4000–3000 BC	Product
Writing	Trade , Record keeping	3400-3200 BC	Process
Bronze	Tools & Weapons	2800 BC	Product
Iron	Tools & Weapons	1200 BC	Product
Water wheel	Inanimate power , Mechanical systems	Early Middle Ages	Product
Three-Masted Sailing Ship	Discovery of the New World , Maritime trade , Colonialism	15th Century	Product
Printing	Knowledge economy , Science education , Financial credit	16th Century	Process
Factory system	Industrial Revolution , Interchangeable parts	Late 18th Century	Organisation
Steam Engine	Industrial Revolution , Machine tools	Late 18th Century	Product
Railways	Suburbs , Commuting , Flexible location of factories	Mid 19th Century	Product
Iron Steamship	Global agricultural trade , International tourism , Dreadnought Battleship	Mid 19th Century	Product
Internal Combustion Engine	Automobile , Airplane , Oil industry , Mobile warfare	Late 19th Century	Product
Electricity	Centralized power generation , Factory electrification , Telegraphic communication	Late 19th Century	Product
Automobile	Suburbs , Commuting , Shopping centres , Long-distance domestic tourism	20th Century	Product
Airplane	International tourism , International sports leagues , Mobile warfare	20th Century	Product
Mass Production	Consumerism , Growth of US economy	20th Century	Organisation
Computer	Digital Revolution	20th Century	Product
Lean Production	Growth of Japanese economy	20th Century	Organisation
Internet	Electronic business , Crowdsourcing , Social networking , Information warfare	20th Century	Product
Biotechnology	Genetically modified food , Bioengineering , Gene therapy	20th Century	Process
Nanotechnology	Nanomaterials , Nanomedicine	21st Century	Process

Benefits from the division of labour - pin factory example

- Without specialization productivity was:
maximum 20 pins a day per worker
- With extensive specialization productivity rose to 4800 pins a day per worker
- Why?
- Learning by doing
- Saving time
- Small improvements to tools
- Are there any downsides of extensive job or task specialization?

But there is also the ugly face of specialization...

- *“In the progress of the division of labour, the employment of the far greater part of those who live by labour, that is, of the great body of the people, comes to be confined to a few very simple operations, frequently to one or two. But the understandings of the greater part of men are necessarily formed by their ordinary employments. The man whose whole life is spent in performing a few simple operations, of which the effects are perhaps always the same, or very nearly the same, has no occasion to exert his understanding or to exercise his invention in finding out expedients for removing difficulties which never occur. He naturally loses, therefore, the habit of such exertion, and generally becomes as stupid and ignorant as it is possible for a human creature to become. The torpor of his mind renders him not only incapable of relishing or bearing a part in any rational conversation, but of conceiving any generous, noble, or tender sentiment, and consequently of forming any just judgment concerning many even of the ordinary duties of private life. [...]. It corrupts even the activity of his body, and renders him incapable of exerting his strength with vigour and perseverance in any other employment than that to which he has been bred. His dexterity at his own particular trade seems, in this manner, to be acquired at the expence of his intellectual, social, and martial virtues.*
- *But in every improved and civilized society this is the state into which the labouring poor, that is, the great body of the people, must necessarily fall, unless government takes some pains to prevent it.” (WN V.i.f: 782)*
- Is this an accurate description of work reality today?
- How to prevent it?

Smith's value theory

- The problem: what determines the relative prices of goods in the economy?
- 'Value in exchange' versus 'value in use'
- Value in exchange = market price of a good
- Value in use = power of a good to satisfy human wants, total utility from consumption of this good

Water-diamond paradox

- How it is possible that:
 1. the value in exchange (price) of a diamond is so high, while its value in use (total utility) is so low for consumers.
 2. the value in exchange (price) of water is so low, while its value in use (total utility) is so high.
- So, there seems to be no connection between value in exchange and value in use
 - Paradox solved at the end of 19. century: Price is related to MU, not TU

Smith's theories of exchange value

- Developed two theories:
 1. labour cost theory of value
 2. cost of production theory of value
- Introduced two analytical states (models) of the economy:
 - Primitive economy (only one factor of production – labour)
 - Advanced economy (three factors of production – capital, labour and land)

Labour cost theory of value

- Exchange value is determined by the quantity of labour required to produce the unit of a good: $p_1/p_2 = a_1/a_2$
- How to measure this required quantity of labuor?
- Which person's labour?
- Not only time (hours of work) matters, when you are to measure quantity of labour – what about stress, difficulty or displeasures of various kinds of labour?
- The theory has a problem when applied to the model of primitive economy and it is likely irrelevant for the advanced model.

Cost of production theory of value

- Relative prices of two goods = relative cost of production of those goods:

$$p_1/p_2 = C_1/C_2,$$

where C is the sum of wage rate, land rent and profit rate paid in the process of production of a unit of a good

- What are the problems with this theory?
- What determines wages, profits and land rents?
- What about the role of demand?
- Applicable only in the long-run in the situation of perfectly elastic supply

Summary of Adam Smith's economics

- Extremely influential, especially in economic policy (laissez-faire)
- Interested mainly in understanding the process of competition, workings of the free market, economic policy and causes of economic growth
- Supporter of (qualified) laissez-faire: policy of government non-intervention (3 exceptions)
- Contextual economic policy
- His theories of economic growth, value and distribution inspired later classical economists
- Provided a grand vision of the free market economy, guided by the invisible hand, that leads from private interests to social optimum.