

History of Economic Thought

BA - Economics

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Directorate of Distance Education

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SYLLABUS - BOOK MAPPING TABLE

History of Economic Thought

Syllabus	Mapping in Book
Unit 1: Early Period Nature and importance of history of economic thought – ancient economic thought – Aristotle, Plato – Medieval economic thought – Contribution of early Muslim scholars to economic thought: Abu Yusuf, Al-Mawardi, Al-Gazali, Ibn Taymiyyah, Ibn Hazm and Ibn Khaldun, Mercantilism: Main characteristics – Physiocracy: Main characteristics.	Unit I: Early Period (Pages 1 - 22)
Unit 2: Classical Period Adam Smith – David Ricardo – Thomas R. Malthus – German romantics and socialists – Sismondi, Karl Marx – economic ideas of J.B. Say – J.S. Mill – Historical School: Senior, List.	Unit II: Classical Period (Pages 23 - 123)
Unit 3: Marginalists The precursors of marginalism – Cournot, Thunen, Gossen – the marginalist revolution – Jevons, Walras, Menger, Bohm-Bawerk, Wicksell and Fisher – the rate of interest – Wicksteed and Weiser – Distribution – Marshall as a great synthesizer – Pigou: Welfare economics – Schumpeter: Role of entrepreneur and innovations.	Unit III: Marginalists (Pages 124 - 171)
Unit 4: J.M. Keynes and his Contributions A Treatise on Money – The General Theory of Employment, Interest and Money.	Unit IV: J.M. Keynes and his Contributions (Pages 172 - 182)
Unit 5: Indian Economic Thought Early economic ideas: Kautilya, Valluvar – Modern economic ideas: Naoroji, Ranade, R.C. Dutt, Gokhale, J.K. Mehta and M.N. Roy – Economic ideas of Gandhi: Village, swadeshi, place of machine and labour, cottage industries, trusteeship – Early approaches to planning – Cooperation as a strategy – Contributions of Vakil, Gadgil and V.K.R.V. Rao – Economic thought of Dr. Ambedkar.	Unit V: Indian Economic Thought (Pages 183 - 240)

CONTENTS

Unit - I: Early Period

1 - 22

- 1.1 Introduction
- 1.2 Nature and Importance of History of Economic Thought
 - 1.2.1 Importance of History of Economic Thought
- 1.3 Ancient Economic Thought
 - 1.3.1 Aristotle (384-322 B.C.)
 - 1.3.2 Plato (427-347 B.C.)
 - 1.3.3 Medieval Economic Thought
- 1.4 Contribution of Early Muslim Scholars to Economic Thought
 - 1.4.1 Abu Yusuf
 - 1.4.2 Al-Mawardi
 - 1.4.3 Al-Gazali
 - 1.4.4 Ibn Taymiyyah
 - 1.4.5 Ibn Hazm
 - 1.4.6 Ibn Khaldun
- 1.5 Mercantilism: Main Characteristics
 - 1.5.1 Mercantilism?
 - 1.5.2 Main Characteristics of Mercantilism
- 1.6 Physiocracy: Main Characteristics
 - 1.6.1 What is Physiocracy?
 - 1.6.2 Basic Principles and Policies of Physiocracy
 - 1.6.3 Natural Order
- 1.7 Answers to 'Check Your Progress'
- 1.8 Summary
- 1.9 Key Terms
- 1.10 Self-Assessment Questions and Exercises
- 1.11 References

Unit II: Classical Period

23 - 123

- 2.1 Introduction
- 2.2 Adam Smith (1723-1790)
 - 2.2.1 Naturalism and Optimism
 - 2.2.2 Division of Labour
 - 2.2.3 Productive and Unproductive Labour
 - 2.2.4 Adam Smith's Theory of Value
 - 2.2.5 Theory of Distribution
 - 2.2.6 Taxation

- 2.2.7 Public Debt
- 2.2.8 Smith on Economic Growth
- 2.3 David Ricardo (1772-1823)
 - 2.3.1 Note on Methodology
 - 2.3.2 Ricardo's Value Analysis
 - 2.3.3 Ricardo Effect
 - 2.3.4 Theory of Distribution
 - 2.3.5 Ricardian Theory of Rent
 - 2.3.6 Ricardo on Machinery and Employment
 - 2.3.7 Ricardo on Taxation
 - 2.3.8 Ricardo's Monetary Theory
 - 2.3.9 Ricardo on Foreign Trade
 - 2.3.10 Ricardo on Economic Growth: Ideas on Stationary State
- 2.4 Thomas Robert Malthus (1766-1835)
 - 2.4.1 Malthus Theory of Glut: Ricardo-Malthus Glut Controversy
- 2.5 German Romantics and Socialists
- 2.6 Jean Charles Sismondi (1773-1842)
- 2.7 Karl Marx – Dynamics of Social Change
 - 2.7.1 Marx's Labour Theory of Value
 - 2.7.2 Karl Heinrich Marx (1818-1883)
 - 2.7.3 Karl Marx – Theory of Profit
 - 2.7.4 The Marxian Theory of Crisis (Business Cycle)
- 2.8 Economic Ideas of J.B. Say (1767-1852)
 - 2.8.1 Say's Law of Market
- 2.9 Economic Ideas of J.S. Mill (1809-1873)
- 2.10 Historical School (1843-1883)
- 2.11 Seniors
 - 2.11.1 William Roscher (1817-1894)
 - 2.11.2 Bruno Hildebrand (1812-1878)
 - 2.11.3 Karl Gustav Knies (1821-1898)
 - 2.11.4 Gustav Schmoller (1830-1917)
- 2.12 Friedrich List (1789-1846)
- 2.13 Answers to 'Check Your Progress'
- 2.14 Summary
- 2.15 Key Terms
- 2.16 Self-Assessment Questions and Exercises
- 2.17 References

Unit III: Marginalists

124 - 171

- 3.1 Introduction
- 3.2 The Precursors of Marginalism
 - 3.2.1 Cournot
 - 3.2.2 Thunen
 - 3.2.3 Gossen
- 3.3 The Marginalist Revolution
 - 3.3.1 Jevons
 - 3.3.2 Walras
 - 3.3.3 Menger
 - 3.3.4 Bohm-Bawerk
 - 3.3.5 Wicksell
 - 3.3.6 Fisher
- 3.4 The Rate of Interest
 - 3.4.1 Wicksteed and Weiser
- 3.5 Distribution – Marshall as a Great Synthesizer
- 3.6 Pigou: Welfare Economics
- 3.7 Schumpeter: Role of Entrepreneur and Innovations
- 3.8 Answers to “Check Your Progress”
- 3.9 Summary
- 3.10 Key Terms
- 3.11 Self-Assessment Questions and Exercises
- 3.12 References

Unit IV: J.M. Keynes and his Contributions

172 - 182

- 4.1 Introduction
- 4.2 J.M. Keynes
- 4.3 A Treatise on Money – The General Theory of Employment
- 4.4 Interest and Money
- 4.5 Answers to “Check Your Progress”
- 4.6 Summary
- 4.7 Key Terms
- 4.8 Self-Assessment Questions and Exercises
- 4.9 References

Unit V: Indian Economic Thought

183 - 240

- 5.1 Introduction
- 5.2 Early Economic Ideas
 - 5.2.1 Kautilya's View
 - 5.2.2 Economic Ideas of Thiruvalluvar

- 5.3 Modern Economic Ideas
 - 5.3.1 Dadabhai Naoroji (1825-1917)
 - 5.3.2 Mahadev Govind Ranade (1842-1901)
 - 5.3.3 Romesh Chandra Dutt (1848-1909)
 - 5.3.4 Gopal Krishna Gokhale (1866-1915)
 - 5.3.5 J.K. Mehta
 - 5.3.6 M.N. Roy
- 5.4 Economic Ideas of Mohandas Karamchand Gandhi (1869-1948)
 - 5.4.1 Village Reorganisation and Agricultural Development
 - 5.4.2 Swadeshi
 - 5.4.3 Place of Machine and Labour
 - 5.4.4 Cottage Industries, Trusteeship
- 5.5 Early Approaches to Planning (National Planning Commission)
- 5.6 Cooperation as a Strategy
 - 5.6.1 Contributions of Vakil
 - 5.6.2 Dhananjay Ramchandra Gadgil
 - 5.6.3 V.K.R.V. Rao
- 5.7 Economic Thought of Dr. Ambedkar
- 5.8 Economic Thought of Periyar
- 5.9 Answers to 'Check Your Progress'
- 5.10 Summary
- 5.11 Key Terms
- 5.12 Self-Assessment Questions and Exercises
- 5.13 References

Unit I Early Period

Learning Objectives:

By the end of this unit the learners would be able to:

- Understand the nature of the history of economic thought.
- Elucidate the ancient economic thought of Aristotle and Plato.
- Describe the medieval economic thought.
- Identify the various features or characteristics of Public Administration.
- Trace the contribution of early Muslim scholars to economic thought.
- Explain the term Mercantilism and Physiocracy.

Structure:

- 1.1 Introduction
- 1.2 Nature and Importance of History of Economic Thought
 - 1.2.1 Importance of History of Economic Thought
- 1.3 Ancient Economic Thought
 - 1.3.1 Aristotle (384-322 B.C.)
 - 1.3.2 Plato (427-347 B.C.)
 - 1.3.3 Medieval Economic Thought
- 1.4 Contribution of Early Muslim Scholars to Economic Thought
 - 1.4.1 Abu Yusuf
 - 1.4.2 Al-Mawardi
 - 1.4.3 Al-Gazali
 - 1.4.4 Ibn Taymiyyah
 - 1.4.5 Ibn Hazm
 - 1.4.6 Ibn Khaldun
- 1.5 Mercantilism: Main Characteristics
 - 1.5.1 Mercantilism?
 - 1.5.2 Main Characteristics of Mercantilism
- 1.6 Physiocracy: Main Characteristics
 - 1.6.1 What is Physiocracy?
 - 1.6.2 Basic Principles and Policies of Physiocracy
 - 1.6.3 Natural Order

NOTES

1.7 Answers to 'Check Your Progress'

1.8 Summary

1.9 Key Terms

1.10 Self-Assessment Questions and Exercises

1.11 References

1.1 INTRODUCTION

Some people view the history of economic theory as the outdated views of deceased authors. There is some kernel of truth in this statement. However, there are many ways of looking at the subject of history of economic thought. Economic thought can be seen as a collection of the extremely individualised, personal, and subjective economic theories of famous economists. Opinions from the many schools of economic thought may also be included in the history of economic theory. It is the whole of all viewpoints on economics, particularly in relation to public policy at any given period and place on various economic concerns. Class relations, production, distribution, value, economic growth, development, and a plethora of other facets of a society's economic existence can all be revealed through economic philosophy. The development of views toward various economic factors across time is traced by the history of economic theory. The development of economic theories is described, and their effects on societal activities and economic institutions are examined, in the history of economic thought. As has been rightly noted, a history of economic thought is a critical analysis of the evolution of economic theories, looking at their causes, connections, manifestations, and outcomes. It is concerned with the history of economic ideas which are placed in order, on the basis of origin. Since human beings have always thought about economic problems for their day-to-day existence, economic thought can be regarded as old as the history of mankind.

1.2 NATURE AND IMPORTANCE OF HISTORY OF ECONOMIC THOUGHT

A systematic collection of human economic theories that attempt to analyse specific economic issues or explain the mechanisms behind specific economic institutions may be found in the history of economic philosophy. Plans, programmes, and conjecture about institutions and their future growth are also found in the history of economic theory. The systematic, chronological, and critical examination of economic ideas and the origins of certain of these ideas is known as the history of economic thinking. Economics started its paradigm in 1776 with *The Wealth of Nations* of Adam Smith. But it was not a precise science. Economics has, become a science since 1870 with the Neo-classical and Marginal Schools who supplied the necessary analytical tools for the falsification and verification of different hypotheses. The science of economics or history of economic analysis has to be analytical. It has to have certain laws and principles and has to study causal relations. Economic science is based on distinct methods and techniques, with the

NOTES

help of which facts can be analysed and interpreted for the purpose of policy prescription. Economic science or the history of economic analysis is analytical and objective, and seeks a transition from good to better and better to best. In other words, it is progressive.

But history of economic thought is subjective, descriptive and cannot specify progress or regress. Up to the year 1870, economic thought could not develop any analytical apparatus which could entitle economics to be considered a science. The ancient thinkers did not have scientific economic thought. Their thought was mixed with religion, politics, philosophy, and so on. This is evident from Plato's Republic, Kautilya's *Arthashastra* and so on.

Economic was established as a separate discipline, accompanying the first paradigm, during the period of Adam Smith. As a result, while the history of economic analysis is inevitably new, the history of economic philosophy is as old as humankind. History of economics is only a part of the history of economic thought which indeed covers a very long way since ancient times. The history of economic science is defined as "the history of men's intellectual efforts to explain economic phenomena, or, to put it another way, the history of the analytic or scientific components of economic thought." However, economic analysis cannot altogether neglect the historical development of thought process on which the direction of economic analysis will depend. Analysis does, of course, separate out personal and subjective inclinations.

1.2.1 Importance of History of Economic Thought

The significance of economic thought history is enormous. It comprises all theories developed by humans about economic issues. Economic philosophy is a compilation of economic ideas from many authors, dating back to antiquity. The theories of economics must be traced back to the practises, institutions, laws, conventions, and so forth of a certain community that prevailed during a specific time in history. Economic ideas are nothing but the reflections of the contemporary economic conditions. The modern ideas are nothing but refined versions of the old ideas. Gray has correctly noted that outdated beliefs only fade away before resurfacing in the right circumstances.

The interpretation of production, distribution, value, growth, trade, development, commerce, industries, and a myriad of other aspects of economic issues and issues is the focus of economic thinking.

The significance of economic philosophy is related to the many eras of economic history, including the Greek, Medieval, Roman, and Modern periods. These periods, however, can also be divided into a number of sub-periods, such as the ancient economic thought, the classical economic thought, the neo-classical economic thought, marginalist thought, historical writers' thoughts, schoolboys' economic thoughts, Marxian thought, Austrian thought, Keynesian thought, and so forth. The evolution of economic ideas is documented in the history of economic thought. The periodisation of economic thought may be based on a number of

NOTES

considerations. Economic thought also encompasses the numerous methodologies used occasionally in the analysis of economic issues by economic historians.

1.3 ANCIENT ECONOMIC THOUGHT

The *Ancient Economic Thought* is not based on any systematic paradigm. In ancient times, economic thought was not organised. It was scattered and haphazard, lying here and there in an unorganised manner. Economic thought in ancient times could be gleaned from the writings of historians, archaeologists and anthropologists. Economic thought during this period was mixed with ethics and philosophy. The economic thought of the ancient times was not scientific. It was drawn from many sources including legends, folklore, myths and so on. The main reasons for the insufficient growth of economic thought was mainly due to the infancy of economic science itself. In fact, economics did not then grow as a full-fledged subject of study. No systematic thinking on economics, therefore, could be had during the ancient times. There were some thoughts on some topical economic problems. Economic thought during this period was mixed up with politics, sociology, metaphysics and history. Different schools of thinking, such as the Greek school of thought, the Roman school of thought, and the Medieval school of thought, can be used to discuss ancient economic theory. These are briefly discussed below:

1.3.1 Aristotle (384-322 B.C.)

Aristotle's theories on the nature and purpose of economics were his greatest contribution to the growth of economic philosophy. According to him, *Oeconomicus* aims at the management of the household economy and *Chrematistics* is concerned with wealth-generation and spending. Since the domestic economy was a natural one, he supported it. Aristotle's books, *Politics* and *Ethics*, contain his economic thinking. Aristotle was against Plato's idea on property communism. Additionally, he supported the institution of slavery. Aristotle considered value-in-use and value-in-exchange. He was the economist who made such a distinction for economic analysis. Aristotle was opposed to paying a high interest rate (usury). A useful tool for enabling transaction was money. Money served as both a means of transaction and a basic accounting unit. Additionally, he believed that money may serve as a value store. Aristotle was in favour of private property, and he was against the joint use of property. He condemned monopoly. He objected to paying exorbitant interest rates because it is unnatural and it leads to an unnatural accumulation. Regarding private property, he advanced three important arguments in its favour; (i) private property increases efficiency by giving incentive; (ii) it promotes social peace; and (iii) individual moral character building requires private property.

Aristotle wanted the maximisation of average wealth, given the constraining natural law. However, there seems to be a contradiction in the analysis of Aristotle. On the one hand, he wanted to maximise economic wealth by granting the right to private property and on the other hand, wanted to restrict accumulation and interest.

Be that as it may, Aristotle's major contribution was the conceptualisation of economics in the form of micro-economic household management.

1.3.2 Plato (427-347 B.C.)

NOTES

The Republic, a book by Plato, contains some of his economic theories. In his writings, Plato stressed the significance of the division of labour in the economy. The division of labour resulted from the inherent distinctions among people. Plato was primarily concerned with the growth of the economy and of output. He was also intrigued by the rise in productivity. Plato also promoted a greater degree of production specialisation. Such a specialisation brings with it the necessity of making exchanges. The guardians and auxiliaries were two types of classes that Plato imagined. The guardian class, according to Plato, should not work for profit or collect property. Only the poorest members of society, such as farmers and craftspeople were allowed to make a profit and assemble property. Exchange and trade were an integral part of the social organisation during the time of Plato. Money served as a standard of worth in addition to being a means of transaction. Money facilitated trade and commerce. According to Plato, specialisation is the root of all economic progress. Plato supported property communism. Plato can be regarded as a pure collectivist. Plato thought that the ownership of private property will lead to a number of benefits which will outweigh the costs. In Plato's view, slavery has been an unavoidable and inevitable institution throughout human history. But he demanded that the slaves be treated well.

1.3.3 Medieval Economic Thought

The Medieval writers were also called Doctors or Scholars. These writers are moralists. The moral dilemmas of right and wrong, justice, and natural law formed the foundation of mediaeval thought. The Medieval writer, St. Augustine, recognised utility and desire as the two important components of value. The Schoolmen used subjective and objective factors for the determination of value. However, even the objective calculations were based on normative methods. The most important single writer who was responsible for the development of Medieval thought was St. Thomas Aquinas.

St. Thomas Aquinas (1225-1274)

Value, according to Aquinas, is nothing more than a fair price (Justum Pretium). The cost of production, risk, and carriage expenses should all be included in the price. It is really unjust to sell in the dearest market and buy from the cheapest market. Aquinas also supported the division of labour in society. He said that all occupations were valuable, and agriculture alone is not superior. Aquinas condemned usury. However, he was in favour of paying the lenders damages and late payment compensation. Interest was regarded as a sinful and unnatural payment. However, interest could be paid to the lender of money for any gain foregone on an alternative investment. Although internal and international trade were developing during the period of Aquinas, still he considered trade as something unnatural. Private property, according to Aquinas, was consistent with the natural law of the land. However, he believed that property should be gained

NOTES

fairly and used for the greater good. A state, according to Aquinas, has many vital functions, including road maintenance and construction, a good money system, accurate weights and measures, and the eradication of poverty should also be provided in addition to sustaining the status quo of law and order.

The Medieval thinkers' discussion on utility and value appears to be very elementary. Medieval thinking was based mainly on morality and ethics. Most of the views of these writers were not original. They were borrowed from the Greek and Roman economic thought. Their ideas on value were normative. They did not have the insight of the problems of a market-oriented economy. Most of the Medieval thoughts can be rationalised on the basis of Relativist notion. These Schoolmen failed to appreciate the advance of the market system. Gradually, however, economic thinking went in favour of trade and commerce and profit. There was a marked shift away from the Medieval theology and a new world of economic thought soon ushered in. It is pointed out that the Medieval concept of *just price* was the beginning for the development of *labour theory of value*. It was indeed a great Medieval contribution.

Check Your Progress

1. Money was a medium of exchange and also a unit of _____.
2. Plato's ideas on economics arose in his book, _____.
3. The Medieval writers were also called _____ or Scholars.

1.4 CONTRIBUTION OF EARLY MUSLIM SCHOLARS TO ECONOMIC THOUGHT

1.4.1 Abu Yusuf

A few centuries ago, the economy benefited from the contributions of several financial geniuses from both the Western and Islamic worlds. However, it's possible that not enough is known about how much earlier the Muslim population's economic ideas were than those of the West. One of them is the financial aspect of Abu Yusuf. His most extraordinary belief is regarding the requirements (ordinances) for assessing taxes.

In light of present circumstances, taxes rank as the largest source of income for a nation. Reformer Abu Yusuf has demonstrated a tax-based assessment concept. It was said in his enormously well-read book, *Al-kharaj*. Even though it was given the name *Al-kharaj*, it also provided clarification on many sources of governmental funding, including *ghanimah*, *jiz'yah*, *usyur*, and *zakat*. Keeping in mind that different types of state financial institutions nowadays are non-bank in nature similar to *zakat*, which is a rapidly expanding source of Islamic funds, both its administration and guidelines. Guidelines in regards to *zakat* are created to help efficient the board of *zakat*.

With respect to, Abu Yusuf made another detailing in assessment and excise matters. When considering the possibility of Abu Yusuf, keep in mind that the book of *al-Kharaj* was written at the caliph Harun al-request. Rashid's The book will be

NOTES

used as a guideline for collecting state revenue and as a sort of viewpoint for managing state funds. The most crucial lesson to be learned from Abu Yusuf's hypothesis is that, among a nation's objectives, the economy should be encouraged.

This study will examine Abu Yusuf's economic theories in light of Islamic public monetary policy. Since Abu Yusuf's ideas were designed to reinstate Islamic rule in the area of economics, his unique ideas only gradually came to light. In order for an equilibrium to occur in basic financial matters, it depended on the significance of a reference while handling a nation's finances. For instance, managing governmental finances in Indonesia could be difficult due to the country's taxation system; however, this study will propose an Islamic financial management system based on Abu Yusuf's philosophy.

1.4.2 Al-Mawardi

Al-Mawardi listed the following duties of the ruler as part of his list of duties: to supervise confidence, carry out and protect equity, protect life and property, establish harmony and security, defend the nation, supervise financial concerns, and provide individual oversight to public issues (Al-Mawardi, 1973, pp. 15-16). In describing the state's financial and development initiatives, Nizam al-Mulk al-Tusi (1961, p. 11) writes: "He (the ruler) will fabricate underground conductors for the water system of land, he will have trenches burrowed, spans worked over wide waterways, and see the land is developed; he will construct strongholds, tracked down new urban areas, assemble respectable landmarks and wonderful homes, and he will have caravan series set up on the highways."

Al-Mawardi's economic way of thinking is the reason for thoughts and considerations about the economy, especially the working of the state and government institutions, public money, public government assistance, destitution, financial conduct, and others. Philosophical review is very significant, in light of the fact that the prospect of a person can not be isolated from the point of view, goals, and strict qualities embraced, as well as setting the social, cultural, political and created around that time.

Basic Human needs, Economic Behaviour and Society Tradition

People are social and political. Normally, people are feeble in addressing every one of the necessities of life. He is unique in relation to each other both from the part of physical, mental, heredity, and another potential, so it requires the collaboration of others and do, then, at that point, set up a local area through the state foundation. The motivation behind man in the public eye and the state is addressing the necessities of the group and epitomize social request that made the government assistance of the local area, even to set themselves up to accomplish everlasting bliss in life following death by running shari'a accurately. As indicated by al-Mawardi (1996), state foundations drove by the head of government is expected to make agreement and concordance with the principles which it embraced to the local area, also the financial existence of society.

NOTES

1.4.3 Al-Ghazali

Al-Ghazali's financial aspects is anchored on five essential Shari'ah - ordered underpinnings of individual and public activity: religion, life, family, property, and intellect. He centers around the economic parts of *maslahah* (social utility), recognizing necessities, solaces and extravagances. Resource living is deficient yet abundance also has its risks. Both excess and parsimony are to be stayed away from, a center course is suggested. The creators look to accommodate between obviously disconnected perspectives on al-Ghazali on abundance and (deliberate) neediness. Al-Ghazali's bits of knowledge on exchange, production, cash, job of the state and public funds are accounted for. Al-Ghazali accentuates moral conduct on the lookout and respects creation and supply of necessities to be a required obligation. He censures accumulating and praises cooperation. Usury is dismissed and equity, harmony and solidness are projected as preconditions of monetary advancement.

As indicated by al-Ghazali, markets develop because of regular powers, as a feature of the "normal request" of things, and as a statement of self-inspired human cravings to deliberately fulfill common economic necessities.

In this manner, during the time spent on economic needs, al-Ghazali enlightens the requirement for division of work and specialization concerning the two spots just as individuals. Further, trading activities increase the value of products by making them accessible at the proper place and time for purchasers. The regular powers of trade likewise lead to the making of expert merchants, who are directed by the Profit motive. While aggregation of abundance as such isn't among the noblest activity in the prevailing plan of things, al-Ghazali remembers it as an important peculiarity - one that is vital for the legitimate working of a dynamic culture and it is in the shared interest of individuals by and large. Besides, while talking about exchanging exercises, al-Ghazali also mentions the need for wellbeing and security of the trading courses, and he proposes the rulers should give such assurance with the goal that the business sectors could thrive.

Regardless of his sharp information on the willful conduct of purchasers and venders in an unregulated economy setting where every substance by looking for its own benefit works to the upside of one another and where dealers reserve the option to acquire benefits, al-Ghazali cautions the merchants - the finance managers - that such market activities with their accentuation on material merchandise and the quest for benefits, ought not be to the at the expenses of ultimate goods "market of the Hereafter", referring ofcourse, to one's salvation. Obviously, his reference is to the "exchanges" with Allah, in His recognition just as the satisfaction of one's strict commitments. Al-Ghazali's continuous updates concerning the significance of the Hereafter consider his part the ideal conduct of dealers and makers (for sure, all members on the lookout) working under the Islamic ethos. Consequently, a Muslim merchant might be happy with a sensible money related benefit, while boosting the chance of profound prizes in the Hereafter, for a definitive objective of every single human action, including economic, is one's salvation.

1.4.4 Ibn Taymiyyah

The equilibrium of the price: Ibn Taymiyyah idea of equilibrium price should be visible from the portrayal when discussing the same price. For Ibn Taymiyyah identical cost is the cost set up by market influences running freely, the gathering between the power interest by offering. This is the thing is implied by the value balance in the thirteenth century AD were conveyed by ST. Thomas. Furthermore Ibn Taymiyyah had gone before and found in the eleventh century AD comparable cost can also be interpreted as a standard cost winning when individuals selling products and is by and large acknowledged as an identical for such merchandise or comparable merchandise in explicit general setting.

According to Ibn Taymiyyah, the market is the meeting of demand and supply in financial concerns. The market, in this sense, is cognitive rather than physical. The most typical method of determining the degree of expenses is to use a market instrument that is based on the strength of interest and supply. The meeting between (demand) and (supply) is known as the equilibrium price (value balance).

Rise and fall of costs isn't connected all of the time with unfairness (zhulm) done by somebody. Periodic explanation is the lack in production or a lessening in imports of goods mentioned. As it requires an increment in how much merchandise while capacity diminishes, costs will normally rise. Then again, on the off chance that the capacity of the goods of merchandise increments and request diminishes, the cost will go down. The statement shows that there is a propensity that happened at the hour of Ibn Taymiyyah that the cost increment is because of unfairness or oppression of the dealers, so the word utilized is zhulm, and that implies wilderness or foul play. He said, costs could ascend because of the decline number of accessible merchandise or an increment in the quantity of inhabitants.

1. Fair Price

The idea of a fair cost basically existing and utilized by the legal advisers since the start of the Islamic presence. Koran itself is exceptionally focused on equity in each part of human existence. Accordingly, it is reasonable if justice is also manifested in market activity, in particular the price.

2. Fair Wages

The idea of fair wages expected as pay levels that should be given to the workers, so they can live a decent center of a community. For instance before the workers are recruited, laborers should definitely know the wages to be gotten from the supplier or employer's work. So there is a component of readiness among workers and labour providers with respect to price levels prevailing in the market.

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1.4.5 Ibn Hazm

Economic thought of Ibn Hazm

The four top economic issues during the reign of Ibn Hazm are:

- (i) Basic needs and Poverty
- (ii) Zakah
- (iii) Taxes
- (iv) Land Tenure systems

Economic Development

1. Fulfillment of Basic Needs and Poverty Eradication

- (a) One of the Maqasid al-Shariah, which Ibn Hazm emphasised, is the preservation of human life and prosperity through the four fundamental requirements of an individual: food, clothes, health, and shelter.
- (b) Basic needs must be met in order to protect the mental and spiritual well-being of the human person.
- (c) The inability to meet bare necessities is a sign of poverty.
- (d) Ibn Hazm emphasised both the role of the state and the responsibility of the wealthy in making sure that the needs of the poor are met as a result.

2. Zakah

- (a) Ibn Hazm tended to do the task by the rich by aiding the poor through the obligatory status, which is zakah, in order to abolish the existence of poverty and satisfy the fundamental needs among the poor people.
- (b) Ibn Hazm asserts that paying zakah is a duty that must be fulfilled during one's lifetime and that must be delivered to the impoverished in addition to one's riches.
- (c) If a person fails to pay zakah (intentionally or due to ignorance of the obligation), zakah debt is never forgiven and is still owed to Allah SWT.
- (d) Zakah is one of Islam's five pillars, and if it is not completed, it is seen as sin.

3. Taxes

- (a) Concerned about the fairness component of the tax system.
- (b) When imposing tax, one must take into account the interests of the populace.
- (c) Worried about how the tax system is set up.
- (d) Exploitative and abusive behaviour must be stopped.
- (e) Taxes were to be collected by adhering to the Syari'ah's bounds.

4. Land Tenure

- (a) Believes that muzara'ah is illegal under Islamic law.
- (b) Ibn Hazm, a socialist, believes that muzara'ah is unenforceable under Islamic law.

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1.4.6 Ibn Khaldun

An early model of political economy is presented by Ibn Khaldun. He says that value-adding activities, in which labour and knowledge are combined with techniques and crafts to produce a higher-valued product, are what drive the economy.

In terms of contemporary political economics, he also distinguished between “profit” and “sustenance,” or surplus and that needed for class reproduction, respectively. He also promotes the development of a science to comprehend society, and in his greatest work, the *Muqaddimah*, he outlines these concepts.

“Civilization and its well-being, as well as economic prosperity,” Khaldun writes in *Al-Muqaddimah*, “depend on production and people’s efforts in all directions in their own interest and profit.” Ibn Khaldun deviated from Muslim historians’ traditions by rejecting the focus on the transmitter’s reliability and instead emphasising the stories’ veracity and encouraging critical thinking. Early theories of labour division, spending, scarcity, and economic development are also shown by Ibn Khaldun.

Khaldun was also among the first to focus on the causes and origins of poverty, arguing that it was a result of the decline in high standards and human values. He also saw how factors like investment, government, and utilization—a forerunner to our sophisticated GDP formula—add to abundance. Khaldun further argued that making bad financial decisions was not the underlying cause of poverty and thus, the public authority ought to be associated with mitigating poverty.

Additionally, Ibn Khaldun believed that gold and silver should be utilised as an Islamic monetary system’s currency since they have intrinsic value (such as the dirham). He emphasised that these coins’ weight and purity should be strictly observed: one dinar should be equal to one mithqal (72 grains of barley, or 4.25 grammes), and seven dinars should be equivalent to ten dirhams (7/10 of a mithqal, or 2.96 grammes).

The writings of Adam Smith and Ibn Khaldun on the division of labour are frequently contrasted.

The individual being who can’t fulfill his necessities without anyone else help. For everyone to advance, they must work together. However, what is obtained through a group’s cooperation satisfies the needs of a much larger number of people than themselves.

For instance, no one can get the portion of wheat they require for meals by himself. They will be able to feed a large number of people many times their own number when six or ten people, including a smith and a carpenter to make the tools,

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and others in charge of the oxen, ploughing, harvesting ripe grain, and all other agricultural activities, set out to obtain their food and work toward that goal either individually or collectively. The output of the workers' combined labour exceeds their individual needs and requirements (Ibn Khaldun 1958, vol. II 271 -272).

Check Your Progress

4. Abu Yusuf as a reformer figure has shown an assessment idea that is _____.
5. The meeting between (demand) and (supply) is known as the _____ (value balance).
6. The weight of 7 dinar should be equal to weight of _____.

1.5 MERCANTILISM: MAIN CHARACTERISTICS**1.5.1 Mercantilism?**

Between 1500 and 1750, merchant capitalism—also known as commercial capitalism or merchant capitalism—emerged in numerous regions of the world. It persisted roughly until Adam Smith's "Wealth of Nations" was published in 1776. In order to describe the informal system that predated the sixteenth century, Adam Smith used the term "mercantile." A group of widely dispersed authors on a variety of significant topics, including as trade and commerce, money, employment, and other topics, make up mercantilism. These authors had some same interests and concerns, but they lacked a shared analytical tool. The mercantilist writers appear to have had little cohesion in the sense that they did not have a set of concepts that they all agreed on.

Cameralism was the name given to mercantilism in Germany; Colbertism was given to it in France; and Mercantilism was given to it in England. It is a set of ideas that advocate for the accumulation of gold and silver in the form of notes, a favourable international trade balance, increased state power, and national prosperity. Political nationalism's economic equivalent is often known as economic nationalism. Protectionism is a term used to describe a system of restrictive trade policies.

Heimann claims that the philosophical foundation for commercial capitalism is mercantilism. In reality, the political economics of capitalism began with mercantilism. During this time, in 1760, Sir James Steuart released his book "Principles of Political Economy." In this year, the first book on political economy was released. Therefore, mercantilism can be seen as a force that gave rise to the political economy system. Sir Thomas Mun, J.B. Colbert, A. Serra, S.J. Child, and S.J. Steuart are the key authors who advocate for capitalism.

1.5.2 Main Characteristics of Mercantilism

The main characteristics of mercantilism are as follows:

- 1. Foreign Trade:** First and foremost, the mercantilists placed a strong focus on a positive trade balance. They held that the possession of gold

and silver mines and a positive trade balance are the two variables that determine a nation's strength and riches.

None of the nations had gold or silver mines, therefore they were able to accumulate huge stocks of these metals by exporting the majority of their manufactured goods and buying the least amount of items from other nations.

"The typical means....to expand our wealth and fortune is by Foreign Trade," Thomas Mun remarked, emphasising the importance of international trade.

This should be encouraged, because the king's great revenue, the kingdom's honour, the noble merchant's profession, the walls of the kingdom, the means of our treasures, the sinews of our wars, the provision of our poor, the betterment of our fields, the nursery of our seafarers, the terror of our enemies—all depend on it."

To maintain a favourable trade balance, mercantilists favoured commercial control. By placing high tariffs and limitations on imports, they were serious about limiting imports.

On the other hand, rewards and other unnatural agricultural and industrial stimuli should be used to promote exports. Several navigation laws were enacted to foster trade and guarantee that native shippers continued to control the country's trade.

In addition to emphasising the need for international trade control, mercantilism also supported the monopoly concept. In the majority of European nations, only a small, privileged group was allowed to engage in international trade. The British government, for instance, only permitted its citizens to conduct free commerce in a small area (i.e., while the rest of the world was divided among numerous joint stock firms for trading purposes (France, Spain, and Portugal), the rest of the world was divided for trading purposes among numerous joint stock companies).

A specific trading sphere was assigned to each organisation. As a result, the East India Company enjoyed a monopoly on trade with Asia, the Africa Company had a monopoly on trade with Africa, and the Levant Company had a monopoly on trade with the Mediterranean. Similarly, European nations granted numerous joint stock firms the ability to trade. East India Companies were established in France, Holland, Sweden, and Denmark to do trade with the East.

The mercantilists applied the monopoly theory to their colonies as well. It was claimed that colonies had no authority to control their economies freely and were required to offer raw materials to the mother country's manufacturers in order to meet the mother country's needs.

The colonial trade was closed to all other foreigners. Except for a few less important items, they were not allowed to trade with the colonies. The only industries that were permitted to grow in the colonies were

NOTES

NOTES

those that did not compete with the mother country. Obviously, this policy resulted in a blatant disregard for the colonial people's interests.

2. **Importance of Money:** Money was highly valued in mercantilism. It valued gold, silver, and other precious metals and saw wealth as the source of all power. Money was also seen as a key element in the development of businesses. Additionally, as the majority of trade at that time involved the exchange of products, people naturally preferred to hold onto gold and silver over commodities. As the state needed more taxes to run its affairs, it became increasingly important to have money, and it naturally chose to pay those taxes in cash rather than in kind. The huge sums needed to wage commercial war with other countries in order to maintain colonies considerably increased the value of money.

Money was also thought to be necessary for a thriving economy. "Where money was limited, trade was sluggish; where it was abundant, trade blossomed," it was widely believed. To summarise, mercantilism highlighted the importance of money for a variety of reasons.

3. **Interest:** Even though there was no agreement among the many mercantilists on how to use and value interest, it was an important aspect of mercantilism. Mun, for instance, defended adding interest by arguing that the borrowed funds could be employed advantageously for commercial purposes, enabling the borrower to make substantial profits.

The mercantilists, on the other hand, favoured low interest rates. They thought that the high interest rates made money scarce. Thomas Manley, John Locke, Nicholas Barbon, and others were mercantilist thinkers who advocated for low interest rates.

Given the lack of liquid funds, inadequate banking facilities, and growing rivalry between merchant-manufacturers and goldsmiths, as well as huge merchant financiers, this mercantilist stance was entirely understandable.

4. **Factors of Production:** For the mercantilists, labour and land were the only factors of production. "Labour is the father and active basis of wealth, just as lands are the mother," Petty maintained. Similarly, Josiah Child shared this belief that land and trade were closely connected.

Most mercantilists emphasised how crucial it was to increase output in order to achieve food self-sufficiency as well as promote exports. The cultivation of waste areas was emphasised as a way to boost or decrease agriculture.

5. **Large Populations:** Mercantilism emphasised the importance of having a big population in order to increase production and war involvement. "The people are the actual strength of the community; dense population generated inventions," Davenant noted, emphasising the need of a large population. It also developed enterprises that enriched the country." Samuel Fortrey fought for immigration freedom and equal rights for immigrants because of the population's significance.

NOTES

He claimed that immigrants will bring wealth with them and boost the country's trade and economy. A large population also made inexpensive labour available, enabling a nation to successfully compete with other nations while increasing its own population. As a result, the state promoted marriage and parenthood.

- 6. Commercial Regulations:** The need for business regulation to ensure that the economy runs smoothly and that social welfare is advanced was acknowledged by mercantilists. Almost every European country enacted legislation to limit imports of foreign goods while encouraging exporters.

Importing raw resources was generally preferred over importing finished goods because it aided the country's industrial development. In order to protect national interests, the majority of states implemented artificial trade restrictions on both internal and external trade. Commercial restrictions were created with narrow national interests in mind because mercantilists believed that the only way a country could benefit was by taking advantage of the interests of another nation.

This explains why mercantilists frequently refused to allow economic considerations to trump political concerns, instead agreeing to subordinate economic life to political ends.

Thomas Mun

The early mercantile policy is described by English businessman Thomas Mun (1571–1641) in his book *England's Treasure through Foreign Trade*. It was widely disseminated as a manuscript before 1664, despite the fact that it was not published until 1664. He wrote about his experiences there in *A Discourse on Trade from England into the East Indies* while he was a member of the East India Company (1621).

Mun advocated a number of tactics to accomplish this goal since he thought that trade was the only way to increase England's treasure (i.e., national wealth). Import requirements could be reduced by increasing the use of land and other domestic natural resources, cutting export taxes on goods developed domestically from imported components, and exporting goods with inelastic demand, all of which could generate more revenue from higher pricing.

Check Your Progress

7. The term 'Mercantilism' was coined by _____.
8. _____ involved the substitution of a scheme.
9. Mercantilist policy was based on a _____.
10. The mercantilist writers were in favour of having a favourable balance of trade which could be earned by exporting more than _____.
11. Who was coined the term 'Mercantilism'?
 - (a) Henry Fayol
 - (b) Adam Smith

NOTES

- (c) F.W. Taylor
- (d) None of the above

12. Which of the following is the factor responsible for the growth of Mercantilism?

- (a) Economic Factors
- (b) Political Factors
- (c) Cultural Factors
- (d) All the above

1.6 PHYSIOCRACY: MAIN CHARACTERISTICS

1.6.1 What is Physiocracy?

A group of French individuals created the physiocracy as a response to the mercantilists' materialistic, rigid, constrained, and controlled mercantile capitalism. In the middle of the eighteenth century, France saw the development of the physiocratic doctrine. Physiocracy is the natural order. It is regarded as "a rationalisation of certain specific political aims." Adam Smith considered physiocracy a school of agriculture. Physiocrats self-identified as economists. The physiocrats held that human happiness and wealth were the result of some natural force. Physiocracy was, in a sense, a political and social system. The physiocrats put forward a complete system of political economy where rule of nature was supreme. It was really the movement for going back to nature and its rustic simplicity. The physiocratic school was more coherent and systematic compared to mercantilism. It was well-organised and more or less orderly. The school was founded by Francois Quesnay.

There were many members of the physiocratic school. The most famous members were: Francois Quesnay, Dupont de Nemours, A.R.J. Turgot, Mirabeau, De la Riviere, Baudeau and Trosne.

1.6.2 Basic Principles and Policies of Physiocracy

The physiocracy's guiding principles and regulations are as follows:

1. The only profession that is productive is agriculture.
2. Trade and industry are sterile professions.
3. Agriculture generates a profit (surplus).
4. Life is happy and meaningful because of a natural order.
5. There is harmony between all social classes.
6. The person should enjoy the most freedom possible.
7. State intervention should be kept to a minimum.
8. Trade should be free because it is a necessary evil.
9. Utility determines value. Money has worth. Price and value are synonymous terms.
10. The pay is at the subsistence level (iron law of wage).

11. The economic system is interdependent.
12. Real wealth is found in material and consumable items.
13. Individual initiative needs to be supported.
14. Product distribution is very important.
15. A medium of exchange is money.
16. Everything is bought, everything is sold, and everything is bought. Say pointed out that money received does not necessarily return to the income stream.
17. Landlords' legitimate source of income is rent.
18. Given that land is the main source of economic activity, there should be a single, direct tax on it.
19. The importance of private property.
20. There's a chance of excessive population growth on land.

NOTES**1.6.3 Natural Order**

The conception of natural order is one of the fundamental bases of the physiocratic system. Natural order supplies the base on which the economic system of physiocracy is built up. Natural order is a philosophical concept. Quesnay built the whole system of physiocracy on the concept of natural order. Physiocracy was described by Dupont de Nemours as a science of natural order. The natural order is designed and ordained by God. It is a permanent, eternal and universal phenomenon. It must not be confused with the state of nature. The state of nature is savage state, but natural order is in conformity with the civilised state. It is founded on law and property rights. It indicates that natural principles, such as those that regulate the physical universe or have control over animal or organic life, apply to human communities. The physiocrats used the concept of natural order to illustrate how all social strata are interdependent on one another and ultimately dependent on nature. The natural order is created by God for giving happiness to mankind.

According to Quesnay, the basic objective of economics is to secure the greatest amount of satisfaction with the least possible outlay. This is in conformity with the system of natural order. When everybody is observing natural order, there cannot be any clash of interest among different classes of people, and the individual interest and social interest cannot be in conflict with each other.

According to Dupont, introspective self-examination will reveal the essence of the natural order. It is already existing in society. It is, however, necessary to realise it. The natural order can be applied to the relation of state with trade and industry. Once the natural order is known, it would be followed by everyone through rational behaviour. It must be noted that the natural order is not the same thing as the social order. A social order is created by human beings, but natural order by God. It is also not the same thing as the state of nature. It is the duty of human beings to first understand the natural order, appreciate its implications and then to bring our lives

NOTES

in conformity with the natural order. The natural order is able to secure for the individual and society the greatest amount of pleasure and happiness.

However, certain institutions are necessary for the working of the natural order. These institutions are: liberty, private property, landed classes, farmers and absolute monarchy. It also requires authority. The freedom to perform one's labour, to enjoy the rewards of one's property, and to enjoy one's freedom in a way that doesn't interfere with others' rights to pursue their own interests are all important components of the natural order. Another requirement for the natural order is laissez faire leading to removal of all restrictions in the way of freedom of contract, free competition and natural rights. The government should perform only the limited necessary functions. It should try to protect life, liberty and property.

If everybody can realise natural order, there would be heaven on this earth. The natural order is sometimes referred to as the rule of some natural laws. This concept might have been brought from the medieval concept of natural justice. The purpose of such a natural order is to ensure an orderly functioning of the universe of discourse. The natural laws are normative laws for governing the behaviour of human beings on an ideal basis. These laws specify certain ideal rights and duties for human beings to perform. Only rational human beings are aware of such order. The natural order is the ideal order of things. The natural laws can ensure the natural rights to man and these laws govern ideal human action. The freedom of mankind is not in any way limited by the natural order; on the other hand, it stands for greater liberty.

The physiocrats had some pre-considered notion about natural order. The natural order is a metaphysical concept, which is not capable of being empirically verified. This makes the concept less scientific and more subjective. The idea that natural order foreshadows utilitarianism at a period when society was not ready for it is made. The physiocrats considered natural order as something supernatural. It was indeed difficult to naturalise the supernatural. Perhaps, it was an attempt to bring about an ideal order of things on the basis of natural justice. Haney has suggested that the physiocratic natural order philosophy was against the materialistic and rigid control of economic life, which was enforced under mercantilism.

Check Your Progress

13. The system of physiocracy developed in France in the middle of the _____.
14. The single tax on agriculture should not exceed 30 per cent of the value of the _____.
15. Which policy could create a consistent national system or regulation of internal trade and industry in towns and countries?
 - (a) Global Policy
 - (b) The national policy
 - (c) The state policy
 - (d) The Industrial Policy

16. What can be applied to the relation of the state with trade and industry?
- (a) The natural order
 - (b) The Political order
 - (c) The Court order
 - (d) None of the above

NOTES**1.7 ANSWERS TO 'CHECK YOUR PROGRESS'**

1. Account
2. The Republic
3. Doctors
4. Tax
5. Equilibrium price
6. 10 dirhams
7. Adam Smith
8. Mercantilist
9. National policy
10. Imports
11. (b) Adam Smith
12. (d) All the above
13. Eighteenth century
14. Net product
15. (b) The national policy
16. (a) The natural order

1.8 SUMMARY

The history of economic ideas is what the history of economic thought is all about which are place in order on the basis of origin. Since human beings have always thought about economic problems for their day-today existence, economic thought can be regarded as old as the history of mankind.

The interpretation of production, distribution, value, growth, trade, development, commerce, industries, and a myriad of other aspects of economic issues and issues is the focus of economic thinking.

Aristotle - According to him, *Oeconomicus* aims at the management of the household economy and *Chrematistics* is concerned with wealth-generation and spending.

Early Muslim thinkers Abu Yusuf, Al Mawardi, Al Gazali, Ibn Taimiyah, Ibn Hazm, and Ibn Khaldun made contributions to economic thinking.

NOTES

Abu Yusuf's economic philosophy in relation to Islamic governmental monetary policy. Since Abu Yusuf's ideas were designed to reinstate Islamic rule in the area of economics, his unique ideas only gradually came to light. In order for the fundamentals of finance to be balanced, it depended on the importance of a reference while handling a nation's finances.

As indicated by al-Mawardi (1996), state foundations drove by the head of government is expected to make agreement and concordance with the principles which it embraced to the local area, also the financial existence of society.

As indicated by al-Ghazali, markets develop because of regular powers, as a feature of the "normal request" of things, and as a statement of self-inspired human cravings to deliberately fulfill common economic necessities.

As indicated by Ibn Taymiyyah market as far as financial matters is the meeting between demand and supply. In this sense, the market is intelligent, not physical.

The four primary global economic issues during the reign of Ibn Hazm are as follows:

- (i) Basic needs and Poverty
- (ii) Zakah
- (iii) Taxes
- (iv) Land Tenure systems

An early political economy model is presented by Ibn Khaldun. He presents value-adding processes as the foundation of the economy, where labour and experience are added to methods and crafts to produce higher-value goods.

In different countries, the term "mercantile" has distinct meanings and connotations. Cameralism was the name given to mercantilism in Germany; Colbertism was given to it in France; and Mercantilism was given to it in England. It is a system of beliefs that supports the amassing of gold and silver, a positive balance of world trade, increasing state authority, and economic success.

A group of French individuals created the physiocracy as a response to the mercantilists' materialistic, rigid, constrained, and controlled mercantile capitalism.

1.9 KEY TERMS

- **Zakat:** One of the Five Pillars of Islam, payment payable yearly under Islamic law on particular types of property utilised for religious and charitable purposes.
- **Sharia'ah:** In religious terms, shariah means "the righteous path" or "the path of God."
- **Mercantilism:** The idea that trade produces prosperity and is boosted by the building up of positive balances, which a government should support through protectionism.

- **Physiocracy:** The “Agricultural System” is another name for the physiocracy. Physiocrats are economic theorists who have contributed to the expansion and advancement of the physiocracy.

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1.10 SELF-ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. On what basis the medieval thought was based on?
2. What has been clarified by Abu Yusuf in Al-Kharaj?
3. Write the economic thought of Ibn Hazm.
4. Explain the term Zakah.
5. List out the main characteristics of mercantilism.
6. List out the main characteristics of Physiocracy.

Long Answer Questions

1. Explain in short the economic thought of Aristotle.
2. Write in short the Medieval thinkers discussions.
3. Explain the contribution of early muslim scholars - Abu Yusuf & Gazali.
4. What is Mercantilism?
5. What is physiocracy?

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2. https://mpira.ub.uni-muenchen.de/84488/13/MPRA_paper_84488.pdf
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Unit II Classical Period

Learning Objectives:

By the end of this unit the learners would be able to:

- Know about the Classical period of Economics.
- Understand Adam Smith - division of labour and theory of value.
- Explain David Ricardo-value, theory of rent, distribution theory.
- Elucidate the Ideas on economic development and International trade.
- Describe Thomas R. Malthus - theory of population & Sismondi's economic thought.
- Identify Kari Marx - dynamics of social change.
- Trace Economic ideas of J.B. Say and J.S. Mill's Economic thoughts.

Structure:

2.1 Introduction

2.2 Adam Smith (1723-1790)

2.2.1 Naturalism and Optimism

2.2.2 Division of Labour

2.2.3 Productive and Unproductive Labour

2.2.4 Adam Smith's Theory of Value

2.2.5 Theory of Distribution

2.2.6 Taxation

2.2.7 Public Debt

2.2.8 Smith on Economic Growth

2.3 David Ricardo (1772-1823)

2.3.1 Note on Methodology

2.3.2 Ricardo's Value Analysis

2.3.3 Ricardo Effect

2.3.4 Theory of Distribution

2.3.5 Ricardian Theory of Rent

2.3.6 Ricardo on Machinery and Employment

2.3.7 Ricardo on Taxation

2.3.8 Ricardo's Monetary Theory

2.3.9 Ricardo on Foreign Trade

NOTES

- 2.3.10 Ricardo on Economic Growth: Ideas on Stationary State
- 2.4 Thomas Robert Malthus (1766-1835)
 - 2.4.1 Malthus Theory of Glut: Ricardo-Malthus Glut Controversy
- 2.5 German Romantics and Socialists
- 2.6 Jean Charles Sismondi (1773-1842)
- 2.7 Karl Marx – Dynamics of Social Change
 - 2.7.1 Marx's Labour Theory of Value
 - 2.7.2 Karl Heinrich Marx (1818-1883)
 - 2.7.3 Karl Marx – Theory of Profit
 - 2.7.4 The Marxian Theory of Crisis (Business Cycle)
- 2.8 Economic Ideas of J.B. Say (1767-1852)
 - 2.8.1 Say's Law of Market
- 2.9 Economic Ideas of J.S. Mill (1809-1873)
- 2.10 Historical School (1843-1883)
- 2.11 Seniors
 - 2.11.1 William Roscher (1817-1894)
 - 2.11.2 Bruno Hildebrand (1812-1878)
 - 2.11.3 Karl Gustav Knies (1821-1898)
 - 2.11.4 Gustav Schmoller (1830-1917)
- 2.12 Friedrich List (1789-1846)
- 2.13 Answers to 'Check Your Progress'
- 2.14 Summary
- 2.15 Key Terms
- 2.16 Self-Assessment Questions and Exercises
- 2.17 References

2.1 INTRODUCTION

We are increasingly gaining a better understanding of the intellectual climate of early nineteenth-century political economics thanks to contemporary studies of classical economic thought. One of the approach's more significant contributions is the notion that there has ever been a joyful unity of opinion, a widely accepted body of theory whose propagation the classical economists were a cohesive band of eager missionaries. The notion that the classical economists were unconcerned with the methodological foundation of their collective work is also increasingly receding from discussions of the subject.

It is desirable to debunk the widely held belief that classical economists were indifferent about obtaining and enunciating a precise definition of the subject of their investigations. This is far from the case. True, J. S. Mill was compelled to

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apologise for the lack of a “strictly logical” description of political economics in 1836, stating that the definition of any discipline “has almost invariably not preceded, but followed, the birth of the science itself.” But many economists already felt the need to specify the parameters of their study. Even while the classical economists generally agreed on what they were talking about, they could not agree on how to define this area of study or even how to imagine the unity and logic of their field.

The early economists were frequently much more concerned with articulating the true essence and nature of their study than many of their descendants. Although the latter, according to Mill, were more qualified for the task, they had far less opportunity to do so. There was a real need for a form of definition for intellectuals in the late eighteenth and early nineteenth century who could support the development of a fresh, new science. They had to demonstrate the distinctiveness of the subject matter or research approach that prevented economics from being included in with other disciplines, even if their definitions just hinted at the genuine character of their inquiry.

Classical writers might express themselves in two ways regarding the essence of economics. They might be able to define the term “political economy.” Alternately, they could specify the type of wealth that economics is concerned with after defining political economy as the science of wealth. Prior to and following Mill’s own thorough effort to define political economics, each of these approaches was freely employed. from being subsumed by some bigger, existing field.

However, after 1830, there is certainly a tendency toward more sophisticated definitions. The practise of conducting a methodological self-examination has become rather popular. Many of the assumptions that economists had previously taken for granted were revealed at this time, and most of the major difficulties that would become the subject of methodological debate in the following century were first stated explicitly. Debates viewed economics as a standalone issue rather than as a stepping stone to a more significant issue in terms of its magnitude. Senior, J.S. Mill, and Cairnes came after, as well as many lesser-known economists, all paid close attention to definition.

The subject of the discipline’s scope was brought up for discussion in 1835 at a meeting of the Political Economy Club of London.

Additionally, this time period saw a major improvement in the approach that was actually used to define the nature of the economy. As will be demonstrated in the following chapters of this article, writers around 1830 started to struggle against the earlier classical economics’ more radical objective conception of it as the study of wealth. After 1830, it became clear to various writers that what they were researching was not so much a series of objective events with wealth as the common denominator, but phenomena emerging from men’s wealth-oriented actions. There was a lot of discussion about what these actions’ core characteristics were as well as the precise balance that needed to be struck in political economy between the realities of human nature and the outside world. But the first step had

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been made toward releasing economics from its ties to material prosperity and wealth.

2.2 ADAM SMITH (1723-1790)

Division of labour, the theory of value, the distribution of capital, opinions on trade, and economic development or growth.

Although Adam Smith was a bachelor, he is regarded as the father of economic science. The greatness of Adam Smith lies in his effort to systematically and analytically present the facts of economics. He introduced economics as a separate discipline. 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. However, even at the time of Adam Smith, economics could not become a science in the true sense of the term. In fact, economics became a science at the end of the classical period, more precisely since 1870, when the neo-classical economics and marginal revolution developed became a part of economics to make it more analytical and verifiable.

Wealth of Nations

Smith's book, *An Inquiry into the Nature and Causes of the Wealth of Nations*, which was published in 1776, is not just an ordinary book. It contained the thinking of the whole epoch. There is nothing in this book which can be called purely original. All the ideas presented in this book are already known. Smith simply presented the ideas in a more systematic and analytical manner. It has been rightly pointed out "The Wealth of Nations is the outpouring not only of a great mind, but of a whole epoch". A quick scan of *The Wealth of Nations*' pages indicates how thoroughly the subject of economics is covered. The division of labour, the creation and use of money, and how prices, salaries, profits, and rent are determined are all covered in Book I. Smith's capital and interest theory is included in Book II. Book III examines the evolution of the European economy from prehistoric times to the eighteenth century. The discussion of various political economy systems in Book IV includes an attack on mercantilism. It also discusses the barriers to free trade. Book V is concerned with taxation and fiscal policy of the eighteenth century Britain.

2.2.1 Naturalism and Optimism

Like the physiocrats, Smith also believed in natural order. He called his natural order as naturalism. He derived his view of naturalism from the physiocrats and also from Francis Hutcheson. It should be noted that Adam Smith was basically a philosopher. He was famous for his *Theory of Moral Sentiment*. The essence of naturalism is that the economic institutions are spontaneous in origin. Optimism says that the naturally created institutions crop up under the influence of self-interest and common natural instinct. This, in a nutshell, is the theory of naturalism. The ideas of naturalism and optimism are not separable from each other. Smith's philosophy is based on the idea that whatever is natural must also be good for the society as a whole.

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Self-interest drives everyone's actions. Every guy, in a sense, is a gain maximizer and a loss minimizer. As a result, each individual engages in the activity that looks to him to be the most profitable. This conceptualization underpins the entire society. Everyone wishes to improve their situation. When people are guided by such a motive, they engage in a variety of activities, resulting in a diverse range of economic organisations. These economic institutions are characterised by their spontaneity. Despite the fact that the institutions are largely motivated by self-interest, they ultimately benefit society. Our expectation of a meal comes not from the goodness of the butcher, brewer, or baker, but rather from their consideration of their own interests. We speak to them in terms of their self-love rather than their humanity, and we never discuss their own needs with them; instead, we focus on their advantages.

Every man should be allowed to make his own decisions since he is the best judge of his own interests. According to Adam Smith, every person is motivated by an invisible hand to advance a goal that was not in line with his intentions while pursuing his own gain. Smith believed that the interests of various economic entities could not conflict given the natural order. Their objectives must be in sync. This is ensured by the operation of the Invisible Hand or automated adjustment mechanism. Smith believes that if perfect competition existed, individual and communal interests might coexist. Liberty, free competition, and laissez-faire are required for the natural order or naturalism to function.

Smith has provided several examples of economic institutions that are beneficial in nature. The institution of money, for example, evolved spontaneously, removing the obstacles of the barter system and facilitating trade, exchange, and commerce. Similarly, the demand-supply construct is of spontaneous origin but it does a great service to the market economy by adjusting supply and demand to the price level. The adjustment of price, demand and supply is natural in origin. But it helps to bring about an equilibrium in the market economy. The demand and supply theories of labour are similarly extended in Smith's theory of population. If there is a high demand for labour and a consistent supply, wages will increase, and in course of time, people will expand their families and labour supply will consequently go up, and, therefore, wages will come down. The reverse will be the case if demand for labour is low and supply of labour is high. The theory of naturalism is also applicable in the case of capital accumulation which is a natural phenomenon. But capital accumulation leads to a great social advantage. Capital accumulation facilitates the task of economic and social development which is very beneficial to all types of people. In the same way, division of labour is a natural institution in the production economy. It arises out of self-interest and leads to a number of advantages like increase in output, increase in efficiency, low cost and possibility of invention.

In truth, every individual is guided by the invisible hand to promote communal interest and welfare while pursuing his own interests. As Adam Smith puts it, a person "truly neither intends nor understands how much he is furthering the public interest." He only has his own security in mind when he chooses

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domestic over foreign industry support, but he only has his own gain in mind when he directs that industry to produce the most valuable goods possible. In this case, as in many others, an invisible hand is guiding him to advance a goal that was not in his original plans.”

The natural order does exist in the universe and guarantees harmony of interests among all classes of people. If there is anything unnatural or undesirable, the Invisible Hand is there to correct it. The forces of perfect competition leads to a few advantages, although it is a natural institution. Perfect competition assures a normal price for the producer, production of a large number of goods and services and the lowest possible production cost. Thus, we find that perfect competition leads to a number of advantages for the society. It should also be noted that perfect competition leads to optimum allocation of resources. Similar is the case with free trade which is a natural practice or institution. Free trade results in factor price equalisation as well as the ability to supply goods and services on the global market at the lowest possible cost.

Smith held that while personal interest promotes the development of economic institutions, it also ensures greater advancement and prosperity of the nation through such institutions. Adam Smith had great confidence in the efficacy of human action. However, he pointed out that there should be certain restrictions on individual actions. For example, the private enterprise to be useful must satisfy the following two conditions: (1) Competition must keep actions within the limit of justice. (2) Entrepreneurs must be guided by personal interest.

Criticisms

Needless to say, Smith assumed mutual interdependence of different sectors and people in the economy. In terms of production, his optimistic theory appears to be true. However, there is little room for optimism and interest harmony in the distribution sector. Smith himself demonstrated that there is the possibility of a conflict of interests in the realm of distribution, between labour and capital, in particular. His hypothesis of optimism is not supported by any scientific principles. Interests on a personal and social level may or may not coincide. The public and private sectors do not share the same shared interests or levels of efficiency. Adam Smith’s conclusion regarding naturalism and optimism is founded on an incomplete inductive or empirical study. These are not predicated on any previous theories or causal connections. It has been discovered that as capitalism advances, society’s class divisions become more pronounced. Smith is incorrect when he asserts that naturalism and optimism may be accomplished independently of the state. In many cases, aid from the government will be needed to foster optimism and naturalism.

A man is not necessarily activated by the motive of self-interest. Smith’s philosophy is over-individualistic. His individual is an economic man dominated by self-interest, self-love and shrewd choice and his economics mixes up individual and social points of view. Thus, it will be difficult to build up a theory on such a mixed notion which is essentially uncertain. Lastly, Smith represented the interest of a single class, i.e., the capitalist class. According to him, the capitalist class

increases welfare of the society. It is obvious now that his observations seem to be contrary to facts.

Be that as it may, it must be noted that Smith's theory of naturalism and optimism is different in many important respects from the physiocratic theory of natural order. This is discussed below:

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Table 2.1: Comparison between Physiocratic Natural Order and Smith's Naturalism

1. It is a natural law applicable to both life and institutions.	1. It is natural or spontaneous economic institutions.
2. Natural order maximises happiness.	2. Beneficial in character.
3. No interference is required.	3. No interference is required.
4. It may be enforced by authorities or human violation.	4. Invisible Hand guarantees automatic adjustment. No enforcement is required.
5. Self-interest of human beings is not brought to the forefront.	5. Selfishness is brought to the forefront.
6. Simply an ideal realisable by cultured and educated people.	6. It is not so. It is a reality.
7. Liberty, free individual action and laissez faire are required.	7. Liberty, free individual action and laissez faire are required.
8. The basis of natural order is property, security and liberty.	8. Smith recognised no such basis.
9. Natural order is to be discovered.	9. It is existing in the universe.
10. Natural order is to be revealed, understood and propagated.	10. These are not necessary.
11. Possibility of clash of individual interest and social interest. Men should sacrifice self-centrism for social welfare.	11. No clash of interest, excepting in the matter of distribution.
12. Natural order is tinged with a note of pessimism because of the possibility of wrong working of human beings and institutions.	12. Invisible Hand corrects the unnatural and undesired things (optimism). Pessimism is also recognised by Smith.

2.2.2 Division of Labour

Adam Smith claimed that the division of labour was essentially the only thing driving economic growth. Division of labour is a system of social cooperation in the production process where every individual is given a job according to his specialisation. He has very elaborately discussed the division of labour in his *Wealth of Nations*. In the beginning of the book, Smith analyses the importance of labour in the production process. He says that labour is the true source of wealth. This is the reason why he placed the discussion on labour at the outset of his book. Labour is the cause of wealth and production. This is the main philosophy of *Wealth of Nations*. Labourers enter into social cooperation for production, and the combined effort of these individuals produces the national dividend. The division

NOTES

of labour facilitates the teamwork required for the manufacture of numerous goods that will satisfy everyone. As a result, it truly contributes to human wellbeing and social advancement. Smith had a very clear idea about the advantages of division of labour which are as follows:

1. Increase in production is possible.
2. The worker acquires greater skill through specialisation.
3. Production takes place at a faster rate.
4. Specialisation leads to invention.

Smith's division of labour is a true dynamic force. He said that there is increased scope in any nation for increasing productivity through division of labour. It follows naturally from people's propensity to trade, barter, and exchange. A high degree of division of labour leads to a high degree of specialisation resulting in increased efficiency and, thereby, increased productivity. Smith linked capital accumulation and innovation to the benefits of labour division. Capital stock and the size of the market, on the other hand, are the elements that restrict the division of labour. Division of labour, in Smith's analysis, is actually technical progress, and, as such, its introduction depends on the opening of new sources of demand. Smith says that division of labour leads to invention of machinery which does not displace labour but rather absorbs it.

Smith's idea that division of labour is limited by the extent of market has been incorporated in the theory of growth, particularly by A Young and R. Nurkse. They say that underdevelopment equilibrium can be broken if there is balanced industrial development, expansion of demand and market. The size of the market has become a limiting factor for investment incentives in modern times, as is shown in every developing nation. The division of labour boosts both overall output and employment of the most productive workers. Smith observes that increased division of labour must increase production which, for its sake, must depend on markets. The extent of the market must expand with the growth of productivity and output. Development process which is started by division of labour is a cumulative process. When capital stock is sufficient and market is expanding, division of labour should be undertaken to increase productivity and national income. Increase in the working population and income not only expands the size of the market, but also increases the volume of saving as labour becomes more specialised. As market expands, incentive to introduce improved method of production increases. These result in further specialisation and productivity increase. The division of labour has the effect of multiplying productivity, which benefits society as a whole. His division of labour thesis served as the basis for the economic law of growing returns, which it points out that as output increases, the unit cost would diminish. The implication of division of labour was fully brought out by Alfred Marshall.

Although a number of criticisms may be levelled against the Smithian theory of division of labour, there is no denying the fact that his theory is relevant to the problems of capital formation in less developed countries. The thesis that division

of labour is dependent on the extent of market is an important clue to economic progress for an economy which is in the midst of underdevelopment equilibrium.

Smith's originality lies in making division of labour the basis of all economic activities and considers it the true explanation of social production. It is the basis of economic progress in modern times. He placed a strong focus on labour as a source of income in order to set his beliefs apart from those of mercantilism and physiocracy. Mercantilism believed that the only source of wealth was international trade and commerce, while physiocrats believed that agriculture was the source of all income. Smith wanted to contradict their mistaken notions.

Smith observed that labour is the source of all wealth. And all classes who work are productive. Smith said that foreign trade and agriculture are ultimately carried on by the labourers. Without labourers, there would be neither trade nor agriculture. According to him, the theory of division of labour is a repudiation of all previous economic theories which took only a partial view of production. Smith wanted to take a broader view of production by considering the entire humanity connected together as common labour for production of economic goods. He said that no class of individual, whether farmer or trader, is more important than the other. Every class has its own place and is essential for production. Smith, through his theory of division of labour, pointed out the important fact that production is a total concept and every type of production is equally necessary in a scheme of social production. The views of earlier writers like physiocrats and mercantilists were one-sided and narrow, against which Smith wanted to direct his philosophy of growth of wealth of nations and the result is his celebrated theory of division of labour.

2.2.3 Productive and Unproductive Labour

Smith defines productive labour as the labour that results in the production of physical products with a market worth. On the other side, unproductive labour produces intangibles like the services provided by monarchs, craftspeople, and instructors. Adam Smith placed a lot of emphasis on the split between productive and inefficient labour in the production process. A productive worker increases the worth of the thing they are working on. On the other hand, unproductive labour adds nothing to anything. Smith adopted a materialistic concept of productivity in his investigation of the distinction between productive and unproductive labour. Many authors criticised this concept. Smith claims that productive labour fixes and realises itself in a certain area that lasts a long time. The services of unproductive labour are destroyed as soon as the services are performed. In the case of ratio of productive to unproductive labour being greater, we can expect a faster rate of capital accumulation. Productive labour can put into motion an equal quantity of labour. This implies that productive labour does not destroy effective demand. Productive labour is perishable in the long run. It is capable of being stocked and stored up for future use.

Smith observes that only durable goods can be congenial productive labour. The production of wage items involves productive labour. The amount of

NOTES

NOTES

productive labour is a growing function of the amount of money needed to pay salaries. The more the fund size, the greater the wealth, and the greater the market size, which will decide the rate of introduction of machinery and the division of labour.

The unproductive workers do not contribute anything towards the expansion of the stock of wage goods. When an employer employs productive labour, he grows richer but when he employs unproductive labour, he becomes poor. By employing more productive labour, future wants can be satisfied in a better way. The bias for accumulation in Smith's theory of development involves a materialistic bias simply because only material goods can stock labour. Therefore, production of material goods by productive labour is the basis of saving and accumulation. Productive labour remains very crucial in an economy because such labour is used for investment. The annual produce which replaces capital is never employed immediately to maintain productive labour.

Another implication of Smith's distinction between productive and unproductive labour is that the productive labour must reproduce itself. The resources for the upkeep of productive labour can be raised by parsimony. The annual output of land and labour can also be enhanced in such a situation. According to Smith, labour that is productive will be paid more for than it actually expends. Productive labour is stored up and can be effectively used in future. It is better to transfer unproductive labour to productive labour.

The third implication of the distinction between productive and unproductive labour is that the latter workers are disguisedly unemployed or partially unemployed. They are, in fact, maintained by their relatives. Their marginal productivity is either zero or close to zero. If such workers are given productive employment, the social product will increase.

The fourth implication of the distinction between productive and unproductive labour is this that when an unproductive labourer receives his wage, there is no further problem to bother; but when a productive labourer receives his wage, then one has to consider the possibility of selling the commodity produced by the productive labourer. This involves risk, uncertainty and time lags. All these are important for the determination of wages. The productive labourers earn their own income, but unproductive labourers are supported by others. This analysis of Smith was very much appreciated by Karl Marx. Whereas a productive labourer creates surplus value, an unproductive labourer cannot create surplus value. Marx credited Smith for finding out such an important truth about the capitalistic economy. Smith's distinction between productive and unproductive labour can be linked with his theory of economic growth. Smith rightly observes that productive labour is able to create capital, increase investment and effective demand. Thus, productive labour can be an important source of creating further productive employment.

2.2.4 Adam Smith's Theory of Value

Adam Smith's theory of value appears to be confusing for many reasons. Firstly, he had a number of theories of value such as demand and supply theory,

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cost of production theory, toil and trouble theory, labour-embodied theory and labour-commanded theory. Secondly, Smith's treatment of value theory is different in his Lectures than that in his *Wealth of Nations*. Thirdly, there appears to be a confusion between the cause of value and the measure of value. Fourthly, the confusion arises also because of the use of labour embodied and labour commanded as a measure of exchange value.

At the beginning of his analysis, a distinction between value in use and value in exchange is made by Adam Smith. In his theory of value, he has attempted to explain the diamond-water contradiction, but he claims that utility cannot serve as the foundation for exchange value. He has not considered the concept of marginal utility. He simply intended to describe how an item's relative price or exchange value changed over time. He did not compare the exchange ratio of individual units but the whole amount of the two commodities. Therefore, the paradox of value could not be explained by him. Adam Smith is credited as having a labour theory of value. According to Adam Smith, the true indicator of the exchange prices of all goods is labour. He contends that a good's trade value is determined by the amount of labour it contains. Smith continues by saying that an item only has worth because it was laborious and difficult to obtain. According to the analysis of *The Wealth of Nations*, labour is the origin, reason for, and yardstick for measuring trade value.

When Adam Smith says that labour is the cause of value, he really means by labour, toil and trouble. However, toil and trouble is not an objective standard measure. Therefore, Adam Smith considered disutility of the common unit of measurement of value. But disutility may be different for different workers for the same type of work. What then is the way out? Adam Smith observed that the money value of disutility with reference to a particular work is equalised by competition.

For measuring value, an invariant standard of measurement is required. Adam Smith says that this invariant measure of value is neither gold nor corn nor silver, because the values of commodities go on changing. According to Adam Smith, the invariant measure is labour, because its value remains more or less the same. When the price of a commodity changes, it is a reflection on the market situation and not on the labour content of the commodities. Corn and silver are not invariable in their values, and, therefore, cannot be used as the invariant measure of value for the purpose of intertemporal and interspatial comparison of exchange value.

In order to understand Adam Smith's theory of value, it is necessary to get acquainted with the terms: cause of value, measure of value, labour-embodied concept of value and labour-commanded concept of value. Cause of value refers to the element that determines value (the source of value). The term "measure of value" refers to the method for computing or measuring value. A commodity's labour embodied content is the total amount of labour it contains. Labour-commanded means the amount of labour that a particular commodity can command or get in exchange for itself in the market. Labour command, needless to say, depends on the market value of a commodity.

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Three Models

Adam Smith used three models for the analysis of his theory of value. In the one-sector model, there is only one factor of production (labour). Land is a free gift and capital does not exist. In such an economy, labour embodied in a commodity is the cause of value. Since there is no other factor to measure value, labour alone is the measure of value. For instance, if it takes two hours to trap a deer and one hour to catch a beaver, then the value of one deer would be equal to the value of two beavers. In a primitive society, where labour is the only factor of production, value is determined by the toil and trouble (disutility). In other words, a commodity's worth is defined by the amount of labour it contains. However, in such a society, labour embodied is the same thing as the labour commanded. In a single-sector model, therefore, labour-command (= labour embodied) is the measure of value and labour embodied is also the cause of value, because these two concepts are the same in a primitive economy. The primitive economy is the crude state of society where capital is not used for production. So, in a primitive society, the cause of value is the same as the measure of value as there is only one factor of production—labour. In a sense, the concept of labour command is not relevant for one-factor model. The toil and trouble theory considers disutility which is a metaphysical concept.

Smith also considered a two-factor model of value. In this case, there are two factors: labour and capital. Adam Smith pointed out that capital can be converted into labour in such a case, because capital is stored-up (dead) labour. Thus, capital can be converted into labour and the measure of value is the labour embodied in the commodity. The cause of value in such a case is also labour embodied. In a three-sector model (or in any multi-sector model), the labour commanded would be different from the labour embodied. The labour-commanded value will include the costs of labour, land and capital. These costs together will be higher than the simple labour-embodied cost. In this case, the measure of value will be the labour-commanded measure. And the cause of value would also be the total cost of land (N), labour (L) and capital (C). Wieser, in this connection, has observed that Adam Smith had two theories of value. What he wants to convey is that in a primitive society, while Adam Smith's labor-embodied theory of value is useful, the labour-commanded theory of value is more suited in a modern society. The measures and cause of different models of Smith's value analysis are given in the following chart:

Chart 2.1: Adam Smith's Value Models

Nature of Model	Labour-embodied (LE) and Labour-commanded (LC)	Measure of Value	Cause of Value
One-sector Model (Only Labour)	$L_E = L_C$	$L_E (= L_C)$	L_E
Two-sector Model (Labour and Capital)	$L_E = L_C$ (Capital can be converted into Labour)	L_E	L_E
Three-sector Model (Land, Labour and Capital)	$L_C > L_E$	L_C	$(L + N + C)$

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Although Smith discussed a three-factor cost theory of value, he did not elaborate the determination of factor cost (distribution). The three-factor model of Adam Smith, is based on the concept of natural price or long-run competitive price. In the value analysis of Adam Smith, it is found that really speaking, the labour theory of value is only relevant in a primitive one-sector economy. In a modern economy, where there are many factors of production, the simple labour-embodied theory of value does not apply. Thus, one can say in the modern perspective that Adam Smith did not have any labour theory of value. This is so because labour embodied is relevant only in one-factor model and cost of production (labour commanded) is relevant in a three-factor model which replicates modern economy.

Adam Smith also speaks of *market price* and *natural price*. Market price is the real price currently in effect on the market, which is decided by supply and demand dynamics. If supply remains constant, an increase in demand can increase the market price, and a decrease in demand can bring down the market price. Similar to how an increase in supply will lower the price while a decrease in supply will raise the price, if demand stays the same. The natural price is the long-term cost that is exactly equal to the value of a good as demanded by labour. The market price may be more than or less than the long-run normal price as shown in the following diagram. However, the market price has a tendency to coincide with the long-run normal price over time. Thus, the market price is a short-run price.

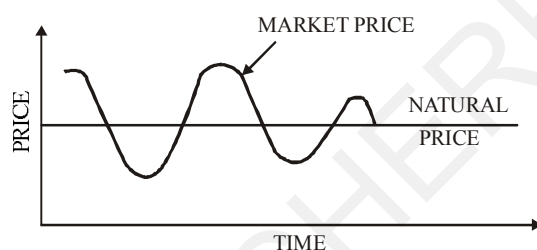


Fig. 2.1

It becomes pretty clear from the analysis of Smith's value theory that Smith never used, not even by implication, the labour commanded as a cause of value. It is always used as a measure. The concept of toil and trouble has been used by Smith only to establish the validity of labour-commanded measure as the universal invariant measure. Smith also did not use the labour-embodied concept as a measure of value, excepting in the one-sector model. In conclusion, it seems that labour is neither the sole source of value nor the sole factor determining exchange value based on the analysis of Smith's theory of value. There are many other determinants of value such as land and capital. The analysis of Smith's value theory seems to be more complete in his *Wealth of Nations* than in his lectures. It is also clear that Smith had a complete understanding of the interdependence of the commodity and factor markets. Be that as it may, the following points of criticism can be levelled against Smith's theory of value:

1. Smith did not realise the fact that in the absence of a distribution theory, the cost of production (labour commanded) cannot be known. Hence, his long-run cost of production theory remains to be illogical.

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2. For determining the cost of production, it is necessary to show that all factors of production are reducible to some common denominator. He could not clearly show as to how different factors of production can be reduced to labour units.
3. The labour theory of value was not one of Smith's several theories of value.
4. He says that normal price is determined by the natural price of factors of production. This is question-begging, because it is not known what is a natural price.
5. His primitive economy model is not realistic.

Despite all these, Smith's value analysis has added a new dimension to the labour theory of value and has become a convenient starting point for further explorations.

2.2.5 Theory of Distribution

Adam Smith did not develop any satisfactory theory of distribution, but he has given many new insights regarding the payment of wages, rent and profit and their determination. Smith's theory of distribution follows from his theory of natural price. According to him, there are natural prices for labour, capital and land. These natural prices determine the natural prices of commodities. Smith has developed a micro-theory of distribution. He was basically interested in the problem of production, not distribution.

Wage: Smith asserts that in a prehistoric society, labour productivity governed wages. But in a multi-sector (multi-factor) society, the labour product is also shared by the capitalist and the landlord. Smith has developed the concept of wage *fund* theory. The wage fund provides a theory of wages as well as a theory of capital. In fact, capital accumulation makes it possible to employ labour. The workers are given advances from the wage fund. The wage fund provides a rationale for saving, and also explains wages and profit. The doctrine says that the labourers are dependent on the capitalists for their subsistence. The size of the wage fund can be increased by the capitalist's saving.

Smith has also developed both contractual theory and subsistence theories of wages. According to Smith, wages cannot go below a minimum level which must be sufficient to maintain the workers. As the size of the wage fund grows, it can support a large number of labourers. However, when the wage level is higher than subsistence, people feel better off and expand their families so that after some time, the labour market gets flooded with a large number of new labourers. Under such a situation, the wage level again comes back to the level of subsistence. The overall wage payment's amount can be explained by the size of the wage fund. However, demand and supply factors account for the individual or average pay rate. By the natural wage, Adam Smith means the subsistence wage. At the subsistence wage, the long-run supply curve of labour becomes perfectly horizontal. However, wages may be higher or lower than the long-term equilibrium wage rate in the short run.

The factors of supply and demand, as well as contracts, affect the short-run wage rate. Smith found the possibility of wage differences among different occupations.

Rent: Smith's idea on rent is not well-founded. He was influenced by the physiocratic notion of rent. According to him, the whole of rent was not due to the investment of capital in land. So, it is found that he also differed from the physiocrats. Smith considers rent a monopoly price. Rent, according to him, is the cost associated with using land. According to Smith, a lease between a landlord and renter will typically specify the total annual rent. Rent is influenced by the location and fertility of land. Regarding rent-price relation, Smith was not very clear. He regarded rent as both price-determining as well as a price-determined. He regarded rent also as gift due to the special natural power of the soil. In connection with rent, Smith has regarded it payment for differential advantage, as a reward for the bounty of nature, monopoly price and contractual payment. Like the physiocrats, he considered rent a form of *surplus*, and also an index of social prosperity.

Profit and Interest: Smith did not make a distinction between interest and profit. He believed that the return on investment was profit, and that profit included interest. He asserts that hiring effective workers results in the accumulation of profit. He says that profit includes wages for inspection and direction. The value of capital stock regulates profit. Smith considers profit as a remuneration for the risk and uncertainty borne by the capitalist. When a man lends his capital, he receives interest, but when he invests his capital in his own enterprise, he gets profit. The lowest rate of profit must include the compensation for the possible loss. The same is the case with interest. Smith viewed profit as a residual or surplus.

He finds an inverse relationship between profit and wages. When accumulation progresses, profit declines mainly because of two factors: increasing competition among the capitalists and increasing demand for labour leading to higher wages. Smith demonstrated that when an economy make disappears (zero) a transition from progressive to stationary state, profit goes on declining and ultimately, at the level of the stationary state. Smith considered two theories of interest: real and monetary. When the amount of products available rises but the amount of money stays the same, the value of money rises, profits fall, and interest rates fall. The rate of interest decreases over time, just like profits do. However, he did not consider interest as a separate payment.

Smith's distributional theory is incredibly hazy. Smith lacked a comprehensive theory of distribution. His distribution theory is shoddy, contradictory, and riddled with physiocratic mistakes. Smith's idea of distribution glaringly lacks the novelty of his theory of production. Smith's distribution theory is the least innovative of all his works, claim Gide and Rist. Smith's theory of distribution revealed a conflict of interest between labour and capital. According to Smith, salaries and profits move in the opposite directions, which is why the interests of labour and capital are at odds. He argued for a larger wage portion of the national income. However, his theory of distribution is pessimistic where the Invisible Hand is inoperative because it cannot bring harmony of interests among the various classes.

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2.2.6 Taxation

Adam Smith advocated a multiple tax structure. He favoured taxation on all classes of people. He put forward the following four canons of taxation:

1. The amount of tax should be known and certain.
2. The taxes should be so determined that they can be collected by the most economical method.
3. Taxes should be so imposed that people can pay them according to their ability.
4. The taxes should be levied in such a manner that they are most likely to be convenient to the taxpayers.

Adam Smith considered a progressive system of taxation. He also considered rent the best source of tax. Tax on land rent is paid by the owner of the land. Tax on the produce on land is also paid by the landlord. If a tax is levied on a house, its incidence falls on both the tenant and the landlord. When a tax is imposed on profit, there is the possibility of shifting its incidence. If a tax is imposed on wages, its incidence is generally shifted to the employer, provided the wage level is at subsistence. A tax on a manufacturing industry will be borne by the consumers of the manufactured articles. In such a case, the prices will rise. If a tax is imposed on interest, it is paid by the interest-earner. It should be noted the Smith was against profit taxation. He thought that a tax on profit will discourage investment, output, employment and growth. He was also against taxation on the necessary articles because such a tax will ultimately increase wages. But he recommended taxation on luxury articles.

2.2.7 Public Debt

Smith discusses public debt in Book V of *The Wealth of Nations*. He pointed out that for performing the functions of the state, government has to incur some expenditure. To finance these expenditures, the government must have some sources of revenue. The common way of collecting revenue is taxation. However, during an emergency or war, taxation is not enough. Thus, the government has to incur public debt. Public debt is incurred because the government does not follow parsimony. The government can borrow from the public if it has performed its functions efficiently in the past. Whenever the government borrows further taxation can be anticipated for repayment of the debt. Smith did not like this method. He was of the opinion that once public debt is incurred, it gets accumulated. For the repayment of debt, the government imposes taxes during war. This tax continues even during the peace time. Sometimes, the government has to incur new debts in order to pay off the old debts.

Public debt transfers money from the public to the government. According to Adam Smith, public debt does not increase the capital stock of the country, rather it destroys some of. Public debt will have an adverse effect on land and capital, which are the two most important sources of revenue. If a tax is imposed on the landlord for the repayment of public debt, the landlords will not be able to make any

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investment for land improvement. In such a case, agriculture of the country will decline. When taxes are imposed on the necessities of life for the purpose of repayment of public debt, the owners and employers of capital stock find that their revenue goes down, along with rate of return on capital. In such a case, capital will be shifted to some other country where the return is higher. The industry of the country, in this situation, will necessarily fall, and such a capital outflow will ruin the trade and commerce of the domestic country.

National debt, according to Adam Smith, is never fairly and completely repaid. The practice of repaying public debt weakens the nation and may ultimately lead to bankruptcy. Many methods can be suggested for the repayment of public debt. Firstly, a popular method is raising the denomination of the coin. However, Adam Smith points out that it will have a very bad consequence. The second method is to adulterate the coin. This operation is also unjust. Thirdly, with fall in the rate of interest, kept for payment of interest there will be some savings in the funds. From these savings, a sinking fund for the repayment of the public debt may be established. This fund also facilitates contracting of new debts. When all is said and done, it must be admitted that Smith's idea that public debt is always unproductive does not seem to be valid today. Nowadays, most governments expand trade and commerce with the help of public debt.

2.2.8 Smith on Economic Growth

You may think of Smith's *Wealth of Nations* as an essay on economic development. For the purpose of economic growth, Smith gives credit to the principles of division of labour. It is capital accumulation, which keeps division of labour an ongoing process. The main determinants of economic growth are capital accumulation, nature, employment and wealth. The larger is the investment of capital the greater is the growth potential of any nation. Capital accumulation enlarges the wage fund which facilitates the employment of a larger number of productive labour. This increases national output, which when sold, brings larger amount of profit, a part of which can be used for further capital accumulation. In this way, the stock of capital in a country grows over time, supporting more workers and producing more output. There is a chain of causation in the growth process. In the following figure, it is shown that growth starts with the division of labour and continues (clockwise) until the stationary state is reached. The growing difficulty in locating chances for lucrative investment outlets, as capital stock in wages over time, is the growth restriction.

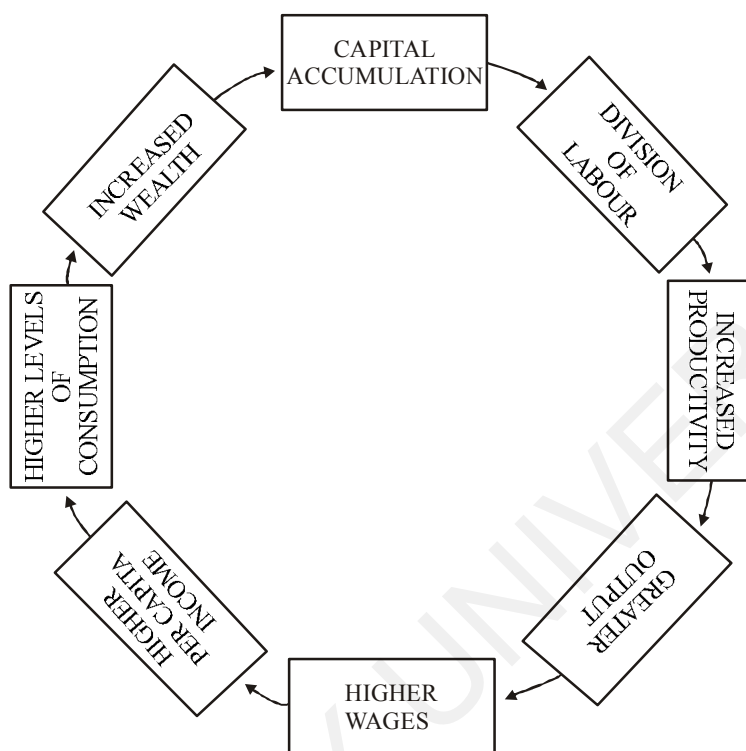


Fig. 2.2

If capital stock increases, it is possible to increase employment of productive labour. This also results in the production of increased amount of real wealth and revenues. Parsimony builds capital; prodigality and misbehaviour destroy it. The relation between capital investment, employment and generation of surplus is shown in the diagram below.

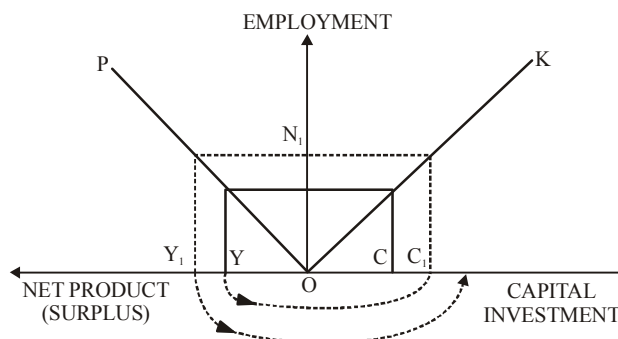


Fig. 2.3

As the diagram shows, when capital investment takes place (OC), employment grows (ON) and the net product in the sense of total product minus wage cost (OY) also is generated. A greater part of this net product (surplus) is

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ploughed back as capital investment which further increases employment and surplus. This process goes on for quite some time till the onset of stationary state.

Capital accumulation is very essential for division of labour. However, according to Smith, it is limited by the extent of market. Division of labour can increase productivity of labour, but unless the market is sufficiently large, the total product may not be sold out. In this context, Smith considered the importance of international trade. He clearly appreciated the role that foreign trade played in the economic development of Great Britain.

As development starts, it becomes cumulative. Given the market and capital accumulation, division of labour goes on increasing the level of productivity. The resultant increasing income and growth of population helps expand the extent of the market further by increasing effective demand. This also permits a large amount of saving out of the increased national income. As the market expands and specialisation increases, ability and incentive to introduce improvement of art also increase. This type of improvement further leads to specialisation and productivity gains.

In the discussion on economic development, Smith recognises in a very general way, the significance of external economies which lead to a reduction in cost. However, Smith is wise enough to observe that there are limits to growth. This has been explained by Smith in his theory of income distribution. He shows that the wage level in the long run remains at the level of subsistence. During the period of capital accumulation, wages may rise beyond the level of subsistence, at least for a temporary period. But the extent of this rise will depend upon the rate of capital accumulation and population growth. Smith demonstrates that during the process of growth, the rate of profit goes on declining over time. This is mainly due to an increase in the wage rate as a consequence of increased competition among the capitalists in the labour market. As the population grows and capital stock becomes very large, the economy reaches the level of full employment and wealth that its soil, climate, and environment permitted it to achieve. When the economy reaches this stage, the rate of capital accumulation declines, wage comes to the subsistence level and profit level falls to zero. This is the famous classical stationary state. At the level of stationary state, the process of capital accumulation and the process of economic development completely stops. This situation is shown in the following diagram:

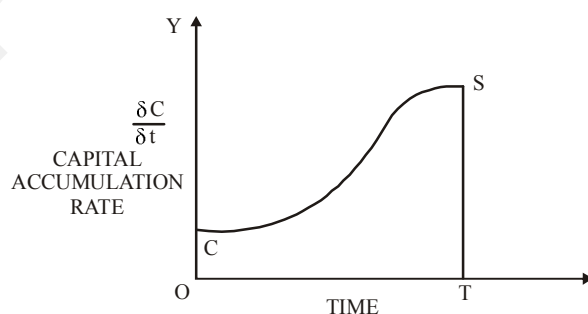


Fig. 2.4

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In the above diagram, the economy grown from C to S during the time path, T. After T, stationary state is reached (wage becomes very high, profit level zero and capital accumulation stops). Smith observes that in the stationary state, rent is very high.

Smith's emphasis on capital accumulation in the process of development is the fundamental element, which has been followed by many later writers. His concept of stationary state dominated the thinking of the entire classical school. Similarly, his observation that during the process of development, real prices of agricultural commodities rise had profoundly influenced the classical economists for a long period of time. Smith was not in favour of governmental interference during the process of economic growth. He regarded economic development as a gradual and self-perpetuating process.

Smith was of the opinion that productive workers constitute the source of saving potential which is a crucial precondition for economic development. The unproductive workers can be productively absorbed in the economy if capital stock is sufficient. In the Smithian theory of growth, capital accumulation is the prime mover. In actuality, the gap between total production and total consumption is accumulation. The level of profit determines the rate of accumulation which itself is a source from which savings can be made and it provides inducement to invest. The demand for labour will rise in tandem with a high rate of capital accumulation, which will not only raise the wage level but will also increase the effective demand. His idea that 'save more and work harder' is the guiding principle for economic development of less developed countries of today. According to V.K.R.V. Rao, the classical theory of development is more relevant to the less developed countries than the Keynesian theory.

Relevance of Wealth of Nations (Growth Theory) to LDCs

Wealth of Nations is an essay on economic growth. It analyses the dynamic forces that determine sustained economic growth. In Adam Smith's analysis, however, allocative problem occupies a subordinate position. But he demonstrated that in a free market economy, the equilibrium process will lead to an optimum allocation of resources. Free competition, according to Smith, can give rise to a number of advantages. Smith was mainly concerned with the long-run determinants of the rate of growth of social output.

Rostow asserts that *The Wealth of Nations* provides a dynamic analysis and a framework for strategy for the developing nations. Why does production grow over time? Smith says that production grows only due to capital accumulation which is the mainspring of all economic progress. Capital accumulation is crucially important for the less developed countries (LDCs). The basic problem of such countries is existence of the vicious circle of poverty. This vicious circle can be replaced by a virtuous process of growth by increasing the tempo of capital accumulation. In a less developed country, as Nurkse observes, balanced growth cannot be achieved owing to the limited market. Smith similarly examined the demand side of the problem by stating that unless the extent of market is broadened,

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division of labour cannot be practiced profitably. He also emphasised that capital formation presupposes willingness and capacity to save. In LDCs, marginal propensity to save is the crucial determinant of growth. The Smithian prescription of working harder and saving more still holds its sway in the backward countries. Smith says that the prospect of development will stimulate an adequate volume of saving.

Smith clearly recognises the fact that the rate of growth of income is an increasing function of saving-income ratio. This seems to be true even today. Smith emphasised the importance of wage goods as the basic necessities in the development of an economy. This problem is also relevant in LDCs. To increase the capital stock in such countries, Smith suggested several methods to tax the income of the rentier class, so that a larger amount of surplus may be collected by the government for capital formation. This suggestion is very beneficial to a country like India which has a very skewed income distribution pattern. In terms of the Smithian model, one can assign priority to production of capital goods only if consumption of luxury goods of some other class is reduced.

Smith shows that agricultural and industrial revolutions go hand in hand. When agriculture is stagnant, industrial development cannot be expected to take place. He was of the opinion that agriculture should be developed first and then industrial development can be taken up. This idea is broadly valid in the theory of planning. Expansion of the industrial sector, in many countries, is limited by the rate of growth of the agricultural sector. Unless agriculture is developed, sufficient surplus cannot be generated for industrial development. Smith stresses the importance of sectoral balance when he discussed the rural-urban exchanges. He is of the opinion that the gain of one sector does not imply the loss of the other, but still he finds the possibilities of the terms of trade being turned against the rural sector. According to Smith, the corporate spirit and the bargaining power in the countryside are rather weak.

Smith advocates government interference in those areas where the prospect of profit is very low. These areas are the public utilities. Smith's idea here corresponds to our idea of socialist state. Smith maintained that if investment is redirected from foreign trade to domestic manufacturing and agriculture, total volume of productive employment may increase.

However, Smith does not assign any dynamic role to the government. In our times, in most of the LDCs, the government has been playing a very crucial role in the drama of development. Smith is concerned not only with the rate of economic development, but also with social policy and attitude. He strongly supported public policy programme for capital formation and employment. Be that as it may, his *Wealth of Nations* contains many lessons for the developing countries, which are on the path of economic development in our times.

Evaluation

Adam Smith was able to create a methodical and thorough book by fusing together both his own contributions and those of his forebears. His *Wealth of*

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Nations is the first full-scale treatise on economics. The Wealth of Nations was the groundwork for modern economics. The future advancement of economic philosophy might not have been feasible without this work. The structure of economic science was firmly set up by him. By reasoning and examples, Adam Smith persuaded his own generation and intellectually governed the next. It must be admitted that his book did not contain any single idea which was original, but it binds together a large number of facts giving new and realistic interpretation. Garner says that Smith has brought a complete revolution in the science of economics. His work was a kind of synthesis. Karl Marx thought that modern economics effectively began with Smith. Smith provided the first paradigm or disciplinary matrix to the science of economics. The Wealth of Nations gave a new conceptual system, an ideological slant and a new methodology to economics. The work provided the ruling paradigm for many years to many economists.

Check Your Progress

1. _____ is regarded as the father of economic science.
2. According to Adam Smith, division of labour is practically the only factor in _____.

2.3 DAVID RICARDO (1772-1823)

Ricardo-value, theory of rent, distribution, ideas on economic development and International trade.

The Ricardian economics, as Schumpeter observes, is difficult to understand, more difficult to interpret and most difficult to make an appraisal. Ricardo was a bird with a different plume. He was a formidable logician and a terribly abstract writer. His Principles of Political Economy and Taxation (1817) is written in such an abstract style that on first reading, one cannot feel that the book contains anything understandable. It is his best known work. Ricardo developed a system of analysis based on abstraction. Ricardo was interested in analysing the problems of political economy rather than in its wealth and progress. He was preoccupied with the then current problems of England and their solutions. He is one of the greatest representatives of the classical economics and is perhaps one of the most controversial economists of all ages. After Adam Smith, Ricardo is the greatest and most talked-about economist of the classical period. He views political economy as an investigation into the rules governing how the output is distributed among the social groups accountable for its production. Ricardo would be remembered for the introduction of a theoretical framework that gave economic thinking a new direction which was unprecedented in the history of economic thought prior to his time.

2.3.1 Note on Methodology

Ricardo had a strong analytical mind and logically sound power of thinking. Ricardo built up, so to say, an engine of analysis. Blaug has said that Ricardo's appeal was based on his capacity to grasp a variety of important issues using a

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straightforward analytical model with only a few strategic variables intended to provide spectacular findings that were decidedly practical in nature. The appeal of Ricardo was both theoretical and realistic. He not only offered ideas to analyse issues, but also workable, real-world remedies. He is still honoured as a great theoretician. He was educated in the country house rather than in the sophisticated environment of a town. The outcome was that his *Principles* turned out to be a very difficult-reading book, both in style and structure.

Ricardo was interested in finding out the laws which govern the distributive shares. His fundamental law of distribution was that wage and profit are inversely related. The methodology used by him is deductive in nature. This is evident in his theory of distribution. Ricardo would build up a theoretical model on the basis of some assumptions, which are not very realistic, and would get some useful theoretical conclusions on the basis of deductions. It must be noted, as pointed by Friedman, that the predictive power of a theory is not disturbed even if the assumptions are wrong. This is perhaps applicable in the case of Ricardian analysis.

Ricardo was a very practical man. His analysis was logically perfect, but not often empirically true. He could perfectly combine theory and practice wherever necessary. His methodology was however, was abstract in nature. He had an analytical mind. The analytical method was used by Ricardo in finding out the functional relationship between the involved variables. Side by side also used the empirical method. This is clear from his theory of value, which Stigler claims is 93% based on the labour theory of value.

Ricardo was concerned with both macro and micro analyses. His relative value analysis is an example of micro analysis. He was also concerned with the macro dynamic behaviour of the crucial variables like wage, rent and profit. His theory of taxation is an example of micro analysis. He has used macro analysis in his theory of distribution.

Ricardo had a peculiar habit of drawing generalisations without going into the empirical truth of the problem and using those generalisations for further studies. This peculiar habit is called the Ricardian vice. These vices are present in his writings of Ricardo. One such vice is the dictum that profit depends on the price of wheat.

Ricardo had a very flexible mind, which would very often change his conclusions whenever he came across new facts. This is evident in his theories of value, machinery and so on. However, this is not an altogether unusual habit for a scientific mind. A theory in science is discarded or modified whenever new facts emerge. He however, failed to take into account the institutional assumptions. He studied the class conflict in the economic system which was liked by Marx.

Ricardo studied economic system as a progressive transformation of a stationary state. The stationary state is a tool of analysis—a conceptual construct. It is not a reality. Be that as it may, The Ricardian analysis is not meant for ordinary readers because of the analytical rigour and inexorable logic that characterised his writings. Given the assumptions, Ricardo would set up a simple one-way relation to

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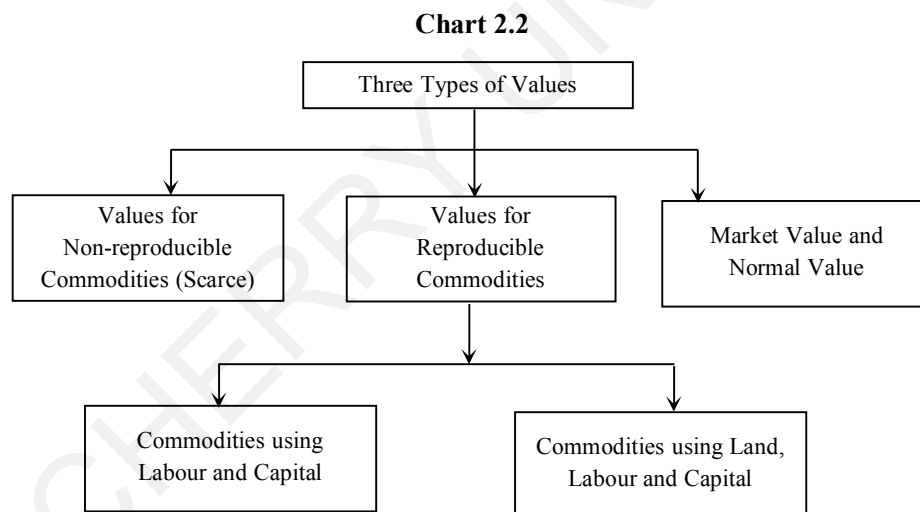
that in the end, the result would come up as a tautology, and tautologies give rise to Ricardian vices. When all is said and done, it must be admitted that Ricardo was an economist with unparalleled analytical insight.

2.3.2 Ricardo's Value Analysis

Throughout his life, till his last days, Ricardo retained doubts about the adequacy of his theory of value. Ricardo's theory of value contains many Smithian legacies:

(1) labour theory of value; (2) natural and market prices; (3) use value and exchange value: and so on.

Ricardo was never satisfied with his value analysis. He has used three types of values: (i) Value relevant for scarce commodities; (ii) Value relevant for reproducible commodities; and (iii) Market value and normal value. This can be conveniently shown in the following chart:



Ricardo starts his analysis of value with reference to value in use and value-in-exchange. According to Ricardo, utility is a precondition of value, but not its explanation. According to him, utility cannot serve as a measure of value but is necessary for a commodity to have trade value. Both scarcity and the amount of labour needed to manufacture commodities with usefulness determine their exchange value. There are some goods that cannot be duplicated; they are rare goods, such as Van Gogh's paintings in which case supply is fixed and value is determined by intensity of demand. These are scarce commodities.

In the case of ordinary reproducible goods, value depends on the amount of labour necessary to produce them. If labour and money are used to generate a commodity, Ricardo would say that since capital can be converted in to labour (capital is dead labour or stored-up labour), value would eventually be determined by how much labour went into producing the good. The value of the commodity will be determined by the cost of labour that was embodied in it along with the cost of labour that was converted to capital if the item was produced through a combination of land, labour, and capital. It should be highlighted that rent is

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excluded from price in the Ricardian concept of value. Therefore, the cost of labour and the cost of capital would determine value. But ultimately, it is the cost of labour which matters most. Ricardo demonstrates that labour generates value in both capitalist and agrarian modes of production. The entire cost of production is converted into labour costs by Ricardo. The labour-embodied theory of value was the one that Ricardo chose to measure relative worth with since it was the closest to the actual truth.

Ricardo was considering the relative value analysis. In cases where different factors of production are used, he measured the cost of production of the factors production. But he got to the conclusion that, even in the event of a multi-sector model, labour is still the best single measure of value. A true cost theory of value was held by Ricardo. But he discovered that labour costs are a reliable indicator of value. He has ignored the influence of demand in the case of the long run values of commodities. Long-term, production factors will return to their normal values, and supply will react to demand in such a way that value and production costs are equivalent. The forces of supply and demand in the market, on the other hand, determine market value. Market price, needless to say, may be more than or less than the normal long-run price. In the long run, the commodities have a tendency to have their normal values. The natural price of a commodity (cost of production) is determined by wages and profit. Whereas Smith included rent as a cost element, Ricardo did not consider rent as a part of value.

According to Ricardo, labour is nothing but the disutility. Now, the question is: what changes the relative price? Wage-profit changes will not affect the relative values, but they may affect the normal price or the absolute price. Even if the relative price is changed as a result of wage-profit change, the effect would be insignificant. When wages rise, some prices will fall relatively, and others will rise. In the Ricardian scheme, rise in wage (W) lowers profit (P) and a decline in "P" reduces the value of capital-intensive commodities relative to goods that require more labour. Thus, capital-intensive goods will receive stimulus. Thus, the average period of production is lengthened. This is Hayek's Ricardo Effect. All this shows that relative value can be influenced by the changes in the distribution pattern of national income (i.e., in wages and profit).

Ricardo's thinking was adaptable. His labour theory of value had always been something he wished to change. He revised his opinion of the labour theory of value in the third edition of *Principles of Political Economy and Taxation*. The following were the changes made to his *Principles* in the Third Edition:

1. As a production factor, he introduced capital.
2. He took into account the varying proportion of labour and capital.
3. He took into account the cost of production.
4. He introduced labour having varying qualities.
5. He wanted to have an invariable measure of value.

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Ricardo had all along a weakness in favour of labour theory of value. He was of the opinion that the labour theory of value can be valid in spite of the existence of different factors of production, if the following conditions are satisfied:

- (1) In every type of manufacturing, the fixed capital to labour ratio stays the same.
- (2) All fixed capitals are equally durable.

It should be noted that if the fixed capital-labour ratio differs, value will also change. The higher the capital-labour (C/L) ratio, the higher would be the value, and the lower the C/L ratio, the lower would be the value. Similarly, value may also be different if the fixed capital differs in turnover rates. Thus, it can be clearly seen that Ricardo appreciated the importance of time element in the theory of value much before Marshal Ricardo had to face a number of difficulties connected with the labour theory of value. However, he was able to eliminate the difficulties one by one, and demonstrated the fact that ultimately, it is the labour which is a very dominant single factor responsible for value. The problems encountered and the solutions suggested by Ricardo are shown in the following chart:

Chart 2.3: Problems with Value Theory

Sources of Problems	Problems	Ricardo's Solutions
Labour	(i) Quality difference of labour.	Adjusted by the market forces in course of time.
	(ii) Efficiency differentials of labour.	Necessary or customary average labour to be used.
	(iii) Differences in kinds of labour.	Can be reduced to standard form.
Capital	(i) Durability differences (time is taken as a factor).	Time element enters into value.
	(ii) Differences in the ratio of fixed capital and circulating capital (time is taken into account).	Time element enters into value.

After considering the difficulties with respect to capital as a factor in the theory of value, Ricardo wrote to McCulloch that after the best consideration, he thought that there are two main causes which may lead to a change in the relative values of commodities: (i) the relative quantity of labour required to produce the commodities and (ii) the relative time taken to produce the commodities. The question regarding fixed capital comes under the second category. The difficulties with respect to labour qualities, efficiencies and kinds have been solved by Ricardo more or less satisfactorily, as shown in the above chart. However, in spite of taking into account the importance of time element, Ricardo stoutly defended the proposition that it is the quantity of labour which is still the best single measure of value. He clung to the labour-quantity explanation and minimised the importance of his own modifications.

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The labour cost and profit determine value in a multi-sector model (capital cost). The difficulty introduced by the element of profit did not pose any real difficulty for Ricardo. He said that profit can be eliminated from the cost of production because it has only a very marginal effect (six to seven per cent) on value. The rate of profit also tends to be the same across industries under perfect competition. Therefore, profit does not pose any real problem. Similarly, labour quality differences can also be eliminated by saying that they do not disturb the value of the same commodity at different time periods. As has been shown earlier, Ricardo pointed out that labour quality variation is already adjusted by the market forces in a free market economy. Ricardo gently came to the peaceful conclusion that in the case of relative value, the real difference is empirically made by the labor-content of the commodity after removing all these upsetting variables from the path of the labour theory of value. In this way, owing to overwhelming importance of labour in the matter of value of a commodity, which is found to be empirically valid, Ricardo came to evolve an empirical labour theory of value. In fact, labour cost according to Stigler (*American Economic Review*, 1958), in the Ricardian labour theory of value, labour accounts for almost 93% of the total cost, with the profit component covering the remaining almost 7%. Stigler appropriately refers to the Ricardian theory of value as the 93% labour theory of value in this way. It must be admitted that Phillips in his Phillips curve analysis has also found recently that a large part of the value of commodity is represented by the labour cost (wage). He has calculated it to be more than 80%. In view of this, Ricardian labour theory of value does not seem to be out of tune at a time when the use of fixed capital was not so high as it is now.

Empirical Labour Theory or Analytical Labour Theory?

From what has been said thus far, it is clear that Ricardo had an empirical labour theory of value. As Stigler noted, he lacked any analytical labour theory of value. His theory was not analytical because an analytical theory is invariably based on functional relationship among the involved variables. Ricardo could not show any such analytical relationship of labour alone on any functional basis. Analytically, labour is the only one factor of value; there are many other factors which have equal claim on value. From analytical standpoint, Ricardo based his estimate of value on actual labour and capital costs. But from an empirical standpoint, Ricardo demonstrated that the primary drivers of relative values are the relative quantities of labour used in the production process. He preferred to build his deterministic system's principles on a solitary, dominant variable. (i.e., labour) instead of a number of less important variables. "I shall consider all the great variations in the relative worth of commodities to be created by the greater or less quantity of labour which may be necessary from time to time to produce them," writes Ricardo.

Ricardo, in the last edition of his *Principles*, emphasised that labour embodied is the most practicable measure of value. However, he wrote to McCulloch: "I am not happy with the explanation which I have given of the principles which regulate value," he wrote to McCulloch. I wish a more capable pen would take on the task."

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Invariable Measure or Value

Ricardo was in search of an invariable measure of value. Needless to say, for properly measuring value, the yardstick of measurement must remain constant (invariable). The quantity of labour can serve as such a constant measure of value, according to Ricardo. It must be noted that the values of commodities would be different under the following two main situations: (i) when the capital-labour ratios are different in different industries; (ii) which the wage-profit ratio changes in the economy. Ricardo tried to find out an invariable measure of value which can be applied under all circumstances. Ricardo found his invariable measure from within the causal system of his value analysis. He noted that to be an ideal invariable measure of value, the following conditions must be satisfied:

1. The commodity which is to be used as an invariable measure must have the average capital-labour ratio in its production everywhere.
2. The same amount of labour produces such a commodity.
3. The average period of production of such a commodity remains the same everywhere.

Needless to say, there is no commodity in the world which can satisfy the above three conditions. Gold was chosen by Ricardo as the standard commodity for the invariable measure of value. However, he was not completely satisfied with this commodity because it had many problems which will prevent it from becoming an ideal standard measure. Therefore, he had to make the following assumptions:

1. A year's time is regarded as the average time of production for gold as well as for corn. Thus, in a sense, these two commodities are found to be identical.
2. It is assumed that all capital is circulating capital and the turnover period of all capital is once a year. The circulating capital is nothing but the wage cost (bill).
3. Wage is spent on the wage goods.
4. There is only one type of wage good, i.e., corn.

In this way, Ricardo could generalise his corn model which could be made applicable to the entire economy. So, the national product can either be measured by corn or by gold. No difference will be made because both these commodities are embodying labour.

Ricardo did not consider Smith's concept of toil and trouble (disutility) as the invariable measure. Ricardo realised that it is impossible to find out a perfect invariable measure of value. But he then wanted to find out the second best commodity which can be used as an invariable measure of value. This commodity was gold. Ricardo in his *Essay on Profits* used corn as the invariable measure. It was more or less satisfactory in a hypothetical one-sector, one-commodity model. This one commodity was corn. So, there was no difficulty. But he soon realised that in a multi-sector model, corn was not a sufficient and perfect invariable measure of value. The corn measure was, therefore, discarded by Ricardo. Ricardo, then

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devised labour-content measure for converting and measuring all commodities in terms of the common labour-content units. With this measure, Ricardo could proceed in measuring the behaviour of the relative factor shares in a multi-sector framework. Needless to say, Ricardo could never find out an invariable measure of value, but he always tried to have one. It is indeed impossible to have a standard invariable measure of value free from all defects. Even in our times, economists are constantly hunting to catch this Heffalump of invariable measure of value in the form of a standard commodity. Sraffa's attempt in this directions, as Moore has shown (Scottish Journal of Political Economy, 1966), has not been quite a success.

Criticisms

1. Ricardo's handling of quality differences of labour is unsatisfactory. He said that wage adjustment in the market will even out the quality differences among labour through the market system. But his initial goal was to determine the item's market value. This seems to be circular reasoning in action.
2. Role of demand is not properly taken into account, excepting in the case of scarce goods.
3. Ricardo has not taken into account depreciation on capital and rate of interest in the matter of commodity values.
4. He has not told as to how capital can be converted into labour.
5. How to convert different types of labour into standard units? Ricardo has not cleared it.
6. According to Ricardo, rent does not enter into price. It is not a cost factor. This is, however, true if land does not have any alternative use. However, as is well-known, land has many alternative uses.

2.3.3 Ricardo Effect

Ricardo effect says that if wages rise, The relative prices of items whose production includes fixed capital or capital with high durability will generally decline, while the relative prices of goods whose production relies mostly on labour and less fixed capital or fixed capital with lower durability would generally increase. This proposition is known as Ricardo Effect. Simply speaking, if wage level goes up, compared to capital-intensive items, the cost of things that require more labour is higher. This is Ricardo Effect.

In the Ricardian system, it is possible to convert circulating capital into fixed capital. This is evident in his chapter on Machinery. But Ricardo brushed aside the manifold relations of substitutions that exist within the universe of production technology. Ricardo was too much given to accepting the sequences on technological data and to neglecting the effect that durabilities have no economic variables.

The Ricardo Effect was used by Hayek in his explanation of business cycle. Hayek says that depression starts by a fall in the inducement to invest. A fall in the inducement to invest is explained by a fall in the rate of profit in the consumer

NOTES

goods industries. It is compatible with the Ricardian proposition that a rise in the real wage will encourage the capitalist to substitute machinery for labour. Conversely, when the real wage goes down, more labour is used instead of machinery. In other words, when the wage level rises, more capital-intensive method of production is used, and when the wage level goes down more labour-intensive method of production is used. Compared to labor-intensive methods of production, capital-intensive methods are more indirect. Thus, the Ricardo Effect ultimately affects the technique of production in a capitalist economy.

According to Hayek, in the later stages of expansion, the real wage rate goes down. This brings about a shift to the less capital-intensive method of production and reduces the demand for loanable funds, and initiates a depression. Similarly, at the last stage of depression, the real wage rate begins to rise. This eventually leads to a substitution of capital-intensive method of production; demand for loanable fund increases and it brings about a general revival. Thus, Hayek's theory of trade cycle is based on what is called Ricardo Effect. This shows that any change in wage-profit rate necessarily changes the structure of prices and, therefore of value.

Comparison between Smithian and Ricardian Value Theories

Smith	Ricardo
1. Labour is emphasised as the main source of value.	1. Labour is emphasised as the main source of value.
2. Labour can be converted into capital.	2. Labour can be converted into capital.
3. Labour is the invariable measure of value (disutility is the standard measure of labour).	3. Money made of gold is an invariable measure of labour). Measure (corn measure in Ricardo's Essays on Profit). Ricardo ultimately adopted labour-content as the invariable measure.
4. Labour commanded is the invariable measure in advanced economies.	4. Labour embodied is the invariable measure in the advanced economies.
5. Relative value is emphasised.	5. Relative value is not emphasised.
6. Rent enters into price.	6. Rent does not enter into price.

2.3.4 Theory of Distribution

Ricardo was interested in finding out the principle by which the income of different factors of production can be determined. Ricardo had a macro theory of distribution. He claims that the main issue in political economy is distribution. His concern with the problem of income distribution arose from his interest in the question of relative share. Ricardo was of the view that as the economy develops, the relative shares of wages, profits and rent will vary.

According to Kaldor, the two pillars of the Ricardian theory of distribution are the marginal and surplus principles. The surplus principle is used to explain how the surplus is divided between wages and profits, whereas the marginal principle examines the proportion of rent. In Ricardo's analysis, output of the economy is

NOTES

distributed among three major shares: rent, wages and profits. The payment for using a piece of land's services is called rent. It arises due to the law of diminishing returns. The difference between the labour product on marginal land and the given average land is rent. Wage is a return to labour. Wage is equal to subsistence. Profit is the residual. It is the income which is left after the payment of wages and rent. Ricardo says that the agricultural sector, in a sense, is more fundamental than the industrial sector. The pattern of distribution in the economy must arise from the agricultural sector, first. The industrial sector's profit rate is based on the agriculture sector's profit rate. The Ricardian system relies on wage rates to determine how much labour is employed. The money rate of profit in business is influenced by the agriculture sector's corn rate of profit.

Rent is the difference between the average product and the marginal product of labour for any given volume of employment. This is shown with the following diagram:

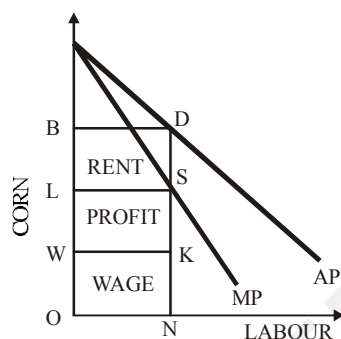


Fig. 2.5

In the diagram, rent is the difference between AP and MP, that is, the area BDLS. Rent depends on the elasticity of these curves and on the extent of diminishing returns. Marginal productivity of labour is equal to wages and profit. Thus, there is exploitation. The wage level is at the level of subsistence, and is shown by the area ONKW. The wage is determined by the supply price of labour which is constant in terms of corn. At the prevailing wage rate OW, there is an infinitely elastic supply curve of labour. And profit is WKSL area which is a residual. Thus, Ricardo has been successful in finding out the shares of labour, land and capital. Ricardo took the following assumptions: (i) Law of diminishing returns; (ii) Malthusian theory of population; (iii) Perfect competition; and (iv) Full employment.

It is pointed out by Ricardo that there is a continuous tendency towards a fall in the rate of profit in the system. Ricardo says that wages and profit are inversely related. This is, in fact, his fundamental theory of distribution. However, it is not necessary that wage has to fall in order to have an increase in profit. Empirically, both may increase at the same time. With economic progress, the money rate of wage goes up, because the subsistence level goes up and, after some time, the profit level will fall, and at the level of stationary state, the profit will be zero, and the rent will be rising.

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According to Ricardo, technical progress cannot be so rapid as to suspend the operation of diminishing returns. He had assumed the Malthusian law of population which has been falsified in the western countries. In the advanced countries, the share of wage was constant for a very long period of time. Similar is the case with the share of profit. Ricardo did not take into account the rate of interest and the different capital compositions of different industries. His notion of value serves as the foundation for his distribution theory. There is a mix of confusion and success in the Ricardian theory of wages and profit. He was not able to show that the fall in profit could not be due to an increase in wage. However, Ricardo's declining rate of profit theory is analytical. Diminishing return was never applied by Ricardo beyond the agricultural sector. His distribution theory, that if wage increases, profit falls, depends on his measure of value. When labour becomes more expensive, capital becomes less valuable. But this is not equivalent to saying that an increase in wage will lead to a decrease in profit.

Thus, it is clear that although logically the Ricardian mode of distribution was internally consistent, still the assumptions and the foundation of his analysis were not satisfactory. Ricardo, more often than not, was consistently wrong regarding his theory of distribution.

Criticisms

1. Ricardo concedes the existence of the law of diminishing returns. But the operation of this law can be halted by technical progress, which Ricardo did not consider.
2. The Malthusian theory of population is also not found to be empirically correct.
3. Ricardo says that rent does not enter into price. This is true only when land has no alternative use. However, Ricardo should have included rent as a cost of production, as Smith did.
4. It is not empirically valid to say that wage and profit go in the opposite direction. Both these can go in the same direction.
5. His theory is a macro theory of distribution. It does not tell us any thing as to how individual wage, profit and rent are determined.

Barkai's Criticisms

H. Barkai, in an article published in *Economica*, August 1959, has pointed out that Ricardian theory of distribution is indeterminate. In his theory of distribution, Ricardo has assumed linear productivity function and generalised it for the economy as a whole. The share of rent will rise if the value of elasticity of the average product curve goes on falling as more and more of variable inputs are applied, i.e., if the gap between the AP and MP curves increases. However, the elasticity of the average product curve does not necessarily fall along a production function showing diminishing returns. "Diminishing returns is a necessary but not a sufficient condition of an increase in the rental share." The Ricardian proposition is true if the proportionate rate of change of MP is always greater than that of AP, that is, if the value of elasticity of AP curve falls. However, it can be shown that over a

certain range of output, the elasticity of AP curve rises. This is shown in the following diagram:

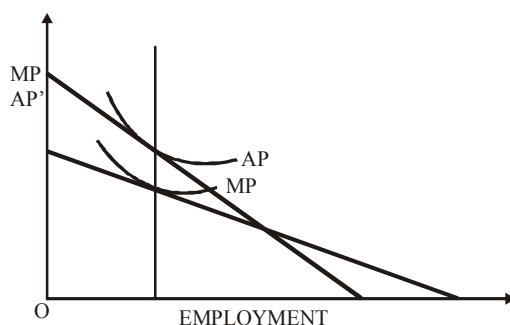


Fig. 2.6

In the diagram, the value of elasticity of the AP curve is rising because the proportionate rate of change of MP is less than that of AP. In such a case, the Ricardian prediction that the share of rent rises in the long run is reversed. The fact is that the productivity function is not necessarily linear. Unless one is going to accept a particular quadratic production function, it must be noted that the rental share is indeterminate. If it is so, then the shares of wages plus profits in the income also become indeterminate. This implies that diminishing return is insufficient as the basis on which Ricardo drew his general theory of distribution.

2.3.5 Ricardian Theory of Rent

According to Ricardo, rent is a surplus of product on superior quality land. Rent is a remuneration derived from the soil's inherent and indestructible properties. When inferior lands are taken into agriculture, a differential excess known as rent occurs. Rent arises as a result of the scarcity of good quality land. As a result, rent is owed to her niggardliness rather than the richness of nature. Rent, according to Ricardo, is not factored into the price. Any agricultural product's market price is equal to its marginal-land production cost (price is equal to marginal cost). Actually, rent is a surplus over costs. The price determines the rent, not the other way around. Rent is high when prices are high. The rent is also low when the pricing is low. Rent is a form of unearned income. It doesn't indicate that the landowner put any work or effort into it. When the market price exceeds the average cost of production, rent is generated. A land plot's rent often equates to the difference between the yield of the plot and the yield of a marginal plot. This is shown in the following diagram:

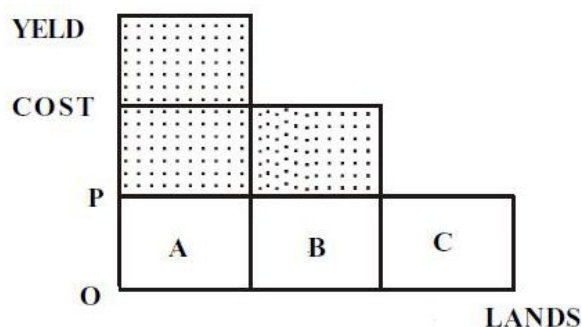


Fig. 2.7

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As the diagram shows, the cost of production of 'C' grade land (marginal land) is equal to the yield on that land. OP being the cost of production, the 'C' grade land does not yield any surplus. The cost of production of this land is exactly equal to the value of its output. Therefore, it is a no-rent land. However, 'B' grade land and 'A' grade land generate some surplus over the cost of production, which can be called rent (as shown by the dotted portions). The 'A' grade land is the most fertile land. Therefore, it has the highest surplus or rent. The second best land is 'B' grade land which generates surplus little less than the surplus of 'A' grade land.

Ricardo's theory of rent was developed as a protest against the landed aristocracy in England when the Corn Laws created a great sensation. Through his rent theory, Ricardo wanted to point out the manner as to how a tenant is exploited by the landlords. It also indicates the impact of technical change, population change and economic progress on landlord-tenant relationship. Ricardo wanted to disprove the physiocratic misconception that bounty of Nature was the cause of rent. He believed that technical improvement in the short run will lower the rent. Therefore, the landlords are not interested in applying technical improvement on land.

Ricardo recognised the conflict of interests of landlords and other classes. It is shown that, by the improvement of land, the landlords are benefited and not the labourers. Rent theory is the reverse of Ricardian theory of value. Rent does not influence value. It is not a cause of value but is its effect.

Ricardo was of the opinion that in the long run, the rent share goes up and the money rate of wage also increases and the share of profit declines. Ricardo has not only shown the possibility of increase of accumulation of unearned income in the hands of the landlords but he has also shown concern over the unproductive nature of the landlord class. Ricardo was much upset by the increasing price and rent during his time in England. However, Ricardo was not correct when he said that the share of rent increases in the long run. History has shown sufficiently clearly that as the society progresses, the share of rent goes down. Anyway, Ricardian framework of the theory of rent shows pessimism in the matter of distribution of income.

Rent develops when population increase necessitates the cultivation of less fertile lands. The cost of maize rises as a result of the harder-to-farm less fertile regions. In the UK, the most significant occurrence at the end of the eighteenth century was high rent as a result of high prices.

The Ricardian theory of rent is related to the law of decreasing returns, which is crucial to comprehending the Ricardian framework. It should be noted that Ricardo did not consider the absolute rent, but he was interested in the differential rent. If the theory of value was to remain cohesive, absolute rent had to be excluded. Ricardo explained the possibility of rent under certain conditions and also explained its absence under certain other conditions.

Criticisms

Classical Period

The following points of criticism may be levelled against the Ricardian theory of rent:

- (i) Ricardo has not defined fertility of land.
- (ii) Contrary to popular belief, people do not cultivate the best quality land first, followed by the second-best land, and so on.
- (iii) The power of soil may not be indestructible as Ricardo thought.
- (iv) Ricardo's non-rent land is not to be found in actual practice.
- (v) Rent does not affect price, which is untrue. Rent as a cost of production does enter into price.
- (vi) According to contemporary theory, rent results from the inelasticity of supply, or from the lack of superior production variables.

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2.3.6 Ricardo on Machinery and Employment

Ricardo's views on machinery followed the traditional analysis of Smith, supplemented by Say's Law of Market, to demonstrate that technological unemployment is impossible. Ricardo highlighted how equipment lowers prices in the first and second editions of his *Principles of Political Economy and Taxation*. He observed that machinery benefits all classes of people, including producers and consumers. Machinery increases per capita output by promoting more and more division of labour. It also moderates the effects of diminishing returns on land. Machinery can lead to a number of advantages such as increased profit, increased size of the wage fund and a higher wage level for the workers.

When Ricardo's *Principles* was published in the same year, John Barton wrote a pamphlet: "Conditions of the Labouring Classes of the Society." In this pamphlet, Barton showed that machinery may displace labour and may also increase unemployment of workers. In this way, Barton questioned the favourable effects of machinery. The logic of Barton was accepted by Ricardo, and he accordingly changed his ideas in the Third Edition of his *Principles*. Ricardo admitted that machinery may be injurious to the working class. Subsequently, the whole idea and attitude of Ricardo on machinery underwent a drastic reorientation. Ricardo pointed out that his error resulted from the assumption that whenever the society's net revenue (profit and rent) increased, its gross income would follow suit. He believed that machinery may lower output for a period of time, and thereby it can make more people unemployed. Additionally, the salary fund can be diminished if the introduction of machinery is accompanied by a direct conversion of circulating capital into fixed capital. Therefore, the means of employing labour is reduced. Ricardo is of the opinion that if machinery is purchased from the wage fund, it will lead to a reduced demand for labour and increase in unemployment. However, if machinery is purchased from out of capitalist saving, employment will not be affected and at the same time, productivity and economic growth would be stimulated.

Knut Wicksell has raised an interesting point in connection with the discussion on Ricardo's machinery question. Wicksell observes that Ricardo's

NOTES

thesis is not theoretically tenable. If machinery increases unemployment, then the wage rate will come down relative to capital expenditure. Therefore, labour-intensive method of production would be profitable. Thus, production would be divided into labour-intensive and capital-intensive methods, and the net profit in both methods would be great.

The use of machinery reduces current output below the previous level, while the rate of profit remains the same. As the quantity of wage goods utilised declines, the demand for manufactured articles falls accordingly, and some labour is permanently displaced.

Machinery and labour are in constant and permanent competition with each other. In this competition, the former cannot frequently be employed unless the labour cost rises. If real wages go down, firms try to substitute labour for machinery. Ricardo effect under British conditions, where food demand was very high, and cost much labour for its production, implied a constantly rising ratio of capital (machinery) to labour. With a growth in capital, the demand for labour may continue to rise, but it may not do so in a ratio that is equal to the increase in capital; rather, the ratio would always be declining.

The introduction of machinery may not always be so bad. If the introduction of machinery leads to technical improvement, capital accumulation and saving may be higher, and the demand for labour may be as high as before. In fact, technical improvement may lead to an improvement in the standard of living of the labourers.

As McCulloch observes, the short-run effects of machinery on output have nothing to do with the benefits of machinery. Ricardo also believed that under certain circumstance, the use of machinery may reduce the gross output. In such case, the price is likely to rise and the demand for labour is likely to go down.

Ricardo never integrated his revised views on machinery with the rest of his analytical framework. The distinction between sudden and gradual change in technology clouds the issue in Ricardian economics. The sudden change in technology may involve an absolute decline in employment, but a gradual change in technology may not involve any technological unemployment. An analysis of Ricardo Effect demonstrates that technical progress takes the form of rising capital requirements per unit of labour and of output leading to secular lag in employment behind growth. This process is also known as capital deepening. If we want to reabsorb labour, it is necessary to have capital-widening, i.e., increase in capital proportionate to output.

Ricardo's discussion in the chapter on machinery opens up the whole series of many unanswered questions about Ricardian economics. His chapter on machinery gives up the assumptions of fixed technical coefficient of production. Ricardo did broach the distinction between innovation due to technical knowledge and innovation due to increased factor price. Ricardo's seminal views on machinery, unfortunately, were not taken seriously by his followers. The chapter on machinery shows the flexible attitude and flinching mind of Ricardo.

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2.3.7 Ricardo on Taxation

According to Ricardo, taxes is the government's use of a share of the goods produced by a nation's workers and land. Taxation is really a burden. Taxes should be so levied as to fall on every person equally, so that it will interfere as little as possible with the natural equilibrium of the system. Taxes should avoid penalising capital. The additional taxes are to be paid out of increased consumption or by diminishing consumption. The revenue should be responsible for paying the tax (income). However, if unproductive consumption is not diminished or production does not increase, the burden of tax will fall on capital, which is not desirable.

A large portion of his book, *Principles of Political Economy and Taxation*, is concerned with the problems of taxation. Ricardo was more concerned with the analysis of the incidence and effects of taxation. He analysed taxation with reference to political economy. Ricardo was in favour of bringing equity in taxation. In such a case, the economy would be free from disturbances. Ricardo's views can be summed up in the following sentences: When wages are at subsistence, direct taxation either on wages or on the products of labour have to be shifted. These taxes can be shifted to profit. But there is a danger. When profits reduce, the motive for capital accumulation goes down. This will also reduce the size of the wage fund. Thus, taxation on profit may be injurious indirectly to the working class. Sometimes, taxation reduces the rate of capital accumulation and may also possibly reduce the means of the country to employ labour.

Taxation imposed on the transfer of property increases the revenue of the state. This will help the state to maintain unproductive workers at the cost of capital of the people. The capital is helpful for maintaining the productivity of the workers. Taxation on property transfer prevents the national capital from being used most profitably. Let us now discuss some individual taxes and their effects and incidence.

Tax on Wages: This tax will increase the wage level, and will decrease correspondingly the level of profit. This tax is not favoured by Ricardo because it may lead to many undesirable consequences.

Tax on Rent: A tax on rent is shifted by the landlord onto the consumers. Such a tax will discourage the cultivation of land, as a portion of this tax will be on the profits of the landlord.

Tax on Profit: Tax on profit will be shifted to the consumers. The prices of commodities will increase. The landlord will get more rent, but he will have to pay more for purchasing the manufactured articles. If the profit of the farmer is taxed, the price of his raw produce will go up. Ricardo observed that if there is proper regulation, the prices of the produce will come back to their original level.

Tax on Commodities: Tax on commodities will increase the prices of the commodities. The tax imposed on manufactured articles will produce the same effect on wages as tax on food. Such a tax will also affect the foreign trade of a country.

NOTES

Tax on Luxury: A tax on luxury articles will be shifted to the consumers. This tax will neither increase the wage level nor reduce the profit level. It will only raise the prices of luxury articles.

Tax on Houses: The owner of the home will be responsible for paying this tax. This is a type of rent which the tenant has to pay. In the case of this type of tax, the demand for houses will decline, and rent will decline. Thus, ultimately this tax may be paid by the owner of the house.

Tax on Gold: There may be a tax on the total amount of gold in circulation, or a tax on the annual production of gold. The effect of gold tax is to reduce the quantity of gold. Therefore, there would be a rise in the value of gold.

Tax on Raw Materials: Such a tax will increase the cost of production. Thus, prices of the produce will rise. The incidence of this tax will be shifted onto the consumers. This tax will increase the wages of the workers. If the price does not rise as a consequence of this tax, the cultivator on whom this tax is imposed will stop cultivation. Thus, production would be curtailed.

Land Tax: It is applicable to a type of land which yields rent or surplus. It does not apply to the marginal land. If this tax is imposed on all cultivated lands, Produce will be subject to a tax, which will raise the cost of produce.

The discussion of taxation takes up one-third of Principles of Political Economy and Taxation. Ricardo has paid close attention to the examination of the various taxation regimes. Ricardo is inclined to treat all taxes as special cases. He, therefore, does not develop a general principle of taxation. He has not given any theoretical formulation for discussing the effects and incidence of taxes. He discussed the temporary effect of taxes (impact) and not the ultimate effects. His discussion on taxation is devoid of any theoretical foundation.

2.3.8 Ricardo's Monetary Theory

Additionally, Ricardo has helped us comprehend monetary economics. He was worried about the economic issues of the day. His two works on currency provide insight into his thinking: (i) High Price of Bullion, Proposal for Economical and Secure and (ii) Currency. The writings of Ricardo served as an inspiration for Gustav Cassel's concept of buying power parity.

In his work, High Price of Bullion, Ricardo outlined the theory of exchange rates under two circumstances in unambiguous terms. The first criteria related to the gold bullion standard, and the second to the standard for non-convertible paper money. According to Ricardo, the Mint Par, or the amount of gold in domestic and foreign currency, can set the exchange rate in the case of a gold standard, subject to some upper and lower species points. The purchasing power of the two currencies can be used to calculate the exchange rate in the case of non-convertible paper money. "While the circulating medium thus consists of undebased coins or paper money promptly exchanged for undebased coins, the exchange can never be further above or below the par than the expenses incurred in the transportation of precious

metals,” he added. However, if it is made up of depreciated paper money, it will inevitably diminish in value according to how much something has depreciated.”

Ricardo was very knowledgeable about the money value theory. He contends that the velocity, confidence, volume of the money supply, and the bank’s lending policy all affect the value or purchasing power of money. Ricardo understood the connection between the money supply and price level even though he did not explain the pure quantity theory of money. At the time Ricardo wrote, England’s price level had recently increased significantly. When it came to identifying some appropriate solutions for limiting the changes in the price level, Ricardo was ahead of Wicksell. Like Wicksell, Ricardo anticipated the implications of the difference in money and natural rates of interest. He noticed that such a discrepancy causes the price level to fluctuate. Ricardo, however, was unable to articulate how the difference between the money rate of interest and the natural rate of interest could be the root of fluctuations in the economy. Ricardo could, however, provide some extremely useful recommendations.

The inflationary issue that England was currently facing was addressed in Ricardo’s *High Price of Bullion*. The Bullionist Controversy was a heated debate that took place during the Napoleonic Wars. Ricardo made a significant contribution to both the comprehension of this issue and its resolution. The UK experienced a significant rise in prices during the Napoleonic Wars. Additionally, the paper money could not be exchanged on demand for goods at a set price. The Bank of England’s gold reserve significantly decreased, and the value of Bank notes decreased. Ricardo blamed the Bank of England’s excessive note production for the hyperinflation. Ricardo suggested that the banks gradually reduce the quantity of their notes in circulation until they had made the remaining notes of equal worth with the coins they represent in order to address the problems with the currency. To put it another way, this should continue until silver and gold bullion prices reach their Mint Par point. In this way, Ricardo advanced knowledge of the causes of inflation and anti-inflationary strategies. He believed that the abrupt decline in the value of money was the only thing that could account for the export of gold from England.

Ricardo examined the elements that determined the value of money in his book, *Proposal of Economical and Secure Currency*. He noted that the value of money will rely on its cost of manufacturing under competitive conditions of money supply. He believed that by keeping the money supply under control, one can keep the value of money stable and prevent both inflation and deflation. He supported the use of paper money as a standard, but he advocated for its proper regulation and oversight. Ricardo suggested nationalising banks in this context. He supported a gold bullion standard in which there would be no gold coins, but the value of the currency would be convertible into gold bars at a set rate. Ricardo was adamant about the superiority of currency (paper currency). But he asserted that bank note circulation must be supported by 100% gold reserves. Ricardo advocated for government oversight of financial decisions. Ricardo was adamant that paper money be used because he believed such a system could bring about convenience,

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NOTES

stability, and automaticity. Ricardo's proposal to nationalise the bank was a blatant admission of the need for the central bank to have a clearly defined monetary policy.

2.3.9 Ricardo on Foreign Trade

The development of the concept of comparative advantage was Ricardo's primary contribution to the idea of global commerce. Interregional trade and global trade were distinguished by Ricardo. Like Adam Smith, Ricardo was initially interested in the application of the principle of absolute advantage in the case of international trade. However, later on, he realised that absolute advantage could not properly explain the special situation of international trade between two different countries. Adam Smith, in fact, could not understand the situation where a single country had absolute advantage of producing two commodities in a two-country, two-commodity and one factor (labour) model of trade. Smith did not go into such a complicated special case. Ricardo explored such a situation with minute interest, and the result was the theory of comparative cost.

Ricardo observed that the same theory which could explain internal trade in a country with reference to absolute cost of advantage, could not explain the situation of international trade. Thus, Ricardo explicitly acknowledged the need for a unique theory of global commerce. This separate theory of Ricardo was the theory of comparative cost advantage. According to some people, the theory of comparative advantage was first found out not by Ricardo but by Torrens from whom Ricardo might have borrowed the term. Be that as it may, it was Ricardo who clearly and elaborately outlined how the concept of comparative advantage applied to global trade. The principle of absolute cost advantage, according to Ricardo, can be used to the case of inter-regional trade, but for international trade, we had to apply the theory of comparative advantage. The theory of comparative advantage says that a country may need to enter into international trade even if it can produce commodities at the lowest cost. This situation was not realised by Adam Smith. Within a nation, trade between two regions requires an absolute cost difference, but a comparative cost difference is a need that must be met for there to be international trade. What is to be compared is not really costs but cost ratios of commodities.

Ricardo explained that international trade could be beneficial for both the countries entering into international trade. Foreign trade raised the living standard of the population of the involved countries. Ricardo had a two-commodity, two-country and one factor (labour) model of international trade. Ricardo observed that other things remaining the same, a country would specialise in the production of those commodities and would export those in which it had the maximum comparative cost advantage or minimum comparative disadvantage. Ricardo made the following assumptions for explaining his theory of comparative cost advantage:

1. Returns to scale are constant.
2. There is free trade.
3. Labour is homogeneous.

4. Internationally, labour is static yet fully movable domestically.
5. There is perfect competition.
6. Only labour costs are used to calculate the cost of production.
7. Labour is the only one productive factor.

NOTES

In order to properly understand the theory of comparative cost advantage, it is essential to consider the three types of cost differences: (i) Equal cost advantage; (ii) Absolute cost advantage; and (iii) Comparative cost advantage. They are explained in the following table:

Table 2.2: Labour Hours Required to Produce One Unit of Cotton and One Unit of Jute

Country	Equal cost difference (I)			Absolute cost difference (II)			Comparative cost difference (III)		
	Cotton (C)	Jute (J)	Domestic rate of exchange	Cotton (C)	Jute (J)	Domestic rate of exchange	Cotton (C)	Jute (J)	Domestic rate of exchange
India (I)	10	20	$I_c = 0.5J$	20	10	$I_c = 2J$	10	20	$I_c = 0.5J$
Bangladesh (B)	15	30	$I_c = 0.5J$	10	20	$I_c = 0.5J$	15	25	$I_c = 0.6J$

Country	Equal cost difference (I)	Absolute cost difference (II)	Comparative cost difference (III)
	Necessary Conditions:		
	$\left(\frac{C_I}{C_B} = \frac{J_I}{J_B} \right)$ $\left(\frac{10}{15} = \frac{20}{30} \right)$	$\left(\frac{C_I}{C_B} > 1 > \frac{J_I}{J_B} \right)$ $\left(\frac{20}{10} > 1 > \frac{10}{20} \right)$	$\left(\frac{C_I}{C_B} < \frac{J_I}{J_B} < 1 \right)$ $\left(\frac{10}{15} < \frac{20}{25} < 1 \right)$

C and J denote the number of labour hours required to produce one unit of cotton and one unit of jute and subscripts I and B indicate India and Bangladesh.)

Trade Positions: No trade	India will export jute to Bangladesh and Bangladesh will export cotton to India.	India will export cotton to Bangladesh and Bangladesh will export jute to India.
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In the above table, Case I shows equal cost difference between India and Bangladesh ($I_c = 0.5J$). Therefore, the comparative cost ratio is the same for both the countries. Therefore, there is no scope for international trade. The domestic cost ratios are equal.

Case II of the table shows absolute cost difference which will be favourable for both the countries to enter into international trade. In this situation, Bangladesh will have an unbeatable edge in the production of cotton, whereas India will have an unbeatable advantage in the production of jute. Therefore, India will export jute to Bangladesh and Bangladesh will export cotton to India. This is evident if we compare the domestic exchange ratios of the two countries.

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Case III of the table shows the comparative cost difference. India produces cotton and jute with an incredible advantage, as shall be seen. So, apparently, India will not enter into trade with Bangladesh. But Ricardo's comparative cost principle points out that even in this case of comparative advantage of both the commodities, there would be international trade between India and Bangladesh, because of the domestic exchange rate differences in both these countries. It would be more advantageous for India to export cotton to Bangladesh, and it would be more advantageous for Bangladesh to export jute to India. By exporting one unit of cotton to Bangladesh, India can get 0.6 unit of jute, but in the absence of trade, India would have exchanged one unit of cotton with 0.5 unit of jute inside the country. Similarly, by exporting jute (0.6 unit), Bangladesh will get more than one unit of cotton from India which is an advantage for Bangladesh because in Bangladesh, 0.6 unit of jute can fetch only one unit of cotton.

The necessary conditions of equal cost difference, absolute cost difference and comparative cost difference are also given in the table in the form of ratios.

The table shows that comparative cost differences are very crucial for the existence of international trade. It can explain satisfactorily the presence of international trade even in the case of absolute advantage of a single country in the production of both the commodities. Case III clearly shows that India has a comparative advantage in the production of cotton (the domestic exchange rate is $I_c = 0.5J$), and Bangladesh has a comparative advantage of producing nuts (the domestic exchange rate is $I_c = 0.6J$). This is a distinct case and cause of international trade which was revealed by the Ricardian theory of comparative cost advantage, and which was overlooked by Adam Smith. However, in the Ricardian theory of trade, many questions remained unanswered. These questions are:

- (1) How could the theory be extended to take into account several countries and several commodities?
- (2) How are the gains of international trade divided among the participating countries?
- (3) What should be the role of money in international trade?

Ricardo could not satisfactorily answer these questions, excepting the last one. Ricardo pointed out that money is not so important in international trade.

Ricardo observed that in the case of free trade, the interests of the country and of the individuals are never inconsistent. They are always compatible. The labour cost theory of value is taken into account by Ricardian theory of trade. He did not modify the analysis of international trade on the basis of qualifications that he introduced in the case of labour theory of value. In the case of international trade, Ricardo assumed that goods generated by unequal amounts of labour are traded between the nations. Capital is regarded as an immobile factor of production in the international market.

Ricardo was a perfect free trader. He is well-known for his theory of comparative cost. He demonstrated that balance of trade would be automatically

adjusted through the mechanism of rate of exchange. In this connection, his Mint Par theory is an important contribution. Ricardo's advocacy for free trade was supported by the following reasons:

- (1) Free trade can lead to maximum benefits from territorial division of labour.
- (2) The automatic adjustment mechanism operating through free trade can give guarantee for equilibrium in the balance of trade through changes in the rate of exchange between the two countries.
- (3) Free trade will check the high prices of corn, high rent and lower profit which were existing in England during the time of Ricardo. Ricardo was interested in the import of cheaper foodgrains from other countries to England. Ricardo was a more staunch supporter of free trade than Adam Smith. Ricardo's confidence in self-adjusting specie flow strengthened his faith in free trade.

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2.3.10 Ricardo on Economic Growth: Ideas on Stationary State

Ricardo was more focused on income distribution and international trade than he was on economic growth. The limitations to income growth will be swiftly reached, according to Ricardo, unless more land could be brought under cultivation or unless food could be imported from other countries at a low cost. Ricardo thought that capital accumulation led to growth. But capital accumulation was a function of profit which depends on wage. Wage level depends on the prices of foodgrains (wage goods). Food prices depend on the availability of either land or food imports. In a growing economy, as output (income) increases, rent rises for the relatively scarce factors and profits fall for the relatively abundant factors. At the point of stationary state (S point in the diagram), the profit rate becomes zero, rent becomes very high and money wages rise considerably. The stationary state is shown in the diagram below.

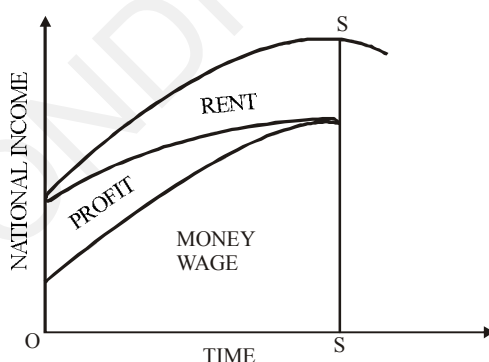


Fig. 2.8

Growth is possible only up to a point but cannot continue because of diminishing return to labour and capital. Land at the margin of cultivation cannot produce enough for feeding the labour at the level of subsistence, even after the profit rate had fallen to zero. All expansion stops. At the level of stationary state, since profit rate is zero, no new investment (new capital accumulation) can take

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place. According to Ricardo, the logical result of all economic progress is stagnation. The stationary state develops in the manner described below.

The ratio of fixed and circulating capital (wage fund) to the population determines the average wage rate. As long as there is a profit, the capital stock will continue to grow, and as labour becomes more in demand, the average salary will also rise, if only momentarily. But as the wage rate goes beyond the level of subsistence, family size of the labourers expands and population increases. This necessitates either the import of food or the cultivation of inferior land. This leads to an increase in rent and a fall in profit and ultimately, the stationary state is reached where the rate of profit becomes zero. (See, for a detailed discussion, the section on J.S. Mill in Chapter 5 *infra*).

Evaluation

Ricardo was a pioneering classical economist. He was more successful than Smith at separating the main economic system groups. He was out-and-out an analytical economist. His main purpose was to build up an engine of analysis. The analytical prowess of Ricardo was better than that of Adam Smith. Ricardo was more consistent and logical in his approach. He was the first economist to have used a theoretical, abstract method in the analysis of economic problems. He modified in some important ways some crucial elements of Smithian theories, e.g., value theory, distribution theory, theory of trade and so on. With Ricardo's immediate followers, the labour theory of value began to fall apart. Because of his focus on product distribution, Ricardo brought up the issue of class relations and drew attention to social, political, and historical aspects of economic study. Ricardo can perhaps be regarded as the first of the socialist economists. He provided the building block for socialist economics, and brought on the surface the question of class conflict in capitalism. Ricardo did not cover many aspects of economic analysis, but his treatment was more rigorous and more scientific.

However, Ricardo had the bad habit of applying very simple abstractions to the solution of practical problems. This habit is regarded by Schumpeter as Ricardian Vice. Ricardo dominated the economic thinking for many years in Britain. He was responsible for many social and economic reforms. Marx had a warm praise for Ricardo. In fact, in our times, Russia is rediscovering Ricardo through Marx. It is sometimes said that Marx is Ricardo minus diminishing returns. Ricardo was partly responsible for the invention of marginal analysis. As a matter of fact, Ricardo applied marginal principle in his theory of distribution, as Nicholas Kaldor has observed. Ricardo made positive contributions to the analysis of rent, taxation, monetary economics and foreign trade analysis. The relationship between changes in the relative shares of land, labour, and capital and the rate of capital accumulation established by Ricardo is still relevant in contemporary economic analysis. In this way, it appears that Ricardian economics is still relevant today. In the words of Lord Keynes: "Ricardo conquered England as completely as the Holy Inquisition conquered Spain. The completeness of the Ricardian victory is something of a curiosity and mystery."

Check Your Progress

3. Ricardo had a strong analytical mind and logically sounds _____.
4. _____ views on machinery followed the traditional analysis of Smith.
5. Ricardo developed a system of analysis based on _____.

NOTES**2.4 THOMAS ROBERT MALTHUS (1766-1835)****Malthusian Theory of Population**

Pre-Malthusian population theory lacked organisation. The first economist to propose a methodical theory of population was Thomas Malthus. In his renowned book *Essay on the Principle of Population as it Affects the Future Improvement of the Society*, Thomas Robert Malthus outlined his opinions on population. He had a conversation with his father about this book, and his father supported his buddy Godwin's utopian concept. Godwin thought that society will eventually emerge that would make it possible to put an end to disease, depression, and conflict. Godwin argued that if human restraints could be lifted, a perfect state could be attained. Malthus rebelled against the general optimism that his father and Godwin were promoting.

Malthus retained the Ricardian preoccupation of land-using bias of economic development. His thesis was, for the first time, an analytical work on population. Here lies the greatness of Malthus. He refuted the optimism of Godwin. He laid the foundation of subsistence theory of wage. His essay on population was published in 1798. However, in the second edition of his *Principle*, he made the following changes:

1. Malthus noted the census of 1801 in the second edition of his *Principle*. But he did not examine the situation in England which had been experiencing a population explosion.
2. He emphasised birth and marriage rates in the second edition, and even in later printings of his *Essay*, he grossly overstated the decline in the death rate that had occurred.
3. In the second edition, he also took into account the preventive measures for population control, and in later editions, he introduced moral restraint from marriage.
4. Malthus mentioned the law of decreasing returns in the second edition of his *Principle*.

Malthus argued that since population growth outpaced food production by a wide margin, considering human prosperity was pointless. The realisation of humanity's ideal of riches was delayed by the discrepancy between population increase and food supply growth. He asserted that as the population of the globe increases, the strain on food supply will destroy perfection and lead to human misery. Malthus received criticism for his pessimism. He gathered facts to support his assertion. In 1803 after revising some of his earlier statements, Malthus had the second edition of his book published. However, his original argument is still valid.

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Influences on Malthus

William Godwin's book which claims that the government is to fault for people's misery and suffering, impelled Malthus to write his Essay.

Malthus was distressed at the prevailing conditions in the UK, and this led him to propound his theory. In England, agriculture was thriving throughout the first part of the 18th century, but at the end of that century, there were unemployment, famine, misery and distress. There was excessive pressure of population on land. The price levels of essential commodities had more than doubled. Malthus as a thinker wanted to find out the cause of and the solution to this problem. Ireland then became overpopulated, and poverty grew along with the population's rapid expansion until famine converted the nation into a hell. Malthus was deeply influenced by the economic conditions of his time and his reaction found expression in his Essay.

The Industrial Revolution brought simultaneously both prosperity and poverty. The society was divided into two classes — the haves and have-nots. The workers were exploited by the capitalists' class. Many people were reduced to paupers which moved the sentiment of Malthus. Malthus became necessarily a pessimist.

In his book *Enquiry Concerning Political Justice and its Influence on Morals and Happiness*, written in 1793, Godwin made the observation that human beings were to blame for both their joys and their misfortunes. He was contemplating a golden age for mankind. Malthus was not prepared to accept the ideas of Godwin, because the ideas went against historical evidence and the personal observation of Malthus.

The ideas of Malthus were much influenced by the writings of Botero, Petty, Sir Walter Raleigh, Sir Mathew Haley, Green, Robert Wallace, Joseph Townsend, Rogers and Smith who showed that a rapidly growing population was the cause of famine and poverty.

Thus, the ideas of Malthus were the product of the circumstances of the time in which Malthus wrote.

Assumptions of Malthusian Theory

1. Humans' sexual inclinations never change. Consequently, the impulse to procreate also doesn't change. This yearning remains unaffected by the advancement of science and civilization.
2. Growth in the population and the quality of life are directly correlated. The desire to procreate rises as the standard of living does. In contrast, the birth rate decreases as the level of life rises.
3. In agriculture, the law of decreasing returns is in effect.

Salient Features of Malthusian Theory

1. Humans have a strong natural sex instinct that can develop very quickly. Population grows in a geometric progression (1, 2, 4, 8, 16, 32...) and doubles every 25 years if unchecked.

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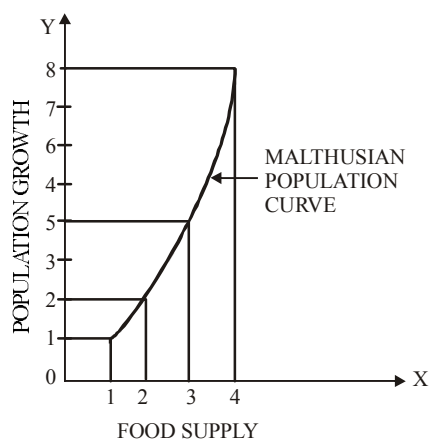
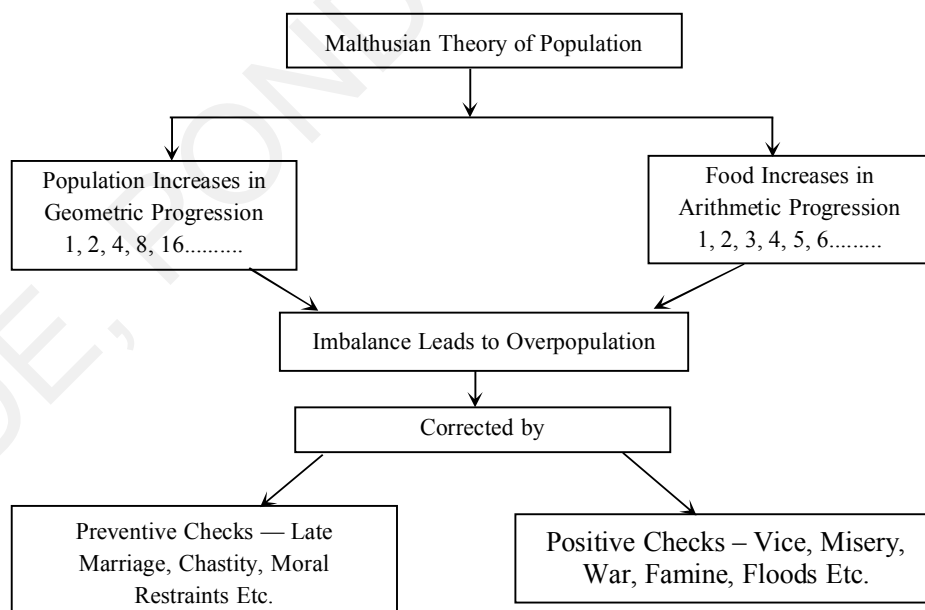


Fig. 2.9

2. The means of subsistence inevitably place a cap on the population. When the ability to survive increases, the human population rises as well, unless some strong and evident controls are in place. Malthus also predicts that over time, population expansion would outpace increases in food production. People will starve to death and there will be suffering if the food supply is insufficient. Therefore, this imbalance can be corrected by limiting population increase.
3. Population will eventually outpace food supply because population grows in a geometric progression whereas food supply grows in an arithmetic progression. Overpopulation would be the result of this imbalance. The availability of food would fall far behind the populace in the race. "The power of population is indefinitely greater than the power on the earth to reproduce subsistence for men". The imbalance between the increase in food supply and population growth is shown by the above diagram.

A summary of Malthusian theory is given in the Chart 2.4.

Chart 2.4: Malthusian Theory of Population



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The vertical axis in the diagram represents population in geometric progression, and the horizontal axis represents food supply in arithmetical progression. Population growth is 8 when the food supply is 4. Because of this imbalance, the population curve is raised upward.

4. Malthus proposed two different kinds of checks: positive checks and preventive checks. Positive checks, in Malthus' view, are crude, and in a civilised society, men utilise forethought, moral restraint, late marriage, and celibacy as preventive methods to reduce the birth rate. If people fail to utilise preventive checks to control population increase, positive checks take the form of pain, vice, starvation, war, disease, pestilence, floods, and other natural calamities that strive to lower population and so bring a balance between population expansion and food supply growth. Malthusian theory can be summarised in the form of a chart.

Criticisms

1. The mathematical representation of the theory illustrating the link between food availability and population growth is not supported by empirical data. While population growth has not been in a geometrical progression that would allow it to double in 25 years in many nations, food supply has expanded more than in an arithmetical progression. In the second version of his Essay, Malthus removed this mathematical type of relationship, though.
2. The standard of living and population growth do not directly correlate positively. According to Malthus, as standards of living rise, population also rises at the same time, and as they decline, birth rates decline. However, there is no empirical support for this. Biological laws demonstrate that fertility declines as civilization advances. People will want an even higher level of living as their standard of living rises. Many people right now will choose a car above a child.
3. Malthus used the law of decreasing returns as the foundation for his study of the world's declining food supply. He was unable to take into account the development of agricultural technology through time, which might defy the law of decreasing returns. The introduction of technical innovation has caused the food supply in many developing and wealthy countries to grow much more quickly than in arithmetical progression.
4. Malthus used the law of decreasing returns as the foundation for his study of the world's declining food supply. He was unable to take into account the development of agricultural technology through time, which might defy the law of decreasing returns. The introduction of technical innovation has caused the food supply in many developing and wealthy countries to grow much more quickly than in arithmetical progression.
5. The Malthusian hypothesis was biased. He claimed that a rising birth rate is the cause of the growing population. In actuality, a decline in the death rate made possible by advances in medical research also contributes to population growth.

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6. Contrary to popular belief, population and overall wealth are not connected. The optimum theory of population is based on this. A country can import food in return for its industrial goods if it is financially wealthy and even if it cannot produce enough food for its population. For instance, the UK imports practically all of its food needs while placing more emphasis on the creation of industrial output.
7. Malthus' theory is false in practise. The rate of per capita income increase affects population growth. The fertility rate decreases when per capita earnings rise quickly above a crucial minimum. In his Social Capillarity Thesis, Dumont has demonstrated that as per capita income rises, people's willingness to have more kids to help support their parents' income falls. When people become accustomed to a high level of living, raising a big family becomes expensive.
8. Malthus holds that human beings' want to reproduce is a steady urge. That is untrue. Age, health, psychological state, and mental make-up all affect sexual inclination.
9. The urge for sex and the desire for offspring are identical in Malthus' eyes. But in reality, these wants are quite different. While the desire for children is influenced by societal, cultural, and religious factors, the urge for sex is a natural impulse. Prof. Huxley correctly notes that "it should be assumed that as the human race develops intellectually and morally, human fecundity will drop."
10. Malthus placed a greater focus on moral constraint as a means of population control. Moral constraint has nothing to do with preventive inspections. He had trouble seeing birth control methods like contraceptives and other family planning tools. Moral restraint cannot curb the population growth on its own.
11. According to Malthus, the positive checks aren't truly the result of population growth. Natural disasters are not unique to overpopulated nations. The natural disasters can also be encountered in less populated nations.
12. Malthus believed that man was not the centre of the population law. In terms of biology, population growth is constrained to a specific percentage, let's say 4%.
13. In history, rapid population growth is quite uncommon. Egypt, Ceylon, and other places throughout history have experienced stable or dropping populations for extended periods of time.
14. It has been established that Malthus was a false prophet. His population hypothesis does not hold true for the nations for which it was developed. His theory has been refuted in developed western nations. In these nations, the birth rate has decreased, the availability of food has grown, and production has outpaced population expansion.

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Validity and Applicability of Malthusian Theory

The Malthusian hypothesis of population is not entirely incorrect, despite its flaws. Every living thing has the innate desire to procreate. Malthus was right to believe that if population increase is not slowed down, human prosperity will suffer. Today's overpopulation is a major barrier to economic development in many developing nations. The Malthusian ghost has once more surfaced in these nations. Malthus, who warned Europe about the dangers of overpopulation, helped to enlighten the continent's nations. The widespread application of preventive measures is evidence that the Malthusian law is true. Malthusian law has "been so repeatedly criticised as to illustrate its validity," claims Prof. Clark.

Numerous economists have used the Malthusian law in their theories of production and distribution, including Marshall, Taussing, Pigou, Patten, etc. Keynes asked, "Is it not the fear of Malthusianism which has created the problem of declining population in France?" Prof. Walker says that "Malthusianism has stood unsheltered, impregnable amid all the controversy that has raged around it."

It is highly advised to utilise birth control methods and other restrictions due to the extreme risk of overpopulation in some nations. Understanding population behaviour in many nations where the balance between population and food availability is a key element requires an understanding of Malthusian theory. Even while the population issue has taken on a slightly different guise today, its significance has not diminished. In every nation, preventive checkups are in full swing, and responsible people's attention has been drawn to the issue of achieving a regular and universal drop in the birth rate. Preventive measures, as advocated by Malthus, have become increasingly common with the rise of civilization.

Over two-thirds of the world, Malthusian doctrine is prevalent. Its jurisdiction encompassed nearly the whole continents of Asia, Africa, and South America. Birth and death rates are very high in these nations, and positive checks are in place. The true goal of population control is not to prevent starving but to end poverty in order to quickly raise *per capita productivity*. As a result, the Malthusian idea is still essentially true today as it was in the past.

2.4.1 Malthus Theory of Glut: Ricardo-Malthus Glut Controversy

Malthus propounded the theory of glut or overproduction as the basis of his analysis of the capitalist economy. He pointed out that in a capitalist economy effective demand can never be sufficient to clear the supply. Malthus wanted to demonstrate, not the possibility of temporary overproduction, but the permanent overproduction possibility of all commodities. Malthus's basic argument was that without exogenous spending by unproductive consumers, the process of capital accumulation would lead to secular stagnation. However, Malthus did not take into account pure monetary explanations of glut. He said that when saving was increased for the purpose of capital accumulation, effective demand would go down to that extent. Therefore, due to under consumption, glut or overproduction would be the necessary outcome.

The concept of glut can be diagrammatically explained as below:

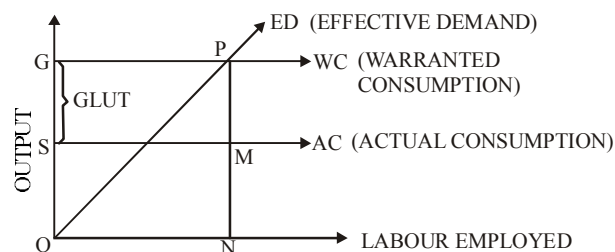


Fig. 2.10

In the diagram above, the vertical axis shows the output produced and the horizontal axis shows the amount of labour employed. Apparently, $OG = PN$. The demand in the economy is deficient to the extent of PM , because the actual consumption is lower than the warranted (justified) consumption. Hence, there arises the stock of unsold goods or what may be called glut. As the diagram shows, the extent of the glut is GS .

Malthus took the issue with Ricardo and the result is the famous controversy between these two stalwarts of economics on the problem of glut. Ricardo and J.B. Say pointed out that general overproduction is impossible. Ricardo's conviction was based on Say's law of market which says that "supply creates its own demand." As soon as there is supply, it is demanded. Thus, Say's law of market assumes away general overproduction. Every demand has a corresponding supply. This law of market was developed by J.B. Say and later on Ricardo took it for granted. The debate between Ricardo and Malthus on the possibility of glut would not have created confusion had the two writers made up their minds about the real meaning of Say's law of market. Ricardo took for granted the dogmatic assertion of Say's identity. Malthus, however, failed to challenge Say's law effectively. Ricardo said that in the long run, supply and demand are absolutely tied together and excess of supply over demand is impossible. However, Ricardo thought that there may be an overproduction of specific and single good. But the general overproduction is impossible in the long run.

Ricardo and J.B. Say observed that there should not be an accumulation of capital more than what is actually necessary for the country. A capital which cannot be productively employed is not accumulated: what is currently produced is also currently consumed. Just as there is a balance between demand and supply of ordinary goods, so also there is a balance between supply and demand of capital goods. When accumulation of capital takes place, wages go up. This has two consequences: (i) profit level goes down, so that accumulation cannot be sustained for a long time, (ii) an increase in the wage level leads to population growth, so that effective demand is increased and sustained. Thus, glut is an impossibility. Of course, during the process of capital accumulation, saving goes up but later on it comes back in the form of increased effective demand. This point of Ricardo is not accepted by Malthus. Ricardo can very well argue that due to accumulation, short-run profit may go up. This may also increase the effective demand. In any way, glut is not possible. Malthus's basic argument, however, stands that too high a

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propensity to save and invest leads to a reduction in consumption. Ricardo's basic argument is that capital accumulation cannot go on indefinitely unless the capital is productively employed. Thus, there cannot be a general overproduction of goods or of capital.

Ricardo and J.B. Say based their analyses on the following two main assumptions:

(i) production is for use only and not for profit, (ii) money is a medium of exchange and it does not disturb the flow of real economic forces.

However, Malthus found that these assumptions were faulty. Malthus recognised the extreme importance of money in an exchange economy. He said that the store of value function of money disturbed the flow of real economic forces. Secondly, Malthus pointed out that in a capitalist economy, production is not for consumption but for profit. Wages and profit are regarded as the two components of value. Malthus said that all wages are spent and a fall in wages will reduce the volume of effective demand and will create underconsumption in the economy. Wage is an element of cost and an element of demand. If the capitalist pays low wages, the demand for his product will fall. Thus, Malthus says that it is very much possible to have overproduction of goods in a capitalist system due to underconsumption. Malthus said that unless a large class of unproductive consumers is maintained, there will be stagnation in the economy. Such a class of consumers will also reduce unemployment in the economy. Malthus has observed that, sometimes, effective demand may not increase even as a result of any increase in the wage rate, because the workers may prefer leisure to consumption. Thus, consumption remains the same and the glut becomes a possibility.

The power to produce, according to Malthus, may not generate an equal power to consume. Malthusian theory of glut is based on his theory of value. But, unlike Ricardo's invariable measure of value, Malthusian measure is a price deflator. Ricardo remarks that although the propensity to save and investment is very high of the capitalists, still general overproduction cannot become possible. Malthus says that if accumulation is very high, which is very likely in a capitalist economy, production will also be very high, which cannot be immediately consumed. Ricardo observes that the extra production can be consumed by the increased population made possible by a system of increased wage level. Malthus, however, retorts by saying that increased population cannot be brought into the market before some 16-18 years.

Malthus, like Ricardo and J.B. Say, rejected the monetary causes of business cycles. Malthus said that if there is a high rate of saving, it will lead to general overproduction. In such a case, the workers receive less, but rich people's consumption is not increased. However, Ricardo was of the opinion that saving will alleviate rather than aggravate the sufferings of the workers. Malthus's attack on Say's law failed due to his insistence that vanishing investment incentives can be explained mainly by the insufficient consumer's demand. According to Ricardo, equity in saving and investing ensures economic sustainability throughout time. If

sufficient demand is not present in the economy, investment cannot be sustained and is not taken up.

Ricardo showed deficiency in the reasoning of Malthus. Malthus, like the physiocrats, argued that consumption will outstrip production, if proper emphasis is not given to agriculture. However, Ricardo fully emphasised the corrective effect of the classical automatic adjustment mechanism (market forces). If saving leads to more and more accumulation unaccompanied by increasing population, then Ricardo says that wages should be higher, but Malthus observes that under such circumstances, wages should be lower. Even if the wage level goes up, Malthus finds the possibility of the same amount of consumption, because of the leisure one of the important points of Ricardo-Malthus glut controversy. However, in the controversy, Ricardo wins over Malthus. It is said that good logic wins over bad logic. Ricardo's use of the Say's law of market was dogmatic and hardly impeccable. But, Ricardo had good logic, given the premises and assumptions of his system.

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Check Your Progress

6. Malthus was the first economist to propound a systematic theory of _____.
7. Malthus became necessarily a _____.
8. Malthusian theory of glut is based on his theory of _____.

2.5 GERMAN ROMANTICS AND SOCIALISTS

Romanticism had an impact on a number of economic theories developed in the early nineteenth century, most notably those of Adam Müller, Simonde de Sismondi, Johann Gottlieb Fichte, and Thomas Carlyle. In a 1984 paper titled "Figures of Romantic Anti-capitalism," Michael Löwy and Robert Sayre first proposed that Romanticism was an anti-capitalist and anti-modernist worldview. Wide-ranging opposition to capitalism that traced its roots back to the Romantic movement in the middle of the nineteenth century, but found additional impetus in the latter half of the century, was known as romantic opposition to free enterprise.

In 1897, Vladimir Lenin stated that "the romanticists' wishes are extremely good" (as are those of the Narodniks). They are superior to the naive optimists who deny the presence of these inconsistencies because they are aware of them.

The main response against the French Revolution and the period of Enlightenment associated with it was typically to see everything as mediaeval and Romantic; even people like Grimm are not exempt from this, according to Karl Marx in 1868. This pattern of resistance to private enterprise, Marx believed, should be pursued in the direction of socialism. The next answer is to delve beyond the Middle Ages into every country's primordial era, which has a connection to the socialist trend even though these erudite folks are unaware of it.

Marx and Engels distinguished between "revolutionary Romanticism," which disregarded private enterprise and worked toward the future, and Romantic analysis

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of free enterprise from a perspective of the past. They saw Romanticism as an impression of the age beginning after the French Revolution and its inherent social contradictions. Additionally, they distinguished between the Romantic writers who romanticised the feudal social structure: they praised those whose works hid democratic and fundamental elements behind traditionalist utopias, while criticising the “reactionary Romantics,” whose sentiments toward the past added up to a defence of the nobility’s interests. Marx and Engels were particularly attached to crafted by such revolutionary romantics as Byron and Shelley.

Check Your Progress

9. In 1984 article called “Figures of Romantic _____”.
10. Marx and Engels distinguished between “_____”.

2.6 JEAN CHARLES SISMONDI (1773-1842)

Sismondi was more and less than a classical writer. He was the first systematic writer to write against the classical economic system, although he was basically a classical economist. He wrote two important books. His *Commercial Wealth* was published in 1803. It contained an exposition of classical ideas. His *New Principles of Political Economy* was published in 1819.

Sismondi and the Classics

Sismondi was initially a classical economist. He was a faithful follower of Adam Smith. He supported the classical principles of economic liberalism, free trade, and laissez faire. He also subscribed to the natural philosophy of Adam Smith. Thus, both theoretically and practically, Sismondi was by heart a classical economist in the early years of his career. However, later on, he completely turned away from the classical system of values and belief. But, unfortunately or fortunately, he could not completely break away with the classical system. He thus, agreed with the classical method of analysis and the classical conclusions and policy prescriptions. He brought out the evil effects of machinery, exploitation of labour under the classical system, low wages and unsatisfactory working conditions of the labourers.

Nature and Method of Political Economy

Sismondi considered political economy “as a moral science where all facts are interwoven and where a false step is taken whenever one single fact is isolated and attention is concentrated upon it alone.” He contends that political economy is fundamentally a moral science that should consider the welfare of humanity. Ethical consideration dominated the ideas of sismondi. He regarded political economy as an art. The science of wealth, or chrematistics as Aristotle called it, was classical political economy. Sismondi did not like this definition of political economy. He said that real purpose of a science should be man and his well-being. Sismondi considered man more important than wealth in political economy.

A science is to be based on experience, observation and history. As a result, it is discovered that political economy is more concerned with man than with riches.

NOTES

Political economy is a study of economic activity in relation to human welfare. This definition of political economy as given by Sismondi is more or less like the definition given by Alfred Marshall. Sismondi gave more emphasis on distribution rather than production, because he was concerned basically with the problem of social justice.

He criticised the abstract deductive method of analysis of the classical economists. He was in favour of an inductive, historical method of analysis. He thus, anticipated the historical school of analysis.

Distribution

Sismondi was essentially interested in the well-being of the masses of society. In this regard, Sismondi believed that distribution issues were more crucial than any other economic issues. He said that the largest possible aggregate production does not necessarily mean the greatest amount of happiness for the people. On the other hand, he believed that a smaller aggregate of wealth, distributed properly, can bring about more happiness and well-being to the people. Sismondi, thus, insisted that distribution should not be left to the blind market forces, but should be regulated by a proper state-sponsored machinery of distribution. He also favoured distributing assets and production tools to those who can use them most effectively. He said that benefits accruing from farming should go to the peasants alone. In his analysis of distribution, Sismondi was pro-labour. He advocated the intervention by the state in the matter of distribution of the national product.

Machinery, Overproduction and Crisis

Sismondi found class conflict in society. He was one of the earliest economists to observe the existence of opposing classes in a society. Marx was greatly indebted to Sismondi for his analysis of class conflict. Sismondi observed that machinery was against the interest of the working class. It reduced employment, increased competition, reduced wages and reduced the demand for the products. Machinery always displaces labour from employment. Machinery can be advantageous provided society can provide alternative jobs to the unemployed people. Sismondi found contradiction in the capitalist system. Whereas production increases under capitalism, purchasing power goes down. Like Malthus, Sismondi also observed that it is impossible for the workers to absorb the whole lot of output of the industries. Overproduction arises from a competitive zeal to produce even if the demand remains the same or goes down. This leads to a glut or excess production from time to time. With the introduction of machinery, unemployment is created and this, once again, decreases the purchasing power of the workers.

Sismondi was not in favour of competition. He said that competition increased exploitation and it also increases overproduction.

Sismondi did not believe in the truth value of Say's law of market. According to him, under the factory system of production, labourers are paid only the subsistence wages. These are inadequate to cope with the growing production of output and services. This results in underconsumption and crisis. According to Sismondi, crisis is caused by mainly three factors: (i) unplanned production and

NOTES

excess competition. (ii) Production is not based on demand consideration but is based on the growth of capital. (iii) Separation of labour and ownership of production. This increases the profit of the capitalists, but it keeps intact the wage of the labourers.

The capitalists cannot increase the demand for the product, excepting increasing temporarily the demand for some luxury goods for them. The progressive concentration of capital deepens the crisis of overproduction. In fact, in a capitalist economy, as Sismondi observed, the gap between output and consumption has a built-in tendency to grow.

Suggested Reforms

Sismondi suggested the following methods of reforming the economic system:

- (i) More and more intervention by the state in the matter of distribution.
- (ii) He rejected communism and feudalism as correct systems.
- (iii) Need for the equilibrium between production and consumption.
- (iv) Revival of the independent producers — small farmers, artisans and so on.
- (v) Slackening of industrial progress and invention in such a way that the necessary adjustment can be made without overproduction.
- (vi) Increase in the welfare of the masses.
- (vii) There should be unions of property-owners and labourers.
- (viii) Limitation of child labour, shortening of hours of work and abolition of Sunday working.

Criticisms

- (i) Sismondi was against the classical deductive method. But he himself adopted the deductive method while propounding his theory of overproduction as the cause of crisis.
- (ii) Most of the fundamental economic concepts and categories used by Sismondi were vague or confused.
- (iii) Sismondi is regarded as a pessimist.
- (iv) Sismondi's reform ideas exhibit some hesitancy as a result of the ongoing struggle between the mind and the emotions. Sometimes, he could not suggest the proper remedy.
- (v) Sismondi was neither a full-fledged Adamite, nor a hard boiled liberal. He was not a full-fledged socialist.
- (vi) According to J.S. Mill, Sismondi's analysis of overproduction is not correct because while there may be overproduction for some particular commodities, a uniform and general overproduction of all commodities is simultaneously impossible.
- (vii) Sismondi had a very uncertain type of position because he, on the one hand, was not anti capitalist but he was a strong supporter of workers.

However, in spite of the above points of criticism, it can be said that he rendered a distinct service by systematically exposing the weak points of classical political economy. His analytical approach anticipates that of the historical school. His emphasis on the importance of state ushered in an epoch of state socialism.

NOTES

Although he was not himself a socialist, still his studies have always provided a lively source for the socialist writers. In fact, he was the source of inspiration for Rodbertus and Marx. He will be regarded as a champion fighting against depression and overproduction. It is indeed difficult to ignore Sismondi's influence on the later socialists.

Check Your Progress

11. Sismondi was initially a classical _____.
12. Sismondi was not in favour of _____.
13. According to J.S. Mill, Sismondi's analysis of _____ is not correct.

2.7 KARL MARX – DYNAMICS OF SOCIAL CHANGE

All of Marx's writings are influenced by his emphasis on the social change process, which is so essential to this way of thinking. Marx does not believe that "providence" or the "objective spirit," two extra-human entities, are the driving force behind history. Marx argued that men should write their own histories. Through the course of human history, men have changed while also competing with nature to dominate it. Over the course of human history, men have changed nature more and more to suit their own needs. Additionally, they change themselves as they change nature.

Man is active in connection to his surroundings, in contrast to all other species, which can only passively adapt to nature's demands by securing a position in the ecological hierarchy that enables them to survive and thrive. He creates tools to modify his natural environment. As soon as they start to produce their means of subsistence, men "begin to distinguish themselves from animals." Men indirectly create their actual material lives by producing their means of subsistence.

Men who "remake their own lives every day" can only achieve this in collaboration with other people. Because of this, man is a zoon political animal. Through their labour, men build bonds with nature that are reflected in their social interactions.

The act of producing life, both one's own life through labour and new life through procreation, appears simultaneously as a twofold relationship, one that is natural and the other that is social. Social collaboration refers to multiple people working together, regardless of the circumstances, format, or goal. This means that a fixed mode of production, or industrial stage, is always linked to a fixed mode of cooperation, or social stage, and that this form of cooperation is a "productive force" in and of itself.

Men develop particular types of social organisation that are in line with particular kinds of production as a result of their struggle against nature and the need to support themselves through related labour. With the exception of those that prevailed in the early stages of primitive communism, all of these forms of social organisation are marked by social inequality. The division of labour promotes the establishment of stratification, or classes of persons distinguished by their varying

NOTES

access to the means of production and varying levels of authority, as civilizations develop from initially undifferentiated hordes. Given the relative scarcity, those who have seized supremacy through the expropriation of the means of production will take priority over any economic surplus that has built. This dominance, however, is constantly contested. Due to class conflicts, “the history of all previously existing society” can be said to be true.

From the dawn of recorded history, free men and slaves, patricians and plebeians, lords and serfs, guildmasters and journeymen, exploiters and exploited, have clashed. However, Marx relied on the historical specificity principle, which means that he believed it was crucial to emphasise that each distinct class conflict, which is rooted in specific productive conditions, must be investigated in its own right. Each historical period is seen as a functional totality with unique ways of production that give rise to certain types of conflicts between the exploiting and non-exploiting classes. Not all exploited classes have the opportunity to successfully assert themselves in battle against their exploiters. Due to the fact that these classes did not represent a dominant mode of production in the future, revolts by ancient slaves or the German peasantry during the Reformation were doomed to fail. On the other hand, as they represented a future form of production and social organisation, the bourgeoisie in the final stages of feudalism and the proletariat in modern times were destined to prevail.

Marx may have supported historical evolution, but it would be incorrect to assume that he also supported unilinear evolution. He was well aware of times of relative stagnation in human history, such as those in Oriental societies, and he was also cognizant of historical circumstances in which social classes had temporarily reached an equilibrium. His essays on Napoleon III’s administration masterfully depict a historical position in which the powers of the old and new class orders are so evenly matched that neither can win, leading to a “Bonapartist” impasse. Marx was also willing to explore the prospect that, despite his lifelong commitment to the idea that the working class holds the key to the development of a classless society, the working class may fall short of its “historical task” and cause humanity to descend into a new kind of barbarism.

After the original phase of primitive communism, Marx proposed four major succeeding forms of production in human history: the Asian, the Ancient, the Feudal, and the Modern Bourgeois form. Each of these resulted from conflicts and hostilities that had grown in the preceding sequence. “No social order ever disappears before all the productive forces for which there is room in it have been developed; and new higher relations of production never appear before the material conditions of their existence have matured in the womb of the old society.”

Classes that could no longer exercise their interests within the confines of the old order emerged as a result of class rivalries unique to each individual mode of production, and at the same time, the expansion of the productive forces reached the boundaries set by earlier productive relations. When this occurred, the old order was destroyed by the new classes, which stood for a novel production principle, and the new productive forces, which had been formed within the framework of the old

NOTES

order, produced the necessary raw materials for future development. The last oppositional manifestation of the social process of production, however, is “the bourgeois relations of production.” The dialectical principle that guided the earlier evolution of humanity will have come to an end after they have been defeated by a victorious proletariat, and harmony will have replaced social struggle in the affairs of men.

No matter the caveats, Marx’s focus on the existential basis of ideas and the necessity of viewing thinking as one among other social activities has remained one of the most persistent aspects of his work. It has integrated into the sociological project permanently together with his economic interpretation of the development of humankind, his theory of class relations, and his emphasis on the isolating features of social life in contemporary society.

2.7.1 Marx’s Labour Theory of Value

Marxian theory of value, commonly known as labour theory of value expresses a social relation in a capitalistic society. A basic form of this relation is commodity. A commodity contains use value as well as exchange value. The quantitative ratio in which the use values of two commodities vary is known as the exchange value.

It should be emphasised that Marx considered both quantitative and qualitative value issues while considering value issues. The qualitative value analysis seeks to find out the relation between producers under historical conditions. Quantitative value analysis is concerned with the determination of exchange value. Something homogenous is expressed through exchange. The only common property that every commodity has with every other commodity is that they are all produced by labour. The term “abstract labour” refers to the uniform (common and general) labour that creates commodities (muscle, nerves and brain powers). The objectification or materialisation of abstract labour is then used to determine value. Marx developed his value analysis in Vol. I of Capital.

Many bourgeois economists, such as Bohm-Bawerk, have criticised Marx for not taking into account two very important causal factors of value, e.g., scarcity and demand and supply positions. Marx, in fact, was interested in finding out the existing production relation through his value analysis. Hence, his analysis had to be on a different philosophical plane.

What is the Measure or Value?

Value is determined by calculating the amount of time required to produce the good under consideration, or the amount of labour that is (on average) socially necessary. The value of the commodity decreases as labour hours are cut back, or when less labour is needed.

In Marxian analysis, exchange value is the necessary form of appearance of value. By neglecting the necessary form of value, Smith and Ricardo divorced value from the specific relation of production, and their analysis was formal rather than dialectical.

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The labor-produced goods have both a natural form and a value form as commodities. The act of trade expresses the social relation (nature) of value. A single commodity does not possess value by itself. The act of exchanging goods and services reduces all the various forms of labour included inside various commodities to their fundamental characteristic of being labour.

The products of work are both in their natural form and in their value form as commodities. Trade expresses the nature (social relation) of value. A single good has no intrinsic value on its own. When goods and services are exchanged, all the different types of labour that go into creating those goods are reduced to their basic labour component.

Components and Creation of Value

What about plant, machinery and raw materials which are used along with labour for the creation of commodities? The value of the machinery and plant, according to Marx, is transferred to the product in stages, equal to their wear and tear at every stage (i.e., depreciation). The product only has that worth, which the means of production give it, and which they themselves lose in the process. They do not create values. They are created by labour. They merely transfer the value already created by labour.

What about natural means of production, e.g., land, air, water and so on? These means do not impart any value to the product.

The value of the raw materials is immediately transferred to the product produced by using them. They cannot create any new value. Labor creates value in the genuine sense of the word. A commodity's worth is determined by the labour hours needed to manufacture it, as well as the labour hours needed by the subsidiary commodities that go into its production.

A commodity is produced by labour power. The amount of labour required to produce and reproduce (maintain) this particular article determines the worth of labour power. Marx includes in the means of subsistence, cultural necessities (minimum), food, shelter, comfort (minimum) necessary for procreation and perpetuation of the labouring class. In other words, wages must be sufficient for the maintenance of the labourer and his family.

However, in capitalism, owing to the weak bargaining power of the worker, wage is reduced to subsistence (also due to the reserve army of labour). Labour market is buyer's market under capitalism. However, a worker produces for the capitalist much in excess of the wage paid to him. Thus, a worker's working time is divided into two parts: (i) In part one, he produces, the value for which he is paid his wage (necessary labour) and (ii) in the second section, he creates the value that the capitalist keeps for himself (surplus labour). Surplus value is the value produced by the excess labour (S). The rate of surplus value is:

$$S' = \frac{S}{V}$$

(S = surplus value, V = variable capital (labour), $S\epsilon$ = the rate of surplus value). This indicates the rate of exploitation of labour. As a result, a commodity's value is composed of three components:

$$C + V + S$$

(where, C = constant capital's value, V = variable capital (labour), and S = surplus value).

In the Marxian scheme, price which is equivalent to cost of production ($C + V$) plus profit may not always be equal to value. They are equal only under an ideal situation. They vary just as the natural price and market price vary from each other. The extent of such variations basically depends on the organic composition of capital (C/V) or capital per worker in the economy. The subject is analysed in detail by Marx in his Transformation Problem. Be that as it may, the divergence between value and price shows a clear departure from the labour theory of value.

2.7.2 Karl Heinrich Marx (1818-1883)

Karl Marx is one of the greatest thinkers of all ages and of all schools. Marx was essentially a classical economist. It was he who also coined the term Classical Economics. Marx's writing has a philosophical flavour. It is also based on some amount of abstraction. Marx's thought ranged over philosophy, history, economics and sociology. In terms of paradigm, Marxian economics introduces a new epoch in economic thought. His writing was mainly directed to the critical analysis of capitalist development and to its ultimate transition to the desideratum of socialism. Marx considered capitalism as a passing phase. He considered economic life in terms of conflicts of interest between the owners of capital and of labour. Marx's most famous works are *The Communist Manifesto* and *Das Kapital*. *Kapital*'s first volume was published in 1867, but the second and third volumes weren't released until after his passing, and the fourth volume was published only in the twentieth century. In what follows we will make some topical discussions on the various aspects of Marxian economic thought.

Materialistic/Economic Interpretation of History (Historical Materialism)

Marx's primary goal was to identify the broad trends in historical change. There are mainly, according to Lenin, three components of Marxism which culminated into 19th century intellectual development; (a) German philosophy (mainly of Hegel), (b) French socialism and (c) British political economy. For Hegel, the society is always dynamic and the change from one situation to another is based on conflict. Hegel referred to this process of development as dialectic, in which new concepts worked to overcome internal tensions rather than completely replace the old. In this process, the new stage is an advance over the old.

Marx was more profoundly influenced by Feuerbach who was a materialist. He claimed that rather than the awareness of man dictating his life and existence, it was actually the consciousness of man that was in control. Marx extended Feuerbach's materialism to the explanation of all dominant ideas prevalent in the society. He also expanded Feuerbach's concept to include history. Feuerbach

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conducted a wholly historical and non-dialectic analysis. To Marx, what matters most is the way production is organised. He made an abstraction like this.

Marx saw the conflict between the forces of production and the relations of production as the driving force behind historical development, in contrast to Hegel's dialectical progression of ideas. Marx believed that human awareness was important, but it could only be comprehended in the context of human history, society, and material circumstances. Marx was also influenced by the ideas of French Revolution (Liberty, Equality and Fraternity). He held the view that a socialist society, in which classes would finally vanish, would be founded on the productive capacity produced by capitalism and would be structured in accordance with a plan formed by complete participation of the working class in decision-making. Marx explained all history as the reflection of class struggle: "The history of all the hitherto existing society is the history of class struggle." (The Communist Manifesto).

Marx's Preface to a Contribution to a Critique of Political Economy contains an extensive explanation of the materialistic theory. Men engage in relationships with one another as masters or slaves when organising production. These relations are specific to modes of production and are studied as class relations. These relations are the base for other political, legal and intellectual life which can be regarded as the superstructure. However, a society's production relations reflect a certain stage in the growth of its material producing forces. The speed and qualitative course of the development of the productive forces can be influenced by production relations. According to historical materialism, the development of the productive forces can be used to explain class conflict as well as the overall course of human history.

Man must always locate the unspoken justification for the system in his social existence and practical day-to-day life before engaging in production relations. It has to be noted that production exists independently of the choice of men even though they have been historically made by men in their development. The serf feels obligated to remain faithful to his lord and the king. The person making a salary is free to sell his labour. He can work to earn more money, but he doesn't question the salary structure.

All of this shows how stable a certain form of production is. When the forces of production, or more simply, the technological capacity to produce, are constrained by the relations of production, instability can result in the system historically. Production relations, which are slow and relatively rigid, are usually put under enormous stress by the forces of production, which have a tendency to be dynamic and change frequently. The old superstructure of ideology and other structures come down as a result of attempts to integrate the new forces of production within the current relations.

These changes, however, are the result of a century's worth of advancement and failure rather than occurring overnight. The outcome of the class struggle determines how production relations will evolve. The dominant class in any mode

NOTES

of production will always oppose the advancement of conditions that would benefit the class that would rule the next society. Working people will be split between two opposing oppressive systems until they eventually become the emerging ruling class under capitalism.

Any change becomes essentially historical in nature, when one seeks to expose the economic law of motion in contemporary society, as did Marx. Marx said that the course of history can be explained because it is governed by certain laws that can be discovered. Hegel emphasised the role of ideas in shaping history. Marx rejected this and substituted in its place the concepts of mode of production and class struggle. Marx has assigned the highest place to economic structure of society (base). All other structures depend essentially on the economic structure. In the course of time, the mode of production undergoes a change and this necessitates suitable changes in social relationships. The existing relationships become incompatible with the alterations in the mode of production, and it is the conflict between these two that generates a social change.

Laws of Motion (Laws of Development) of Capitalism

According to Karl Marx, there are certain laws or general tendencies in a capitalist economy. These tendencies arise out of the capitalist mode of production. The laws of motion of capitalism, as discussed by Marx, are given below:

1. Every capitalist economy is concerned with accumulation of capital. Every capitalist wants to become supreme in competition with other capitalists. There is, therefore, competition such that the big enterprises engulf the small ones. Because of this tendency, the average size of the big firm grows continuously. At the same time, many companies destroyed by competition are absorbed by the large companies. Industry will become more and more centralised under capitalism, and a small number of capitalists will hold the majority of the economic power.
2. Larger and larger accumulation of capital is the law of capitalism. This is done for survival and for gaining supremacy.
3. The proportion of fixed capital to movable capital (labour) keeps rising in a capitalist economy. This is referred to as boosting capital's organic composition.
4. The rate of profit keeps declining as a result of the growing organic composition of capital. An increase in the organic composition of capital will result in a tendency for the rate of profit to decline when the rate of surplus value is constant.
5. The introduction of machinery and the substitution of more capital for labour lead to unemployment. Thus, there arises a growing industrial reserve army.
6. Capitalism will lead to the increasing proletarianisation of the working population, as a result of unemployment and exploitation.
7. Capitalism ultimately faces crisis.

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8. Capitalistic production develops circumstances for the objective socialisation of production, as a result of growing interdependence.

Contradictions in the Capitalist Mode of Production

A series of fundamental contradictions in the capitalist mode of production can be traced from the laws of motion of capitalism. Ernest Mandel has specified the following points of contradictions, as found out by Marx:

1. The objective socialisation of production and private exploitation, profit-appropriation, and private sector ownership of the means of production are in conflict with one another.
2. The growing productivity of the capitalist system and the restricted consumption of the working class are in conflict.
3. A contradiction is revealed in a capitalist system between the planned production in each firm and organisation and anarchy in the whole of the capitalist productive system. This results from the existence of private property and a generalised system of commodity production.
4. There is a contradiction between the expansion of science and technology emancipate the humanity and the tendency of the capitalist to exploit the masses, particularly, those who are workers. These expansionary forces lead to the destruction of humanity through war, aggression and so on. Thus, the humanity is confronted with two contradictory situations like socialism and barbarism.
5. There is, in capitalism, an inherent tendency towards a class struggle between labour and capital.
6. Capital accumulation is done with a view to earning higher profit. But in actual practice, capital accumulation leads to a falling rate of profit.

The clash between the dynamic production forces and the static production relations is the source of capitalism's contradictions.

Marxian Theory of Surplus Value

Marx's theory of value serves as the foundation for his notion of surplus value. If a commodity's trade value is equal to the labour time that went into producing it, then the product's exchange value must also be equal to the labour time. In actuality, the wage for labour must match the amount of labour that is produced. But capitalism does allow for this. In such a system, labour has a lower exchange value than its output. Examining Marx's theory of surplus value can help to provide an explanation for this.

If we take into account a system of simple commodity production, we find that the producers sell out their products in the market in order to purchase some other necessary products. Thus, the producers start with commodities, convert them into money and the same money is converted into some other commodities. This relation that obtains in simple commodity production can be written as C-M-C. But under capitalism, the process is changed. The capitalists here start with money for the purchase of commodities, then those commodities are again sold out for money.

NOTES

Thus, money comes at the beginning and also at the end. This can be written as M-C-M. Here, money acquires the character of capital. It must be noted with interest that in capitalism, money is the beginning and money is the end. In this process of conversion, the money that is obtained at the end, i.e., M' is greater than the money at the beginning, i.e., M . This is a very important feature of capitalism. The qualitative transformation of use-value here is replaced by a quantitative explanation of exchange value as the objective of production. The difference between M' and M is the surplus value which is the income of the capitalists.

Labor is a commodity in a capitalist system. As a result, it must be valuable. The amount of labour required to produce an item determines the worth of labour power. In order to produce labour, upkeep and sustenance are needed. The cost of the maintenance of the labour is what gives labour power its value.

Marx observes that labour is paid only a subsistence wage in capitalism which can only purchase subsistence goods (wage goods) necessary for the maintenance of the labour. A labourer, suppose, requires four hours of labour to earn his subsistence, then, assuming twelve hours' manday, the value of the product created by the labourer for the remaining eight hours can be regarded as surplus value, i.e., labour over and above the subsistence requirement. Marx says that under capitalism, labour power is the source of surplus value which is pocketed by the capitalist. Thus, a manday can be divided into two portions: one portion is devoted by the labourer for earning his subsistence and the rest is devoted by the labourer for the creation of surplus value for the capitalist for whom he is working. Thus, it can be said that a labourer is paid less than his productivity, which means that there is exploitation under capitalism. The working day of the labourer which can be divided into two may be called: necessary labour and surplus labour. Necessary labour produces subsistence and surplus labour produces surplus value. Under capitalism, the necessary labour is equal to the wage and the surplus labour is devoted to the production of surplus value.

Under capitalism, value of a commodity consists of three parts: (i) value of equipment, machinery and raw materials. All these come under constant capital (C). (ii) Another part of the value will consist of expenditure on labour power. This is called the variable capital (V). (iii) The third part is called surplus value (S). The sum of the value of the constant capital, the value of the variable capital, and the surplus value is therefore the total value. Or, total value = $C + V + S$. The ratio of surplus value to variable capital, or $S = s/v$, can be used to calculate the rate of surplus value (S).

In a capitalist economy, the rate of surplus value is nothing but the rate of exploitation by the capitalists. The following three elements influence the size of the rate of surplus value or exploitation: three factors: (i) labour productivity; (ii) the amount of goods that go into determining real wages; and (iii) the length of the workday. By extending the working hours, the surplus value may be raised, or by lowering the real wage rate or by increasing labour productivity. All the above three factors may also be used in combination. If the surplus value is increased by lengthening the working day (manday), it can be regarded as absolute surplus value.

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However, relative surplus value refers to surplus value that has been increased by reducing the pay rate or raising labour productivity. A unique characteristic of capitalism is the generation of surplus value. This is inherent in the system and it cannot be helped, because the capitalist is a mere cog in the wheel of capitalist system. A capitalist worth the name of a capitalist can only progress by exploiting the labourers through the realisation of the surplus value. If the position of the workers and that of the labourers are swapped, the result will remain the same as before.

Marx's fundamental presumption that the rate of surplus value will be constant across all industries and companies is crucial. Such an assumption is based on two propositions: (i) all firms and industries just use that amount of labour which is socially necessary—neither less nor more. This means that the production process everywhere is based on the technique of production and the same labour-intensity; (ii) the existence of a labour force which is homogeneous, transferable and mobile. However, these assumptions are limiting.

2.7.3 Karl Marx – Theory of Profit

Marx breaks down the rule of the rate of profit into two sections. In the first, he explains why there is even a tendency for the rate of profit to decline. He then goes into a number of things that work to offset this tendency and even change it into a brief increase in the rate of profit, leaving the decline in the rate of profit as nothing more than a “tendency.” Different trends in the rate of profit emerge because these counteracting forces are more or less prevalent in various countries at various times. Marx's theory states that the rate of profit must eventually decline.

Marx presents a rather expansive existential thesis with this “rule,” which is neither factually substantiated nor disproven. According to the “law,” the capitalist method of growth of the forces of production leads to a long-term decline in the rate of profit. Since the law is supposed to apply to future development and the mere fact that the rate of profit has decreased in the past does not predict the future, even if this does not constitute a proof. If the rate of profit has increased in the past, this is also not a rebuttal because the legislation only calls for a “tendential” reduction in the rate of profit, which could still happen in the future. Marx's reasoning can be considered as being argumentatively conclusive even if the law cannot be empirically proven.

Here, two things need to be set apart. The first point relates to how “the law as such” and “counteracting forces” interact. Marx makes the underlying assumption that, over the long run, the law-derived decline in profit rate dominates all opposing causes. However, Marx does not explain why this is the case.

The second issue is related to the “law as such”: Has Marx successfully established the “law as such”? It may be demonstrated that Marx fails to provide such a demonstration, which is the only issue this section will address. The “law of the propensity of the rate of profit to fall” immediately fails since the “law as such” cannot be supported, rather than first crumbling in the face of “counteracting forces.”

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Marx first assumes a constant rate of surplus-value and then presents a numerical example of a rising value composition of capital in order to make the case for the decline in the rate of profit, which then inevitably results in a fall in the rate of profit. Marx indirectly, but fundamentally, expresses the profit rate he determines from the first equation in this observation:

$$(1) \quad p = \frac{S}{C + V}$$

by dividing the numerator and denominator by v :

$$(2) \quad p = \frac{s/v}{(c/v) + 1}$$

It is obvious that the value of the entire fraction decreases if, as Marx first postulates, the numerator s/v stays constant and the denominator $(c/v) + 1$ increases since c/v increases. The numerator, however, changes over time. The generation of relative surplus-value, or an increase in the rate of surplus-value, causes an increase in the value composition of capital. Contrary to popular belief, an increase in productivity does not, as is commonly believed, increase the rate of surplus-value; rather, it increases the conditions under which the law as a whole is supposed to be derived, with the increase in c occurring specifically during the production of relative surplus-value, which in turn causes an increase in the rate of surplus-value. Marx emphasises that the rate of profit likewise decreases in the case of a rising rate of surplus-value shortly after the initial example as a result. But whether this can be proven conclusively is the real issue.

The numerator and denominator of the aforementioned fraction rise as both the value-composition of capital and the rate of surplus value rise. Marx must show that the denominator rises faster than the numerator over time if he wants to support his argument that the rate of profit has fallen. However, there is absolutely no support for such a comparison of growth rates. In the text, Marx refers to this issue more often than he offers any supporting evidence. Every time he claims that the law has been established just to reintroduce an argument in support of it, his ambiguity is obvious. These attempts at justification rely on the idea that as the rate of surplus value rises, so too does the number of employees employed by a given piece of capital.

Marx appears to finally be able to demonstrate a decline in the rate of profit even in the case of an increasing rate of surplus-value in the notes from which Engels constructed the fifteenth chapter of the third volume with the following justification: if the number of workers continues to decline, then at some point the surplus-value they create will also decline-regardless of how much the rate of surplus-value may rise. A numerical example makes this simple to understand: Twenty-four workers produce a total of forty-eight hours of surplus labour, or two hours of surplus labour each worker. However, if just two workers are required for production as a result of a significant increase in productivity, these two workers can only produce forty-eight hours of surplus labour if each works for twenty-four hours without receiving payment. Consequently, Marx draws the following

NOTES

conclusion: “The compensation of the reduced number of employees by a rise in the level of labour exploitation has definite limits, that cannot be overstepped; this can undoubtedly control the decline in the profit rate, but it cannot cancel it entirely.”

This conclusion is true, but, only if the capital ($c + v$) needed to hire the two workers is at least equal to what was needed to hire the twenty-four workers previously. Marx had only shown that the numerator's value falls in equation (1). The denominator must at least stay constant if a fall in the value of the numerator is to cause a decline in the value of the entire fraction. If the value of the denominator also falls, we would have the issue that both the numerator and the denominator fall, and the issue would then become which falls quicker. We cannot, however, rule out the possibility that the capital needed to hire just two employees is less than what would be needed to hire 24. Why? Instead of having to pay salaries for 24 workers, only two workers' wages are required. Since there has been a significant gain in productivity (just two workers are required instead of twenty-four), we can assume that there has also been a significant rise in productivity in the consumer products sector, resulting in a fall in the value of labour. Thus, the total compensation for the two employees is not just one-twelfth that of the twenty-four employees, but also considerably less. On the other hand, the amount of constant capital consumed likewise grows. However, it is necessary for c to increase by at least the same amount as v decreases in order for the denominator $c + v$ to at least stay the same. But since we don't know by how much, neither do we know whether the denominator rises nor fall, and hence, neither do we know whether the rate of profit (the value of our fraction) drops. Therefore, nothing can be proven.

This illustrates a key issue: the rate of profit is always a relationship between two quantities, regardless of how we define it. These two quantities (or parts of these two quantities) travel in a specified direction. However, that is insufficient because the key question is which of the two quantities changes more quickly, which we do not know. For this reason, nothing can be said about long-term trends in the rate of profit at the general level at which Marx makes his arguments. There is another issue, however it cannot be covered in any detail here. The alleged cause of the fall in the rate of profit is the expansion of c , which is not entirely limitless. Marx makes the case that the increasing application of constant capital hits its own limits in the contraction of variable capital in the second half of the fifteenth chapter of the first volume of *Capital*. This provides another defence against the “law as such” if it is constantly taken into account.

2.7.4 The Marxian Theory of Crisis (Business Cycle)

Marx did not give any systematic theory of a business cycle. His discussion on crisis is scattered over his writings. Marx argued that capitalist economies are prone to crises. Marxist terminology describes this struggle as a crisis when the forces of production clash with the relations of production. As a result of crisis, capitalism ultimately ends. There are several factors which are responsible for the generation of crisis in a capitalist economy. Breakdown of capitalism is, therefore, inevitable. We can now explain three main reasons for the crisis in a capitalist economy.

NOTES

1. Crisis Arising from Underconsumption

Under consumption or lack of effective demand is regarded as one of the main factors responsible for crisis in a capitalistic economy. This can be called realisation problem or realisation crisis. Like Keynes, Marx believed that in a capitalist economy, consumption cannot cope with production. As the capitalist economy grows, there is tremendous growth of its productive power. However, the consumption power of the workers does not grow in the same proportion. The wage level remains static at subsistence. As a result, the rate at which the productive capacity grows is not the same as the rate at which the purchasing power grows. Because of the limited consumption, it is difficult for the capitalist to sell out the goods and services produced by him. The excess value that has already been produced in the form of goods is inaccessible to the capitalist. When the capitalist finds that his profit level is going down, which is inevitable in a capitalist economy, he reduces the wage level of the workers. This reduced wage level is mainly responsible for the reduced effective demand. Low wages narrow down the market and render crisis inevitable. The consumption of both workers and capitalists is constrained in a capitalist society by a variety of variables. The consumption of the capitalist remains limited because of his desire to accumulate capital, and the consumption of the workers becomes limited by low wage, poverty and unemployment. Capitalism faces a crisis from the failure to realise surplus value when the capitalist market becomes limited. According to Marx, there is a contradiction between the forces of production and the forces of consumption. In fact, “the ultimate reason for all real crises always remains the poverty and restricted consumption of the masses as opposed to the drive of capitalist production to develop the productive forces as though only the absolute consumptive power of society constituted their limit.”

2. Crisis Arising out of Disproportionality

Another cause of crisis is related to accumulation due to the disproportional growth of different departments. In Marx's analysis, the capital goods department expands more rapidly than other departments. When physical boundaries are eventually reached and the capital goods sector is unable to purchase inputs to meet its own needs, a crisis results. Business fluctuations begin as soon as accumulation is compelled to slow down via the circuits of capital. Anarchic and uncontrolled production is a hallmark of capitalism. Production is based on market information which is imperfect. In such a situation, production cannot be expected to be equal to demand. Therefore, there is always the possibility of either overproduction or underproduction. In a capitalist economy, all the sectors of industries cannot grow in the same proportion. There is an imbalance between supply and demand. Marx notes that the traditional notion of Say's Law of Market, according to which supply generates demand, does not hold true in a capitalist system. This is mainly because investment decisions remain uncoordinated in a capitalist economy. Under these situations, disproportionality is the inevitable result. Thus, under capitalism, “crises originate because individual businessmen have, at best, only a partial knowledge of the market they are serving and tend to produce either too much or too little. These

NOTES

errors call forth adjustments, but only small errors can be corrected without general disturbance.”

3. Crisis Arising out of Falling Rate of Profit

Marx focused primarily on the propensity of the profit rate to decline as the root of the capitalist crises. In the near term, an increase in wage rate may be the cause of the endogenous decline in the profit rate. In a capitalist system, there is a natural tendency for the rate of profit to decline with time. This can be shown from the following formulae.

Total value = $c + v + s$, (The letters “c,” “v,” and “s” stand for constant capital, variable capital, and surplus value, respectively).

The rate of surplus value (s') can be indicated by (q).

$$q = \frac{c}{c+v}$$

The rate of surplus value (s') can be indicated by:

$$s' = \frac{s}{v}$$

The rate of profit (p) can be indicated by:

$$p = \frac{s}{c+v}$$

From the above ratios, it is possible to derive the formula for profit which is of great importance to Marxian theory of the falling tendency of the rate of profit. The formula can be derived with the help of the above ratios in the following way:

$$\begin{aligned} p &= \frac{s}{c+v} \\ &= \frac{sv}{v(c+v)} = \frac{sc + sv - sc}{v(c+v)} = \frac{s(c+v) - sc}{v(c+v)} \\ &= \frac{s(c+v)}{v(c+v)} - \frac{sc}{v(c+v)} = \frac{s}{v} - \frac{s}{v} \times \frac{c}{c+v} \end{aligned}$$

$$p = s' - s'(q)$$

$$p = s'(1 - q)$$

The above equation shows that the rate of surplus value (s') remaining the same, a rise in the organic composition of capital will lead to a fall in the rate of profit. As industry grows larger, constant capital expands more rapidly than variable capital. Since labour power produces surplus value, the rate of profit inevitably decreases. Marx's analysis makes the assumption that exploitation or surplus value growth is constant. Prof. Dobb claims that the primary justification for the Marxian theory of crisis is the propensity of profit rates to decline. With the growth in the organic composition of capital and the accumulation of capital, profit

NOTES

rate declines which affects adversely the rate of investment and accumulation. Thus, Marx finds a contradiction here. The goal of capitalism accumulation is to increase profit, yet in the end, greater accumulation results in a profit that is diminishing. Investment decreases when the profit rate drops, which causes company fluctuations brought on by underinvestment. According to Marx, “the rate of profit, being the goal of capitalist production..., its fall checks the formation of new independent capitals and thus appears as a threat to the development of the capitalist production process. It breeds overproduction, speculation, crisis and surplus-capital alongside surplus-population.”

The rate of profit often decreases when capitalism reaches its maturity. It should be observed, however, that even while there is a trend for profit rates to decline, this does not necessarily indicate that industrial profit rates are also declining. It can signify a decrease in either the interest rate or the rental rate, or both. Rent, interest, and industrial profit are all included in Marx’ definition of profit. The overall profit does not necessarily decrease when the profit rate does. A declining profit rate may very well indicate an increase in overall profit. It should be emphasised that not all industries have the same organic composition of capital. A sector with a higher proportion of organic capital will see lower profit margins. Slower social capital turnover, which is brought on by an increase in fixed capital and challenges with commodity marketing, is another reason for the lowering average rate of profit. The annual mass of surplus value per unit of capital decreases as a result. The following diagram illustrates the declining rate of profit (P).

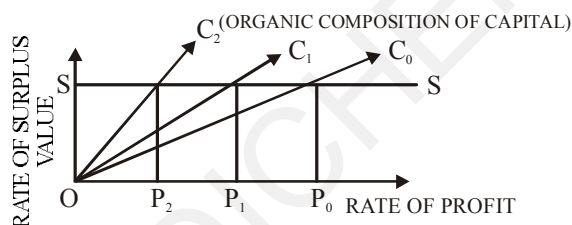


Fig. 2.11

In the above diagram, the rate of surplus value (S/V) is given (OS). If the organic composition of capital ($C/(C + V)$) increases, the rate of surplus value (OS) will decrease while maintaining this rate as constant $\frac{S}{(C+V)}$, as evident from the

diagram. In the diagram, $P_0 > P_1 > P_2$. Curves OC_0 , OC_1 and OC_2 show organic compositions of capital such that $OC_2 > OC_1 > OC_0$. It is evident that lowest profit is correlated with largest organic component of capital (OC_2 line) (OP_2).

Determinants of Profit

There are many determinants of profit. Firstly, the rate of surplus value affects the rate of profit. When all other factors remain constant, the rate of profit increases with the rate of surplus value. Second, the organic composition of capital, or the ratio of constant capital to variable capital (C/V), affects the rate of profit. Since variable capital creates surplus value, the rate of profit decreases as the organic

NOTES

component of capital increases. It is considered that as capitalism expands, the organic makeup of capital also increases. As a result, the rate of profit declines. Thirdly, the rate of profit is also influenced by the capital turnover rate. The rate of capital turnover and the rate of profit are inversely related. In comparison to capital with a longer turnover period, the capital with a faster turnover can exploit more labour over a given length of time. Fourthly, the amount of capital invested affects the profit rate as well. If other factors remain constant, the rate of profit may be higher the more capital invested. Finally, the efficiency of the utilisation of constant capital has a significant impact on the profit rate. These economies might lower the cost of production, which would raise both the rate of profit and the overall amount of profit.

Factors Counteracting the Falling Rate of Profit

Firstly, by increasing the intensity of exploitation of labour, the rate of surplus value can be increased. Similar to this, increasing the workday could lead to more profit or labour being exploited. Second, by lowering the salary level below the value of labour power, the tendency for the profit rate to decline can be addressed. Thirdly, the expansion of relative overpopulation, which enables the expansion of the labour reserve army, can guarantee industrial development with a low organic capital composition. As a result, it slows the profit's rate of decline. Fourthly, the same development that raises the constant capital's mass relative to the variable capital also lowers the value of its component due to higher productivity. Therefore, if constant capital is made less expensive, the organic composition of capital will be reduced as well, which will moderate the tendency for profit rates to decline. Last but not least, a capitalist's super-profit from abroad plays a significant role in mitigating the propensity for domestic profit rates to decline.

The law of the declining rate of profit functions as a trend that only materialises under specific conditions and over an extended period of time. The law serves as a symbol of capitalism's contradictions, notably those that exist between the goals of capitalist production and the strategies employed to achieve those goals. The law exacerbates the fundamental tensions of capitalism because it increases specialisation and concentration of production while only allowing for private appropriation of the benefits. Capital accumulation is done with a view to earning higher profit. But in actual practice, capital accumulation leads to a falling rate of profit.

Criticism against the Theory of Crisis

- (i) According to Paul Sweezy, there are some factors which may cancel out the effects of underconsumption. In the case of new industries having a large gestation period, factors of production can earn income much earlier than the production of goods and services. In such a situation, underconsumption does not necessarily follow.
- (ii) Because of population growth, variable capital can grow without raising wages and the rate of profit may not be affected.

- (iii) Marx himself has criticised the underconsumption theories put forward by other economists. But he himself has made this theory the basis of his explanation of economic crisis.
- (iv) Marx observed that capitalist economy has developed tremendous productive capacity. But how can this happen if there is underconsumption? If underconsumption is that serious, the capitalist society should have faced realisation crisis much earlier.
- (v) If the rate of surplus value stays constant, the declining profit rate is accurate. The rate of excess value does not, however, stay constant. If the surplus value rate remains constant, increasing labour productivity raises real wages. Thus, underconsumption theory cannot be supported empirically.

NOTES**Check Your Progress**

- 14. Marx's writing has a philosophical _____.
- 15. According to Marx, there is a contradiction between the forces of _____ and the forces of consumption.
- 16. The rate of profit also depends on the amount of capital _____.

2.8 ECONOMIC IDEAS OF J.B. SAY (1767-1852)

J.B. Say has popularised the ideas of Adam Smith, although he has differed from Smith on many counts. Political economy, according to him, is the study of the rules that control wealth. Say claims that the production, distribution, and consumption of wealth are all aspects of political economy. Political economy is seen by Say as a theoretical and descriptive science. Its role is to analyse, observe, and describe rather than to offer advice. Political economy is not a pragmatic art. According to Say, political economy is based on a few fundamental principles which can be helpful for drawing certain valid conclusions.

Say's book, *Treatise on Political Economy*, contains his ideas on economics. Say disagreed with Smith's classification of labour as either productive or unproductive. He contends that because professional people's services actually have exchange value, they might be seen as productive. Say gave the concept of utility more weight when determining value. In his view, utility is the intrinsic ability of goods to satiate human desires, and utility is the source of value. He criticised Adam Smith for emphasising the cost of production side of value too highly. He rejected the conventional labour theory of value. Say was unable to uncover an equilibrium theory of value, nevertheless.

Say contributed positively to the idea of production. He defined production as the creation not of matter but of utility. He recognised the importance of capital and land in production. He laid stress upon the entrepreneur which was not emphasised by Adam Smith. J.B. Say claimed that the value of a factor of production was derived from the value of that factor's output. In fact, entrepreneurs provided an important link between product market and factor market. Thus, Say introduced the

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fourth factor of production, namely, entrepreneur. He regarded manufacturing as equally important as agriculture. He also recognised both the advantages and disadvantages of the process of division of labour. It should be noted that Smith emphasised only the advantages of division of labour. Say noted that man does not create but merely transforms matters and that production is merely the creation of utility. So, Say's definition of production is the development of utility.

Say also differed from Smith regarding government interference. Unlike Adam Smith, J.B. Say wanted the government to set up works of public utility in order to create more employment for the unemployed people.

According to J.B. Say, tax should be lighter because otherwise it will make people paupers. Extreme taxation will make the people economically worse-off without enriching the state. However, his view on taxation was not as general as that of Adam Smith.

Be that as it may, J.B. Say made the most notable contribution in developing his theory of market. Let us elaborate this.

2.8.1 Say's Law of Market

According to J.B. Say's law of the market, supply generates demand on its own. This implies that general overproduction or unemployment cannot take place. Production creates income to the factors of production. This income generates demand for the goods produced. Overproduction is not possible under a barter system, because things are traded for one another. However, for a money economy, it can be said that people make savings. But in the classical system, the rate of interest mechanism could ensure the conversion of saving into investment expenditure to ensure full utilisation of resources.

Say's law can be interpreted both as an *Identity* and as an *Equality*. While the identity cannot be refuted, the equality can be. If money is a veil and acts simply as a unit of account, and is regarded as *neutral*, Say's law can be applied in a money economy. Say's identity can be expressed in the form of *Walras's Law*. Even a money economy can be regarded as a barter economy, when money has no utility of its own, and it is not demanded per se. The whole amount of products required would therefore equal the total amount of things delivered. i.e.,

$$\sum_{i=1}^n P_i D_i = \sum_{i=1}^n P_i S_i$$

Thus, excess supply is once again impossible. However, when it also serves as a medium of exchange (positive demand for money holding), and when total demand for all goods ($n-1$) is equal to the total supply of all goods ($n-1$), Walras's law states that the demand for money (n th commodity) will also be equal to the supply of money:

$$\sum_{i=1}^{n-1} P_i D_i = \sum_{i=1}^{n-1} P_i S_i \text{ then } D_n = S_n$$

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Thus, in the case of money, acting as medium of exchange, Say's identity implies that the money market is always in equilibrium, for supply of goods would mean demand of money for the purchase of other commodities, irrespective of the price level. A change in the price level does not disturb the relation between the goods sector and the money sector. Money is neutral.

Say's equality implies that a perfectly competitive economy has an inherent tendency towards full employment via wage-price flexibility (price mechanism). Say's equality assumed the possibility of temporary deficiency in demand. Excess supply in the commodity market implying excess demand for money will bring down general price level which will once again restore equilibrium between demand and supply of commodities, and between demand and supply of money. Thus, with the help of price flexibility, full employment equilibrium can be resorted in the economy. The classical Quantity Theory of Money suggests, in fact, the same conclusion.

Implicit Assumptions of Say's Law

- (i) Expansion of market is possible. There is no deficiency of effective demand.
- (ii) The government does not interfere with the automatic functioning of the economic system.
- (iii) Automatic adjustment is possible in the economy.
- (iv) Rate of interest is flexible and it can bring about necessary equilibrium between saving and investment.
- (v) Labour and capital find their place in the market not by supplanting others, but by offering their own products in exchange.
- (vi) Price mechanism is smoothly functioning in the economy.
- (vii) All savings are automatically invested.
- (viii) There is optimum allocation of resources.
- (ix) Perfect competition prevails in the market.
- (x) Commodity prices and factor prices are in perfect equilibrium.
- (xi) There is free enterprise economy.
- (xii) The equilibrium process in the economy is perceived from the long-term perspective.

It should be noted that these assumptions were not explicitly stated by J.B. Say; but these classical assumptions were implicit for the analytical validity of Say's law of market.

Implications of Say's Law

- (a) The most important implication of Say's Law is that general overproduction and unemployment are impossible in an economy with price flexibility, laissez faire, automatic adjustment mechanism, and so on, as were assumed by the classical economists.

NOTES

- (b) Money has no important role to play in the process of development. It is simply a veil and does not disturb the real equilibrium of the system. But money is used simply as a medium of exchange.
- (c) According to Pigou, wage rate is an important mechanism to bring about full employment and automatic adjustment in the market which is based on free and perfect competition.
- (d) The flexibility of rate of interest is helpful for bringing about an equilibrium between saving and investment which ensures equilibrium in the goods market.
- (e) There is no lack of purchasing power or of effective demand. Whenever any output is produced, it also brings an equivalent amount of income so that the output can be purchased. Thus, supply implies demand from the macroeconomic point of view.
- (f) So long as there are unemployed resources, it is possible to increase employment and production.
- (g) It is possible to pay remuneration to the factors of production from the growing national income which is made possible by the employment of new resources. Therefore, the community would be at an advantage by exploiting the idle resources.
- (h) The economic system has a built-in flexibility and it can work automatically without any external interference. At full employment, a free economy naturally achieves equilibrium.

It is interesting to note that J.B. Say has never used the phrase, "Supply creates its own demand," to explain the law of market. The phrase was for the first time used by Keynes to explain Say's law of market. In spite of price changes, the classical economists never claimed that total demand and total supply are always equal. They also did never say that there cannot be any deviation from full employment. They rather stated that a perfectly competitive economy always tends towards full employment.

What Say's law really conveys is that excess supply of goods or excess demand for money is self-corrected automatically through market forces. If the effective demand for goods is inadequate, prices must fall. This will increase the real value of cash balances (i.e., a positive real balance effect) which will increase the purchasing power and effective demand for goods in the economy, because the excess balance will be spent out. This additional demand for goods will eliminate the excess supply of goods in the commodity market. A zero excess supply of goods or a zero excess demand for money will mean the existence of an equilibrium condition in the market. Such an equilibrium condition can also be brought about by the situation of price rise (negative real balance effect) when there is deficient supply of goods or deficient demand for money in the economy. Thus, supply creates its own demand not despite price variation but because of price variation. This argument implies that same set of forces influences both absolute and relative price levels. In fact, for each set of relative prices, there is a

corresponding set of absolute prices at which the money market would be in equilibrium.

Be that as it may, Keynes observed that a perfectly competitive mature capitalist economy does not automatically tend towards full employment. The attainment of full employment is prevented by many factors such as, liquidity trap, wage-price rigidity, low interest, elasticity of investment and so forth. During the Depression of Thirties, Keynes showed that supply automatically could not generate corresponding demand. Keynes postulated that current income is not automatically spent on consumption goods and investment. Income is not spent at a rate at which all the factors of production could be employed. The gap between income and expenditure leads to the deficiency of current effective demands. Thus, market is not automatically cleared and supply cannot fully create its own demand. Thus, Keynes denied the validity of Say's law of market in a capitalist economy. In this regard, the views of Keynes and Marx were similar.

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Check Your Progress

17. J.B. Say defined production as the creation not of matter but of _____.
18. Say's law can be interpreted both as an Identity and as an _____.
19. Walras's law states that the demand for money will also be equal to the _____.

2.9 ECONOMIC IDEAS OF J.S. MILL (1809-1873)

John Stuart Mill heralds the end of one epoch and the beginning of another in the development of Classical political economy. His work is transitional in nature. Principles of Political Economy is John Stuart Mill's best-known publication. He is recognised for his restatement of classicism. Political economy, according to him, is the study of the nature of wealth and the rules governing its creation and distribution. During his time, Classical economics rose to its apex and had also experienced its downfall.

Agreement and Disagreement with the Classical Writers

Mill both agreed and disagreed with the Classical writers on many important points. The following are the points of agreement:

- (i) Mill recognised the Classical theory of self-interest. It recognised the individual motive of having maximum pleasure and minimum pain.
- (ii) Mill agreed broadly with Classical law of free competition and freedom of action.
- (iii) Mill broadly agreed with the Classical theory of value the demand and supply approach.
- (iv) Mill was supporting the Classical theory of free trade with some modifications.
- (v) Mill accepted the validity of the Malthusian theory of population.
- (vi) Mill was a champion of liberty and liberalism.

NOTES

- (vii) Mill agreed with the Ricardian theory of rent.
- (viii) Mill also accepted, up to a certain point, the validity of the Classical wage fund doctrine.
- (ix) Mill also agreed to the ultimate end of economic progress in terms of stationary state.

However, the following are the points of disagreement between Mill and the Classical economists:

1. Unlike the Classical economists, Mill thought that economic laws are neither permanent nor universal in character. The laws of distribution may be changed by human beings.
2. Whereas the Classical economists considered political economy as a science of wealth, Mill considered it both as a science as well as an art. He also favoured inductive or empirical analyses.
3. The Classical economists analysed economic phenomena in terms of static conditions, but Mill introduced dynamic analyses.
4. Mill was not completely against the intervention of the government. He prescribed government intervention in certain cases.
5. In the field of international trade, Mill suggested protection for domestic infant industries.
6. Mill was also of the view that the wage fund doctrine is not fully correct. In fact, wages can be increased by the trade unions.
7. Mill, unlike the Classics, considered stationary state as a state of bliss and optimism.

Laws of Production and Distribution

The laws of distribution are distinct from the laws of production, according to Mill. The principles of production have a physical reality quality. The laws of production are certain and sure laws. They cannot be changed by human volition. There is nothing optional or arbitrary about them. On the other hand, the laws of distribution can be changed by human beings through legislation or otherwise. The custom, tradition, and social regulations all influence how money and riches are distributed. Obviously, therefore, Mill advocated the plausibility of changes in the laws of distribution. But he said that the laws of production cannot be altered. The things once there, mankind cannot do away with them as they like. Mill pleaded for more and more competition in the spheres of production and exchange. He advocated many important types of reforms leading to the better distribution of income and wealth.

Mill observes that the functional distribution of income among the various classes of society is influenced by the distribution of property by drawing this type of distinction between the rules of production and the laws of distribution, which itself is the outcome of historical change. The distinction between the two kinds of laws is, however, not tenable. This is so because distinction implies independence

NOTES

of the forces of income generation and income distribution. Whereas, the laws of production are positive laws, the laws of distribution are normative laws. The former laws explain what is and the latter laws explain what should be. Needless to say, much depends on how such a distinction is actually applied in different cases. Mill's explanation suggests that distribution has nothing to do with the process of valuation. This notion, however, is not correct. Production is not a matter of historical accident. In fact, it is very difficult to analyse the determination of relative prices in the product market on the basis of a given pattern of income distribution. Similarly, it is almost impossible to precisely determine the factor pricing like rent, wage, interest and so on in the factor market alone. Factor prices and product prices are simultaneously determined in both the markets.

The Classical people made a mistake by incorporating a dichotomy in the pricing process. According to the Classical economists, relative price is determined in the product market and the absolute price is determined in the money market. These two markets and these two prices, according to them, are independent of each other. This is precisely wrong. Patinkin showed that the Classical dichotomy was wrong. Patinkin demonstrated that markets are interdependent: they cannot be separated out. Everything in the economy depends on everything in the spirit of general equilibrium. Similarly, the factor prices and product prices are to be simultaneously determined through a process of general equilibrium which may use the technique of Tatonnement (trial and error method). Unfortunately, this important truth was not realised by J.S. Mill. Like many Classical economists, Mill could not distinguish the pricing problem with the given resources from feedback effect of the growth of these resources on prices. He also could not explicitly explain the implications of short-run and long-run differences in the pricing problem. All this stood in the way of a meaningful presentation of value and distribution theories in a logical sequence. He never attempted a general equilibrium analysis.

Production

Labor and natural objects are the two main production agents, in Mill's view. Work can be done physically or mentally. The things that arise naturally are those that do so voluntarily. Labor is always and only used to set things in motion. Goods are produced both by labour and nature. There are three kinds of utility produced by labour: (i) Permanent and incorporated utilities in external things. Labor is used to produce external material goods.; (ii) Labour may be employed for making human beings more useful and serviceable; and (iii) Labour may be used for producing direct utility. In this case, utility may not be fixed or embodied in any object.

Mill analysed the Classical theory of productive and unproductive labour. Unproductive labour is that labour which does not create any material wealth. Productive labour creates material wealth. However, Mill included more occupations and professions under productive labour as compared to Smith.

NOTES

In addition to labour and natural agent, Mill also recognised the importance of capital as a factor of production. He advanced the following four fundamental features of capital:

1. Capital is the result of saving.
2. Industrial development is limited by capital.
3. Capital is saved for the purpose of productive consumption.
4. Capital is supported and employed by productive labour.

A circulating capital is only used once in the production process. Mill acknowledged the significance of the law of diminishing returns in agriculture in his examination of production. Under such a situation, the danger of overpopulation becomes serious. In addition, Mill listed some benefits of the division of labour. He came to the same realisation as Smith that the size of the market has an impact on the division of labour. He also observed that when, the market extends, labourers become more productive.

Distribution

Mill considered a threefold division of product among labour, land and capital. As has been pointed out earlier, the laws of distribution can be changed by human beings.

Wage: According to Mill, salaries are influenced by the supply and demand for labour, or are regulated by competition or custom. Wages also depend on the relative amount of capital and population. Wage is regulated by the wage fund. Reducing the number of workers or expanding capital development are two ways to raise wages so that the size of the wage fund increases. Mill, however, later on abandoned the wage fund doctrine. He pointed out in an article in the *Fortnightly Review* that wages can very well be increased by the actions of the trade unions. It may be argued that Mill was never serious about the efficacy of the rigid wage fund theory.

Profit: Profit is the share of the capitalist. This is a remuneration for abstinence. Mill was not able to separate out profit and interest. He simply pointed out that profit is greater than interest. Profit arises from the fact that the labourers are given less than their products. The rate of profit as a return to capital must be optimum. But the rate of profit, as Ricardo also realised, is also dependent on the wage rate. When the wage rate is very low, the profit rate is very high. Profit includes wages for superintendence and indemnity for risk. According to Mill, the forces of supply and demand determine short-term salaries, whereas the cost of maintaining the workforce determines natural earnings over the long term.

Rent: Mill accepted the Ricardian theory of rent. Rent is the extra profit generated by better lands over the worst land used for cultivation. It is the result of monopoly on land. It is a payment for the superior power over that of the other areas for which no rent is paid. Rent does not enter into price.

From the above discussion, it becomes clear that Mill had been following the main Classical theory of distribution with very little modification. The modification is particularly noticeable in his wage fund theory.

NOTES

Value Analysis

According to Mill, value is an important subject of political economy. Value can refer to both value-in-use and value-in-exchange. What is more important is the value-in-exchange. He emphasised the fact that there may be a fluctuation in the general price level but there cannot be any fluctuation in the value of a commodity. The changes in the values of commodities can only be with reference to the exchange value of another commodity. A commodity can have value only when it can satisfy human wants. There are three types of goods: (i) Goods having perfect in elasticity of supply or absolutely limited in supply; (ii) goods which are perfectly elastic in supply; and (iii) goods which are relatively elastic in supply or which can be increased only with the increase in cost. These types of goods and their valuation processes are shown below:

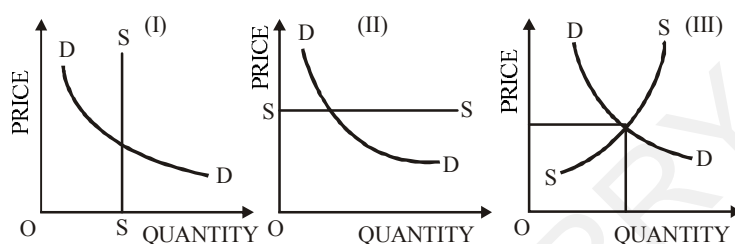


Fig. 2.12

Demand and supply factors play a major role in determining the value of the first category of products. In the second case of goods, the cost of production determines the value, and in the third situation, the value is defined by the cost of production under the most challenging conditions. Mill is quite sure between the demand-determined price of category first type of goods, and supply-determined price of the second class of goods, nevertheless, he overlooks the fact that the law of demand and supply is entirely universal and is relevant in both situations (Case Third).

The law of demand has been explained by Mill in the sense that supply and demand have an opposite relationship with respect to price. He also understood that variations in price level are not just caused by changes in supply and demand; it is also valid to argue that changes in price level affect the amount of demand and supply. According to Mill, the price is set at a margin where the quantity supplied and demanded are equal. In this way, he made the demand equilibrium in this connection. This itself was a contribution to the price analysis. According to Mill, a shift in supply and demand might momentarily account for a commodity's value; but this type of explanation only refers to unstable value. On the other hand, cost production can explain normal, natural or permanent value of a commodity. This, then, can be regarded as a long-run normal price, which was explained by Adam Smith. Mill was very complacent with his explanation of commodity values. He joyfully declared: "Happily there is nothing in the law of value which remains for

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the present or for any future writer to clear up; the theory of the subject is complete.” However, this complacency was his mistake. In fact, many things remained to be done towards the value analysis, which were attempted by the Marginalists and by Alfred Marshall.

Classical Stationary State: Mill's Views

According to the Classical model, stagnation is the outcome of capitalist progress. The Classical concept of stationary state is essentially a concept of mature economy in which, according to Adam Smith, wealth would be very great, yet there would be constant scarcity of employment. But unemployment does not play a decisive part in Mill and Ricardo's framework of analysis. According to Ricardo's concept, stagnation refers to “gross produce” or “gross national product at full employment,” as we call today. Stationary state arises out of the falling rate of profit and consequent choking off of capital formation. Stationary state ultimately would lead to constant population but capital accumulation would stop earlier before population growth reaches its maximum. In Mill's stationary state, population and stock of capital would remain constant. Ricardo thought that since there would not be any maladjustment, stationary state might be desirable.

Mill's Views

Mill, unlike other Classical economists, did not take the picture of stationary state as a gloomy one; rather, he took a complacent and platonic attitude towards the stationary state, where, according to him, human improvement and technological progress were still possible. Mill stated that “when a country has long possessed a large production, and a large net income to make savings from, and when, therefore, the means have long existed of making a great annual addition to capital, it is one of the characteristics of such country, that the rate of profit is habitually within, as it were, a hand's breadth of the minimum, and the country, therefore, on the very verge of the stationary state.”

According to Mill, the stationary state has virtually evolved into a form of paradise where the government can attempt to attain equality in terms of wealth and opportunity. Mill was emphatic about the opportunity for personal development in a stationary state. The stationary state is a frictionless state. He considered such a state as a state of bliss rather than a state of human misery. Moral advancement will be at its height in the stationary state. There would also be real peace and harmony. It would be possible to make improvements to the art of life, as well as a variety of little cultural, moral, and social adjustments. Mill has a strong optimism for the stationary state. In this state, distribution will be more even and the workers' lot would be improved. He said that “the stationary state would be on the whole a very considerable improvement on our present condition.”

Magnificent Dynamics

William Baumol has presented a beautiful summary of the Classical “magnificent dynamics”. It mainly analyses the growth of population at different stages. At the state of maximum growth of population, the population has just enough money per person to support reproduction at the level of physical

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subsistence. If the population is below its maximum, wages would be higher than the minimum necessary to survive, which would cause population to increase, and profit would be higher which will lead to more capital accumulation and investment to equip the workers with more working capital. When capital is nothing but wage funds, the accumulation from profits would be utilised in providing working capital to the larger amount of employed people.

But growth of capital and population will encounter diminishing returns in course of time due to the scarcity of natural resources. Ultimately, the gap between production and subsistence will be more and more narrowed and eventually, it would disappear. Therefore, profit would be eliminated and wage would no longer be above subsistence. When there is no profit, accumulation would stop. Stock of capital would be stationary. Similarly, when wage is at the subsistence level, population growth also will cease. Thus, the economy will be characterised by a stationary equilibrium.

Classical stationary state can be explained in the following diagram. The aggregate production function, or P curve, is linked to decreasing returns to labour and capital. Line OS stands for the volume of subsistence for labour proportionate to population growth. When population is less than OL, output can be higher than subsistence. At working population OA, total output minus rent is AC. Here, AB stands for the pay, and BC for the profit. As population and employment go on increasing, it can be shown that profit level initially goes on increasing from BC to EF but then it gradually comes down and ultimately at point K profit becomes zero. The level of wages remains at subsistence but the money wages go on increasing from AB to DE and then to GH. When the population is OD, the total produce minus rent is DF out of which DE goes to the labourers as wage and EF goes to the capitalist as profit. In the same way, when the total population is OG, the total output minus rent is GI, out of which GH part is paid as wage and HI goes to the capitalist as profit. In this way, employment may be extended up to the point L where the entire output minus rent would be eaten away in the form of wage by the labourers. So, there would be no profit. At this stage, the stationary state will come. Before the advent of stationary state, there would be more capital formation, more population and more employment. But the process is checked at point OL where profit ceases, growth of population ceases and wage becomes equal to minimum subsistence.

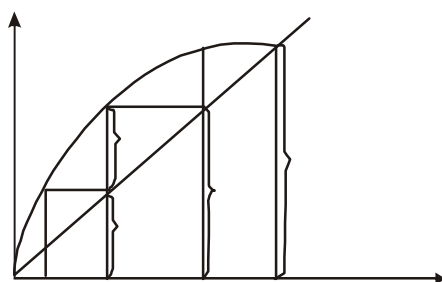


Fig. 2.13: Working Population

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Criticisms

1. Classical writers could not appreciate the great offsetting role of technology. Technological progress can lift upward the whole production function by raising capital per worker and thereby making each worker more productive. In actuality, technology has triumphed against declining returns in the struggle between the two.
2. Some of the classical economists failed to foresee the potentiality of Asia and Africa which, in the subsequent period provided a vast scope for foreign investment for British capital and prevented the appearance of stagnation in the nineteenth century.
3. The classical concept of capital is deficient. It is nothing more than 'wage fund'. Capital can provide more and better tools to workers with which they can increase productivity. If capital accumulation is faster than population growth, the limitations imposed by natural resources may be overcome, even with no technical progress. Thus, stationary state can be prevented.
4. In the analysis of population, the Classical economists concentrated only on two relationships: (i) Wages to population growth, and (ii) diminishing returns to labour and capital. Although mainly economic factors are important in the explanation of population dynamics, there can be other more important factors. Thus, the restricted base on which these two relationships were formulated does not appear to be relevant in our times.

Though logically valid, the Classical stationary state has not been encountered in any country.

Check Your Progress

20. Mill's best known work is his Principles of _____.
21. Mill was emphatic about the opportunity for personal development in a _____.
22. The classical concept of capital is _____.

2.10 HISTORICAL SCHOOL (1843-1883)

In the middle of the nineteenth century, in Germany, the Historical School was originally established. It was the result of grounded social science study. The historical method of study was created by the Historical School. The senior and younger divisions of the school were separate. William Roscher, Karl Knies, and B. Hildebrand are the writers from the more senior generation. Gustav Schmoller is the dominant member of the younger group. The British historicism is represented by Bagehot, Spencer, Darwin, Ingram, among others. Institutional school is a part of historical school.

Rise of Historical School

Historical School is a reaction against the classical school of economic thought. Historicism grew in Germany at a time when the German economy was

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backward, and it was undergoing a process of economic development. There was an air of change in every walk of life in Germany in the mid-nineteenth century. Germany, during this period, witnessed the existence of the classical system of economic philosophy and also a wave of economic liberalism. There was the growth of criticism against the classical philosophy. There were several reasons for the growth of historicism in Germany:

1. The German economic thought was not till then strong enough to have any independent philosophy of its own, and there was no strongly entrenched economic doctrine prevailing in Germany. Theoretical economics had never become firmly established in Germany. Schumpeter observed that theory was an alien plant in Germany. It was therefore, a virgin soil for the growth of indigenous theory.
2. German philosophy was based on an organic approach against the classical individualistic approach. Hegel's philosophy and Savigny's organic jurisprudence had a significant impact on the German way of thinking about life and things. Hegelian philosophy which was so influential was based on the concept of change and relativity which gave a new direction and a new thinking like historicism. Hegelian philosophy did not tolerate individualism of the classical system. Savigny had a significant impact on the development of historical education. He showed that the formulation of laws required a historical study of socio-economic phenomena. Hegel laid much stress on the evolution of ideas as the motive force for social change. This idea had a positive effect on the growth of historical school in Germany.
3. Freidrich List and Adam Muller had also the formative influence on the growth of historical movement. These writers emphasised the need of a national economy and a benevolent state for the growth of German economy. The studies made by List were based on historical evidence and data.
4. William Dilthey advocated historical studies for realistic results and conclusions. He also spoke on the need for understanding historical events. He said that, on the basis of the understanding of history, the real foundation of a social science like economics can be built up.
5. L.V. Stein, a distinguished contemporary thinker in Germany, combined Hegelian idealism with French philosophy to explore the possibility of a new approach to the study of economics.
6. Sismondi, another contemporary thinker, criticised the classical approach to economic analysis, particularly of Ricardo. He emphasised the need for historical study of facts and environments for the proper growth of economic science.
7. The contemporary economic problems in Germany could not be solved by the classical line of approach. New labour and industrial problems arose in Germany which could be tackled only by a new type of approach which found expression in the growth of historicism.

NOTES

The Historical School had its origin, on the one hand, in German Romanticism and, on the other, in the opposition to classicism. The former gives the school an anti-individualistic trend. The Historical School had a significant impact for almost 40 years. The school started its career with the publication of Roscher's Grundriss. The Historical School did not oppose the growth of capitalism, but it simply wanted to reform capitalism. The Historical School was not very opposed to classical political economy, but the younger generation of the historical school, particularly Schmoller, was vehemently opposed to the classical philosophy.

Historical School's Criticism against Classicism

The Historical School levelled the following charges against the classical economists:

- (i) The classical system of economy is too much individualistic. It is based on free individual choice, liberty, free trade and so on. It is not nationalistic. Nation is not given supreme importance in the classical system of analysis. Nation is secondary to personal freedom and will.
- (ii) The foundation of the traditional political economy is materialism. It is founded on the ideas of financial gain, the best possible return, and national prosperity. In essence, it is a system of national wealth.
- (iii) The laissez-faire system serves as the foundation for the classical system. The system forbids the government from playing a useful role. The role of government is reduced to the least intervention in economic, social and political matters. This is not justified according to the historical school. The government should take the lead in all endeavours, especially when it comes to economic development.
- (iv) The importance of institutions and the environment was also disregarded by the classical school. It goes without saying that they have a significant impact on both the lives of nations and individuals. The classical economists have made a serious mistake by neglecting the role of these very crucial factors.
- (v) According to the historical school, the classical law or theory is supposed to be universal or absolute in character. The classical economists like Adam Smith, Ricardo, and Malthus committed a terrible sin in this regard. The classicists believed that economic laws were operative everywhere and always. The historical school stressed the idea that no law is absolute or universal in character. Every law is subject to change in theory and practice. The character of law is only relative. The laws are provisional in the sense, that the economy is dynamic in character, and every time the progress of history gives rise to new facts, on the basis of which laws are to be modified. For example, free trade may be very good for some countries, but it is not good for all the countries for all the times. For the developing countries, protection may be a more desirable rule. Therefore, the laws are only conditional, based on certain assumptions and circumstances. The exact laws of physical sciences cannot be applied to a

NOTES

social science like economics. Moreover, the laws of physical sciences are also not absolute. They are also provisional and conditional. Alfred Marshall also pointed out that economic laws are only statements of tendencies. Knies clearly stated that economic laws are necessarily conditional.

However, it must be noted that the classical writers never strongly denied the relativity of their own generalisations and conclusions. Laws of distribution are artificial laws, according to J.S. Mill. Consequently, things are modifiable by humans in times of necessity.

- (vi) The classical economists treated human beings as self-interested entities. They were guided by the concept of homo-economicus or economic man. The classical concept of man was simply a man always after gain. The historians observe that a man is not simply a profit-maximiser. He has many other interests and motives, such as desire for glory, pleasure, sense of duty, love, pity, benevolence and so on. The historical school did not approve of the classical self-interested man. This crude psychological assumption about man was not accepted by the historical school. Schmoller raised objection against the classical self-interested man. According to Hildebrand, if the classical concept of man (Homo-economicus) is taken as the basis, the political economy could be a mere natural history of egoism.

However, it must be noted that J.S. Mill realised that self-interestedness is not the only motive of human beings. A man is governed, according to him, by other motives as well. Therefore, this criticism of the historical school is not wholly correct.

- (vii) The historical school contends that the classical school erroneously employed abstractions and deductions. The classical school's deductive or prior technique is completely unjustified. The historical school recommended using induction based on observations rather than deduction. The fundamental component of the historical school is the inductive technique of thinking. The historians emphasised that the classical school's use of deductive reasoning was grounded in empirically incorrect facts for its premises. Therefore, employing such an approach has the potential to cause more harm than good. According to Schmoller, "we may hope to build up an economic theory that shall fully account for the complexity of economic facts only through patient observation and rigorous induction." The historical school makes the point that the traditional approach is inadequate, incorrect, and hurried.

However, it has been pointed out by some authors that even the deductive method is useful. In this regard, Schmoller noted that both induction and deduction are essential for the advancement of knowledge. However, Pareto is of the opinion that discussion on method is purely a wastage of time. The aim of any science is to discover uniformities which can be done by following a suitable method of enquiry. It must also be noted

NOTES

that J.S. Mill spoke about the necessity of inductive or empirical studies in a science like economics. His principles on experimental verifications are well-known to students of logic and scientific method.

Positive Ideas of Historical School

The following are the major positive ideas of the historical school:

- (i) The classical economists analysed economic phenomena mechanically with the help of certain simplifying tools and assumptions. In this way, they reduced the complex phenomena into some simple generalisations. In other words, the classical economists used a simplifying procedure known as reductionism. The historical school, on the other hand, gave importance to environment.

The historians pointed out that a mechanical view of life is inadequate for analysing the complex socio-economic phenomena. Studying an individual as a social entity in relation to their environment and society is necessary which was entirely neglected by the classical school.

- (ii) The historical school noted that it is impossible to get a successful outcome without studying social organisations and institutions. The historians took into account society's natural order. They placed a strong emphasis on studying economic phenomena in relation to social facts. Such a line of approach was advised by A. Comte.
- (iii) The historians took a dynamic view of life and considered the economic system as dynamic in nature, which means a constant need to write and rewrite the political economy with reference to new facts and materials.
- (iv) The historical school clearly recognised the importance of the application of historical or inductive method in the analysis of economic phenomena. The school was of the opinion that without studying the facts of life, we cannot get any realistic picture. Abstract reasoning is useless. Only historical study can lead to important policy prescription.
- (v) The historical school placed great emphasis on the study of the past since it can offer valuable insight into current events. Hildebrand observed that human beings are the children of civilisation and are products of history. The historians emphasised on the importance of the study of the different stages of historical development of a nation so that every phenomenon can be explained with reference to the stage of the history. History should be regarded as the organ on of social science. Political economy was to be a single branch of the sociology that Comte wanted to build. The historical school shared this perspective on economics.
- (vi) The historians argued for the significance of the state in a country's economic activities. They did not favour the classical idea of laissez faire. According to historians, there can be no national growth without the assistance of the state.
- (vii) The historians supported the expansion of a nationalist economic system and a national development system, and not a simple general economic

system. This idea found its best expression in the writings of F. List. In a sense, the historians were nationalists of the first order.

- (viii) It was one of the essential features of historicism to advocate for a complete knowledge of history and historical sequences. According to the historians, without the knowledge of history, it is impossible to appreciate the socio-economic events and it is also impossible to find out the solution required. Knowledge of history is a thing of primary importance.
- (ix) All social aspects, including the geography, the social structure, the natural resources, the character of the people and so on are essential for a proper study of economic life of a nation in the context of the whole milieu. A thorough examination of the entire society is necessary for a complete knowledge of one facet of life.

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Critical Appraisal

The following points of criticism can be levelled against the historical school:

1. Historical study is not always very helpful. Historical study provides some descriptive facts. However, a science is necessarily explanatory rather than descriptive. Aristotle observed that there can be no science without generalisation. Historical studies cannot provide any explanation. Therefore, it is not a scientific method.
2. Historical method recommends the introduction of induction or empiricism. But successful empiricism must be based on some theory. Therefore, sometimes, it is pointed out that a correct method of analysis must take into account both deduction and induction, or what is known as logical positivism. Even Schmoller laid stress on the importance of deduction.
3. In fact, the historical explanations of many historical events may be correctly known. History itself requires explanation. It is a mistake to observe that history alone can provide explanation for every event.
4. Historical method is a partial method. There is a counterpart of it known as the deductive method. Just as the deductive method is not a complete method, so is the historical method.
5. The historical method put emphasis on the question of relativism. It said that everything is relative in character. It did not, however, challenge the legitimacy of the capitalist system. It did not say that capitalist system is a relative system and a passing phase.
6. The historical school's criticism against the classical system was too much exaggerated. In fact, some of the classical economists advocated government intervention, for the need of empirical study and also for the dynamic analysis of economic events. In this connection, the name of J.S. Mill is noteworthy.
7. The historical school could not find out any historical law of Development.

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Decline

Because of the above defects and criticisms of the historical school, many people did not take historismus as a complete substitute for the classical system. Nor was it taken as a superior school of analysis.

Menger an Austrian economist, vehemently criticised the historical school. This caused a severe damage to the reputation of the historical school. The school did not find any favour with French political economists. So, there was, in course of time, a decline of the historical school. In America, the historical school led to the development of *Institutionalism* under the leadership of Thorstein Veblen. The publication of Marshall's *Principles*, which provided a synthesis, brought about the complete eclipse of the *Historical School*.

Merits (Impact)

In spite of the above points of criticism, the merits of historical school can hardly be neglected. Historismus was clear enough in emphasising the importance of the study of historical facts or empiricism. It provided a realistic and dynamic approach to the study of economic problems. It also realised the importance of historical facts and institutions. The school was responsible for the refinement of many of the classical economic ideas. The historical school has shown the limitations of economic science by pointing out that its analysis is relevant with reference to only particular time and place. The school brought to the forefront the importance of relativism in the study of economic phenomena. Jevons clearly noted the importance of statistical verification for economic analysis. Marshall lauded the work of the historians. Keynes noted that political economy can be improved by studying economic history in particular. The historians encourage high-level historical studies in economics. According to Gide and Rist, the historical school has been instrumental in broadening the scope of economics.

Check Your Progress

23. According to the _____, the classical law or theory is supposed to be universal or absolute in character.
24. The Historical School was very influential for nearly _____ years.
25. Theoretical economics had never become firmly established in _____.

2.11 SENIOR'S

Some of the Senior's or founders of Historical School

Karl Gustav Knies, Bruno Hildebrand, and William Roscher are known for founding the old historical school. Gustav Schmoller is the young historical school's most significant representative. Let us discuss their contributions very briefly.

2.11.1 William Roscher (1817-1894)

For his *Principles of Political Economy*, Roscher is well known. In actuality, he is the institution's creator. Outline of Lectures on Political Science According to

NOTES

the Historical Method, another book he wrote, was also published. Roscher regarded historical study as the foundation of any analytical study. In his Outline, he has stated the principles of historical method and has recommended the introduction of historical method in economic investigation. According to him, the classical method was abstract and hence is useless. He wanted to investigate into the laws and the characters of various economic institutions. He referred to his method as the Physiological or Historical Method. According to him, the historical method was more scientific and practical. He suggested the importance of both historical data for the analysis of the economy and of the institutions.

Roscher introduced the importance of acknowledging the relative nature of economic theories and laws. Political economy is really a relative science. He also observed that institutions are partly good and partly bad. Economic relations between individuals reflect a social and cultural evolution. In fact, the state is not just the sum total of its members. It is more than that. Roscher was of the opinion that for establishing an economic truth, more and more historical data should be studied. The historical method attempts to combine organic, statistical and biological analyses to discover certain laws. These laws are relative in character. It should be noted that Roscher was not an extreme historicist. He did not totally reject Ricardian economics.

Roscher was not willing to consider economics as simply a set of normative principles. He did not favour normative analysis of economics. He considered economics with various social configurations. He was in search of laws of socio-economic development. He argued that "Once the natural laws of Political Economy are sufficiently known and recognised, all that is needed, in any given instance, is more exact and reliable statistics of the facts involved to reconcile all party controversies on questions of the politics of public economy."

Roscher thought that economics cannot be meaningfully separated from other disciplines and phenomena. Roscher used in his study many historical and statistical data. However, in spite of all this, he was unable to codify a historical development law. He failed to change the direction of economic analysis.

2.11.2 Bruno Hildebrand (1812-1878)

In 1848, Hildebrand published his book, National Economy of the Present and Future. In this book, Hildebrand challenged the claim of classical economists thought they had discovered universally applicable natural economic laws for all eras and nations. He separated theoretical analysis from practical economic questions. He laid more emphasis on theoretical analysis. Hildebrand did not believe in the existence of natural laws of any type which could be made universally applicable. He did not also believe in the harmony of class interests, which the classical economists had postulated. He did not accept many of the classical propositions. He criticised the classical proposition that man is the end object of political economy. Hildebrand did not believe in the cosmopolitan nature of economic laws. He was of the opinion that knowledge of history will not only be

NOTES

helpful for the growth of economic science but it also helps to recreate it along more scientific and realistic lines.

Hildebrand proposed a stage theory of development based on historical evolution. According to him, the evolution of the economy would be through different stages of history, such as, means of exchange, money stage, credit stage, and so on. The credit stage would be the final stage of economic evolution. He was interested in finding out the basis of economic civilisation of different nations. He was primarily interested in finding out the historical law of development. But unfortunately, he could not find out any such law till the end of his life.

Hildebrand observed that the goal of political economy is to create a path for a historical perspective and to turn the discipline's science into a set of ideas which will be mainly concerned with the development of national economy. Hildebrand rejected the classical notion of atomistic society. He also could not agree with the classical materialistic view of life and society. According to him, political economy has to be based on the welfare of the people and of the state. He clearly indicated the use of historical method. Hildebrand was interested in the application of statistics for economic analysis and research. This itself was a distinct contribution.

2.11.3 Karl Gustav Knies (1821-1898)

The third person to join the German historical school was Knies. He wrote a book titled *Political Economy from the Historical Method* (1853). He also wrote a book on *Gold and Credit*. His work on *Gold and Credit* is an outstanding contribution to the theory of money, banking and currency. Knies was a vehement but systematic critic of the classical school. According to him, Roscher was not a systematic and clear critic of the classical school. He chided Roscher for approving the classical method of analysis. He observed that Hildebrand also could not perfectly realise the mission of Historismus. According to Knies, Hildebrand's law of development was a concession towards a pure theory. Knies believes that historical studies are the basis of economic analysis, and that the economic system passes through a number of different phases which are dependent on the stage of civilisation. No economic system can be regarded as the final and as the last one.

According to Knies, there is nothing like economic laws. Every economic aspect must be examined with reference to history. Economic generalisations are never universally valid. They are simply relative in character. He rejected the cosmopolitan view of economic laws. Knies criticised Hildebrand and Roscher for their failures. But all these writers agree to the fact that historical studies are the only legitimate basis for economic analysis. He paid a good deal of attention to the development of analytical method in economics. He never advocated the use of a partial method of analysis. He was well aware of the difference between economic history and political economy.

2.11.4 Gustav Schmoller (1830-1917)

Gustav Schmoller was the founder of the younger historical school of Germany. His book *Outline of General Economic Theory* (1900-1904) contained

NOTES

the most outstanding contribution of Schmoller towards the development of the young historical school. He presented a dynamic view of economic life. He was also interested in the theoretical analysis of economic problems, and offered solutions to these problems. He analysed the historical evolution of various economic institutions. In his analysis of economic problems, he profusely used statistical analysis.

The most important contribution of Schmoller was his ideas on the use of methodology. Unlike the members of the German historical school, Schmoller was in favour of using both deductive and inductive methods of analysis. He said: "Induction and deduction are both necessary for the science just as the right and left foot are both needed for walking". The same view was also later on accepted by Marshall. The new historical school concentrated more on the practical problems.

Schmoller had the ambition to develop economic science through historical and descriptive facts. He was a very liberal member of the historical school. Schmoller believed in the existence of economic laws. He was very critical of the laws of development propounded by Hildebrand. According to him, it is very necessary to make economics more pragmatic for national policy and development. In his Grundriss (Outline...), he dealt with a number of topics on economic problems.

Schmoller observed that all received economic theories, like Ricardian theories, are not only useless but also pernicious. Schumpeter noted that Schmollerian economics was essentially a historical sociology. Schmoller made an attempt to study economics in its organic perspective. But Schmoller's search for the laws regulating the economic organism failed. Since the time of Schmoller, the German historical school began to slowly disintegrate, partly due to the induction of inferior members and partly due to its bias in favour of an incomplete methodology, namely, deduction. As pointed out earlier, the German historical school was eclipsed by the rise of the Neo-classical school.

Check Your Progress

26. Roscher introduced the importance of acknowledging the relative nature of _____ and laws.
27. Hildebrand rejected the _____ of atomistic society.
28. According to Knies, there is nothing like _____ laws.
29. The most important contribution of Schmoller was his ideas on the use of _____.

2.12 FRIEDRICH LIST (1789-1846)

List is considered as the father of American Protectionism. The ideas of List were influenced by the backward economic conditions of Germany, when List was writing. List had, at the beginning, a liberal view about foreign trade. But this view was subsequently changed. List wrote a very fascinating book, *The National System of Political Economy*. List's economic ideas are the best examples of

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relativist analysis. His ideas on theories were the product of circumstances prevailing in the then Germany. By 1830, the German states were asking for economic unity and uniform tariffs. In fact, Germany was passing through a stagnant industrial period. This situation compelled List to take interest in the study of the relevance of free trade.

List was strongly opposed to the cosmopolitan and absolutist notions of classical political economy. List argued that the principles of classical political economy are not applicable to all countries under all circumstances. By contrast, the principles introduced by List were strongly nationalistic and historical. He examined the classical principle with reference to the German economy, and came to the conclusion that classical economics was not applicable to Germany.

Theory of Nationality

List gave importance to the necessity of study of every nation very carefully. He said that every nation is a different world with its own problems, possibilities and prospects. Every guy is a part of a nation, and the political clout of that nation greatly affects his prosperity as a person. Nations are of unequal strength. Every nation must pass through several stages of growth.

Ultimately, it will come to a stage when it will get independence and become a strong power. List favoured economic nationalism for every nation. Thus, the political economy of every nation is different from that of every other. The national economy of every state shows the path along with its economy can grow, attain its economic culture and can freely mix up with the other independent nations of the world. In finding out this path of development, a nation cannot segregate economics from politics. He did not approve of laissez faire or non-intervention by the government. He supported the view that the government needs to take the lead in promoting the nation's economic growth. The administration must understand how to boost, safeguard, and retain a country's productive power. List subordinated economics to politics in general. The government must know the economic effects of every political change in the country. List argued that in a country like Germany of that time, free trade which displaced population and domestic industry was undesirable. List was in favour of sacrificing the present for the future. The ultimate goal of economic activity, in List's opinion, is the growth of economic power and the nation as a whole. In this process, industry becomes a very potent force. He said that industry is a social force which can itself create and improve labour and capital. In addition to improving the present, industry can also give a direction for the future development of a nation. Thus, List recommended the introduction of industrialisation even at the temporary loss.

Theory of Productive Power

List advocated the creation of potential productive power. He said that the potential productive power is more important than the present productive power. He said that the nation's growth depends on the potential productive power. List did not accept the labour theory of valuation. He said it is simply a shopkeeper's theory. He is of the opinion that every change in the government action influences

NOTES

the productive power of the nation. In this connection, as already pointed out, List observed that the present temporary gain may be sacrificed for the greater future gain. Not riches but productive ability is the most important economic factor in the development process. In the words of List: "The power of producing wealth is... infinitely more important than the wealth itself." List speaks of properly utilising the economic resources for the future development of a nation. In this connection, List justifies protection to the developing or infant industries. He criticises the classical notion of capital accumulation by saying that the accumulation of exchange value is not at all important. In this connection, List says that it is necessary to properly maintain the economic, political and moral institutions of a nation. However, the best productive power of a nation is its manufacturing industries. Therefore, it must be noted that a nation should develop, first of all, its manufacturing sector. Compared to agriculture, manufacturing enables a better use of a nation's product. He is of the opinion that tariff can be utilised as an instrument of industrial development.

Stages of Economic Development

Before reaching maturity, an economy must go through the five stages of development listed below, according to List. These stages are: (1) barbaric, (2) pastoral, (3) agricultural, (4) agricultural-manufacturing, and (5) agricultural-manufacturing-commercial.

List found that in the case of first three stages, free trade between the nations will be very helpful, however, governments must provide protection to economies in between the last two phases of development until the last level of development is reached. Similarly, at the final stage of development, free trade can be helpful. In fact, in such a situation, free trade will guard against retrogression and indolence of the manufacturing industries. List stated that there is no justification for international competitiveness until all nations have achieved the full stage of development, because the nations will be on an unequal footing. Therefore, any exchange before the attainment of the final mature stage, will be an unequal exchange. In this connection, he favoured the imposition of protection on the underdeveloped German industries because at the same time the German economy could not attain the final stage of economic development.

In the beginning, List supported free trade as a means of advancing agriculture. In the second stage, the nation should develop manufacturing industries. Foreign trade should be developed in the third stage and protection measures may be adopted in the fourth stage. Unrestricted competition can be allowed between nations only in the fifth stage of development.

Protectionism

It must be noted that List was not out and out a protectionist. He believed that only during certain pivotal times in a nation's development history was protection justified. He, however, supported the view that for the growth of infant industries, it is necessary to protect these industries. List was neither a protectionist nor a free trader. He was a supporter of both. He observed that each policy must be

NOTES

considered against the economic situation of a nation. The following are the important features of List's theory of protection: (i) Protection can be granted for giving industrial education and for attaining industrial independence. (ii) No protection should be given to agriculture because it will lead to higher food prices and higher cost of living. (iii) Equal protection should not be granted to all types of industries. (iv) Protection should be granted to the infant industries. (v) Protection is desirable for those industries which are facing foreign competition. (vi) Protection should not be granted to the developed industries.

Evaluation

List adopted in his analysis the method of historical comparison. He has shown the importance of the relativist economic analysis. He has also given a number of valid points against the economic orthodoxy of classical liberalism. He has provided the necessary springboard for the German Historical School. In an important sense, List may be considered as the real forerunner of this school.

Check Your Progress

30. List favoured economic _____ for every nation
31. List speaks of properly utilising the _____ for the future development of a nation.
32. List was in favour of free trade in the first stage for the promotion of _____.

2.13 ANSWERS TO 'CHECK YOUR PROGRESS'

1. Adam Smith
2. Economic progress
3. Power of thinking
4. Ricardo's
5. Abstraction
6. Population.
7. Pessimist
8. Value
9. Anti-capitalism
10. Revolutionary Romanticism
11. Economist
12. Competition
13. Overproduction
14. Flavour
15. Production
16. Invested
17. Utility

18. Equality
19. Supply of money
20. Political Economy
21. Stationary state
22. Deficient
23. Historical school
24. Forty
25. Germany
26. Economic theories
27. Classical notion
28. Economic
29. Methodology
30. Nationalism
31. Economic resources
32. Agriculture

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2.14 SUMMARY

Adam Smith is regarded as the father of economic science. The greatness of Adam Smith lies in his effort to systematically and analytically present the facts of economics. He introduced economics as a separate discipline. 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.

Smith believed that the interests of various economic entities could not conflict given the natural order. Their objectives must be in sync. This is ensured by the operation of the Invisible Hand or automated adjustment mechanism.

Adam Smith claimed that the division of labour was essentially the only driver of economic development. Division of labour is a system of social cooperation in the production process where every individual is given a job according to his specialisation. Adam Smith has very elaborately discussed the division of labour in his *Wealth of Nations*. He says that labour is the true source of wealth. This is the reason why he placed the discussion on labour at the outset of his book. Labour is the cause of wealth and production. This is the main philosophy of *Wealth of Nations*. Labourers enter into social cooperation for production, and the national dividend is the result of these people's collective efforts. The division of labour enables the coordinated efforts required for the manufacture of numerous goods that will satisfy everyone.

Ricardian economics, as Schumpeter observes, is 'difficult to understand, more difficult to interpret and most difficult to make an appraisal'. Ricardo was a bird with a different plume. He was a formidable logician and a terribly abstract

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writer. His *Principles of Political Economy and Taxation* (1817) is written in such an abstract style that on first reading, one cannot feel that the book contains anything understandable. The *Principles of Political Economy and Taxation* is his best known work. Ricardo developed a system of analysis based on abstraction.

Ricardo had a strong analytical mind and logically sound power of thinking. Ricardo built up, so to say, an engine of analysis. Ricardo's appeal, according to Blaug, was founded on his ability to address a variety of complex problems utilising a straightforward analytical model with just a few key strategic considerations, producing stunning, undeniably useful conclusions. The appeal of Ricardo was both theoretical and realistic. He not only offered theory to analyse issues, but he also offered workable, real-world remedies. He is still honoured as a great theoretician.

Say's Law of the Market was added to Ricardo's classical Smithian analysis of machinery in order to demonstrate the impossibility of technical unemployment. In his *Principles of Political Economy and Taxation*, first and second editions. The impact of machinery in lowering prices was highlighted by Ricardo. He observed that machinery benefits all classes of people, including producers and consumers.

Machinery increases per capita output by promoting more and more division of labour. It also moderates the effects of diminishing returns on land. Machinery can lead to a number of advantages such as increased profit, increased size of the wage fund and a higher wage level for the workers.

Pre-Malthusian population theory lacked organisation. The first economist to put forth a thorough population theory was Thomas Malthus. Thomas Robert Malthus wrote on population in his well-known book *Essay on the Principle of Population as it Affects the Future Improvement of Society*. He had a conversation with his father about this book, and his father supported his buddy Godwin's utopian concept.

Malthus propounded the theory of glut or overproduction as the basis of his analysis of the capitalist economy. He pointed out that in a capital economy effective demand can never be sufficient to clear the supply. Malthus wanted to demonstrate, not the possibility of temporary overproduction, but the permanent overproduction possibility of all commodities. Malthus's basic argument was that without exogenous spending by unproductive consumers, the process of capital accumulation would lead to secular stagnation.

Malthus took the issue with Ricardo and the result is the famous controversy between these two stalwarts of economics on the problem of glut. Ricardo and J.B. Say pointed out that general overproduction is impossible. Ricardo's conviction was based on Say's law of market which says that "supply creates its own demand." As soon as there is supply, it is demanded. Thus, Say's law of market assumes away general overproduction. Every demand has a corresponding supply.

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2.15 KEY TERMS

- **Endogenous:** having an internal cause or origin.
- **Aggravates:** make (a problem, injury, or offence) worse or more serious.
- **Laissez faire:** the practise of not meddling and allowing things to go their own way.
- **Dichotomy:** two things that are or are shown as being opposing or completely distinct are divided or contrasted.
- **Historismus:** German word for historism (is a philosophical and historiographical theory).
- **Historical School:** Historical School is a reaction against the classical school of economic thought.

2.16 SELF-ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Discuss Adam Smith's "division of labour".
2. Explain the theory of rent.
3. Discuss Sismondi's Economic thoughts.
4. Discuss economic ideas of J. B. Say.
5. Discuss J. S. Mill's Economic thoughts.
6. Write the statement of Mill's view.
7. List the stages of economic development.
8. Write the important features of lists theory of protection.

Long Answer Questions

1. Explain in details the Classical period of Economics.
2. Discuss the theory of value written by Adam Smith.
3. Explain capital accumulation distribution.
4. Discuss David Ricardo's-value.
5. Discuss "Distribution Theory".
6. Explain Thomas R. Mathus' "theory of population".
7. Explain Kari Marx's dynamics of social charge.
8. Write about the Marx & Engel's Romanticism.
9. Write in short the rise of Historical School.

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Unit III Marginalists

Learning Objectives:

By the end of this unit the learners would be able to:

- Understand Marginalism.
- Explain the work of Marginalist Revolution.
- Elucidate the work on rate of interest by Wicksteed and Weiser.
- Analyse distribution theory of Marshall and Pigou welfare economics.

Structure:

- 3.1 Introduction
- 3.2 The Precursors of Marginalism
 - 3.2.1 Cournot
 - 3.2.2 Thunen
 - 3.2.3 Gossen
- 3.3 The Marginalist Revolution
 - 3.3.1 Jevons
 - 3.3.2 Walras
 - 3.3.3 Menger
 - 3.3.4 Bohm-Bawerk
 - 3.3.5 Wicksell
 - 3.3.6 Fisher
- 3.4 The Rate of Interest
 - 3.4.1 Wicksteed and Weiser
- 3.5 Distribution – Marshall as a Great Synthesizer
- 3.6 Pigou: Welfare Economics
- 3.7 Schumpeter: Role of Entrepreneur and Innovations
- 3.8 Answers to “Check Your Progress”
- 3.9 Summary
- 3.10 Key Terms
- 3.11 Self-Assessment Questions and Exercises
- 3.12 References

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3.1 INTRODUCTION

A theory of economics called marginalism makes use of the marginal utility of products and services to try and explain why their values differ from one another. The idea of a constraint is similar to that of a boundary or margin. Any individual's margin is situated according to their endowment, which is generally defined to include opportunities. This endowment is governed by a variety of factors, such as physical laws (which limit the types of energy and matter that can be changed), natural occurrences (which dictate the presence of natural resources), and the results of previous actions made by the individual and by others. A marginal value is a value that remains true in the presence of specific restrictions. For instance, the price of diamonds is higher than the price of water because gems provide more added satisfaction than water.

The utility of a good or service's marginal use is known as its marginal utility. According to the presumption of economic rationality, its utility comes from the finest possible sequence of acts in which its use is incorporated and is least urgent.

The term "utility" has come to be officially defined in 20th-century mainstream economics as a quantification that captures preferences by allocating bigger amounts to states, goods, services, or applications that are of higher priority. But before this rule in economics was established, there was marginalism and the idea of marginal utility. The concept of use or usefulness, which is more broadly understood, is at the core of marginalism. The term "marginal utility" was coined from the translation of the German "Grenznutzen," which literally translates to "border use" and refers to the marginal use, and more general formulations of marginal utility do not treat quantification as a necessary component. However, none of the early marginalists argued that utility was not measured; some did treat quantification as a necessary component, and even those who did not did so when writing explanatory essays. Given this situation, it is not surprising to see a lot of presentations that do not take a more comprehensive approach.

3.2 THE PRECURSORS OF MARGINALISM

Despite having numerous forerunners, several economists used marginalism to develop a theory of value and a theory of wealth in the late nineteenth century, Marginal Utility. Here are some economics explained below - Cournot, Thunen, Gossen.

3.2.1 Cournot

Cournot was a mathematical economist. He interpreted economics in his own original way. He wrote a number of books including *Researches into the Mathematical Principles of the Theory of Wealth* (1838), *Principles of the Theory of Wealth* (1863), and *Review Summary of Economic Doctrines* (1876). He also written a lot about political economy theory.

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Economic Theory

Cournot explained the importance of mathematics in the analysis of economics. He examines meticulously the theory of price. According to him, demand for an article varies with its price, but demand, supply and price are all interrelated variables. He analysed the theory of demand. He was responsible for the introduction of demand curve in economic analysis. He said that the relationship between demand and price is $D = f(P)$. The quantity requested depends on a number of factors, including wealth, income, and so forth. But these are assumed as constant at the time of drawing the individual demand curve for a commodity. Cournot, however, noted that if any one of the above variables changes, the demand for the commodity ultimately changes. Cournot recognised the value of making the assumption that other things will remain the same (*ceteris paribus*). His law of demand is similar to the modern conceptions of the demand function.

Cournot gave much importance to empirical analysis based on observations of facts. Cournot rejected utility as the foundation of the demand analysis presented by him. He observed that sales or demands increase when price decreases. He was concerned with the average annual price. Cournot explained the theoretical foundation of negatively-sloped demand function.

Monopoly

Cournot explained the profit-maximising behaviour of monopolists with reference to his classic example of the proprietor of a mineral spring. Cournot demonstrated that a monopolist does not necessarily charge the highest price, although he can get it. A monopolist generally adjusts his price so as to maximise his net income. In the case of zero cost, the monopolist will maximise his gross income. When the marginal cost doubles the marginal revenue, something happens. In the case of zero cost, a maximum occurs when marginal revenue equals zero. Cournot's analysis of monopoly can be explained with the help of the following figure.

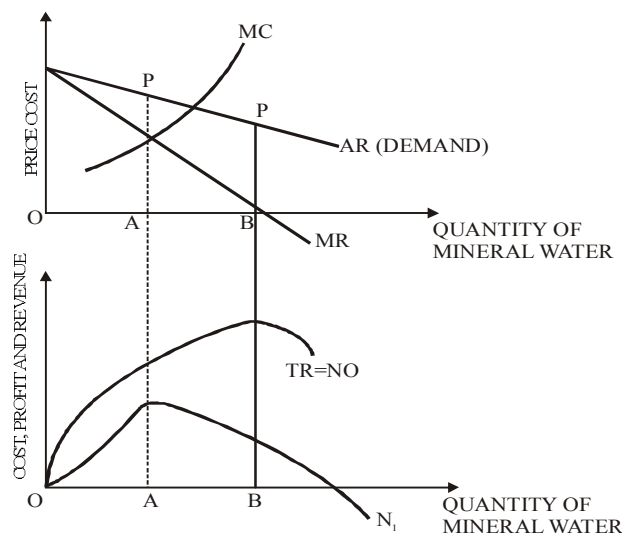


Fig. 3.1

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As shown in the figure, the owner of the mineral water having zero cost will adjust the sale of mineral water in such a way that he is able to sell OB amount at BP price. At this quantity, the marginal revenue is equal to marginal cost, i.e., $MR = MC = \text{zero}$. As shown in the figure in the case of zero cost, the total revenue curve (TR) becomes the profit function. Cournot established that profit will be maximum at a point where $MR = MC$, and this point of output is OA and price will be AP. It is to be noted that in this case of positive cost, Compared to the situation of zero cost, the output would be lower and the price would be greater. The mineral spring is run to maximise net yields at OA rather than to maximise gross returns at OB. Needless to say, Cournot's work on monopoly is well-comparable with any one of the modern works in the same subject.

Duopoly Model

Cournot is very famous for his duopoly analysis. His theory of duopoly is based on the assumptions that buyers quote prices and sellers merely adjust their output to those prices. Every duopolist calculates the demand function for the product and then sets the quantity sold. In this process, he assumes that his rival's output remains unchanged. In this situation, it is possible to have a determinate solution. Cournot's solution is given in the figure below.

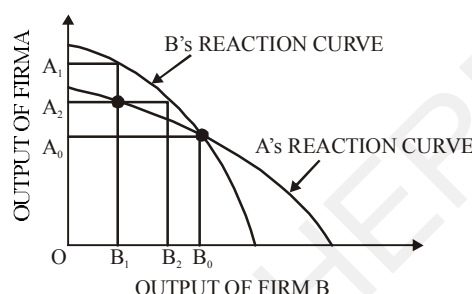


Fig. 3.2

In this figure, Cournot has introduced the reaction curves. Every reaction curve shows the optimum output of one duopolistic as a function of the output of the second one. It should be noted that in a duopoly, there are two vendors, A and B, aware of the aggregate demand curve for their completely homogeneous product. Cournot takes the case of mineral water. In order to analyse the duopoly problem, Cournot developed a new tool of graphical analysis known as reaction curve. As per the figure, A is producing A_1 and B is producing B_1 , whereupon, A will produce A_2 and B will produce B_2 and so on. The output will tend to have equilibrium values, A_0 and B_0 . The point of equilibrium would be P. At this point, the duopolists will share the profits and set a common price that is higher than the price in a totally competitive market but lower than the price charged by a simple monopolist. According to Cournot, the output under duopoly will be two-thirds of the output produced under perfect competition. In fact, output can be determined by the formula: $\frac{n}{n+1}$ (where n is the number of producers). Thus, if the number of producers is 2, the output would be $\frac{2}{3}$ times of the competitive output. If there are five producers, the quantity of output to be produced would be $\frac{5}{6}$ times the competitive output. Cournot pointed out that if there is collusion between the two

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duopolists, the result would be a monopoly. This will have its effect on output and price.

Evaluation

Cournot was an original writer. He provided many theoretical innovations in his analysis of economic problems. He analysed many important problems in economics such as a discussion on stability conditions of various economic equilibrium, composite and derived demand and also a clear statement of the simple competitive model. However, of all these, Cournot's reputation lies in his analysis of monopoly and duopoly. But, subsequently many of the assumptions of Cournot were changed by later theorists like Edgeworth and Bertrand. Bertrand criticised Cournot's solution of duopoly, and suggested that it is reasonable to believe that sellers decide on prices, and that each seller bases his own price on that of his competitors. He found that this is more realistic than the output setting behaviour of the duopolist. Similarly, Edgeworth modified Cournot's analysis of monopoly and introduced uncertainty of mutual reactions.

Be that as it may, many of the important developments in the areas of monopoly and duopoly in our times are explained with reference to the solution already attempted by Cournot. His simple model till now stimulates many ideas on similar problems in economics. He had a grand insight into economic theories. He was, moreover, equipped with the necessary tool kit of analysis of explaining the economic problems on empirical foundation. However, unfortunately, economic historians could not properly appreciate the contributions of Cournot.

3.2.2 Thunen

Yon Thunen was a German agriculturist. However, he contributed to the development of many aspects of economic science. Thunen was a practical man but he was interested in the development of theoretical economics. His most famous book is *The Isolated State*. He is credited with a number of original contributions and insights. He has developed the concepts of rent, theory of distribution, diminishing returns and so on. His contribution to the theory of location is a pioneering one. He has also developed marginal analysis in a very systematic way.

Method of Analysis

He was aware of how theory and facts should interact. For any scientific inquiry, this is crucial. Thunen analysed using the conventional abstract approach. The method of analysis is deductive in nature. However, he also experimented with the empirical method of study which is evident in his study of location problem. Thunen also utilised what is called the marginal analysis in the development of price and distribution theories. He has used the method of imputation in order to find out the contribution of a factor of production.

Value Analysis

Thunen may be placed under the category of utility theorists. This is because: (i) he attempted to establish his theory of distribution using this market price, taking its existence for granted; (ii) his work on distribution theory is more or less

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in line with that of utility theorists who have done comparable work. In the determination of price, Thunen has emphasised demand and supply. He has tried to explain in this way the equilibrium price. Thunen has distinguished between two types of prices — market price and average price. According to him, the market price seldom equates with the average price. The market price hovers around the average price. He explained the determination of the average price from the long-run point of view. His concept of average price seems to be the same as the classical natural price. Thunen notes that the cost of production must be covered by the price. Price, according to Thunen, should be equal to the marginal cost of the amount required by the society. In his analysis, there is an adjustment process through which the market price becomes equated with the marginal cost.

Theory of Location

Von Thunen considered an imaginary state, circular in geographical form, with a city at the centre. In such a state, all lands are of equal fertility and all labourers are equally productive. Under this situation, it is possible to find out the area of cultivation of each crop and commodity. According to Thunen, locational factor is very important for the analysis of rent and price. He considered the best system of land use. The father of economic location theory is credited to Von Thunen. The pattern of land use has been described by him with reference to a series of concentric circles. The important factor in the analysis of land use pattern is the distance from the main city where all goods and services are sold. The land rents and transport costs are the main considerations in the locational decision. Thunen shows that it is better to produce the delicate, perishable and short-lived products near the city. These commodities are fresh vegetables, milk and so on. He has considered the entire problem in terms of transport cost. Since the rent is relatively high in the nearest area of the town, any crop which requires a large amount of labour cannot be produced there. As one goes further away from the city, the land rent goes on declining but the transport cost increases. According to Thunen, the successive regions of land are devoted first to forestry, then crop rotation, then grains, and stock farming respectively.

Thunen was more concerned with the unit of land rather than the unit of product. Suppose, that a given area is designated for wheat production. What should be the boundary beyond which production cannot be economically profitable? Thunen says that the boundary will be at a distance from the city where the net return to the farmer is zero. The least-expensive position for each crop within the isolated state is determined by Thunen's location model, although the methodology can be generalised to more than two crops and for the industrial sector as well. He was the first economist to study the influence of distance on the economies of agriculture.

Distribution Theory

Von Thunen is well-known for his marginal principle-based examination of distribution theory. According to him, a worker's pay should be the same as the value of their marginal product. The same idea applies to other manufacturing factors as well. Thunen has based his analysis on the law of diminishing returns and

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on the marginal analysis of distribution. He said that employment can be extended up to that point (ON) where the marginal productivity of labour becomes equal to the wage level, as shown in following diagram.

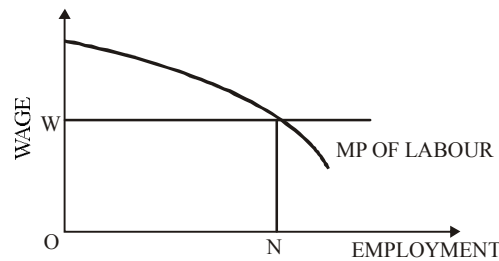


Fig. 3.3

Von Thunen was really worried about the bad economic conditions of the workers. He was in favour of giving more to the workers. His concept of natural wage includes the subsistence plus some amount which is required for maintaining and increasing the efficiency of workers. He was the first economist to view wages as something more than the mere subsistence. He analysed the marginal productivity theory of distribution. He has calculated the natural wage (N_w) as $N_w = \sqrt{AP}$, where A is the subsistence cost, and P is the productivity of labour. He observes that wages of workers remain low because the capital gets more than what it should get from the total production. He took into account two different categories of labourers, one generating capital products and the other creating consumables. He concludes that through competition, wages in these two types of professions will get equalised.

According to Von Thunen, rent is a sort of surplus. Rent is that portion of landlord's income which exists after the payment of interest. As is shown earlier, in the determination of rent, locational factors become very important in the analysis of Thunen. "The price of corn must be so high that the rent of that 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". A very crucial factor determining rent is the distance. Unlike Ricardo, Thunen has given more importance to the situation of land rather than to fertility. In his analysis, rent is not a fixed amount; it changes depending on the price level and interest rate.

Thunen applied the marginal principle in the determination of interest, i.e., interest would be calculated as the value of capital's marginal production. He did, however, recognise that capital's marginal productivity is diminishing, suggesting a further fall in the interest rate. As a result, interest is decided by capital's marginal productivity. In fact, he was the first economist to apply the rule of diminishing returns to all production inputs.

State and Trade

Initially, Thunen was the supporter of free trade, but subsequently he changed his idea when he observed that free trade is not an absolute good. He said that under some circumstances, protection may be necessary for the growth of national industries. He suggested increasing role of state for introducing a number of

necessary social reforms which are necessary for the economic progress of a nation. He said that regarding trade, both the national and the cosmopolitan views are valid in economics and that there is no contradiction between these two views.

Evaluation

It is possible to consider Von Thunen to be one of the true pioneers of marginal analysis. He came to understand that equal distribution of resources is the best way to maximise the overall product. He was also the first economist to have worked out a scheme of natural wage and to have realised the importance of giving the workers a wage higher than the subsistence cost. He was also one of the first to introduce calculus in analysing economic problems. Mark Blaug has rightly called him the “first truly modern economist”.

3.2.3 Gossen

Gossen's Contribution to Economics

Gossen's contribution to the creation of the marginal utility doctrine will ensure his place in the annals of economic philosophy. He developed the marginalist doctrine in his book, *Development of the Laws of Exchange among Men* (1854). It is said that his contribution is well-comparable with the contribution of Copernicus. According to Gossen, there exists some confusion in economic theory owing to the lack of mathematical treatment. If mathematics is not introduced in economics, the analysis cannot be complete and precise. Therefore, he suggested the mathematical interpretation of economic analysis. Even more, he emphasised that while it is impossible to quantify satisfaction in absolute terms, comparisons can always be drawn using geometrical concepts. His book makes an effort to explain economics using mathematical principles. The result of twenty years of study and contemplation is Gossen's book.

A utilitarian philosopher, Gossen. He says that every man should strive to maximise his level of satisfaction in life. On the basis of satisfaction and utility, Gossen has formulated the following three principles or laws:

1. As a consumer increases their use of a given good or service, the marginal utility they obtain from that consumption continues to decline. This process goes on, till the relevant want is completely satisfied and the point of satiety is reached. This is the first law of Gossen, which can be regarded as the law of diminishing marginal utility.
2. Gossen states that when a consumer is to consume different goods, then he equates their marginal utilities in order to derive maximum satisfaction from the total consumption.

Thus, if he consumes three goods (x, y and z), he will compare the marginal utility of these products minus their individual costs.

$$\frac{MU_X}{P_X} = \frac{MU_Y}{P_Y} = \frac{MU_Z}{P_Z}$$

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This is the second law of Gossen. In modern times, this law is known as the Law of *Equi-marginal Utility*. Obviously, this law applies to a situation where the consumer is not able to satisfy all his wants at a time completely.

3. Gossen's third law follows from the above two laws. Since the marginal utility of a good diminishes with its stock, the good will have positive marginal utility only so long as its supply falls short of its demand. The marginal utility of the good will decrease to zero if the supply can fully fulfil consumer demand.

These laws are based on assumption of rationality on the part of consumers. Additionally, it is predicated on the idea that every consumer wants to maximise their enjoyment and minimise their usefulness (or pain).

According to Gossen, an object's value is inversely proportional to how well it can satiate human desires. On the basis of this, Gossen has divided commodities into the following three types:

- (i) There are goods which have all the properties of satisfying wants. These commodities are called 'consumer goods'.
- (ii) There are some commodities which cannot alone satisfy completely the needs of the consumers. These commodities are called 'complementary goods'.
- (iii) Some items, such as land and machinery, have an indirect value because they can be used to manufacture items from the other two types. These items are referred to as "producers' goods."

Gossen has also, in this connection, developed his *Theory of Imputation*.

According to Gossen, goods which can satisfy only one type of want have limited consumption and use. Regarding the contribution of cost, According to Gossen, various things need varying amounts of labour (disutility) to produce them. He asserts that when the quantity AB is produced, a commodity's value reaches its peak, i.e., when production is continued up to the point which equalises disutility (difficulty) and the utility (value). This is shown in the following diagram.

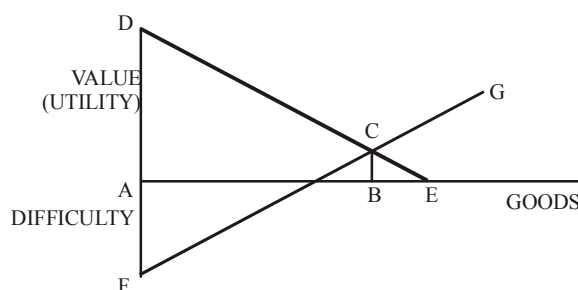


Fig. 3.4

Men must invest their time and energy in such a way that the final unit of any given satisfaction is equal to the amount of disutility that will be caused if that unit

is produced in the final instant of effort in order to experience the greatest degree of satisfaction (i.e., at the margin of disutility).

Gossen has always distinguished *needs* from *luxury* or *pleasure*. The meanings of these concepts are self-explanatory.

However, Gossen has emphasised the subjective aspects of value. His division of products into many kinds is suggestive of Menger's study. Gossen's theory of value remained, in a sense, incomplete. Gossen gave more importance to utility rather than to the cost of production. Cost of production was looked upon as a form of disutility. He linked the marginal disutility of a good's creation with its marginal utility, or value. However, Gossen's analysis of marginal utility is very precise and complete. But the chief criticism levelled against Gossen is that his analysis lacks elegance and clarity in exposition. Many of the most recent advancements in economic theory were foreshadowed by Gossen. He created the subjective aspect of value and invented the notion of value's marginal usefulness. Jevons drew most of his inspiration from the writings of Hermann Heinrich Gossen. In fact, Jevons' theory of value is based on Gossen's ideas on utility.

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Check Your Progress

1. Cournot explained the importance of _____ in the analysis of economics.
2. Gossen is a _____ philosopher.
3. According to Von Thunen, rent is a sort of _____.

3.3 THE MARGINALIST REVOLUTION

The Marginalist Revolution, or marginalist theory, is thought to mark the boundary between traditional and contemporary economics. Here are some of the marginalist revolutionaries' contribution to economic thought.

3.3.1 Jevons

Jevons's Contribution to Economic Analysis

It is believed that the marginalist revolution, also known as marginalist theory, marks the division between conventional and modern economics. According to him, economic laws can be reduced to certain basic mathematical principles and these principles can be derived from human actions. Jevons argued that utility alone determines value. An object's ability to bring joy and alleviate suffering is known as its utility. He has made a distinction between utility overall and utility to the last degree. His ultimate level of utility can be characterised as minimal. He asserts that as the quantity of an item increases, the final degree of utility diminishes. According to Jevons, value is equal to the final degree of utility. Total utility never interested Jevons. To Jevons, final degree of utility was more important than total utility. He also did not entertain the idea of interpersonal comparison of utility. In Chapter 3, he defined utility as "the abstract quality whereby an object serves our own purpose, and becomes entitled to rank as a commodity. Whatever can produce pleasure or prevent pain may possess utility." The utility, however, is not

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proportional to the quantity of the commodity, but quantity does influence its amount.

The connection between the quantity of a good and its utility has been described by Jevons in terms of a figure, as given below.

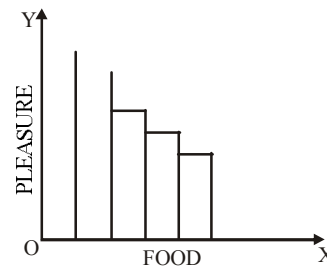


Fig. 3.5

In the above diagram, each rectangle measures the utility of an increment of food. As the first two increments were vital to life, according to Jevons, they can be left as undefined. In fact, they had no limit. In case, we assume that the increments of foods are infinitely small, we can draw a continuous line as in the diagram 7.3.

The figure 7.3 shows total utility as an area and the degree of utility as a line, such as CD. If u means the whole utility of consuming x , then u is a function of x . In the above figure, DF is an increment of x , $DCEF$ is an increment of u and CD is an increment of u , increment of x or the degree of utility. Since the limit of increment of u , increment of x is du/dx , the degree of utility can be regarded as the differential coefficient of u as a function x .

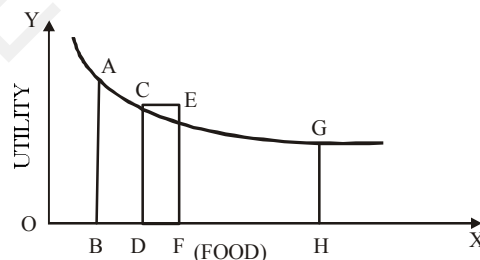


Fig. 3.6

The utility from the last unit of the commodity represents the final degree of utility. According to Jevons, the notion of final degree of usefulness is essential for economic theory. On this basis, one can very easily explain away the diamond-water paradox. Water has almost no value in a temperate climate simply water's final degree of utility is nearly 0 since the supply is so abundant compared to the demand.

According to Jevons, economics is concerned with the maximisation of total utility in the context of given wants. However, when a commodity is divided among many uses so that its final degree of usefulness is the same in each use, total utility is maximised. This law is the adaptation of Gossen's second law. This concept is now understood to be the law of equal marginal benefit or satisfaction. Jevons' contribution lies in analysing value in terms of subjective utility analysis.

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The traditional idea of value was objective since it considered the entire social process in the determination of value and entirely neglected the subjective factors. Jevons was not satisfied with the classical objective theory of value. He, therefore, introduced his subjective theory of value based on utility.

Jevons also introduced the theory of exchange which explained prices in actual markets. His concept of market included at least two persons trading in commodities. Each dealer was aware of the commodity supply and how it affected prices. Every trader wanted to maximise his own interest (profit) and exchange in the market takes place on the basis of that slightest possibility of profit. According to Jevons, competitive market requires complete knowledge for its smooth functioning.

Jevons introduced the concept of trading body for the management of demand and supply in the market. Trading body was designed to solve the problems of price determination in the market. However, his concept of trading body is not different from the concept of individuals in the market. Jevons explained the problems and difficulties involved in the process of market exchange. He also realised the importance of bargaining capacities of buyers and sellers in the market. Jevons also recognised the possibility of market distortion through differing marginal utilities of money of different persons operating in the market. He observed that exchange produced equality of degrees of utility for every individual. Exchange maximises utility only for a given income distribution.

According to Jevons, labour changes the supply of a commodity and thereby changes the final degree of utility (marginal utility). In this way, labour can have some effects on prices. But he adds that because value depends on the ultimate level of utility, labour is never the origin of worth. According to this justification, production costs dictate supply, and supply determines the final level of utility which determines the value of a commodity.

Jevons did not give any complete theory of distribution. His analysis of distribution depended mainly on Ricardo's theory of distribution. He, of course, anticipated Austrian capital theory. He explained the possibility of backward-sloping supply curve of labour. His rent theory was purely in nature. In the analysis of wage, Jevons explained the importance of the balance between pleasure and pain. This can be explained in the figure below.

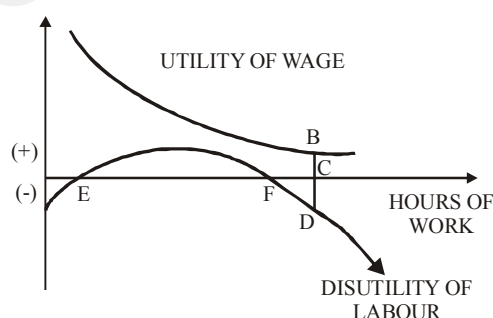


Fig. 3.7

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In the figure, hours of work are shown on the horizontal axis and marginal utility on the vertical axis. The top curve which measures the utility of the wage to the labourer declines gradually according to the law of diminishing satisfaction. The bottom curve measures the disutility or pain of the labour to the worker. Every work involves some disutility. Since initially every work involves some inertia, the bottom curve has a negative portion to the left of E. Some moderate amount of labour gives pleasure and therefore, it can be depicted by the segment between E and F. Larger and larger amount of work will cause pains and drudgery and can be explained by the negative segment to the right of F. The point at which BC and CD become equal is the amount of labour which will equate the pain of the work with the utility of the wage, and labour will stop there.

It should be noted that Jevons' theory of exchange is till now considered as very relevant. For the analysis of exchange problems in economics concerning individual, he provided us the rule that the reciprocal of the ratio of the final degree of utility of the commodity available after the trade is complete will be the ratio of any transaction of any two commodities. To convert Jevons' expression into the modern consumer's allocation formula, we can say that an equilibrium allocation of expenditures implies the satisfaction of the following situation:

$$\frac{MU_X}{MU_Y} = \frac{y}{x} = \frac{P_x}{P_Y} = \frac{MU_x}{P_x} = \frac{MU_y}{P_y} = \frac{y}{x}$$

(Where, MU_x is the marginal utility of commodity x, MU_y is the marginal utility of commodity y, P_x is the price of x and P_y is the price of y.)

Jevons does not presuppose cardinal measureability of utility in this study. He is just concerned with the marginal utility ratio.

Despite many shortcomings of Jevons' contributions to economic analysis, he is still regarded as a major analytical economist of the same rank as Gossen, Menger and Walras. According to Eric Roll, "Jevons made the scattered fragments of earlier utility analysis into a comprehensive theory of value, exchange and distribution."

3.3.2 Walras

Contribution of Walras: A simultaneous auction called a "Walrasian auction," named after Leon Walras, involves each agent calculating and submitting to the auctioneer their demand for the good at each potential price. Following that, the price is established so that the aggregate demand from all agents equals the aggregate supply of the good. In light of this, a Walrasian auction perfectly balances supply and demand.

- Let $x = \{x^1, \dots, x^L\}$ represent an allocation of goods to L consumers. (Each element of the above list is itself a vector of n goods.)
- Let $w = \{w^1, \dots, w^L\}$ represent the initial endowments of the L consumers.
- Let $p = (p_1, \dots, p_n)$ represent a vector of n prices.

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Walrasian equilibrium is represented by a list (x^*, p^*) such that

- x^{*l} is preferred to x^l for all x^l that satisfies the budget constraint

$$p^* x^l \leq p^* w^l$$

That is, all consumers maximize their utility.

- Demand does not exceed supply for each good. That is,

$$\sum_l (x^{*l} - w^l) \leq 0$$

Define an aggregate excess demand function $z(p) = \sum_l x^{*l}(p) - w^l$.

- If each consumer has strictly increasing and strictly convex preferences, then $z(p)$ is continuous.
- $z(p)$ is homogeneous of degree 0.
- Walras' law holds: $p \cdot z(p) = 0$.

Proof of Walras' law

Budget constraints are equivalent because utility functions are strictly rising. The consumer's l budget is constrained by

$$p \cdot x^l = p \cdot w^l$$

Sum over all l , we get $p \cdot \sum_l x^l = p \cdot \sum_l w^l$ which is precisely Walras' law.

The practical significance of Walras' law is that if $z_1 = z_2 = \dots = z_{n-1} = 0$ and z_n must be zero if $p_n > 0$. This states that all we need to do to determine the competitive equilibrium is to ensure that $n-1$ of the markets are clear. The n -th market also clears once this condition is met.

We require a fixed-point theorem to show that Walrasian equilibrium exists:

The fixed-point theorem of Brouwer

There must be some x in S such that $x = f(x)$ if $f: S \rightarrow S$ is a continuous mapping from a compact and convex set S to itself.

Proof of existence of Walrasian equilibrium

Since excess demand functions are homogeneous of degree 0, whenever $z(p^*) \leq 0$, we have $z(tp^*) \leq 0$. In other words, whenever (x^*, p^*) is a competitive equilibrium, (x^*, tp^*) is a competitive equilibrium as well. We adjust pricing such that they always add up to 1. As a result, we focus only on prices for the $n-1$ dimensional unit simplex:

$$S = \{p \text{ in } \mathbb{R}^{+n} : \sum_{i=1}^n p_i = 1\}$$

Define the mapping $g: S \rightarrow S$ by

$$g_i(p) = [p_i + \max\{0, z_i(p)\}] / [1 + \sum_j \max\{0, z_j(p)\}]$$

Note that g is continuous and the range of g is in S because $\sum_i g_i = 1$. So g is a continuous mapping from S to S . By Brouwer's fixed-point theorem, there exists a p^* such that $p^* = g(p^*)$.

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We want to show that this p^* is a Walrasian equilibrium. From the fixed-point property of p^* , we have, for $i=1, \dots, n$,

$$p_i^* = [p_i^* + \max \{0, z_i(p^*)\}] / [1 + \sum_j \max \{0, z_j(p^*)\}]$$

Cross-multiply to get:

$$p_i^* \sum_j \max \{0, z_j(p^*)\} = \max \{0, z_i(p^*)\}$$

Multiply the i -th equation $z_i(p^*)$ and sum over all the n equations:

$$\sum_i p_i^* z_i(p^*) \sum_j \max \{0, z_j(p^*)\} = \sum_i z_i(p^*) \max \{0, z_i(p^*)\}$$

By Walras' law, the left side of the above equation is 0, so

$$\sum_i z_i(p^*) \max \{0, z_i(p^*)\} = 0$$

But each of the n terms in this sum is non-negative. So for the sum to be equal to 0, we must have $z_i(p^*) \leq 0$ for each i .

First Welfare Theorem

If an allocation (x, p) is Walrasian equilibrium, then x is a Pareto efficient allocation.

Proof: Let x' be a feasible allocation that everyone prefers to x . Then, for every consumer l , the bundle x'^l must be beyond l 's budget:

$$p \cdot w^l < p \cdot x'^l$$

Sum over all l and using the fact that x' is feasible, we arrive at a contradiction:

$$p \cdot \sum_l w^l < p \cdot \sum_l x'^l = p \cdot \sum_l w^l$$

Second Welfare Theorem

Suppose x^* is a Pareto efficient allocation in an economy with endowment vector w . Assume that preferences are convex. If the endowments are redistributed so that the new endowment vector is x^* . Then x^* is a competitive equilibrium allocation associated with this economy with endowment vector x^* .

Proof: Since preferences are convex, the aggregate excess demand function for the economy with endowment vector x^* is continuous, so a Walrasian equilibrium exists. Let (x^{\sim}, p^{\sim}) be a Walrasian equilibrium for this economy. We want to show that (x^*, p^{\sim}) is a Walrasian equilibrium.

Since everyone prefers the equilibrium bundle to their endowment bundle in Walrasian equilibrium, we must have

$$u^l(x^{\sim l}) \geq u^l(x^{*l})$$

But x^* is a Pareto efficient allocation. There is no other realistic package that could make everyone strictly better off. As a result, the inequality mentioned above must persist.

$$u^l(x^{\sim l}) = u^l(x^{*l})$$

Now, this equation implies that if $x^{\sim l}$ solves $\max u^l(x^l)$ s.t. $p^{\sim} \cdot x^l \leq p^{\sim} \cdot x^{*l}$ then x^{*l} must also be a solution to the same problem. In other words, x^{*l} maximizes l 's

utility subject to the budget constraint at prices \tilde{p} . Furthermore, $x^* \leq w$ by definition of feasibility. So (\tilde{p}, x^*) must be a competitive equilibrium.

It should be noted that the endowments need not be redistributed to x^* to make the second welfare theorem work. Any new endowment vector x' that satisfies $\tilde{p} \cdot x'^l = \tilde{p} \cdot x^{*l}$ for all l will equally do the trick.

3.3.3 Menger

Carl Menger's 'Principles of Economics' was published in 1871. According to some, Menger's claim to the invention of marginal principle was as good as Jevons's. Menger is sometimes regarded as a marginal economist. In what follows, we will examine some of the contributions of Menger in the different areas of economics.

Methodology of Economics

Menger considered individual as the centre of economic analysis. But his approach is quite different from that of others. According to Menger, the atomistic approach is a necessary for methodology but lacks an ethical underpinning. The first economist to develop a subjective theory of value that is free of hedonistic philosophy was Menger. When Menger was writing, the Historical School was at the apex of glory. However, Menger castigated the historical method of study of economic phenomena. He was not in favour of exclusive emphasis on the historical method of studying economic problems. He also criticised the German Historical School for neglecting altogether the deductive method of study. Menger reverted to the classical deductive method of analysis, with some modifications.

The Menger-Schmoller controversy, known as Methodenstreit, was a significant step forward in the realm of economic methodology. The historical school was against economic laws and economic theory. The school preferred the term 'economic regularities' and also substituted the term 'doctrine' in place of economic theory. According to the German historical school, economic theory was not really necessary for scientific research. Menger was in favour of the deductive method and the theoretical analysis of economics. This does not mean that he was against the historical method. He simply pointed out that historical method alone was insufficient. Self-interest, utility maximisation, and comprehensive knowledge were maintained by Menger as the pillars upon which economics must be based.

Goods

Menger made a systematic discussion on different types of goods prevalent in an economy. Menger classified goods according to the directness with which they satisfied human wants. First-order goods immediately met human needs. Only indirectly could goods of the second and higher orders satisfy human needs. The majority of items in the first tier are for consumption, whereas the majority of goods in the second and higher orders are for capital and production. In order that a thing may be a good, it must satisfy the following four conditions:

1. There must be a human need.
2. The good must be able to satisfy the need.

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3. The consumer must recognise the want-satisfying capability of the good.
4. The individual has the authority and capacity to use the good for their own fulfilment.

There are some goods which are scarce in supply in relation to demand. These goods are called *economic goods*. However, when the goods are plentiful in supply in relation to demand, they are called 'non-economic goods' or 'free goods'. There are some goods known as complementary goods which can be used only in combination with other goods.

In the transformation of higher order goods into lower order goods, time is very essential. According to Menger, economic progress requires the increasing use of goods of a higher order. Menger also emphasises how all of the products we consume are fundamentally interdependent and complementary to one another. He establishes the foundation for restricted utility maximisation in this way.

Value

As has been pointed out earlier, the economic character of goods is the consequence of a single cause — scarcity. According to Menger, a good's worth does not come from the good itself but rather from how it relates to our wants. Needless to say, value will differ as the relationship differs. Goods which are very essential for life would be consumed first and goods of lesser necessities would be consumed later. The more critical demands must be met first, followed by the less critical needs. Menger contends that value is determined by the lowest utility one obtains from the good rather than the overall utility. The law of declining marginal utility was implied in Menger's reasoning even if it was not explicitly stated. According to Menger, value is primarily an individual phenomenon that exists independently of the state and its rules. The satisfaction that would be lost if that fraction were subtracted from the total quantity must be measured in order to determine the worth of a good. In other words, the significance given to the least satisfaction made possible by a single portion of the entire amount of goods available determines the worth of any component of the available quantity of goods. This implies that a good's value is based on its marginal utility. The identical Jevons's final utility degree is this. Menger claims that subjective value serves as the foundation for setting prices.

The relationship between the subjective valuations of the two products will change when two people are actually exchanging two goods until the relationship is the same for both people. In other words, for both persons exchanging the items, the ratio of the marginal utility of the two goods will be the same in equilibrium.

The following figure illustrates the law of equi-marginal utility, which Menger expressed in his own exceptional way:

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I	II	III	IV	V	VI	VII	VIII	IX	X
10	9	8	7	6	5	4	3	2	1
9	8	7	6	5	4	3	2	1	0
8	7	6	5	4	3	2	1	0	
7	6	5	4	3	2	1	0		
6	5	4	3	2	1	0			
5	4	3	2	1	0				
4	3	2	1	0					
3	2	1	0						
2	1	0							
1	0								
0									

In the above chart, ten goods are arranged in a descending order of importance to the consumer such that good one (I) is having the highest utility and goods (X) is having the lowest. Good I may be regarded as food. Every column of the chart shows the units of satisfaction which the consumer can get by consuming the successive units of the commodity. For example, if one unit of commodity (I) is consumed, the consumer will get ten units of satisfaction, and then nine units, then eight and so on. It is believed that consuming a good will bring about independent satisfaction. The price of one unit of any good is assumed to be rupee one. The consumer with the given income will start purchasing the first good which is a sheer necessity (food). The consumer spends his money in such a way that the marginal utilities derived from the purchase of different goods will be equal. Thus, if the consumer has three rupees to spend, he will purchase two units of good (I) and one unit of good (II). In this case, the marginal utility will be nine from both the goods. In the same way, if the consumer has ten rupees to spend, he will purchase four units of good (I), three units of good (II), two units of good (III) and one unit of good (IV), so that the marginal utility in every case becomes seven units. This equalisation of marginal utilities is a way of attaining consumers' equilibrium as has been explained by Carl Menger. This law reveals that given the scarce means, the individual will arrange his various consumptions in a way that all levels of satisfaction are equal at the margin.

According to Menger's theory, a good's worth is determined by the least urgent satisfaction that can be obtained from a given stock of goods. Menger also took into account how the quality of a good might affect its price. He also analysed the effects of competition and monopoly on the value analysis. He, however, did not relate satisfaction to the demand curve. He like Jevons, ignored consumer's surplus. Menger observed that the values of the higher order goods depended on the exited value of goods of the lower order they serve to produce. In the Austrian theory, it is possible to get the value of the producers' goods from the value of the consumers' goods. Value, after all, is a judgement of the mind.

NOTES**Imputation**

On his theory of imputation, Menger constructed his theory of distribution. Imputation is a word that describes how the worth of producing agents is determined by the value of their output. It is important to keep in mind that the value of lower-order goods that these goods produced influences the value of higher-order products (including the value of the component of production). As a result, the cost of the bread it produces sets the price of flour. In the same way, the value of labour depends on the goods it produces. Menger creates the marginal productivity theory of distribution based on this fact. The value loss that the product would experience if a production factor were removed from the process will be used to calculate the share of that factor in the final product. In other words, the marginal value of productivity of a manufacturing factor determines its worth. Thus, it can be shown that Menger was developing and supporting marginal analysis. An outstanding merit of Menger's distribution theory was that a single analytical treatment was given to all the productive services.

Menger also wrote on the origin of money. He considered that the inconveniences of barter were responsible for the development of money. Money also facilitated the quantification of subjective value. Money acted as a price index and as a medium of exchange. However, Menger's contribution to economics was not free from criticism. The following points of criticism can be levelled against Menger.

Criticisms

1. Menger did not give us a satisfactory theory of price.
2. He neglected the role of diminishing returns in the explanation of supply.
3. His theory of imputation has many difficulties regarding the method of valuation.
4. The classification of goods of different orders is not scientific and precise.

Despite the criticisms, his masterly explanation of utility, value and imputation cannot be minimised in any way. It is to be noted, that he is the father of the Austrian school of economic thought.

3.3.4 Bohm-Bawerk**Bohm-Bawerk's Theory of Capital**

Bohm-Bawerk's contribution lies in the theory of capital and interest. His contribution to capital theory can be known from his book, *Positive Theory of Capital*. His idea of capital was influenced by a variety of factors. First, there was a desire to approach the relevant problem more consistently using the marginal utility theory. Secondly, he wanted to make some original contribution to the theory of capital.

Bohm-Bawerk defines capital "as a group of products which serve as a means to the acquisition of goods". According to him, capital is a produced means of production. The aim of production is the making of goods for consumption. Goods may be produced either directly or indirectly. The indirect method is the round-

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about process which takes time. Prior to the manufacturing of consumer goods, the roundabout process requires the manufacture of producers' goods (capital). Due to the fact that capital serves as a source of income in the form of interest, Bohm-Bawerk views it as a factor of production. Capital is the result rather than the cause of profitable method of production. According to him, capital is an intermediate product of nature and labour. He says that there is a close relation between saving and capital formation. Capital goods can be regarded as future goods. Capital does not constitute a third, separate component of production.

Capital is an intermediate factor whose supply is dependent on land and labour that was formerly used in the production of capital. According to Bohm-Bawerk, it is necessary to make a distinction between the generated factors of production and the original components of production (such as land and labour).

The importance of capital in production is to permit the introduction of more productive and at the same time more time-consuming run-about method of production. The round-about method of production is a check against the production of capital in abundance. It is complemented by situation of time preference. The ultimate limitation to investment is imposed by time one is willing to wait for return.

The round-about method of production gives a better result than the direct method of production. This is one of the most fundamental proposition of production theory. However, Bohm-Bawerk observes that round-about methods are necessarily and always more time-consuming than direct methods. It must be noted that the rate at which the overall product increases decreases with each additional unit of production time. The round-about method of production has been found to be more productive than ordinary direct method of production required for the production.

According to Bohm-Bawerk, since capital is stored-up labour, the more the capital, the older is the average age of the capital stock. However, his theory of capital makes much better sense when it is realised that his concept of capital includes only circulating capital (i.e., funds tied up in the form of goods in process). The function of the working capital is to support labour during the gestation period of production. On the assumption that labour remains fixed, longer production time requires more capital per worker when it is found that period of production can be extended.

Bohm-Bawerk also made a distinction between the produced means of production and other forms of capital because he was trying to solve the problems connected with interest and rent. He also distinguishes between individual and national capital. He made it clear that he was concerned with the problems of national capital.

Productivity, on account of round-about process of production, increases due to technical improvement. He observes: "This is the true importance which attaches to our entering on round-about ways of production, and this is the reason of the result associated with them: every round-about way means the enlisting in our

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service of a power which is stronger or more cunning than the human hand; every extension of the round-about way means an addition to the powers which enter into the service of man, and the shifting of some portion of the burden of production from the scarce and costly labour of human beings to the prodigal powers of nature.”

When the round-about method of production increases productivity of capital, every capital increases the demand for capital. According to Bohm-Bawerk, every extension of the roundabout process is followed by an increase in the technical outcome that is then proportionally smaller than the rise in process length. The demand for capital is mainly because of its necessity in production and because of its higher productivity as compared to the direct method of production of consumer goods. The demand for capital cannot be infinite because of the decreasing marginal productivity of capital in a round-about method of production.

In Bohm-Bawerks’s theory, it is very important to find out the length of the period of production. What factors define the typical production period? When an economy’s input and output flows are balanced, the average period of production can be regarded as equal to the value of capital invested in the plant divided by the value of the flow of input or output per year. The quotient or average period of production is lengthened either when more capital is invested during a period of time or when the same capital is frozen in production for a longer period of time.

The average period of production in a one-sector economy is equal to $\theta = \frac{K}{I}$ (where K is the amount of real capital and I is the flow of inputs or investment). In a stationary state, the net investment being zero, the application of inputs corresponds to capital consumption. The workers’ consumption is fully replenished.

When capital consists of consumer goods in process, “the average period of production is simply the sum of investment periods of all the labour inputs weighted by the number of inputs. The average period of production remains a weighted arithmetic mean of labour-days per year weighted by the duration of labour services up to the moment of final sale divided by the total number of labour-days applied.” The basic objective of calculation of average period of production is to get an index of capital intensity for the purpose of comparison in a production process which is characterised by varying capital structure.

Bohm-Bawerk’s Theory of Interest

The most important contribution of Bohm-Bawerk to the theory of interest can be found in his book *Capital and Interest: A Critical History of Economic Theory*. His first volume entitled *History and Criticism of Interest Theories* contains a criticism of earlier theories of interest. His book entitled *Positive Theory of Capital* contains his own theory of capital and interest. The Marginal Productivity Theory, the Abstinence Theory, and other theories of interest were all critically analysed by Bohm-Bawerk before he presented his own theory of interest. He found that all the existing theories of interest were unsatisfactory. Bohm-Bawerk introduced the significance of the time element in the calculation of the rate of interest in his

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theory of interest. According to him, interest is a social as well as a political problem. In fact, the problem of interest is a problem of distribution because out of the total flow of national income, a portion goes to the capitalist as interest income. Bohm-Bawerk thinks that since capital is not an original source of wealth, the problem of interest is not a problem of production theory.

Why is interest paid? Bohm-Bawerk cites three reasons as to why there is an interest and how large it is (the famous *dire grunde*). The two of the grounds are psychological and the third ground is technical in nature. When given the choice between present and future goods, Bohm-Bawerk notes that people typically overestimate future resources and underestimate future demands. The former is brought on by hope, and the latter by a lack of creativity. The marginal utility of commodities in the present as compared to the marginal utility of goods in the future is increased as a result of these two factors. As a result, they add an *Agio*, or premium, to the current items. An *Agio*, or premium, must be paid in order to summon forth a supply of the present in exchange for the future commodities. Another reason for preferring present to future is the uncertainty of life and things in future. According to Bohm-Bawerk, current products are the best means of satiating human wants and desires. As a result, they are more useful than the future commodities. Another reason for the emergence of interest is the superiority of round-about method of capitalistic technology which is used for production. More can be produced by a wisely-chosen round-about method of production that can be produced by the direct method. The round-about method of production uses capital which is more productive. Therefore, some interest has to be paid for its use. This method of production requires present investment which will command a premium because of the promise of future increased output at a reduced cost and also because of the sacrifice on the part of the saver to part with his capital. From all this, the payment of interest appears to be justified. Interest is a natural phenomenon which cannot be dispensed with even in a socialist economy.

What determines the rate of interest? The balance between the supply and demand for capital affects the interest rate. The marginal productivity of capital affects the demand for capital. There will always be a need for capital. The rate of interest has a direct impact on the availability of capital or savings. The supply of capital increases with a greater interest rate, while the supply decreases with a lower interest rate. It has to be noted that capital mainly consists of means of subsistence advanced to the labourers. Therefore, the determination of the rate of interest is a matter of exchange of labour for consumer goods. The marginal productivity of extending the average period of output determines the rate of interest for a certain supply of subsistence funds. The profitable time of production extends with a lower rate of interest. In Bohm-Bawerk's analysis, the equilibrium rate of interest is determined by "the productiveness of the last extension of production economically permissible." In other words, the rate of interest is actually determined by the marginal productivity of prolonging the time of production. The productivity of the capitalist system of production generates

NOTES

interest. Many factors such as the size of the subsistence fund, number of workers and technological conditions are responsible for a change in the rate of interest.

The classical and neo-classical theories of interest are still recognised as having their roots in Bohm-Bawerk's Theory of Interest, which was the first systematic theory of interest. Bohm-Bawerk's theory of interest is original in nature. However, it has been criticised by many on different grounds. His theory has been attacked at least on three grounds:

1. He had either misunderstood or misinterpreted all the earlier theories of interest.
2. His own theory of interest is nothing but a new interpretation of the earlier theories.
3. His own assumptions and reasoning are inadequate and incomplete.

Despite Bohm-Bawerk's criticism against productivity theories of interest, his own theory of interest has remained essentially the same as the marginal productivity theory of interest.

3.3.5 Wicksell

Wicksell is a very renowned representative of the Swedish school. He has significantly influenced the growth of the monetary theory, capital theory, distribution theory, and theory of value. The marginal productivity theory of value and distribution was created by him. The monetary theory is where he made his most well-known contribution. He has also made contributions to the business cycle theory. The most important expression of his ideas can be found in his book, *Lecture of Political Economy*. His another famous book is, *Interest and Price*.

3.3.6 Fisher

Upstate New York is where Irving Fisher was born in 1867. At Yale, he received a diverse education while studying both physics and philosophy. In addition to his work on astronomy, mechanics, and geometry, he authored poetry. However, he focused most on mathematics and economics, even though Yale does not have an academic department for economics. He advocated for eugenics, peace, and prohibition. The Econometric Society and the American Economic Association are only two of the organisations he founded or served as president of.

A community's preference for a dollar of current [revenue] over a dollar of future [income] is measured by interest, according to Fisher. His area of research was known as the "impatience and opportunity" theory. Fisher posited that interest rates are the outcome of the interaction of two forces: the investment opportunity principle and people's "time preference" for capital now (that income invested now will yield greater income in the future). This line of thinking is extremely similar to that of Eugen von Böhm-Bawerk. The memory of John Rae and Eugen von Böhm-Bawerk, who laid the foundations on which I have attempted to build, is honoured in Fisher's dedication of Theory of Interest. Fisher, however, disagreed with Böhm-Bawerk's that roundaboutness inevitably boosts output, contending that given a positive interest rate, no one would ever choose a longer term unless it were more

fruitful. Therefore, if we examine the processes chosen, we do see that longer times are more fruitful. But, he argued, the length of the period does not in itself contribute to productivity.

Additionally, Fisher was the first economist to explicitly differentiate between real and nominal interest rates. He emphasised that the nominal interest rate—the one we observe—minus the anticipated inflation rate is the real interest rate. The actual interest rate is just 5% if, for instance, the nominal interest rate is 12% and consumers anticipate a 7% inflation rate. Once more, current economists still have this as their fundamental concept.

Fisher developed a more recent version of monetarism, or the quantity theory of money. In order to explain his theory, he used the equation of exchange, which states that $MV = PT$, where M is the amount of money in circulation, V is its velocity, or how quickly it moves through an economy, P is its price level, and T is the total number of transactions. Once more, contemporary economists still employ this equation, however typically they do so in the form $MV = Py$, where y equals real income. The equation can be a very effective tool for determining whether one's economic reasoning is consistent.

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Check Your Progress

4. Jevons maintained that value depends entirely on _____.
5. Walrasian auction perfectly matches the _____ and the demand.
6. Carl Menger's 'Principles of Economics' was published in _____.
7. Menger classified _____ according to the directness with which they satisfied human wants.
8. Bohm-Bawerk defines capital "as a group of products which serve as a means to the _____ of goods".
9. Wicksell is a very renowned representative of the _____ school.
10. Fisher was also the first economist to distinguish clearly between real and _____ interest rates.

3.4 THE RATE OF INTEREST

The theory of rate of interest is explained here by Weiser as utility was the cause of value.

3.4.1 Wicksteed and Weiser

Wicksteed

Wicksteed, a Unitarian minister's son who was born in 1844, attended University College, London, and Manchester New College from 1861 to 1867, when he graduated with a master's degree in classics and a gold medal. 10 In 1867, Wicksteed followed his father into the Unitarian ministry and began an incredibly wide range of scholarly and theological investigations.

Wicksteed's first contribution to economic theory was a critique of Volume I of Das Kapital in October 1884. It was once published in To-Day, which, in 1884,

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had writings by many of the era's socialists. It was a Fabian project of the Economic Circle. Although no effective response to Wicksteed's critique of George Bernard Shaw's shift from the Marxian to the Jevonian theory of cost was published, it had a larger impact on the theory adopted by British socialists. Some authors have compared Böhm-1896 Bawerk's attack on the labour concept of value to Wicksteed's critique.

Wicksteed concentrated his attention on two key concerns while demonstrating a thorough understanding of many of the precise components of Marx's argument. Is the labour time of ordinary goods used to determine their exchange value? Does Marx's claim apply to the "labour force" that Wicksteed referred to? Regarding the first query, Wicksteed agrees with Marx in saying that for two commodities to be exchanged, they must both be distinct from one another in order to motivate the exchange and share a characteristic in order to be comparable.

He claims that Marx's claim that commodities only share "abstract labour" was arbitrary and instead capitalises on the idea that labour time only "counts" when producing something valuable. Wicksteed contends that on the contrary, all commodities have "abstract utility, i.e., the capacity to satiate human desires," and that this is also true of exchangeable items that are not freely reproduced.

As a result, he suggests 'abstract utility as the measure of value,' which is a clever variation on the argument. Wicksteed contends, however, that for freely reproducible goods, equilibrium relative cost and relative labour prices will coincide - but not because labour quantities determine prices, but rather because labour will be allocated to produce those parts of the goods that suggest marginal utilities proportional to the given labour costs or historical masters, the products of monopolised industries, etc. Even this unexpected turn of events won't hold. Wicksteed then turns his attention to "the cost of labour," noting that in a society without slaves, labour is no longer allocated to the production of "labor-force" under coercive pressures. He concludes that it serves no purpose to assume that the cash pay rate to the labour value ratio for basic wage items will be the same as the cash price to embodied labour ratio for everyday goods. Thus, he draws the conclusion that Marx has not demonstrated that "surplus labour" is the source of profit. None of the contributors to *ToDay* or the several British socialist publications of the time, including George Bernard Shaw, offered a response to Wicksteed's contention that even came close to being of a high calibre.

Weiser

Wieser wrote two important books: *Natural Value* and *Social Economics*. He was following the tradition set by Menger. His important contributions are discussed below:

Value Theory

According to Wieser, value is determined by cost and utility. Menger did not give so much of importance to distribution as Wieser did. Wieser also gave much emphasis on cost. The Austrian theory of value had a gap of which Menger was

NOTES

aware. But he himself could not bridge the gap. It was Wieser who tried to fill the gap by introducing the cost element in the determination of value. Of course, Wieser did not use the concept of real cost. In the analysis of value, Wieser did not take into account disutility in the traditional sense. To him, utility was the cause of value. However, value is, after all, a circular process. Wieser contends that the values of their product determine the worth of products of a higher degree. This derived value can be regarded as the cost. He spoke about the *opportunity cost*. In the pricing process, cost and price become equal at the margin. His idea of cost is different from the classical and neo-classical concepts of cost. The cost element became the basis of his theory of value. Once found out, cost may be taken as given. His concept of opportunity cost may be regarded as: "Given the quantity of the factors of production, competition for the factors of production in the different lines of employment will distribute them in such a way that the values of the different products permit them to earn the same total amount in every alternative use."

Wieser contends that a producer's output determines the value of their commodities. As a result, the factor's marginal production determines its value. The traditional cost of production is really a specific example of the general marginal utility-based value analysis in this regard. Wieser notes that the traditional understanding of production cost is really a utility concept. Wieser did not find any contradiction between utility and cost. He considered cost in terms of marginal utility. According to Wieser, classical labour theory of value is not conceptually correct. He sticks to the marginal utility approach of value and completely breaks away with the classical objective cost analysis of value. Wieser examines value from the perspective of the subjective element. The law of diminishing marginal utility was explicitly defined by Wieser in the context of his value analysis. Thus, value necessitates scarcity.

According to Wieser, utility is the first principle in the undertaker's economy; however, the transferred value and the social utility could be at odds. In such a situation, the exchange value comes out on top. He underlined the bad effects of monopoly on social utility which otherwise is maximised under perfect competition. Wieser, in this context, advocated selected governmental interferences, particularly for the following four reasons:

1. Governmental interference is essential when the economy has a limited number of capitalists.
2. The negative impacts of monopolies and the concentration of economic power should be eliminated by the government.
3. There are some areas such as education, police, defence, where governmental interference is essential.
4. When a product must be delivered under questionable conditions or when the profit is too little for a private company to be profitable, the government should step in.

Worth-in-use depends on usefulness in a self-contained, idealised economy, and items are created in accordance with the rank of their value. In this perspective,

NOTES

exchange value serves as a proxy for personal acquisition. However, in a real economy, usefulness and purchasing power are both factors that affect exchange value. Some commodities' prices are determined by the weakest (poorest) buyers' estimations. Thus, the prices in the real world do not reflect necessarily marginal utility.

Natural Value

Wieser's analysis of natural value is a distinct contribution to economics. Wieser defines natural value as "value as we should find it in a community at a high stage of development carrying on its economic life without price or exchange." This type of value exists in a communistic state. In an economy where items are valued only by the relationship between the amount of the stock and the marginal utility, this value is significant. Nothing, including error, fraud, force, and the like, disturbs it. Natural value, however, only makes up one component of pricing in the real world. There may be many other factors responsible. Natural value, of course, is completely a neutral phenomenon.

The formulation of natural value requires, however, a market system of allocation. Natural value does not support a socialist system in any direction. However, it should be emphasised that Wieser was the first economist to highlight the applicability of the market system of allocation as well as the generality of the theory of utility assessment.

Theory of Imputation

According to Wieser, Menger's method of imputation was defective in the sense that it could lead to overvaluation of inputs. Wieser makes the supposition that all production materials are actually used in the best possible way, and those resources are combined in fixed proportions. In his theory of imputation, Wieser showed with the help of simultaneous equations that every input has a definite share in the total product and that the total product is exhausted if the factors are paid their shares. Wieser replaced the negative imputation method by a positive method of imputation. He said that the contribution of a factor can be measured by the productive contribution that is made by the addition of a factor to the total value. Wieser observes that the withdrawal of a factor affects the productivity of other factors, too. This was not realised by Menger.

According to Wieser, the value of a factor is measured by the least valuable good it creates when it is used in the manufacture of a number of commodities. It is assumed that the input has a value, and that value establishes the opportunity cost of using it in other ways. Values of inputs and outputs in a system are dictated by the opportunity cost.

Instead of a marginal value of productivity, the value of an additional unit of input applied to production is defined by the marginal utility of the additional units produced. The Austrians have a theory of input valuation known as the marginal utility product in this sense. It must be admitted that value analysis of the Austrians reached its peak with Wieser's natural value which can be regarded as the highest theoretical achievement of Wieser.

Social Economics

Marginalists

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Theory of Social Economics is a seminal work of Wieser. It has four parts covering the theory of simple economy, the theories of the world economy, the state economy, and the social economy. Social process is a topic that interests economists. It must therefore be founded on social economy. Wieser came to the conclusion that economic forces played a very dominant role in social revolution. He carefully analysed economic sociology. A theory of economic welfare is all that Wieser's theory of social economics is. The evolution of economic society, according to Wieser, is determined by certain characteristics of human nature, and mostly, by the elements of power and leadership. These developments led to a stratification of social structure which leads to the fragmentation of utilities and prices. On the basis of his theory of social Development, Wieser was able to make normative evaluation and to place labour and business power block at the centre. He argued for the establishment of labour unions as a countervailing force in the labour market, particularly against the exploitation by the monopolist and oligopolist. Wieser wanted the labourers to unite and use strike as a defensive weapon. He was also in favour of the expanded role of state for protecting properties, for national progress, for economic welfare, and for the regulation of social economy. State's role was essential for the establishment of certain types of industries like public utilities. The state is helpful for the social equalisation of use-value.

His social economics is an economic policy normative programme. His view of economic process was Darwinian but he did not advocate stationary state. His was a theory of power-oriented evolution with a framework of static utility analysis. He deduced conclusions regarding the effects of power on welfare. Wieser favoured private property. His contribution lies in combining utility theory with an evolutionary theory of institution. The importance of his contribution lies in the solution he suggested to solve the paradox that exists between private property and maximisation of utility.

Check Your Progress

11. The _____ theory of value had a gap of which Menger was aware.
12. Through the _____, values of inputs and outputs are determined in a system.
13. Wieser's theory of social economics is nothing but a theory of economic _____.

3.5 DISTRIBUTION – MARSHALL AS A GREAT SYNTHESIZER

Economics started its career as a science since the year 1870. The year 1870 witnessed two important streams of thought: one was neo-classical school and the other was marginalist revolution. The classical period formally ended in 1870 but the dominating classical spirit still continued for quite some time. Marshall began making significant contributions to economic theory in the 1870s of the nineteenth

NOTES

century. He was the leader of the Cambridge school or what is popularly known as the Neo-classical school.

Marshall's Contribution to Economics

Marshall's *Principles of Economics* is divided into six books. Books I and II deal with Preliminary Survey and Some Fundamental Notions. Book III deals with Wants and their Satisfaction. Book IV deals with The Agents of Production. Book V deals with The General Relations of Demand, Supply and Value, and Book VI discusses Distribution of the National Income.

Nature, Scope and Method of Economics

For the first time, Marshall disintegrated economics from political economy. Economics was started as an independent science. In the introductory chapter, Marshall defined economics as follows: "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." According to him, economics is a discipline that examines how people make and spend money. Economics is a social science in his eyes. There is no gospel of money in it. Wealth is the subject of economics, but more crucially, economics is the study of man.

According to Marshall, "The function of the science is to collect, arrange, and analyse economic facts and to apply the knowledge gained by observation and experience, in determining what are likely to be immediate and ultimate effects of various groups of causes; and it is held that the laws of economics are statements of tendencies expressed in the indicative mood and not ethical precepts in the imperative. Economic laws and reasoning in fact are merely a part of the material which conscience and common sense have to turn to account in solving practical problems and in laying down rules which may be a guide in life."

The method of analysis that Marshall followed is called the partial equilibrium analysis. He concentrated on the demand for a single commodity in terms of the rest. In the partial equilibrium analysis, the interdependence in the economic system is not taken for granted. The analysis is based on a method where other things are assumed to remain constant (*ceteris paribus*). This takes into account one thing at a time by considering other things remaining the same.

He recognised the absence of a long chain of deductions in economics. According to him, no economist, not even Ricardo, attempted a simple deductive approach. He combined both deductive and inductive approaches.

Cardinal Utility

Marshall assumed that marginal utility is measurable in principle. Money can be used to quantify utility. He also believed that the marginal value of money remains constant. Marshall noted that a commodity's marginal usefulness is unrelated to the amount of other commodities a person has. On the basis of these two assumptions, Marshall tried to analyse consumers' equilibrium.

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Demand, Supply and Price

Marshall has reconciled the marginal utility principle of Jevons and the Austrian school with the classical cost of production theory by introducing time element into the analysis. He is regarded as a great synthesiser. Marshall synthesised the earlier theories by introducing his theory of demand and supply as determinants of value. The marginal cost of production behind both supply and demand in importance. Marshall utilises the utilitarian approach of the Austrian school in the demand side and the cost of production approach of the classical school. Thus, Marshall brought about a harmony of two opposite trends of economic thought. As Marshall puts it: "We could just as easily disagree about whether the bottom or top blade of a pair of scissors is responsible for cutting a piece of paper as we could about whether utility or production costs determine how much something is worth. While it's true that when one blade is kept motionless while the other is moved to cut, we can casually assert that the second blade is doing the cutting, the claim isn't exactly correct. Utility and cost (demand and supply) play an equal role in determining value, much as the two blades of a pair of scissors are equally vital for cutting a sheet of paper. The demand-supply construct is the most notable contribution of Marshall in the theory of value.

Marshall also developed the general law of demand, which states that the higher the quantity to be sold, the lower the price at which it must be provided in order to attract buyers; or, to put it another way, the quantity requested rises with a decrease in price and falls with an increase in price.

Marshall bases his analysis of price on the concept of time. He made a distinction between normal value and market value. The normal value is a long-term phenomenon as opposed to the market value, which is a short-term occurrence. Marshall separates four situations: The market values, which balance supply and demand with supply being delivered, come first. There are also normal values, which might refer to short or lengthy periods of time, as the second and third options. In the formal category, we define supply as an amount that can be produced at a given price with a given supply of tools and labour, whereas in the latter, supply refers to the amount that can be produced by a plant that can be produced and used in a financially rewarding manner within a predetermined amount of time. Finally, in the very long run, we can take into account changes in the economic data like population, techniques, capital, organisation and so on. Thus, there would be slow and secular changes in normal values. It should be noted that demand is an active factor in the short period. Normal value is attainable only in a long period of time, which corresponds to the cost of production.

Agents of Production

Land, labour, capital, and organisation are the production's agents. There is a fixed supply of land. It has no production costs. Marshall points out that the law of diminishing returns applies to land. One way to put this is as follows: Unless it also happens to coincide with an advancement in the cultivation arts, an increase in the capital and labour committed to the cultivation of land generally results in a less than proportionate rise in the amount of produce raised. Labour is defined as the

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economic work of man, either manual or intellectual. Capital is stored-up provision for the production of material goods and services. Capital is a derived agent. It is the combination of man's work and nature's assistance. In fact, wealth and knowledge can be had from the primary agents which are man and nature.

Law of Diminishing Utility

The additional advantage that a person receives from a given increase in his stock of a product reduces with every increase in the stock that he already has, according to Marshall's definition of the law of diminishing utility.

The marginal utility of a commodity serves as the basis for the demand price in Marshall's research. On this basis, it is possible to construct a demand schedule which relates quantities and amounts a person would be willing to pay for a commodity.

Elasticity of Demand

The elasticity of demand (E_d), according to Marshall, is the product of the percentage change in the quantity required and the percentage change in the price. Or,

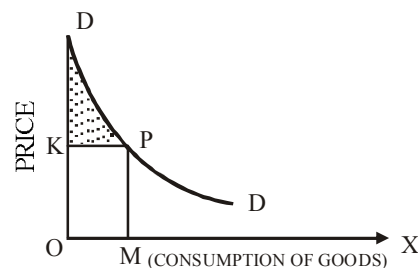
$$E_d = - \frac{\delta Q}{\delta p} \times \frac{P}{Q}$$

Where, δQ is the change in the quantity demanded, δP is the change in the price.

A commodity's market elasticity of demand is high or low depending on how much or how little is demanded for a given drop in price and how much or how little is demanded for a given price increase. Marshall's analysis of elasticity proved useful in many practical economic applications. However, it must be noted that the concept of elasticity did not originate with Marshall. The concept was used by Cournot and others.

Consumer's Surplus

The term "consumer's surplus" was first used by Marshall in regard to the price-utility relationship. The surplus satisfaction that a customer can obtain when he purchases a good at a lower cost than he would be willing to pay for it is known as the consumer's surplus. The distinction between the overall utility and (OMPD) and the marginal utility (OMPK), as in our diagram. In the diagram, the consumer's surplus is DKP.

**Fig. 3.8**

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The concept has been extensively used by the welfare economists. Additionally, Marshall made use of the notion of producer surplus. The discrepancy between the market price and the supply price of labour and capital is used to quantify this. Interpersonal utility comparisons serve as the foundation for the notion of consumer surplus. Marshall took the idea of the consumer's excess from Dupuit.

Internal and External Economies

Economies of scale are the advantages of large-scale production. Internal economies and external economies are the two categories of economies of scale. Internal economies arise because of internal factors like specialisation, better management, efficiency and so on. External economies arise out of the external factors such as common transportation, common infrastructure, common information among a number of industries of the same type in a particular area of production.

Representative Firm

In discussing the factors governing the supply price of a commodity, Marshall introduced the concept of representative firm. A representative firm is one that has a reasonable lifespan, a reasonable level of success, is managed normally, and has typical access to both internal and external economies. Marshall introduced this concept to find a solution for difficulties in determining the long-run normal value of a commodity whose production obeys the law of increasing returns. According to him, the long-run normal value should be equivalent to a sample company's cost of production. Similar to the representative tree in a virgin forest, the representative firm maintains a roughly constant size, and the economies brought about by its own resources stay constant. This concept was developed by Marshall for analysing the supply price of a commodity.

Quasi-Rent

A type of short-term excess revenue that is obtained through production elements other than land is known as quasi-rent. The phrase refers to earnings from human-made production tools like machinery and other tools of the trade. Quasi-rent refers to the short period income accruing to fixed capital. It is the net return to an asset of limited life. If the demand for machines goes up in the short run, they will earn an extra income similar to rent. But in the long run, their supply can be increased, and as such, quasi-rent will vanish away.

Distribution of Income

According to Marshall, distribution of income is an integral part of the process of valuation. Each of the agents of production has both demand and supply. Each factor has its demand price which is set by its marginal productivity, and its supply price which is set by its marginal cost. Marshall uses the demand and supply strategy to calculate the costs of the production elements. His theory of rent is Ricardian in nature. Marshall, like Ricardo, emphasised the surplus aspect of rent. However, he has distinguished between pure rent and quasi-rent. The pure rent arises on land which has no supply price. At least temporarily, the demand for and

NOTES

supply of capital determine the interest rate. The cost of saving and waiting determines the supply of capital, while the potential gain or loss determines the demand for capital. According to Marshall, the influence of both the supply and demand of labour together determines wage. The cost of training and upbringing affects the supply price of labour. Marshall calls profits as earnings of management and returns on capital. Profits fluctuate with price changes and depend on many factors. Profits are not certain income. In the short period, there may be or may not be any profit.

Marshall's distribution theory is but an extension of his general theory of value. According to Haney, "On the whole or at bottom, Marshall's theory of distribution is dominated by cost."

Appraisal

Marshall is rightly considered as the father of modern economics. "Marshall for the first time revealed the unity of the economic system and presented it as a coherent whole of interrelated parts functioning in mutual dependence upon one another". He established the Cambridge school of economics which is still functioning with all the seriousness and originality. For more than a generation, the economic literature has been guided by Marshall's outstanding work. He developed the new engine of analysis for unfolding the truth involved in economic phenomena. His *Principles of Economics* will remain a great book for all times to come. It has already earned its place as a classic. Marshall was one of the first economists to rationalise that economics is an evolutionary science. He was fully aware that he was building an essentially temporary structure. According to Lord Keynes, Marshall was the best scientist in the world for the past 100 years in his particular discipline. Marshall's tools of analysis have remained very useful particularly for the development of economic science. Though he had a static theory, he always looked beyond it and introduced dynamic elements whenever he could.

Marshall was the first economist to demonstrate that output cannot always be maximised by perfect competition. Marshall anticipated the theory of imperfect competition. He had a definite theory of economic evolution which stood in the very centre of his thought process. His analysis was partial in nature. But, he made generalisations about the economic process and system.

Despite many limitations of his analysis, like incomplete distribution theory, partial equilibrium analysis, unrealistic representative firm and so on, Marshallian economics has stood the test of time. Marshall developed a system and analysed economic problems with his own tool kit to derive necessary conclusions. Schumpeter has rightly called him a great economist. Marshall "will stand in the history of economic thought as one who made more progress towards a united and consistent theory of value and distribution than any predecessor."

Check Your Progress

14. Marshall was also contributing profusely to economic thought since the _____ of the nineteenth century.
15. Economics is a study of _____, but more importantly, it is a study of man.
16. The _____ construct is the most notable contribution of Marshall in the theory of value.
17. _____ is defined as the economic work of man, either manual or intellectual.
18. _____ was the first economist to show that perfect competition will not always maximise output.

NOTES**3.6 PIGOU: WELFARE ECONOMICS****Pigou's Contribution to Welfare Economics**

The contemporary welfare economics was initially created by Pigou and Pareto. The Economics of Welfare by Pigou is a masterpiece. It stands for the neo-classical economics welfare tradition. In essence, Pigou was a neoclassical economist. His writing began to place more focus on welfare than on enjoyment. Pigou derived the majority of the significant theoretical terms he used from Marshallian analysis. However, Pigou has broken many significant traditions from the Marshall Islands. Marshall's main focus was on the surplus analysis. Pigou's main area of interest was marginal analysis, which deals with weighing the benefits and drawbacks of very minor changes in the output of various industries.

Pigou contends that economic well-being is a component of social well-being that can be directly or indirectly included in the framework of monetary measurement. Social welfare, according to Pigou, is the sum total of individual welfare. He also pointed out that individual welfare is nothing but the sum total of the satisfaction experienced by a person within a given period of time. To, him, economic welfare and national dividend are coordinates, because the former is affected by the latter in various ways.

Pigou's analysis included a number of assumptions, including:

1. Each person aims to maximise his or her personal satisfaction (or utility).
2. Utility comparisons between people are conceivable.
3. If wealth is distributed from wealthy to poor people, welfare will rise.
4. Analysis of welfare has a normative bent.
5. The ability of man to be satisfied is equal.
6. People with higher real incomes will feel happier than those with lower real incomes.

Economic welfare has both a subjective as well as an objective or material counterpart. He asserts that national income is the flow of products created annually following the upkeep of capital, which can be measured in terms of money. For optimum output or ideal output, Pigou observes that society should maximise the

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increase in national dividends by equating marginal social products (MSP) in all the industries. In other words,

$$MSP_x = MSP_y = \dots = MSP_n$$

where x, y, \dots, n are all industries. The marginal unit of money must also yield the same amount of satisfaction to everyone. According to him, the national product will be maximum with the optimum application of economic resources when the marginal private net product (MPNP) value equals the marginal social net product (MSNP) value (MPNP). According to Pigou, the private net product is the portion of the social net product that may be sold and the proceeds added to the person's earnings. The social net product is the whole contribution contributed to the national dividend. However, there are several possible divergences between MSNP and MPNP. They are the following:

1. One potential difference has to do with how some long-lasting industrial tools are divided into tenancies and ownership. It's likely that occasionally individuals other than the owners make a portion of the investment intended to develop long-lasting production tools. The MSNP and MPNP would diverge if this were to occur. This divergence will be normally associated with wasteful forms of tenancy laws.
2. The second type of divergence is associated with the external diseconomies in consumption, such as, the smoky chimney concept. In such a case, the production of commodity gives rise to incidental disservices or diseconomies to a party who is neither the producer nor the consumer of the product being produced but simply happens to be the resident of the locality where the production is being organised. Thus, the factory chimney only increases the laundry bills of the neighbours.
3. Another type of divergence between MSNP and MPNP is that in which the MSP of resources employed in an industry with decreasing supply price is greater than their MPP. In such a case, the output of that industry will be less than optimum.

It must be noted that the supply price of a commodity is different for the community and for the industry, and, secondly, the supply price of a commodity is also different for an industry and for an equilibrium firm. As in the case of an increasing returns industry, the MSP becomes bigger than MPP when the industry's supply price is lower than the equilibrium firm's supply price. In such a situation, economic welfare can be raised by giving a subsidy to the increasing returns industries.

Pigou is concerned with an economic system which is fairly competitive and where $MPNP = MSNP$. This equality can be brought about by tax or subsidy. This is why, state intervention becomes essential.

Pigou measures economic welfare of society indirectly by measuring the physical national dividend valued at appropriate prices. For finding out whether any

economic change has improved welfare or not, he applies the following double criterion:

- (a) Economic welfare has increased if an increase in national dividend has taken place without any increase in factor supply.
- (b) If wealth has been transferred from the wealthy to the poor, economic welfare has increased.

Pigou notes that societal and private interests do not coincide. Modern analysis of external effects is to be found in a crude form in Pigou's distinction between social and private valuation of economic activities. In Pigou's analysis, the optimum output (ideal output) is reached when competition equalises the MPPs in all uses. It is an economic system where MPNP is equal to MSNP automatically. Pigou favours a policy of income equalisation.

Hla Myint observes a basic difference between Paretian optimum and Pigovian optimum. Whereas the Paretian optimum is not designed for practical application, Pigovian theory mainly deals with the practical application of welfare economics. Pigou's distinction between economic and general welfare, on the one hand, and that between marginal private product and marginal social product, on the other, are meant for solving some practical problems. Paretian optimum provides us with the methodological problems of the study of welfare economics, but Pigovian optimum has contributed to the growth of applied welfare economics. Pigou is concerned with the promising fruit and not with light alone.

Although Pigou represents the neo-classical school and has followed broadly the tradition of Marshall, still, one can find some differences between Pigou and Marshall. Pigou recognises all particular frictions which may develop under *laissez faire* and which were usually treated as special cases by most neo-classical writers. Pigou considered all conflicts that are likely to arise, under a generalised concept, known as a "marginal social product." Pigou's approach is more general with respect to the measurement of social economic-welfare. Pigou's ideal output requires the following conditions to be satisfied:

- (i) A certain number of productive resources are being used.
- (ii) The movement between different occupations does not involve any cost.
- (iii) Only one type of resources arrangements will make the national dividend optimum.

Critical Appraisal

Pigou's welfare economics is not an objective study. It is based on the assumption of man's equal capacity for satisfaction. Prof. Little has raised the following points of criticism against Pigou's welfare economics:

1. Satisfaction cannot be added, as Pigou says. According to Little, it is impossible to make a sum total of satisfaction of the society.
2. Satisfaction and happiness of different individuals cannot be compared without making value judgement.

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3. According to Little, Pigou's study is wholly based on a strict normative principle. Thus, welfare becomes ethical in nature.

Tapas Mazumdar and others have pointed out that Pigou's distinctions between economic welfare and general welfare are meaningless.

Pigou has not considered the factors of immobility, indivisibility and imperfect knowledge. However, despite all this, "Pigou achieved what Marshall could not do in his written work –the integration of the normative problems with the positive ones the building-up of a rigorous theoretical analysis which would serve as a scientific theory of economic policy."

Check Your Progress

19. Pigou was basically a _____ economist.
20. Welfare will increase if wealth is transferred from _____ to poor people.
21. Pigou observes that private interest and _____ are not in harmony.

3.7 SCHUMPETER: ROLE OF ENTREPRENEUR AND INNOVATIONS

Entrepreneurship

Schumpeter viewed capitalism as a kind of perpetual revolution that upends the existing social and economic order. And within this framework, the entrepreneur assumes the role of the revolutionary, upending the existing order to bring about radical change.

Schumpeter is thought to have been the first academic to popularise the idea of entrepreneurship, or at the very least, its economic importance. He coined the name *Unternehmergeist*, which translates to "entrepreneur-spirit," and said that these people controlled the economy because they were in charge of bringing about innovation and technical advancement.

Due to their advancement of the new goods, technologies, and/or manufacturing techniques that serve as the catalyst for change, entrepreneurs are frequently the driving force behind creative destruction. Higher living standards are made possible through entrepreneurial innovation and experimentation, which constantly upend the status quo and introduce new equilibria.

Schumpeter's Innovation Theory

Although there have been instances of the term "innovation" being used to describe something uncommon since the late 1880s, none of the first innovators have had the same impact as Joseph Schumpeter. He contends that customer preferences are predetermined and do not change on their own. Therefore, they are not to blame for the economic upheaval. Additionally, consumers have a passive role in the process of economic development. Schumpeter defined development as a historical process of structural changes that are significantly fueled by innovation. In his *Theory of Economic Development* and subsequent works, he classified these changes into five categories:

1. the introduction of a new product or a new variety of an existing product;
2. use of novel (yet-unproven in the market) methods of product manufacture or selling;
3. opening of a new market (a market where a certain industry branch was not yet represented);
4. acquisition of new raw material or semi-finished product supply sources;
5. such as the establishment or dissolution of a monopoly position, a new industrial structure.

NOTES**Check Your Progress**

22. Entrepreneurs are often the guiding force behind _____ destruction.
23. Schumpeter described development as historical process of _____ changes.

3.8 ANSWERS TO “CHECK YOUR PROGRESS”

1. Mathematics
2. Utilitarian
3. Surplus
4. Utility
5. Supply
6. 1871
7. Goods
8. Acquisition
9. Swedish
10. Nominal
11. Austrian
12. Opportunity cost
13. Welfare
14. Seventies
15. Wealth
16. Demand-supply
17. Labour
18. Marshall
19. Neoclassical
20. Rich people
21. Social interest
22. Creative
23. Structural

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3.9 SUMMARY

For marginal economists, reaching equilibrium is key. The focus of economic discourse changed from overall quantity to minor variations in these totals. The marginal economists made virtually no contribution to the growth of macroeconomics. The welfare-maximizing consequences of perfect competition were supported by the marginalists. They borrowed from the earlier English economists some subjective principles like human rationality, equilibrium technique, importance of competition and so on. They added an emphasis on demand. The market pricing of factors was explained by them on the basis of their marginal productivity.

The marginal productivity theory, a contemporary theory of distribution, also makes use of the margin notion. Ricardian marginal analysis has been employed by the Austrian school of thought. Pricing of output and pricing of the production factors are distinguished from one another. Marginalism is once again the method that makes it easier to get the desired outcome. The issue of the national product being divided among the production factors was given greater attention by classical economics than the issue of pricing production elements.

The marginal principle, which aims to explain the share of rent, is the foundation of the Ricardian theory of distribution. The difference between average and marginal products is all that rent is. The marginal principle of the Ricardian theory is a partial inspiration for Marshall's marginal productivity theory of distribution, which is really a neo-classical theory. The marginal productivity theory asserts that a factor's price is equal to its marginal productivity in its most basic form. An important corollary from the marginal productivity theory is the Cobb-Douglas type of production function, total product is exhausted if each factor receives a reward equal to its marginal product, according to the Exhaustion theorem or Euler's theorem.

According to Gossen, there exists some confusion in economic theory owing to the lack of mathematical treatment. If mathematics is not introduced in economics, the analysis cannot be complete and precise. Therefore, he suggested the mathematical interpretation of economic analysis. Even more, he emphasised that while it is impossible to quantify satisfaction in absolute terms, comparisons can always be drawn using geometrical concepts. His book makes an effort to explain economics using mathematical principles. The result of twenty years of study and contemplation is Gossen's book.

Gossen is a utilitarian philosopher. He asserts that every man should make every effort to maximise his level of satisfaction in life. On the basis of satisfaction and utility, Gossen has formulated the following three principles or laws: (1) Any given commodity's marginal utility, which is derived from consumption, continues to decline as the consumer increases the consumption of that commodity. (2) Gossen states that when a consumer is to consume different goods, then he equates their marginal utilities in order to derive maximum satisfaction from the total consumption. (3) Gossen's third law follows from the above two laws. Considering

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that an item's marginal utility decreases with its stock, the good will have positive marginal utility only so long as its supply falls short of its demand. The marginal utility of the good will decrease to zero if the supply can fully fulfil consumer demand.

Cournot provided many theoretical innovations in his analysis of economic problems. He analysed many important problems in economics such as a discussion on stability conditions of various economic equilibrium, combined and derived demand as well as a concise explanation of the basic competitive model. However, of all these, Cournot's reputation lies in his analysis of monopoly and duopoly.

According to him, the system of price can be an instrument for checking the human wants. He took note of the scarcity problem in the economy. Both the theory of value and the idea of marginal utility were rejected by him. According to him, economic theory is not able to deal with reality. It is indeed very difficult to know value in the proper sense of the term. The subjective value has no scientific basis. Therefore, it can be relegated to the background. He wanted to make the science of economics objective and abstract. Although he took for granted the existence of utility, still he discarded the concept of utility at the margin. He wanted economics to be a science dealing with empirical things. To him, scarcity was the fundamental basis of price. In this connection, he described the equilibrium price, which was established at a location where total supply and total demand met.

Principles of Economics by Carl Menger was released in 1871. According to some, Menger's claim to the invention of marginal principle was as good as Jevons's. Menger is sometimes regarded as a marginal economist.

Menger considered individual as the centre of economic analysis. But his approach is quite different from that of others. According to Menger, the atomistic approach is a necessary for methodology but lacks an ethical underpinning. Menger was the first economists to develop an independent from hedonist philosophy subjective theory of value.

Menger made a systematic discussion on different types of goods prevalent in an economy. Menger classified goods according to the directness with which they satisfied human wants. First-order goods immediately met human needs. Only indirectly could goods of the second and higher orders satisfy human needs. Consumer products make up the majority of commodities of the first order, whereas goods of the second and higher orders are capital and production goods. In order that a thing may be a good, the following four criteria must be met: (1) There must be a human need. (2) The good must be able to satisfy the need. (3) The consumer must recognise the want-satisfying capability of the good. (4) The individual has the authority and capacity to use the good for their own fulfilment.

Menger claims that subjective value serves as the foundation for setting prices. The relationship between the subjective valuations of the two products will change when two people are actually exchanging two goods until the relationship is the same for both people. In other words, for both persons exchanging the items, the ratio of the marginal utility of the two goods will be the same in equilibrium.

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On his theory of imputation, Menger constructed his theory of distribution. Imputation is a concept that bases the worth of productive agents on the worth of the goods they produce. The value of the goods of a higher order is dependent on the value of the commodities of a lower order that these goods generated, it must be mentioned. Therefore, the worth of the bread made from it determines the value of the flour. The worth of labour is also influenced by the products it creates. Menger creates the marginal productivity theory of distribution based on this fact. The value loss that the product would experience if a production factor were removed from the process will be used to calculate the share of that factor in the final product.

According to Wieser, value is determined by cost and utility. Menger did not give so much of importance to distribution as Wieser did. Wieser also gave much emphasis on cost. Menger was aware of a flaw in the Austrian theory of value. But he himself could not bridge the gap. It was Wieser who tried to fill the gap by introducing the cost element in the determination of value. Of course, Wieser did not use the concept of real cost. In the analysis of value, Wieser did not take into account disutility in the traditional sense. To him, utility was the cause of value. However, value is, after all, a circular process. According to Wieser, the values of their product determine the value of products of a higher degree. This derived value can be regarded as the cost.

Wieser's analysis of natural value is a distinct contribution to economics. Wieser defines natural value as "value as we should find it in a community at a high stage of development carrying on its economic life without price or exchange." This type of value exists in a communistic state. In an economy where items are valued only by the relationship between the amount of the stock and the marginal utility, this value is significant. Nothing, including error, fraud, force, and the like, disturbs it. Natural value, however, only makes up one component of pricing in the real world. There may be many other factors responsible. Natural value, of course, is completely a neutral phenomenon.

The theory of capital and interest is where Bohm-Bawerk made his contribution. His contribution to capital theory can be known from his book, *Positive Theory of Capital*. His idea of capital was influenced by a variety of factors. First, there was a desire to approach the relevant problem more consistently using the marginal utility theory. Secondly, he wanted to contribute something unique to the theory of capital.

Bohm-Bawerk defines capital "as a group of products which serve as a means to the acquisition of goods". According to him, a manufactured means of production is capital. Making items for consumption is the goal of production. Goods may be produced either directly or indirectly. The indirect method is the round-about process which takes time. Prior to the manufacturing of consumer goods, the roundabout process requires the manufacture of producers' goods (capital). Due to the fact that capital serves as a source of income in the form of interest, Bohm-Bawerk views it as a factor of production. Bohm-Bawerk observes that round-about methods are necessarily and always more time-consuming than

direct methods. It has to be noticed that the amount of the final product grows at a declining rate as production time increases.

The round-about method of production gives a better result than the direct method of production. This is one of the most fundamental proposition of production theory.

In reality, economic principles and logic are simply a portion of the information that conscience and common sense must take into consideration in order to resolve practical issues and establish norms that may serve as a guide in daily life. The method of analysis that Marshall followed is called the partial equilibrium analysis. He concentrated on the demand for a single commodity in terms of the rest. In the partial equilibrium analysis, the interdependence in the economic system is not taken for granted. The analysis is based on a method where other things are assumed to remain constant. This takes into account one thing at a time by considering other things remaining the same.

Marshall assumed that marginal utility is measurable in principle. Money can be used to quantify utility. He also believed that the marginal value of money remains constant. Marshall noted that a commodity's marginal usefulness is unrelated to the amount of other commodities a person has. On the basis of these two assumptions, Marshall tried to analyse consumers' equilibrium.

Marshall has reconciled the marginal utility principle of Jevons and the Austrian school with the classical cost of production theory by introducing time element into the analysis. He is regarded as a great synthesiser. Marshall synthesised the earlier theories by introducing his theory of demand and supply as determinants of value. Behind demand is marginal utility and behind supply is the marginal cost of production. Marshall utilises the utilitarian approach of the Austrian school in the demand side and the cost of production approach of the classical school. Thus, Marshall brought about a harmony of two opposite trends of economic thought.

Marshall's analysis of price is based on time element. He made a distinction between normal value and market value. Unlike the market value, which is a short-term phenomenon, the normal value is a long-term phenomenon. Marshall separates four situations: The market values, which balance supply and demand with supply being delivered, come first. There are also normal values, which might refer to short or lengthy periods of time, as the second and third options. In the formal category, we define supply as an amount that can be produced at a given price with a given supply of tools and labour, whereas in the latter, supply refers to the amount that can be produced by a plant that can be produced and used in a financially rewarding manner within a predetermined amount of time. Finally, in the very long run, we can take into account Changes in the economic data like population, techniques, capital, organisation and so on. Thus, there would be slow and secular changes in normal values. It should be noted that demand is an active factor in the short period. Normal value is attainable only lit a long period of time, which corresponds to the cost of production.

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The law of decreasing utility, according to Marshall, states that the additional benefit that a person receives from a specific increase in his stock of a thing decreases with each subsequent increase in the stock that he currently has. The marginal utility of a commodity serves as the basis for the demand price in Marshall's research. On this basis, it is possible to construct a demand schedule which relates quantities and amounts a person would be willing to pay for a commodity.

Marshall very precisely defined the elasticity of demand (E_d) as the percentage change in the amount demanded divided by the price change's %. A commodity's market elasticity of demand is high or low depending on how much or how little is demanded for a given drop in price and how much or how little is demanded for a given price increase. Marshall's analysis of elasticity proved useful in many practical economic applications. However, it must be noted that the concept of elasticity did not originate with Marshall. The concept was used by Cournot and others.

Economies of scale are the advantages of large-scale production. Internal economies and external economies are the two categories of economies of scale. Internal variables like specialisation, improved management, efficiency, and so on give rise to internal economies. External economies arise out of the external factors such as common transportation, common infrastructure, common information among a number of industries of the same type in a particular area of production.

A type of short-term excess revenue that is obtained through production elements other than land is known as quasi-rent. The phrase refers to earnings from human-made production tools like machinery and other tools of the trade. Quasi-rent refers to the short period income accruing to fixed capital. It is the net return to an asset of limited life. They will make an additional income comparable to rent if there is an increase in the short-term demand for machines. However, over time, their supply might be expanded, and as a result, quasi-rent will cease to exist.

According to Marshall, distribution of income is an integral part of the process of valuation. There is demand for each of the manufacturing agents as well as supply.

Marshall uses the demand and supply strategy to calculate the costs of the production elements. His rent hypothesis is a Ricardian one. Marshall, like Ricardo, emphasised the surplus aspect of rent. However, he has distinguished between pure rent and quasi-rent. The pure rent arises on land which has no supply price. At least temporarily, the demand for and supply of capital determine the interest rate. The cost of saving and waiting determines the supply of capital, while the potential gain or loss determines the demand for capital. According to Marshall, the influence of both the supply and demand of labour together determines wage. The supply price of labour is determined by the cost of rearing and training. Marshall calls profits as earnings of management and returns on capital. Profits fluctuate with price changes and depend on many factors. Profits are not certain income. In the short period, there may be or may not be any profit.

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Post-Marshallian developments have seen the emergence of many economists like Wicksteed, Piero Sraffa, Mrs. Joan Robinson, Edward Chamberlin, Sir John Hicks, Lord Robbins and so on. However, in this section, we will confine only to a few authors.

Joan Robinson was brought up under the Marshallian tradition. Her most important work is the *Economics of Imperfect Competition* which heralded the Cambridge revolt against the father of Cambridge economics (Marshall). Her book was published in 1933. She pointed out that perfect competition does not hold good in the real world. Therefore, she considered the situation of imperfect competition where the number of sellers is limited. The book consisted of examinations of pricing situations under monopoly with varying degrees of discrimination, and monopsony. She considered the fact that buyers show irrational preference for the products of some sellers. In the analysis of imperfect competition, she pointed out that the equilibrium price and output will follow the principle of parity between marginal cost and marginal revenue. But she did not take into account the cases of oligopoly, and selling cost. Her analysis shows that under imperfect competition, prices would be higher and output would be lower than under competitive conditions. Imperfect competition is marked by the presence of excess capacity. In her analysis, product differentiation and non-price competition do not play any important role. Joan Robinson has dealt with the cases of discriminating monopoly in a masterly way.

In Chamberlin's theory, there is no concept of industry. Each company has a monopoly on its own product, which is differentiated from the similar products of other firms. In his analysis of equilibrium, a group of firms and their products can be considered.

Chamberlin has taken into account the cases of two producers (duopoly) and also the cases of a few producers (oligopoly). Chamberlin calls his system monopolistic competition because in such a system, there is competition between monopolists of individual differentiated products. In Chamberlin's theory of monopolistic competition, one of the most crucial premises is that most businesses engage not just in price competition but also in non-price competition. According to him, every monopolistic company has a special offering or competitive edge that enables it some control over output and price.

Wicksell is a very renowned representative of the Swedish school. He has significantly influenced the growth of the monetary theory, capital theory, distribution theory, and theory of value. The marginal productivity theory of value and distribution was created by him. His most famous contribution is towards the monetary theory.

Wicksell used the Austrian definition of capital. However, he made sufficient improvement over the Austrian theory of capital. Wicksell considered interest as the return on capital. "Interest is an organic growth out of capital, a certain percentage."

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He claims that labour and land are saved up as capital. Interest is the difference between the marginal productivity of labour and land currently available and labour and land saved up in the past. Compared to the land and labour that have been saved, there is an abundance of both in the present. A time element separates the current land and labour from the stored-up land and labour.

Wicksell argues that if the productivities of stored-up land and labour and those of current land and labour are equal, there would be no rate of interest. When the rate of interest is low, there would be increased demand for long-term capital investment. This will gradually relate to a rise in the rate of interest. However, ultimately there would be a tendency of the rate of interest to be equal for different maturity periods of capital investment.

Wicksell is more famous for his contribution to monetary economics. He recognises the existence of two rates of interest: Natural rate of interest and Market rate of interest. The relationship between these two rates of interest is an important determinant of price level. The natural rate of interest is that rate which tends to equate saving and investment in the economy, and tends to equal the expected yield on capital. This idea is quite similar to Keynes' marginal efficiency of capital. The interest rate that balances the supply of savings and the demand for capital is known as the natural rate of interest. The institutions charge the market interest rate (bank rate). The market interest rate could be greater or lower than the natural interest rate. When the market rate of interest is below the natural rate, saving will decrease and expenditure will go up on capital outlay and on consumption.

Wicksell considered saving and investment in an ex-ante sense. Savings and investment are equivalent in this regard, but if saving outpaces investment, income is lowered, consumption declines, and the price level decreases. On the other hand if saving is below investment, the income level and price level will rise. Thus, a situation like inflation will be created. The relationship between saving and investment can be maintained by the use of technique of monetary control such as the bank rate. Savings will be discouraged and investment can be encouraged if the bank rate is kept low enough.

Wicksell's analysis of trade cycle springs from his analysis of cumulative process. Trade cycle essentially arises out of disequilibrium in the monetary sector. Another reason for the growth of trade cycle is the disequilibrium between technical progress and population growth. He introduced period analysis into the explanation of capital formation and capital productivity. He was one of the earliest economists to explain the price movement inter-temporally. He explained the inflation between 1895 and 1910 as due to the overproduction of gold in the Transvaal. He explained the decrease in the price level during the 1930s as due to a fall in the production of goods and services.

Wicksell will remain an important monetary economist for all times to come for his path-breaking analysis of the nexus between natural and market rate of interest and his analysis of monetary equilibrium. He has been a source of inspiration to many Swedish economists like Ohlin, Lindhal and Myrdal.

3.10 KEY TERMS

- **Utilitarianism:** A moral theory known as utilitarianism favours activities that increase happiness or pleasure and disapproves of those that increase sadness or harm. A utilitarian ideology would seek to improve society as a whole when used to guide social, economic, or political decisions.
- **Distortion:** The action of deformation.
- **Meticulously:** Showing close attention to detail, or careful, punctilious, and scrupulous.
- **Empirical analysis:** Empirical analysis is a method for studying and interpreting data that is based on empirical research.

3.11 SELF-ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Discuss the precursors of marginalism - Gossen.
2. Write in short the economic theory of Cournot.
3. Who is Thunen?
4. What is state and trade according to Thunen?
5. What is Marginal Revolution?
7. Discuss about Alfred Marshall
8. Explain the contribution of Alfred Marshall in Economics.

Long Answer Questions

1. Explain the term monopoly and Duopoly of Cournot.
2. Write Thunen's theory of location.
3. Write three principles or laws of Gossen
4. Write Walras first and second welfare theorem.
5. Discuss about the contribution of Willian Stanley Jevons in Economics.
6. Discuss about Carl Menger.
7. Discuss about the Eugen Von Bohm Bawerk determination of rate of interest.
8. Who is Kunt Wicksell? Discuss about the explanation of Kunt Wicksell.

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Unit IV J.M. Keynes and his Contributions

Learning Objectives:

By the end of this unit the learners would be able to:

- Understand the work of J.M. Keynes
- Explain the theory of employment.
- Elucidate the value of money in economic thought.
- Analyse the difference between keynesian views and classical views

Structure:

- 4.1 Introduction
- 4.2 J.M. Keynes
- 4.3 A Treatise on Money – The General Theory of Employment
- 4.4 Interest and Money
- 4.5 Answers to “Check Your Progress”
- 4.6 Summary
- 4.7 Key Terms
- 4.8 Self-Assessment Questions and Exercises
- 4.9 References

4.1 INTRODUCTION

The 1960s and the beginning of the 1970s saw the greatest impact of the theories of English economist John Maynard Keynes (1883–1946). Keynes’ supporters among economists at the time widely credited him with preserving capitalism as a whole.

The Keynesian economists’ narrative went something like this. According to all appearances, capitalism was nearing its demise during the 1930s Great Depression. Traditional liberal (1) economists and (2), who had long dominated the field of economics, asserted that capitalism would swiftly recover from the Depression without government involvement when it first started. Thus, these economists advised the government to take almost no action to promote economic recovery.

Then, John Maynard Keynes, a famous economist in Britain, argued that capitalism could endure under the new circumstances indefinitely if several long-

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standing practises of capitalist governments and central banks were altered. The Keynesians smugly came to the conclusion that socialism was not actually necessary after all when looking back on the Depression years from the perspective of the prosperous 1960s.

4.2 J.M. KEYNES

Keynes is perhaps the greatest economist of the twentieth century and will remain one of the greatest in the history of economics. Keynes changed the way economists analyse the economy. His new paradigm may be called a general macroeconomic analysis. He revolutionised economic thinking so much so that the Keynesian economics is called Keynesian revolution. Without going into the appropriateness of the term 'revolution' here, one can safely pen down the fact that Keynes introduced a school which can be called New Economics. Keynes was basically a classical economist. Keynes' contribution to the classical tradition is his famous Treatise on Money. Keynes is primarily a monetary economist. He analysed the monetary problems in macro perspective. Keynes found that the classical prescription of monetary policy could not eliminate unemployment and the great depression of the thirties. He then examined very closely the problems associated with unemployment and depression. His 1936 book, General Theory of Employment, Interest, and Money, addresses this. Keynesian economics, therefore, is sometimes called the economics of depression. Anyway, Keynes pointed out the inefficacy of monetary policy and prescribed the use of fiscal policy for curing unemployment and depression. Keynes has written a number of books including Indian Currency and Finance (1913), A Tract on Monetary Reform (1923) and How to Pay for the War (1940). However, the General Theory is his magnum opus.

Although Keynes was primarily a classical economist, still he differed on many important points from the classical economists. The main points of differences between Keynes and the classicists can be shown in the following chart:

Classical Views	Keynesian Views
1. The amount of money in circulation and the price level are closely related.	1. No such direct relationship exist. the relation is only indirect.
2. Saving-investment equality is brought about by the rate of interest mechanism.	2. The equality between saving and investment is brought about by income level.
3. Rate of interest is a flow.	3. Rate of interest is a stock.
4. Labour supply depends on real wage rate.	4. Labour supply depends on money wage rate.
5. There is no money illusion.	5. There is money illusion.
6. Equilibrium full employment is present in the economy.	6. The economy is at underemployment equilibrium.
7. The automatic adjustment works.	7. There is no such thing.
8. No speculative demand for money.	8. There is speculative demand for money.

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9. Wages are flexible.	9. Wages are rigid downward.
10. Supply creates its own demand.	10. Supply is generally greater than demand. (They are not equal).
11. Money is a veil.	11. Money is important for dynamic activity.
12. Rate of interest is a reward for saving	12. The interest rate is a compensation for sacrificing liquidity.
13. Laissez faire.	13. No laissez faire.
14. When the wage level goes down, employment goes up.	14. When the wage level goes down, employment goes down.
15. Saving is good.	15. Saving is bad.
16. Balance budget.	16. Unbalanced budget.
17. Long-run.	17. Short-run.

Check Your Progress

1. Keynes is primarily a _____ economist.
2. He revolutionised economic thinking so much, that the Keynesian economics is called _____.

4.3 A TREATISE ON MONEY – THE GENERAL THEORY OF EMPLOYMENT

In his General Theory, Keynes attacks the classical theory of employment and systematically develops his own theory of employment, output and income. According to Keynes, an economy's total revenue depends on its level of employment. Employment volume is influenced by effective demand. Effective demand is influenced by both aggregate supply and demand prices. Effective demand is determined by the moment at which the aggregate demand function and the aggregate supply function are in equilibrium. In the Keynesian model, aggregate supply function is assumed as given, and the whole analysis centres round the factors that determine and influence aggregate demand function. Demand for consumption and investment determine effective demand. Consumption is influenced by one's income level and tendency to consume. The tendency to spend money does not rise in lockstep with an increase in income. Keynes notes that the consumption function is more or less constant in the short term. Therefore, for increasing employment in the short period, the main emphasis is placed on investment. Investment bridges the gap between income and consumption. If there is not enough investment, employment and income will decrease because aggregate demand will be higher than aggregate supply. Thus, variation in employment and income mainly depends on the variation in investment.

Two variables affect investment: (i) the marginal efficiency of capital and (ii) the interest rate. The supply price of capital and the potential return on investment both affect the marginal efficiency of capital. The physical and economic factors that affect capital supply include technical conditions of production, which, in the

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short run, cannot be significantly altered. Therefore, in the short run, prospective yield becomes a more dominant factor in investment decision. When profit expectations are high and the entrepreneurs are guided by “animal spirits”, the rate of investment generally becomes higher. On the other hand, when profit expectations are low, investment goes down.

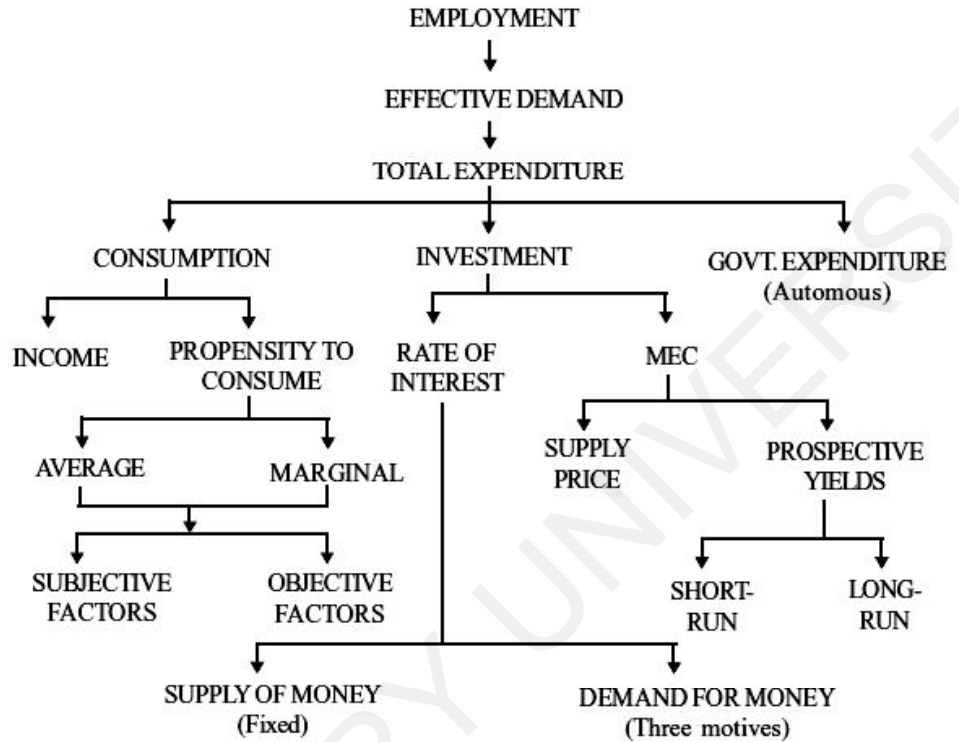
The amount of money and the preference for liquidity affect the interest rate, which is another factor in investment decisions. If money is made available, the liquidity preference will decide the interest rate. Liquidity preference depends on three human motives: (1) transaction motive, (2) precautionary motive, and (3) speculative motive. The first two motives for holding money are generally interest-inelastic, while the third one may be said to be interest-elastic. However, if liquidity preference is granted, the banking system’s monetary policy determines the interest rate. Increased investment can be achieved by either lowering interest rates or increasing the marginal efficiency of capital, or by doing both at once.

An increase in investment typically results in a rise in income and employment. But employment will not increase, if the propensity to consume of the people is reduced at the same time. In fact, consumption function is the “heart of Keynesian analysis” of employment and income. A rise in income and employment without a corresponding increase in investment is sustained by increased consumption at least up to a point.

The importance of investment and consumption, for employment, income and output, in the Keynesian theory, can be best understood with reference to the operation of the multiplier effect. The multiplier refers to the numerical coefficient indicating the increase in income that results from a given increase in investment. The multiplier “establishes a precise relationship, given the propensity to consume, between aggregate employment and income and the rate of investment.” An increase in investment generates an increase in income, which then fuels an increase in demand for consumer products, fueling still another rise in income and employment. A given increase in investment leads to a multiple gain in income through the propensity to consume when the process becomes cumulative. The multiplier’s size is determined by the marginal propensity to consume. The multiplier will be high if the marginal propensity to consume is high, and vice versa. Therefore, for increasing income and employment, both marginal propensity to consume as well as investment have to be increased. However, since the marginal propensity to consume is expected to decrease with a rise in income, it is vital to accelerate economic investment. Investment demand along with consumption demand will determine the effective demand which, in turn, will decide an economy’s level of income and employment. The Keynesian theory of employment, income, and output can be viewed in this way. Keynesian theory of employment is summarised in the chart 4.1.

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Chart 4.1



Check Your Progress

3. According to Keynes, total income of an economy is a function of total _____.
4. Variation in employment and income mainly depends on the variation in _____.

4.4 INTEREST AND MONEY

Keynes built up a short-run macroeconomic model with many variables. He divided the economy into the following three markets and analysed their economic variables and equilibrium conditions.

Goods Market

When aggregate demand and supply are equal, the products market is said to be in equilibrium, or,

$$Y = C_p + I_p$$

(Income is the sum of scheduled spending and planned saving.)

$$C_p = f(Y, r, A, \alpha)$$

(Planned consumption depends on income, rate of interest, real value of assets and income distribution.)

$$I_p = f(Y, r)$$

(Investment plans are directly influenced by income and indirectly by interest rates.)

$$S_p = f(Y, r)$$

(Planned saving depends on income and rate of interest.)

$$I_p = S_p$$

(Planned investment and planned saving are equal.)

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Money Market

$M_d = M_s$ (Supply and demand for money are equal.)

$M_d = L(PY) + L(r)$ (Transactional demand for money and speculative demand for money make up the total demand for money.)

$M_s = M_0$ (Money supply is fixed.)

Labour Market

$N_d = N_s$ (Supply and demand for labour are equal.)

$N_d = f(W/P)$ (Real wage rate affects the demand for labour.)

$N_s = f(W)$ (The demand for labour depends on the money wage rate.)

$Q = f(N, K, T)$ (Output depends on labour, capital and technology being given.)

Diagrammatically,

In the panels A and C: Given the equilibrium rate of interest (r_0) investment is I_0 . Given the saving function S , at equilibrium, $I_0 = S_0$ and equilibrium income is Y_0 .

In panel D: Y is the production function, corresponding to Y_0 and N_0 .

In panel F: No employment corresponds with W/P_0 (real wage rate), which is determined by real wage function W/P in panel (G).

In panels G and E: At P_0 , the money wage rate is W_0 , and money income is $P_0 Y_0$, then transaction demand for money (LPY) is MT_0 .

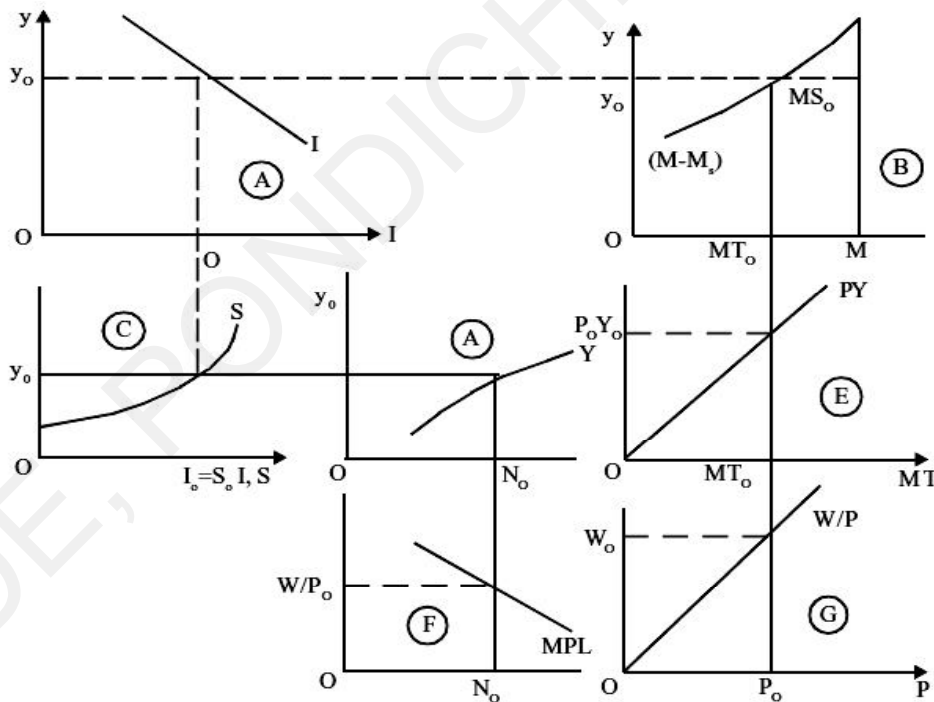


Fig. 4.1

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In panel B: (M-Ms) function divides total money OM between OMT0 (active balance) and MS0 (speculative balance) (at r_0 rate of interest). If the rate of interest is below r_0 , income, investment, employment go up and the real wage rate goes down. The model clearly suggests that equilibrium may occur at any level of employment (N_0 is not necessarily full employment in the diagram) within the upper limit by the size of the labour force. It also denies the existence of any automatic adjustment mechanism, because of the existence of rigidities caused by either endogenous or exogenous factors. This model prescribes government intervention for attaining higher employment and income.

Income Determination

Keynesian economics is basically concerned with the determination of income and employment. Keynes explained the income theory systematically through saving (S) and investment (I) equilibrium approach in his General Theory. The income theory upholds that aggregate demand is determined by aggregate expenditure (E) which consists of consumption expenditure (C) and investment expenditure (I). Expenditure generates income in a macroeconomic sense, and income generates further expenditure. In this way, there is some circularity, where income (Y) and expenditure can be interchangeably used. Let us briefly explain his ideas:

$$E = C + I$$

(Total expenditure is equal to consumption and investment expenditures.)

However, one part of the income is saved and the other part is consumed. Thus,

$$Y = C + S$$

In Keynesian hypothesis, total expenditure (E) determines total income in such a way that:

$$E = Y$$

$$\text{Thus, } Y = C + I.$$

Income (Y) is composed of the following two sets of factors:

$$Y = C + I$$

$$Y = C + S$$

$$\text{or } C + I = C + S$$

$$\text{or } I = S$$

Saving (S) and Investment (I) equality is, thus, definitional. According to Keynes, equality in saving and investing is a prerequisite for economic stability, regardless of the employment rate. However, the mechanism of income causes equality between saving and investing, and this equality results in price level stability. However, when (S) and (I) are not equal, then price level and income level cannot be in equilibrium.

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Needless to say, the process of income determination involves many forces, many variables, many stages and many sectors. In a simplistic analysis with a two-sector model, comprising households and business sector, the income generation can be regarded as:

$$Y = C_0 + bY + I$$

(where b is the marginal propensity to consume and C_0 represents autonomous consumption.)

Given the values of b (MPC), C_0 and investment (I), the degree of revenue can be ascertained. The equilibrium income is disturbed under the following two situations:

- (i) If saving is not equal to investment.
- (ii) If total supply does not meet total demand.

If the level of investment changes, income will be changed. This can be explained with the help of the investment multiplier which says that if investment is changed, income will change by a multiple of investment. All this will give the short-run determination of income, as in the Keynesian theory. The income determination process can also be discussed with reference to the government sector and open economy.

Check Your Progress

5. Planned saving depends on income and _____.
6. Demand for labour is equal to _____ of labour.

4.5 ANSWERS TO “CHECK YOUR PROGRESS”

1. Monetary
2. Keynesian revolution
3. Employment
4. Investment
5. Rate of interest
6. Supply

4.6 SUMMARY

Keynes' contribution to the classical tradition is his famous Treatise on Money. Keynes is primarily a monetary economist. He analysed the monetary problems in macro perspective. Keynes found that the classical prescription of monetary policy could not eliminate unemployment and the great depression of the thirties. He then examined very closely the problems associated with unemployment and depression.

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Keynes built up a short-run macroeconomic model with many variables. He divided the economy into the three markets and analysed their economic variables and equilibrium conditions.

Keynes attacks the classical theory of employment and systematically develops his own theory of employment, output and income. According to Keynes, an economy's total revenue depends on its level of employment. Employment volume is influenced by effective demand. Effective demand is influenced by both aggregate supply and demand prices. Effective demand is determined by the moment at which the aggregate demand function and the aggregate supply function are in equilibrium. The Keynesian model takes the aggregate supply function for granted, and the whole analysis centres round the factors that determine and influence aggregate demand function. Demand for consumption and investment determine effective demand. Consumption is influenced by one's income level and tendency to consume. The tendency to spend money does not rise in lockstep with an increase in income. Keynes notes that the consumption function is more or less constant in the short term. Therefore, for increasing employment in the short period, the main emphasis is placed on investment. Investment bridges the gap between income and consumption.

4.7 KEY TERMS

- **Treatise on Money:** English economist John Maynard Keynes wrote a two-volume work titled A Treatise on Money, which was released in 1930.
- **Equilibrium:** A state in which opposing forces or influences are balanced.
- **Aggregate expenditure:** The total of all the elements' economic expenditures made within a specific time period is the aggregate expenditure.
- **Propensity:** An inclination or natural tendency to behave in a particular way.

4.8 SELF-ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Give the name of Keynes new paradigm.
2. Name the two factors that depends on investment.
3. The terms that depends on liquidity preference on three human motives.
4. List out the three markets of economy according to Keynes.

Long Answer Questions

1. Write the difference between Classical View and Keynesian View.
2. Explain with chart the importance of investment and consumption.
3. Explain the income determination of Keynes.

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Unit V Indian Economic Thought

Learning Objectives:

By the end of this unit the learners would be able to:

- Understand the early economic ideas of Kautilya & Valluvar.
- Explain the Modern economic ideas of Naoroji, Ranade and others.
- Trace out the economic ideas of Gandhiji's village, Swadeshi, trusteeship etc.,
- Meaning of early approaches to planning.
- Understand the cooperation as a strategy by Vakil, Gadgil, VKRV Rao.
- Explain the economic thought of Dr. B. R. Ambedkar.

Structure:

- 5.1 Introduction
- 5.2 Early Economic Ideas
 - 5.2.1 Kautilya's View
 - 5.2.2 Economic Ideas of Thiruvalluvar
- 5.3 Modern Economic Ideas
 - 5.3.1 Dadabhai Naoroji (1825-1917)
 - 5.3.2 Mahadev Govind Ranade (1842-1901)
 - 5.3.3 Romesh Chandra Dutt (1848-1909)
 - 5.3.4 Gopal Krishna Gokhale (1866-1915)
 - 5.3.5 J.K. Mehta
 - 5.3.6 M.N. Roy
- 5.4 Economic Ideas of Mohandas Karamchand Gandhi (1869-1948)
 - 5.4.1 Village Reorganisation and Agricultural Development
 - 5.4.2 Swadeshi
 - 5.4.3 Place of Machine and Labour
 - 5.4.4 Cottage Industries, Trusteeship
- 5.5 Early Approaches to Planning (National Planning Commission)
- 5.6 Cooperation as a Strategy
 - 5.6.1 Contributions of Vakil
 - 5.6.2 Dhananjay Ramchandra Gadgil
 - 5.6.3 V.K.R.V. Rao

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5.7 Economic Thought of Dr. Ambedkar

5.8 Economic Thought of Periyar

5.9 Answers to 'Check Your Progress'

5.10 Summary

5.11 Key Terms

5.12 Self-Assessment Questions and Exercises

5.13 References

5.1 INTRODUCTION

There is limited awareness of Indian economic thought's history outside of India. Economic researchers hardly ever conduct any research. The topic has the potential to provide a range of principles that might aid in the continued development of Economics. The discipline has to be revitalised, and students and others need to be inspired with new zeal.

Dadabhai Naoroji established the fundamental framework for teaching Indian Economics as a separate topic. But in the early days, well before the momentum for Independence movements gained steam, Mahadev Govind Ranade was the one who gave Indian economics shape and was successful in establishing it as a separate topic. He is revered as the "founder of Indian economics," in fact.

There are theories that suggest the name "Indian Economics" was coined by nineteenth-century Indian authors who held the opinion that the western-taught economic principles did not apply to Indian settings. In fact, because individuals in India are just as motivated by money as those in other parts of the world, economist Brij Narain claimed that there is "no science of Indian economics" separate from the science of "generic economics."

The gold standard, decentralised planning, the right to private property, economic freedom or free enterprises, individual liberty, and other radical principles were supported by economists like B. R. Ambedkar. Additionally, Ambedkar was well aware of the importance of decentralised planning as opposed to central planning for the society's knowledge problem (as perceived in the Independent India).

Unfortunately, one of the greatest tragedies in the history of Indian economic thought is the marginalisation of the economic ideas of giants like R B Lotvala, V S Srinivasa Sastri, Lajpat Rai, Gopalakrishna Gokhale, Ranade, S V Doraiswami, B R Ambedkar, C. Rajagopalachari, B R Shenoy, N A Palkhivala, Bankimchandra Chattopadhyay, Minoo Masani and the likes, despite their original and novel contributions made to Indian economic thought.

The ideas of M.K. Gandhi, who believed that the higher education system should be handled by the private sector, which manages businesses and corporations and has an incentive to do so (instead of the inefficient system of government), are hardly ever mentioned. The "intellectual servitude of the Indian

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society,” according to economist Narendra Jadhav, is the reason of the widespread ignorance of some of the Indian economic ideas. The way open-minded economists widen the logical thinking with good reasoning will determine the future course of Indian economic philosophy.

5.2 EARLY ECONOMIC IDEAS

India has a distinguished past, and even in the fourth century B.C., thoughts on economic topics were as complete as those in modern Anglo-Saxon nations or anywhere else in the world. Additionally, they are extremely similar to current theories on the subject. The claim that the traditional Indian economic theories “have just a small interest from the standpoint of current science” is untrue. They can be boiled down to a handful of moral principles. The Vedas, Upanishads, and Epics are just a few examples of the ancient literature that contains an unfathomably vast ocean of economic concepts. It is true that until recently, economics did not exist independently as a field of study. This also applies to India. If we consider things objectively and without prejudice, we should come to the conclusion that ideas grow alongside civilization’s advancement, which is mostly the result of a nation’s physical and geographical conditions. Mountains, flora and wildlife, climate, river basins, and mineral richness have all served as sources of inspiration for the growth of mythology, religion, and the cultural and economic lives of humans. The Himalayas, the Ganges, and the Yamuna have influenced not only our political and economic lives but also the Indian population’s creative art, literature, philosophy, and religion. Numerous examples from Vedic and ancient literature can be given to support this claim.

5.2.1 Kautilya’s View

The main source of information is the Arthashastra, written by Kautilya. The name of Kautilya was Vishnu Gupta. He was a Brahmin of learning. He is recognised by the name Kautilya because he was an authority on political strategy and diplomacy. He served as Chandra Gupta Maurya’s chief minister. He was in charge of overthrowing the monarch of Nand and giving Chandra Gupta control of the realm. In his book, Kautilya provides a comprehensive depiction of governmental processes as well as the responsibilities of monarchs, ministers, and other officials. His Arthashastra, which comprises fifteen chapters and roughly 430 pages, is based on prior treaties. He has admitted that he owes Shukracharya and Brahaspati money. He has viewed the economy as an ongoing process. Almost all facets of economics theory and practice are covered. Additionally, it covers a variety of other topics, including diplomacy, agriculture, spinning and weaving, law courts, women’s rights, care for the elderly and helpless, marriage and divorce, public finance, and maintenance of the army and navy. He offers several thoughts on a welfare state in his book.

The Ideas of Kautilya

1. **Nature and Purpose of Material Wealth:** As one of the Purusharthas, the concept of Artha (wealth) played a significant role in the Vedic

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Period's system of economic theory. According to the Vedic seers and sages, the idea of Varta (national economy) was that Artha, or material wealth or prosperity, was necessary for the stability and upkeep of the social structure and organisation that gave each person the means and opportunities to lead a respectable life while also ensuring adequate self expression, self-realization, and salvation. Thus, the concepts of want and welfare were inextricably linked to that of riches. In those days, wealth included livestock, particularly cows and horses. People in ancient India were free to work and amass riches, but only to the level that was required to satisfy their own needs and the needs of their family members.

2. **Varta:** Ancient thinkers most frequently referred to the science of national economy as "Varta," hence the term. Agriculture, livestock husbandry, and trading are all part of Kautilya in Varta.
3. **Agriculture and Animal Husbandry:** In Varta, farming and animal husbandry played significant roles. As the foundational sources of new wealth, these were viewed.
4. **Dignity of Labour:** A man should live an active life of rigorous labour for 100 years, according to the Vedas. Thus, the dignity of labour was recognised by the ancient sages. Additionally, Kautilya recognised the 'ashram vyavastha' of the earlier philosophers. He didn't advocate for using slave labour. In his code of labour discipline, Kautilya outlined punishments for anyone who refused to work after being paid. The right to depart also applied in some circumstances to labourers. A written agreement between the employer and the employee is also possible.
5. **Trade:** Ancient philosophers only supported trade—internal or international—when there was a surplus after appropriate domestic or local requirements had been satisfied. In general, it was thought that exchanging goods in internal trade was unnecessary.
6. **Public Finance:** One of the state's most significant sources of income was taxation. It was referred to as "Raj kar." According to the rules of the Hindu religion, the tax rate was established. The tax receipts, in Kautilya's opinion, can be split into three categories: (a) Income obtained from taxes paid on goods made domestically; (b) Income obtained from taxes paid on goods made in the nation's capital; and (c) Income obtained from taxes paid on imports and exports. The primary tenets of taxation were thus as follows: (i) taxes should be imposed annually and shouldn't burden taxpayers; and (ii) wealthy people should be subject to taxes based on their wealth or capacity to pay. The burden should be shared in such a way that neither the state nor the taxpayer suffer. Wealthy people should be given a prominent position in society because they are expected to contribute more to the state. The arrangement of central finance is essentially the only topic Kautilya covered in his writings. He avoided addressing the local finance issues.

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In his list of public expenditures, Kautilya included the following: (i) national defence; (ii) public administration; (iii) ministerial salaries and expenses for government departments; (iv) expenditures for government storehouses, etc.; (v) costs associated with maintaining national storehouses and granaries; (vi) costs associated with maintaining armies; and (vii) costs associated with purchasing priceless gems, stones, and ornaments. Whatever was left was added to the treasury and war fund.

7. **Population:** The ancient Indian thinkers did not worry about a big population. It was seen as a source of power. Ten sons to a newlywed couple were regarded by the Vedas as being just. Due to the high death rate brought on by the ongoing battles between minor states and the deaths brought on by insufficient medical facilities, it was thought that the population could not increase beyond a reasonable level. Kautilya even advocated for the establishment of colonies to aid with immigration.
8. **Slavery:** Slaves were treated as family members in ancient India and were not obliged to perform menial tasks. He was formerly a hereditary domestic servant with no rights to amass riches or own property. In any event, he was superior to a hired labour.
9. **Welfare State:** Ancient Indian philosophers had a very distinct understanding of the welfare state. On the basis of justice and equality, wages were set. There was no worker or cultivator exploitation by the employers, landlords, or capitalists. High interest rates were opposed by both Manu and Kautilya. In the Dharma Shastra, Manu has provided directions for controlling interest rates. Even the charging of compound interest was forbidden by him. Profits, in Kautilya's view, are the benefits of exclusively entrepreneurial activity. The basis for Kautilya's conception of the state is the industrial complex. He claims that the state should follow three principles: first, it should focus on industries that directly contribute to the nation's self-sufficiency and independence, such as those that produce gold, silver, diamonds, and iron; second, it should support other industries like farming, spinning, and weaving; third, it should ensure that activities related to production, distribution, and consumption are done effectively and in accordance with the law. Thus, it suggests that the state has an absolute hold over people, but only with the aim of enhancing their welfare.
10. **Social Security:** The social security system was not as developed in Kautilya's era as it is today.
11. **Interest:** Although the ancient philosophers agreed that interest should be charged, they opposed exorbitant interest rates. Kautilya suggested regulating the interest rate.
12. **Price Control:** The fundamental goal of price control was to safeguard customers from the unethical and cunning business practises.

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13. Socio-Economic Institutions: As previously mentioned, the socioeconomic system of ancient India was built on religious tenets. Every aspect of life, including family and social relationships, economic endeavours, and spiritual existence, was ruled by religious regulations. A study of Hinduism involves examining the state and the “varna ashram,” which is a study of social and economic interactions. The earth was therefore everyone’s property.

14. Town Planning: Ancient India had a highly developed understanding of town design, particularly under the Mauryan rulers. For the purposes of national defence and economic necessity, the communities were combined. The segmentation of the city area, the enlargement of the main roadways, and the reorientation of the main streets were all part of town planning. After careful consideration, the capital was established. For the purpose of preventing fires and maintaining sanitary conditions, detailed regulations were established.

5.2.2 Economic Ideas of Thiruvalluvar

The following points highlight the top seven economic ideas of Thiruvalluvar. the economic ideas are:

1. Factors of Production
2. Agriculture
3. Public Finance
4. Poverty and Begging
5. Wealth
6. Ethics
7. Welfare State

Factors of Production: Thiruvalluvar has made many passing references about the elements of manufacturing viz., Land, Labour, Capital, Organisation, Time, Technology etc. He says, “Unfailing harvest, equipped physique of men, crew of guys whose wealth is aware of no diminution, are the elements of an economy”, (Kural 61). Further he says, “Executing the work at the desirable time is positive to supply items (wealth)”, “Nothing is not possible if accomplished with the assist of time and technology”.

Agriculture: Agriculture, in Thiruvalluvar’s opinion, is the most important economic activity. The development of the other economic sectors depends on their prosperity, making them the world’s pivot. “The ploughmen alone,” he claims, “life as the freemen of the soil; the rest are merely slaves that are behind on their toil.”

Because other professions were considered “sterile,” according to the French Physiocrats, agriculture was the only productive career. Thiruvalluvar shared the Physiocrats’ view that agriculture was superior to all other professions.

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Public Finance: Under the areas of Public Revenue, Financial Administration, and Public Expenditure, Thiruvalluvar provided a detailed definition of Public Finance.

He has stated these as the following:

1. Creation of revenue
2. Collection of revenue
3. Management of revenue, and
4. Public expenditure.

Valluvar opposed the practise of collecting taxes forcibly. He contrasted an oppressive king who levied taxes to a highway robber.

The following three key revenue sources:

1. Wealth that comes by itself;
2. Customs duties;
3. Tributes paid by the defeated kings, i.e., 'reparation'.

Notably, Valluvar did not include land revenue, which was the primary source of income at the time.

Poverty and Begging: According to Valluvar, everyone's right to be free from hunger is a fundamental freedom that should be valued by all people. He asserts that "poor" is the primary cause of all evils that result in never-ending pain.

Valluvar thought it was absurd to try to solve the problems of poverty through begging. He denounced poverty and begging as two of society's worst sins. It is untrue to argue that some people were forced to beg by fate. If humans stay by means of begging, he said, "May the creator of the universe who has decreed so, go begging and perish."

Wealth: Thiruvalluvar supported a socialist state. There won't be any industry, disease, illiteracy, or poverty in a welfare state.

The essential state beautifying components are:

1. Perfect health and disease-free folks
2. Plentiful wealth
3. Decent crop
4. Prosperity and happiness and
5. Complete protection of the populace.

Last but not least, one of his kurals demonstrates the primary traits of a peaceful state. "It is that country which can be called a good country wherein there are no several parties, where there are no internal dissensions; where there are no internal enemies."

Ethics: The complete education of Thiruvalluvar used to be on ethics. He used to be in opposition to illegal and unlawful techniques of realising the

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objectives. There need to be ethics not only in objectives, but also in realising these objectives. He regarded drinking, gambling and prostitution as evils that did damage to the socio-economic lifestyles of a society.

Check Your Progress

1. He is known by the name of Kautilya because he was an expert in _____ and political strategy.
2. Thiruvalluvar also had the belief that _____ was superior to all other occupations.
3. In a welfare state there will be no poverty, illiteracy, disease and _____.

5.3 MODERN ECONOMIC IDEAS

The economic continuities that result from local factors or economic structure are missed if colonialism is the exclusive focus on India's economic history. In actuality, market-oriented British colonial policies did start a process of economic growth centred on the manufacture of items that were labour- and resource-intensive. However, low rates of private and public infrastructure investment, excessively low rates of education, caste- and gender-based social inequality, a delayed demographic transition to lower birth rates, and the ensuing heavy demographic burden on physical capital and natural resources limited the capacity for productivity per worker.

A school of economic thought known as "Gandhian economics" is based on the socio-economic theories advanced by Indian nationalist Mohandas Gandhi. Its affinity to the tenets and goals of peaceful humanistic socialism is essentially what defines it, although it also rejects violent class warfare and advocates for socioeconomic harmony. Gandhi's economic theories oppose materialism while simultaneously promoting spiritual growth and unity.

5.3.1 Dadabhai Naoroji (1825-1917)

Naoroji's book *Poverty and Un-British Rule in India*, which was first released in 1901 and amended in 1911, contains the majority of his economic theories. The knowledge of the drain theory, national income analysis, poverty, and the public finance and public expenditure system in India has been aided by Naoroji. Let's quickly go over each of these.

Drain Theory

The first Indian economist to talk about the flow of resources from India to England was Dadabhai Naoroji. The drain of Indian resources is thought to have begun in the middle of the eighteenth century with the transfer of resources from India to England. The drain idea was thoroughly analysed by Dadabhai Naoroji in his book in 1871. Unrequited exports of Indian goods served as the drain. The drain resulted from the following: (i) the East India Company employees' transfers of savings from India to England; (ii) European workers' transfers to England for the support of their families; (iii) transfers for the purchase of British goods; (iv)

government purchases of goods made in Britain; and (v) interest payments made to England on public debt.

The export surplus in India's foreign trade was brought on by the remittances. Naoroji claims that between 1814 and 1865, there was a £350 million drain on resources. The drain on the East India Company's account is thought to be about £3 million annually. Later, the drain kept becoming worse. A movement of purchasing power from the poor rural to the wealthier urban areas also constituted an internal drain. Naoroji discovered that the poor people of India provided 75% of the country's tax revenue. In addition to being largely political in character, the public debt also had a relatively high interest rate. The drain also included the waste of human talent and productivity. The artisans were forced to return to the rural areas when the British destroyed communities, cottages, and handicrafts. A significant amount of aesthetic effectiveness and talent was lost in this procedure. This is one way that human resources are being wasted. Agriculture exports served as the conduit for the draining of India's resources.

The underdevelopment of the Indian economy and poverty were caused by the outflow of resources.

The profit from exports, freight, and insurance were all a drain. India was forced to pay Britain's war costs. India also contributed to the costs associated with maintaining the British military. Professionally skilled Indians were also leaving India and migrating to England. This is what is known as the brain drain in modern times. It was a moral drain, according to Dadabhai.

National Income Estimate

The British government's incorrect calculation of India's national income did not satisfy Naoroji. Naoroji thought the official estimate wasn't good enough. The British government used to provide some information about India's national income in the book *The Material and Moral Progress of India*. Naoroji favoured calculating the national income on an annual basis. According to Naoroji's calculations, India's per capita income for the year 1870–1871 was only ₹ 20, while it was ₹ 420 in the United Kingdom. His calculations were based on the minimal necessities that keep people in generally excellent health and decent behaviour. In this regard, Naoroji considered the everyday maintenance needs of inmates in Indian jails, common agricultural labourers, low-paid government employees, and emigrant coolies. He discovered that these groups of people needed an average of 34 dollars per day just to survive. According to Naoroji, the per capita income was far lower than the ordinary Indian's per capita needs.

The main criticisms of Dadabhai's calculating approach focused on the fact that he ignored a number of factors, including railroad riches, government stock, foreign commerce, and other factors. Naoroji made the point that railroads don't generate any wealth. It only moves wealth from one place to another. The situation with government stock is similar. No nation's material wealth is increased by stock. Similar to this, domestic trade and real estate do not produce any material riches. Of certainly, foreign trade generates income. However, in the case of India, all

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trade-related earnings go to England. These are Dadabhai's responses to Danvers' points on how some products are not included in the calculation of India's national GDP. While pointing out that Naoroji's handling of national income was based on "the physiocratic concept of the materiality of revenue," V.K.R.V. Rao accepted Naoroji's technique of calculating national income.

Poverty in India

According to Naoroji's calculations, the facts on per capita income show that India is extremely poor. Average per capita income in India was ₹ 20 while per capita subsistence costs were ₹ 34. From here, one may determine how poor India is. The majority of Indians lived in utter destitution. They merely subsisted by taking from capital wealth, taking on debt, and engaging in disinvestment. The economic situation of the average person was significantly worse than that of those incarcerated. Even for the food and clothing that a criminal can acquire, there is rarely enough output in a good season, let alone for all petty luxuries, all social suffering, and any preparation for a poor season, according to Dadabhai. The middle class and wealthy class of people were undoubtedly in a better financial position. The Indian poor were disproportionately impacted by the income distribution pattern. Racial and regional income discrepancies further emphasised the differences in income distribution. In India, Indians used to earn far less money than English people. British people primarily took advantage of the people of India. Poverty resulted from the exploitation.

The economic outflow from India was a significant contributor to the poverty in India. India became a nation of the poor as a result of the constant outflow. Although India's population was growing, agricultural output was declining. The agricultural labourers' pay was quite meagre. Real wages continued to decline despite ongoing price increases. The British rulers' exploitation of Indian trade, industry, and commerce led to poverty in India. But India's poverty was not really brought on by overpopulation. The actual reason was the capital flight from India to England. J.S. Mill determined that India's industrial and agricultural backwardness was a result of a lack of capital. The people of India struggled with poverty and a sense of estrangement. The majority of the top occupations in India were filled by Britons. Despite their abilities, many Indians were forced to remain idle or underemployed. The Indian people were unable to exercise their legal rights, therefore they withdrew from the drama of societal advancement. The Indian population was feeling frustrated. According to Naoroji, the exhaustion of India's resources as well as excessive spending on public debt and European service are the main causes of the country's poverty. Dadabhai made an effort to put a number on the severity of India's poverty and its negative impacts. He demonstrated how British control impoverished the Indian people.

Public Finance and Financial Administration

Naoroji showed the mismanagement created by the British rulers in the realm of income and expenditure. The bulk of the revenue was realised from the Indian people. The incidence of land revenue ultimately fell on the poor cultivators. The tax system was highly regressive in character. This was particularly true in the case

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of salt tax. The tax rate was very high. It was twenty-two per cent in India whereas it was merely eight per cent in England. But the British rulers maintained that the people of India were taxed lightly. There was another aspect of the Indian tax system. In India, there was no equivalent of the quid pro quo that existed in England, where taxpayers used to receive some advantage from the government.

The military and defence were likewise heavily funded. Gladstone acknowledged that the 1893 military spending in India was undoubtedly concerning. The people of India did not profit from the railways. The homes of the railway officials who lived in England were built with Indian money. The best positions on the railways were reserved for English nationals. The interest rates on India's public debt were quite high. In 1871, Naoroji pegged the national debt at £100 million. There were also hefty house fees. Dr. Ganguli notes that there are three persistent issues in the field of public finance: (i) a significant tax burden in relation to India's small tax base; (ii) a higher tax rate in India than in England; and (iii) a connection between taxation and Britain's ongoing economic outflow.

There was a severe shortage of spices in India as a result of the massive export of spices from India to England. The exchange rate between the British pound sterling and the Indian rupee was always maintained by the British people. India suffered because of the Indian silver standard. Each year, India's national debt grew quickly, raising concerns among all of the country's leaders. The high cost of debt payment was another factor in the poverty of the Indian people. The financial administrative structure was predisposed to favour waste and pointless government spending. The government was robbing the Indian people at every chance.

Reforms

Naoroji offered a few reformative suggestions to improve the state of affairs. These initiatives include: (i) An equitable adjustment to England's and India's financial relations. (ii) India should be granted permission to exploit her own produce for both investment and consumption. (iii) The employment market is becoming more and more Indianized. (iv) Public loans with lower interest rates for investments in India. (v) A cap on government spending, including salaries, benefits, and pensions. (vi) A decrease in the interest rate on the national debt (vii) Administrative costs should be kept to a minimum. (viii) A thorough national education plan. (ix) Attractive capital for wasteland cultivation and funding for public works initiatives.

Naoroji made a few reformative recommendations to make things better. These programmes comprise: (i) A fair readjusting of the financial ties between England and India. (ii) India should be allowed to profit from her own agricultural output for both investment and consumption. (iii) There is a growing Indianization of the labour sector. (iv) Public financing for investments in India with lower interest rates. (v) A restriction on the amount the government can spend on salaries, benefits, and pensions. (vi) A decline in the national debt's interest rate (vii) Administrative expenses have to be as low as possible. (viii) A comprehensive

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national education strategy. (ix) Attractive funding for public works projects and wasteland cultivation

Evaluation

One could consider Naoroji to be the founding father of Indian political economy. His writings on the outflow theory and national income estimation continue to serve as reliable sources for further study in these fields. His drain hypothesis served as the foundation for the theory of imperialism. His books give us insight into how British India's economy functioned as well as the causes of Indian poverty and underdevelopment. Dadabhai supported creating a welfare state in India. Naoroji was able to more or less accurately estimate India's national revenue despite the dearth of statistical data. Among India's nationalist economists, Naoroji is held in high regard.

5.3.2 Mahadev Govind Ranade (1842-1901)

Ranade's *Essays on Indian Economics* contain his economic viewpoints (1898). *Indian Political Economy*, the opening chapter, contains the work's core message. In 1892, a lecture on this subject was given at the Deccan College in Puna. The three primary topics of Ranade's economic theories are (i) study methodology, (ii) an explanation of India's backwardness and poverty, and (iii) India's development and industrialization and the role of the state. Let's talk about these three elements.

Historical Method of Study

Ranade was a strong supporter of studying economics historically. He stated: "If the law of relativity and correspondence holds good in politics and social sciences generally, it ought to hold good equally in all kindred subjects, including among others, the science of National Wealth or it is more popularly described, Political Economy." Political economy, according to him, is closely related to many other areas of social philosophy. He acknowledges that the laws of distribution are partly human institutions, just as J.S. Mill. As a result, these laws are modifiable. He rejected the traditional idea of economic absolutism. A pragmatic economist, he was. He disliked the classical system's deductive style of analysis. On the other hand, he considered the historical method to be more suited than the deductive abstract classical technique because it takes the past into consideration when predicting the future. The foundation of the applied science of economics is relativity. He claims that political economy is an idealised science for which the relative historical method would be preferable. But he advocated studying theory and practise at the same time. "Theory is only enlarged practice and practice is theory in its relation to proximate causes." He criticised the absolutism and irrational assumptions of the classical economists. He claimed that outside of England, the basic tenets of economic theory are irrelevant. In light of the circumstances in India, he rejected the tenets of the British classical political economics. He criticised the classical authors for studying economics using a historical perspective. For a nation like India, Ranade did embrace the Malthusian theory of population, though.

Backwardness/Poverty in India

He described a variety of causes for India's poverty and development hindrances. These include a conservative outlook, hazy agricultural circumstances, a lack of capital, unskilled labour, unenthusiastic individuals, a lack of accumulating motivation, the exodus of talent and resources from the area, among other things. India only produces raw resources for export. Cooperation is hardly ever seen. Agriculture is still practised nowadays. Petty farming, retail business, and employment by underprivileged individuals using borrowed money are all examples. A landed gentry or wealthy middle class are nonexistent in a country like India. Ranade claims that while our religion forbids the accumulating of riches and power, our institutions and laws favour a modest quality of living. The Indian people's faces bear the general traits of stagnation and dependence, despair, and poverty. Additionally, India has been losing enough brains and income to Britain each year. This stands out as the root of Indian poverty.

After the British arrived, poverty in India significantly grew. The Indian economy is unbalanced and backward. There aren't enough suitable financing facilities. Additionally flawed are the land policies. Industrial development was hampered by a lack of finance options. Ranade points out that India is now a provider of raw materials for British companies and a ready market for British goods as a result of bad British policies. The main factor contributing to India's poverty is the country's over-reliance on subpar agriculture.

Development and Industrialisation in India

Ranade noted that if certain genuine and necessary initiatives are followed, the Indian economy may be grown and poverty can be eradicated. Here are a few of them in brief:

In a nation like India, urbanisation and industrialization must go hand in hand. The development of agriculture should be connected to urbanisation and industrialization. India needs to pay closer attention to its industrialization. Indian industry need to be safeguarded. Ranade desired that India create raw resources and refine them for export to other nations as completed items. He supported the import of production expertise and method. For sugar imports into India, he urged the introduction of high tariffs. He advised the Indian government to follow an effective strategy for the country's industrial growth. Ranade believed that India should compete with foreigners despite the British Government's objective of free trade. India must cooperate to organise labour and capital, and it must allow the unrestricted importation of international expertise and equipment.

He asserted that the only way to stop famines in India was to diversify the country's economy. He supported the growth of some vital industries, such as the Indian iron and steel industry.

In Ranade's view, riches encompassed not only material possessions but also knowledge and technology. In his work on Indian Political Economy, he makes this point very clearly.

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Ranade proposed that the actual tillers should own the land. He also advocated fixing the proportion of farmers' output in total. He supported Ryotwari land settlement for a minimum of three decades. Ranade proposed institutional changes in the agriculture industry to facilitate loans in the sector. He advocated for the state's promoting role in this area. He was in favour of making India's land assessments more certain.

Ranade emphasised that social, political, economic, and institutional issues all play a role in how an economy develops. He also advocated for India to establish a planned economy, which would essentially be a welfare state.

Ranade proposed liberalising land policy and adjusting taxation to the comfort of cultivators. He desired a thorough reorganisation to simplify the nation's credit structure. Ranade argues that a fundamental shift in the relationship between the soil and those who farm it is necessary to free the nation from its powerlessness. He advocated for the coexistence of various farming practises.

Ranade disputed the British claim that arid regions are only suitable for the production of raw minerals. Ranade disagreed with this motivated application of the Ricardian idea of comparative costs. He claimed that India could certainly become an expert in both the manufacturing and processing of raw materials. He offered solutions for increasing home production.

He attributed the hoarding of gold and silver on the Indians. He asserts that these precious metals can be effectively employed for development purposes. The nation's economic resources must be appropriately managed. India benefits from having a lot of natural resources and a lot of labour available. Therefore, industries that need labour and raw materials can be started in India.

Ranade supported the nation's population policy taking a balanced approach. He advocated for emigration from densely inhabited areas to less populated ones. He desired a balanced population across the nation's regions.

Ranade argued that the existence of the non-agricultural market is necessary for the development of agriculture. He acknowledged the interconnectedness of industry and agriculture. Given that India has a sizable labour surplus, India's industrial growth strategy may be focused on labour-intensive production techniques. He proposed creating an institutional loan structure. India has financial resources, but they must be used for development. Institutions like banks and financial intermediaries are necessary for this. Ranade proposed safeguarding emerging sectors early on in the growth process.

Ranade believed that the state's constructive role is of highest importance for the industrial growth of the nation. Let's elaborate on this.

Role of State

Ranade asked the government to play a constructive role in the industrial growth of the nation by safeguarding domestic industries and in other ways. He claimed that both agriculture and industry have been harmed by state policy in India. Economic lag and poverty in India were largely caused by British policy.

NOTES

Ranade envisioned the state as a welfare state that must implement numerous reforms in a variety of areas. Political, social, and economic institutions, whose activities are to be channelled by the state, were crucial to India's economic development. Given that the private sector in India is so conspicuously absent, the state should take the lead in all initiatives. According to Ranade, "the state is now more and more recognised as the national organ for caring for national needs in all subjects in which individual and cooperative efforts are most likely to be as successful and economical as national effort." Relegating them to the straightforward responsibility of upholding peace and order is truly depriving the community of the benefits of the social union.

According to Ranade, the laissez-faire approach may be more detrimental than beneficial for a developing nation like India. In such a nation, the state must act as a companion, teacher, and mentor. It must offer incentives and subsidies to promote industrial growth. Trade, finance, and commerce must be regulated by the government. Additionally, it must control teamwork. Ranade commended the British administration for lending money to India at a cheap interest rate. The government is responsible for things like communication, industrial growth, agricultural development, and education. In this aspect, Ranade backed the Cultural System's stance. The government must implement a variety of development-related laws and regulations.

Evaluation

Ranade was blind to the exploitation of Indian resources caused by the use of British money. Ranade was a pragmatic economist, nevertheless. He made a number of crucial, doable recommendations for the advancement of India. He is both a relativist and a nationalist economist.

5.3.3 Romesh Chandra Dutt (1848-1909)

Economic historian and government official Romesh Chandra Dutt was. *Famines in India* and *Economic History of India* (Two Volumes) are two of his most well-known works.

The destitution of Indians motivated Dutt. He considered the numerous factors contributing to India's widespread poverty. He claimed that the British had no interest in seeing the Indian economy grow. He did, however, commend the British for introducing modern civilisation, peace, education, science, and technology to India. They had crafted sound laws and established a powerful and effective administrative apparatus. Dutt held the British government in the highest respect as a result of all of these. But he believed that the material well-being of Indians could not have been improved by the British administration; rather, it had progressively deteriorated. Indians were made to suffer from both extreme and moderate poverty. In India, famine was a factor in the country's poverty. However, there were other factors contributing to Indian poverty.

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Causes of Indian Poverty

1. **Backwardness of Indian Agriculture:** The hefty taxation of land prevented Indian farmers from producing any surplus for their own well-being and the growth of the agricultural industry. The land tax was extremely high and unreliable. In Bengal and Northern India, it even reached the level of 80% to 90% of the rental. By oppressing the populace, the tax was implemented in a very primitive way. Every time, the tax was raised without providing a justification. Sometimes the entire surplus crop on the farm was seized by the land tax. All of this suggested that Indian agriculture was unable to produce any surpluses and could not sustain its dependent population. The end effect was severe poverty and high levels of debt. Modern technologies and irrigation infrastructure were lacking in agriculture. The agrarian system was extremely archaic and unproductive. Production methods were subpar, and the land was in terrible condition. The pricing of agricultural goods were not in the cultivators' favour, and the system of land tenure was also highly conventional. All of these indicated low agricultural output in India.
2. **Downfall of Indian Industries:** The growth of India's industry did not interest the British. They desired to restrict India to serving as both a market for British products and a source of raw resources for British industry. Indian industry development was halted by the British. Their business practises were self-serving. It stifled the expansion of the manufacturing sector in India. Indian silk and cotton products in particular were subject to heavy tariffs upon entry into Britain, yet British goods were allowed entry into India duty-free or with little fees. Many talented Indian artisans were laid off. The British government devastated the small-town and rural industries. The artisans were forced to return to agriculture, where there was a significant increase in population pressure on the land, worsening the situation of poverty. The development of the powerloom caused the Indian industrial sector to completely collapse. The British government levied an excise charge on cotton textile output. As a result, Indian manufacturers lost their ability to compete on the global market.
3. **High Growth of Population:** According to Dutt, the rapid population expansion in India was a major contributor to the country's poverty. The reason for India's low per capita agricultural output was its high population density. During the British occupation, the population's standard of living significantly decreased.
4. **Unsound Taxation:** The land tax was extremely high and based on ambiguity. The idea of reciprocal advantage did not underpin taxation. The state did nothing but take; it did not provide anything of value to the populace. Instead of creating new industries or reviving existing ones, the state instead squeezed the populace to get as much as possible from them. Dutt claimed that tax payers in India paid 40% more in taxes than those

NOTES

in Britain and Ireland. Additionally, Indian taxation was not based on any sensible principles. The extremely expensive financial administrative system contributed to the high tax burden as well. Under British administration, India's sources of national wealth had mostly shrunk.

- 5. Excessive Home Charges:** Every year, India transferred a sizable sum of money to England in the form of "home charges." While past foreign rulers in India also took advantage of the populace, they did so by spending the proceeds locally. As a result, the Indian people gained something indirectly. But things were different under British authority. India's money regularly poured into England. India suffered as a result, whereas England benefited. In India, English officials were only allowed to hold the highest positions. The Home Charges gradually increased because to the high taxes. The Home Charges were a blatant drain on Indian resources and made a significant contribution to the rise of Indian poverty.

Suggested Remedies to Remove Poverty

Several strategies were put up by R.C. Dutt to end poverty in India. He primarily recommends the following::

- (i) Rationalization of the land income system is necessary. He recommended making land settlements for a duration of more than thirty years. The land tax cess must be applied to the cultivators' direct benefit. When the state collects direct land revenue, the rate shouldn't be higher than 20% in any given case and not more than 10% for the district as a whole.
- (ii) The excise taxes imposed on mill industries ought to be eliminated.
- (iii) Reduce the interest rate on the nation's debt.
- (iv) The repayment of public debt might be accomplished by means of a sinking fund.
- (v) The British government needs to split its costs between the military and the civil sector.
- (vi) By hiring more Indians in the civil service and in high-paying jobs, civil charges may be decreased.
- (vii) Rural areas should have irrigation works, and the cost may be covered by regular earnings.
- (viii) It might be forbidden to build any more railroads.
- (ix) In the legislative body, there ought to be representation for Indians. The Indian Constitution may be altered in this regard.
- (x) He advocated for the resuscitation of home-based and small businesses.
- (xi) Savings in government spending.
- (xii) Decrease in household expenses.
- (xiii) Expanding irrigation infrastructure to include agriculture.

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Dutt noted that the costs of the Mutiny had increased India's burden and had resulted in even higher taxation. The agricultural industry was required to shoulder a large portion of this increasing tax load. India's meagre financial resources were heavily strained by the cost of building its railways. Inevitably, this contributed to India's governmental debt increasing. Under these conditions, poverty will affect any nation. All of this was caused by the application of some economic laws, which apply consistently and uniformly in situations like this.

Famines in India

R.C. Dutt also investigated the Indian famines. In the year 1900, he published his book about the Indian famines. He listed some factors that have contributed to famines in India. He claimed that the extremely low purchasing power of the populace is the primary cause of starvation. It may not always be the result of poor output or productivity. He has refuted British people's incorrect assumptions about what causes famines in India. The British believe that the causes of the famines in India are (i) rapid population expansion, (ii) people's careless and extravagant spending habits, (iii) moneylenders' exploitation, and (iv) crop failures.

When Dutt was writing, the rate of population increase in India was significantly lower than it was in England. He also rejected the notion that Indians were wasteful with their money. According to him, Indians are thrifty and frugal. Although the moneylenders undoubtedly took advantage of the Indian populace, the country's farmers are still required to pay their taxes by visiting the village moneylenders. According to Dutt, famines don't happen because crops fail but rather because people are unable to buy food from nearby provinces that have abundant harvests. The absence of revenue is the main factor causing famine. He noted how severely famines had devastated India in the latter quarter of the nineteenth century. Famine prevention methods and suggestions for ending poverty share many similarities.

Evaluation

It is important to acknowledge Dutt's contribution to the study of famines and poverty. His understanding of India's economic history is astounding. He correctly noted that the Indian people's poverty was the true driver of the Indian economy's underdevelopment during the British era. India's lack of development was brought on by the poor British economic strategy.

5.3.4 Gopal Krishna Gokhale (1866-1915)

Ganesh Krishna More of a political figurehead than an economist, Gokhale. He served as Mahatma Gandhi's political mentor. Gokhale is renowned for both his testimony before the Welby Commission on Indian expenditures and his budget speeches. A book by V.G. Kale titled *Gokhale and Economic Reforms* contains the majority of Gokhale's economic viewpoints. The following is a discussion of some of Gokhale's key economic concepts.

Drain Theory

Gokhale claims that the British-created economic and social conditions are to blame for India's resource drain. The drain was created as a result of several unfavourable policies that England enforced on India, including free trade, the destruction of industries, and others. Gokhale believed that the draining of resources from India was to blame for the country's poverty. For a nation like India, he was in favour of industrial growth.

Gokhale, however, was not ignorant of the nuances of Dadabhai Naoroji's theory of drain. Gokhale made it very apparent that some of the payments made to England were offset by the benefits gained by India from England, such as capital borrowing and the upkeep of an army and navy for national defence. Gokhale noted that the amount of drain was extremely substantial but could be much diminished. He expressed dissatisfaction about how expensive Indian bureaucracy is. He supported providing Indians positions in the military and public service. However, Gokhale cautioned that making any broad generalisations about the impact of the Indian population outflow would be completely absurd.

Public Finance and Public Administration

Gokhale presented the Welby Commission with four crucial issues. These significant challenges include: (1) India's public spending has grown rapidly without the nation's economy keeping pace. (2) There is an uneven distribution of fees between India and England. Gokhale therefore argued that these fees should be split equally between India and England. (3) The provinces lack the necessary financial resources. As a result, they should be given increasing financial authority over the management of federal funds. (4) The Viceregal Council, which will be made up of a sufficient number of Indian delegates, should have responsibility over finances.

Gokhale drew attention to certain irrational requirements imposed by the British government in India. These taxes include the salt tax, the cotton tax, and others. The salt tax was incredibly regressive. Gokhale also wished to eliminate the opium tax and the cotton charge. Additionally, he opposed the petroleum tax because it primarily affected the poor.

Gokhale discovered that the British government in India had a surplus budget for a few years. The British government asserted that it was evidence of India's prosperity. Gokhale disputed this assertion. According to him, the excess was just a financial one and did not represent actual prosperity. Second, Gokhale made the observation that the surplus budget suggests that impoverished people have been subjected to higher taxes than necessary. Therefore, a surplus budget indicates that the poor would suffer more. Thirdly, the government aimed to establish a financial equilibrium at a time when the value of the rupee was at its lowest through the surplus budget. Budget surpluses provide the impression that things are prosperous. Additionally, it will imply that the government can use the extra funds however it sees fit. It provides the government more authority to play Russian roulette with the lives of the populace. If there is actually a surplus, the government should use it to

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improve public welfare or lower individual tax rates. It should be emphasised that Gokhale had a great concern for the well-being of Indians. The surpluses were made to cover the British government's increased expenses in India. However, these expenses were the main causes of outflow.

Gokhale noted that government spending must be prudent and that taxes should be maintained as low as possible in his budget address from 1902. He favoured increasing spending on sectors such as sanitation, agriculture, industry, public health, and education. He spoke in favour of implementing progressive taxation.

He was also concerned about the Indian economy's rising inflation. According to him, inflation increased the price of development projects and brought to severe pain for the poor. The currency was also impacted by inflation. He urged an expert group to conduct an investigation into the exorbitant rates.

Gokhale conducted a highly sophisticated analysis of the British Government's manipulation of the exchange rate against India's interests. According to him, such manipulation was carried out in order to raise British citizens' salaries. Gokhale demonstrated that the additional cost to Indian taxpayers amounted to \$30,000 per year as a result of the unjustified manipulation of the currency rate. He supported reform and stable currency rates.

Economic Conditions in India

Gokhale became aware of the poverty in India. He provided information to disprove the British Government's claim that India was becoming more prosperous and to demonstrate the growing poverty there. He claimed that despite a budget surplus, the tax burden on the populace, which was a major contributor to poverty, did not go down. He said that the income tax and salt tax collection was not even keeping up with the usual population expansion. This led him to the conclusion that the material well-being of the Indian people was constantly declining, and he considered this to be the saddest development in the entirety of the global economic history.

Suggested Reforms

Gokhale put out a number of measures for the country's better financial management and administration, as well as for enhancing the welfare of the populace. The key recommendations made by G.K. Gokhale are as follows:

- (i) He was in favour of India's industrialization.
- (ii) He suggested conducting an investigation to determine whether the sugar business in India could expand.
- (iii) He argued for the implementation of a long-term solution to the land revenue issue.
- (iv) He pushed the government to establish land mortgage banks in order to lessen moneylender abuse.

NOTES

- (v) He advocated for the implementation of education, particularly for child labour.
- (vi) He introduced a resolution to forbid the hiring of indentured labourers for the Natal colony. He claimed that indentured labour amounted to a de facto slave society.
- (vii) He argued more strongly for preventative irrigation than for fiscal relief from the famine.
- (viii) He wished for the state to take control of the railroads.
- (ix) Gokhale promoted the protection of Indian industries with the appropriate level of protection.
- (x) Promotion of industrial and technical education while training a select group of Indians overseas.
- (xi) The improvement of workers' living conditions.
- (xii) Decrease in revenue.
- (xiii) Establishment of cooperative groups that offer low-interest loans.
- (xiv) Elimination of agricultural debt.
- (xv) He supported distributing power more evenly.

Evaluation

Gokhale's innovative ideas on Indian public finance and financial management have made him a well-known figure. His belief that public enterprise must step in where private enterprise falters appears to be well-founded. To improve the welfare of the Indian people, he made a number of realistic reformative recommendations. He was fully aware of the effects that altering government spending on the nation's production, distribution, and employment would have. His main focus was on putting an end to Indian poverty. Gokhale supported stricter financial management and a stronger economy in each province. "Gokhale was perhaps the first in India to emphasise that government expenditure and income should be directed to set right deficiencies in the working of the economic system"

5.3.5 J.K. Mehta

Jamshed Kaikusroo Mehta became well-known for creating, enhancing, and mastering neoclassical economics tools beginning in the early 1930s and continuing for almost forty years. By his contemporaries' acknowledgment of him, it is well demonstrated. While Joan Robinson (1933, p. xv) acknowledged him as the independent creator of the concept of marginal revenue, H. H. Liebhafsky judged his writings to have the sobering insights of a scholar with considerable critical skill.

Single-commodity markets instead of aggregate market whose size was considered by the classical a single-commodity firms and individuals, mimicking firms, came into focus, J.K. Mehta was an economist of this neo-classical genre, ever-perfecting, ever-completing the neo-classical system. But there seemed to be running a parallel streak in him right from the beginning; for example, he tried to

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locate every factor of production in the man himself though he borrows it from the Austrian tradition. Finally, he also tried to impregnate economics with a philosophy that is capable of changing the whole edifice. One may find in his writings a good dose of mathematics, physics and metaphysics irrespective of the topic.

Theory of Wantlessness

Wants are the root cause of miseries as they cause pain and, therefore, man wants to get rid of them. This is the basic premise. Two important properties of wants that are suggested are: (1) psychological attachment of the person to the object wanted and (2) absence of the wanted object with the person in question. There are two ways in which man can proceed to do that—one is of satisfying them by readjusting environmental forces with endogenous forces, and the other is of removing the cause of wants by readjusting endogenous forces with exogenous ones. One seeks harmonization of the environment with the self and the other, harmonization of the self with the environment. Removal of attachment is the wantlessness and possession of the object is fulfillments. The latter method is generally resorted to, as it yields a pleasurable feeling (Mehta, 1962, p. 66) but is inconsistent as physical objects are transient and need to be replaced. Further, once a person gets used to satisfying wants by arranging material objects for his sense organs he is likely to feel miserable when he fails to arrange those material objects. Hence, he/she is likely to struggle throughout his life only to find in the end that his wants remain unfulfilled. The more one fulfils them the more he finds them unfulfilled.

5.3.6 M.N. Roy

Roy claims that one of the fundamental aspects of capitalism by which the working class is exploited is surplus price manufacturing. It was seen by Roy as the central error of Marxist economics. Roy claims that excess is a capitalist tool and that surplus values make social growth possible. Marx actually accepted the need for and growth of social value of surplus values. Eliminating surplus costs will be impossible and perhaps dangerous.

No civilization can grow, in Roy's opinion, unless it has excess values. Roy accordingly emphasises surplus values in particular. Roy contends that if the production of surplus value ever slows, society's development will stagnate. We see a dichotomy there. In a certain sense, it may be said that society's growth will stagnate in addition to surplus value. Contrarily, it might be said that labour is exploited wherever there is surplus value. Marx, however, is unaware of labour exploitation. He has argued for a form of surplus value that doesn't include labour exploitation. Marx stated in another place that it was necessary to stop the classification appropriation of social surplus.

According to Roy's interpretation of Marxism in this regard, "the expropriation of the expropriation used to be the circumstance for the end of exploitation of man via man." How is it feasible in the financial system, then? In this regard, Roy continues by stating that such a demand is no longer moral or economical. Roy claims that it is a call for social justice and that a Marxist

revolution would not call for it. Roy, however, believes that such an outlook does not reflect actual circumstances. There is no logical reason why labour exploitation must occur where there is surplus value.

Even in Russia's socialist economy, where socialism formerly predominated, surplus value is produced. How therefore do we defend the idea that labour exploitation occurs in socialist nations, including Russia? There is no minimum threshold for asserting that labour exploitation leads to excess value: Industries that grow quickly tend to accumulate quickly and heavily, leaving a margin of surplus value.

According to Roy, "If manufacturing of surplus costs symbolises labour exploitation, then labour is exploited under Socialism; and it should be accepted that the socialist economic system of Russia labour is even more abused - to produce big surplus costs to be accumulated into new capital." Roy contends that there is no link between the exploitation of labour and the buildup of surplus costs. Capitalism and socialism would both be equally guilty if it were considered that the supply of labour exploitation is determined by surplus costs.

Check Your Progress

4. According to Naoroji, the extent of drain was to the tune of _____ million during 1814-1865.
5. The British policy was mainly responsible for the economic _____ and poverty in India.
6. Romesh Chandra Dutt was a _____ and economic historian.
7. India's drain of resources has been created because of the economic and social conditions created by the _____.
8. There is no floor of claiming that surplus value is the result of exploitation of _____.

5.4 ECONOMIC IDEAS OF MOHANDAS KARAMCHAND GANDHI (1869-1948)

M.K. Gandhi was neither a politician nor an economist. He had a socialist strategy built on love, compassion, truth, and non-violence. Gandhi aspired to a society that was perfect in his eyes. His political, sociological, and philosophical principles are all intertwined with his economic beliefs. Gandhi's main concerns were with the unrestricted development of people and the emancipation of the oppressed and exploited masses. Gandhi's economic theories are dispersed among his numerous texts. Following is a quick discussion of Gandhi's main economic theories.

Welfare Economy

Gandhi favoured increasing social assistance to the fullest extent possible. The welfare is more of a spiritual nature than it is of a material kind. His idea of welfare is founded on the development of the entire psyche of the individual. The idea of the *homo-economicus*, or economic man, goes against it. Gandhi favoured fewer injustices and unrestricted human development. Gandhi did not equate wealth with

NOTES

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welfare. Gandhi advocated for meeting the necessities of life, such as food, clothing, and shelter. He opposed the accumulation of wealth that went beyond what was absolutely necessary. He had visions of a socialist future where everyone's basic needs would be addressed. Gandhi believed that occasionally it was essential to intentionally decrease one's desires.

According to Gandhi, moral and ethical principles should serve as the foundation for all economic actions. Gandhian economics and ethics are actually closely related. His economics were moral yet pragmatist.

5.4.1 Village Reorganisation and Agricultural Development

Gandhi supported villages that could support themselves. He intended to cultivate using a method that wouldn't degrade our soil. The soil must not be harmed by the usage of fertiliser. He opposed the use of synthetic fertilisers. He chose well irrigation over huge hydropower plants for irrigation because the latter will result in exploitation. Gandhi was opposed to private land ownership. For balanced farming, he believed that communal ownership of land is preferable. The owners of the land ought to be the farmers. The remaining villages must receive the excess produce grown on the farm. India, according to Gandhi, is a rural nation. India's development therefore rests on the growth of its villages. Every community must function as a separate republic. Every town is required to grow the ingredients for its own use. Every hamlet must have all the amenities and facilities it needs, including a public hall, a school, a theatre, and a water supply. He favoured restoring the previous village system. He improved the Sarvodaya village system. Village issues must be adequately resolved in order to end poverty and enable people to live happy, independent lives. Gandhi placed a strong emphasis on reviving rural industries including soap, paper, khadi, and hand-pounding. The village will contribute to a decentralised economy in some way.

Gandhi favoured the complete eradication of the zamindari system. He argued for the necessity of a group effort rather than favouring individual or peasant farming.

5.4.2 Swadeshi

Let's look at the effects of swadeshi in the area of economy first. Gandhi believed that the destructive deviation from the path of swadeshi in the monetary and industrial life was the cause of the extreme poverty experienced by the majority of people. Gandhi urged adherents of the swadeshi philosophy to only consume goods made by their neighbours, support these industries by making them effective, and develop them where necessary. He discovered the solution, which was universalizing khadi or a spinning wheel that met these requirements. Khadi is to him the solar system's Sun for the community. Numerous industries on the planets can support khadi. Decentralization of manufacturing and distribution of necessities of life is referred to as the "Khadi philosophy."

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Decentralisation

Gandhi favoured a decentralised pattern of growth because it is healthier physically and spiritually. A country like India can flourish with the least amount of disruption and dislocation by utilising decentralised industry. Decentralization objectives can be served by small and local industries. Large-scale enterprises typically make up the centralised industries. These sectors promote regimentation and are antidemocratic. Village industries promote the growth of pleasure between labour and capital and are also highly democratic. However, certain industries are massive by nature. You cannot escape them. Gandhi supported state control of certain businesses in the situation. These industries ought to be strictly regulated.

Gandhi supported decentralisation as a way to prevent bloodshed. He advocated for delocalization of manufacturing as opposed to concentration in specific regions. He noted that village industries may progressively become mechanised.

Large enterprises can occasionally be found to be wasteful. These sectors of the economy are unrelated to one another. Gandhi believed that, for the most part, people should endeavour to use local resources and energy to create their economies. In small-scale and cottage enterprises, power must be used extremely carefully to avoid exploitation. In addition to providing electricity, animals like cows and horses also produce waste. They are useful for manure as well as for ploughing the ground.

Gandhi opposed industrialization because it just promotes material advancement and does not aid in the development of the individual's individuality. Life's end is not marked by material advancement. He favoured decentralisation from the very beginning of industrial growth. He supported making some fundamental and important industries nationalised. Gandhi advocated decentralisation as a way to counteract the negative effects of a centralised economy.

5.4.3 Place of Machine and Labour**Use of Machinery**

Gandhi was opposed to the use of equipment. Gandhi claimed that machinery was to blame for India's plight. Machines were used to ruin Indian handicrafts. Worker slaves are created by machinery. It results in appalling working conditions. Human labour is replaced, which raises the unemployment rate. Gandhi claims that using machinery powered by electricity to replace labour is illegal. It is incorrect to believe that machinery reduces labour costs. Only a select few people benefit from machinery, since it worsens the situation of the unemployed and oppressed masses. Family businesses that operate on a smaller scale contribute more to increased output and employment than do large-scale businesses. Gandhi objected to the fact that employment is always reduced in large-scale industries. The employment differences between these two types of industries can be shown in the following diagram which shows that large-scale industries have the possibility of generation of more unemployment.

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Gandhi may have been impressed by the ability of cottage and village enterprises to absorb labour. This reasoning made sense when seen from the standpoint of India's significant labour surplus.

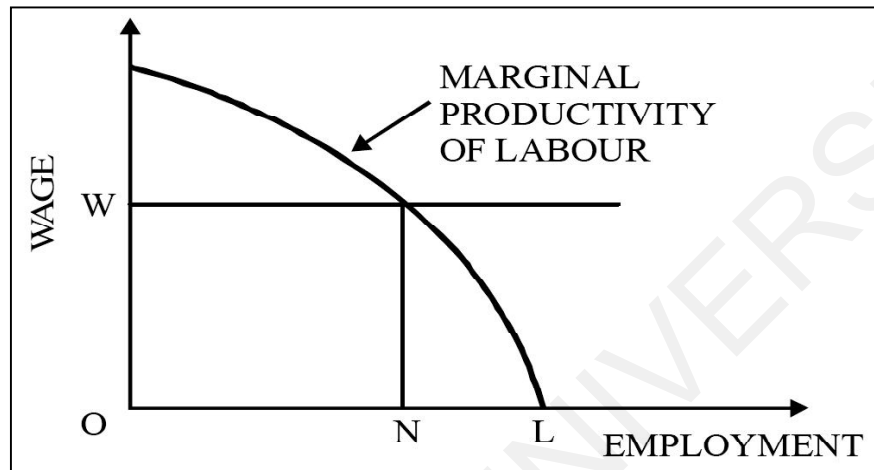


Fig. 5.1

In the above diagram, ON is the amount of employment generated by the largescale industries which want to maximise profit; but a family-type industry which wants to maximise output and employment can generate OL amount of employment. Thus, if employment generation is regarded as an objective function, Gandhi's advocacy for village-type industries seems to be on a rational ground.

Gandhi does not believe that industrialization is necessary in any nation. Gandhi appears to be against technology since it "establishes [man's] own command over and makes him their slave." He was rational enough to assert that equipment is OK so long as it does not deny large populations of humans the chance to work, boosts their productivity, or turns them into slaves. He supported the usage of electricity in the community. Because machinery fosters strife between labour and capital, he detested it. Additionally, the individuality of the workers is compromised by machinery. Gandhi, however, was not against all forms of mechanisation. He disapproved of the obsession with labour-saving technology. He was in favour of any machinery that served as a servant to the workers and aided them. Mechanization was beneficial, especially for nations with a shortage of labour. It is harmful to economies with a labour excess.

On Labour

In an economy, labour has a very important role to play. Gandhi supported the creation of labour unions in many production locations. The labour union's efforts ought to be guided by truth, arbitration, and non-violence. The rights and interests of the union members shall be protected. The state's duties will be divided among the unions. He supported striking. He personally was the leader of many strikes. But he made the point that the strike's justification was necessary. He supported labour's involvement in management. He promoted shorter workdays, greater leisure time, and economic equality in the workplace. He supported equal compensation for similar work. He noted that the world would be a much happier

NOTES

place to live in if the distinction between labour and capital were abolished. He sought the collaboration of labour and capital. Labour should be the ruler of capital, not the other way around. Gandhi supported maximising the wellbeing of the working class. He recognised the value of treating workers with respect.

Bread Labour

Gandhi advocated for each person to provide for their daily needs through their own labour. This holds true for all forms of labour. The lives of labourers would be happier and healthier if this were practised. Without some form of physical labour known as “bread labour,” no one has the right to food. He denounced futile labour.

5.4.4 Cottage Industries, Trusteeship

Indian Cottage Industries

For almost 50 years, the cottage has served as India’s gateway to the outside world. What started as an effort to preserve the traditional craftsmanship and excellence of skill as a part of national heritage has evolved into a cultural movement in its own right thanks to the attention that the emporium has drawn from numerous heads of State, prime ministers, ambassadors, and a host of other dignitaries from around the world. All of India’s diverse arts, crafts, and clothing have come together under one roof as a result. From a small sales station, the emporium has grown into the biggest in the nation, with a strong reputation for providing ethnicity, authenticity, and quality on all of the goods it houses. Come and experience India’s enchantment via the Cottage’s perspective.

The Central Cottage Industries Emporium was designed as a display of the works of Indian artisans, weavers, and folk artists. It has become a favourite with clients in India and around the world. It has taken extra care to ensure that through its products, the decor, the display, and everything else that goes with it, you get a sense of what the real India is all about. This one-of-a-kind store has approached the selling of handicrafts from multiple angles, including market research, hand-selected purchasing, creative promotion design development, impeccable goods, cautious inventories, and a range of ancillary services to provide a fully immersive shopping experience.

With its emporia in five cities—Delhi, Mumbai, Kolkata, Chennai, and Bangalore—as well as franchise stores in Gurgaon and Jaipur that carry goods from all 50 states, Cottage has been thriving. The Rajiv Gandhi Handicrafts Bhawan in Delhi also houses Cottage’s two exclusive product showrooms, Cottage Carpets & Cottage Art Gallery. Our sole goal is to provide the finest possible service to our customers while also showcasing the talent of the many artists and craftspeople who would otherwise vanish into obscurity and providing them with a bright future through our direct market access. We simultaneously engage in direct communication with craftspeople, recreating some of the most traditional crafts while also keeping expenses under control.

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Indian Trusteeships

The Indian Trusts Act of 1882 covers every aspect of trusts, trustees, and beneficiaries. Every person who is capable of retaining property may serve as a trustee, but they must be competent to contract in order to carry out trusts that require the exercise of discretion. This is stated in section 10 of the Indian Trusts Act of 1882.

Because trustees have a “fiduciary” duty to the trust’s beneficiaries, the role of trustee is very significant. As a result, they have a variety of important responsibilities as they are in a unique position of trust. If you are a trustee, it is imperative that you are aware of your responsibilities because failing to do so could result in legal action for “breach of trust.” A trustee can be someone who is allowed to own property. A court must appoint a trustee to serve in the minor’s place until the minor turns 20 if the trustee is a minor (someone under the age of 20).

In general, the main duties of trustees are:

- To behave in the trust’s beneficiaries’ best interests
- To exercise fairness toward beneficiaries and toward groups of recipients
- Not to use information or power obtained as a result of being a trustee to push one’s own agenda (unless the trustee discloses their personal interests to the trust’s settler and gets their informed approval).
- To take initiative rather than relying on others to make decisions for you (except if the trust document explicitly permits delegation)
- To manage others’ affairs honestly, skillfully, and with the level of care that a sensible businessperson would exercise
- to have a complete understanding of the trust’s terms as stated in the trust deed, which serves as the principal trust document, as well as any potential beneficiaries and the trust’s assets and liabilities.

Check Your Progress

9. M.K. Gandhi was neither an economist nor a _____.
10. Gandhi wanted the abolition of _____ system without any compensation.
11. Indian _____ were destroyed by the use of machinery.
12. Gandhi does not find any necessity of _____ in any country.

**5.5 EARLY APPROACHES TO PLANNING
(NATIONAL PLANNING COMMISSION)**

India’s five-year plans are created by the Planning Commission, a department of the Indian government, among other duties.

Rudimentary economic planning was originally introduced in India in 1938 by Netaji Subhas Chandra Bose, then the president of the Congress, and was developed by Meghnad Saha. It is derived from the sovereign authority of the state.

A planning board was also legally constituted by the British Raj and operated from 1944 to 1946. In 1944, economists and businessmen independently created three different development plans.

Following India's declaration of independence, a formal style of planning was adopted, and the Planning Commission, which reports directly to the Indian Prime Minister and is presided over by Prime Minister Jawaharlal Nehru, was subsequently founded on March 15, 1950. The Planning Commission is a part of the Central/Union Government and was not established by law or the Constitution.

Two further five-year plans were developed until 1965, when there was a pause due to the Indo-Pakistan Conflict, after the first Five-Year Plan was introduced in 1951 with a primary focus on the development of the agricultural sector. Drought in two consecutive years, currency devaluation, general price increases, and resource depletion interfered with planning, and after three Annual Plans between 1966 and 1969, the fourth Five-year plan was launched in 1969.

Due to the rapidly shifting political climate at the Center, the Eighth Plan was unable to launch in 1990, and the years 1990–1991 and 1991–1992 were considered as Annual Plans instead. 1992 saw the official inauguration of the Eighth Plan following the start of structural adjustment efforts.

Since the launch of the Ninth Plan in 1997, the emphasis on the public sector has diminished, and the current thinking on planning in the country, in general, is that it should increasingly be of an indicative nature. For the first eight Plans, the emphasis was on a growing public sector with massive investments in basic and heavy industries.

Check Your Progress

13. India was established on 15 March _____, with Prime Minister Jawaharlal Nehru as the chairman.
14. The first Five-year Plan was launched in _____.

5.6 COOPERATION AS A STRATEGY

5.6.1 Contributions of Vakil

The following points highlight the top nine contributions of C.N. Vakil to Economics. The contributions are:

1. Planning
2. Wage-Goods Model
3. Role of Technological Progress
4. Consumption Multiplier
5. Poverty
6. Deficit Financing and Public Expenditure
7. International Trade

NOTES

NOTES

8. Extension Work

9. Inflation

Contribution # 1. Planning

Prof. Vakil (along with Prof. P.R. Brahmananda) put forward an alternative approach to Indian planning, which was opposite to that of the Mahalanobis model, at the time of the formulation of the second five year plan for India. Vakil's plan frame was related to Marxian concept of variable capital (v). This model is based on classical economic philosophy, in particular Ricardo, Marx, Rosenstein Rodan and Ragnar Nurkse.

All these models are based totally on the assumption that, there exist a big reserve group of labour in rural areas for creating economies. In different words, the disguised unemployment made the financial savings potential. This is based totally on the view of that labour should be transferred from agriculture, without reducing manufacturing and deployed for producing actual capital goods. In short, for the improvement of the Indian economy, with large-scale disguised unemployment, the bottleneck desirable is no longer the fundamental and heavy capital goods (as felt by means of Mahalanobis) however the wage-goods.

Assumptions

The plan frame proposed by Vakil was based on the following assumptions:

1. Wages are paid in advance of production. This assumption is similar to that of Marx, Van- Neumann, Leontif, Nurkse, etc.
2. Variable capital or wage goods constitute exclusively food.
3. Labour was able to manufacture capital products without the aid of other production variables.
4. The role of the potential surplus might not be procurable and further that there might be a need to provide for slightly higher consumption levels than in agriculture to workers engaged in Non-agriculture (consumption). The model is developed with a multiplier formula which is based/autonomous increase in the stock of wage foods in the hands of planning authorities.
5. In rural areas there prevails disguised unemployment to a great extent. Therefore, existence of large industrial reserve army.
6. The transfer of disguised unemployed workers from rural sector does not lead to the decrease in the output in the farm sector.
7. There exists a gap in accumulation of wage goods. To the extent of that/gap, forced savings have to be effected by reducing present consumption (by imposing taxes) or by importing wage goods.
8. The wages paid to the newly employed workers will be higher than the consumption of disguised unemployed.

Contribution # 2. Wage-Goods Model

According to Vakil, the growth of economy is based on numerous economic and non-economic factors. The most important factor of economic factors is to accumulate the capital.

The non-economic factors is change the living condition of the poor people i.e. To invest in high level. And the demand for goods produced will decide the investment in production of that.

Due to low income the demand is less and so the market is also very limited.

For large scale employment, Vakil suggested a wage-goods strategy as best alternative to the Mahalanobis model during the finalization of second five year plan.

Since economic system does not supply wage-goods in the short-run, employment and investment will decrease. The rate of transfer of unemployed workers from the farm sector to the non-farm sector (capital goods sector) depends upon the rate of increase in the supply of wage-goods.

According to Vakil the gap of wages and goods to be removed, then only the problem of unemployment can be solved. So he planned a model with wage goods as the important element.

Therefore, the problem of unemployment has to be tackled without sacrificing technical progress and rapid accumulation of capital, Vakil felt that, the Mahalanobis model does not solve the problem of unemployment and economic growth in India, because the model has a contradiction between theory and statistical frame.

Contribution # 3. Role of Technological Progress

Vakil emphasised that technological development is a effective engine of increase in output as it did not motive unemployment in developed economies (at the full employment level) and that it led to increase living standard of people. However, in a our country, if the required capital accumulation does not take place technological development aggravates unemployment.

In short, Vakil argued that, for the improvement of the Indian economy, what was a abundant need of wage goods, technological progress, reorganization of institutions, adjustments in the price policy, and mobilisation of sources for funding taxation and savings. To mobilize compulsory savings, taxes, adjustment in monopoly prices, and different receipts are needed.

Similarly, in Vakil's model, the wage-goods equation determines level of employment and growth of the economy. Increase in the supply of wage-goods by one unit will lead to an increase in employment by certain units. This relation is described by Vakil as the consumption multiplier.

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Contribution # 4. Consumption Multiplier

The consumption multiplier developed by Vakil is based on certain specific assumptions, as under:

1. The marginal propensity to consume of wage-goods producers is zero.
2. The money and real wage rate remain constant.
3. Price level remains constant.
4. The wage-goods farm sector experiences widespread disguised unemployment. The average wage products consumed by the fictitious employee (d) are below the real wage (W).
5. The supply of credit is perfectly elastic, therefore, rate of interest remains constant.
6. Increase in the activities of the public sector does not lead to disincentives in the private sector.
7. There are not difficulties in the mobilization and transportation of goods.
8. The size of the population remains constant.

Contribution # 5. Poverty

According to Prof. C.N. Vakil, poverty in a country may be due to defects either in the production of wealth or in its distribution. Both these problems are equally important, but it is obvious that if the production or the national dividend is small, the question of distribution would be of comparatively less importance.

According to Prof. C.N. Vakil, poverty in a country due to difference in production of wealth or its distribution.

Further, he viewed the causes as two separate entities:

- (1) Internal and
- (2) External.

1. Internal causes:

- (A) The majority of people depend upon agricultural activity. As there is not work for the large mass of the agricultural population during the off season
- (B) According to Prof. C.N. Vakil, the number of dependents in an average family in the country is large. Usually, an only earning member supports a large family. This kind of situation exists not only among the agricultural population but also among urban population and the higher classes.
- (C) Prof. Vakil feels, Sadhus adds to the burden of poverty on the productive members of society.
- (D) Presence of different climates in different parts of the country stands in the way of continuous and sustained work, either physical or mental. This again increases the number of unemployed, another index poverty.

2. External causes:

- (a) International trade and commerce: Prof Vakil thinks that the chief external cause of poverty is due to the economic life and the changes due the international trade and commerce, done by modern means of communication. According to him,

As per him, the idea of our business relations with different nations has not been for our greatest benefit, and the interior change in the internal economy of individuals expected by the incredible change isn't yet finished.

- (b) Commercial and industrial relations with other countries: He has brought out well the fundamental elements of India's business and modern relations with different nations. During British rule in India there was a quiet and unavoidable monetary attack of the nation, upheld by the exceptionally coordinated modern arrangement of England and different nations and belittled by the Indian organization.

From one perspective, India delivered enormous amounts of fluctuated fabricated articles, the presentation of which had been efficiently supported; on the other, countless unfamiliar business people had been permitted to get comfortable the country with the end goal of modern and business abuse. This can influence the inward creation, work, and so on lastly exasperate states of neediness.

Remedies

Prof. C.N. Vakil has suggested some remedies to remove poverty. He states that the production should be increased and distribution be equal. He suggested to improve agriculture and to use the better inputs of seeds, implements and manure, sinking of large numbers of wells and creation of other irrigation facilities, concerted efforts to promote the co-operative movement and suitable education to assure enough employment opportunity and reward to the agricultural family.

He further suggested that there should be Land Mortgage Banks, to finance the farmers. And also Cooperative for solving the financial problems of farmers.

He suggested to increase the cottage industries for the employment for farmer in off season and those who are not willing to migrate from rural to urban areas.

About land tax, Prof. Vakil said it should be fixed as income tax with reference to the income from the agricultural land and conditions.

His view is that unless the to prevent the industrial exploitation of foreigner or non-Indians the problem of Indian poverty cannot be solved. He also guided to bring out changes in society as early marriage, lowering of mortality rates and incidence of diseases, provision of sanitation, removal of purdah system and provision of suitable work to them

Prof. Vakil believed that free and compulsory primary education was desirable. He was also of the view that rural universities should be established to create an

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interest in the better understanding of and efforts to solve, the problems that affect the life of the rural people in their proximity.

Contribution # 6. Deficit Financing and Public Expenditure

Prof. Vakil firmly protested shortage financing as a way to back the plans. He drifted the possibility that. It is the Keynesian idea of siphoning cash into the economy to counterbalance a downturn which is one of the indecencies of private enterprise. This is a transient solution for created nations to eliminate despondency or to bring out balance in the economy. It has made an extraordinary devastation, inflation and poverty also.

His huge commitment lay in shortening the public consumption by selecting a Public Expenditure Commission. One Public Expenditure Commission was set up in 1921 by the Britishers, from that point forward we have no such Commission. It had a healthy impact in carrying things to sensible extents.

Contribution # 7. International Trade

On the subject of assurance, he stressed that, "Security ought to just be for an impermanent period and when an industry has been appropriately settled, it ought to have the option to confront rivalry. This is the best way to defend the interest of the shopper which one generally overlooked in such matters.

Thus he was in favour of slow and partial competition rather than opening of the whole economy at once. He welcomed the New Gold Policy of the Government to sell gold at international price and import gold.

He was in favour of joint ventures abroad, consultancy in Gulf countries and trade with OECD countries in primary products. He was in favour of joint ventures abroad, consultancy in Gulf countries and trade with OECD countries in primary products.

Contribution # 8. Extension Work

Prof. Vakil laid much emphasis on extension work without which the colossal task of rural development was not possible.

A class of youthful volunteers and learners ought to be raised to coordinate information on rural sciences, farming financial matters, rural social science, town enterprises, policy implementation wellbeing and family government assistance, etc. Farming poly-strategies and a middle for rural improvement were expected to fill the gap between advanced education and the requirements of individuals.

Contribution # 9. Inflation

Vakil was the main Indian financial analyst who caused to notice the price rise winding. The meaning of expansion, as given by Prof. C.N. Vakil is that, when supply of cash in a nation increments and the inventory of merchandise doesn't increment in a similar way, the circumstance is portrayed as one in which more money chases scarce goods. Such a tendency is called inflation.

Prof. Vakil said that, "We inherited inflation on Independence and we have followed an inflationary policy due to incorrect notions or wrong application of

NOTES

western theories to our conditions. This has seriously interfered with our attack on poverty and our efforts at planning". Vakil had suggested that the immediate object of policy should be to drastically lower the prevalence of "black money" and to roll back prices to a lower level.

Evaluation of Contributions by C.N. Vakil

Prof. Vakil can be rightly considered as the originator and pro-pounder of certain standpoints and approaches relevant to modern economics in India:

1. He was among the earliest of business analysts anywhere to have observationally applied the undeniable amount hypothesis to comprehend value conduct. He considered the amount of cash, the speed of cash and the stockpile of genuine result. He isolated the financial variables from the genuine elements.
2. Vakil was among the earliest to have sought after the non-independence of cash supply and its progressions in a country which cabins its gold/unfamiliar trade/unfamiliar security holds in a far off nation and brings in its own not entirely settled by the previous.
3. Prof. Vakil noticed the strong relation between deficit financing in the form of sales of ad hoc treasury bill and currency supply.
4. Prof. Vakil emphasized the need for linking money supply changes to aggregate real output changes rather than to volume of trade changes. He thus rejected the link between money supply and the needs of foreign trade. Total trade changes, foreign as well as internal would be a better proxy for real output changes.
5. Prof. Vakil widened the concept of the brain to include more items than the 'English'(Home) charges. The entire financial policy of the British Government had to be scrutinized in order to understand the magnitude of the excess brain-burden imposed on the Indian people.
6. Prof. Vakil also was the earliest in India to have related the rate of the public use and tax collection to the per-capita pay of the local area. The case for a decrease in open use was contended on the score of its unfriendly impacts on the Poor people of the country.
7. Prof. Vakil voiced concerns at the growth of defence expenditure in India and urged the case for close economic monitoring of defence expenditures.
8. He was also instrumental in recognizing the need for scientific surveys of public opinion in matters like group tensions, effects of war and rising prices on the middle class, etc. his achievement in this connection is parallel to that of Prof. Mahalanobis, who pioneered National Sample Surveys, to understand the economic conditions of the people.
9. Prof. Vakil was also among the few public men who thought that the basic causes behind communal tensions and riots was economic insecurity along with economic disparities.

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5.6.2 Dhananjay Ramchandra Gadgil

Former Gokhale Institute director Dhananjay Ramchandra Gadgil, also known as D. R. Gadgil, was an economist from India. He possessed a personal library of more than 3,000 books and very broad intellectual interests, including sociology, public affairs, history, biology, and astronomy. He is credited for creating the Gadgil formula.

Gadgil earned an honoris causa Doctor of Letters degree, a Master of Arts degree, and a Master of Letters degree from the University of Cambridge. Three sons and one daughter are the result of his marriage to Shrimati Pramila.

At the University of Poona, he was the vice chancellor. He served in the Rajya Sabha as a nominated member from 3 January 1966 to 31 August 1967. In 1940, during the Mysore event, he also served as president of the Indian Economic Association.

In 1945, famous economist Dr. D.R. Gadgil presided over a gathering of irrigators where the concept of a cooperative was first put forth. The first cooperative society to be established in Pravaranagar wasn't registered until the end of 1948. The government decided to only give co-operatives industrial licences for the sugar industry in 1954 as a result of the Pravara's overwhelming success. According to Shri. D.R. Gadgil, the Pravara Cooperative Sugar Factory was the first industrial co-operative operation in Asia. On February 8, 2008, Dr. Manmohan Singh, the Indian Prime Minister, unveiled a statue of him in Pravara Nagar.

5.6.3 V.K.R.V. Rao

The top thirteen contributions made by V.K.R.V. Rao to economics are highlighted in the following points. Contributions include: 1. Economic activity; 2. Characteristics of developing nations; 3. Industrial development; 4. Methodology of National Income; 5. Institutional Growth; 6. Poverty; 7. Finance of the Deficit; 8. Fiscal Policy; 9. Income Tax; 10. Price Policy; 11. Economic Growth and the Human Factor; 12. Economic growth and full employment 13. Keynesian Multiplier Principle Applicability to Developing Nations.

Contribution # 1. Economic Activity

V.K.R.V. Rao inspected the connection of financial movement to the furthest limit of all human activity. The techniques utilized for getting financial products, for sure is called economic activity, can either advance or hinder the improvement of human character.

There are four elements in economic activity

- (1) The art element in work;
- (2) The dignity and pride element in work;
- (3) The personality-killing element in work; and
- (4) The character-forming element in work.

Contribution # 2. Features of Underdeveloped Countries:

Dr. Rao identified the following, features of an underdeveloped economy:

- (1) Prevalence of disguised unemployment;
- (2) Dominance of production under household enterprises;
- (3) A substantial portion of production for personal use;
- (4) Agriculture's supremacy;
- (5) Lack of technological expertise;
- (6) Capital equipment shortage;
- (7) An approximate or unity-sized marginal tendency to consume;
- (8) A significant amount of any increased demand for food when there is an increase in income.

Contribution # 3. Industrial Development

Dr. Rao accepted that industrialization would give an answer for the population pressure in farming. However, during the years preceding his dying, Dr. Rao had begun voicing solid worry at the break between the raising portion of industry and the falling portion of agribusiness in public result joined by a falling offer in horticulture of business.

Contribution # 4. National Income Methodology

Dr. Rao applied unadulterated logical exercise in the assessment of National Income. This was his remarkable accomplishment around then and gave validity to his work throughout the long term he turned out to be an ever increasing number of decisive on the insightful constraints of between country examinations of public and per capita income. He was bothered truly by three issues.

First, at great deal of what becomes marketed and exchange- value derived output in developed countries gets unrecorded and underestimated in developing countries.

Secondly, a significant portion of national income in developed countries represents compensation or countervailing costs of final goods. This is so both in the material production and tertiary sectors.

Thirdly, there is no scientific basis for estimating values of government expenditures not all of which may have a marketable/commercial significance.

Dr. Rao's own theoretical and applied contributions to national income analysis can bear out a full-fledged research dissension of international significance.

Contribution # 5. Institutional Development

Dr. Rao founded the three major institutions of post-graduate work, training and research. These are:

- (i) Delhi School of Economics, 1948,
- (ii) The Institute of Economic Growth in 1957 and
- (iii) The Institute of Social and Economic Change in 1972.

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As a minister of education Dr.Rao initiated in 1965 the Indian Council of Social Science Research which is now founding the number of research institutions in the country. He also innovated Agro-Economic Research Centres and Research Units in demography in different parts of the country.

Contribution # 6. Poverty

VKRV Rao studied a number of problems that are related to poverty and under nutrition in India and criticised some of the researches of economist like Dandekar, Rath, Bardhan and Sukhatma etc., on measurement of poverty in rural and urban India.

According to Rao, the poverty should be measure on the basis of Nutritional norm of daily calorie intake by Consumer Unit and and expenses done on the daily calories intake per consumer unit and then treat half the population lying in expenditure class and the entire population in the lower expenditure classes as the poor.

This is the technique employed by using Dandekar and Rath (1971) in their famous book 'Poverty in India'. And it has been used by some researchers more or less the same or similar, but the method does not seemed to be correct. While the share of under-nutritional poverty declines when income increase, and the end result was found that the Poor include non-poor and that the non-poor included the poor. (Rao, 1977).

Rao seemed to believe that Dandekar and Rath got the 'paradoxical result' because they based the estimates of poverty on the sole criterion of calorie intake. He says: 'The balanced diet approach is preferable to the calorie intake approach.

Contribution # 7. Deficit Financing

Dr. Rao has pointed out that in case of deficit financing by the government the rise in price is more than expenditures is larger due to growth of currency, absence of direct return or absence of the supply of goods and services, absence of sale able securities and higher opportunity of wastage and failure to promote increased productivity. There can be forced financial savings for financing monetary development.

The only question is the extent to which it can be resorted, because it is bound to result in a certain rise in prices due to the following factors:

- (a) Attempt on the part of the Government to make up for the fall in the real value of its deficit- financed outlay;
- (b) Failure on the part of the Government to mop up for the exchequer any part of the increase in profit that follows deficit financing;
- (c) Failure of the Government to prevent the banking system from adopting a liberal credit policy;
- (d) Failure on the part of the Government to undertake an effective system of price control and controlled distribution of essential wage goods;

- (e) Compensatory rise in money wage rate; and
- (f) Use of deficit financing for unproductive expenditure which adds neither to consumption nor to capital formation.

A rise in the money rates of wages should be prevented. The reserve ratio of banks should be raised and the flow of additional bank credit should be well-regulated under credit policy. In addition, public-understanding and cooperation are needed since taxation, wage, credit and price controls normally create resentment.

Contribution # 8. Fiscal Policy

According to V.K.R.V. Rao fiscal policy aims at maximizing the mopping up of deficit- precipitated increment in incomes by taxes and loans; and these can be built-in with the rise in income, It will be automatic in the flow-back into the exchequer. Wage policy have taken the shape of stopping to the most viable extent a rise in the cash price of wages.

Inorder to do this, the price of basic wage goods has to controlled and a controlled distribution. With the positive support of labour the policy of deficit financed investment in a correct project with their cooperation and participation for implementing it.

Rao emphasised the importance of public cooperation and understanding as a key element in reducing the price impact of deficit finance. Taxation, savings, credit controls, wage controls, price controls, and controlled distribution, all these normally cause resentment.

For successful functioning. it should be fully accepted and understand the purpose of it.Hence the positive need for promoting public understanding and cooperation while undertaking deficit financing for capital formation.

Contribution # 9. Income Tax

In his work “Taxation of Income in India”, which dealt with the history of income tax from 1860 to 1929, he concluded by saying that “the Indian system of income tax reveals an absence of any background of the theory or principle. No attempt has so far been made by the government to examine the fundamental principle underlying its levy or to analyse its incidence. Such improvements as have been made from time to time are of a piecemeal character”.

Hence, for improving the system he suggested the following measures:

- (i) Gross and net incomes should be clearly distinguished;
- (ii) Hindu undivided families should be statutorily recognized;
- (iii) Agricultural incomes should not be exempted;
- (iv) The rate of tax should be properly graduated; and
- (v) The courts of appeal should be established.

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Contribution # 10. Price Policy

V.K.R.V. Rao argued that the price is a crucial mechanism to carry out various functions and that policy is created with a specific context in mind Viz., it has to help in the more adequate and more efficient performance of these functions. This function's primary goal is to achieve the necessary balance between the supply and demand for both goods and production inputs.

Contribution # 11. The Human Factor in Economic Growth

V.K.R.V. Rao insisted that science and technology has reduced the death rate but not succeeded in reducing the birth rate. What is needed, therefore, is a deliberate effort on the part of science and technology to devise methods that would lead to a sharp fall in the birth rate and are capable of application in the underdeveloped world.

It is important to include the human factor in economic growth for deliberate regulation of the growth of numbers and a drastic reduction in the birth rate. The psychological and sociological factors necessary for this purpose have of course to be studied and acted upon by the governments and peoples of the underdeveloped countries; but a conference that deals with the application of science and technology for promoting economic growth, should also give adequate attention to the application of science and technology for reducing the birth rate in the underdeveloped countries

The one more element of human factor concerned in underdeveloped countries are large number of peoples are not able to take advantage of limited facilities which is available for modernization and increase in productivity. These section of people are called weaker section. They are unable to grow in the society due to their sub-human economic status and also because of their social organisation and traditional values, way of living and Cultural and psychological characteristics that are inhabited for taking advantage of the facilities that planning and economic development places at their disposal.

The result has been that progress is slow and the gap continues to widen between the developing and the developed economies. Particularly human resource-rich nations like India must adopt a significantly more optimistic and educated attitude to the effective exploitation of the human factor than they have so far.

Contribution # 12. Full-Employment and Economic Development

After reviewing the ideas of Keynes, William Fellner, Ohlin, Beveridge, Mrs. Robinson, A.P. Lerner, etc., about full -employment and frictional unemployment Dr. Rao feels that in under developed counties there is another category of unemployment – disguised unemployment which is different from the type of involuntary unemployed which is found in developed countries.

According to Dr. Rao, economic development involves something more. In this connection, he has quoted the UN Sub-commission on Economic Development. "The objective is the promotion of higher standards of living, full employment and

NOTES

condition of economic and social progress and development in the countries concerned, and the manner for achieving it is a sound, efficient and fuller utilization of man-power, natural resources, energy and capital". Dr. Rao concludes that the Keynesian treatment of full employment is not only unsatisfactory as regards the removal of the types of involuntary unemployment in both developed and undeveloped economics, but is also deficient as regards the productivity of employed labour.

Contribution # 13. On Relevance of Keynesian Multiplier Principle to Under-Developed Countries

How far Keynes' theory is relevant to under-developed countries is a question which Dr. Rao had attempted to answer about four decades ago. According to him, Keynes' theory of employment, notably the multiplier principle, has little bearing on judgments about public policy in developing nations.

Dr. Rao has underlined the following conditions which must be satisfied in an economy, if the multiplier principle is to be applied in practice:

- (i) There must not exist unemployment in any form other than Keynesian unemployment.
- (ii) The economy must be primarily industrial and the supply curves of consumer goods must have a positive slope.
- (iii) Excess capacity should exist in the consumer goods industries which would enable them to expand their output in response to increasing demand for their products.
- (iv) There has to be abundance of capital in the country, making the working capital supply that is necessary for higher output fairly elastic.

Dr. Rao asserts that these conditions are rarely satisfied in under-developed economies and, therefore, Keynesian multiplier principle remains inoperative in these countries.

To get rid of poverty, Disparity and injustice India must follow the ideas of V K R V Rao. All Indians who live up to ancient and endure ideals for the unity and strength of nation must think modern to achieve the future vision and confidence.

Check Your Progress

15. Prof. Vakil believed that free and compulsory _____ was desirable.
16. He welcomed the _____ of the Government to sell gold at international price and import gold.
17. The _____ and pride element in work.
18. _____ of production under household enterprises.

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5.7 ECONOMIC THOUGHT OF DR. AMBEDKAR**Introduction**

Ambedkar was born on April 14, 1891 in the Central Provinces in the town and military cantonment of Mhow (now formally known as Dr. Ambedkar Nagar) (now in Madhya Pradesh). He was the 14th and final child born to Laxman Murbadkar's daughter Bhimabai Sakpal and army officer Ramji Maloji Sakpal, who held the rank of Subedar. His family had Marathi ancestry and originated in the Ratnagiri district of modern-day Maharashtra's Ambadawe town (Mandangad taluka). Ambedkar was born into the Mahar (dalit) caste, which was discriminated against on the basis of their socioeconomic status and treated as untouchables.

He completed his degree in 1912 specialising in Economics and political science from Bombay University and got an job in Baroda State government. Sayajirao Gaekwad III (Gaekwad of Baroda) awarded him a scholarship worth £11.50 (Sterling) a month for three years. With this money, he attended Columbia University in New York City for his postgraduate studies. He returned to India in June 1917 as a result of the expiration of his Baroda scholarship. He received a D.Sc. in Economics from the University of London in 1923, and that same year, Gray's Inn called him to the bar. He received honoris causa degrees for his third and fourth doctorates (LL.D. from Columbia in 1952 and D.Litt. from Osmania in 1953).

Dr. Ambedkar through his movements represented the problem of physical and economical exploitation. He struggled against land tenure system called Khoti. The impact of social, political, and economic changes both before and after independence may be seen in India's mixed economy. He has provided Indian Economics with a fresh sociopolitical perspective.

Choosing to "changeover from economics to law and politics," Dr. Ambedkar He clearly told "continued devaluation of the Indian currency which while was good for Indian exports, was not good for the Indian economy. Increasing and decreasing values of gold and silver has been problematic issue to decide exchange rate." As the price of metal gold and silver keeps on changing it was difficult to decide the standard of gold coin exchange Ambedkar was not a supporter of intentional devaluation, whether it was planned or not. He claimed that a weak currency encourages exports and raises domestic prices.

In the current situation globalization and privatization are mostly affecting factors to economy. Govt. is supporting to increase export. The trading classes gain from this at the expense of the domestic underclass.

Funds

The main point he makes that a government should use the fund for the betterment of the people. If the Govt. could not concentrate to proper use of fund, it will be misuse of fund and slow growth rate of society. An increasing problem for Indian economics is the political classes and corruption. If the central and state

government a lot a provident for the poor and backward class it is almost deduct by the middlemen and politician.

Economy needs the fund for the betterment of human beings lives in society by facilitating them like roads, law and order, defense, disaster management, infrastructure etc. In a democracy, the elected representatives form the government and make a commitment to the populace to improve their welfare through the wise provision of such public goods and services. The populace places their trust in the government by giving it the power to decide on taxation and spending policies. Due to lack knowledge in selecting representative they mislead and the citizens are in trouble. For instance, if the agriculture sector is given a certain amount of money to improve its facilities without specifying the item of expenditure, it would be more prudent to spend it on agricultural laboratories, crop loans, canals, dams, markets, warehouses, and other agricultural-related items rather than on frivolous items like opulent offices, air-conditioned meeting rooms, public spaces in villages, etc.

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Production

Land is simply one of many components that go into producing goods and services, he claimed, and the productivity of one factor of production depends on the ratio in which the other factors of production are combined. In his words: “the chief object of an efficient production consists in making every factor in the concern contribute its highest; and it can do that only when it can co-operate with its fellow of the required capacity. Thus, there is an best of proportions that ought to subsist among the Various elements combined, although the best will differ with the modifications in proportions” From this he proceeds to say that if agriculture “is to be treated as an economic enterprise, then, by itself, there could be no such thing as a large or small holding”. He draws the conclusion that “India’s industrialization is the most sound answer for its agricultural issues.” Most of the population is engages in farming in India, The unemployment in agriculture and the increasing population can be the biggest problem for an economy. Industrialisation is a positive solution given by him.

Economic

He thought that his economics research would result in useful policy recommendations. He was therefore better at evaluating the technical aspects of the field to demonstrate economic theorems than policy-oriented welfare issues. This does not imply that he lost attention for the theoretical inferences made by others. The fact that his understanding of economic theory was so current is remarkable, to put it mildly. In addition to having extensive and in-depth knowledge of economics, he also applied what he knew about the subject to the situation. Just as an illustration, he mentions the contributions that were regarded in the American Economic Review in a paper he authored in 1918.

Ambedkar received economics training, and up until 1921, he worked as a professional economist before entering politics. He published three academic works on economics:

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- Administration and Finance of the East India Company
- The Evolution of Provincial Finance in British India
- The Problem of the Rupee: Its Origin and Its Solution

Society

He said, "Society is always conservative. It does not change unless it is compelled to and that too very slowly. When change begins, there is always a struggle between the old and the new, and the new is always in danger of being eliminated in the struggle for survival unless it is supported". That was his personal experience of practical life of untouchables. He devoted his whole life for the upliftment of society and worked hard to destroy the distance between high level and low level untouchable. He fought for human rights and equal right to use the nature and to be apart of the nation. He was a 'Masiha' for all the backward castes. He was a true pioneer in many aspects of Indian economic history.

Ambedkar's Thesis

The first Indian to obtain a doctorate in economics abroad was Ambedkar. He stated that the Indian economy should be made more beautiful through industrialization and agricultural growth. He mistook agricultural financing for India's most significant enterprise. Sharad Pawar claims that Ambedkar's vision was essential in helping the government reach its goal of food security. Ambedkar advocated for national economic and social development, emphasising the importance of education, public health, and residential facilities as the primary amenities.

The issue of the Rupee: Its Origin and Solution, his DSc thesis from 1923, investigates the causes of the Rupee's depreciation. In this dissertation, he supported a modified form of the gold preference and opposed the gold exchange that Keynes supported in his book *Indian Currency and Finance* (1909), contending that it was considerably less stable. In order to stabilise foreign exchange rates and prices, he favoured ending the production of all additional rupee coins and minting a gold coin.

Caste in India

He contends that the caste system impedes the movement of labour (upper castes would not engage in lower caste occupations) and the movement of wealth since it divides labourers and has a hierarchical structure (assuming buyers would make investments first in their own caste occupation). Babasaheb describes how endogamy was the foundation of the caste system in his essay *Castes in India*. The emergence of Sati and child marriage is a result of his concern on maintaining caste exclusivity.

Ambedkar presented in the paper a sociological phenomena that resulted from the Brahmins' adoption of a rigorously endogamous marriage rule, which inspired other groups to follow suit in an effort to imitate this self-declared elite. He stated that "the superposition of endogamy on exogamy means the introduction of caste".

Women Rights

Ambedkar aimed to increase the representation of women in all spheres of life, including politics. Ambedkar was one of the earliest activists to advocate for the rights of working women even while serving as a legislator under the colonial government.

One of the country's early feminist activists and leaders was Babasaheb Ambedkar. Babasaheb had observed, I gauge a community's development by the degree of advancement women have attained. In spite of this, his feminist contributions sometimes go unappreciated and unacknowledged.

Ambedkar did not advocate for the rights of women, but he regularly worked with women to help them understand the goal of gender equality. He made an effort to ensure that women were covered by labour regulations. He played a key role in reducing the range of working hours and improving the working environment. As a member of Bombay's Legislative Council in 1928, he backed a Bill that would have given factory workers' wives compensated maternity leave.

Hindu Code Bill

The Hindu Code Bill was one of Ambedkar's most significant feminist achievements. The task of writing the Hindu Code Bill fell to Ambedkar. This Bill was intended to define property procedures for both men and women as well as structure regulations for marriage, divorce, and adoption, among other things. Ambedkar took advantage of the opportunity to ensure that women had full rights within the system. He discussed issues such as the elimination of the birthright to property, property acquired through survivorship, daughters receiving half of the share, the transformation of women's constrained property into an absolute estate, the elimination of caste in matters of marriage and adoption, and the monogamy and divorce precept. In spite of strong opposition from conservative Hindu members in the parliament, Ambedkar continued to use these issues.

Agricultural Reforms

According to Ambedkar, a lot of agricultural land is either idle or is not being used to its full potential. He thought there was a "ideal proportion" of manufacturing components to allow for the most efficient use of agricultural land. In order to do this, he observed that the key issue was the increased number of people who relied on agriculture at the time. He therefore supported economic industrialisation so that these farm labourers could be utilised elsewhere.

In Dr. Ambedkar's view, land reform should uplift the untouchables, who had historically been primarily landless or tiny farmers. His main idea was that the traditional farming methods, which were gradually losing their efficacy, needed to be replaced by joint or collaborative farming. In his work "Small Holdings in India and their Remedies" (The Journal of Indian Economic Society, Vols. 1, 2, and 3), he made a strong case against the dominant land tenure system (Kothi), which has left rural dalits suffering from severe financial exploitation. In order to stop cash lenders from abusing their position, he sponsored a bill into the state assembly. His

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successful campaign against Mahar Watan freed a sizable portion of the rural poor from their digital serfdom.

5.8 ECONOMIC THOUGHT OF PERIYAR

Erode On September 17, 1879, Venkata Ramasamy was born to a Kannada Balija family in Erode, which at the time was a part of the Madras Presidency's Coimbatore district. Venkatappa Nayakar (or Venkata) was Ramasamy's father, and Chinnathyee, Muthammal was his mother. He has two sisters, Kannamma and Ponnuthoy, as well as an older brother named Krishnaswamy. Later, he came to be known as "Periyar," which is Tamil for "older" or "respected one."

Member of Congress Party (1919–1925)

Ramasamy left his business and resigned from his positions in government in 1919, at which point he joined the Indian National Congress. He actively promoted the use of Khadi, picketed toddy shops, boycotted establishments that sold clothing from abroad, and worked to end untouchability while serving as chairman of the Erode Municipality. Ramasamy faced jail time in 1921 for protesting toddy shops in Erode. During the Tirupur session of 1922, Ramasamy was chosen president of the Madras Presidency Congress Committee, where he vehemently advocated for reservation in government posts and education. Due to discrimination and disregard, his attempts to join the Congress party had been unsuccessful, and he left the party in 1925.



Fig. 5.2

Vaikom Satyagraha (1924–1925)

In and around the temple region, there had been severe legal requirements of untouchability in Vaikom, a tiny city in Kerala state, formerly Travancore. Harijans, often known as Dalits, were forbidden from entering the shrine itself, let alone the closed streets leading up to it. Anti-caste feelings were growing, hence Vaikom was selected as the ideal location for a planned Satyagraha in 1924. A movement to grant all castes access to the temples had already started under his guidance. As a result, there were agitations and demonstrations. Ramasamy and his wife Nagamma arrived in Vaikom on April 14. They were immediately detained and sent in jail for taking part. Gandhi objected to non-Keralites and non-Hindus participating, but Ramasamy and his supporters persisted in supporting the resolution until it was eventually abandoned. He was given the name Vaikom Veeran by his adherents who took part in the Satyagraha.

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Self-Respect Movement



Fig. 5.3

While other nationalist forerunners focused on the fight for political independence, Ramasamy and his supporters persisted in trying to persuade the government to take action to stop social inequalities (abolish untouchability, the manual scavenging system, etc.). From the inception, the Self-Respect Movement was said to be “committed to the goal of giving non-Brahmins a feel of delight completely based on their Dravidian past.” The Ramasamy Self-Respect Movement Institution was registered in 1952 with a set of objectives that included the dissemination of useful understanding of political education. to enable people to

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live free lives, free from slavery to anything that goes against their goals and respect for themselves; to eradicate pointless traditions, pointless rituals, and irrational superstitions from society; to end the current social structure—where caste, religion, community, and common occupations—that has bound the majority of people and established “superior” and “inferior” classes—and to grant people equal rights. utterly abolishing untouchability and establishing a unified society based mostly on brotherhood and sisterhood; to grant women the same rights as males; to discourage and promote love marriages, widow weddings, intercaste and interreligious marriages, and to have the marriages recorded under civil law, to prevent child marriages and marriages wholly based on law favourable to one sect. Additionally, to create and maintain homes for widows and orphans as well as to administer educational institutions.

International Travel (1929–1932)

From December 1929 to January 1930, Ramasamy travelled throughout Malaya for one month in order to spread the self-respect ideology. Ramasamy arrived in Penang with his wife Nagammal and his disciples after departing from Nagapattinam, and 50,000 Tamil Malaysians bought him. He launched the Tamils Conference in the same month, met with the Tamils Reformatory Sangam in Ipoh, and then travelled to Singapore. He travelled to Europe in December 1931 with S. Ramanathan and Erode Ramu to, in my opinion, familiarise himself with their political structures, social movements, manner of life, economic and social progress, and public administration. While spending three months in Russia, he travelled to Egypt, Greece, Turkey, the Soviet Union, Germany, England, Spain, France, and Portugal. He stopped at Ceylon on the way back before arriving in India in November 1932. The visit influenced Ramasamy’s political philosophy in order to realise the social concept of self-respect.

Opposition to Hindi

When Chakravarthi Rajagopalachari became the Chief Minister of the Madras Presidency in 1937, he made Hindi a required language in the classroom, which sparked a number of anti-Hindi agitations. Ramasamy, the Justice Party under Sir A. T. Panneerselvam, and Tamil nationalists organised anti-Hindi demonstrations in 1938 that resulted in multiple arrests by the Rajaji administration.

The phrase “Tamil Nadu for Tamilians” was first used by Ramasamy in opposition to the introduction of Hindi in schools during the same year. He asserted that the Aryans infiltrated Dravidian civilization through the introduction of Hindi, which was a dangerous strategy. He believed that the adoption of Hindi would elevate the Hindi-speaking North Indians over Tamils. Ramasamy asserted that Hindi would no longer hinder Tamil development but rather would utterly destroy their cultural and destroy the creative ideas that Tamil had successfully instilled over the last few decades.

Politicians from South India united in their resistance to Hindi, transcending party boundaries. Anti-Hindi protests occurred frequently in 1948, 1952, and 1965.

Dravidar Kazhagam (1944–onwards)

Conjeevaram Natarajan Annadurai, Ramasamy's top lieutenant, founded the Dravida Munnetra Kazhagam (DMK), also known as the Dravidian Progressive Federation, in 1949. This resulted from differences between the two; whilst Annadurai collaborated with the Delhi administration while still asserting raised kingdom independence, Ramasamy supported the creation of a distinct, impartial Dravidian or Tamil state.

NOTES

Rationalism

Rationalism used to be the cornerstone of Ramasamy's concepts and the movements he started. His idea of an inconsequential minority in society was taking advantage of the majority and attempting to keep it in a position of subordination forever. In regards to caste, he claimed that no other living thing attacks or degrades its own class. But despite being considered a rational being, man still commits these crimes. The disparities, hostility, degradation, poverty, and depravity that are currently accepted as normal in society are caused by ignorance and rationalism, not by God or the terrible passage of time. Ramasamy has penned dozens of examples of various occurrences where British control was superior to self-government in his books and journals. His thought held that the ruling forces had caused rationalism, which was supposed to pave the way for everyone to live peaceful lives, to impoverish and worry people. He highlighted the contrast between the West sending signals to the planets and the Tamil civilization in India sending rice and other food to their deceased forefathers through the Brahmins as an example.

Self-respect

Ramasamy's view of a good and widely accepted world served as the foundation for much of his self-respect philosophy. His ideology advocates that logical thought must serve as the foundation for all human action. Furthermore, human beings' innate intuition leads them to look at everything objectively, even movements and natural phenomena, and to reject accepting something unreasonable as equivalent to slavery. Therefore, the concept of self-respect stated that human actions needed to be directed by reason, that right and wrong should be obvious from logical reasoning, and that conclusions reached from purpose were to be appreciated at all times. Freedom can be compared to the beliefs and actions that people on the basis of "reason" consider to be "right." There is no longer much of a difference between "freedom" and "self-respect."

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Women's Rights: Social Reform and Eradication of Caste



Fig. 5.4: Ramasamy with Muhammad Ali Jinnah and B. R. Ambedkar



Fig. 5.5: Ramasamy on Postal Stamp of India, Issued in 2009

Ramasamy wanted sceptical people to perceive their society as far from perfect and in desperate need of transformation. He wanted the political parties, the administration, and the social workers to recognise the social ills and courageously take action to eradicate them. The philosophy of Ramasamy does not distinguish between social and political service anymore. He asserted that the fundamental duty of a government is to effectively manage society, and that religion's organising principle was the social order.

Despite the growing progress of urbanisation, rural India still made up the majority of the Indian subcontinent at the time. As a result, rural residents suffered an economic and social downturn as a result of the distinction between urban and

NOTES

rural areas. The word “village” was used disparagingly in places by Ramasamy, just as the word “outcast” was used disparagingly in social groups. Additionally, he promoted the modernization of rural areas by constructing public infrastructure like police stations, schools, libraries, radio stations, and roads.

Ramasamy believed that a tiny group of smart humans formed caste distinctions to rule Indian civilization. He also asserted that worms, birds, and other creatures thought to be irrational do not develop castes or distinctions between high and low in their own species. However, despite being thought of as a logical being, man used to suffer from these because of discrimination and religion.

Tamil Language and Writing

Ramasamy mentioned that using the Tamil script for writing about the arts—which are good for people’s lifestyles and build knowledge, genius, and bravery—and spreading them among the populace will enlighten the populace. Additionally, he stated that it will improve the language, and as a result, it may be viewed as an enthusiasm for Tamil. Ramasamy’s thoughts on Tamil alphabet reforms protected these such as the motives for the vowel ‘ஈ’ (i) having a cursive and looped illustration of the brief structure ‘இ’ (I). Many Tamil characters are determined in various shapes in stone inscriptions from 400–500 years ago. Just as a few compound characters have separate signs and symptoms to point out their size as in ‘கா’, ‘கே’ (kA:, kE:), Ramasamy wondered why different compound characters like ‘கி’, ‘கீ’, ‘கு’, ‘கூ’ (kI, ki:, kU, ku:) (indicated integrally as of now), mustn’t have separate signs. According to Ramasamy, it was also important to change the shape of the letters, create new symbols, add new letters, and similarly, eliminate superfluous ones. As a result, a language’s and its script’s brilliance depends solely on how readily they may be comprehended or realised.”

Thoughts on the Thirukkural

Ramasamy praised the Thirukkural as a priceless text that held numerous philosophical and scientific insights. He also appreciated the work’s secularism. Ramasamy complimented Thiruvalluvar for describing God as an impersonal being with only superhuman qualities. Additionally, he suggested that reading the Thirukkural will help one develop self-respect by gaining knowledge of politics, society, and economics. He asserted that even if some of the concepts in this ancient book of ethics may not apply to modern culture, it acknowledged these changes. Thirukkural was written by a great Dravidian Thiruvalluvar to free the Dravidians when Dravida Nadu (Dravidistan) was under Indo-Aryan deception, according to one of Ramasamy’s statements on it from Veeramani’s Collected Works of Ramasamy. Ramasamy further argued that because Thirukkural is secular, it has the potential to become the common book of belief for all humanity and can be held on par with or even superior to the sacred books of all religions.

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Check Your Progress

19. His family was of Marathi background from the town of _____.
20. He struggled against land tenure system called _____.
21. The main point he makes that a government should use the fund for the _____ of the people.

5.9 ANSWERS TO 'CHECK YOUR PROGRESS'

1. Diplomacy
2. Agriculture
3. Industry
4. £350
5. Backwardness
6. Civil Servant
7. Britishers
8. Labour
9. Politician
10. Zamindari
11. Handicrafts
12. Industrialisation
13. 1950
14. 1951
15. Primary Education
16. New Gold Policy
17. Dignity
18. Dominance
19. Ambadawe
20. Khoti
21. Betterment

5.10 SUMMARY

In his book, Kautilya provides a comprehensive depiction of governmental processes as well as the responsibilities of monarchs, ministers, and other officials. His Arthashastra, which comprises fifteen chapters and roughly 430 pages, is based on prior treaties. He has admitted that he owes Shukracharya and Brahaspati money. He has viewed the economy as an ongoing process.

Thiruvalluvar has frequently alluded to the components of production, such as land, labour, capital, organisation, time, and technology. through his kural on a

nation's economic theories. Agriculture is the most important economic activity, in Thiruvalluvar's view.

The first Indian economist to talk about the flow of resources from India to England was Dadabhai Naoroji. The drain of Indian resources is thought to have begun in the middle of the eighteenth century with the transfer of resources from India to England.

According to Naoroji's calculations, the facts on per capita income show that India is extremely poor. Average per capita income in India was ₹ 20 while per capita subsistence costs were ₹ 34. From here, one may determine how poor India is. The majority of Indians lived in utter destitution. They merely subsisted by taking from capital wealth, taking on debt, and engaging in disinvestment. The economic situation of the average person was significantly worse than that of those incarcerated.

Naoroji demonstrated the financial incompetence brought about by the British suzerains. The Indian population provided the majority of the income. The impoverished cultivators were ultimately responsible for the incidence of land revenue. The tax structure had a very regressive nature. In the case of the salt tax, this was especially true. The tax levy was incredibly high. When compared to England, it was only 8%, but it was 22% in India. However, the British overlords insisted that India's citizens paid minimal taxes.

One could consider Naoroji to be the founding father of Indian political economy. His writings on the outflow theory and national income estimation continue to serve as reliable sources for further study in these fields. His drain hypothesis served as the foundation for the theory of imperialism. His books give us insight into how British India's economy functioned as well as the causes of Indian poverty and underdevelopment.

Ranade's *Essays on Indian Economics* contain his economic viewpoints (1898). Indian Political Economy, the opening chapter, contains the work's core message. In 1892, a lecture on this subject was given at the Deccan College in Puna. The three primary topics of Ranade's economic theories are (i) study methodology, (ii) an explanation of India's backwardness and poverty, and (iii) India's development and industrialization and the role of the state.

Ranade was a strong supporter of studying economics historically. "If the law of relativity and correspondence holds good in politics and the social sciences generally," he stated, "it ought to hold good equally in other related topics, including, among others, the science of National Wealth or, as it is more commonly known, Political Economy." Political economy, according to him, is closely related to many other areas of social philosophy. He acknowledges that the laws of distribution are partially human institutions, like J.S. Mill.

M.K. Gandhi was neither a politician nor an economist. He had a socialist strategy built on love, compassion, truth, and non-violence. Gandhi aspired to a society that was perfect in his eyes. His political, sociological, and philosophical

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principles are all intertwined with his economic beliefs. Gandhi's main concerns were with the unrestricted development of people and the emancipation of the oppressed and exploited masses. Gandhi's many books contain a smattering of his economic concepts.

Gandhi favoured increasing social assistance to the fullest extent possible. The welfare is more of a spiritual nature than it is of a material kind. His idea of welfare is founded on the development of the entire psyche of the individual. The idea of the homo-economicus, or economic man, goes against it. Gandhi favoured fewer injustices and unrestricted human development. Gandhi did not equate wealth with welfare. Gandhi advocated for meeting the necessities of life, such as food, clothing, and shelter. He opposed the accumulation of wealth that went beyond what was absolutely necessary.

India, according to Gandhi, is a rural nation. India's development therefore rests on the growth of its villages. Gandhi favoured the complete eradication of the zamindari system. He argued for the necessity of a group effort rather than favouring individual or peasant farming. Gandhi may have been impressed by the ability of cottage and village enterprises to absorb labour. This reasoning made sense when seen from the standpoint of India's significant labour surplus.

Jamshed Kaikusroo Mehta became well-known for creating, enhancing, and mastering neoclassical economics tools beginning in the early 1930s and continuing for almost forty years. By his contemporaries acknowledging him, it is well proved. While Joan Robinson (1933, p. xv) acknowledged him as the independent creator of the concept of marginal revenue, H. H. Liebhasfsky judged his writings to have the sobering insights of a scholar with considerable critical skill.

Roy claims that one of the fundamental aspects of capitalism by which the working class is exploited is surplus price manufacturing. It was seen by Roy as the central error of Marxist economics.

India's five-year plans are created by the Planning Commission, a department of the Indian government, among other duties.

Prof. Vakil can be rightly considered as the originator and pro-pounder of certain standpoints and approaches relevant to modern economics in India: He considered the amount of cash, the speed of cash and the stockpile of genuine result.

The top thirteen contributions made by V.K.R.V. Rao to economics are highlighted in the following points. Contributions include: 1. Economic activity; 2. characteristics of developing nations; 3. Industrial development; 4. Methodology of National Income; 5. Institutional Growth; 6. Poverty; 7. Finance of the Deficit; 8. Fiscal Policy; 9. Income Tax; 10. Price Policy; 11. Economic Growth and the Human Factor; 12. Economic growth and full employment; 13. Keynesian Multiplier Principle Applicability to Developing Nations.

Dr. Ambedkar through his movements represented the problem of physical and economical exploitation. He struggled against land tenure system called Khoti. The impact of social, political, and economic changes both before and after

NOTES

independence may be seen in India's mixed economy. He has provided Indian Economics with a fresh sociopolitical perspective. Economy needs the fund for the betterment of human beings lives in society by facilitating them like roads, law and order, defense, disaster management, infrastructure etc. He said, "Society is always conservative. It does not change unless it is compelled to and that too very slowly. When change begins, there is always a struggle between the old and the new, and the new is always in danger of being eliminated in the struggle for survival unless it is supported".

Erode Venkatappa Ramasamy (17 September 1879 – 24 December 1973), revered as Periyar^[a] or Thanthai^[b] Periyar, was an Indian politician and social activist who founded the Dravidar Kazhagam and the Self-Respect Movement. As the "Father of the Dravidian movement," he is well-known. His birth anniversary has been observed as "Social Justice Day" in the Indian state of Tamil Nadu since 2021. He promoted the principles of rationalism, self-respect, women's rights and eradication of caste.

5.11 KEY TERMS

- **Varta:** The study of a country's economy. In Varta, Kautilya encompassed trade, animal husbandry, and agriculture.
- **Kural:** Consists of 1,330 small couplets, or kurals, of seven words each. It is a traditional Tamil literature.
- **Physiocrats:** A member of a school of French economists that advocated for high prices for agricultural products and claimed that agriculture was the source of all wealth in the 18th century.
- **Affinity:** A natural liking for and understanding of someone or something.
- **Laissez Faire:** is a policy that permits companies to operate with little or no government interference.
- **Cess:** Cess is a type of tax that is imposed or charged in addition to a taxpayer's base tax due.
- **Mutiny:** is a refusal by people, usually soldiers or sailors, to continue obeying a person in authority.
- **Defacto Slave system:** The conditions of unfree labour and forced labour that most slaves endure.
- **Zamindari System:** ZAMINDARI is the system of landholding and tax collection by zamindars.
- **Decentralisation:** When multiple local offices or authorities take up control of a project or organisation instead of just one.
- **Emporia:** A huge store with a broad selection of goods or a store with a specific kind of goods is referred to as an emporium.
- **Mahalanobis model:** The key economist of India's Second Five Year Plan.

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5.12 SELF-ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What is known as 'Raj Kar'?
2. According to Thiruvalluvar what are the elements of manufacturing?
3. In which year did Dadabhai Naoroji analysed the drain theory?
4. In which three subjects did Ranade economic ideas concentrated?
5. For what Gokhale is known for?
6. Who was M.K.Gandhi?
7. When was the eight plan launched?
8. List out the contribution of C N Vakil.
9. List out the contribution of VKRV Rao.
10. Write the names of the books wrote by Dr.Ambedkar.

Long Answer Questions

1. Discuss early Indian economic ideas of Kautilya.
2. Describe any five economic ideas of Thiruvalluvar.
3. Explain modern Indian economic ideas of Naoroji and Ranade.
4. Discuss economic ideas of Gandhi.
5. Explain village swadeshi and place of machine & Labour.
6. Discuss Indian cottage industries and trusteeship.
7. Discuss the national planning committee.
8. Explain Gadgil Co-operation as a way of life & strategy of development.
9. Explain the J. K. Mehta Wantlessness.
10. Explain about Mahadev Govind Ranade and his contribution in Economics.
11. Discuss about Romesh Chandra Dutt.
12. Explain about Gopal Krishna Gokhale.
13. Describe wage-goods model of CN Vakil.
14. C N Vakil's contribution of Poverty, discuss it.
15. Write the view of society according to Dr. Ambedkar.

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