

Chapter Five: The Classical School – Adam Smith (pg 61-83)

Historic Background

1723-1790, born in Scotland, a product of the Scottish Enlightenment
The Scottish vs. the English Enlightenment
Prof of logic, then moral philosophy
1759 The Theory of Moral Sentiments
Now switched away from philosophy, towards law and political economy
Became a Tutor, toured France, met the physiocrats....
Began WON
1776, published the Wealth of Nations
Nice guy, charitable

The theory of Moral Sentiments
What restrains Selfishness?
Sympathy – (empathy, fellow-feelings) – can overcome even selfishness
We care about the happiness of others
Social and unsocial passions
Necessity vs. Vanity
Joy vs. sorrow
We are social beings – can't live outside society
To live together, a system of Justice is required
MORAL LAWS – that which restrain our selfish impulses
Come from God

Wealth of Nation

LONNNGGGGG Discourse on the Moral case for Free Markets

Division of Labor

The example of a Pin Factory
Smith recognized the role of specialization
People get better at the job (increased dexterity)
Less time is wasted in transactions (no travel time)
Capital can be applied efficiently (specialized tools)
And now we talk about exchange.....
The mercantilists/physiocrats were not concerned with production
Now called “Smithian growth”

The Harmony of Interests and Limited Government

We are motivated by our own self interests
But there is a hidden, natural order in the system
Nobody intends the public good, only their own private gain
But they must compete with each other.....
(note cons vs. cons, prod vs. prod)
People are also capable of defining and pursuing their self interest (rationality)
So the govt. should not get involved.....
It is not capable of improving on individuals decisions

It is not motivated to improve on individuals decisions
 Smith believed England was wealthy in spite of its government
 Note: Smith lived in England, not France
 Believed that harmony and trade were good internationally as well
 Dangerous to war with a rich neighbor
 But good to trade with one, they have money to make purchases
 He thus was against subsidies in trade, and mercantilist protections
 More trade would lead to more specialization.....
 And thus more production for all
 Did believe in Government to....
 Protect society from foreign attack
 Establish administration of Justice
 (didn't understand common laws competition)
 Create public works/spending that markets could not (public goods)
 Canals, public schools (both public good and externality issues)
 Good instincts, but didn't systematize in any way
 Some other deviations, mostly common sense ones (money)

The Economic Laws of a Competitive Economy

Value: The water-diamond paradox
 Never did solve it.....
 No concept of total utility vs. marginal utility
 The questions of pearls (demand or supply?)
 Smith – supply (cost of production)
 Natural price vs. exchange price (later)
 Pearls are valuable because we need to dive for them...
 In a primitive society (no capital)
 Value comes from the amount of labor used to produce it
 Other factors are abundant and free (land), or non-existent (capital)
 The deer – beaver example
 How much time to trap a deer, or beaver? Production value
 This also determined the exchange value (one deer is one hour)
 In an advanced economy
 The pure labor value of production breaks down
 Ten pounds of potatoes vs. a spindle of cotton yarn
 Both take 10 hours of labor, but
 One needs no capital, one needs no land
 The real value can no longer be measured just by labor inputs
 But they can be measured by the quantity of labor they can purchase
 Competition will drive down prices.....
 So the cost of the good will be fixed
 (assumes in long run, constant returns to scale, profits)
 Wrong for rising or falling returns to scale)

Market Price

Intrinsic or Natural price, and market price
 Natural price is the long run price below which producers will not produce
 The Market price is the actual price at which exchange occurs
 Can be above, below, or equal to the intrinsic price
 Prices could/would vary for transitory reasons.

Not exactly supply and demand as we know it...
Smith distinguished between the real price and the money price
Restating Hume and other, that real wealth (labor),
Not money wealth, was important

Wages

The aggregate level of wages
The growth of wages over time
The Wage structure
 The Wage-fund theory to explain first two
Wages are paid by capitalists as a “loan” to workers
 There is a stock of capital flowing around to maintain this
Average annual wages = Wages fund/# workers
 Since the wages fund can vary (depends on amount produced)
 So can average wages
 As capital accumulates, wage funds increase.....
A HUGE departure from the Mercantilists
 Additionally, thought better health = better workers
 Efficiency wage theory

The wage structure implies that all wages are in equilibrium across sectors
What causes wages to equalize, but at unequal levels
 Agreeableness of occupation (non-pecuniary benefits)
 Cost of Acquiring necessary skills (human capital)
 Regularity of Employment (risk premiums)
 Level of trust/responsibility (Monitoring costs)
 Probability/improbability of success (uncertainty premiums)

Profit

The return on risks....
So profits must compensate for capital, and possible losses
 Profit rates fall with competition
Gross profits include losses, the result is net profits

Interest must be paid, confusion about what interest was....

Rent

Various views.....
When commodities sold, price covers labor, capital and rent
 So rent enters the price of goods produced on land
But elsewhere rent is the cost of using land, the highest a peasant can pay
 So now rent is a residual, high prices make high rent,
 and low prices low rent
Groping towards a factor theory of production, but didn't find it.

Money and Debt

Deemphasized the importance of money
 Facilitates commerce, but not production....
 And production creates the wealth of nations
 Specie is a “dead stock” of capital, it exists, but can't grow

Smith argued for paper money and reserves
“Highways and Gold, airways and paper money”
In direct contradiction of the Mercantilists
Smith thought coin important, but only that there be “enough”
After “enough”, it was to accumulate dead stock capital
Smith failed to recognize gold’s value as
a “fixed and accepted” medium of exchange

Smith Hated debt – even internally held debt (mercantilist idiots)
Did NOT view it as just the left hand paying the right hand
Debt meant more govt. spending, which would be bad...
No business cycles to speak of in 1776
Debt would create an incentive for capitalists to move overseas

Economic Development

Where does economic growth/development come from

Division of labor – more growth because people are more specialized
Also, now more capital can be used