

# History of Economic Thought

## Lecture 3

- I. Ricardo`s System
- II. John Stuart Mill and his  
*‘Principles of Political Economy’*

# Lecture Plan

## I. Ricardo`s System

1. General characteristics of Ricardo`s role in Economics
2. The Theory of Value and Distribution
3. The Theory of Rent
4. The Theory of Comparative Costs (Advantages) in International Trade
5. The final conclusions on Ricardo`s System

# Lecture Plan

## II. John Stuart Mill and his '*Principles of Political Economy*'

1. The Laws of Production and Distribution
2. The Problem of Demand and Supply
3. J. S. Mill's Vision of the Organisation of Industry

I.

## **1. General characteristics of Ricardo`s role in Economics**

David Ricardo (1772-1823)

Ricardo`s contributions to the Economics:

- Theory of Value
- Theory of Distribution
- Theory of Comparative Advantages in International Trade

Ricardo is considered together with Adam Smith to be the founder of the Economic Classic School

# **1. General characteristics of Ricardo`s role in Economics**

David Ricardo (1772-1823)

Ricardo`s main works:

- “On the Principles of Political Economy and Taxation” (1817): it deals with the problems of Value, Rent and Taxation
- “Essay on the Influence of a Low Price of Corn on the Profits of Stock” (1815): it develops the labour theory of value and the Law of Diminishing Returns.

## 2. The Theory of Value and Distribution

- At the heart of the Ricardian system is the notion that economic growth must sooner or later be hindered due to scarcity of natural resources. At the same time it is implied that ever new expenditures of factors of production result in diminishing returns
- D. Ricardo continued the development of the theory of division of labour and labour theory of value laid down by A. Smith.

## 2. The Theory of Value and Distribution

- In accordance with D. Ricardo, national economy consists of two big spheres: agriculture and manufacture. And there are three social classes that are derivative from this economic structure: workers, capitalists and landowners. And their respective incomes are: wages, profits and rents.

## 2. The Theory of Value and Distribution

An extract from his *“Essay on the Influence of Low Price of Corn on the Profits of Stock”*:

*The exchangeable value of all commodities, rises as the difficulties of their production increase. If then new difficulties occur in the production of corn, from more labour being necessary, whilst no more labour is required to produce gold, silver, cloth, linen, etc. the exchangeable value of corn will necessarily rise, as compared with those things.*






## 2. The Theory of Value and Distribution



*On the contrary, facilities in the production of corn, or of any other commodity of whatever kind, which shall afford the same produce with less labour, will lower its exchangeable value [Ricardo, 1815, p.16].*

## 2. The Theory of Value and Distribution

From this citation it follows that the value of every commodity increases or decreases proportionally to the quantity of labour spent on its production.

- D. Ricardo definitely ruled out utility as the determining factor of value. He denied any quantitative connection between quantity and value. In that Ricardo followed Adam Smith's celebrated paradox of value which was formulated in terms of his comparison between the utility of water and its value and the utility of diamonds and their value. 

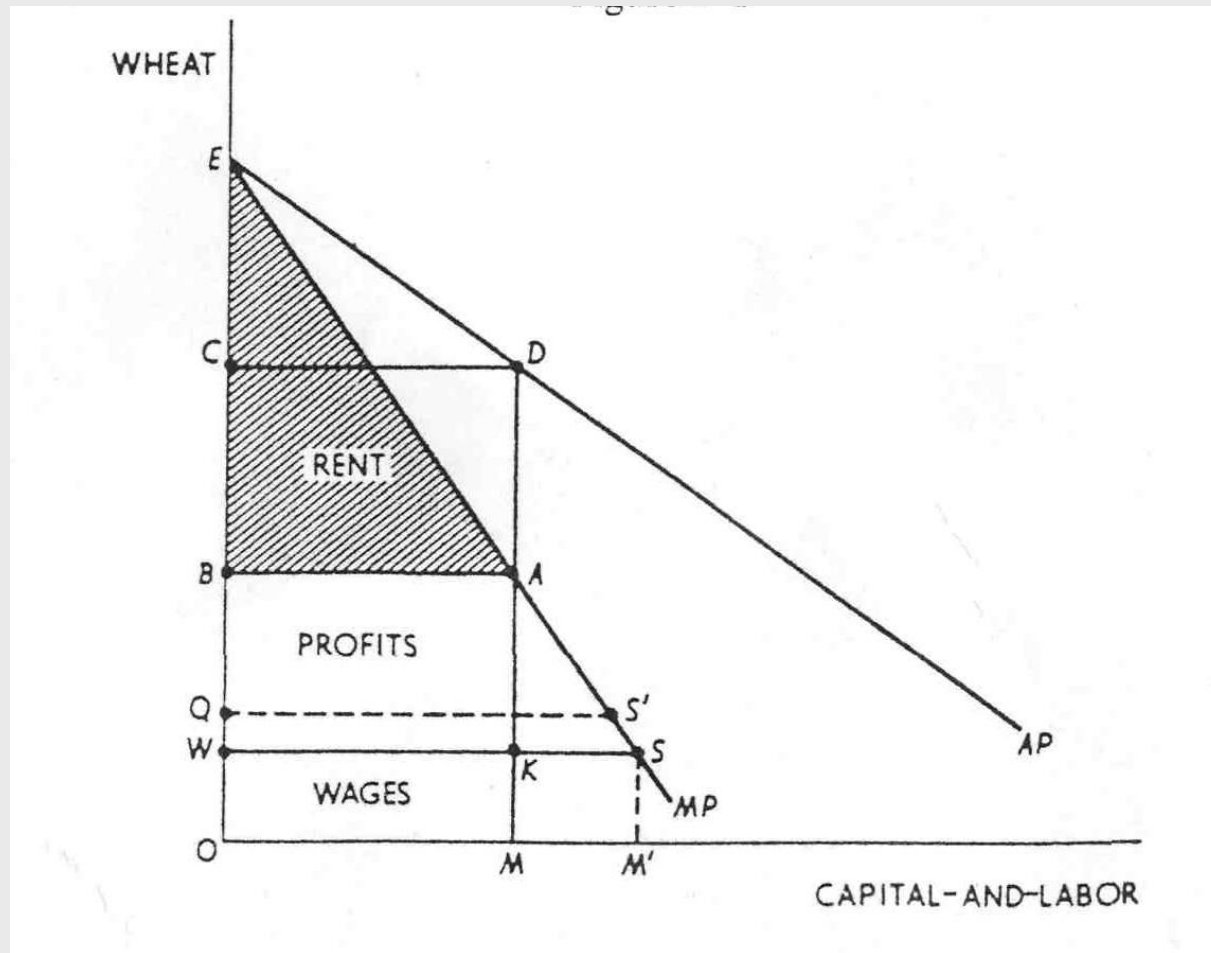
## 2. The Theory of Value and Distribution

In so doing, he simply thought that utility was essential to value but devoid of any decisive role. Ricardo pointed out that value of commodities includes both labour spent directly in the process of production and labour embodied in machines and tools used in the process of production of commodities. In the latter case value is simply transferred from the tools of production to a newly produced commodity. In so doing, the tools of production do not create a new value: →

## 2. The Theory of Value and Distribution

- They transfer their own value to the commodity that is being produced. In this case, Ricardo disagreed with affirmations of such a well-known classical economist as J.-B. Say who considered the capital to be a value productive factor.
- Contrary to Smith, Ricardo differentiated use value (usefulness, wealth) and value (expenditures of labour to produce this usefulness)

## 2.The Theory of Value and Distribution



## 2.The Theory of Value and Distribution

This figure shows the Ricardo`s model of distribution of the total product: it consists of wages, profits and rent. Profits, according to Ricardo, were a residue – something left after wages and rent had been paid. And wages would tend to subsistence level. It means that they should provide labourers with minimum quantity of goods required for their survival.

## 2.The Theory of Value and Distribution

- Ricardo thought (disagreeing with Smith) that value of a commodity does not depend on wages, but it depends on quantity of labour required for its production. Increase of wages decreases the profits (the inverse interdependence of these two kinds of incomes).
- In accordance with Ricardo, the main tendency in the sphere of income-distribution is the following: the real wages are constant, rent increases, and profit decreases.

## **2.The Theory of Value and Distribution**

- Ricardo formulated the so-called “Iron Law of Wages” which says: if wages exceed some physical minimum required for labourers` survival, it stimulates the birthrate and number of children in their families. It results in increase of labour population and labour supply which in its term reduces wages to a very low level.



# 3.The Theory of Rent

- As it was shown in the previous question, rent is a part of a total product appropriated by land owners
  - Ricardo investigated into the origin of rent. And he showed that the main factor that causes the appearance of rent is the shortage of fertile land in any society.
- “If all land had the same properties, if it were unlimited in quantity and uniform in quality, no charge could be made for its use unless where it possessed peculiar advantages of situation... It only, then, because land is not unlimited in quantity and uniform in quality,... that rent is ever paid for the use of it.” [Ricardo, 1821, p. 70]

# 3.The Theory of Rent


- In so doing, Ricardo showed that rent is the indication of poverty rather than riches
- Ricardo stated that market value of wheat is determined by quantity of labour spent on its production using poor land. That`s why the owners of fertile land get the rent as the difference between the market value of wheat and the value of wheat produced on the fertile land (which is significantly less)

# 3.The Theory of Rent

- Suppose, says Ricardo, there are two neighbouring landlords. On one landlord's fields the soil is fertile, and with the labour of a hundred men and a given amount of equipment he can raise fifteen hundred bushels of grain. On the second landlord's fields, the soil is less fecund; the same men and their equipment will raise only one thousand bushels. This is merely a fact of nature, but it has the economic consequence; →

# 3.The Theory of Rent

Grain will be cheaper, per bushel, on the fortunate landlord's estate. Obviously, since both landlords must pay out the same wages and capital expenses, and there will be an advantage in cost to the man who secures five hundred more bushels than his competitor.

That's exactly this difference in costs that generates rent according to Ricardo. Indeed, the greater the difference between two farms, the greater will be the differential rent. 

# 3.The Theory of Rent

If, for example, it is just barely profitable to raise grain at a cost of \$2.00 a bushel on a very bad land, then certainly a fortunate landowner whose rich soil produces grain at a cost of only 50 cent a bushel will gain a large rent indeed. For *both* farms will sell the grain at the market at the same price – say \$2.10 – and the owner of the better land will therefore be able to pocket the difference of \$1.50 in their respective costs of production.

## 4. The Theory of Comparative Costs (Advantages) in International Trade

- David Ricardo further developed Adam Smith's idea of the role of the division of labour under the form of theory of comparative costs (advantages)
- The value of the national product is the same for the closed economy and for an open one: foreign trade as such will not affect wage rates or the rate of profit; foreign trade does increase a country's 'riches' and real income will always be higher with free trade than without. These propositions are directed against Smith's view that a higher rate of profit in foreign trade pulls up the rate of profit at home

## **4.The Theory of Comparative Costs (Advantages) in International Trade**


- The Law of Comparative Costs demonstrates the benefits of the territorial division of labour
- It is already well-known to you that even the countries that possess absolute advantages towards other countries still may gain from foreign trade exchanges with them: it is due to the existence of comparative advantages (it means opportunity costs of production of the same goods in different countries)

## **4.The Theory of Comparative Costs (Advantages) in International Trade**


- But Ricardo`s doctrine is incomplete: it shows how nations may gain by trade, but it fails to tell us how the gain from trade is divided among the trading countries



# 5.The final conclusions on Ricardo`s System

- To Ricardo, the economic world was constantly tending to expand. As capitalists accumulated, they built new shops and factories. Therefore, the demand for labourers increased. This boosted wages, but only temporarily, because better pay would soon result in flooding the market with still more workers. But as population expanded, it would become necessary to push the margin of land cultivation out further. More mouths would demand more grain, and more grain would demand more fields. 

## 5. The final conclusions on Ricardo`s System

- And quite naturally, the new fields put into seed would not be so productive as those already in use.
- As the growing population caused more and more land put into use, the cost of producing grain would rise. So, of course, would the selling price of grain. It would result in increase of the rents of well-situated landlords and wages. And here comes the pessimistic conclusion made by Ricardo on the world`s future: workers are paid more, and as a result their families become more numerous, supply of labour increases, and the wages fall. 

## 5. The final conclusions on Ricardo`s System

- And capitalists face the same pessimistic prospects, as they are put in a double squeeze: first, they have to pay higher wages to workers; secondly, their profit decrease.
- That`s why, in accordance with Ricardo`s views, the economic development leads to the deadlock, and his system sometimes is called *a tragic system*.

## **5. The final conclusions on Ricardo`s System**

- The post-ricardian world escaped the deadlock, forecasted by this great man, due to the enourmous increase of productivity of labour, resulted from the permanent scientific and technological progress.


## II. John Stuart Mill and his '*Principles of Political Economy*'

### 1. The Laws of Production and Distribution

**John Stuart Mill (1806-1873) – one of David Ricardo's close friends**

- J. S. Mill tried to bring Adam Smith up-to-date.
- His main contributions to economics are:
  - 1) He divided production and distribution in his work because he believed that the laws of production were of universal applicability whereas the laws of distribution were to some extent guided by institutional arrangements (i.e. by the laws and customs of the society

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- 2) J. S. Mill stressed the necessity to analyze the economic life both in statics and dynamics because in order to reveal the specific economic laws for each respective case
- 3) He disagreed with Ricardo on the structure of the price of the goods. We saw on the previous slides that Ricardo did not include rent into the cost of production. But Mill realised that if land had more than one use, then there would be opportunity costs for 

## II. John Stuart Mill and his '*Principles of Political Economy*'

for the use of land, and rent, in that sense, might enter into cost of production.

## II. John Stuart Mill and his '*Principles of Political Economy*'

### 2. The Problem of Demand and Supply

- J. S. Mill pointed out that the value of the commodities is influenced by the number of factors, others than the quantity of the spent labour. In this context, he mentioned the so-called 'paradox of old wine': the prices of young and old wines are different though the expenditures to produce them are the same. Mill, basing on this example, precised: price changes under the impact of demand and supply. But, at the same time, 




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### 2. The Problem of Demand and Supply

There is a reverse interdependence: the price itself influences demand and supply.

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### 3. J. S. Mill's Vision of the Organisation of Industry

- Mill's vision of the future was a vision in which the organisation of industry eventually result itself into cooperative enterprises. There is a great dispute these days about was a socialist or a liberalist.
- Mill supported the State ownership of certain public utilities (he wrote on public water supply, and he was not unfavourable to 

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### 3. J. S. Mill's Vision of the Organisation of Industry

nationalisation of railways.

- As regards taxation, he was utterly against progressive income tax, because he regarded it as penalizing the enterprising against those who preferred not to be enterprising.