

Tutorial letter 201/1/2015

History of Economic Thought ECS3705

Semester 1

Department of Economics

IMPORTANT INFORMATION:

This tutorial letter contains solutions to
assignment 01.

BAR CODE

Dear Student

ANSWERS TO ASSIGNMENT 01 (first semester)

The correct answers were:

Question 11: [2]

Question 16: [4]

Question 21: [2]

Question 12: [3]

Question 17: [1]

Question 22: [3]

Question 13: [3]

Question 18: [1]

Question 23: [2]

Question 14: [4]

Question 19: [2]

Question 24: [2]

Question 15: [3]

Question 20: [2]

Question 25: [4]

We will briefly explain why the two statements given in each of the questions were correct or incorrect.

11.

a. Contemporary economic theory is shaped, in part, by attempts to find solutions for logical failures in preceding economic theory.

Correct. Present day economic theories have emerged, in part, out of attempts to solve the problems of the past (Brue and Grant 2013: 3-5).

b. Economic ideas and theories are solely inspired by the problems of the day.

Incorrect. As discussed in the Brue and Grant (2013: 3-5), economic ideas and theories can indeed be inspired by the problems and circumstances of the day, but not only nor always. They are also shaped by internal factors, such as the resolution of some mistake or paradox found in earlier theory on the same topic. See previous statement.

12.

a. Mercantilists viewed the interests of the merchant as being in stark opposition to the interests of the state.

Incorrect. Mercantilist policies amounted to an alliance between the king (the state) and the merchant, whereby the king gave monopoly privileges to the merchant and the merchant provided tax income (in the form of precious-metal money) for the king (Brue and Grant 2013: 18; see also the Guide on mercantilism).

b. Mercantilists introduced the concept of the "balance of payments".

Correct. This is one of the lasting contributions of the mercantilists (Brue and Grant 2013: 19).

- 13.
- a. Mercantilism favoured a *laissez faire* system, where the interest of the merchant took precedence over that of the consumer.
Incorrect. It is true that in the mercantilist system the interest of the merchant took precedence over that of the consumer. But it is not true that mercantilism favoured a *laissez faire* system. Rather, it used the power of government to pursue its aims, in particular the power to create monopoly privileges for the merchant. See Brue and Grant (2013: 15).
- b. As one of their lasting contributions, the mercantilists realised that government regulation is necessary to ensure uniform weights and measures, and a standardised coinage.
Correct. This is clearly stated in the Brue and Grant (2013: 20).
- 14.
- a. Physiocrats wished to institute a single direct tax on landowners' rent income in place of the myriad of indirect taxes levied on various people and classes of society.
Correct. This was the central tax proposal of the physiocrats, which was the logical consequence of their idea that only land produced an economic surplus (2013: 37).
- b. Physiocrats acknowledged that the wealth of nations consists of goods rather than specie, but it must be agricultural or manufactured goods.
Correct. The physiocratic idea of wealth consisting of goods was an advance over the mercantilist idea that wealth consists of gold or silver money (specie). But the physiocratic idea of wealth was limiting in that only goods produced in the primary sector (mainly agriculture) contributed towards wealth creation. Manufacturing was considered "useful but sterile" (Brue and Grant 2013: 37). It was useful in that its output was considered as part of wealth. But it was sterile in that it did not generate a surplus (added value) over and above its cost of production. The value of manufactured goods merely add up to the value of the raw material and the food-for-labour (both generated in the primary sector) which went into producing them.
- 15.
- a. Physiocrats favoured small-scale farming with independent peasants farming their own small pieces of land.
Incorrect. Physiocrats favoured large farm units, as they believed in the superior productivity of large-scale farming (Brue and Grant 2013: 37-38).
- b. Physiocrats favoured minimal government.
Correct. This is implicit in the *laissez-faire* approach of the physiocrats (Brue and Grant 2013: 37).

- 16.
- a. The classical writers, Adam Smith in particular, were followers of the Enlightenment. According to Enlightenment thought, individuals do not need to be told by an authoritarian state what is good for them. They are capable of determining for themselves what is in their own best interest.
- Correct.** See the Guide on Adam Smith, and Brue and Grant (2013: 68).
- b. According to the classical school, the functioning of society can be described with the aid of laws similar to the laws of the physical sciences. Economic policy should be aimed at giving those laws free rein or full scope so that they can guide society towards the common good.
- Correct.** See Brue and Grant (2013: 49-53) as well as the sections in the Guide on the classical forerunners and Smith.
- 17.
- a. Smith's *Theory of moral sentiments* has little bearing on his economic ideas as contained in the *Wealth of nations*.
- Incorrect.** As the Brue and Grant note, "the books [*Theory of moral sentiments* and *Wealth of nations*] stand side by side, presenting different but complementary facets of his [Smith's] thinking" (2013: 69). Very broadly, the *Theory of moral sentiments* is about how selfishness is restrained by moral sentiments, while the *Wealth of nations* is about how selfishness is restrained by competition (the invisible hand). See also the relevant sections in the Guide (29-30).
- b. The productivity gains by way of increased labour specialisation (what Smith called the "division of labour") have nothing to do with the productivity gains by way of industrialisation (use of machinery in production).
- Incorrect.** Industrialisation is one of the products of the division of labour. See Brue and Grant (2013: 73). See also the applicable sections in the Guide (31).
- 18.
- a. Smith's theory of value was intended to explain "value in use".
- Incorrect.** Smith's theory of value was intended to explain "value in exchange" (market price). Because Smith could not solve the water-diamond paradox, he ignored "value in use" ("utility") as a determinant of market price (Brue and Grant 2013: 78; Guide: 33-34).
- b. Smith's value theory was intended to explain short-term market prices.
- Incorrect.** Smith's theory of value was intended to explain long-term natural prices. The natural price is the price towards which short-term market prices gravitate and around which short-term market prices fluctuate (Brue and Grant 2013: 80; Guide: 33-34).

- 19.
- a. Classical economists, Smith included, did not treat profit and interest separately, implying that profit is the reward for contributing and risking capital only.
Correct. Profit is what the owners of a firm receive in reward for whatever they contributed. Because ownership can, in principle, contribute all the production factors (capital, labour, entrepreneurship and land), profit can contain the rewards for all these production factors. As a minimum, the owners of a firm must contribute at least some of the capital and entrepreneurship, but they can also contribute land and labour (the owners of smaller firms often work as labourers in their own firm). The classics were, however, inclined to treat profit as the typical reward for contributing capital only, with the result that they used the concepts of profit and interest as close to meaning the same thing. See Guide: 36-37.
- b. According to Smith, wages will always remain at their subsistence level.
Incorrect. The opposite is plainly stated in the Brue and Grant (2013: 81).
- 20.
- a. Malthus believed that agricultural production increased arithmetically and the population increased geometrically.
Correct. See Brue and Grant (2013: 94).
- b. Malthus' preventative checks on population reduce the death rate and his positive checks reduce the birth rate.
Incorrect. It is the other way around. See Brue and Grant (2013: 94-95).
- 21.
- a. Malthus believed that government aid to the poor (the Poor Laws) is not a remedy to the problem of hunger.
Correct. The Poor Laws state that the poor should have a minimum income irrespective of their earnings. In the event that earnings fell below the prescribed level, government was supposed to pay the grants. According to Malthus, giving aid to the poor would cause more children to survive, which would worsen that problem of hunger. He concluded that government should not give aid to the poor (Brue and Grant 2013: 96-97).
- b. Say's law rejects the notion that the economy tends towards a situation where aggregate demand is sufficient to buy up aggregate supply.
Incorrect. According to Say's law of markets "supply creates its demand". This implies that total production will be bought up, ruling out the possibility of aggregate overproduction (although there may be overproduction in individual markets). Therefore Say's law accepts the belief that the economy tends towards a situation where aggregate demand is sufficient enough to buy up aggregate supply (Brue and Grant 2013: 97-100, Guide: 45-47).

- 22.
- a. According to Ricardo, rent influences the price of agricultural output.
Incorrect. It is the other way around. According to Ricardo's rent theory, rent has no influence on the price of agricultural output, while the price of agricultural output determines the level of land rents (see 2013: 110-112; Guide: 52-54).
- b. According to Ricardo, rent is paid only on non-marginal land.
Correct. The essence of Ricardo's rent theory is that rent is paid only on non-marginal land, i.e. land which is more productive than the least productive land that is just productive and profitable enough to merit cultivation (see 2000: 114-118, 2007: 102-105; Guide: 53). As Brue and Grant (2013: 114) note: "Rent is price determined but not price determining."
- 23.
- a. In Ricardo's value theory, relative price is determined by the relative amounts of labour time used in production. If so, capital-labour ratios must be assumed equal in all sectors, and capital and labour have to be equally productive in all sectors.
Correct. One of the weaknesses of Ricardo's value theory is that it needs to make these unrealistic assumptions (see 2013: 114-117; Guide: 54-55)
- b. In Ricardo's value theory, a change in the profit rate affects relative price.
Incorrect. The whole point of Ricardo's value theory is that changes in the profit rate do not influence relative price. It is thereby assumed that the profit rate is equal in all sectors (2013: 115-116; Guide: 55).
- 24.
- a. According to Ricardo, value is primarily exchange value rather than use value.
Correct. Ricardo believed that the value of a commodity was explained by how much exchange value it possesses. However, for a commodity to have exchange value, it must have use value. Ricardo's theory of value is based on the 'labour theory of value', according to which the exchange value of a commodity is determined by the amount of labour necessary to produce it.
- b. According to Ricardo, gains from trade occur only if an imported commodity is produced at lower absolute costs than would be incurred by its home production.
Incorrect. According to the Ricardo's theory of trade, each nation should produce the product for which it has the lowest domestic opportunity costs. Therefore the analysis of gains from trade is based on the principle of relative cost (opportunity cost) and not on the principle of absolute cost (Brue and Grant 2013: 123-125).

- 25.
- a. According to Mill, the limit to wealth and employment is not deficiency of total demand but deficiency of total supply and productive power.
Correct. See Brue and Grant (2013: 148-149). See also the Guide (61).
- b. According to Mill, an improvement in law and order and education will reduce the “minimum necessary rate of profit” which stimulates investment.
Correct. According to Mill, investment is undertaken only if it promises to the investor some “minimum necessary rate of profit” (similar to Keynes’s *marginal rate of efficiency*). The investment must promise some minimum level of future profit, in compensation for the risk accepted in investing money. The lower this minimum necessary rate of profit, the more investment will be undertaken. See Brue and Grant (2013: 154-156). See also Guide (61).

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We trust you will enjoy your studies in the remainder of the semester.

Please be sure to keep a steady study pace throughout the semester and not to leave most of your preparation for the exam to the last couple of weeks before its date. In addition to a large amount of factual knowledge, success in the examination also requires that you acquire a good understanding of the study material, which requires that it is slowly “digested” over a longer period of time.

Always feel free to contact us by phone or email if you have any problem with any section of the prescribed study material.

Regards,

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