


EXAM

Q + A 

ECS 306J:

May/June 2012:

Section A:

1) Mercantilism as rent-seeking behaviour:

- Economic rent is defined as profits beyond those that would be just necessary to keep the merchant capitalists engaged in their present activities, just sufficient to compensate them for their opportunity costs
- Rent seeking activities are simply attempts by private parties to increase their profits by securing favourable laws and regulations from government
- Laws took the form of grants of monopoly status and regulations that made it difficult for new producers and merchants to compete successfully against the established ones

2) Physiocrats on tax shifting:

- Physiocrats thought that because only agriculture produced a surplus, which the landowner received in the form of rent, only the landowner should be taxed
- All taxes imposed on others would be passed on to the landowner anyway
- A direct tax on the landowner was preferable to indirect taxes, which increased as they were passed along to others

3) Smith on self-interest, selfishness (greed), and the common good:

- Smith considered the disturbing problem of our own selfishness and how it could be curbed and controlled
- Smith says that our moral faculties prescribe rules of conduct that restrain our actions of selfishness
- Moral Sentiments and Wealth of Nations reconcile the individual with the social interest through the principle of the invisible hand, or natural harmony, and the principle of natural liberty of the individual
- In moral Sentiments – sympathy and benevolence restrain selfishness
- Wealth on Nations – competition channels economic self-interest toward the social good

4) How the division of labour enhances productivity, and what restricts this productivity enhancing effect:

- The division of labour increases the quantity of output produced for three reasons:
- 1) Each worker develops increased dexterity in performing one single task repeatedly
- 2) Time is saved if the worker need not go from one kind of work to another
- 3) Machinery can be invented to increase productivity once tasks have been simplified and made routine through the division of labour

5) **Ricardo on rent at the extensive margin of cultivation:**

The produce from marginal land will bring in enough revenue to cover all the expenses of production plus the average rate of profit on the investment in labour and capital

The value of farm produce depends on the labour required per unit of output on the least productive land in use

- The better land produces a surplus that is taken by the landowner as rent

6) **Marx on the distinction between labour power and labour time as the basis for his theory of exploitation:**

- Labour power refers to a person's ability to work and produce commodities
- Labour power is itself a commodity that is bought and sold in the market; it is what the capitalist needs to make profits
- Labour time is the actual process and duration of work

• Employer's pay workers according to their labour power, they pay the going market wage
 • Employer's pay workers the full value of their labour power, but the wage only equals a part of the value the labourers create

7) **Marshall on the Law of Demand and the equimarginal principle:**

- The consumer wishing to maximise utility will allocate money income in such a way that the marginal utility of the last dollar spent on all commodities is equal
- Eventually the ratios of marginal utilities to the respective prices of the goods equalise and the consumer's total utility is maximised

Law of demand: Expenditures in equilibrium = $\frac{MU_x}{P_x} = \frac{MU_y}{P_y}$ D & D
 $\uparrow D \rightarrow \downarrow P$ $\uparrow P \rightarrow \downarrow D$ \Rightarrow law of downward sloping demand ΔD
 $\downarrow P =$ substitution + income effect

8) **Walras on general equilibrium analysis:**

- Walras developed and advocated general equilibrium analysis, which considers the interrelationships among many variables in the economy
- Presents a framework consisting of the basic price and output interrelationships for the economy as a whole, including both commodities and factors of production

P + output
 (P.e.a)

Rock dropped into pond \rightarrow ripples - B in economy \rightarrow D radiate outward with dim. force
 Ripples reach shore \rightarrow rebound to affect initial point of impact \rightarrow feedback

9) **Institutions and their role in economic explanation:**

- An institution is not merely a organisation or establishment for the promotion of a particular objective, like a school and a prison
- It is an organised pattern of group behaviour, well-established and accepted as a fundamental part of the culture
- It includes customs, social habits, laws and ways of living

effects of D in single markets, reverberation continues in market until eq. is achieved in all markets

10) **Lucas on the long-run aggregate supply curve:**

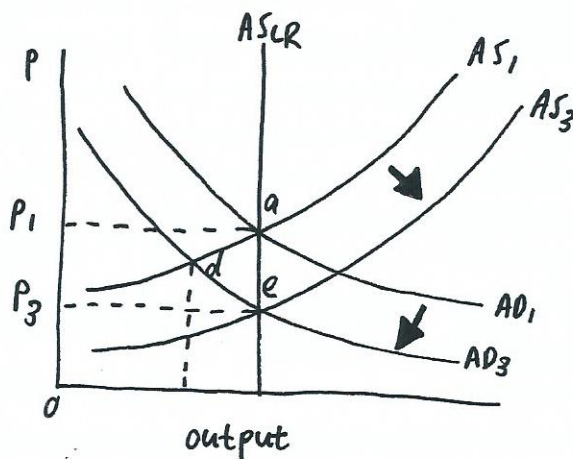
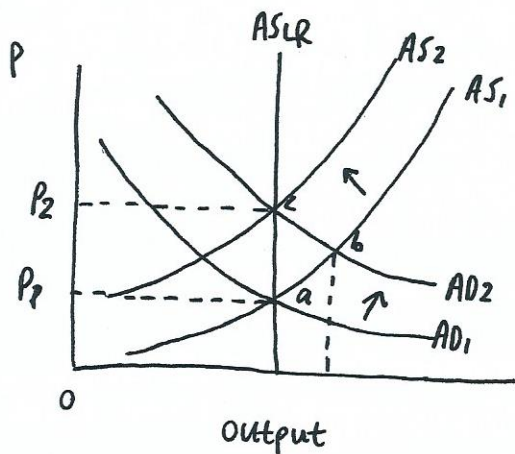
- Increase in AD temporarily moves the economy from a to b
- The economy then moves to c because of rising nominal wages and other input prices shift the short-run AS curve left

- An increase in AD moves the economy directly from a to c along the long-run aggregate supply curve AS
- A decrease in AD temporarily moves the economy from a to d
- Declines in nominal wages and other input prices shift the short-run aggregate supply rightward
- The economy moves to e
- A decrease in AD moves the economy directly from a to e along the long-run aggregate supply curve AS

Section B:

2) Economics of Thomas Malthus:

3) John Maynard Keynes:



unanticipated $\uparrow AD$ ($AD_1 \rightarrow AD_2$)
temporarily moves economy from a \rightarrow b
economy moves to c because of \uparrow nominal wages and other inputs - shift $AS_1 \rightarrow AS_2$

anticipated $\uparrow AD$ moves economy from a \rightarrow c along AS_{LR}

unanticipated $\downarrow AD$ ($AD_1 \rightarrow AD_3$)
temporarily moves economy a \rightarrow d
economy moves to e because \downarrow nominal wages and input prices - shift $AS_1 \rightarrow AS_3$

anticipated $\downarrow AD$ moves economy from a \rightarrow e along AS_{LR}

ECS 306J:

Oct/Nov 2010:

Section A:

1) Fear of goods:

- Duty-free importation of raw materials that could not be produced domestically, protection for manufactured goods and raw material that could be produced domestically, and export restriction on raw materials
- This emphasis on exports and a reluctance to import has been called 'the fear of goods'
- $\uparrow \text{exports} \rightarrow \uparrow \text{inflow of gold and silver} \rightarrow \uparrow \text{wealth of the nation.}$

2) Tableau economique:

- Depicted the circular flow of goods and money in an ideal, freely competitive economy
- Was the first systematic analysis of the flow of wealth on what later came to be called a macroeconomic basis
- Economists such as Smith, Marx and Keynes, who also described economic activities in terms of large aggregates, paid tribute to Quesnay for originating this approach

3) The division of labour and its limits:

- The division of labour, said Smith, increases the quantity of output produced for 3 reasons:
- Each worker develops increased dexterity in performing one single task repeatedly
- Time is saved if the worker need not go from one kind of work to another
- Machinery can be invented to increase productivity once tasks have been simplified and made routine through the division of labour

4) The distinction between natural price and market price:

- The natural price is the long-run price below which the entrepreneurs no longer would continue to sell their goods
- In a desperate decision they would sell good more cheaply, but this would not continue
- They could always go out of business or enter another line of production

- The market price is the actual price at which any commodity is sold
- It may be above, below, or exactly the same as its natural price

5) The role of cooperation-association and competition-disassociation in a collectivist economy and a liberal-capitalist economy:

6) **Institutions and their role in institutionalist economics:**

- An institution is not merely an organisation or establishment for the promotion of a particular objective, like a school, a prison, a union, or a federal reserve bank
- It is also an organised pattern of group behaviour, well-established and accepted as a fundamental part of the culture
- It includes customs, social habits, laws, modes of thinking, and ways of living
- Institutionalists were especially interested in analysing and reforming the institutions of credit, monopoly, absentee ownership, labour management relations, social security, and the distribution of income
- They advocated economic planning and the mitigation of the swings of the business cycle

• Emphasised the role of institutions in economic life

7) **The credit system according to Veblen:**

- Credit plays a special role in modern business
- Borrowing money can increase profits as long as the current rate of business earnings exceeds the rate of interest
- The competitive use of credit in extending business operations gives an enterprise a differential advantage against other competitors, but the credit expansion has no aggregate effect on earnings or on total industrial output

dit → ↑ profit → earnings > rate of interest

8) **Why a fall in the nominal wage rate need not raise the level of employment according to Keynes:**

- A deep and general reduction of nominal wages makes for bad economic policy
- He held that a single firm can increase sales and employment through wage cuts because the demand for its products will remain unaffected
- A whole economy cannot easily increase sales by cutting nominal wages because wages are a source of demand for goods as well as a cost of production

9) **Endogenous money according to the Post Keynesians:**

- Post-Keynesians regard the stock of money as being essentially endogenous to the economy, changing in response to changes in the level of wages
- The needs of trade dictate the supply of money

10) **The distinction between rational expectations and adaptive expectations:**

- Adaptive expectations – Friedman's theory of the inflation-unemployment relationship is based on the assumption of adaptive expectations
- People determine their expectations about future inflation on the basis of past and present inflation and change their expectations only as new events unfold

- Economic agents form rational expectations about future outcomes of current stabilisation policy
 - Although the idea of rational expectations was not original, it was Lucas who developed its implications for macroeconomic theory and policy
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Section B:

Marx's theory of exploitation:

- 1) The theory of exploitation:
 - Labour power versus labour time: labour power refers to a person's ability to work and produce commodities; labour time is the actual process and duration of work.
 - Labour power is itself a commodity that is bought and sold in the market; it is what the capitalist needs to make profit
 - Employers pay wages to workers equivalent to the workers' labour power, they pay the going market wage
 - The market wage is sufficient only to purchase the cultural subsistence required for survival and perpetuation of the labour force
- 2) Surplus value:
 - According to Marx, exploitation of labour arises only when workers can produce more in a day than they must consume in order to maintain themselves and their families
 - Then employers pay the workers the full market value of their labour power, but the daily pay equals only part of the value the labourers create
 - Through their ownership of capital, employers possess that which workers need to gain subsistence: jobs that pay wages
 - The labour time they spend during the workday creates a larger sum of values than the value of their own labour power, the costs of subsistence. The owners of the means of production garner a surplus value
- 3) The rate of surplus value:
 - Marx designated the part of capital invested in machinery and raw materials as constant capital
- 4) The rate of profit:
 - The rate of profit (p') in Marx's formulation is the ratio of surplus value to the total capital invested

Analytical Flaws:

- 1) Defects in the labour theory of value:
 - Contemporary economists dispute that workers are the source of all exchange value
- 2) Problems with Marx's theory of exploitation:
 - The wages paid to workers tend toward the cultural subsistence because of the presence of a large reserve army of the unemployed

- 3) Shortcomings in Marx's analysis of capital accumulation:
 - Marx believed that capital accumulation causes a falling rate of profit, worsening business crises, and technological unemployment
 - 4) Problems with the idea of class conflict:
 - Marx's prediction of the inevitability of class conflict rests on his theories of exploitation and capital accumulation, the latter causing a falling rate of profit, worsening crises, and technological unemployment
 - Marxian revolutions did not occur in the advanced capitalist nations (such as England, France, and Germany) where Marx expected them
 - The nations in which they did occur (Russia, China) had a woeful lack of capital accumulation at the time of revolt
 - Moreover, the dramatic collapse of Marxism in eastern Europe and the Soviet Union exposed a disdain for Marxism, at least as it had manifested itself historically, even among the so-called proletariat
 - The historical evidence simply does not support Marx's theory of class conflict
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Economics of John Stuart Mill:

Wage Fund

- Wages depend on the supply and demand for labour
 - Demand for labour is influenced by the part of capital set aside for the payment of labour.
 - Supply of labour depends on no of people seeking work.
- Under the rule of competition wages can't be affected by anything other than relative amounts of capital and population.
 - Wage rates cant rise except by increase of aggregate funds employed in hiring workers or decrease in no of workers employed and vi ser versa
 - This creates a unitary elastic demand for labour.
- According to Mill, government can't increase total wage payments by fixing min wage above equilibrium level.
 - Given a wage fund of fixed size, higher wage income some workers would receive would be offset by los wage income of those who became un-employed.
 - This can be rectified by gov increasing the wage fund through forced saving (through taxation) and using proceeds to overcome the employment created by min wage laws.
- The wage fund doctrine opposes unionism but Mill did not use it for this purpose, workers can't raise income through collective action, if one wage rate increases another must fall
 - Mill argued in favour of workers right to combine to raise wages, even though he found unions seldom effectual, and even when effectual, seldom desirable

- The wage fund concept was erroneous , there is no predetermined portion of capital that must go to labour:
 - This idea arose from the fruits of the harvest from one season was used to pay for the labour for the following season.
 - Today wages are not paid by circulating capital, but from a current flow of funds, derived from sale of output.
 - Note: future economists would point out the decision to hire the worker would not be based on past revenue, but on prospective revenue that worker would produce if hired.
 - Mill argued that unions could raise the general level of wages, but the size of the fund could not be altered, therefore unemployment would increase and cause the un-employed to decrease the size of the families they were having, this would decrease the supply of labour relative to the wage fund and increase the general level of wages.
- Profit: made up of three parts
 - Interest
 - Insurance
 - Wage of superintendence
 - These were the rewards for:
 - Abstinence
 - Risk attractiveness
 - Exertion applied in the exertion of capital
 - The rate of profit in all spheres of the employment of capital tends towards equality so long as allowances are made for:
 - Differences in risk
 - Differences in attractiveness of different employment
 - And natural or artificial monopoly

Mill noted that expenditure on education and training partly represent investment justified by later wage returns

Dynamics of the Economy

- Mill forecasted an increase in production and population as society grew its mastery over nature, increased role of corporations, and security of person and property. Improvements in industry would be diminished by diminishing returns in agriculture and mining as population grew.
 - But mill believed that progress of society would tend to diminish the min acceptable rate of profit, decreasing the risk of investment and thereby reducing min necessary rate of profit

Mill on Government

- Mill argued for minimisation of the role of state, stating that individual understood their own interests better than the gov does.

- However he did point out that individuals are not the best judges when it comes to social problems such as education, provision of essential services such as gas and water (creating natural monopolies)
 - Government should partake in things that serve the general interest of the people, but that are not profitable to individuals
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