

# History of Economic Thought

Ordinary exam 21.12.2023

## Outline of solution

1. (a) The survey should contain the following: The early attempts to explain value as originating in the contributions of the production factors land and labour, as described by Petty, as well as subsequent further developments of this ideas, such as Cantillon and the argument that all could eventually be reduced to the contribution of land, and to the labour theory of value which became the dominating approach in the classical period, even though there were several variations. With Ricardo the labour theory of value was connected with theory of diminishing returns to scale on land, since the price of agricultural products would be determined by the labour input on the last piece of land turned into cultivation. The role of demand was generally given a secondary role compared to the role of production costs, although it was given more attention by the later classical writers, including Mill.

(b) With the marginalists, the demand side would be given much more attention, and the role of utility would be given much attention. The approach would differ from the early forerunners such as Gossen to the three main directions, who also introduced subjective utility in slightly different ways. A more general common feature of the marginalists was that the theory dealt with prices, such as they would arise either through bargaining or in an organized market, rather than with some underlying values, so that value theory as such was replaced by price theory.

2. (a) The early marginalists took over from the classical writers a view of interest as profit of invested capital, the latter being the outlays to initiate production, and a specific theory of interest materialized only slowly. In the English tradition, the approach to capital as a production factor and interest as its remuneration had its most outspoken representative in J.B.Clark, who identified interest as marginal product of capital. This was followed up by Wicksteed who showed that remuneration of factors would exhaust output under constant returns to scale. In the Austrian tradition, von Wieser still worked with production in classical form, but Böhm-Bawerk introduced more general production functions and formulated a theory of interest rate determination, the most remarkable part of which was the idea of higher productivity of roundabout methods. In the French tradition, the Walrasian theory of general equilibrium was primarily directed towards explanation of current prices, and the theory of interest rates was given limited attention.

Later marginalists contributed to the theory in several ways, thus Fisher gave the first precise analysis of interest rates as determined by time preferences, and both Fisher and Wicksell demonstrated the relation between interest rates and price changes.

(b) In Keynesian economics, the interest rate is determined in the market for funds available for investment and funds made available by savers through the intermediation of the financial sector, following the earlier ideas of Wicksell. The Keynesian treatment differed

crucially from the established view, according to which government spending would compete with private investment for savings and rise interests and inflation rates without changing the unemployment rate. In the Keynesian theory, government spending would increase production and through this savings, meaning that the equilibrium is achieved through changes in effective demand. Thus, the role of the interest rate is a different one, influencing the investment demand not in itself equilibrating savings and investment.

**3.** (a) Although Adam Smith represents the final break with the mercantilist traditions of regulation, he did recognize the need for government engagement in the supply of several public goods, emphasizing that the financing of such government activities by taxes should be kept to a minimum. This approach was shared by subsequent classical writers such as Malthus and Ricardo, who supplemented it by considerations of whether the financing should be immediate through taxes or it should be postponed through loans. In addition, Ricardo considered the impact of taxes on commodity prices, thus introducing the theory of tax incidence.

(b) Dupuit, a forerunner of marginalism, was concerned about public works and their payment and may be considered as the first to consider cost-benefit analysis as well as deadweight of taxes. The first generation of marginalists differed little from the classical economists in their view upon government activities and taxation. But the methods of treatment were subsequently refined, Marshall introduced the modern treatment of market distortions due to taxation, and he introduced the notion of externalities, Wicksell introduced the idea of balancing the tax burden with the utility gain obtained from the public consumption. Later, Pigou gave a more detailed analysis of externalities, introducing what is now called the Pigou tax, as well as welfare effects of income redistribution.