

History of Economic Thought

Re-exam 10.2.2022 – 24.2.2023

Outline of solution

1. (a) Division of labour as illustrated by the classical pin factory example of Adam Smith occurs when workers are separated into distinct uses of labour power. In the strict version of returns to scale, the comparison is about the use of a greater number of workers carrying out identical tasks. In a modern microeconomic perspective, division of labour relates to extension of the number of input commodities, whereas returns to scale deals with changing the use of a given set of input commodities.

(b) The marginalists attempted to establish a theory of income distribution based on marginal productivities. Such a theory will give an exhaustive explanation of income distribution only if the remuneration of productive factors exactly corresponds to what is produced, and this will occur only under the condition of constant returns to scale in production, as pointed out by Wicksteed and contemporaries. Since constant returns to scale was considered as a natural property of production, this was not seen as particularly restrictive, and possible violation could be caused by omission of some productive factor.

2. The main message in the article is that Gossen was indeed a pioneer in economic science, both in the treatment of utility and the application of mathematics, but his interest was not in explaining price or value by supply and demand but rather in establishing a new theory of human behaviour. In this sense it would be misleading to consider Gossen as a forerunner of the marginalist revolution.

(i) Gossen was innovative in his treatment of utility, in particular utility of the later as compared to earlier consumption, but his notion of marginal utility involved time in a very essential way, considering utility as something which develops as the particular activity is repeated, so that utility depends on experience.

(ii) Since time matters for marginal utility in Gossen's work, it becomes an important element of the theory of consumption choices, and in this way Gossen can be seen as a forerunner of later attempts to incorporate an additional budget constraint w.r.t. time.

(iii) The importance of time and experience has been taken up by other theorists, and the general approach in Gossen points in the direction of modern behavioral economics.

3. (a) The marginalists took over a quantity theory of money from earlier economic writers, but it was subsequently refined by Wicksell, who added the intermediation of a financial sector, and Fisher, who gave it the formulation known from subsequent textbooks. The basic message of the quantity theory, namely that a change in the money supply would transform itself to a corresponding change in the level of prices, was not interfered with.

(b) In the Keynesian revolution, the classical quantity theory was replaced by the addition of a demand relationship, giving rise to the liquidity preference in the General Theory. With

this formulation, and under the condition of disequilibrium in labour and commodity markets, a change in the money supply could result in reduced unemployment without necessarily changing the price level.

The opponents to the Keynesian view would argue that expansionist fiscal or monetary policy would result in price changes rather than increased employment, and they found a new theoretical underpinning in the theory of rational expectations, according to which the economic agents would take action based on their expectations of their outcome from any government intervention.