

## **History of Economic Thought**

Ordinary Exam 10.2.2026

### **Outline of solution**

The answer to each of the questions should take the form of a short essay touching upon the points stated below:

1. Among the early preclassical writers, Cantillon paid attention to profit as the remuneration of entrepreneurs, mainly for bearing the risk of enterprise. A systematical treatment of profits comes with Adam Smith, where profit emerges as the difference between the value of production and the outlays, in particular the wage fund. With Ricardo, profit is also a residual, and over time it is reduced due to the increased payment of rent. In the writings of Marx, profit played an independent as the main objective of the capitalists, which however was subject to the law of declining rate of profits.

Neoclassical writers, notably J.B.Clark, introduced capital as a factor of production, with interest appearing as its remuneration, and entrepreneurial profits would be zero under constant returns to scale, since factor remuneration would exhaust the product. Later contributors pointed to the remuneration of risk-bearing, and Schumpeter connected profits with innovation.

2. Self-interest has been mentioned as a motivation for economic activity already by the mercantilists and early preclassical writers, and it was dealt with at length by Adam Smith. The formulation in terms of utility and a systematical treatment of utility came only with Bentham, where the perspective of the individual was given increased attention in connection with economic decisions at the level of society. According to Bentham, the individual preferences were as important for such decisions as any outside judgement, and their use gave rise to the so-called felicific calculus, determining what is best for society.

The use of utility in connection with consumer demand came much later. Demand functions were introduced by Cournot but without reference to utility, and although Dupuit used both demand functions and notions of marginal utility, they were not connected systematically. Gossen and Jevons discussed markets and determination of prices using marginal utility but the derivation of demand from utility came only with Marshall.

Although welfare considerations can be traced in Bentham's writing, a systematical treatment came only with the marginalists. The approach used by Marshall and

later Pigou assumed interpersonally comparable utilities, and the modern approach was introduced by Pareto.

3. Increasing returns to scale means that output increases more than proportionally when input is increased. It is inherent in the pin factory example of Adam Smith at least when using an aggregate production function. The fundamental problem for the theory of prices is that at given prices an entrepreneur will want to extend production in order to increase profits, and the resulting oversupply will mean that the market breaks down, presumably resulting in a monopoly.

While Adam Smith saw a possibility of retaining the functioning of competitive markets by extending them to foreign countries or colonies, most authors assumed that increasing returns to scale would occur only in long-term production, and in the short run capacity constraints would prevent the breakdown of markets. Another explanation was proposed by Marshall based on a life cycle with initial increasing returns and subsequent decreasing returns, but constant returns to scale holds at industry level.