Chapter Seven: The Classical School – David Ricardo (pg 99-120)

David Ricardo (English, 1772-1823) Leading Classical economist after Smith
Born of Jewish immigrants from Holland
Became a stockbroker, Unitarian, made a small fortune
Died early (aged 51) of an ear infection

Stock buying strategy – markets over-reacted to events
- Early observer of "herd behavior"
- Content with small profits, venture capitalist
- So widely respected that he became a "market maker"

Supported many political reforms that went against his "class" interests

Came to economics late – at age 27
- Didn't write anything till he was 37
  - A great thinker, but not a natural writer

A powerful deductive thinker
- Basic Premises to General Laws
- Not "inductive", never used history to inform theories, only to illustrate

The Currency Question

England was going through currency crises as a result of French Revolution and Napoleonic wars
- England was on the Gold Standard
- But used Paper money, and the price of gold was rising….

Effectively, the bank of England has gone off the gold standard
- Ricardo analyzed this, again using good old PV=MRT
- The problem, according to Ricardo, was to much paper money was printed
  - The price of gold had not risen, the value of money had fallen
- There would be a run on the bank if the link was restored, argued the bank

Eventually, Ricardo's arguments won the day, and redemption was restored (1972)

The Theory of Diminishing Returns and Rent

- Rent is the extra money given to owners for the indestructible part of the land
- Nobody pays rent when land is "free" or abundant
- Rent only comes into play as land becomes less free
  - This is marginal analyses – the rent changes as the supply of land changes
- Diminishing returns……
  - Both in the amount of land (new land is less useful)
  - And the intensity of cultivation (more inputs are less useful)

Rent, in Ricardo's views, are determined by the price of Grain
- As the price of grain rises, tenants bid up the value (rents) of land
- So high grain prices cause high rents, not the other way around
  - Thus, the corn laws help the landlords

The Theory of Exchange Value and Relative Prices

Exchange Value

- Ricardo understood the importance of relative vs. absolute value
  - To have exchange value, a good must have use value
- If something had use value, its exchange value depended on
  - Its scarcity
  - The amount of labor used in making it
- Some items (un-reproducable ones) only have scarcity value
  - Rare art: its exchange value now only determined by demand
    - Not by the work originally put into it
- Most commodities are reproducible
  - Value of goods depends on the labor put into them
    - And the labor put into the capital to create them
- So all exchange value due to labor put into it
  - So if the beaver-deer ratio changes,
    - Either the ratio of work necessary to catch them changed
    - Or the amount of labor used to produce hunting tools changed

What about……

- **Differing Capital-Labor ratios**
  - Consider the potato to cloth comparison
    - Both need the same amount of labor, but one also needs capital
  - Ricardo asserts that the capital inputs are necessarily small
    - And thus the effects are also small
    - Very unsatisfying answer
- **Differences in labor Quality**
  - Ricardo recognized this, and thought labor could be substituted
    - If worker A produced twice what B produced
    - We could switch them, values would stay the same.
- **Wages, Profits and Rents**
  - Exchange value does not depend on wages, it depends on labor
    - Skilled labor will get more wages
    - But that's irrelevant, they represent more labor
      - Skills = greater productivity
  - Wages and profits are inversely related….
    - So a change in wages does not change exchange value
- <u>*This means that labor does NOT have to get all the value of what it produces*</u>
- **Relative Prices**
  - Depend on short term supply and demand fluctuations
    - But don't change the exchange value

Ricardian Equivalence……

- Does private saving increase as public debt rises?

The Distribution of Income

Wrote to Malthus about: production vs. distribution

- The law can deal with proportions, it can't mandate quantities

Income from three sources

- Wages

Profits (including interests)
Rent

Wages

Natural price of labor – the price of wages that
Provides a subsistence existence, while
Population stays steady
The market price fluctuates around this natural price
Note, this view was in accordance with Malthus
But…..
Expanding capital could keep increasing the wage fund faster than pop
Ricardo's view of sustenance differed from Malthus
"cable t.v. as a right"

Profits

Rates of profits will tend to equalize
Profits and wages are inversely related
Smith thought profits could keep rising as capital did
Ricardo didn't
diminishing returns meant capital accumulation would stop
but population growth would not

Example: what if wages rise?
Then the production costs rise – so the good sells for a higher price
People buy from elsewhere – gold flows out
And this causes the money supply to drop, so prices fall
But the wages are stuck, so profits must fall

Rents

As population increases, the demand for food increases
As the price of food rises, rents rise
As prices rise, natural wages will rise
And thus, as per profits, profits will necessarily fall

A contemporary Representation

(Insert Graph)…..

Policy Implications
The poor laws are bad – they hurt the rich, but don't help the poor
A tax on rent will only affect rent
So tax rent, it can't be passed on to others
He also opposed the corn laws
They kept the price of corn high, which meant higher rents
They interfered with specialization from …..

The Theory of Comparative Costs

Smith supported more trade, because it led to more specialization
    Specialize in what you are good at……
But what if you are not good at anything?

Ricardo – specialize in what you are relatively good at….
    The law of comparative advantage
        Ricardo assumed that capital and labor were stationary
        Also assumed that costs were linearly increasing with output
            (no diminishing returns)
        All costs are measured in labor hours

Output per unit of Labor Employed

	Wine	Cloth
Portugal	3	6
England	1	5
total	4	11

Gains from Specialization and Trade
Portugal transfers one unit of labor from cloth to wine, England two units from wine to cloth…..

	Wine	Cloth
Portugal	+3	-6
England	-2	+10
total	+1	+4

Some have said, this was the first thing economists said was both non-intuitive and true…..

Ricardo did not ever talk about how the gains would be distributed (mills did later)
Ricardo, and many others, did not extend the theory out to other things.

Ricardo on unemployment
    Skip

Assessment

    Contributed the use of abstract reasoning
    Comparative advantage
    Marginal analyses (prototype anyway)
    Diminishing returns in agriculture
    Distribution of income
He was wrong on…….
    Overestimated the impact of diminishing returns
    His analysis of rent was confusing
    His views on capital were sometimes just wrong (capital and labor could be complementary)