(Mis)understanding Classical Economics

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2011

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In 1936, Keynes published *The General Theory of Employment, Interest and Money*, one of the most influential books in economics of the twentieth century. With this publication, Keynes has confused and will continue to confuse generations of economists as to what classical economics means. This confusion, rather this misunderstanding, is an issue, for classical economics, as revived by Piero Sraffa in 1960, offers an alternate approach to understanding and explaining economic phenomena. This short essay argues that the 'classical economists' whom Keynes referred to in *The General Theory* were actually those economists who primarily employed 'marginal methods' in economics, i.e. he was referring to the neoclassical economists.

As early as the first chapter of *The General Theory*, Keynes points out that "the postulates of classical theory are applicable to a special case only" and that, "the characteristics of the special case assumed by the classical theory happen not to be those of the economic society in which we actually live" (Keynes 1936, 3). Whose works was Keynes referring to, when he mentioned classical theory? Soon, we are told that he wants to include not only the predecessors of Ricardo as classical economists (as Marx did), but also the followers of Ricardo. Among the followers of Ricardo, Keynes specifically mentions the names of J S Mill, Marshall, Edgeworth and Pigou. However, a close reading of *The General Theory* reveals that by classical theory, Keynes is mainly talking about the economics of Marshall and

Pigou.[1]

Classical economics refers to the works of economists such as Quesnay, Smith, Ricardo and Marx; and, neoclassical economics comprises the analysis carried out by Marshall, Jevons, Menger, Walras and Pigou. Both these approaches differ in terms of what they consider to be the objective of economic analysis. Classical economics studies the production, distribution, consumption and reproduction of the social surplus (output/wealth) in an economy, by dividing the inhabitants into broad social classes. Whereas, neoclassical economics examines how scarce resources are allocated in an economy, between individuals. In other words, neoclassical economics is a study of choice. For our purposes, we look at certain postulates which Keynes associated with classical economics. This is then compared to the analysis of one of the best representatives of the classical school – that of David Ricardo.

Wage determination and the causes of unemployment in classical economics (read Pigou), according to Keynes, were the most flawed. The classical theory of employment[2] has two fundamental postulates (Keynes 1997, 5). The first one is that the wage is equal to the marginal product of labour. That is, the precise contribution a worker makes to the total output, is given back to the worker as his/her wage. The second postulate says that "the real wage of an employed person is that which is just sufficient to induce the volume of labour actually employed to be forthcoming" (*Ibid*). In other words, the utility of the wage is equal to the marginal disutility of that employment. Therefore, at the equilibrium level of employment, the wages received by workers will exactly equal their contribution made to the production

1 See also Robinson 1969, ix.

2 According to Keynes, Pigou's *Theory of Unemployment* is "the only detailed account of the classical theory of employment which exists" (Keynes 1997, 7).

process. And, the wages paid by the employer would be such that it would precisely induce the labour of the workers. This is so because the benefit (utility) received by the worker offsets all kinds of distress the worker has to undergo during the duration of the work. This theory posits that the equilibrium level of employment is brought about by bargaining between the entrepreneurs or employers and the workers. At this point, both the equilibrium employment as well as the wage are determined. In other words, the orthodox theory maintained that labour, as a class, was in a position to determine "what real wage shall correspond to *full* employment, i.e. The *maximum* quantity of employment which is compatible with a given real wage" (Keynes 1997, 12).

From the works of Ricardo, it is evident that wages were not explained by taking recourse to any marginal theory. Like the early classical economists such as Petty, Cantillon and Smith, Ricardo too distinguished between the natural price and market price of labour. The natural price of labour, for Ricardo, "is that price which is necessary to enable the labourers, one with another, to subsist and to perpetuate their race, without either increase or diminution" (Ricardo 2004, 93). Hence, the natural price of labour depended on the price of food and other necessaries. Thus, it varied across both time and space; for, "It essentially depends on the habits and customs of the people" (Ricardo 2004, 96-97). The market price of labour, according to Ricardo "is the price which is really paid for it, from the natural operation of the proportion of the supply to the demand" (Ricardo 2004, 94). The market price of labour or the wages was determined by the demand and supply of labour as well as by the prices of the subsistence goods. And the market price of labour was considered to revolve around the natural price of labour. In short, the wages or the market price of labour at a particular place, depends on the demand and supply of labour, on the price of food and other necessaries around that place and on the “habits and customs of the people”.

Ricardo in a later edition of his *Principles* added a chapter which analysed the loss of jobs brought about by the introduction of machinery. Again, like other classical economists, Ricardo never stated that unemployment was a transitory phenomenon. On the other hand, it was a very serious issue thrown up by the rapid technological developments which were taking place in Europe. As he posits, “the substitution of machinery for human labour, is often very injurious to the interests of the class of labourers” (Ricardo 2004, 388) because “some of their number will be thrown out of employment” (Ricardo 2004, 390). And, Ricardo also pointed out that the demand for labour will not increase in proportion to the increase of capital, implying that unemployment of labour and accumulation of capital go hand in hand. In other words, unemployment can be a permanent phenomenon.

From the above discussion, it becomes clear that, for Ricardo, unemployment is not a transitory phenomenon as it was for Pigou. Also, wages were not determined by the marginal product of labour nor by the disutility of employment. In fact, one of the major difference between the classical approach and the neoclassical approach lies in the use of the marginal method. Ricardo employed the marginal principle only in explaining the formation of rents. However, the later economists generalised this to explain the formation of not only rents, but also that of wages and profits (see Bharadwaj 1994, 42-43).

To conclude, it is clear that the economists Keynes criticised were mainly Marshall and Pigou. These economists belong to the neoclassical economics school, which employs the marginal method and argues that wages equals the marginal product of labour; and that in equilibrium, there is full employment. In contrast, Ricardo, in the tradition of classical economics, pointed out that wages are determined by various socio-economic forces, which are not easily amenable to economic analysis; and that unemployment can be a permanent feature of any economy.

Acknowledgements

I thank Nilesh Kumar for having motivated this discussion and also for his helpful comments on an earlier draft.

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