UNIT - III

CLASSICAL DOCTRINES

Classical Individualism

Individualism is the moral stance, political philosophy, ideology, or social outlook that stresses "the moral worth of the individual". Individualists promote the exercise of one's goals and desires and so value independence and self-reliance, while opposing most external interference upon one's own interests, whether by society, family or any other group or institution.

Classical economists' major theories (works) are based and classified into two fundamental ideas. a. Naturalism (spontaneous origin of economic institutions, spontaneity) b. optimism (beneficence). According to Adam smith both these ideas are closely connected. He believed and proved all the economic institutions are created by human being. Such as division of labour, money, capital, theory of demand and supply, population and labour changes, etc. came into existence spontaneously. Through a process of evolution man fell the need and established various economic institutions.

Division of labour is the result of common tendency among men which is spontaneously developed under the self interests and benefits all. According to Smith, capital was the true source of economic life. They considered capital as a phenomenon of greatest importance most essential for national wealth.

Optimism explains the beneficent character the spontaneity.

Naturalism and optimism were inseparable. According to Classical economists, the personal interests not only lead to the creation and maintenance of economic institutions but also ensure that the nation progresses towards greater wealth and prosperity. Hence, the institutions created by human beings were not only natural but beneficial too.

They believed that individuals, if left to themselves, would serve society even though it was not their intention. The individual was led by 'an invisible hand' to do good for the society.

Harmony of Interests

Classical economists believed in the natural organisation of the economic order under the influence of personal interest. They believed that individuals, if left to themselves, would serve society even though it was not their intention. They believed that the interests of the individuals coincided with the interests of the society. Smith illustrated the idea of the harmony of interests with the following example: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, bat from their regard to their own interest."

Classical Liberalism

Classical liberalism is the philosophy committed to the ideal of limited government (Laiseez-faire) and free markets.

Classical liberalism developed in the 19th century in Europe and the United States. Although classical liberalism built on ideas that had already developed by the end of the 18th century, it advocated a specific kind of society, government and public policy required as a result of the Industrial Revolution and urbanization. Notable individuals who have contributed to classical liberalism include J.B.Say, Thomas Malthus and David Ricardo. It drew on the economics of Adam Smith, a psychological understanding of individual liberty, natural law and utilitarianism.

Classical liberals thought that individuals should be free to pursue their self-interest without control or restraint by society. Individuals should be free to obtain work from the highest-paying employers, while the profit motive would ensure that products that people desired were produced at prices they would pay. In a free market, both labor and capital would receive the greatest possible reward, while production would be organized efficiently to meet consumer demand.

Government, as explained by Adam Smith, had only three functions: protection against foreign invaders, protection of citizens from wrongs committed against them by other citizens, and building and maintaining public institutions and public works that the private sector could not profitably provide.

Classical liberalism places a particular emphasis on the sovereignty of the individual, with private property rights being seen as essential to individual liberty. This forms the philosophical basis for laissez-faire public policy.

Adam Smith's The Wealth of Nations, published in 1776, was to provide most of the ideas of classical liberal economics. According to Smith self-interest is the motivation for the production of goods and services. An "invisible hand" directed the tradesman to work toward the public good. This provided a moral justification for the accumulation of wealth, which had previously been viewed as sinful. His main emphasis was on the benefit of free internal and international trade, which he thought could increase wealth through specialization in production. He also opposed restrictive trade preferences, state grants of monopolies, and employers' organisations and trade unions. Government should be limited to defence, public works and the administration of justice, financed by taxes based on income.

J.B. Say was a French economist. . His most important contribution to economic thinking was "Say's law", which was interpreted by classical economists that there could be no overproduction in a market, and that there would always be a balance between supply and demand. This general belief influenced government policies until the 1930s. Following this law, since the economic cycle was seen as self-correcting, government did not intervene during periods of economic hardship because it was seen as futile.

Laissez-faire Policy

Classical economists were a great advocate of *laissez-faire*—non-intervention by government in business. According to him, governments are wasteful, corrupt and incompetent. So he advocated a minimum role for government. He was against the state intervention in economic activities and also against state control over economic institutions.

According to him, the government should limit its functions, to three duties—(1) Protects the society from violence and invasion from foreign states (2) Administration of law and justice and (3) the establishment of and maintenance of certain public works and institutions.

ARGUMENTS IN FAVOUR OF LAISSEZ FAIRE

The arguments given by Smith in favour of non- intervention of government are as follows:

1. It leads to progress and harmony.
2. It will help free trade and promote maximum possible international trade.
3. Private enterprise is cheaper and productive while the State enterprise is inefficient, unproductive and expensive.
4. Capital will be employed carefully and purposefully.

FREE TRADE

Classical economists advocated free trade. They believed free foreign trade would promote greater division of labour. While the mercantilists believed that each nation enriched itself at the expense of its neighbour, Smith believed in an international harmony of interests.

The classical economists made a powerful case for free domestic exchange and free foreign trade.

Adam Smith argued that nations or regions should specialize in producing goods for which they are particularly well-suited. For example, warm, dry sunny regions have an advantage in producing olive oil. David Ricardo made a more sophisticated argument that mutually beneficial trade can depend only on relative advantage not absolute advantage. In his famous example, Portugal can produce both wine and cloth more cheaply than England. However England can produce cloth relatively more cheaply than Portugal. Therefore the two countries gain if Portugal specializes in producing wine for England and England in producing cloth for Portugal. In a conventional modern example, an attorney is a faster typist than her secretary. However, both gain if the attorney spends her time negotiating, paying her secretary to type the briefs. (In other words, the secretary is relatively better at typing.)

Adam Smith thought that protectionism against free trade was a scam on the public on behalf of producers, carried out in the name of nationalism. Even if overall economic interests had not been harmed by tariffs, he was opposed to them on the grounds that patriotism should not be perverted by scoundrels to enrich them.

Classical economic analysis shows that free trade increases the global level of output because free trade permits specialization among countries. Specialization allows nations to devote their scarce resources to the production of the particular goods and services for which that nation has

a comparative advantage. The benefits of specialization, coupled with economies of scale, increase the global production possibility frontier. An increase in the global production possibility frontier indicates that the absolute quantity of goods and services produced is highest under free trade. Not only are the absolute quantity of goods and services higher, but the particular combination of goods and services actually produced will yield the highest possible utility to global consumers.
Free trade policies generally promote the following features:

- Trade of goods without taxes (including tariffs) or other trade barriers (e.g., quotas on imports or subsidies for producers)
- Trade in services without taxes or other trade barriers
- The absence of "trade-distorting" policies (such as taxes, subsidies, regulations, or laws) that give some firms, households, or factors of production an advantage over others
- free access to markets
- free access to market information

One of the main arguments against free trade is that, when trade introduces lower cost international competitors, it puts domestic producers out of business. A common argument for tariffs and other import barriers is that “infant industries” need protection from foreign competition while they develop their own economies of scale. That can be a valid argument, especially when that foreign competition behaves like a monopolist.

THE CLASSICAL THEORY OF EMPLOYMENT

The classical view on Employment is discussed below.

ASSUMPTIONS:

The classical theory of employment was based on some important assumptions.

1) FULL EMPLOYMENT:

Classical theory assumes Full employment in the economy. According to classical economists, full employment is a normal situation and unemployment is an abnormal situation. Even if there is less than full employment there is always a tendency towards full employment. Unemployment is only a temporary phenomenon. To them unemployment occurs due to monopoly and government interferences.

2) ALLOCATION OF RESOURCES: Classical economists believed that all factors of production are always fully employed and there is no-scope for additional employments. They argued that increase in production in one direction could be achieved only by reduction in production in another direction in the economy.

3) LAISSEZ-FAIRE: Classical had great faith in Laissez-faire system. It means non-intervention policy. This system does not allow any government intervention in business matters. Classicals had great faith in price mechanism, profit motive, perfect competition and self-adjusting system.

4) SAY'S LAW OF MARKET:

This law is the core of the classical theory. It is states that supply creates its. own demand. According to this law, general over production and unemployment is logically impossible and cannot exist in an economy under normal conditions. What ever produced will be automatically consumed. Aggregate demand always equal to aggregate supply. Additional production generates additional income. This additional income will be always automatically spent on consumption. This there is no break in the circulation flow of income, classicals considered savings become investments which is another form of spending.

5) ROLE OF MONEY:

Classicals considered money as a medium of exchange. Money is demanded only for transaction puiposes. They completely ignored the store of value function of money.

6) AUTOMATIC ADJUSTMENT:

Classicals assumed that the forces of demand and supply are self-adjusting at full employment levels. The flexible wages, prices, interest system will act as an invisible hand to bring out automatic adjustment in the economic system.

7) LONG TERM EQUILIBRIUM:

Classicals assumed that automatic adjustment will take place only in the long run. Reduction in wages, prices, interest will influence the demand and supply only in the long run.

8) SAVINGS:

Classicals gave much importance to saving. If all individuals save more, the aggregate savings of community will go up. Saving is considered as a great Social Virtue.

9) PARTIAL EQULIBRIUM:

Classical equilibrium is a partial equilibrium, and not a general equilibrium. The classical is only applicable to a firm or an industry but not to the economy.

10) IMPORTANCE OF RATE OF INTERESTS:

Rate of interest occupies a very important place in the classical system. It acts as the equilibrating mechanism between saving and investment. Classicals considered that rate of interest is the reward for saving.

If higher the rate of interest, higher the savings and vice versa. On the other hand, lower the rate of interest, higher the investment and vice versa If the investment exceeds savings, the rate of interest will rise, As a result saving will increase and investment will fall till the two are equal at full employment level.

Deductive Method of Economic Analysis:

The deductive method is also named as analytical, abstract or prior method. The deductive method consists in deriving conclusions from general truths, takes few general principles and applies them draw conclusions. For instance, if we accept the general proposition that man is entirely motivated by self-interest, we concluded that self-interest is the motivating factor of all economic activities of human being. In applying the deductive method of economic analysis, we proceed from general to particular.

The classical school of economists notably, Ricardo, Senior, J.S. Mill, Malthus, Pigou, applied the deductive method in their economic investigations.

Steps of Deductive Method:

The main steps involved in deductive logic are as under:

(i) Perception of the problem to be inquired into: In the process of deriving economic generalizations, the analyst must have a clear and precise idea of the problem to be inquired into, ii) Defining of terms: The next step in this direction is to define clearly the technical terms used analysis. Further, assumptions made for a theory should also be precise.

(iii) Deducing hypothesis from the assumptions: The third step in deriving generalizations is deducing hypothesis from the assumptions taken.

(iv) Testing of hypothesis: Before establishing laws or generalizations, hypothesis should be verified through direct observations of events in the rear world and through statistical methods. (Their inverse relationship between price and quantity demanded of a good is a well established generalization).

Merits of Deductive Method:

The main merits of deductive method are *as* under:

This method is near to reality. It is less time consuming and less expensive. The use of mathematical techniques in deducing theories of economics brings exactness and clarity in economic analysis.

There being limited scope of experimentation, the method helps in deriving economic theories. The method *is* simple because it *is* analytical.

Demerits of Deductive Method:

The shortcomings of the deductive approach are:

The deductive method is simple and precise only if the underlying assumptions are valid. More often the assumptions turn out to be based on half truths or have no relation to reality. The conclusions drawn from such assumptions will, therefore, be misleading.

Professor Learner describes the deductive method as 'armchair' analysis. According to him, the premises from which inferences are drawn may not hold good at all times, and places. As such deductive reasoning is not applicable universally.

The deductive method is highly abstract. It require: a great deal of care to avoid bad logic or faulty economic reasoning.

As the deductive method employed by the classical economists led to many facile conclusions due to reliance on imperfect and incorrect assumptions, therefore, under the German Historical School of economists, a sharp reaction began against this method. *They* advocated a more realistic method for economic analysis known as inductive method.