

## **Subject – History of Economic Thought - II**

### **Notes Unit 2 Part B**

**By -**

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### **The Marginalist Revolution -**

Adam Smith was the founding father of economic science, but even he was perplexed by real economic value: Why do people sometimes value non-essential goods more than essential goods? A paradox in value appeared to exist that couldn't be rationally explained. This became known as the paradox of "value in use" versus "value in exchange."

The best-known example of this is the diamond-water paradox. Even though diamonds serve no vital purpose, and water is essential to human life, individual diamonds are far more valuable than individual units of water. On the surface, it seems like water should be worth more.

Independently and almost simultaneously, three economists solved this puzzle in the 1870s: William Stanley Jevons, Carl Menger, and Leon Walras. They suggested that individual consumers don't choose between all of the world's water versus all of the world's diamonds; obviously, they would pick water if given that choice.

Rather, individuals pick between increments of a good. They separately determine the worth of having one additional unit of water or one additional unit of diamonds. These individual choices are made on the margin.

Ostensibly, water is far easier to come by, and most people already have access to enough water to fulfill their wants. In these conditions, the value of that extra unit of water is relatively low. This is not usually the case with diamonds because diamonds are expensive to buy.

Of course, an incredibly thirsty man in the desert might value that extra unit of water more than an extra diamond. This is the difference between total utility and marginal utility.

### **Why Is Marginalism Important?**

The development of marginalist theory helped to better explain human rationality, human action, subjective valuation, and efficient market prices. In doing so, marginal analysis opened the door for a new era in microeconomics.

Marginal utility can be difficult to gauge as it is hard to assess how much utility an individual gets from one more unit of a good or service, especially since this measurement is different for every individual. This concept is laid out in the law of diminishing marginal utility, which states that as consumption increases, utility decreases.

For example, if someone is craving a cheeseburger, they may be willing to pay extra for a cheeseburger if they were really hungry, let's say, \$10. Now, after the first cheeseburger, the same individual might still be hungry but thinks spending \$10 on another cheeseburger is too much.

They would, however, buy another cheeseburger if it cost \$5 instead of \$10. This law of diminishing marginal utility shows that the value of a cheeseburger is less once an individual increases their consumption of it.

Marginalism helps businesses price their goods accurately as it gives an insight into what a consumer values. The price decreases as consumption increases and vice versa. Price and quantity, therefore, have an inverse relationship.

### **The Bottom Line -**

Marginalism seeks to understand the additional value a consumer gains from an additional unit of a good or service and how their purchasing decisions are affected by that.

Businesses can use marginalism to correctly price their products to ensure that they are at a value that people will continue to buy or even buy in the first place. It is an important area of economics that tries to understand the behavior of individuals.

## **Distribution theory -**

**Distribution theory**, in economics, the systematic attempt to account for the sharing of the national income among the owners of the factors of production—land, labour, and capital. Traditionally, economists have studied how the costs of these factors and the size of their return—rent, wages, and profits—are fixed.

The theory of distribution involves three distinguishable sets of questions. First, how is the national income distributed among persons? How many persons earn less than \$10,000, how many between \$10,000 and \$20,000, how many between \$20,000 and \$30,000, and so on? Are there regularities in these statistics? Is it possible to generalize about them? This is the problem of personal distribution. Second, what determines the prices of the factors of production? What are the influences governing the wage rate for a specific kind of labour? Why is the general wage level of a country not lower or higher than it is? What determines the rate of interest? What determines profits and rents? These questions have to do with functional distribution. Third, how is the national income distributed proportionally among the factors of production? What determines the share of labour in the national income, the share of capital, the share of land? This is the problem of distributive shares. Although the three sets of problems are obviously interrelated, they should not be confused with one another. The theoretical approaches to each of them involve quite different considerations.

Aspects of distribution

## **Personal distribution -**

Personal distribution is primarily a matter of statistics and the conclusions that can be drawn from them. When incomes are charted according to the number of people in each size category, the resulting frequency distribution is rather startling. Generally, the top 10 percent of income receivers get between 25 and 35 percent of the national income, while the lowest 20 percent of

the income receivers get about 5 percent of the national income. The inequality seems to be greatest in poor countries and diminishes somewhat in the course of economic development.

There are various explanations of the inequality. Some authorities point to the natural inequality of human beings (differences in intelligence and ability), others to the effects of social institutions (including education); some emphasize economic factors such as scarcity; others invoke political concepts such as power, exploitation, or the structure of society.

For a long time, economists were pessimistic as to the possibilities of any substantial improvement in the lot of those at the bottom of the income distribution. They generally held that the scarcity of productive land and the tendency of population to increase faster than the means of subsistence-imposed limits on distributive justice. David Ricardo, in *On the Principles of Political Economy and Taxation* (1817), held that the landlords would receive an increasing part of the national income while capitalists would get less and less and that this shift in distribution would lead to economic stagnation. Karl Marx prophesied that the workers would be increasingly exploited and made miserable and that these conditions would lead to the downfall of capitalism. Neither prediction materialized. Thus, in the Western world the share of rents has dwindled to a few percent of the national income, while the share of labour has gradually increased. For some time, economists believed that the share of labour was more or less constant, but investigations show that economic development is accompanied by an increasing share of labour. Though the statistics are complicated by technical problems, it is safe to say that in the United States, the share of wages rose from more than half the national income at the beginning of the century to more than 70 percent in the 1980s.

Contemporary approaches to this aspect of income distribution vary. Some are highly abstract and are closely related to the study of the whole, the modern macroeconomics of saving and investment. These will not be dealt with here. A simple common-sense approach employs an equation that starts by writing labour's share as the quotient of the total wage bill and the national income, and then writes the wage bill as the product of the wage level and the amount of labour (wage bill = wage level  $\times$  amount of labour); next the national income is written as the product of the national output and the price level (national income = national output  $\times$  price level); the result is that the share of labour equals the quotient of the average real wage rate and

labour productivity, the latter being the quotient of the national output and the amount of labour. If these two variables move in a parallel fashion, the share of labour is constant. If the real wage rate increases faster than the amount of labour productivity, the share of labour goes up. Similar reasoning applies to the shares of capital and land. This simple arithmetic is useful for an understanding of what happens in the real world, but for a profounder analysis one must turn to the theory of functional distribution.

### **Functional distribution -**

The theory of functional distribution, which attempts to explain the prices of land, labour, and capital, is a standard subject in economics. It sees the demand for land, labour, and capital as derived demand, stemming from the demand for final goods. Behind this lies the idea that a businessman demands inputs of land, labour, and capital because he needs them in the production of goods that he sells. The theory of distribution is thus related to the theory of production, one of the well-developed subjects of economics. The reasoning that synthesizes production and distribution theory is called neoclassical theory.

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