A stylized illustration of a factory scene. In the foreground, a man in a white lab coat sits at a desk, looking through a microscope. In the center, a large, muscular man in a blue apron is pushing a large gear. In the background, a worker in a cap and overalls carries a hammer on his shoulder, walking past a factory building with smokestacks. The scene is overlaid with a semi-transparent blue and green gradient.

History of Economic Thought

Course ECO 423

Chapter 2: The Birth of Political Economy

Birth of Political Economy



Mercantilism

1500 - 1776

Thomas Mun
Sir William Petty



Physiocratic School

1756 - 1776

François Quesnay



Classical School- Forerunners

1691 - 1776

Sir Dudley North
Richard Cantillon
David Hume

The Putting-Out System and the Birth of Capitalist Industry

Decline of the Manorial System

Creation of the Working Class

Age of Exploration

Initial accumulation of capital



Decline of the Manorial System

Urban Growth & Market Penetration

- Rise in urban populations created demand for rural food and raw materials.
- Rural-urban trade expanded, leading to rural specialization in agriculture and raw goods.
- Lords began relying on cities for manufactured and luxury goods.

Peasant Commutation & Market Integration

- Peasants began selling surplus produce for money at grain markets.
- Used money to buy out (commute) labor obligations, becoming semi-independent producers.
- Incentivized production and market engagement, gradually weakening traditional feudal ties.
- By the mid-14th century, money rents became more common than labor services.

Lords Renting Land (Demesne Alienation)

- Lords, needing cash, rented land to peasants instead of relying on labor services.
- Transitioned into absentee landlords, often moving to cities or engaging in warfare.

Crises Accelerating Decline

- **Hundred Years' War (1337–1453)** caused instability and chaos.
- **Black Death (1348–49)** halved England's population, mirrored across Europe.
- Labor shortages led to higher wages and cheaper land rents.

Feudal Backlash & Resistance

- Nobles tried to revoke commutations and reimpose labor services.
- Peasants resisted, valuing their new market-based freedoms and independence.

Peasant Revolts (Late 14th–Early 16th Centuries)

- Widespread and violent revolts erupted across Europe (notably in England and Germany).
- Revolts were extremely brutal on both sides, reflecting deep social conflict.
- The German Peasants' War (1524–25) saw 100,000+ peasants killed.

Creation of the Working Class

- **Population Surge**
 - Western Europe's population grew by nearly one-third in the 16th century.
 - By 1600, the population reached approximately 70 million.
- **Enclosure Movement**
 - Began in England as early as the 13th century and peaked in the 15th–16th centuries.
 - Nobility enclosed common lands for sheep grazing to supply the growing wool industry.
 - Sheep required minimal labor and brought high profits.
- **Displacement of Rural Populations**
 - Enclosures forced 75%–90% of tenants in some areas off the land.
 - Displaced people migrated to cities seeking employment.
 - Further rounds of enclosure continued into the 19th century.
- **Creation of a Landless Labor Force**
 - Former peasants became propertyless workers with only labor to sell.
 - Created a large labor pool for emerging capitalist industries.
 - Also provided manpower for armies, navies, colonization, and consumer markets.
- **Economic Displacement Beyond Enclosures**
 - Many small landholders (peasants, yeomen, minor nobles) went bankrupt due to rising rents and debt.
 - Exorbitant monetary rents and unpayable debts led to widespread financial ruin.
- **Urban Guild Exclusivity**
 - City guilds became more restrictive, protecting the incomes of existing members.
 - Entry barriers excluded many from independent production.
 - Resulted in a growing urban working class without access to production tools or guild membership.

Age of Exploration

Intellectual and Scientific Awakening

- The 16th-century intellectual revival spurred scientific progress.
- Technological advancements such as the **telescope** and **compass** enabled more accurate, long-distance navigation.
- This progress initiated the **Age of Exploration**, expanding global maritime activity.

Global Exploration and Colonization

- Europeans quickly established sea routes to **India, Africa, and the Americas**.
- Exploration had two major effects:
 - A massive **influx of precious metals** (gold and silver) into Europe.
 - The beginning of large-scale **European colonization**.

Monetary Shortage and Precious Metals Influx

- From 1300 to 1500, European gold and silver production was stagnant.
- Expansion of market activity caused a **critical shortage of money** (mostly gold and silver coins).
- Portuguese extraction of African gold in the 1450s helped but didn't fully solve the issue.

Price Revolution

- Mid-16th century: Massive inflow of gold and silver from the Americas.
- Led to the **most prolonged inflation in European history**.
- Prices increased by **150–400%** across Europe during the 16th century.

Winners and Losers of Inflation

Prices of manufactured goods rose faster than **rents and wages**.

- **Landlords and workers** suffered as their real incomes fell.
- **Capitalists benefited:**
 - Paid **lower real wages**.
 - Profited from **rising inventory values**.
 - Reaped greater profits amid inflationary trends.

Initial accumulation of capital

- **Primitive Accumulation of Capital (Initial Accumulation)**

- Key sources of early capital formation:
 - **Rapidly expanding trade and commerce**
 - **The putting-out system** (pre-factory production)
 - **The enclosure movement**
 - **Price inflation** (from influx of precious metals)
- Other less honorable sources:
 - **Colonial plunder**
 - **Piracy**
 - **Slave trade**

- **Expansion of the Putting-Out System**

- Became widespread across many manufacturing sectors in the 16th–17th centuries.
- Although not yet factory-based, it introduced **greater specialization** and boosted **productivity**.

- **Technological Improvements**

- Advances in **shipbuilding** and **navigation** reduced transport costs.
- These innovations supported the **rapid growth of trade and capitalist production**.

- **Rise of the Capitalist Class**

- The **bourgeoisie (middle class)** grew in power and gradually **replaced the nobility** as the dominant economic force.

- **Formation of Modern Nation-States**

- Monarchs aligned with the capitalist class to:
 - **Defeat feudal rivals**
 - **Centralized state power**
 - **Unify markets** (standardized laws, measures, and currencies)
 - Provide **military protection for commerce**
- In return, capitalists provided **financial support** (taxes, loans, etc.) to monarchs.

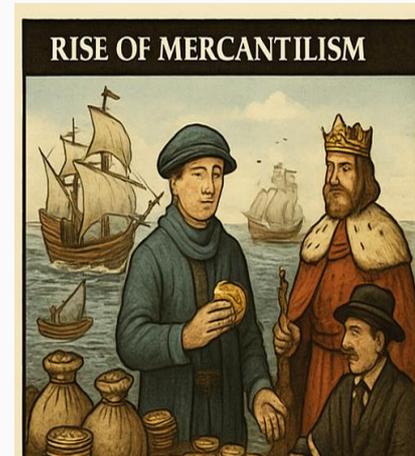
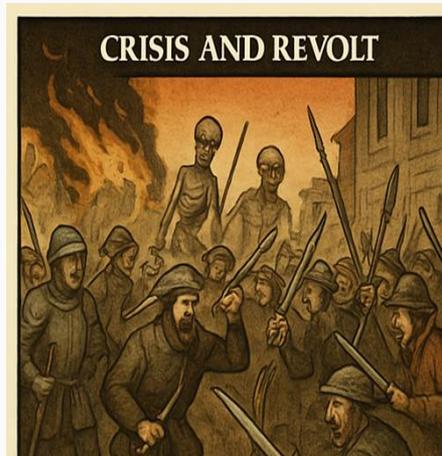
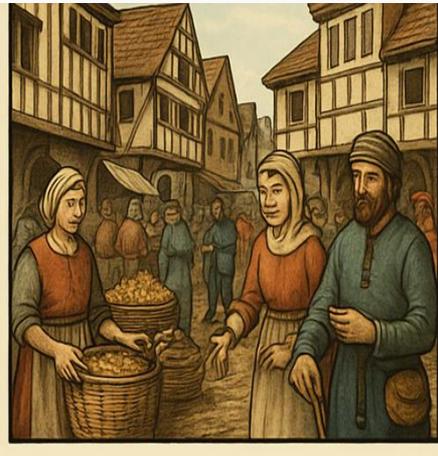
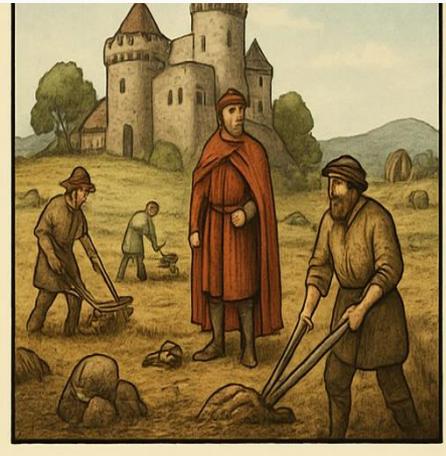
- **Dominance of Merchant-Capitalists**

- By the late 1500s and early 1600s, cities in England, France, Spain, and the Low Countries had:
 - **Thriving capitalist economies**
 - **Merchant-capitalists** dominating both **trade and manufacturing**

- **Emergence of Mercantilism**

- **This phase of early capitalism—marked by state-supported commercial growth—is known as mercantilism.**

The Putting-Out System and the Birth of Capitalist Industry



Earliest phase of Mercantilism:

Bullionism

- originated in the period during which Europe was experiencing an acute shortage of gold and silver bullion, and, hence, did not have enough money to service the rapidly expanding volume of trade.
- Bullionist policies were designed to attract a flow of gold and silver into a country and to keep them there by prohibiting their export.
- These restrictions lasted from the late Middle Ages into the sixteenth and seventeenth centuries.

Main features:

The **only true measure of a nation's wealth** was thought to be the amount of gold and silver it held, essential for political power and military strength.

Countries should **export more than they import to bring in more bullion**. Precious metals were to be **hoarded**, not spent abroad.

Colonies were valuable **sources of bullion** and raw materials.

Luxury goods were often imported using precious metals, seen as a **drain on national wealth**, so their consumption was discouraged.

States often granted **monopolies to trading companies** to control and concentrate trade flows that brought in bullion.

Mercantilism: major tenets

- Mercantilists believed that a **nation's wealth was measured by its gold and silver reserves**. They prioritized accumulating bullion through trade surpluses, even selling goods to enemies during wartime if paid in gold.
- **Mercantilist nationalism** held that nations should build wealth by promoting exports and weakening rivals, as resources were seen as limited. **One country could increase its resources only at the expense of another**. This view **encouraged militarism**, requiring strong navies and merchant fleets. To support naval power, policies like England's "political Lent" were enacted to boost the fishing industry and train sailors.
- **Mercantilists promoted duty-free importation of non-domestic raw materials while protecting domestic goods and restricting raw material exports to support manufacturing and accumulate wealth**. This "fear of goods" prioritized merchants over consumers, limiting imports to retain gold. Harsh laws, including severe penalties, enforced export bans on raw materials like wool and sheep to keep production costs low and boost exports.

Mercantilism: major tenets

- **Mercantilists supported colonization to keep colonies dependent and exploit them for the mother country's benefit.** Policies like the English Navigation Acts restricted colonial trade to English ships, limited exports to England only, and banned many foreign imports into the colonies. Colonial manufacturing was suppressed to ensure colonies remained sources of cheap raw materials and markets for English goods.
- **Mercantilists opposed internal tolls and taxes that hindered trade and raised export costs.** However, they did not support free internal trade and instead favored monopolies and exclusive trading rights to control commerce.
- **Mercantilists believed a strong central government was essential to enforce regulations, grant trade monopolies, limit competition, and support key industries with subsidies and tariffs.** The government also controlled production quality to protect exports and national reputation. Central authority was needed to implement broader mercantilist goals like nationalism, protectionism, and colonial dominance.
- **Mercantilists valued a large, hard-working population to supply soldiers and labor,** keep wages low, boost export competitiveness through lower prices, and reduce idleness by encouraging full workforce participation.

Whom Did the Mercantilist School Benefit or Seek to Benefit?

- **Mercantilism primarily benefited merchant capitalists, kings, and government officials.**
- Those with power and access to monopolies and privileges gained the most.
- Historians often view mercantilism as a form of extreme rent-seeking behavior.
- **Economic rent** refers to profits exceeding what's needed to keep a business operating (i.e., above opportunity cost).
- **Rent seeking** involves private parties lobbying for laws and regulations that increase their profits without increasing productivity.
- Laws took the form of grants of monopoly status, prohibitions against imports, and regulations that made it difficult for new producers and merchants to compete successfully against the established ones.

How Was the Mercantilist School Valid, Useful, or Correct in Its Time?

- Bullionism made some sense during the transition from a self-sufficient economy to a money-based, trade-oriented one.
- The growth of commerce required more money in circulation, but banking systems were underdeveloped.
- Wars were funded directly with bullion, which was essential for hiring soldiers, building ships, and diplomacy.
- Britain needed precious metals for trade with the Baltic and East Indies, where paper money wasn't accepted.
- Colonies were used to supply gold and silver for these international payments.
- Before international finance systems existed, bullion was key for settling foreign trade balances.
- An influx of bullion made tax collection easier.
- Mercantilists understood that more money in circulation could lead to stable or rising prices as trade expanded.
- The move from self-sufficiency to market economies increased the need for currency.
- Some mercantilists realized that more bullion lowered interest rates and stimulated business activity.

Which Tenets of the Mercantilist School Became Lasting Contributions?

- **Mercantilism helped elevate the social status of merchants, previously viewed as inferior by the medieval aristocracy.** By showing that merchants could benefit the nation when guided by the state, mercantilists made commerce respectable. Over time, aristocrats joined business ventures and even married into merchant families, blending noble and commercial lineages.
- **Mercantilism indirectly promoted nationalism by emphasizing the need for strong central government regulation.** This was necessary for uniform standards in trade, protecting consumers in underdeveloped markets, and encouraging risk-taking in commerce through monopoly privileges.
- **Mercantilism helped transform Europe's economy by fostering privileged chartered trading companies, which introduced new products, created markets for manufactured goods, and encouraged capital investment.** It also expanded internal markets, promoted the free movement of goods, standardized laws and taxes, and improved protection for people and goods in transit.

Significant contribution: Thomas Mun

Thomas Mun (1571–1641), the son of a British dealer in textiles, acquired his wealth and reputation while he was a merchant in the Italian and Near Eastern trade. After he was elected a director of the East India Company.



Significant contribution: Thomas Mun

Advocate of Mercantilism

- Thomas Mun was a leading **mercantilist thinker**, promoting the idea that a nation's wealth depended on its **accumulation of precious metals (gold and silver)**.

Wealth Through Trade Surplus

- The central idea in Mun's thinking: **exports must exceed imports**.
- Trade deficits in one area (like with the East Indies) didn't matter if overall exports exceed imports.

Export of Gold Justified

- He supported the **export of gold** if it allowed for the **import of goods** that could be **re-exported at a profit**, ultimately increasing the nation's treasure.

Production is Subservient to Trade

- Although production is necessary, Mun emphasized that **the ultimate goal is not production itself, but a trade surplus** leading to more gold.

Significant contribution: Thomas Mun

Home Trade vs. Foreign Trade

- Mun argued **domestic trade does not enrich the nation**, since one citizen's gain is another's loss.
- Only **foreign trade increases national wealth**.

Role of English Ships

- He emphasized that exports should be carried in **English ships** to gain additional income through **freight and insurance charges**.

Use of Domestic Resources

- Advocated using **unused land (wasteland)** to grow products like hemp, flax, and tobacco to **reduce reliance on imports**.

Early Balance of Payments Analysis

- Mun took a **broad view of trade** by analyzing the **overall balance of payments**, not just bilateral trade with individual countries.

Significant contribution: Thomas Mun

Included Invisible Exports and Imports

- Remarkably ahead of his time, he considered “**invisible**” **items** in the balance of payments:
 - Freight, insurance, ship losses
 - Costs of foreign wars, espionage, and bribes
 - Travel expenses, smuggling, and gifts to foreigners
 - Interest payments and religious remittances sent abroad

Invisible items in the **balance of payments** refer to **transactions that do not involve the physical movement of goods**, but still affect a country’s financial position. These are typically **services, income flows, and transfers**.

Significant contribution: Sir William Petty

Sir William Petty (1623–1687) was a mercantilist who offered some new ideas that foreshadowed classical economics. The son of a poor clothier, he achieved great wealth, fame, and honor. This is an example of the upward mobility that was slowly becoming possible in seventeenth-century Britain. During his busy life Petty was a sailor, a physician, a professor of anatomy, an inventor, a surveyor, a member of Parliament, a promoter of iron and copper works, an experimental shipbuilder, an author, a statistician, and a large landowner.



Significant contribution: Sir William Petty

Support for Freer Trade:

- Favored freer **foreign trade** than most mercantilists.
- Saw free trade as a way to **reduce smuggling**.
- Advocated **moderate import taxes** on finished goods and **light taxes** on raw materials.

Opposition to Export Restrictions on Money:

- Rejected bans on exporting money but criticized payments to foreigners for:
 - Shipping services
 - Foreign fishing (especially by the Dutch)
 - Imported goods that **England could produce itself**

Population and Economic Strength:

- **Larger populations reduce the cost of governance per person** (early concept of economies of scale).
- Stated that “fewness of people is real poverty.”

Significant contribution: Sir William Petty

Full Employment Vision:

- Advocated for **public employment** of the jobless in:
 - Infrastructure (roads, bridges, rivers)
 - Agriculture and manufacturing
 - State-sponsored work programs to reduce unemployment

Support for Poll Taxes:

- Proposed a **poll tax** as a way to motivate families to **ensure children are employed** and contribute economically.

Productive Labor—even in Futile Projects:

- Like Keynes centuries later, Petty argued even “**useless work**” (e.g., building pyramids) was worthwhile if it **generated employment** and did **not rely on foreign imports**.

Physiocracy

The physiocrats appeared in France toward the end of the mercantilist epoch. The beginning of this school can be dated to 1756 when Quesnay published his first article on economics in the Grande Encyclopédie. The school ended in 1776.

Physiocracy was a reaction to mercantilism and to the feudal characteristics of the old regime in France.. Physiocrats reacted against this rigid, feudal, and corrupt system. Their ideas brought economic liberalization, especially in agriculture and trade.

- **Over-regulation of production** (e.g., threads per inch) stifled innovation and adaptation.
- Government rules were **inequitable and corruptly enforced**.
- **Internal tolls, tariffs, and local taxes** blocked the free movement of goods.
- **Peasants heavily taxed**, while **nobles and clergy were exempt**.
- **Tax farming** encouraged over-taxation for private gain.
- Paid dues to lords for **inheritance and land transfer**.
- Forced to use and pay for lord-controlled services (mills, winepresses).
- Subjected to **corvée labor** (unpaid work on roads).
- **Severe regulation** of grain trade (permits, price controls, movement limits).
- **Inter-provincial trade restricted**, causing local surpluses and nearby famines.
- Focus was on **supply control**, not agricultural growth.
- **Guilds restricted labor entry**, fixed prices, and blocked competition.
- **Litigation between guilds** was frequent, costly, and absurd (e.g., roasters vs. poulterers).
- **Guilds persisted until 1789**, hindering free market reforms.

Physiocracy

The essential doctrines of the Physiocrats: it is commonly argued that the "wealth" of a nation is defined not as its stocks of gold and silver but rather as the size of the product net ("net product") of its industries. A particular activity generates a "net product" or "surplus" if the value of the outputs of that activity exceeds the value of the inputs that went into it.

The Physiocrats' fundamental axiom is that only agriculture is "productive" (i.e. yields a net product). Manufacturing and commerce, they asserted, take up as much value in inputs as they create in output, and thus are "sterile".



Physiocracy: major tenets

- The physiocrats believed in a "natural order" governed by laws similar to those in the physical world, as discovered by Newton. They held that human societies should align with these natural laws, including in economic life. According to them, individuals had a natural right to benefit from their own labor, as long as it did not infringe on the rights of others.
- The phrase *laissez-faire*, *laissez-passer*, meaning minimal government interference in economic affairs, was promoted by Vincent de Gournay. The physiocrats supported this idea, advocating for free enterprise and trade, and opposing feudal, mercantilist, and government restrictions. They believed government should only protect life, property, and contractual freedom.
- The physiocrats emphasized agriculture (and possibly mining) as the only truly productive sector, believing it generated a surplus beyond production costs. In contrast, they viewed industry, trade, and professions as sterile, merely reproducing consumed value without creating new wealth.
- The physiocrats believed only landowners should be taxed, as agriculture alone produced a surplus, received by them as rent. They favored direct taxes on landowners over indirect taxes, which they argued were ultimately passed on and became more burdensome.
- Interrelatedness of the economy. Quesnay, in particular, and the physiocrats, in general, analyzed the circular flow of goods and money within the economy.

Whom Did the Physiocratic School Benefit or Seek to Benefit?

- **Peasants** would benefit from the end of burdensome obligations to landowners. However, they would become wage laborers on large, capitalistic farms.
- **Business** interests would benefit from the removal of restrictions on production and trade.
- The physiocrats indirectly promoted **industry** through laissez-faire policies, freer internal grain trade and boost exports of farm goods and imports of manufactured goods.
- They supported **large, progressive farms** using wage labor and advanced techniques, mostly found in northern France.
- **Large farm producers** with surpluses would gain from the emphasis on agriculture and free grain trade.
- Taxing agricultural surplus would lower land values, hurting landowning nobility rather than **entrepreneurial farmers**.
- The **nobility and clergy** were largely tax-exempt, while commoner landowners bore heavy tax burdens.

How Was the Physiocratic School Valid, Useful, or Correct in Its Time?

Agriculture, despite primitive methods, often yielded surpluses that could be saved and reinvested.

These agricultural surpluses helped drive economic growth and later industrial development in countries like France, the U.S., Germany, Japan, and Russia.

By promoting *laissez-faire*, the physiocrats oppose barriers to capitalist economic development.

Their ideas unintentionally supported the French Revolution of 1789, which removed many obstacles to progress.

The physiocrats shifted focus from commerce to agriculture, emphasizing production over exchange as the source of wealth.

They supported direct taxation as a fair alternative to widespread and corrosive indirect taxes.

They advocated for capital accumulation through reduced consumption by the wealthy, aiming to boost economic growth.

Which Tenets of the Physiocratic School Became Lasting Contributions?

First, by examining society as a whole and analyzing the laws that governed the circulation of wealth and goods, they founded economics as a social science.

Second, the law of diminishing returns—usually credited to Malthus and Ricardo—actually was stated earlier by the physiocrat Turgot.

Third, the physiocrats originated the analysis of tax shifting and incidence that today is an important part of applied microeconomics.

Finally, by advocating *laissez-faire*, the physiocrats turned the attention of economists to the question of the proper role of government in the economy.

Significant contribution: François Quesnay

François Quesnay (1694–1774), the son of a landed proprietor, was the founder and leader of the physiocratic school. Trained to be a physician, he made a fortune through his skill in medicine and surgery. Quesnay rose to be the court physician of Louis XV and Madame de Pompadour. In 1750 he met Vincent de Gournay (French Economist) and soon became more interested in economics than in medicine.



Significant contribution: François Quesnay

Quesnay believed small farms were inefficient and supported large farms run by "entrepreneurs," anticipating modern large-scale agricultural enterprises.

He viewed society as similar to a physical organism, with wealth and goods circulating like blood in the body, a natural order.

Quesnay emphasized that human-made laws should align with natural laws.

Quesnay expressed his belief that natural law, not rulers, should govern society.

His *Tableau Économique* (first in 1758, revised in 1766) was the first systematic macroeconomic model, illustrating the circular flow of goods and money in a competitive economy.

This model laid the foundation for future macroeconomic analysis and influenced economists like Adam Smith, Karl Marx, and John Maynard Keynes.

Significant contribution: Quesnay's Tableau Economique

Quesnay assumed land was owned by landlords and cultivated by tenant farmers. Tenant farmers were seen as the only truly productive class.

Their output had to cover their own needs, those of the landowners (including the king, clergy, and public servants), and the sterile class (manufacturers and merchants).

The Tableau Économique illustrated how the agricultural surplus (net product) circulated among these three classes.

It also showed how this surplus was reproduced annually, supporting the continuity of economic activity.

The Tableau Economique foreshadowed national income analysis and laid the foundation for statistical work to describe an economy. Quesnay himself tried to estimate the values of annual output and other aggregates.

The table also explicitly conveyed the concept of equilibrium within the economy as a whole, because if one of the interdependent variables changed, others would change also. Furthermore, Quesnay's table is a predecessor of the input-output analysis, which Leontief introduced in the 1930s and which economists still widely use today.

Significant contribution: Quesnay's Tableau Economique

Farmers begin with a gross product of 5 billion livres; 2 billion is used for production needs (food, seed, fodder), leaving 3 billion for sale.

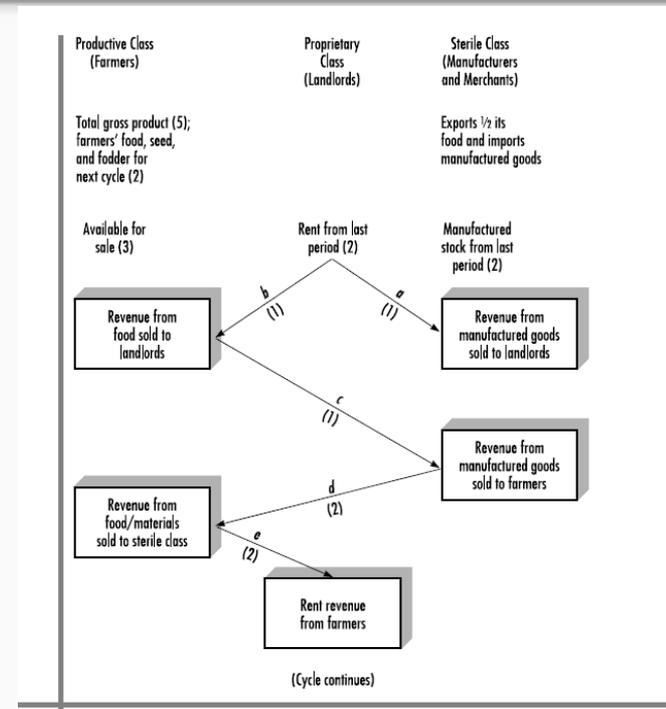
Landlords have 2 billion livres in rent (paid by farmers) from the previous cycle. Manufacturers/merchants (sterile class) have 2 billion livres in goods from the previous cycle.

Landlords spend 1 billion on manufactured goods (→ sterile class, a) and 1 billion on food (→ farmers, b). Farmers use the 1 billion earned from landlords to buy manufactured goods (→ sterile class, c).

The sterile class now has 2 billion in revenue (1B from landlords and 1B from farmers by selling manufactured goods) and spends it on 2 billion worth of food and raw materials from the farmers (d). Farmers now have the inputs needed to produce the next cycle's 5 billion in output (e).

Landlords hold food, goods, and a claim for 2 billion in rent from the upcoming harvest. The sterile class holds 2 billion in inputs to make the next round of manufactured goods.

The economic cycle then repeats.



Forerunners of the classical school: historical context



The scientific revolution:
universe is governed by natural laws!

The industrial revolution



Forerunners of the classical school: major tenets

Minimal government intervention: The classical school believed in minimal government involvement, arguing that a free, competitive market could regulate itself and naturally move toward full employment. Government's role should be limited to protecting property rights, national defense, and public education.

Self-interested economic behavior: Classical economists believed that self-interest drives economic behavior—producers seek profits, workers seek wages, and consumers aim to satisfy their needs.

Harmony of interest: Except for Ricardo, classical economists believed in a natural harmony of interests, where individuals pursuing their own goals also benefit society as a whole.

Importance of all economic resources and activities: Classical economists emphasized that all resources—land, labor, capital, and entrepreneurship—and all activities, including agriculture, commerce, production, and trade, contribute to national wealth, unlike earlier views that favored only commerce or agriculture.

Economic laws: Classical economists contributed key economic theories—such as comparative advantage and diminishing returns—and believed these laws were universal and unchanging.

Whom Did the Classical School Benefit or Seek to Benefit?

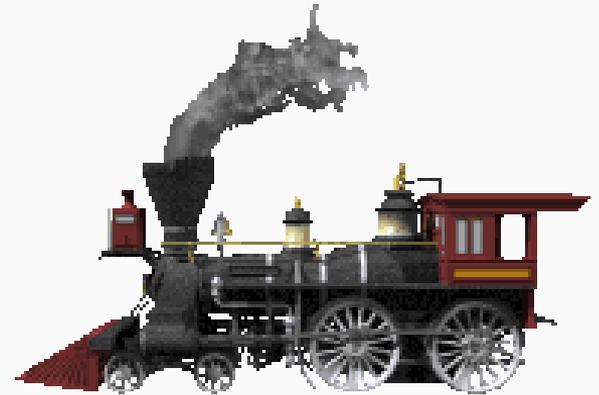
- Classical economics promoted capital accumulation and long-term economic growth.
- It gave businesspeople, merchants, and industrialists respectability and elevated their social status.
- Entrepreneurs were seen as serving society by seeking profits.
- Classical doctrines supported a favorable climate for industry, trade, and profit.
- Business owners and managers gained the most material benefits.
- Industrialization also had costs, especially for wage earners who faced long hours and low pay.
- Over time, economic progress improved workers' conditions and income.
- Today, wages and salaries make up about two-thirds of national income in industrial market economies.

How Was the Classical School Valid, Useful, or Correct in Its Time?

- Classical economics justified the practices of enterprising individuals and the removal of outdated mercantilist restrictions. It supported competition as a natural regulator of the economy.
- Limited government was favored due to inefficiency and corruption in public institutions.
- The removal of feudal land laws enabled landowners to use land as credit, promoting investment.
- Industrialization required maximizing production, which classical economics supported by prioritizing private sector growth. Reinvested capitalist profits fueled rapid industrial expansion.
- A larger public sector would have required higher taxes, reducing funds for private investment. Classical economics expanded markets through free trade and the growth of an urban labor force.
- Urban laborers bought goods in markets, unlike subsistence farmers, increasing monetary economic activity.
- Agriculture became more integrated with the market economy, benefiting merchants and processors.

Which Tenets of the Classical School Became Lasting Contributions?

- (1) the law of diminishing returns,
- (2) the law of comparative advantage,
- (3) the notion of consumer sovereignty,
- (4) the importance of capital accumulation to economic growth,
- (5) the market as a mechanism for reconciling the interests of individuals with those of society.



Significant contributions: Sir Dudley North

Sir Dudley North (1641–1691), living during the height of the mercantilist period, struck hard at the heart of mercantilist doctrine. He was a wealthy merchant in the Turkish trade who later became commissioner of customs and then a treasury official. North has been called the world's first prominent free trader.



Significant contributions: Sir Dudley North

Trade is mutually beneficial: North emphasized that trade benefits both countries involved, not just the one with a trade surplus.

Purpose of trade is exchange, not hoarding: He argued that trade's goal is to exchange surpluses, not to accumulate gold or silver (specie).

Wealth is not precious metals: North rejected the mercantilist idea that national wealth is measured by stocks of gold and silver.

Emphasis on business enterprise: He focused on the importance of enterprise and accumulation rather than on precious metal accumulation.

Critique of mercantilist theory: North challenged the underlying theory of mercantilism rather than its practices.

Limited view on manufacturing: Reflecting the 17th-century context, he did not recognize manufacturing as a major productive activity.

Significant contributions: Sir Dudley North

Money supply adjusts through trade: North observed that international commerce naturally redistributes the money supply according to trade needs.

Support for laissez-faire: He advocated minimal government intervention to maximize gains from both domestic and international trade.

Opposition to special interests: North criticized the use of government power to grant privileges to special interests, opposing mercantilist favoritism.

Anti-war economic view: He believed that money spent on war and foreign payments without returns impoverishes a nation.

Wealth includes goods and services: North viewed national wealth as including both goods (domestic and imported) and services, not just monetary assets.

Significant contributions: Richard Cantillon

*Richard Cantillon (1680?–1734) was born in Ireland. He spent many years in Paris, becoming a wealthy banker and a successful speculator in stocks and foreign currencies. In 1734 Cantillon was robbed and murdered and his house was set afire, probably by a cook he had dismissed ten days earlier. His only book, *Essai sur la Nature du Commerce en Général*, was written between 1730 and 1734 and published in French in 1755.*



Significant contributions: Richard Cantillon

Introduced the concept of the entrepreneur: Cantillon emphasized the entrepreneur as a central figure in economic life—someone who takes on risk by committing to fixed payments in hopes of uncertain returns, earning profit as a reward.

Early monetary circulation theory: He explained how money circulates between landlords, farmers, and city entrepreneurs, anticipating the *Tableau Économique* of the Physiocrats.

Developed a theory of value and price: Cantillon focused on intrinsic value of a good, the "real" cost to produce something, based on how much **land** and **labor** it takes, market prices fluctuating around this intrinsic value based on supply and demand of the goods.

Anticipated Malthusian population theory: He observed that population growth is dependent on the means of subsistence, similar to later ideas by Thomas Malthus.

Analyzed interest as risk compensation: Interest was viewed as a reward for the risk taken by lenders, tied to the potential profits entrepreneurs could earn.

Recognized the role of banks in credit creation: He explained fractional reserve banking, noting that banks can lend out a large portion of deposited gold without reducing the utility of bank-issued deposits.

Significant contributions: Richard Cantillon

Critiqued unproductive social classes: Cantillon criticized nobles and monks for not contributing to production, though he conceded nobles had wartime utility; monks, he argued, were neither useful nor ornamental.

Criticized excessive religious holidays: He argued that too many holy days reduced national labor by about one-eighth annually, impacting productivity.

Advocated export surpluses for economic growth: Though partially mercantilist, he believed export surpluses helped business but warned they couldn't last indefinitely.

Opposed reliance on mined precious metals: Cantillon argued that domestic gold and silver mining raises prices and wages, leading to more imports and harming local production—citing Spain as a negative example.

Emphasized production over specie accumulation: He saw the sale of goods abroad, not the stockpiling of gold, as the true driver of national prosperity.

Recognized the inflationary effects of money influx: He described how increased money from trade leads to higher consumption and prices, greater imports, loss of trade, and emigration of workers.

Significant contributions: David Hume

*David Hume (1711–1776) was born in Scotland twelve years before his fellow national and friend, Adam Smith. Hume entered the University of Edinburgh at the age of twelve and left at fifteen without taking a degree. Later, eminent as a philosopher, Hume was twice refused a chair in philosophy at Edinburgh because of his skeptical spirit and unorthodox thinking. In fact Adam Smith was once nearly expelled from Oxford University because a copy of Hume's *A Treatise of Human Nature* was found in his room. His reputation as an economist was established by his economic essays in *Political Discourses*, published in 1752. Of all the forerunners of classical economics, Hume came closest to the ideas of Smith.*



Significant contributions: David Hume

Price-specie flow mechanism: Hume explained how trade imbalances correct themselves naturally under a gold standard—export surpluses bring in gold, raising prices and reducing exports; import surpluses lead to gold outflows, lowering prices and increasing exports.

Support for laissez-faire: He argued that government intervention is unnecessary; market forces naturally restore international equilibrium.

Quantity theory of money: Hume, following Locke, stated that the general price level is determined by the money supply (given velocity and output).

Lag between money supply and price level changes: He noted that increases or decreases in money initially affect **spending, output, and employment**, with price level changes occurring later.

Equilibrium as a natural law: Hume believed that the economy has a natural tendency to return to equilibrium when disturbed.

Flexible exchange rates also correct trade imbalances: Even without gold flows, exchange rate depreciation makes imports more expensive and exports cheaper, eventually correcting trade deficits.

Significant contributions: David Hume

International trade is a positive-sum game: Hume opposed the mercantilist view that one nation's gain is another's loss, arguing instead that all nations can benefit from trade.

Long-run convergence of rich and poor nations: He argued that wealthier nations develop high costs (especially in labor and provisions), which enables poorer nations to become competitive in manufacturing over time.

Early understanding of demand elasticity: Hume suggested that lowering wine duties could increase government revenue, anticipating the concept of price elasticity of demand.

Critique of physiocratic tax doctrine: Hume rejected the idea that taxes on labor are passed on to landowners via higher wages and reduced rent; he argued that **wages are determined by supply and demand for labor**, not taxation.

Taxes affect laborers directly: When goods consumed by workers are taxed, workers respond by **consuming less or working more**, rather than shifting the burden to landowners.

Significant contributions: forerunners of classical school

Aspect	North	Cantillon	Hume
Trade Philosophy	Mutual benefit, free trade	Export surplus (short-term), sale of goods	Price-specie flow, positive-sum
Money and Specie	Opposed specie hoarding	Differentiated between trade and mining gains	Quantity theory, money flows regulate trade
Value & Production	Emphasis on commerce	Value from land & labor, focus on entrepreneurs	Not focused on value theory, noted labor-market dynamics
Government Role	Laissez-faire, anti-privilege	Mixed stance	Strong laissez-faire advocate
Contribution to Economics	Early liberal thought	Forerunner of classical economics	Key figure in monetary theory

Quiz for practice

What was the primary goal of mercantilist economic policy?

- A. Promoting consumer spending
- B. Maximizing agricultural output
- C. Accumulating gold and silver through trade surpluses
- D. Encouraging free trade and open markets

Quiz for practice

According to mercantilist thought, which of the following was considered a drain on national wealth?

- A. Exporting manufactured goods
- B. Importing luxury goods
- C. Collecting bullion
- D. Establishing colonies

Quiz for practice

What policy was commonly used by mercantilist governments to support domestic industries?

- A. Free trade agreements
- B. Deregulation of markets
- C. Tariffs and subsidies
- D. Floating exchange rates

Quiz for practice

Who were the primary beneficiaries of mercantilist policies?

- A. Peasants and rural laborers
- B. Industrial workers and artisans
- C. Merchant capitalists and the monarchy
- D. Foreign trading partners

Quiz for practice

Which of the following statements best describes the concept of "bullionism" in mercantilism?

- A. Wealth is measured by agricultural surplus
- B. Nations should hoard gold and silver and restrict their export
- C. Governments should not interfere in economic matters
- D. Colonies should be allowed to trade freely with other nations

Quiz for practice

Which of the following statements is true in describing Thomas Mun's view?

- A. Domestic trade increases national wealth
- B. The ultimate goal is production
- C. Exports should be carried in foreign ships
- D. Utilizing unused lands helps to reduce reliance on imports

Quiz for practice

According to Sir William Petty, how does a larger population affect the cost of governance?

- A. It increases total government spending significantly
- B. It has no impact on administrative costs
- C. It reduces the cost of governance per person
- D. It leads to more unemployment and economic decline

Quiz for practice

Which of the following describe(s) the Classical School's view on government intervention in the economy?

- A. Government should control prices and production
- B. Government should nationalize key industries
- C. The market should regulate itself with minimal government interference
- D. Government should provide for public education

Quiz for practice

What did classical economists believe about the relationship between individual interests and society?

- A. Individual and social interests are usually in conflict
- B. Pursuing self-interest harms society
- C. Individual pursuit of self-interest can benefit society as a whole
- D. Social planning is needed to align individual actions

Quiz for practice

Which of the following are key contributions of the Classical School?

- A. Central planning model
- B. Theory of monopoly pricing
- C. Law of comparative advantage
- D. Law of diminishing returns

Quiz for practice

Which of the following best reflects the Classical School's belief in natural law as it applies to economic systems?

- A. Economic outcomes are best determined by democratic votes to ensure fairness.
- B. Markets require constant regulation because natural laws do not apply to human behavior.
- C. Just like physical laws govern nature, economic systems function best when individuals pursue self-interest within a framework of minimal interference.
- D. Natural law implies that only agriculture is productive and should be prioritized in economic planning.

Quiz for practice

Which of the following best represents Sir Dudley North's view on trade?

- A. Trade is mutually beneficial for both countries involved
- B. Trade should be restricted to protect local industries
- C. Trade is a zero-sum game between nations
- D. Gold reserves determine trade success

