Economic Insights

FEDERAL RESERVE BANK OF DALLAS VOLUME 9, NUMBER 2

David Ricardo

Theory of Free International Trade

Few ideas have been as widely accepted by economists and as roundly rejected by many other people as the doctrine of free international trade. Economists base their acceptance of the mutual benefits from such trade on a concept called comparative advantage. The theory is most closely associated with the writings of the great English classical school economist David Ricardo. Although his career in the field of political economy was brief, Ricardo became one of the most influential—and financially successful—practitioners the discipline has ever known.

Today, world trade agreements are under increasing attack. Many people are deeply concerned about such issues as outsourcing and the physical location—and relocation—of firms doing business across national borders. In light of these developments, we offer this latest Economic Insights *on the life and ideas of one of free trade's most ardent theoretical defenders. Anyone interested in this issue should become familiar with Ricardo's work. We hope this short piece provides a useful starting point.*

— **Bob McTeer**
President
Federal Reserve Bank of Dallas

David Ricardo was born in London in 1772, one of 17 children. His parents were Sephardic Jews who had emigrated to England. His father, Abraham, was a successful stockbroker. Ricardo's business career started when he began working for his father at age 14, but at 21 he married a Quaker, which created a family rift that sent Ricardo into the world completely on his own. He nonetheless prospered as a stockbroker and left a vast estate at his death.

Having no money problems, Ricardo could afford to spend a great deal of time in intellectual pursuits, and he became interested in many subjects. Besides political economy, which he took up after reading Adam Smith's *Wealth of Nations* in 1799, he also studied mathematics, mineralogy, chemistry and geology. His career as an active political economist lasted but 14 years.[1]

Ricardo's first major work in the field of economics, *The High Price of Bullion, a Proof of the Depreciation of Bank Notes*, was published in 1810. This pamphlet became very influential, making Ricardo's name familiar to those in government who sought economic advice. A parliamentary inquiry into the high bullion price may have been the direct result of the pamphlet's publication, but that's speculative. In any case, the government report's conclusion—that the inflation then occurring in England was the result of too many paper banknotes being created—was Ricardo's own claim in his pamphlet.

David Ricardo

This helped to cement in the public's mind the idea that Ricardo was an economist of some standing. That status brought him into contact with other famous political economists of his time, notably James Mill and Thomas Robert Malthus. Mill became Ricardo's mentor, coaching him and inspiring him to write more in their shared field.

In 1814, Ricardo retired from business life and bought an estate in Gloucestershire. A year later, he published his next major work in economics, *Essay on the Influence of a Low Price of Corn on the Profits of Stock*. In that work, Ricardo laid out what was to become a key idea in neoclassical eco-

The Beneficent Effects of Free Trade and National Profit Equalization

Under a system of perfectly free commerce, each country naturally devotes its capital and labour to such employments as are most beneficial to each. This pursuit of individual advantage is admirably connected with the universal good of the whole. By stimulating industry, by rewarding ingenuity, and by using most efficaciously the peculiar powers bestowed by nature, it distributes labour most effectively and most economically: while, by increasing the general mass of productions, it diffuses general benefit, and binds together by one common tie of interest and intercourse, the universal society of nations throughout the civilized world. It is this principle which determines that wine shall be made in France and Portugal, that corn shall be grown in America and Poland, and that hardware and other goods shall be manufactured in England.

In one and the same country, profits are, generally speaking, always on the same level; or differ only as the employment of capital may be more or less secure and agreeable. It is not so between different countries. If the profits of capital employed in Yorkshire should exceed those of capital employed in London, capital would speedily move from London to Yorkshire, and an equality of profits would be effected; but if in consequence of the diminished rate of production in the lands of England, from the increase of capital and population, wages should rise, and profits fall, it would not follow that capital and population would necessarily move from England to Holland, or Spain, or Russia, where profits might be higher. ■

—On the Principles of Political Economy and Taxation (Cambridge, UK: Cambridge University Press, 1983), 133–34

nomics: the so-called law of diminishing returns as it applied to labor and capital. Generally, as it applies to cultivation of crops, this law states that increasing the quantities of inputs will increase total production up to a point, but then output must decline, given that the land used is fixed in size. Although increasing production is possible, and perhaps common at first, at some point the marginal returns to additional inputs must decline, followed by their average returns and, thus, total output must decline as well.

Ricardo's purpose in exploring the issue of land rents was British legislation called the Corn Laws. Passed in 1815, these laws forbade the importation into England of food grown elsewhere and sought to maintain the rising prices for British agricultural products that had occurred during the Napoleonic wars, when the French navy had embargoed British ports. Facing the loss of food imports, Britain had to use more of its own land to feed its population. This caused crop prices, and hence, land rents to rise at rapid rates during the war period. The protectionist Corn Laws were an attempt to maintain the agricultural status quo after Napoleon's defeat and a return to peaceful conditions.

Ricardo, himself a landowner who was profiting from the rising rents, nevertheless argued that the Corn Laws should not be enacted and, after they were, continued to argue strenuously for their repeal. Beyond that, the observed rent increases suggested to Ricardo a general theory of land rent. The reason rent exists, he argued, was that as more and more land of diminishing fertility was applied to growing food, the better lands commanded a premium. This was an argument for rent on the *extensive margin*, that is, as more land was cultivated. But Ricardo also argued for rent on the *intensive margin*, that is, where similar lands experienced different diminishing returns to capital and labor. In Ricardo's view, the Corn Laws generated rents both ex-

Taxation Impedes Growth, and Its Incidence Falls Not Necessarily Where the Law Says

There are no taxes which have not a tendency to lessen the power to accumulate. All taxes must either fall on capital or revenue. If they encroach on capital, they must proportionably diminish that fund by whose extent the extent of the productive industry of the country must always be regulated; and if they fall on revenue, they must either lessen accumulation, or force the contributors to save the amount of the tax, by making a corresponding diminution of their former unproductive consumption of the necessaries and luxuries of life. Some taxes will produce these effects in a much greater degree than others; but the great evil of taxation is to be found, not so much in any selection of its objects, as in the general amount of its effects taken collectively.

Taxes are not necessarily taxes on capital because they are laid on capital; nor on income because they are laid on income…. The desire which every man has to keep his station in life, and to maintain his wealth at the height which it has once attained, occasions most taxes, whether laid on capital or on income, to be paid from income; and therefore as taxation proceeds, or as government increases its expenditure, the annual enjoyments of the people must be diminished, unless they are enabled proportionally to increase their capitals and income. It should be the policy of governments to encourage a disposition to do this in the people, and never to lay such taxes as will inevitably fall on capital; since by so doing, they impair the funds for the maintenance of labour, and thereby diminish the future production of the country. ■

—On the Principles of Political Economy and Taxation, 152–53 tensively and intensively. His analysis of the effects of the Corn Laws produced the famous Ricardian theory of rent.[2]

In 1817, he expanded his pamphlet on rent and retitled it *On the Principles of Political Economy and Taxation*. By 1819, he had been elected to the House of Commons, where he continued to be an active participant in the policy discussions of his time.

Ricardo died suddenly of an ear infection in 1823, leaving an estate estimated at $126 million (current dollars). As Mark Blaug comments: "Ricardo may or may not have been the greatest economist that ever lived, but he was certainly the richest."[3]

Ricardo's Contributions and System

Ricardo's approach to economics differed markedly from that of Adam Smith. Ricardo was a pure theoretician, an architect of a simple, highly abstract model from which he drew policy conclusions. His most important assumption was that economic growth must decline and end due to the scarcity of land and its falling marginal productivity. In this, we see the origin of John Stuart Mill's later contention that economic stagnation would flow from the working out of the capitalist productive process. It also is very suggestive of later arguments by John Maynard Keynes of the continuing potential macrostagnation that, according to Keynes and many of his followers, flows from a chronic insufficiency of aggregate demand in any relatively closed-market economy.

Ricardo's foremost contemporary critic was Malthus, author of the famous pamphlet *An Essay on the Principle of Population*. It was from Malthus that Ricardo took the argument of an ever-growing population that pressed against all economic expansions, an assumption that lay at the heart of Ricardo's model. His central consideration in his *Principles* was to show how distributional changes between wages, rent, interest and profit affected the prospects for long-run capital accumulation and economic growth.[4] Because his model produced a falling rate of profit and an ever-rising price for corn (grains), Ricardo favored an end to the Corn Laws, arguing that Britain ought to import corn from countries better equipped to produce it at lower cost. He hated the rising rents he attributed to the laws, since they came, in his view, at the expense of the driving force of the economy—profits.

Twenty-three years after his death, the laws were repealed and Ricardo's international free trade agenda became one with British public policy. Ricardo had provided an answer to Britain's long-term growth problems, and Britain became the "workshop of the world," importing most of its food and "outsourcing" most of its agricultural employment. Ricardo's ideas became "the fountainhead of all nineteenth-century free trade doctrine!"[5]

One of the ideas for which Ricardo is most remembered is the theory of comparative advantage. Ricardo demonstrated that for two nations without input factor mobility, specialization and trade could result in increased total output and lower costs than if each nation tried to produce in isolation. Since Ricardo's exposition, the distinction between absolute and comparative advantage has been taught as one of the field's most brilliant insights. Nations will export not only what they have an absolute advantage in producing, but also what they have a *comparative cost edge in producing*. Some historians of economic thought have sought to show that others, specifically James Mill and Robert Torrens, stated the idea, or something close to it, prior to Ricardo. Such writers tend to discount Ricardo's version of the theory as very short and possibly even incorrect.[6]

The Potential Pitfalls for Paper Monies

There is no point more important in issuing paper money, than to be fully impressed with the effects which follow from the principle of limitation of quantity. It will scarcely be believed fifty years hence, that Bank directors and ministers gravely contended in our times, both in parliament, and before committees of parliament, that the issue of notes by the Bank of England, unchecked by any power in the holders of such notes, to demand in exchange either specie, or bullion, had not, nor could have any effect on the prices of commodities, bullion, or foreign exchanges. After the establishment of Banks, the State has not the sole power of coining or issuing money. The currency may as effectually be increased by paper as by coin; so that if a State were to debase its money, and limit its quantity, it could not support its value, because the Banks would have an equal power of adding to the whole quantity of circulation. On these principles, it will be seen that it is not necessary that paper money should be payable in specie to secure its value; it is only necessary that its quantity should be regulated according to the value of the metal which is declared to be the standard. If the standard were gold of a given weight and fineness, paper might be increased with every fall in the value of gold, or, which is the same thing in its effects, with every rise in the price of goods…. Experience, however, shows, that neither a State nor a Bank ever have had the unrestricted power of issuing paper money, without abusing that power: in all States, therefore, the issue of paper money ought to be under some check and control; and none seems so proper for that purpose, as that of subjecting the issuers of paper money to the obligation of paying their notes, either in gold coin or bullion. ■

—On the Principles of Political Economy and Taxation, 353–54, 356

Other economic historians defend Ricardo and argue the contrary.[7] Regardless of ongoing academic disputes, it is unlikely that historians of economic thought will reverse their position on Ricardo's original authorship of this idea.

Another major contribution Ricardo made to economics was the doctrine of fiscal equivalence, or, as it has come to be known today, Ricardian equivalence. His argument, as put forth in Chapter 17 of his *Principles*, is as follows: It doesn't matter whether government finances itself through taxes or debt. They are equivalent and have no appreciable effect on household consumption or capital formation. This is because either the public sector will save or run a deficit, or households will do likewise and at the same rate. Further, expectantly, taxpayers view a deficit as a future tax increase and will save to pay for it, while a surplus is viewed as a future tax cut with an opposite result. Households will arrange their private affairs to frustrate the long-run effects of either finance approach, as judged from a macroeconomic policy perspective. (To be sure, Ricardo did not want government to issue debt rather than raise tax revenue, regardless of the truth of his equivalence insight.)

Other concerns that Ricardo devoted himself to were monetary reform, the distribution of national income and the determination of an invariant measure of value. Ricardo favored redemption of paper money in gold bullion, argued for decoupling the Bank of England from that nation's money supply creation and contended that labor costs were the best long-run invariant measure of the value of goods and services—a labor cost theory of value not unlike what Smith had also proposed in *Wealth of Nations*. Ricardo was a believer in the strict quantity theory of money, whereby the price level is directly proportional to the quantity of money circulating and changes in that quantity of money change prices instead of real factors.

Ricardo's theory of rent was tied directly to the marginal productivity of land, his theory of value was tied directly to labor costs, and his theory of distribution stood atop both concepts, with Malthusian economic stagnation as a major assumption. Ricardo was not so naive as to attempt to explain all market prices by labor costs. He recognized the importance of "nonreproducible" commodities whose value was solely determined by their rarity in the market. However, he considered these things—rare paintings, fine wines—to be a small portion of overall market consumption. He also allowed a role for capital in determining value and argued that an increase in fixed (more permanent) capital as opposed to circulating (perishable) capital would increase value. By allowing value to be influenced by capital, Ricardo indirectly suggested that *time* played a major role in value, a discovery later generally attributed to other economists.[8]

Ricardo's model, abstract and highly deductive, became the means by which he advocated public policy. A free trade enthusiast, he also was not a fan of public expenditure, believing most such spending to be at worst wasteful or at best incapable of changing aggregate well-being and output. His influence should not be underestimated, especially in Great Britain, for as Keynes wrote, "Ricardo conquered England as completely as the Holy Inquisition conquered Spain."[9] ■

— **Robert L. Formaini**
Senior Economist

Notes

1 "David Ricardo," by G. de Vivo, in *The New Palgrave: A Dictionary of Economics*, ed. John Eatwell, Murray Milgate and Peter Newman, vol. 4, London: Macmillan Press, 1987, pp. 183–98.

2 See the general discussion in *A History of Economic Theory and Method,* by Robert B. Ekelund, Jr., and Robert F. Hébert, 4th ed., New York: McGraw-Hill, 1997, pp. 144–46.

3 *Great Economists before Keynes*, by Mark Blaug, New York: Cambridge University Press, 1986, p. 201.

4 Ekelund and Hébert (1997), p. 147.

5 Blaug (1986), p. 203.

6 *Classical Economics: An Austrian Perspective on the History of Economic Thought*, by Murray Rothbard, vol. 2, Hants, UK: Edward Elgar, 1995, pp. 96–98.

7 "David Ricardo's Discovery of Comparative Advantage," by Roy J. Ruffin, *History of Political Economy*, vol. 34, Winter 2002, pp. 727–48.

8 Ekelund and Hébert (1997), p. 148.

9 *The General Theory of Employment, Interest and Money*, by John Maynard Keynes, New York: Harcourt Brace, 1936, p. 32.

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Please address all correspondence to
Economic Insights
Public Affairs Department
Federal Reserve Bank of Dallas
P.O. Box 655906
Dallas, TX 75265-5906

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