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| Grove city college |
| Say’s Law: A Historical Analysis and its Impact on Economics |
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Econ 408

In the history of the economic profession, one of the most commonly misunderstood and misinterpreted laws is the Law of Markets, otherwise known as Say’s Law. Over the years Say’s Law has been reformed and misconstrued to mean something entirely different from what it was originally intentioned. That begs the question, what was the purpose of Say’s law and what does it really mean? It is clear that some interpretations of Say’s law are off the mark and miss the point of what Say really said. In order to come to a conclusion a survey of the literature across time will be necessary. This will be down in chronological order, critiques coming first, defenses second.

In the debate over who should get the credit for the Law of Markets, some point to James Mill, father of John Stuart Mill, as the one who initially developed the idea. Some believe that is was neither Mill nor Say who first championed this idea but rather Adam Smith in his book *Wealth of Nations.* Smith states that people would demand with their incomes either consumers or producers’ goods rather than cash balances, because to do otherwise would irrational. (Thweatt, 1980, p. 1). Many believe that James Mill, with the help of Adam Smith, was able to present a balanced discussion of the Law of Markets (Thweatt, 1980, p. 1). Mill states that income that is received from producing would be spent on products. Mill presents an interesting example of a merchant deciding whether or not to hold cash balances and then deciding not to:

…by employing what he can spare from consumption in augmenting the capital he has in his business, he can increase his revenue next year. Or if he cannot employ it to advantage himself, he may lend it to some other person who can.... If he cannot employ what he saves with any advantage, he will not save it. No one thinks of accumulating dead stock…no man saves any part of his income which he has not a prospect of employing with advantage. (Mill, 1804, p.13)

As you can see, this quote from Mill is very similar to the idea presented by Smith in *Wealth of Nations.* Though Mill left out the qualification found in Smith that savings are spent only when there is tolerable security in the country (Thweatt, 1980, p.2). It is widely accepted that Say was among the earlier writers to discuss this law, though none really give him outright credit with actually developing the law (Baumol, 1999 p.1). “The bottom line is that to them, as to us, the Law may justly be deemed partly Say’s. But it is emphatically not Say’s alone” (Baumol, 1999 p.204).

# Regardless of who developed the Law of Markets, much of the contention and debate begins with Jean-Baptiste Say himself. Say was a French economist born in 1767. He was in favor of free trade, competition, and lifting regulations on business. As stated earlier, though he is credited with the law of markets, he was not the true creator of the law. In his book *A Treatise on Political Economy* published in 1803, Say states that “…it is production that opens a demand for products” (Say, 1803). Say also states that “that a product is no sooner created, than it, from that instant, affords a market for other products to the full extent of its own value” (Say, 1803). It appears that is is from this quote that much of the controversy of Say’s law begins. This law has been a hotly contested issue for many generations.

# It is also important to have an understanding of what Say believed before one looks at the critiques and defenses. In his discussion of the law, Say emphasized the importance of the real sector of the economy for national welfare where money only served as an instrument to facilitate production and help with exchange (Baumol, 1999, p.2). Say also rejected the idea that excessive savings would reduce demand for products and that a general lack of demand was the biggest threat to prosperity. Savings would go directly into investment in production and that investment does more for growth than wasteful expenditures on resources, similar to government spending and luxury expenditures. He believed the biggest threat was actually the unwillingness to produce (Baumol, 1999, p.2). A.S. Skinner in his article “Say’s Law: Origins and Contents, Skinner lays out an excellent origin and purpose to Say’s Law:

# Say's law is concerned with this relationship: the relationship between production and income or purchasing power. In the original for-mulation, the idea was simple and established with reference to inter-niational trade. Say stated the basic truth that if two nations are engaged in trade they must have the wherewithal to exchange; they must each produce commodities before they can purchase each other's commodities (Skinner, 1967, p. 157).

# He goes on to note that when two nations are unable to trade because one does not have the supply with which to meet the other’s demands, it is not lack of desire to trade that causes the problem, but the lack of supply. (Skinner, 1967, p. 157).

One of the earliest critiques of Say’s law comes from Thomas Robert Malthus. Malthus was a British scholar born in 1766. He was also a clergyman and popularized the economic theory of rent. In a letter to David Ricardo, Malthus writes “Effectual demand consists of two elements, the power and will to purchase. . . . A nation must certainly have the power of purchasing all that it produces, but I can easily conceive it not to have the will” (Malthus, 1827). Malthus was a strong believer in the idea that a general glut of goods could in fact exist. This idea comes out in his work *Definitions of Political Economy* published in 1827. Malthus states

“The question of a glut is exclusively whether it may be general, as well as particular, and not whether it may be permanent as well as temporary ... [The] tendency, in the natural course of things, to cure a glut or scarcity, is no more a proof that such evils have never existed, than the tendency of the healing processes of nature to cure some disorders without assistance from man, is a proof that such disorders never existed.” (Malthus, 1827)

At the time there was a great divide between the rich and the poor. This lead Malthus to believe that the workers would live on the “simplest food, the poorest clothing, and the meanest houses…”, essentially, subsistence living. The fact that these workers are unable to afford the luxuries of life would cause them to not consume as many goods as they are producing. This would lead to overproduction and under consumption, or a glut of goods (Anderson, p. 14). What set Malthus apart from other economists at the time was his belief that demand deficiency could cause recessions (Kates, 1997, p.198). Another point of contention for Malthus was that sometimes exchanges were not always goods for goods. He noted that goods could be exchanged for services and that goods were used for satisfying human wants. He believed that if wants were satisfied but extra income existed then a glut would still occur (Anderson, p.15). Say responded to Malthus’ argument when we wrote in a letter to him:

"I go farther than you: I say they are all purchased with labour, extending that expression to the services rendered by capital and land. I say that they cannot be purchased by any other means; that the value and utility of things in all cases are produced by such services” (Say)

This takes us back to Say’s belief that coordination failures could cause a serious slow-down of the circulation of money and goods and it is this that causes depressions (Jonsson, 1995, p. 150).

Malthus also argued for effectual demand which involves the will to consume something. He believed that one could have the ability to purchase something but if he did not desire it then no demand would exist. Anderson writes about Malthus and his view of effectual demand, “While Malthus’ analysis is hardly controversial from an economic viewpoint, the clergyman saw something economically sinister if the rich failed to consume enough goods to prevent a glut.

The response to Malthus was large. James Mill, J.R. McCulloch, Robert Torrens and J-B Say all joined in the debate, writing a series of books and pamphlets attacking Malthus and his view (Kates, 1995, p. 198). The debate came to a close around the time of John Stuart Mill’s Principles that was published in 1948. Many economists at the time believed that demand deficiency, otherwise known as a general glut, was impossible (Kates, 1995, p.198).

John Maynard Keynes took misconstruing Say’s law to a whole new level in his *General Theory* published in 1937. Keynes summarized the law as “supply creates its own demand” but many believe that he did not have it right (Baumol, 1999, p.1). Keynes view of Say’s law became widely popular and accepted because of his establishment as a well-known economist and the timing of the release of General Theory, in the middle of the great depression (Anderson, p.17). Keynes attacks Say’s law by saying:

Thus Say’s Law, that the aggregate demand price of output as a whole is equal to its aggregate supply price for all volumes of output, is equivalent to the proposition that there is no obstacle to full employment. If, however, this is not the true law relating the aggregate demand and supply functions, there is a vitally important chapter of economic theory which remains to be written and without which all discussion concerning the volume of aggregate employment are futile. (Keynes, 1937)

Here Keynes tries to make us believe that Say though that there was no obstacle to full employment and since full employment did not exist in the economy at the time, Say’s law could not hold. Aggregate demand is where Keynes believed Say’s law ran into problems. He believed there was a lack of aggregate demand which came about by disequilibrium of planned savings and investing (Anderson, p. 18). Keynes feared hoarding because he thought it was the wealthy who needed to spend in order to keep aggregate demand at market clearing levels, since the poor we living at subsistence levels (Anderson, p. 19).

In refuting Say, many critiquing Keynes point out that he only took into account one of the complex of ideas on the Law of Markets and represented it as the whole. He also offered an egregious mischaracterization of Say’s view by claiming that they denied the possibility of depression and unemployment and believed that all forms of intervention in the market to prevent such conditions were harmful (Baumol, 1999, p.201). Some, like Baumol, believe that Keynes did not even study what Say had written (p.201).

It was *General Theory* that distorted Say’s Law and sent it on the course it has found to this day. In saying that “supply creates its own demand”, Keynes essentially said that everything that one would produce will be bought. Therefore, according to Keynes, if Say’s Law were true, then recession and high unemployment were theoretically impossible and if they did occur at all, would be very brief (Kates, 1995, p. 192). Keynes’ intent was to overturn the judgement associated with Say’s Law. A quote from Keynes offers insight into his mindset, “…but they have not extricated themselves from his basic assumptions and particularly from his fallacy that demand is created by supply.” (Kates, 1995, p. 192).

More recent critiques of Say’s law have come from Oskar Lange, Gary Becker, and William Baumol. Lange attempted to create a formula of the notion that supply creates its own demand:

Σj pjxj = 0, for (j = 1,…,n),

In this equation, pj is the price of good j and xj is the excess demand for that good. The equation states that “that the sum of the money value of quantities of goods and services demanded at any time must be identically equal to the money value of the quantities offered for sale” (Baumol, 1999, p.201). Lange’s equation runs into problems because “it fails to recognize the many other fundamental strands of the discussion – including concern over unemployment and depression” (Baumol, 1999, p.201). Lang also concluded that Say’s Law could only apply in a barter economy and that money had no other role than as a “worthless medium of exchance” (Kates, 1995 p.192). Lange wrote, “Say’s Law precludes any monetary theory. The theory of money must, therefore, start with a rejection of Say’s Law” (Lange, 1968 p.167). To Lange, acceptance of Say’s law would imply that unemployment and recession were impossible and that a development of a coherent monetary system was also logically impossible (Kates, p.194).

Another more recent critique is that of Becker and Baumol. They argue that Say, and other contemporaries, recognized that “supply creates its own demand” may not hold in the short run. Say believed that even if there was a desire to hoard that the market would quickly and automatically restore equilibrium (Baumol, 1999, p. 201). Becker and Baumol contributed a major part to this debate because they attempted to distinguish between “Walras’ Law”, Say’s Identity”, and “Say’s Equality”. Walras’ Law is defined as “total demand, including the demand for money, is equal to total supply, including the supply of money” (Kates, 1995, p. 194). Say’s Identity refers to the proposition that the total demand for goods is always equal purchases with receipts of one’s sales (Kates, p.194-195). Say’s Principle is a variant of Say’s Law, “No transactor consciously plans to purchase units of any commodity without at the same time planning to finance the purchase either from profit receipts or from the sale unites of some other commodity” (Kates, 1995, p.195).

There were also many defenders of Say and his Law. Another contemporary of both Say and Malthus who jumped into this debate was David Ricardo. While Malthus was against Say in this debate, Ricardo spent time refuting Malthus. Ricardo was another British economist who was born 1772. Much like Say, Ricardo based his refutation on “the idea that people produce, not for the sake of production, but the sake of consumption” (Anderson, p. 15). Ricardo states:

No man produces but with a view to consume or sell, and he never sells but with an intention to purchase some other commodity, which may be immediately useful to him, or which may contribute to future production. By producing, then, he necessarily becomes either the consumer of his own goods, or the purchaser and consumer of the goods of some other person. (Ricardo, 1817).

Also, like Say, he believed that gluts were only temporary and proportional in nature instead of being general (Anderson, p. 16).

A chief supporter of Say was John Stuart Mill. J.S. Mill was a British philosopher whose father, James Mill, as noted earlier, is often credited with the formation of Say’s Law. Mill also believed that overproduction was impossible. He believed that if money was a commodity, an increase or decrease in the demand, by Walras’ Law, cannot result in general overproduction (Balassa, 1959, p. 267). He also asserts that if equilibrium is disturbed that the system will automatically reach a new equilibrium point, therefore assuming that the system is stable. Here Mill is essentially postulating Say’s Equality (Balassa, 1959, p. 268). Mill was able to reach two different conclusions based on the view of money. First, if money was viewed as a commodity, he states:

"In order to render the argument for the impossibility of an excess of all com- modities applicable to the case in which a circulating medium is employed, money must itself be considered as a commodity. It must undoubtedly be admitted that there cannot be an excess of all other commodities and an excess of money at the same time." (Mill, 1844)

And if money is not considered a commodity:

"it may very well occur, that there may be, at some given time, a very general inclination to sell with as little delay as possible, accompanied with a general inclination to defer all purchases as long as possible. This is always actually the case in those periods which are described as periods of general excess. And no one, after sufficient explanation, will contest the possibility of general excess, in this sense of the word” (Mill, 1844)

Mills does make note that the use of “credit money” make possible a divergence between aggregate demand and aggregate supply. This two-fold view of money is something Keynes completely ignored (Balassa, 1959, p. 268). Despite Mill’s belief there is the possibility of overproduction, he still defended Say. It was the idea that there could be a permanent glut caused by deficiency of effective demand that Mill set out to refute (Balassa, 1959, p. 272). He believed that “it is impossible to have a deficiency of the ‘will to purchase’ because production will not be checked until ‘all the wants of all the inhabitants of a country are fully satisified’” (Balassa, 1959, p. 272).

This leads to the question of, what did Say really say? W.H Hutt, in his book Say’s Law Revisited (1974), does a fantastic job breaking down the statement, quoted earlier, in which Say’s law first makes an appearance. A summarized version will be used here, for a full explanation please see Hutt’s book. Breaking down the law into smaller segments helps bring about a better understanding of the law itself. “One can only buy with what one has produced,” so an individual can only buy out of his own income. “The one product constitutes the means of purchasing another” meaning that one buys with money’s worth, not with money. “A product created offers, from that instant, a market for other commodities to the full total of its value” Basically what he is saying here is that some commodities are overly abundant because the production of others has come to be in short supply. Some would say that money is scarce, therefore sales are down, and when in reality it is the other products that are scarce. Also, one must consider that “the value we can buy is equal to the value we can produce” would mean that two individuals must be able to offer each other the same value for each other’s products in order for voluntary exchange to occur (Jonsson, 1995, p. 147). “It is when we fail to produce value for others that we no longer have the means to buy their products” (Jonsson, 1995, p. 149). It is clear that Keynes would have had a much harder time refuting Say’s law if he had actually used this quote in his General Theory instead of John Stuart Mills’ idea on Say’s law (Hutt, 1974, pp. 25-26).

Hutt also makes note that Say’s law “implies that all outputs constitute ‘power to demand,’ in the sense of ‘power to supply by valuing inputs and outputs at money’s worth’” (Hutt, 1974, p.26). He makes it clear that “power to demand” does not necessarily mean “willingness to demand” because one can refrain from exchanging any part of his output. He cites the example of a farmer producing produce and using some of it to feed his family and selling the rest. So if he consumes 1 percent of his total output, that part of his supply is demanded by him and must be valued like the other 99 percent. This proves “power to supply” is exercised “power to demand” (Hutt, p. 26).

In his article “On the True Meaning of Say’s Law, Steven Kates makes a point of saying that many who have written on Say’s law continue to distort it when they try to make it seem that Say believed there was a possibility that demand failure might be a cause of recession. “Whether expressed by the words ‘there is no such thing as a general glut’ or stated as the proposition that overproduction is impossible, it was this conclusion which was meant.” (Kates, 1997, p. 191). Kates also makes the claim that recessions and high unemployment were never the consequence of demand failure (Kates, 1997, p.191). Kates goes on to explain that no economist would deny that recessions were possible (Kates, 1997, p.192). It is also noted that the idea of recession that Say and other classical economics had was not that they did not exist and could not occur, but that a recession would occur because the goods being produced were not the goods being demanded. Therefore recessions were not due to insufficient demand but to the wrong goods and services having been produced (Kates, 1997, p. 198). Say’s Law denied the possibility of demand failure. Recessions were due to cumulative errors in the production process (Kates, 1997, p. 198). This is similar to the Austrian Business Cycle Theory.

Say also makes it clear that production does not automatically create revenues that can be used to buy other goods, since “the existence of these revenues depends on the production having exchangeable value, which it can only have in consequence of want which there is such production in the actual state of society” (Jonsson, 1995, p. 149). Say refutes a point made by Keynes long before Keynes’ ever made it, another indication that Keynes did not pay close attention to what Say wrote. Say also refutes the idea of a general glut of goods by saying that this is nearly impossible. He recognizes that though it is likely that at some point one area of the economy would have an excess supply, it is also likely that at the same time another area would not have an excess. Say also portrays the idea of increased wealth through an increase in real wages, and this would not occur if recessions were created by some limit on people’s willingness to consume (Jonsson, 1995, p.151)

It is clear that Say’s Law is the idea that people produce products, that others are demanding, in order to make a profit, which they can spend on other goods. This process continues indefinitely. The problem that a market will run into is when someone is producing goods that no one is demanding. Keynes’ interpretation allows for this when he says “supply creates his own demand”. This would assume that no matter what someone produces there will be a demand for it. This is clearly not the case.

Say’s Law is also relevant in Austrian Economics. The Law is useful in Austrian Economics as a point of contact and dialogue with the Keynesian mainstream, Keynes’ mutation of Say’s Law also Austrians to go right to the heart of Keynesian fallacies. This law also forms a bridge from entrepreneurial error to depressions in general and clarifying the reasoning for the inevitable downturn in an inflationary trade cycle (Martin, 2004, p. 10). Austrian Business Cycle Theory allows for recessions and depressions as soon as entrepreneurial error occurs. Say refers to this when he speaks to the ignorance of producers. It is easy to see that large producer makes an error or there are multiple errors made my groups of producers and a lack of revenue occurs (Martin, 2004, p. 11). It must also be noted that Say’s Law is not a superset of the Austrian Business Cycle Theory, because ABCT deals with unique properties of money (Martin, 2004, p.11).

Say’s Law or the Law of Markets has been a hotly debated topic over the centuries. Though it has been credit to J-B Say, it has been idea that has been discussed since Adam Smith. Thomas Malthus and John Maynard Keynes were both key opponents to Say’s Law that changed the way the world viewed it. Since Malthus and Keynes there have been numerous other more modern interpretations of the Law, from Oskar Lange to Gary Becker. Some of Say’s contemporaries, like David Ricardo and John Stuart Mill, defended the law and tried to elaborate on the ideas. After seeing both sides of the debate, it is clear that the interpretation of Keynes and Malthus was incorrect. Say’s Law as it was originally stated, is sound and should be the basis for our views of this topic.

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