Handout C: What Creates Value?

Directions: Read the documents in Handout B and then answer the following questions thoroughly. Be prepared to share your answers with the class when finished.

Excerpts from *An Inquiry Into the Nature and Causes of the Wealth of Nations* by Adam Smith (1776)

You are a diamond miner who has collected a multi-million dollar fortune in diamonds. To sell your diamonds in the capital city, you need to cross an enormous desert. You get lost, however, and have to drink your last drop of water.

After a day baking in the sun and on the verge of death, you encounter a man with a single, ice-cold bottle of water.

1. How much of your diamond fortune would you pay for that bottle of water? Why?
2. Why does the relative value of water and diamonds change?
3. Smith defines this difference in perceived value as “value in use” versus “value in exchange”? What does he mean?

Excerpts from *On the Principles of Political Economy and Taxation* by David Ricardo (1821)

The labor theory of value states that the value of a manufactured good is based on the amount of labor that went into the production of the product. Because labor is the highest cost to producers, this implies that the higher the input costs of the product, the higher the price required to purchase it.

1. Because they create the product, is a worker’s labor the sole source of added value of a product? Who or what else adds to the value of the product?
2. What does this theory imply about a good that a lazy, low-skilled worker produces versus an identical good that is produced by an enterprising and high-skilled worker produces?
3. What if a team of highly-skilled workers spent a year making one pickle-flavored lollipop? The cost of labor is very high. Does that mean the value of the end product will be high? Why or why not?

Excerpt from *The Theory of Political Economy* by William Stanley Jevons (1888)

Jevons states that utility, or the satisfaction or happiness a good or service brings us, is the sole source of value. But, as is implied in this excerpt, that satisfaction diminishes as we obtain more and more of the commodity. Therefore, the more of a good we obtain, the less we are willing to pay for it.
Handout C: Page 2

1. In the first document, Smith discussed the diamond-water paradox. The labor theory of value could not explain why there was this difference of value between diamonds and water. How does the utility theory solve this problem?

2. Many economists believe that there is no “correct” price and that prices are not “too high” or “too low”. Instead, they say that value is subjective. What do they mean by this?

3. Your friend really wants to go to a concert that you have tickets to. You paid $40 for the tickets. She is willing to pay $60 for them. You sell them to her. What must be true about your utility for the tickets compared to your friend's utility?

Excerpts from *Principles of Economics* by Alfred Marshall (1920)

Marshall states, “We might as reasonably dispute whether it is the upper or the under blade of a pair of scissors that cuts a piece of paper, as whether value is governed by utility or cost of production.”

1. How does this relate to both the labor theory of value and the utility theory of value?

2. According to Marshall, how do prices adjust when the demand price is less than the supply price (and vice versa)?

3. Who makes the decision what the equilibrium price of a good or service should be?


Marx states, “The value of labor-power is determined by the value of the necessaries of life habitually required by the average laborer. The quantity of these necessaries is known at any given epoch of a given society, and can therefore be treated as a constant magnitude.”

1. Marx believed that the value of labor is dependent upon not only the wages paid to the workers, but also necessities such as food, shelter, and clothing for the workers. Explain how this theory could change the way that value is determined.

2. According to Marx, what are the circumstances that lead to the value of a product or commodity?