

# ADAM SMITH'S THEORY OF ECONOMIC GROWTH



"Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things."

Adam Smith

# NATURAL LAW

- Every individual is motivated by his/her own self interest
- This self interest leads to the ultimate common good for all

*Invisible Hand*



**Guided market mechanism**



- Smith opposed government intervention in industry & commerce
- Advocated free trade & policy of laissez-faire in economic affairs



# DIVISION OF LABOUR

- **Results in improvement in labor productivity by**
  - ❑ Increasing dexterity
  - ❑ Saving time/time management
  - ❑ Invention of large number of labor-saving machines
- **Technological improvement results in division of labor & market expansion**
- **Size of market determines the division of labor**

# PROCESS OF CAPITAL ACCUMULATION

- Smith held that capital accumulation must precede the introduction of division of labor
- A necessary condition of economic development
- To Smith, the problem of economic development was related to the ability of people to save & invest more
- Rate of saving  Rate of investment  
But Capital investments or Rent from land  Rate of saving

**Iron Law of Wages** (Capitalists & landlords save, Laborers do not) Real wages always tend, in the long run, toward the minimum wage necessary to sustain the life of the worker.



# PROCESS OF CAPITAL ACCUMULATION

Classical economists like Smith believed in the existence of **WAGE FUND**.

Under stationary conditions

Wage rates fall to subsistence level

In periods of rapid capital accumulation

Wage rates rise above the subsistence level

# WHY DO CAPITALISTS MAKE INVESTMENTS?

To earn profits

Future profits depends on

- Present climate for investment
- Actual profits



# WHY DO CAPITALISTS MAKE INVESTMENTS?



According to  
Smith



Profits fall with economic progress

Increase in  
Capital  
Accumulation

Increases  
Capitalist's  
Competition

Increases Wage

Lowers profits

# AGENTS OF GROWTH



**Farmers**

**Producers**

**Businessmen**

**Agents of  
economic  
progress**

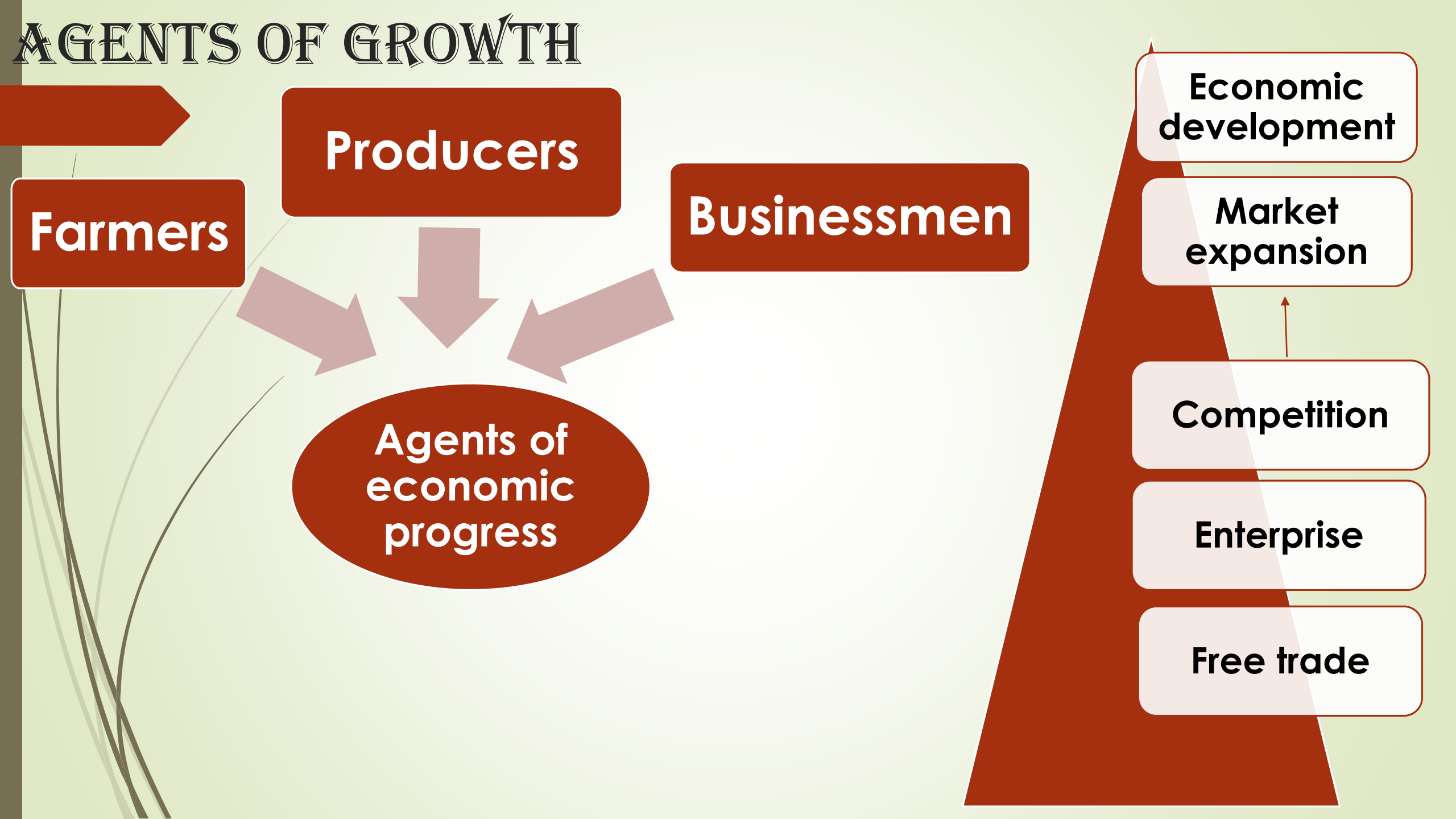
**Economic  
development**

**Market  
expansion**

**Competition**

**Enterprise**

**Free trade**





# PROCESS OF GROWTH

**Growth in agriculture,  
manufacturing &  
commerce**

**Capital  
accumulation**

**Technical  
progress**

**Population  
growth**

**Market  
expansions**

**Division of  
labor**

**Rise in profits**

# STATIONARY STATE

- **Scarcity of natural resources stops growth**
- **Wages fall to subsistence level**
- **Competition among businessmen lowers profits as low as possible**
- **Profits continue falling, investments decline and capitalism reaches the stationary state**
- ❑ **As a result:**
  - 1. Capital accumulation stops**
  - 2. Population becomes stationary**
  - 3. Profits are minimum**
  - 4. Wages are at the subsistence level**
  - 5. No change in per capita income and production**
  - 6. Thus economy reaches the stage of stagnation**

# LIMITATIONS

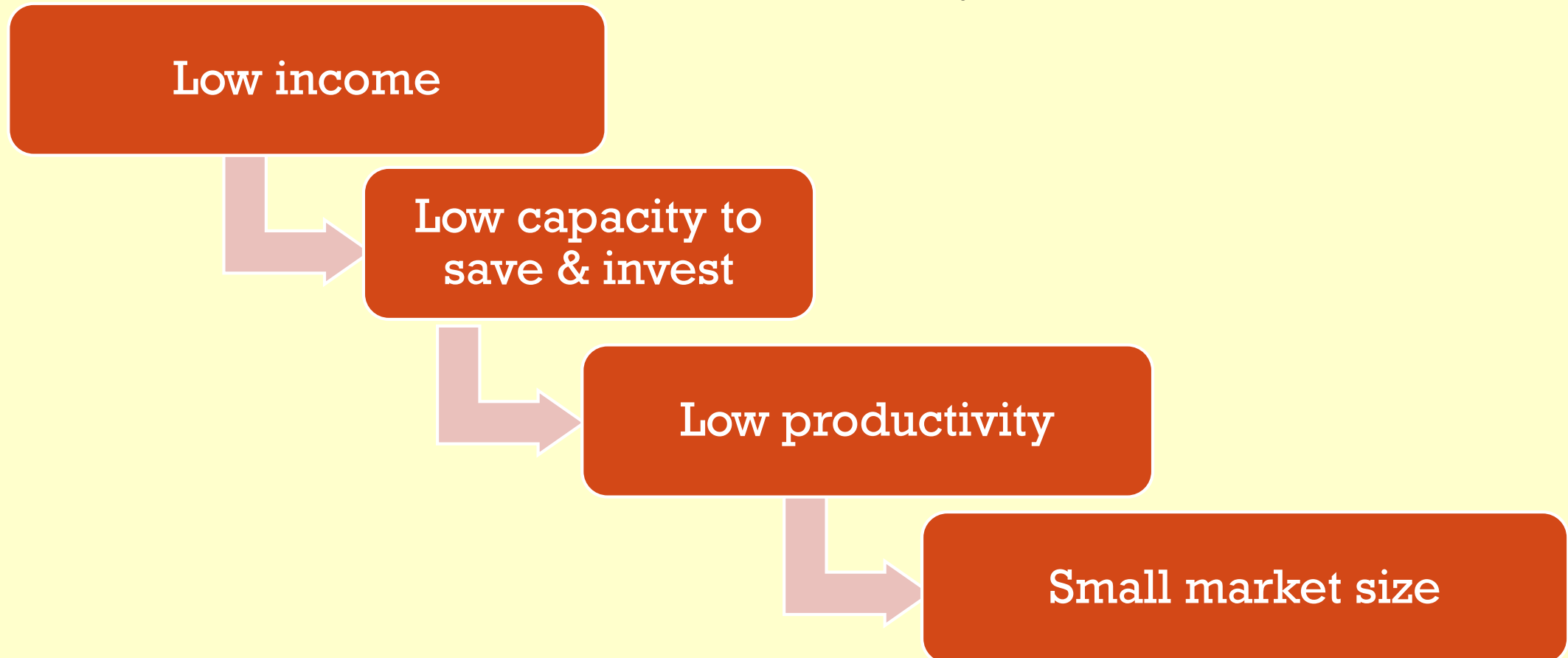
- **Rigid division of society**
- **One-sided saving base**
- **Unrealistic assumption of perfect competition**
- **Neglect of entrepreneur**
- **Unrealistic assumption of stationary state**
- **Static model**

# APPLICABILITY TO UNDERDEVELOPED COUNTRIES

- Limited validity for underdeveloped countries

Reasons are:

- ❑ Size of market is small → Low capacity to save and invest



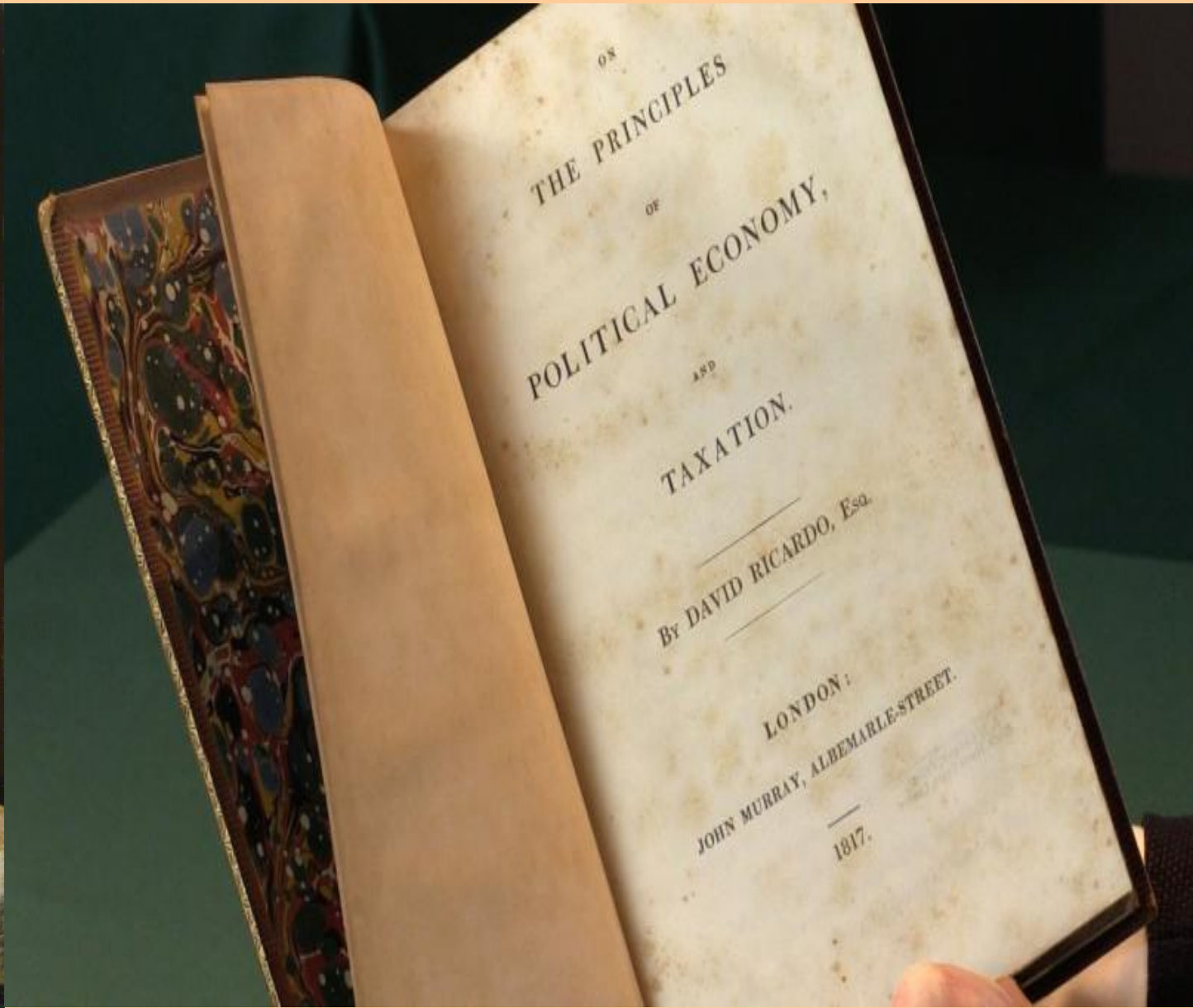
# APPLICABILITY TO UNDERDEVELOPED COUNTRIES

- Despite this, in underdeveloped countries, development is possible through government intervention and not solely through the *laissez-faire policy*
- However, with the help of government/state, the farmers, traders and producers can help raise productivity and develop the economy as mentioned by Smith

This interdependence between the state and the 3 growth agents points towards the importance of balanced growth for such economies



# THE RICARDIAN THEORY



# ASSUMPTIONS OF RICARDO'S THEORY

- All land is used for corn production & working forces in agriculture help in determining distribution in industry
- Law of diminishing returns operates on land
- Supply of land is fixed
- Demand for corn is perfectly elastic
- Labor and capital are variable inputs
- Capital consists of circulating capital
- There is capital homogeneity



# ASSUMPTIONS OF RICARDO'S THEORY

- **Technical knowledge is given**
- **All workers are paid a subsistence wage**
- **Supply price of labor is given and constant**
- **Accumulation of capital determines demand for labor & both demand and supply price are independent of the marginal productivity of labor**
- **There is perfect competition**
- **Capital accumulation results from profits**

While Adam Smith laid emphasis on *“Wealth of Nations”*

David Ricardo laid emphasis on *“Income Distribution & Foreign Trade”*

**Ricardo’s ideas on development pertain to:**

*Capital accumulation*

*Behavior of rent, wages and profits*

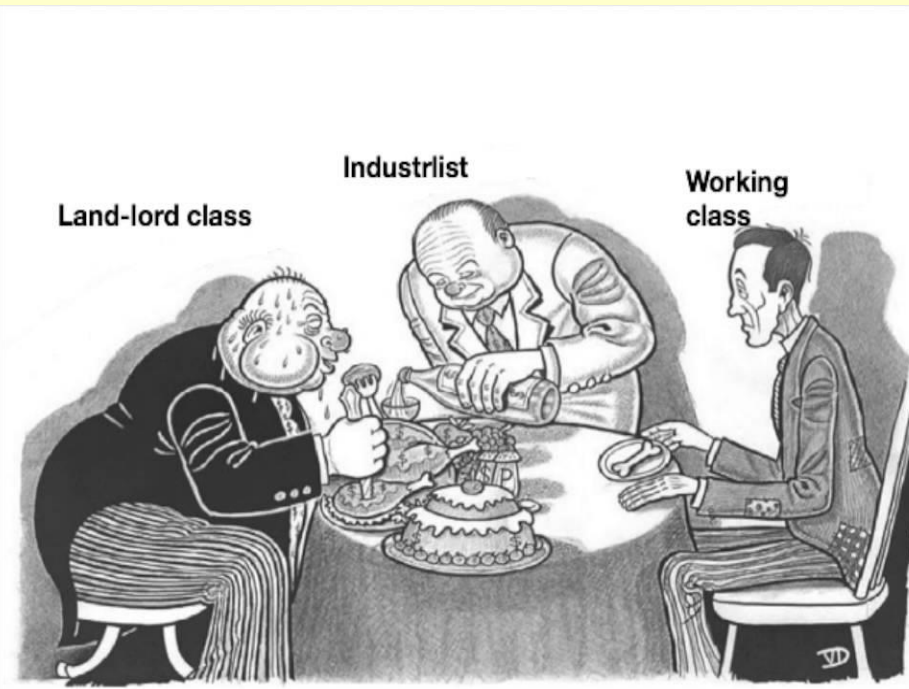
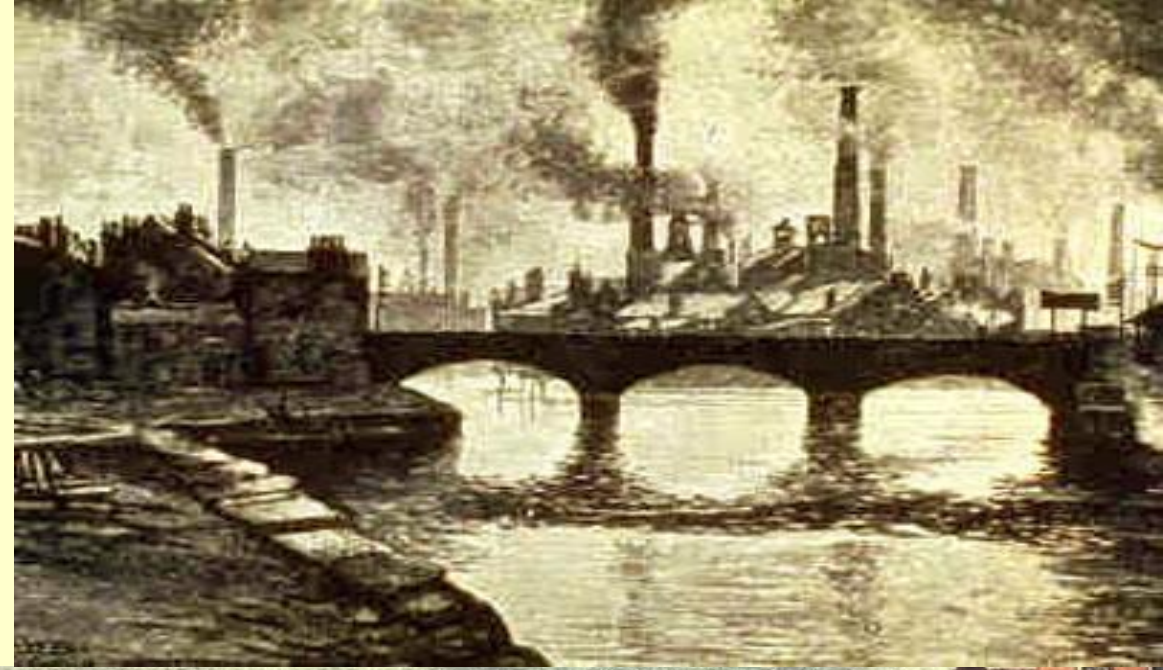
*Stationary state*

*International trade*

# 1. Capital accumulation

Ricardo identified 3 agents of production:

- i. *Capitalists*
- ii. *Laborers*
- iii. *Landlords*





## i. Capitalists

- Saves the most
- Saves out of profit
- Raise capital formation

For Ricardo, primary source of accumulation is PROFIT. Secondary includes WAGES & RENT



**PROFIT = MARKET VALUE OF FINISHED PRODUCT – COST(SUBSISTENCE WAGE)**

Profits ➡ Expand existing plants/start new ventures ➡ Rapid economic activities ➡ Creation of new ventures ➡ External economies ➡ Promotion & acceleration of capital accumulation

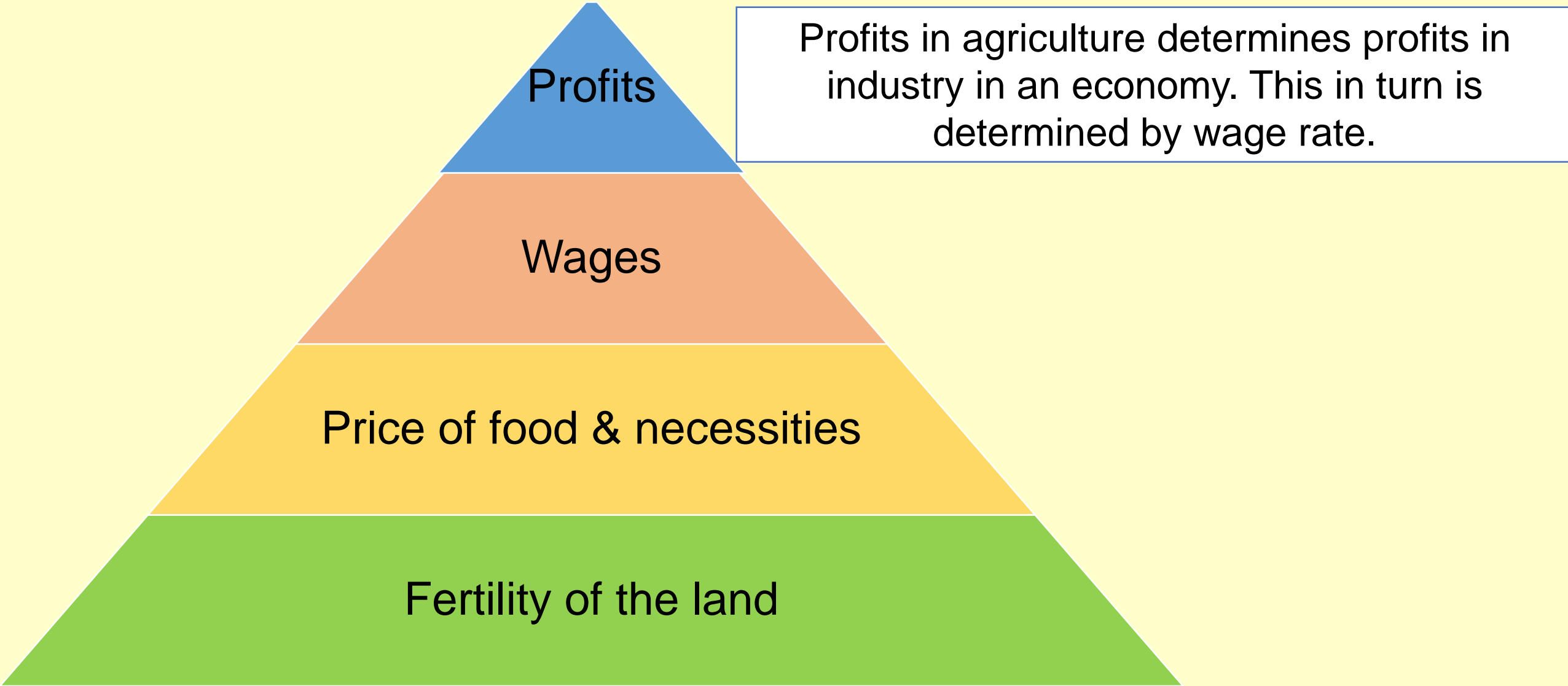
Capitalists take risks in exploiting profitable investing opportunities, which equalizes the returns from various economic activities. This helps in maximizing the national output.

## ii. The working class/laborers

- Largest group among the agents of production
- Depends on capitalists for employment
- Their wages are determined by *Wage-fund*
- Their *wage-rate* depends upon *Wage-fund* & no. of workers
- **Positive correlation** between wage rate & size of population (low wage rate will create difficulties to meet the necessities of life for the working class)



- To explain the effects of wages on profits & capital accumulation, Ricardo used agricultural profits as the basis
- Agricultural profits determine industrial profits





## ■ What about corns???

- Wages depends upon the prices of corns
- Price of corns thus determines subsistence wage
- Price of corn will increase when due to the operation of the law of diminishing returns the output on the marginal land decreases





## 2. Behavior of rent, wages and profits

- After deducting share of land (rent) from national income, that which remains is divided between wages & profits
- With development, a change occurs in the relative shares of wages & profits
- Profits depend on wages alone
- In the short run, wages may rise or fall but in the long run wages are at the subsistence level

## 2. Behavior of rent, wages and profits

### Why wages remain at subsistence level in the long run??

- ☐ Population growth
- ☐ Rise in demand for agricultural land
- ☐ Inferior land brought under cultivation
- ☐ Law of Diminishing Returns operates
- ☐ Increase in agricultural output do not meet the increased demand of population which results in rise in prices of agricultural products
- ☐ Wage rates in monetary terms rise **but real wages remain at the subsistence level**
- ☐ Increase in money wage rate reduces rate of profit
- ☐ Thus ultimately rate of profit tends to fall as population grows

## 2. Behavior of rent, wages and profits

- ❑ Ricardo thus visualized that population growth and limited supply of land could adversely affect the saving, profit & fresh investment
- ❑ Did not however suggest ways to solve this problem

**Innovation and improved methods of production can overcome this problem**

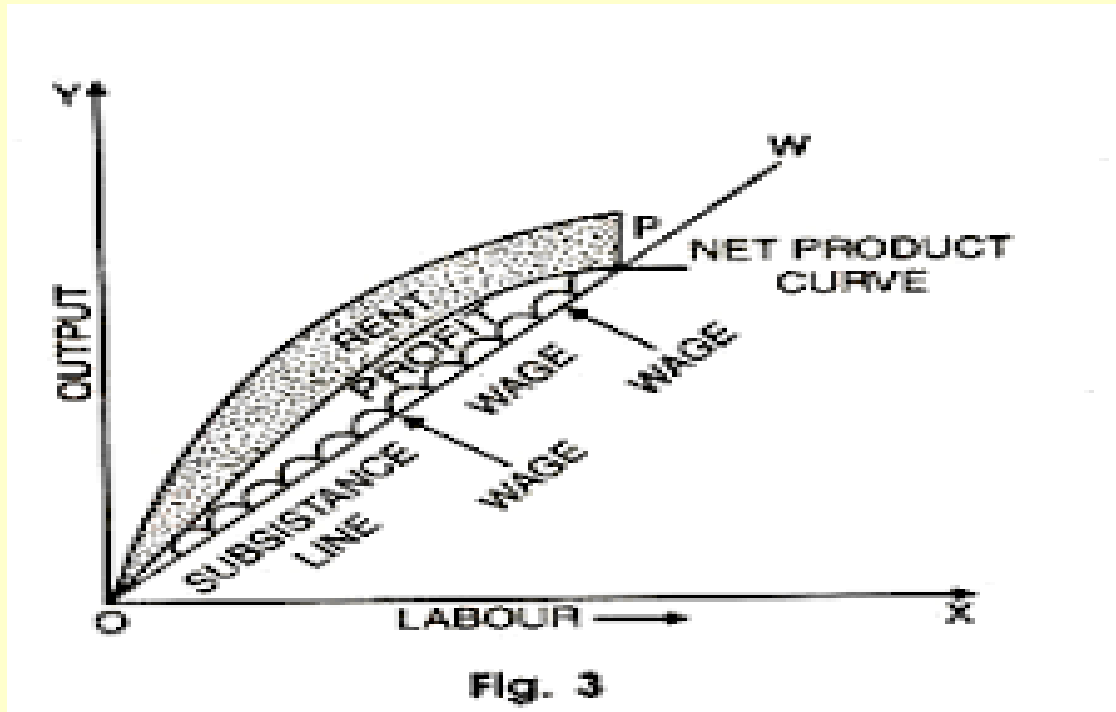


### Modern Agriculture

- More than 90% of farmers today work using the most innovative practices and growing techniques to produce enough food, fuel and fiber for a growing world, while minimizing their environmental footprint at the same time.
- The term “modern agriculture” depicts their commitment to innovation, stewardship and meeting the global food challenge all at once – there is nothing conventional about that

A photograph of a modern green tractor pulling a large, complex precision farming implement across a field. The implement has multiple rows of sensors and actuators, demonstrating advanced agricultural technology.

### 3. Stationary state



- ❑ It is a state where entrepreneurs have no tendency to increase or decrease output.
- ❑ Ricardo identified this state in terms of falling rate of profit
- ❑ Decline in rate of profit halts the process of capital accumulation and hence development
- ❑ With that the population growth also decreases
- ❑ The economy thus enters a stationary state

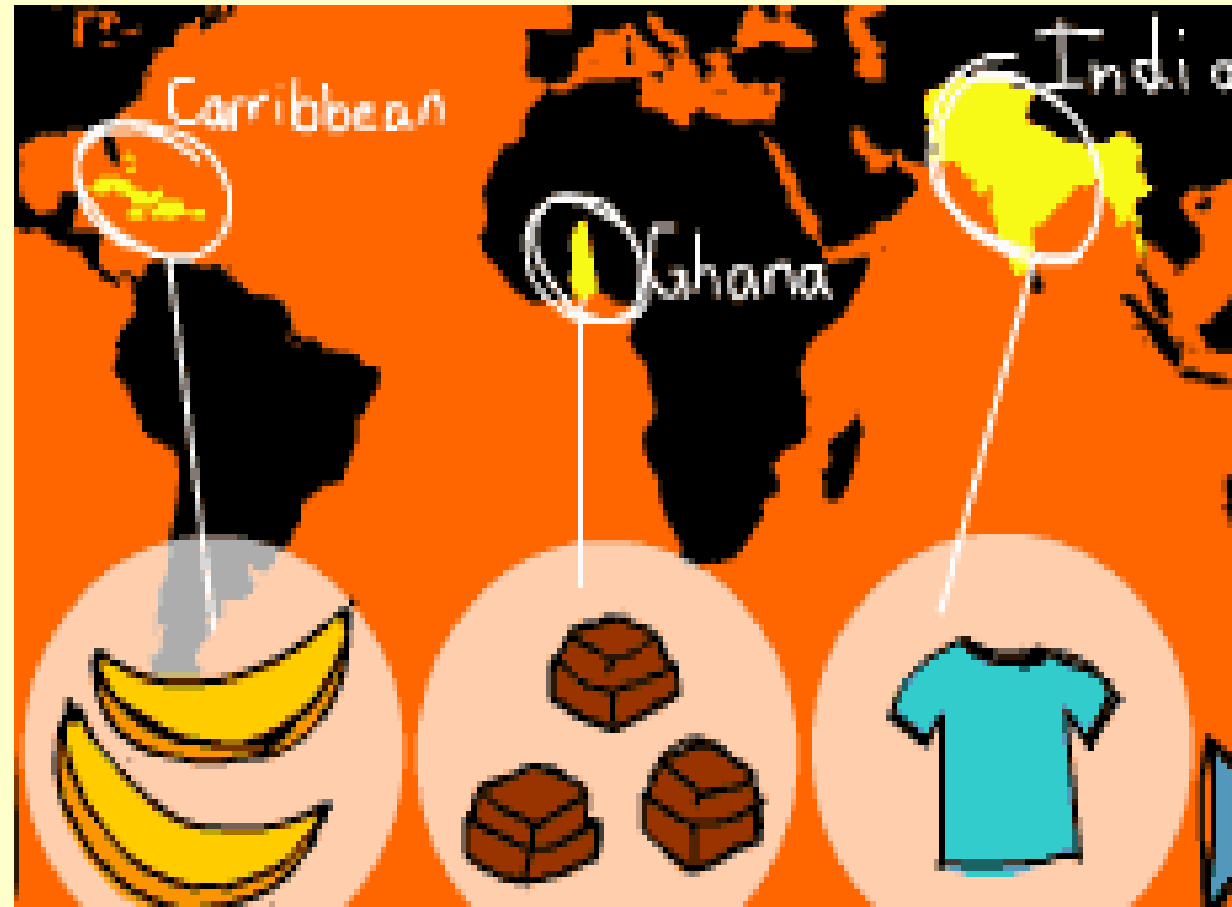
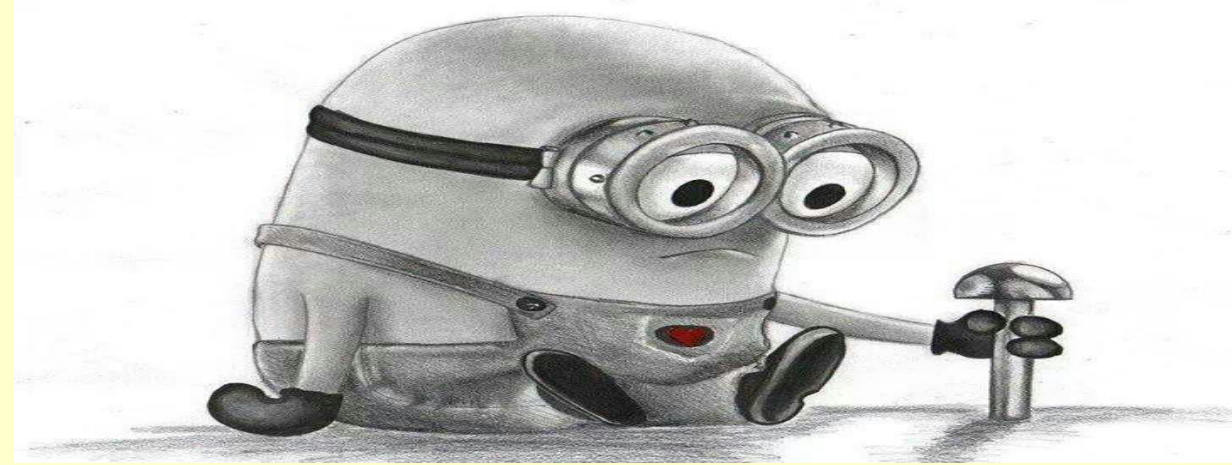


### 3. International Trade

❑ Painted a **gloomy picture of society** in the stationary state

**HOWEVER**

- ❑ He **advocated the role of international trade** that can provide opportunities for fresh investment
- ❑ He advocated free international trade
- Government intervention restricts mobility of labor and capital
- Obstacles to division of labor



### **3. International Trade**

- ❑ Formulated the comparative cost theory of international trade
- Specialization of production is the basis of this theory
- Specialization leads to utilization of resources
- Helps produce output at minimum cost
- Investment in export-oriented industries would benefit capitalists and help earn profits
- This profit would be reinvested to encourage development activities
- Chain of development activities will result in recovery and prosperity of the economy

**Thus free trade would mitigate the stationary state**

## **Limitations:**

- I. Operation of the law of diminishing returns is criticized
- II. Malthusian theory of population is open to objection
- III. Unrealistic assumptions

**Merits:** Analyzes some vital questions related to development like

- I. Explains the determination of relative factor shares
- II. Until it reaches the stationary state, this theory considers the economy as dynamic one
- III. Highlights the importance of development variables like capital accumulation, population, profits, wages and rents



# THE MALTHUSIAN THEORY

## Thomas Malthus

- Born: February 14, 1766, Surrey, United Kingdom.
- Died: December 29, 1834, Bath, United Kingdom.
- Wrote 'An essay in the First Principle of population' first published in 1798
- Debatable whether the principles of Malthus two hundred years ago ( that were very revolutionary and controversial ) have any relevance to the modern world.
- The world population in 1798 was at nine million people. We have now passed the seven billion mark.



## ❑ Malthus's Concept of development

- Economic development is not an automatic process
- Required consistent efforts of people
- Development process is not smooth
- Prior to reaching the optimum development level, economy reaches the slump several times
- Economic development could be achieved by increasing country's wealth
- Country's wealth depended partly on quantity of output produced by its labor force & partly on the valuation of this produce



## ❑ Population Growth and Economic Development

- Malthus stated that population growth alone is not sufficient to foster economic development
  - Rather population growth is the result of the development process
- HOW??** Increase in rate of capital accumulation → Increase in labor demand → Encourages population growth
- Mere population growth does not increase wealth
  - Population growth increases wealth only if it increases **effective demand**, which ultimately leads to increase in wealth



# Population Theory

**Table 1**  
**Malthusian Theory of Population**

Population increases in geometrical progression 1, 2, 4, 8, 16, 32, 64, 128, 256 (in 200 years)

Food Supply increases in arithmetical progression 1, 2, 3, 4, 5, 6, 7, 8, 9 (in 200 years).

Imbalance leads to over population

Corrected by

Preventive checks—late marriage, chastity, moral restraint, etc.

Positive checks—vice, misery, war, famine, floods, etc.

## ❑ Effective Demand

- Effective demand is that level of aggregate demand at which it is equal to aggregate supply.
- Effective demand is expressed by aggregate expenditure of an economy





## ❑ Role of Production and Distribution

- To Malthus, production and distribution are “*two grand elements of wealth*”
- Both can increase a nation's wealth in the short time if combined in the right proportion
- According to Malthus, maximum production and optimum allocation of resources can increase a country's wealth in the short run





# ❑ Factors in Economic Development

- Explaining difference between Potential GNP and Actual GNP
- Achieving high level of Potential GNP
- Size of Potential GNP determined by *land, labor, capital & organization*
- Employment of *land, labor, capital & organization* in right proportions maximize production in **economy's 2 major sectors, i.e. agriculture and industry**



- Capital accumulation, soil fertility & technological progress increase productivity in the above 2 major sectors



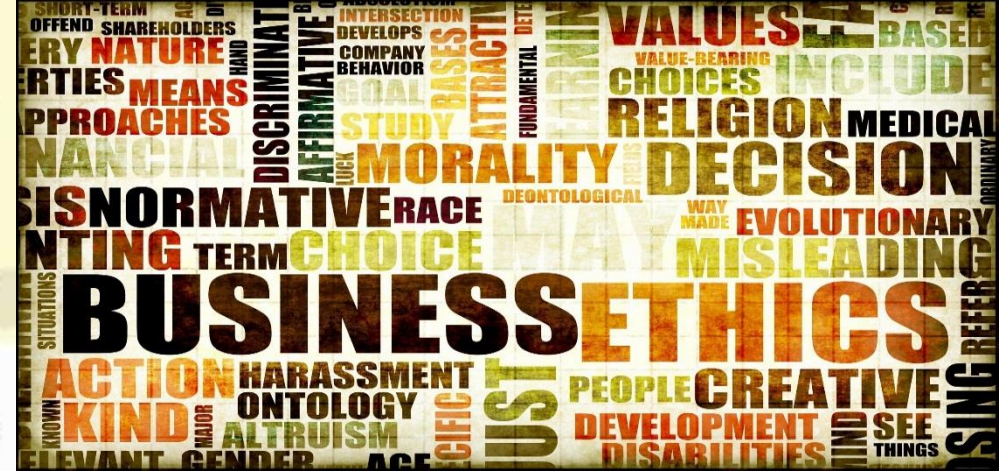
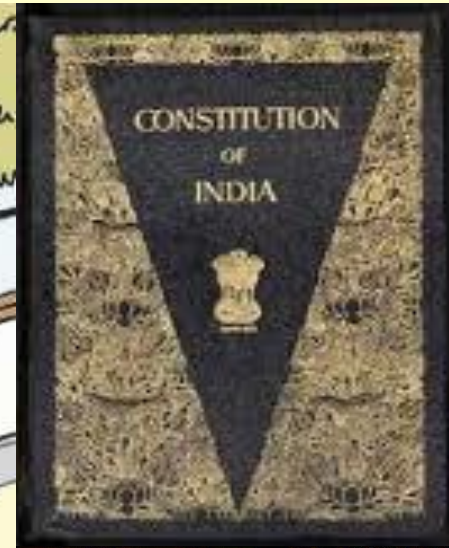
# ❑ Factors in Economic Development

- Non-economic factors like *security of property, good constitution, properly administered laws, prevailing habits, work ethics and attitude* etc. also contribute to economic development

## BIZARRE! MLAs CAUGHT SLEEPING ON CAMERA

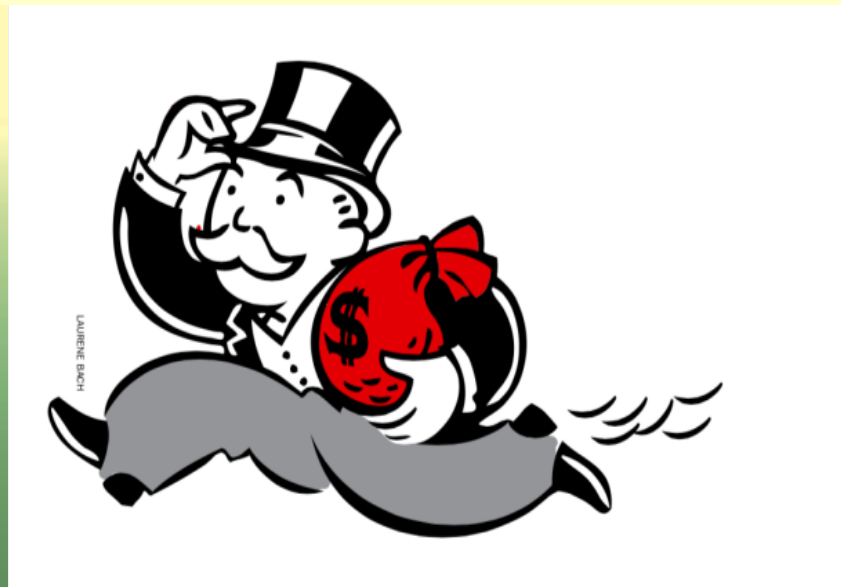


We are keen on finishing corruption.  
In fact, we have been keen on it for the last 64 years.



# ❑ Process of Capital Accumulation

- Most important determinant of economic development
- Its source is higher profits
- Profits come from savings of capitalists as workers are too poor to save
- But excess saving and less expenditure by capitalists on consumer goods to have larger profits will retard economic growth
- Optimum propensity to save





## ❑ Deficiency of Effective Demand

- Malthus did not agree with Say's Law of Markets
- Commodities are exchanged directly for labor than for commodities
- Excess supply of commodities in market in relation to demand
- This demand-supply gap cannot be filled by capitalists as well
- General over-production and glut of commodities in the market due to deficiency of effective demand/under consumption
- Leads to fall in prices, profits, saving, investment & capital accumulation

# ❑ Economic Stagnation

➤ Gluts and under consumption lead to economic stagnation

HOW??

Labor supply inelastic in short run, but capital supply can increase faster than population growth

Capitalists invest on productive labor to increase capital supply



Increase in wages due to competition

Effective demand do not increase as workers prefer leisure to increased consumption



Results in a general glut of commodities

Prices fall, profits decline, investment falls & both the power of accumulation and the motive to accumulation strongly decline

## ❑ Measures to Promote Economic Development

1. **Balanced Growth** of both the agricultural & industrial sectors
2. **Raising Effective Demand** by
  - i. More equal distribution of wealth and landed property,
  - ii. Expansion of internal and external trade,
  - iii. Maintenance of “unproductive consumption” and
  - iv. Public works schemes to remove unemployment



## ❑ Limitations of Malthus's Theory

1. Secular stagnation not inherent in capital accumulation
2. Negative view of capital accumulation
3. Commodities not exchanged for commodities directly
4. Unproductive consumers retard progress
5. One-sided saving base

## ❑ **Applicability of Malthus's Theory to Underdeveloped Countries**

1. He wrote about poverty, economic backwardness and underdevelopment of not only European countries, but whole of Asia, Africa and Latin America which justify its relevance even today
2. His analysis of a dualistic economy is highly realistic
3. His analysis of the causes of poverty of the peasantry makes sense
4. Relation between population growth and economic development is fully applicable
5. His views on the various factors that promote development
6. Policy measures suggested by Malthus on structural changes, land reforms, balanced growth, internal & external trade, equitable distribution of wealth & land and public works programs

## ❑ Non-Applicability of Malthus's Theory to Underdeveloped Countries

1. His *theory of under consumption* have no relevance
2. His remedy to maintain effective demand through “unproductive consumption” by capitalists and unproductive workers are not applicable to the prevalent conditions in underdeveloped countries

Adam Smith and Malthus and  
Ricardo ! There is something  
about these three figures to  
evoke more than ordinary  
sentiments from us their children  
in the spirit.

John Maynard Keynes

