

Adam Smith's theory

Adam Smith is regarded as the foremost classical economists. His monumental work, "An enquiry into the nature and causes of the wealth of nations" published in 1776 was primarily concerned with the problem of economic development. Though he did not expound any systematic growth theory, yet a coherent theory has been constructed by later day economists, which are explained below:

Natural law:

Adam Smith believed in the doctrine of 'natural law' in economic affairs. He regarded every person as the best judge of his self interest who should be left to pursue it to his own advantage. In furthering his own self-interest, he would also further the common good. In pursuance of this, each individual was led by 'invisible hand' which guided market mechanism. "it is not to the benevolence of the baker but to his self-interest that we owe our bread", said Smith. Since every individual if left free, will seek to maximize aggregate wealth. Smith was naturally opposed to any government intervention in industry and commerce. He was a staunch free trader and advocated the policy of laissez-faire in economic affairs. The 'invisible hand'- the automatic equilibrium mechanism of the perfectly competitive market tended to maximize national wealth.

Division of labour:

Division of labour is the starting point of smith's theory of economic growth. It is division of labour that results in the greatest improvement in the productive powers of labour. He attributes this increase in productivity: 1. to the increase in the dexterity of every worker, 2. to the saving in time to produce goods and 3. To the invention of a large number of labour-saving machines. The last cause of increase in productivity stems not from labour but from capital. It is improved technology that leads to division of labour and the expansion of the market. Division of labour, however, depends on the size of the market. One of his famous sayings that, "the division of labour is limited by the extent of the market," implies that, division of labour increases with the extension of the market. For this purpose, expansion of commerce and international trade is especially beneficial. With the increase in population and transport facilities, there is bound to be greater division of labour and increase in capital.

Process of capital accumulation:

Smith, however, emphasized that capital accumulation must precede the introduction of division of labour. Like the modern economists, Smith regarded capital accumulation as a necessary condition for economic development. So the problem of economic development was largely dependent on the ability of the people to save more and invest more in a country. The rate of investment was determined by the rate of saving and savings were invested in full. But almost all savings were invested in full. But almost all savings resulted from capital investments and landlords were capable of saving. The workers were considered incapable of saving. This belief was

based on the “Iron law of wages”. The idea is that wages tend to equal the amount necessary for the subsistence of the labourers. If the total wages at any time becomes higher than the subsistence level, the labour force will increase, competition for employment will become keener and wages will come down to the subsistence level. In such a situation, some of the workers will find it difficult to pull on below an accustomed normal living standard. They will, therefore, be unable to marry or bring up children. The working force will be reduced and competition among the capitalists for employing workers would tend to raise wages. Thus, Smith believed that, “under stationary conditions, wage rates fall to the subsistence level, whereas in periods of rapid accumulation, they rise above this level. The extent to which they rise depends both upon the rate of accumulation and upon the rate of population growth”. He believed that savings found their way into investment more or less automatically. Thus the wage fund could be increased by increasing the rate of net investment.

According to Smith, investments were made because the capitalists expected to earn profits on them and the future expectations with regard to profits depended on the present climate for investment as well as actual profits. Smith believed that profits tended to fall with economic progress. When the rate of capital accumulation increases, increasing competition among capitalists raises wages and tends to lower profits. In fact, it is the increasing difficulty of finding new profitable investment outlets that leads to falling profits.

Regarding the role of interest rate in economic development, Smith wrote that with the increase in prosperity, progress and population, the rate of interest falls, and as a result the supply of capital is augmented. The reason being that with the fall in interest rate the money-lenders will lend more to earn more interest for the purpose of maintaining their standard of living. Under the circumstances they will themselves start investing and become entrepreneurs. Thus, even with the fall in the rate of interest there is increase in capital accumulation and economic progress.

So far as rent is concerned, Smith believed that economic progress involves rise in money as well as real rentals, and a rise in rental share of national income. This is because the interests of the land owners are closely connected with the general interest of society.

Agents of growth:

According to Smith, farmers, producers and businessmen are the agents of economic progress. It was free trade, enterprise and competition led farmers, producers, and businessmen to expand the market which in turn made economic development possible. The functions of these three are interrelated. To Smith, development of agriculture leads to increase in construction works and commerce. When agricultural surplus arises as a result of economic development, the demand for commercial services and manufactured articles rises. This leads to commercial progress and the establishment of manufacturing industries. On the other hand, their development leads to increase in agricultural production when farmers use advanced production

techniques. Thus capital accumulation and economic development take place due to the emergence of the farmer, the producer and the businessmen.

Process of Growth:

Taking institutional political and natural factors for granted, Smith starts from the assumption that a social group- we may call it a 'nation' – will experience a certain rate of economic growth that is accounted for by increase in numbers and by saving. This induces a widening of market which in turn increases division of labour and thus increases division of labour and thus increases productivity. In this theory the economy grows like a tree. According to Smith, this process of growth is cumulative when there is prosperity as a result of progress in agriculture, manufacturing industries and commerce, it leads to capital accumulation, technical progress, increase in population expansion of markets, division of labour and rise in profits continuously. All this happens in Smith's progressive state which, is in reality the cheerful and the hearty state to all the different orders of the society".

Stationary state:

But this progressive state is not endless. It ultimately leads to a stationary state. It is the scarcity of natural resources that finally stops growth. In such a state, the competition for employment would reduce wages to the subsistence level and competition among businessmen would bring profits fall. They continue to fall, investment also starts declining and in this way the end result of capitalism is the stationary state. When this happens, capital accumulation stops, population becomes stationary, profits are the minimum, wages are at the subsistence level, there is no change in per capita income and production and the economy reaches the state of stagnation. According to Smith, the stationary state is dull, the declining melancholy. Life is hard in the stationary state for the different sections of the society and miserable in the declining state.

A Critical appraisal:

Smith's theory has the great merit of pointing out "how economic growth came about and what factors and policies impede it". In particular, he pointed out the importance of saving and capital accumulation of improved technology, division of labour and expansion of market in production and of the process of balanced growth in the interdependence of farmers, traders and producers. Despite these merits it has certain weaknesses.

1. Rigid division of society:

Smith's theory is based on the socio-economic environment prevailing in Great Britain and certain parts of Europe. It assumes the existence of a rigid division of society between capitalists and labourers. But the middle class occupies an important place in modern society. Thus, this theory neglects the role of the middle class which provides the necessary impetus to economic development.

2. One-sided saving base:

According to Smith, capitalists, landlords and money lenders save. This is, however, a one-sided base of savings, because, it did not occur to him that the major source of savings in an advanced society was the income-receives and not the capitalists and landlords.

3. Unrealistic assumption of perfect competition:

Smith's whole theory is based upon the unrealistic assumption of perfect competition. This laissez-faire policy of perfect competition is not to be found in any economy. Rather, a number of restrictions are imposed on the private sector, and on internal and international trade in every country of the world.

4. Neglect of entrepreneur:

Smith neglects the role of the entrepreneurs in development. This is a serious defect in his theory. The entrepreneur is the focal point of development, as pointed out by Schumpeter. It is the entrepreneur who organizer and brings about innovations thereby leading to capital formation.

5. Unrealistic assumption of stationary state:

Smith is of the view that the end result of a capitalist economy is the stationary state. It implies that there is change in such an economy but around a point of equilibrium. There is progress but it is steady, uniform and regular. But this explanation of the process of development is not satisfactory because development takes place by 'fits and starts' and is not uniform and steady. Thus the assumption of the stationary state is unrealistic.

6. Static model:

According to Hicks, Smith's model, though it looks like a growth model, is not a growth model in the modern sense. It does not exhibit a sequence. Thus it is a static model.

Its relevance for underdeveloped country:

Despite all this, Smith's growth economics is of some use for the less developed countries. His emphasis on raising the productivity of labour through division of labour, further, promoted by capital accumulation and extension of market is important in these countries, where product per worker is very low. His concern for raising savings to increase capital formation is also of great significance for these countries, where domestic saving and therefore capital formation are very low. It is also good for these countries to note the advantage of more international trade, in particular of expansion of exports to extend the market and demand for their products.

To conclude, Smith's theory has much to enlighten us in respect of the factors of development. It has also greatly influenced the development theories. But quite a significant part of Smith's economics is dated as a model of growth, it has only been a static one that cannot handle time and change. However, to an extent is still useful for underdevelopment countries. All in all, Adam Smith still lives on.
