

David Ricardo's Theory of Economic Development:

Like Prof Adam Smith, Ricardo also presented his views on economic development in his book, "**The principles of political economy and taxation**" (1817) and his correspondence with a number of economists that contain his idea on which his model of development has been built. Here it is useful to note the main points implicit in his analysis of the principles of economics, is the importance of agriculture in the economy, the operations of the law of diminishing returns in the field of agriculture, labour theory of value, theory of rent, the pattern of distribution of national income, among landlords, capitalist and labour, the theory of comparative cost advantage are the main ideas in Ricardian theory. Ricardo focused on growth and all that goes with it such as capital accumulation and savings. But he also brought into the limelight the limits of growth caused by the scarcity of natural resources.

Assumption of the theory:

The Ricardian theory is based on the following assumptions:

1. That all land is used for the production of corn and the working forces in agriculture help in determining distribution in industry.
2. The law of diminishing returns operates on land.
3. The supply of land is fixed.
4. The demand of corn is perfectly inelastic.
5. That labour and capital are variable inputs.
6. The state of technical knowledge is given.
7. That all workers are paid subsistence wages.
8. The supply price of labour is given and constant.
9. The demand for labour depends upon the accumulation of capital and that both demand and supply price are independent of the marginal productivity of labour.
10. There is perfect competition.
11. That capital accumulation results from profit.

Given these assumptions, the Ricardian theory is based on the interrelations of three groups in the economy. They are landlords, capitalists, and labourers, among who the entire produce of land is distributed, as, rent, profit and wages.

Division of Rent, Profit and Wages:

Given the total output of corn the share of each group can be determined. Rent per unit of land is the difference between the average and marginal product or, total rent equals the difference between the average product and the marginal product of labour multiplied by the quantity of labour and capital applied on land. The wage rate is determined by wage fund divided by the number of workers employed at the subsistence level. Thus, out of total corn produced and sold, rent has the right and the residual is distributed between wage and profit, while interest is included in profit.

Process of capital accumulation:

According to Ricardo, capital accumulation is the outcome of profit because profit leads to saving of wealth which is used for capital formation. Capital accumulation depends on two factors: First, the capacity, to save, and second the will to save the capacity to save is

more important in capital accumulation. This depends upon the net income of society, which is a surplus out of total output after meeting the cost of workers subsistence. The larger the surplus, larger will be the capacity to save.

The profit rate:

The rate of profit is equal to the ratio of profits to capital employed. But since capital consists only of working capital, it is equal to the wage bill. So long as the rate of profit is positive, capital accumulation will continue. The labour force will grow proportionately and the total wage fund will also increase. In reality, profit depends on wages, wages on the price of corn and the price of corn depends on the fertility of the marginal land. In this way, there is an inverse relation between profits and wages, and wages rise or fall in keeping with the price of corn. When there are improvements in agriculture, the productive power of land increases this results in the fall in the price of corn. As a result, the subsistence wage also falls, but profits increase and there is more capital accumulation. This will increase the demand for labour and the wage rate will rise. This, in turn, will increase population and the demand for corn and its price. Thus wages will rise and profits decline.

Increase in wages:

Ricardo tried to show that it is only under different conditions that capital accumulation will reduce profits. In the Ricardian system wages play an active role in determining income between capital and labour. The wage rate increases when the prices of commodities forming the subsistence of the workers increase. The commodities consumed by workers are primarily agricultural products. As the demand for population and food increases, less fertile land is brought under cultivation. For this purpose, to produce a unit of the product more labourers are required. The demand for labour starts rising, which, raises wages. Moreover, to match the increasing cost of subsistence, money-wages will also continue to rise. Thus wages would rise with the increase in the price of corn and then profits would decline. In such a situation, rent also increases which absorbs the rise in the price of corn. Since wages also increases, the ratio of capitalist's profits declines. This will ultimately retard capital accumulation.

Declining profits in other industries:

According to Ricardo, "the profits of the farmer regulate the profits of all other trades". Therefore, the money rate of profit earned on capital must be equal in equilibrium both in agriculture and industry. In manufacturing industry corn is used as an input and equality in the rate of profit comes through a definite relationship between the prices of industrial goods and the price of corn. Thus, when the profit rate declines in the agricultural sector, it also declines in the manufacturing industry. For with the rise in the price of corn, the industry will have to raise the wages of labourers, thereby, reducing profits. Thus the price of corn determines the rate of profit in industry. When profits decline in the agricultural sector, profits of all trades also decline.

Other sources of capital accumulation:

According to Ricardo, economic development depends on the difference between production and consumption. He therefore, lays emphasis on increasing production and consumption. However, the productivity of labour may be increased through

technological changes and better organisation. In this way, capital accumulation can also be increased. But the use of more machines will employ fewer workers. This will lead to unemployment and reduced wages. Since the economic condition of the workers worsens with the employment of more machines Ricardo regards technological conditions as given and constant.

i. Taxes:

Taxes are a source of capital accumulation in the hands of the government. According to Ricardo, taxes are to be levied only to reduce conspicuous consumption. Otherwise, the imposition of taxes on capitalists, land-lords, and labourers will transfer resources from these groups to the government. But taxes adversely affect investment; therefore, Ricardo does not favour the imposition of taxes because, a tax reduces income, profits and capital accumulation.

ii. Savings:

Therefore, Ricardo lays emphasis on capital accumulation through savings. Savings can be formed through less expenditure and more production and by increasing the rates of profits and reducing the prices of commodities. The larger the savings, the more will be capital accumulation.

iii. Free trade:

Ricardo is in favour of free trade, free trade is an important factor for economic development of the country. The profit rate can be saved from declining by importing corn. The capital accumulation will, therefore, continue to be high. In this way, the resources of the world can be used more efficiently through foreign trade. But the import of corn leads to fall in the demand for labour which deteriorates the economic condition of labourers. On the other hand, landlords and capitalists do not think it fit to import cheap corn from foreign countries, as a result their profits decline. This is but natural, because with the application of the law of diminishing returns on land and increase in population, the price of corn and wages increase the profit rate declines.

Total output increases with economic development and with it the wage fund also rises. This leads to a proportionate increase in the amount of labour. As population increases, the demand for corn rises, which, also raises the price of the corn. Moreover, with the application of the law of diminishing returns on land, rents continue to rise and profits have a tendency to fall. Ultimately increasing population and rents eliminate profits.

Stationary State:

According to Ricardo, there is a natural tendency for the profit rate to fall in the economy so that the country ultimately reaches the stationary state. When capital accumulation rises with increase in profits, total production increases which raises the demand for corn and its price. As population increases inferior grades of land are cultivated to meet the increasing demand of corn. Rents on the superior grades of land rise and absorb a greater share of the output produced on these lands. This reduces the share of capitalists and labourers. Profits decline and wages tend to fall to the subsistence level. This process of rising rents and declining profits continues till the output from the marginal land just covers the subsistence wage of the labour employed. Then profits are zero. The

stationary state arrives, in this state capital accumulation stops, population does not grow, the wage rate is at the subsistence level and technical progress ceases.

Critical Appraisal:

Ricardo was the forerunner of modern economists and his ideas on economic growth have been adopted. They are as follows:

1. Agricultural development:

Ricardo emphasized the importance of agricultural development in economic growth, because industrial development depends on it. This sequence of development has been in vogue in Great Britain and other European countries, and this is also to be found in underdeveloped countries like India.

2. Profit rate:

Ricardo advocated the increase in the profit rate in economic development for capital accumulation depends on it. Modern economist like W.A. Lewis also emphasizes the importance of increasing the profit-rate for capital accumulation.

3. Importance of saving:

Like modern economists, Ricardo's theory underlines the importance of saving for higher capital accumulation. Thus Ricardo was the forerunner of modern economists.

4. Foreign trade:

Ricardo gave much importance to foreign trade in improving the economic condition of the economy because it leads to the maximum utilization of resources and increase in income.

5. Dynamic theory:

Despite these merits of his theory, it has certain weaknesses which are discussed below:

1. Neglects the impact of technology:

Ricardo pointed out that improved technology in the industrial field leads to the displacement of labour and other adverse consequences. In the beginning, technological progress might counteract the action of diminishing returns. But ultimately when the impact of technological progress is exhausted, diminishing returns set in and the economy moves towards stationary state. Rapid increase of farm produce in the advanced nations has proved that Ricardo under-estimated the potentialities of technological progress in counteracting diminishing returns of land.

2. Wrong notion of the stationary state:

The Ricardian view that the economy reaches the stationary state automatically is baseless because no economy attains the stationary state in which profits are increasing, production and capital accumulation is taking place.

3. Baseless notion regarding population:

The Ricardian view that the wage rate does not increase with the rise in population has been disproved. First, the Malthusian theory of population has been proved wrong by population trends prevailing in the western world. Second, wages have not tended to be

at the subsistence level, rather, there has been a continuous increase in money wages and population has tended to decline.

4. Impracticable Laissez-faire policy:

The Ricardian theory is based on the impracticable notion of laissez-faire. According to this policy there is no government interference and the economy operates automatically through perfect competition. In reality, there is no economy which is free from governmental interference and in which perfect competition prevails.

5. Neglects institutional factors:

One of the main defects of the Ricardian theory is that it neglects the role of institutional factors. They have been assumed as given. But they are crucial in economic development and cannot be overlooked.

6. Distribution rather than growth theory:

According to Schumpeter, the Ricardian theory is not a growth theory but it is the theory of distribution which determines the share of workers, landlords and capitalists. Even in this, he regards the share of land as primary and the residual as the share of labour and capital. Ricardo failed to present a functional theory of distribution because he did not determine the share of each factor separately.

7. Land also produces goods other than corn:

Ricardo believed that only one product corn is produced on land. But this is an outdated notion because land produces a variety of products other than corn.

8. Capital and labour not fixed co-efficient:

The Ricardian assumption that capital and labour are fixed co-efficients of production is not correct. This assumption is invalid because labour and capital are independent variables.

9. Neglects the interest rate:

The most serious defect of the Ricardian theory is the neglect of the rate of interest in economic growth. He does not regard the interest rate as an independent reward of capital but includes it in profits.
