THE THEORY

Adam Smith is regarded as the foremost classical economist. 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 is 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 an *"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 maximise his own wealth, therefore all individuals, if left free, will maximise 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 equilibrating mechanism of the perfectly competitive market tended to maximise national wealth.

Division of Labour is the starting point of Smith's theory of economic growth. It is divis labour that results in the greatest improvement in the productive powers of labour. He attri this increase in productivity: (1) to the increase in the dexterity of every worker; (2) t saving in time to produce goods; and (3) to the invention of large number of labour-sa machines.[1] The last cause of increase in productivity stems not from labour but from cap is improved *technology* that leads to division of labour and the expansion of the marke what leads to division of labour is a certain propensity in human nature—the propens truck, barter and exchange one thing for another. Division of labour, however, depends o size of the market. One of his famous sayings that 'the division of labour is limited by the e of the market' implies that the division of labour increases with the extension of the marke this purpose, expansion of commerce and international trade is especially beneficial. W increase in population and transport facilities, there is bound to be greater division of l and increase in capital.

Process of Capital Accumulation. Smith, however, emphasized that capital accumulation precede the introduction of division of labour. Like the modern economists, Smith reg capital accumulation as a necessary condition for economic development. So the probl economic development was largely the ability of the people to save more and invest mo country. The rate of investment was determined by the rate of saving and savings were in in full. But almost all savings resulted from capital investments or the renting of land. S capitalists and landlords were held to be capable of saving. The labouring classes were cons to be incapable of saving. This belief was based on the 'Iron Law of Wages'. The c economists also believed in the existence of a *wages fund.* The idea is that *wages* tend to eq amount necessary for the subsistence of the labourers. If the total wages fund at an becomes higher than the subsistence level, the labour force will increase, competition f ployment will become keener and wages will come down to the subsistence level. In s situation, some of the workers will find it difficult to pull on below an accustomed n living standard. They will, therefore, be unable to marry or bring up children. The wo force will be reduced and competition among the capitalists for employing workers w tend to raise wages. Thus, Smith believed that "under stationary conditions, wage rates the subsistence level, whereas in periods of rapid capital accumulation, they rise abov level. The extent to which they rise depends both upon the rate of accumulation and upo rate of population growth."[2] The wages fund was, however, built up of savings and was u for hiring labour through investments. He believed that savings found their way into inves more or less automatically. Thus the wages fund could be increased by increasing the rate investment.

Why do Capitalists Make Investments? According to Smith, investments were made be the capitalists expected to earn *profits* on them; and the future expectations with regard to p depended on the present climate for investment as well as actual profits. But what is the beh of profits during the development process? Smith believed that profits tended to fal economic progress. When the rate of capital accumulation increases, increasing compe among capitalists raises wages and tends to lower profits. In fact, it is the increasing dif of finding new profitable investment outlets that leads to falling profits.

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1. Adam Smith, *An Inquiry into the Nat...*
2. G.M. M...

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 moneylenders will lend more to earn more interest for the purpose of maintaining their standard of living at the previous level. Thus the quantity of capital for lending will increase with the fall in the rate of interest. But when the rate of interest falls considerably the moneylenders are unable to lend more in order to earn more to maintain 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 landowners 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 that 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 far 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 businessman.

Process of Growth. "Taking institutional, political and natural factors far granted, Smith starts from the assumption that a racial 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 is turn increases division of labour and thus increases productivity... In this theory the economy grows like a tree. This process is no doubt exposed to disturbances by external factors, that are not economic,...but in itself it proceeds steadily, continuously. Each situation grows out of the preceding one in a uniquely determined way, and the individuals whose acts combine to produce each situation count individually for no more than the individual cells of a tree."[3] 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 an opulent state, the competition for employment would reduce wages to the subsistence level and competition among businessmen would bring profits as low as possible. Once 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 sationary; profits are the minimum; wages are at the subsistence level; there is no change in per capita income

3. Richard V. Clemence, (ed.) *Essays of J.A. Schumpeter*, pp. 232-33. Italics mine.

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. All this happens in a free market economy.

Smith's theory is explained in terms of Fig.1 where time is taken on the horizontal axis and rate of accumulation, dK/dT, on the vertical axis. The economy grows from K to S during the time path T. After T, the economy reaches the stationary state linked to S where further growth does not take place because wages rise so high that profits become zero and capital accumulation stops.

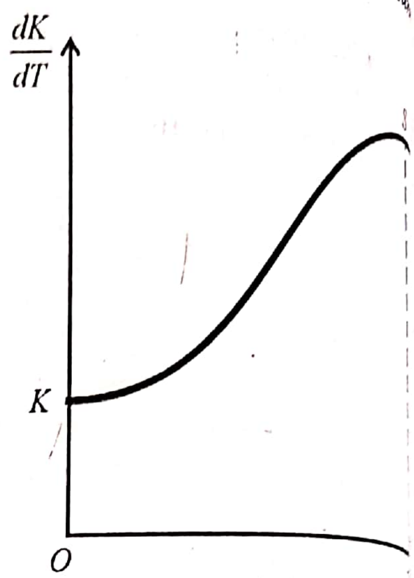

Fig. 1

A CRITICAL APPRAISAL

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

1. Rigid Division of Society. Smith's theory is based on the socio-economic envi... prevailing in Great Britain and certain parts of Europe. It assumes the existence of a rigid... of society between capitalists (including landlords) and labourers. But the middle class... an important place in modern society. Thus, this theory neglects the role of the mid... which provides the necessary impetus to economic development.

2. One-sided Saving Base. According to Smith, capitalists, landlords and moneylend... This is, however, a one-sided base of savings because it did not occur to him that th... source of savings in an advanced society was the income-receivers and not the capita... landlords.

3. Unrealistic Assumption of Perfect Competition. Smith's whole theory is based o... unrealistic assumption of perfect competition. This *laissez-faire* policy of perfect comp... not to be found in any economy. Rather, a number of restrictions are imposed on th... sector, and on internal and international trade in every country of the world.

4. Neglect of Entrepreneur. Smith neglects the role of the entrepreneur in developme... a serious defect in his theory. The entrepreneur is the focal point of development, as... out by Schumpeter. It is the entrepreneur who organises and brings about innovation... leading to capital formation.

5. Unrealistic Assumption of Stationary State. Smith is of the view that the end r... capitalist economy is the stationary state. It implies that there is change in such an eco... 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 dev... takes place by 'fits and starts' and is not uniform and steady. Thus the assumption of the... state is unrealistic.

6. Static Model. According to Hicks, Smith's model, though it looks like a growth mo... a growth model in the modern sense. It does not exhibit a sequence.[4] Thus it is a stat...

4. J. Hicks, *Capital and Growth*, 1965.

ITS APPLICABILITY TO UNDERDEVELOPED COUNTRIES

The Smith theory of economic development has limited validity for underdeveloped countries. In such economies, the size of the market is small. As a result, the capacity to save and inducement to invest are low The size of the market is determined by the volume of production. This in turn depends on the level of income. 'Capacity to buy means capacity to produce' here. And productivity, to a certain extent, depends on the degree to which capital is employed in production. Since the size of the market is small, productivity is low, and low productivity implies low level of income. The low level of income results in small capacity to save and inducement to invest and they keep the size of the market small. To use the Keynesian terminology, the level of real income is low in underdeveloped countries but the propensity to consume is very high and every increase in income is spent on food products. Little is saved and invested. The volume of production remains at a low level. Consequently, the size of the market remains small.

Moreover, political, social and institutional assumptions underlying Smith's theory are not applicable to the conditions prevailing in underdeveloped countries. *Laissez-faire* has lost its significance in such economies. Competition has been gradually replaced by monopoly which has tended to perpetuate and strengthen the vicious circles of poverty. Therefore, development is possible through government intervention rather than through a policy of *laissez-faire.*

Conclusion. Despite this, Smith's theory of economic development points toward certain factors that are helpful in the process of developing underdeveloped countries. Farmers, traders and producers, the three agents of growth mentioned by Smith, can help in developing the economy by raising productivity in their respective spheres. In the absence of a free market economy, the state can induce them to produce more, as is being done in India. Their interdependence also points toward the importance of balanced growth for such economies.

In particular, Smith extolled the virtues of saving which is regarded as a crucial factor for capital formation in underdeveloped countries. He wrote, "Every prodigal appears to be a public enemy and every frugal man a public benefactor."

Further, his emphasis on improved technology, division of labour and expansion of market in the process of development has become the corner stone of policy in such countries. As aptly remarked by Rostow, indeed looked at from the present day, the *Wealth of Nations* is a dynamic analysis, and programme of policy for an underdeveloped country.