UNIT 1 CLASSICAL THEORY

Structure

1.1 INTRODUCTION

As you know, theories are fundamental to any subject. If you are a student of Arts with Political Science and Economics as subjects, you might have studied Political Theory and Economic Theory. Likewise, in development studies also, theories of development are fundamental to the concept of development. This unit discusses the classical theory of development. The leading members of the classical school are Adam Smith, David Ricardo, and J. S. Mill. This unit mainly discusses the thoughts of these important economists who belong to the classical school of development. In the subsequent unit you will read about the Marxian Theory.

After studying this unit you should be able to:

- explain classical philosophy of development;
- discuss classical theories of development; and
- point out the criticisms of classical theory of development.

1.2 CLASSICAL PHILOSOPHY OF DEVELOPMENT

The philosophical foundation of the classical school is embedded in an individualistic outlook. The classical economists were basically concerned with the activities of individuals. According to classicists, it is the welfare of each individual that leads to the welfare of the society and not vice versa. There is no conflict between the interests of the individuals and those of society. The welfare of society is the sum total of the well-being of all the individuals living in that society. The classical economists derived their conclusions by different reasoning. By adopting the inductive process, Smith says that individualism is the outcome of the principle of natural liberty. Adam says that individualism is the outcome of the principle of natural liberty. Adam Smith contends that when each individual acts freely, according to the natural laws operating within him, he maximizes his individual welfare and his society's welfare in the physical world. In Smith's view, the ideal economy is a self-regulating market system that automatically satisfies the economic needs of the people. He arrived at this conclusion more from his observations of individual behaviour and functioning of society than from some abstract principle. He describes the market mechanism as an "invisible hand" that leads all individuals, in pursuit of their own self-interests, to produce the greatest benefit for society as a whole. He approves of only three fields for government action: defense, justice, and public works and institutions. On the other hand, classical economists such as Ricardo and Bentham rejected the concepts of natural law and natural liberty, and derived their conclusions on the 'principle of utility'. According to this principle, each individual strives to maximize 'pleasure' in his various decisions.

Another important aspect of the classical school of development is the doctrine of *laissez-faire*. The doctrine of *laissez-faire* upholds the idea of economic liberalism. In other words, it says: let the natural forces of the economic system work independently, and they will produce results beneficial to both the individual and to society. Guided by his philosophy of Naturalism and Optimism, Smith advocated a policy of economic liberty. This policy has both negative and positive arguments. Negative arguments are set against the interference of government in economic activities, while positive arguments demonstrated the desirability of free trade.

Smith gave two arguments in support of the doctrine of *laissez-faire*:

i) Economic liberty allows for full and free working of the mechanism of the invisible hand in a competitive economy, which ensures the maximum national wealth

ii) Economic liberty facilitates setting in forces which are responsible for the growth of the wealth of a country over a period of time.

Thus, the doctrine of natural order works in the economic field through the laws of the market and the laws of motion.

The classical economists are followers of the doctrine of *laissez-faire*. They criticized the mercantilist system of protection. Smith incorporated some of the Physiocrats' ideas, including *laissez-faire*, into their economic theories, but rejected the idea that only agriculture was productive. The classical economists were against the subsidization of agriculture in the form of the Corn Laws. They rejected the mercantilist's protectionist policy of trade. They opposed all kinds of restrictions on economic activities. According to them, all economies function best under private initiatives and competitive conditions, rather than under state control. Individual action motivated by enlightened self-interest and regulated by competition tends to promote individual as well as social welfare. The classical economists opposed the system of relief, or subsidy, to the poor on the ground that it promoted laziness, and increased their family size. The economists in the classical school produced their "magnificent dynamics" during a period in which capitalism was emerging from a post feudal society. A free market economy, which is also called the capitalist economy, has the following features

a) individual actions are regulated by the forces of self-interest and competition

b) production is organized by private individuals with a profit motive

c) all goods and services of productive factors are brought for sale in the market.

The industrial revolution led to vast changes in society. These changes raised the question of how a society could be organized. The market economy posed theoretical as well as practical problems. On the theoretical side, the problem was to show how such an economy could develop and respond to the needs of society. On the practical side of public policy, the problem was whether to allow private forces to function freely, or to allow state intervention to achieve social objectives. The classical economists attempted to answer these questions.

The classical school of thought is further governed by the Law of Market. As mentioned earlier, according to Smith, the market is governed by two forces

a) self-interest (the chief stimulator of individual action)

b) competition (the beneficial outcome of the society).

The natural sentiment of self interest in a society of similarly motivated individuals results in competition. Through this automatic mechanism of competition, these individuals are driven to produce those goods which the society wants, in the quantities that society desires and at prices that the society is prepared to pay. Thus, the invisible hand of beneficial natural order is nothing but the automatic mechanism of a competitive market which regulates the economic activities to produce maximum social welfare.

Almost all the classical economists, except Malthus, accepted Say's formulation that: "Supply creates its own demand". Say's law implies three things

a) Money is a veil: its only function is to serve as a medium of exchange

b) General over production, or market glut, is impossible

c) Full employment equilibrium is automatically ensured.

So, in this view, in the long run, there can never be a market glut. Therefore, the free economy always attains full employment equilibrium in the long run. Imbalance in the labour market is the result of imbalance in the goods market. Full employment equilibrium is automatically restored by free market forces.

Now that you are familiar with the classical philosophy of development, try and answer the following questions in *Check Your Progress 1.*

Check Your Progress 1

Note: a) Write your answer in about 50 words.

b) Check your answers with possible answers given at the end of the unit.

1) Explain the doctrine of laissez-faire.

....

....

....

....

2) Discuss Adam Smith's argument in favour of laissez-faire.

....

....

....

....

1.3 CLASSICAL THEORIES OF ECONOMIC GROWTH AND DEVELOPMENT

The classical economists were primarily concerned with the dynamics of economic growth of a capitalist economy. In their view, population growth and capital accumulation are the necessary conditions of growth. The forces of diminishing returns and technological advancements determine the pace of economic growth. Capital accumulation, which itself is determined by the rate of profit, on one hand, creates a demand for labour, and, on the other, fosters technological improvements by facilitating the division of labour. Population, which tends to grow rapidly, increases the demand for food. Food production is subject to diminishing returns. Thus, we have two forces working in opposite directions: technological advancements promoting growth on one side, and the eventuality of diminishing returns that retard growth on the other. Thus, the long run trend of the economy depends upon the relative strength of these two forces.

The three theories of economic growth that are based on the classical school of thought are:

a) **The Optimistic Theory** (Adam Smith): According to Smith, the process of development never comes to an end. Capital accumulation has two favourable effects. On one hand, it facilitates technological progress by making division of labour possible. On the other, it expands markets by increasing wages. Thus, economic growth continues forever.

Smith's optimism is because

i) He took into consideration that machines are complementary to labour, but neglected the labour-replacing effect of technology

ii) He assumed constant returns, and bypassed the gloomy effects of diminishing return

iii) He focused on aggregate wealth resulting from division of labour, economies of scale and the invisible hand.

b) **The Pessimistic Theory** (Ricardo, Malthus): Ricardo and Malthus were pessimistic in their vision of the long run process of growth. Ricardo was less concerned about growth, and more about income distribution and trade. The Ricardian growth model emphasized the limits to growth imposed by the scarcity of land. Malthus maintained that the geometric growth of the population would outrun the arithmetical growth of food production. As a result, the process of economic growth would come to a standstill. The limits to growth are posed by land and population growth.

c) **The Moderate Theory** (J.S.Mill): Mill followed the middle path. On one hand, refused to accept the Pessimistic theory due to two reasons. First, he hoped that the growing popularity and effectiveness of moral restraint would lighten the problem of over-population. Second, he was confident of a cultural change that would occur and would slacken the acquisitive spirit of society. However, Mill was not optimistic. He did not believe in the favourable effects of technological improvements. These improvements, themselves, are subject to diminishing returns.

Adam Smith's Growth Model

Adam Smith's theory of economic development is derived from his famous book The ***Wealth of Nations***. The main points of his theory of economic development are

- Natural law
- *Laissez-faire*
- The division of labour
- Capital accumulation

Adam Smith advocated natural law in economic affairs. He opposed any government intervention in economic affairs of a country. He was a staunch free trader and advocated the policy of *laissez-faire* in economic affairs. He opined that natural laws are superior to law of states.

Adam Smith recognized three factors of production, namely land, labour, and capital

$Y = f(K, L, N)$

Y = Income

K = Stock of Capital

L = Labour Force

N = Land

In Smith's growth model, the process of development is initiated by the employment of productive labour, accelerated by the division of labour, and regulated by capital accumulation. The determinants of economic growth are

a) capital accumulation

b) the size of the working population

c) the extent of the market.

Smith's dynamics of the growth process can be understood with the help of the following three propositions

i) a rise in capital accumulation raises the ratio of productive to unproductive workers

ii) increased demand for a work force raises the wage rate above the subsistence level which, in turn, increases the supply of the work force

iii) an increase in the working population enlarges the size of the market, and widens the scope of division of labour.

Given adequate market possibilities and the basis for the capital accumulation, a division of labour takes place which increases the productivity of labour. The increased productivity of labour enhances national income, and enlarges the size of the working population. Both these elements widen market possibilities, and broaden the base for capital accumulation. This further increases the scope for the division of labour. Thus, the system becomes self-sustaining and cumulative. Smith observed that farmers, producers, and businessmen are the key agents of economic growth. It is the free trade, enterprise, and competition that led farmers, producers, and businessmen to expand the market; and which subsequently makes economic development interrelated.

The Ricardian Dynamic Model

Ricardo was concerned with a dynamic analysis. His theory of distribution was closely connected with the theory of growth. According to him the tendency to accumulate capital is the prime motive force in the process of economic growth. Capital accumulation means saving, and saving is regulated by the power to save and the will to save. The power to save depends upon the net income or the amount of the surplus over the total product necessary to maintain labour's subsistence level. The will to save depends upon the rate of profit. If the rate of profit is high, the capitalist will tend to consume less, and save more, and, *vice versa*. Thus, capital accumulation is an increasing function of net income.

Capital accumulation increases the demand for labour by pushing up market wages. Rising wages lead to the growth of population which in turn brings wages to the equilibrium level of subsistence minimum. The marginal product (or, total product-less-rent) of capital and labour falls as a consequence of the law of diminishing returns. Thus, real wages being constant at the subsistence level, a fall in the marginal product means that the relative share of labour (wages) increases and the relative share of capital (profits) falls. Out of these profits, again, there will be capital accumulation, but at a reduced rate, because profits will have fallen. The process of growth will continue until the profits fall to zero. At this stage, capital accumulation stops, the progress of economy halts, and the system reaches a stationary state.

In the Ricardian analysis, two more forces determine the pattern of development. They are: the law of population and the law of diminishing returns. The rate of capital accumulation regulates the demand for labour, and the demand for labour regulates the rate of population growth. Diminishing returns can be remedied by technological improvements. But, Ricardo believes that technological progress is also subject to the law of diminishing returns. Thus, in the long run, the law of diminishing returns must operate and productivity must fall.

The other two important edifices of the Ricardian model are the Law of Rent and the Corn Laws. The Law of Rent is based on the observation that the differing fertility of land yields unequal profit to the capital and on the labour that is applied on it. As far as the Corn Laws is concerned, Ricardo was against the Corn Laws. The Corn Laws were important tariffs designed to support domestic corn prices against competition from less expensive foreign imports. The Corn Laws aimed at enhancing the profits of the landowners. Ricardo believed that higher tariffs would shift the distribution of income in favour of the landlords.

Malthusian Theory of Development

T. R. Malthus pioneered the theory of population and linked it with development. According to Malthus, population growth is the end product of the whole process of economic development. However, the increase in population cannot take place without proportionate increase in wealth. He was of the opinion that mere increase in population cannot provide a stimulus to economic expansion. In his view, population growth promotes development only when it brings an increase in effective demand.

Malthus contended that the process of growth is not automatic and easy. It needs a conscious deliberate effort on the part of the people to promote growth. He did not see any movement of the economy towards a stationary state, but, he emphasized that the economy may reach slumps many times before it achieved an optimum level of development. Therefore, the process of development consists of many ups and downs, and the journey is not a smooth one.

The Components of Malthusian Theory

The various components of Malthusian theory are

i) **Population Growth and Economic Development:** The Malthusian principle of population states that the population increases faster than the food supply. According to Malthus, population growth will promote economic development only when it increases the effective demand, and it is the increase in effective demand which will lead to increase in wealth.

ii) **Factors in Economic Development:** According to Malthus the size of potential gross national product depends on land, labour, capital, and organization. When these four factors are combined in the right proportion, they maximize production in the agriculture and industrial sectors. The increase in production in the agriculture and industrial sector could be brought about thorough the accumulation of capital, fertility of soil, and technological progress.

iii) **Capital Accumulation:** According to Malthus, capital accumulation is the most important determinant of economic growth. Capital is indispensable to development. He was of the opinion that 'no permanent and continued increase in wealth can take place without increase in capital'. The prime source of accumulation of capital is profit which is generated through savings.

iv) **The Role of Production and Distribution:** Malthus regarded production and distribution, the two vital elements of wealth generation. Their appropriate combination will lead to a faster rate of increase of wealth. The potentiality of economic development depends on the appropriate strategy of production and its distribution.

v) **The Role of Foreign Trade:** Malthus assigned adequate importance to foreign trade in speeding up economic growth. It provides incentives for investing as it leads to the expansion of market for goods produced.

vi) **Economic Stagnation:** According to Malthus, the supply of labour is inelastic in the short run. In this case, the supply of capital increases faster than the increase in population, and this may lead to an increase in wages. However, he believed that rise in wage does not lead to an increase in effective demand because workers prefer leisure to increased consumption. As a result, prices fall, profits decline, investment falls, and, consequently, accumulation of capital is constrained. This state of affairs leads to economic stagnation.

J.S. Mill's Theory of Development

J.S. Mill has made a significant contribution to the theory of economic development. According to Mill, economic development is a function of land, labour, and capital. He treated land and labour as original factors of production, and capital as the stock previously accumulated from the production of labour. According to him, the wealth of a nation increases production faster than the labour force. He also distinguished between productive consumption, and unproductive consumption. Productive consumption is that consumption which increases the productive power of the community.

The important constituents of Mill's theory of development are

i) control of population growth

ii) a wage fund

iii) The role of capital accumulation

iv) rate of profit

v) The role of the state

vi) The stationary state

Control of Population Growth: Mill believed in the Malthusian Theory of Population. According to Mill, the tendency of a population is to increase faster than the means of living. Therefore, there is a need to restrict population growth in order to bring faster development.

The Wage Fund: According to Mill, the elasticity of labour supply is very high in response to rises in wages. Wages usually cross the subsistence level. Wages are paid out of capital, and, hence, they are limited by the existing fund of capital. Further, wages are determined by the demand and supply of labour. Any change in the wage rate is affected by the change in capital or population. Thus, the rise and fall in wages depends upon whether capital grows faster than a population, or whether population grows faster than capital. Mill pointed out that an increase in consumption leads to a decline in investment. On the other hand, increases in investment lead to an increased wage fund, and this leads to economic progress. Mill believed that the wage fund depends upon the aggregate fund of capital, and the wages that are paid out of capital as advances.

The Role of Capital Accumulation: Capital is defined as the previously accumulated stock of the products of formal labour: the higher the capital, the larger the size of wages and, thus, the higher the demand for productive labour. Capital is the result of savings, and savings means the abstinence from present consumption for the sake of future investment. According to Mill, capital accumulation depends upon

i) the size of the fund that savings can make, and

ii) the strength of the disposition to save.

Thus, capital is the kingdom of development, and it is the upshot of investment.

The Rate of Profit: According to Mill, the ultimate tendency in an economy is for the rate of profit to decline due to diminishing returns in agriculture, and an increase in the population at a Malthusian rate. In the absence of technical improvement in agriculture, and with a high population growth rate, the rate of profit is bound to decline, and the economy will approach a stationary state.

The Role of State: J S. Mill was an ardent supporter of *laissez faire* and a advocated a minimum role for the state in economic affairs. Mill was in favour of free trade, and against protectionism. He prescribed protection only for infant industries. In his view, the government has an important role to civilize citizens by providing educational facilities. However, he did not consider education as an investment in capital which stimulates economic growth.

The Stationary State: The stationary state is a stage where there could be no increase in either population, or in the stock of capital. Profit becomes minimal. However, there would still be a rise in the standard of living because of improvements in the art of living, and increased leisure through technical progress. According to J.S. Mill the stationary state is imminent. He supported the stationary state as it leads to improvement in income distribution, and large remuneration for labour.

Now that you are familiar with the classical theories of economic growth and development, try and answer the following questions in *Check Your Progress 2.*

Check Your Progress 2

Note: a) Write your answer in about 50 words.

b) Check your answers with possible answers given at the end of the unit.

1) Discuss the key features of Ricardian theory.

....

....

....

....

2) What is Say's Law?

....

....

....

....

1.4 AN OVERVIEW OF THE CLASSICAL THEORY OF ECONOMIC GROWTH AND DEVELOPMENT

In the previous section we discussed the views of Adam Smith, Ricardo and J S Mill on the process of growth in capitalist economies. We have also explained the process in which a growing capitalist economy would reach stationary state. On several issues, there is little consensus among these economists. Therefore, it gives an impression that it may not be proper to give a single synthesized model and name it as the Classical Model.

However, it is clear that the classical economists had explained growth process in terms of rate of technological progress and population growth. In their view, technological progress continues for some time, but finally slows down and the falling rates of profits further prevent capital accumulation. It is at this stage that the economy slumps into stagnation. Some of the broad features of classical theory follow.

The classical theorists have postulated production, which can be written as:

$Y = f(K, N, L, T)$

K = Capital

N = Labour Force

L = Land

T = Level of Technology

The output depends on the stock of capital, labour force, land, and level of technology. Technological progress is constrained by capital accumulation. Classical economists are of the opinion that, the process of technological progress was capital absorbing and therefore capital accumulation is a pre-requisite for a steady advance of technology.

Investment depends on profit. Classical economists opined that productive activities are motivated by profit, and thus, any productive investment is guided by the profit motive.

The labour supply and technological progress determine the level of profit.

R = f (L, T)

R = Profit

L = Labour Supply

T = Techonological Progress

According to classical economists, the level of profit is determined by the supply of the labour force, the population growth, and technological progress.

The size of labour force is constrained by the size of the Wage Fund.

L = f (W)

L = Labour force

W = Wage fund

The classical economists asserted that it is the amount of money that is available to pay the wage bill that determines the population growth.

The wage fund is determined by the level of investment

W = f (I)

W = Wage fund

I = Investment

The wage fund is defined as the amount of money available for paying wages to hired workers. It constitutes working capital, and is created out of savings.

According to classical economists, an increase in profits brings an increase in investment. This augments the capital stock, which, in turn, permits technological progress, and raises the wage fund. Increased wages lead to population growth, which raises labour costs (through diminishing returns to labour on land), and reduces profits. This circular process continues. As a result of reduced profits, investment falls, technological progress is retarded, wages decline, population growth slows, returns to labour on land increase, labour costs fall, and profits rise, and so on. In the long run, the classical economists envisaged a stationary, or stagnant state. In a mature economy, diminishing returns tend to outrun technological progress. Eventually, profits fall to such a low level that further investments stop, and wages and population cease to grow. This is termed the stationary state.

The circularity that we outlined above is even more apparent when we have the whole system before us. Let us look at a system of equations and its logic.

1)	Production	Q = f (L,K,S , T)
2)	Technology	T = T(I)
3)	Investment	I = Δ K = I(R)
4)	Profit	R = R(T, L)

5)	Employment	$L = L(W)$
6)	Wages	$W = W(I)$
7)	Total Output	$Q = R + W$
8)	Wage rate	$W = wL$

In order to understand the mechanism of the growth process, let us start with profits which are regarded as the prime movers of an economy. The cause and effect process proceeds as follows:

$$\Delta R \rightarrow \Delta I \rightarrow \Delta K \rightarrow \Delta T \rightarrow \Delta W \rightarrow \Delta L \rightarrow \Delta R.$$

An increase in profits brings an increase in investment. It permits capitalists to take advantage of the steady flow of improved techniques, and raises the wage fund. This leads to accelerated population growth, which, in turn, causes decreasing returns to labour on the land, thereby raising labour costs, and reducing profits. Contrarily, reduced profits mean reduced investment, retarded technological progress, a diminished wage fund, and the slowing down of population growth.

According to the classical school, when a population is relatively small, returns on land will be high, perhaps even increasing. However, as a population grows, it encounters rapidly diminishing returns. Technological progress takes place at a steady rate, provided enough capital is forthcoming to exploit the opportunities. Thus, in an advanced economy, diminishing returns to land, and the consequent rise in labour costs will outrun effective technological progress. Profit falls, then investment drops, technological progress is retarded, the wage fund ceases to grow, and so population also ceases to grow. Thus, the classical concept of the stationary state is a historical phase, and not just an analytical model. It is essentially a concept of a mature economy. Stagnation results from the natural tendency of profits to fall, and the consequent decline of capital accumulation. The end result of capitalist development is stagnation.

1.5 THE RELEVANCE OF CLASSICAL THEORIES TO UNDER DEVELOPED COUNTRIES

The classical theories of growth are limited in scope and specific in approach. They developed in England at the time of the Industrial Revolution, and suggested policy measures particularly suited to the problems of that period. Coincidentally, classical analysis is found to be useful in examining the growth problems of the present day underdeveloped countries. In fact, no other traditional theory of economic growth has so much relevance to the problems of the underdeveloped countries as classical theory. Most underdeveloped countries, today, experience the classic symptoms of economic stagnation, i.e. population growth, higher labour-land ratio, and low wages. The Lewis' Model of Dualism is an offshoot of classical theory. It is applicable to an underdeveloped economy with two sectors: a subsistence sector, and a capitalist sector. The distinguishing feature of the subsistence sector is the existence of disguised unemployment, which implies zero, or even negative, marginal productivity. Average productivity is very low. The capitalist sector is an advanced sector where capitalists use reproducible capital, and employ wage labour in the productive process in order to earn profits.

As the capitalist sector expands, it draws labour from the subsistence sector. It is assumed that the subsistence sector is the source of unlimited supply of labour. In other words, there are more workers who are willing to work than are demanded at the existing wage rate. The actual wage rate in the capitalist sector is determined by what the workers earn in the subsistence sector. Workers are paid in the subsistence sector with wages that are equal to their average productivity. The producers in the capitalist sector pay higher wages as an incentive for them to leave their traditional areas of work in the subsistence sector. The process of expansion continues until all surplus labour in the subsistence sector is absorbed in the capitalist sector.

1.6 A CRITICAL APPRAISAL OF CLASSICAL THEORIES

The following are the criticisms of classical theories

1) It is a static model as it does not exhibit any sequence. While it looks like a growth model, in a real sense it is not really a growth model.

2) The classical model does not emphasize the role of entrepreneurs, who really bring about innovations that lead to capital formation.

3) The classical theory is based on the unrealistic assumption of perfect competition. However, free and fair competition is never found anywhere.

4) It ignores the role of the state. State non-action is a highly impractical policy. In today's complex society, state intervention is indispensable.

5) It ignores the significant role played by the middle class in modern society. It only recognizes two classes: the capitalist, and the labourer class.

6) It neglects the significant contribution made by technological advancement and modern technical know-how.

7) Currently, technological modernization raises labour productivity and total factor productivity. Wages rise, according to the rise in labour efficiency.

8) It is wrong to say that capital accumulation leads to secular stagnation. In reality, it raises the demand for consumer goods, and the share of wages and profits.

9) The Malthusian theory of population and the Ricardian theory of diminishing return have no relevance in the capitalist or socialist countries that have modern technology.

10) The wage fund theory is absurd. Wages are never fixed or reducible as the classicists believe. Mill related the wage fund to capital, not national dividend.

11) A stationary state is not a likely reality, either for developed countries, or for underdeveloped countries. The stationary state is not necessarily undesirable. Rather, it is a pleasant social stage when people enjoy leisure, luxury, and peace with economic security.

12) Smith also failed to distinguish between the conditions of a static society and those of a dynamic society.

13) Ricardo's real interest was in the theory of distribution, and not in the theory of growth. He did not analyze the problems of employment and cyclical fluctuations.

You have read about the classical theory of growth and development, its relevance to underdeveloped countries and criticisms of classical theories. Now, try and answer the following questions given in the *Check Your Progress 3.*

Check Your Progress 3

Note: a) Write your answer in about 50 words.

b) Check your answers with possible answers given at the end of the unit.

1) Explain, briefly, the Classical Theory of Economic Growth.

....

....

....

....

2) Write three important criticisms of classical theory.

....

....

....

....

1.7 LET US SUM UP

In this unit, we explained the classical theory of economic growth. We studied Smith's model, Ricardo's model and J.S. Mill's theory of development separately. We made a critical appraisal of classical theory, and examined its relevance to the developing countries.

1.8 REFERENCES AND SELECTED READINGS

Adelman, I. (1961), *Theories of Economic Growth and Development*, Stanford University Press, California.

Dixit, A.K. (1976), *Theory of Equilibrium Growth*, Oxford University Press, Oxford.

Eltis, W. (2000), *The Classical Theory of Economic Growth,* 2nd Edition, Palgrave Macmillan.

Higgins, B. (1999), *Economic Development*, Universal Books, New Delhi.

Kindlberger, C. P. (1984), *Economic Development*, Mac Graw Hill, Singapore

Kuznet, S. (1971), *Economic Growth of Nations*, Harvard University Pres, Cambridge.

Mark, B. (1987), "Classical Economics," *The New Palgrave Dictionary of Economics*, Vol. 1, pp. 414-45.

Myrdal, G. (1968), *Asian Drama*, Pantheon, New York.

Samuel H. (1987), *Classical Economics*, Oxford: Blackwell.

1.9 CHECK YOUR PROGRESS-POSSIBLE ANSWERS

Check Your Progress 1

1) **Explain the doctrine of *laissez-faire***

   Answer: The doctrine of *laissez-faire* upholds the idea of economic liberalism. That is, let the natural forces of the economic system work independently, and they will produce results beneficial to both the individual, and to society. Guided by his philosophy of naturalism and optimism, Smith advocated a policy of economic liberty. This policy has both negative and positive arguments. Negative arguments are set against government interference in economic activities, while positive arguments demonstrated the desirability of free trade.

2) **Discuss Adam Smith's argument in favour of *laissez-faire*.**

   Answer: Smith gave two arguments in support of the doctrine of *laissez-faire*:

   i) Economic liberty allows for full and free working of the mechanism of the invisible hand in a competitive economy, which ensures the maximum national wealth

   ii) Economic liberty facilitates setting in forces which are responsible for the growth of the wealth of a country over a period of time.

Check Your Progress 2

1) **Discuss key features of Ricardian theory**

   Answer: According to Ricardo, capital accumulation increases the demand for labour by pushing up market wages. Rising wages lead to the growth of population which, in turn, brings wages to the equilibrium level of subsistence minimum. The marginal product (or, total product-less-rent) of capital and labour fall as a consequence of the law of diminishing returns. The relative share of labour (wages) increases and the relative share of capital (profits) falls. In the Ricardian analysis, two more forces determine the pattern of development. They are: the law of population and the law of diminishing returns. The process of growth will continue until profits fall to zero. At this stage, capital accumulation stops, and an economy reaches a stationary state.

2) **What is Say's Law? Explain.**

   Answer: Say's law means "Supply creates its own demand". This implies three things: (*1*) Money is a veil; its only function is to serve as a medium of exchange; (*2*) general over-production (market glut) is impossible; (c) full employment equilibrium is automatically ensured. So, in the long run, there can never be a market glut. Therefore, the free economy always attains full employment equilibrium in the long run. An imbalance in the labour market is the result of an imbalance in the goods market. Full employment equilibrium is automatically restored by free market forces.

Check Your Progress 3

1) **Explain the Classical Theory of Economic Growth, briefly.**

Answer: According to classical economists, an increase in profits brings an increase in investment. This augments the capital stock, which, in turn, permits technological progress, and raises the wages fund. Increased wages lead to population growth, which raises labour costs (through diminishing returns to labour on land), and reduces profits. The cause-and-effect process is circular, and proceeds as follows:

$\Delta R \rightarrow \Delta I \rightarrow \Delta K \rightarrow \Delta T \rightarrow \Delta W \rightarrow \Delta L \rightarrow \Delta R.$

2) **Write three important criticisms of classical theory.**

Answer: The following are three important criticisms of classical theories

i) It is a static model as it does not exhibit any sequence. While it looks like a growth model, in a real sense it is not really a growth model.

ii) The classical model does not emphasize the role of entrepreneurs, who really bring about innovations that lead to capital formation.

iii) The classical theory is based on the unrealistic assumption of perfect competition. However, free and fair competition is never found anywhere.