

Adam smiths theories of economic growth economics essay



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Abstract: The purpose of this essay is to explain Adam Smith's theories of economic growth contributing to the current economic development through investment and capital accumulation. Moreover, this will also show the role of agriculture in the industry sector and the division of labor in the agricultural sector to the industry sector in the economic development.

The great classical economists of the eighteenth century were all development economists writing about forces determining the progress of nations as the countries embarked on the process of industrialization. The question of why the pace of development differs between countries has been at the forefront of economic enquiry ever since. One of Adam Smith's most important contributions was to introduce the notion of increasing returns based on the division of labor and balanced between agriculture and industry. He emphasized that the growth of output and living standards is first and foremost on investment and capital accumulation.[1] What is the outcome of the investment and capital accumulation for a developing country?

First, to know the relationship between economic growth coming from investment and capital accumulation, we should know what capital accumulation means. Capital accumulation is that it enhances a country's capacity to produce goods in the future and enables it to grow fast. There are many types of capital goods[2] such as first, plant and machinery, used in the factories and offices, which yield no utility directly but produce consumption goods and services, infrastructure investment, which partly provides goods and services directly and at the same time makes other forms of investment more productive, for example transport facilities, telecommunications, power generation, the provision of water facilities and

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so on, second, expenditure on the research and development (R&D), which may improve the productivity of labor or capital, or both. R&D can lead to new inventions and then to innovation-either process innovation or product innovation. Process innovation makes the production of existing products more efficient. Product innovations involve the creation of new products that not only add to utility but also enhance productivity by enabling new ways of doing things, for example information technology. The last one is social expenditure such as investment in health and education, which also provides some utility directly but at the same time, makes individuals and society more productive.

Indeed if the capital is defined as any asset that generates the additional future stream of income to society, many goods and services ought to be included as a part of a country's capital stock. Developing economies lay great emphasis on the importance of capital accumulation, and stress the need to raise the level of investment in relation to output. Development is associated with industrialization and industrialization with capital accumulation. Rostow (1960) defined the process of take-off into sustained growth in terms of a critical ratio of investment to national product. Arthur Lewis (1955) has described the process of development as one of transforming a country from being a 5 per cent saver and investor to a 12 per cent saver and investor. In fact, it is common for countries to calculate fairly precise ratios of investment to national income that will be required either to achieve a particular rate of growth or to prevent per capita income from falling. H. G Johnson (1969) singles out capital accumulation in its widest sense as the distinguishing characteristic of development, and has

described the structural transformation of economies as a generalized process of the capital accumulation. He emphasizes that the condition of being developed consists of having established, efficient social and economic mechanisms for the maintaining and increasing large stocks of capital per head in the various forms. Similarly the condition of being 'underdeveloped' is characterized by the possession of relatively small stocks of the various kinds of capital.

The returns to investment in developing countries are likely to be much higher than in developed countries, which already have large quantities of capital per head. In countries where specialization and the division of labor is minimal, the scope for capital to permit more round about methods of production and increase productivity will be greater than where specialization has already reached a high level of sophistication. Moreover, in technologically backward countries the rate of growth of capital required to absorb new technology is likely to be greater than in advanced countries. By definition, technologically backward countries also have a backlog of technology to make up. Furthermore, in a labor-abundant economy with a low capital-labor ratio, the very act of capital deepening- giving each worker a little more capital to work with- may make a substantial difference to total product, much more than in countries where the process of capital deepening has been a continuing process of some length of time. All these factors represent important contributions that capital can make to economic progress, which may be relatively more important the smaller the initial capital stock of a country is relative to its population. It is a familiar

economic production that the scarcer one factor of production is in relation to another, the higher its productivity, all other things being equal.

Additionally, Adam Smith emphasizes that the increasing returns based on the division of labor. He saw this vision of labor gaining from the specialization as the very basis of the social economy.[3] This problem was explained by Arthur Lewis in a dual economy with a modern exchange sector and indigenous subsistence sector, assuming that there are unlimited supplies of labor in the subsistence sector in the sense that the supply of labor exceeds the demand for labor at the subsistence wage. The marginal product of workers in the subsistence sector is equal to or less than the subsistence or institutional wage so that a reduction in the number of workers would not lower the average (subsistence) product of labor and might raise it.

The marginal product of labor may be zero or negative in an economy that is still at a fairly low level of development and increasing a rapid growth of population[4]. One of diminishing returns in agriculture is an activity that is liable to diminishing returns of owing to the fixity of the supply of land. However, in the essay of Malthus on the Principle of Population (1798), it claimed that there is a constant tendency in all animated life to increase beyond the nourishment prepared for it. According to Malthus, population goes on doubling itself every twenty five years, or increases in geometrical ratio. In this case, it is a stage that land cannot provide further workers with a living unless the existing workers reduce their hours of work.

Moreover, Adam Smith also emphasizes that while the diminishing returns in the agricultural sector, increasing returns are prevalent in most industrial activities. He saw that the labor left in the agricultural sector is transferred to the industrial sector. He said that the division of labor (labor specialization) determined the level of labor productivity, but the division of labor is limited by the extent of the market. But the extent of market partly depends on the division of labor as the determinant of per capita income. Smith uses the example of the production of pins. There is no point in installing machinery to deal with the different processes of production if the market is very small. But they will use machinery for their production in economical saving if the market is large. To quote Smith again: When the market is very small, no person can have any encouragement to dedicate himself entirely to one employment, for want of power to exchange all that surplus part of the produce of his own labor, which over and above his own consumption, for such parts of the produce of other men's labor as he has occasion for.

Even though industry is the most important factor to economic development, in Smith's vision, the balance between agriculture and industry is essential for the growth and development process to proceed without impediment. Agriculture plays an important role in the process of economic development through a production contribution, a factor contribution, a market contribution and foreign exchange contribution.

The product contribution refers to the food surplus in agriculture sector to feed the industrial labor working in alternative occupations. In Rostow's model of economic growth, the take-off stage of development must be preceded by an agriculture revolution. He raised the example of the <https://assignbuster.com/adam-smiths-theories-of-economic-growth-economics-essay/>

revolution in Britain which is the first country to industrialize. The first experience of agriculture revolution is based on the abolition of serfdom and enclosure movement, which raised agricultural productivity and provided surplus labor and food to support industrial expansion.

In the less developed or developing countries, the marketable surplus of food is the essential stage in the early development because the development requires in the marketable surplus to increase in the labor productivity in industry. For instance, in Japan at the time of the Meiji Restoration (1867), when landowners were compulsorily taxed, and more dramatically in Russia in the 1920s, when there was mass genocide of the Kulaks (small prosperous landowners) during Stalin's collectivization program [Economic Growth, Development and Globalization, 129]. Moreover, the neoclassical model of development process recognized the importance of the marketable surplus that unless the marketable surplus rises as the demand for food increase, the price of food will tend to rise. Therefore, the marketable surplus is the major constraint on the industrial growth.

In the factor distribution for in industrial sector, there are two parts: a labor contribution and a capital contribution. The existent labor surplus plays an important role in the development process. Industrial sector can get the lower cost of labor released from the agricultural sector in the production process. It means that the lower the cost of industrial labor, the faster the rate of industrial expansion is. South-East Asian's industrial development is growing very fast fuelled by the cheap labor from the agriculture. For instance, the cheap labor in China's industries will lead its economic growth very fast for more than last two decades. Secondly, agriculture is a source of <https://assignbuster.com/adam-smiths-theories-of-economic-growth-economics-essay/>

saving and capital accumulation for industrial development. For example, the saving of farmer in the rural bank, the form of taxing the agricultural sector and using the proceeds for investment. Moreover, in traditional way, the government collects taxes through the price policies of marketing boards through establishing agricultural product market. The agricultural product price sold in the market is higher than one providing farmers.

The demand from agriculture is the major source of autonomous demand for industrial goods. In the developing countries, the agricultural sector is likely to provide the largest market for industrial goods. There are complementarities between agricultural and industrial growth. The World Bank's 1979 World Development report remarked that " a stagnant rural economy with low purchasing power holds back industrial growth in many developing countries." [5] In other words, a precondition for rapid industrial growth is a rapidly expanding agricultural sector, at least in terms of purchasing power. There are also relations between the price of the agricultural goods and industrial goods. It is meant that low price of agricultural goods for industries is the low cost for industries to produce or we can say that industries get the low price of material input. But there needs to be equilibrium terms of trade between the two sectors to achieve balanced growth between the two sectors.

In Adam Smith vision, without an extensive foreign market, manufactures could not well flourish. So agriculture is the important foreign exchange contribution because many countries in the world cannot grow or can grow but not enough for their demand. Moreover, the foreign exchange is also a resource like saving for industrial sector.

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In short, we can say that, Adam Smith theories on “ the growth of output and living standards is first and foremost on investment and capital accumulation” and the role of agriculture in development give a lot of benefit in contributing to the economic development, especially in the developing countries because all current developed countries started with the investment in machine, technology to improve their productivity in both the agricultural sector and industrial sector. In the agricultural sector in both the developed countries and developing countries, machinery is an important factor to improve the productivities and reduce the use of labors who can do many work in the same time. On the other hands, they can work in other sector, industrial sector to get the income to improve their living standard. Additionally, in the industrial sector is machinery and technology is efficiently encouraging the productivities. Many developed countries are using machinery and technologies in the industries both heavy and light industries. The growth of productivity makes the countries developed their economic very fast. Moreover, the current problem of the world is the imbalance between the agricultural sector and the industrial sector. So there is shortage in food to feed the world population. This shortage make the population of some countries live hungrily. The price of agricultural product is growing, making the world leaders including the United Nations warn the starvation and call for supporting the food aid for the poor counties which is facing this problem. So the theories of economic growth of classical Model are playing an important role in the contribution to develop and reduce the poverty and hunger in the current world.