Module 2

Lecture 6

Topics

Adam Smith III

2.3.1 Distribution Theory

- Distribution theory mainly refers to the theory how income is distributed among the owners of different factors of production viz. labor, capital and land.

- This requires a theory of how the prices of these factors of production are determined.

2.3.1.1 Wage

- Smith offered different theories for wage: subsistence theory, productivity theory, a bargaining theory, a residual claimant theory, and a wages fund theory.

- Smith was apparently aware of the possible contradictions involved in these different theories. But his formulations seem more realistic as we don't see only one mechanism in place in all the sectors.

- Smith pointed out that in the bargaining model laborers are disadvantaged in the context of eighteenth century England. This is because there are fewer employers than the employees, anti-union law but no law prohibiting formation of cartels by capitalists, and unlike poor laborers, capitalists have enough resources to survive through strike and lock outs.

- According to the wage fund doctrine, the most popular theory of wage among the classical economists, capitalists set aside a fixed fund to pay wage so that the laborers can live during the production process.

- This theory predicts that wage rate = wage fund/labor force.

2.3.1.2 Profit

- Smith was extremely brief in his account of profit. This position was common among the early classicals who made no serious attempt to explain profit until the 1820s, when they started responding to socialist criticism of profit.

- He accepted profit as a legitimate payment to capitalists for performing a socially useful activity.

- The lack of analysis of the emergence and nature of property rights in Smithian analysis makes it vulnerable to the attacks that would come later from Marxian point of view.

2.3.1.3 Rent

- Smith suggested at least four theories of rent: demands by the land lords, monopoly right over land, differential advantages and the bounty of nature.

- He also switched its view from :\rent is price determining" to \rent is price determined"

2.3.1.4 Rate of profit over time

- Capital accumulation is the key to the wealth of nation.

- But according to Smith the rate of profit will fall over time due to three reasons:

1. *Competition in the labor market:* Capital accumulation will lead to greater demand for labor which will raise wage and depress rate of profit.

2. *Competition in the commodity market*: Competition among producers will lead to over production which will reduce price and rate of profit.

3. *Competition in the investment market*: Employment of more and more capital on a fixed number of investment project will lead to decline in the return to capital.

2.3.2 Welfare

- Smith tried to formulate a measure of welfare. His starting point was more consumption means more welfare.

- But how to aggregate different types of commodities in a single measure?

- Money can be the yardstick of measurement.

- But what if value of money (i.e. prices of commodities) changes over time?

- Smith thought that disutility of worker can be a time invariant yardstick.

- However, he did not indicate how to measure laborer's disutility.