D.N.R.COLLEGE (A) BHIMAVARAM

P.G. DEPARTMENT OF ECONOMICS

E-CONTENT

SEMESTER -III PAPER – I

EVOLUTION OF ECONOMIC DOCTRINES

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UNIT –I

TOPIC: ADAMSMITH THEORY OF ECONOMIC DEVELOPMENT

Adam Smith is considered to be the father of economics. It is not so because he was first explorer in the field of economics, also not because he revolutionized economic planning by his maiden ideas, but because he abbreviated what he had received from his predecessors and handed it down as a guide to the coming generations.He was the editor and not the author, organizer and not the originator of economic science.

"He was the man of systematic work and balanced presentation, not of great new ideas but a man who carefully investigates the given data, criticizes them cooly and sensibly, and coordinates the judgements arrived at with others which have already been established".

Adam Smith contained all his ideas in his "Wealth of Nations". The most important aspect of this book was a Theory of Economic Development. Physiocracy came into existence due to mercantilism. They believed in science of natural laws and emphasised the significance of agriculture and contended that it is the only industry that can make country wealthy. Adam Smith's 'Wealth of Nations' was scientific not because it contained the absolute truth but because it came as a turning point, the beginning of all that came after, as it was the end of all that came before.

The main points of the theory are as under:

Natural Law:

Adam Smith proposes natural law in economic affairs. He advocated the philosophy of free and independent action. If every individual member of society is left to peruse his economic activity, he will maximize the output to the best of his ability. Freedom of action brings out the best of an individual which increases society wealth and progress. Adam Smith opposed any government intervention in industry and commerce.

He was a staunch free trader and advocated the policy of Laissez-Faire in economic affairs. He opines that natural laws are superior to law of states. Statutory law or manmade law can never be perfect and beneficial for the society, that is why Smith respects nature's law because nature is just and moral. Nature teaches man the lesson of morality and honesty. These exercise favourable effects on the economic progress of society.

Laissez Faire:

Adam Smith's theory is based on the principle of 'Laissez-Faire' which requires that state should not impose any restriction on freedom of an individual. The theory of economic development rests on the pillars of saving, division of labour and wide extent of market. Saving or capital accumulation is the starting point of this theory. He believed that “there is a set of rules or rights of justice and perhaps even of morality in general which are, or may be known by all men by hello either or reason or of a moral sense, and which possesses an authority superior to that of such commands of human sovereigns and such customary legal and moral regulations as may contravene them”.

The policy of laissez-faire allows the producers to produce as much they like, earn as much income as they can and save as much they like. Adam Smith believed that it is safe to leave the economy to be propelled, regulated and controlled by invisible hand i.e. the forces of competition motivated by self interest be allowed to play their part in minimizing the volume of savings for development.

Production Function:

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

Y = f (K, L, N)

K = Stock of Capital

L = Labour force

N = Land

He emphasized labour as an important factor of production along with other factors and observed, “The annual labour of nation is the fund which originally supplies it with all necessaries and conveniences of life which it annually consumes and which consists always either in immediate produce from other nations”. Since the growth is a function of capital, labour, land and technology and land being passive element is least important. Prof. Adam Smith regarded labour as father and land as mother. He wrote, “To him (farmer) land is the only instrument which enables him to earn the wages of his labour and to make profits of this stock”.

The production function does not conceive the possibility of diminishing marginal productivity. It is subject to law of increasing returns to scale. Smith argued that real cost of production shall tend to diminish with the passage of time, as a result the existence of internal and external economies occurring out of the increases in market size.

Adam Smith asserted that division of labour does not depend merely on technological feasibility, it greatly depends on the extent of the market as well and the size of market depends on the available stock and the institutional restrictions placed upon both domestic and international trade. Smith observes that, “when the market is small, no person can have encouragement to dedicate himself entirely to one employment, for want of power to exchange all the surplus part of production of his own labour, which is over and above his own consumption, for such parts of the produce of other man’s labour as he has occasion for”.

Smith also recognizes the importance of technological development for improvement in productivity and which is possible only if sufficient capital is available. He wrote, “The person who employs his stock in maintaining labour, endeavors, therefore, both to make among his workmen the most proper distribution of employment and furnish them with the best machines which he can either invent or afford to purchase. His ambition in both these respects is generally in proportion to the extent of his stock or to the number of people which it can employ”.

Division of Labour:

The rate of economic growth is determined by the size of productive labour and productivity of labour. The productivity of labour depends upon technological progress of a country and which, in turn, depends upon the division of labour. This division of labour becomes the true dynamic force in Adam Smith’s theory of growth. The only remarkable feature of Smith’s account of division of labour is pointed by Prof.

Schumpeter as “nobody, either before or after Adam Smith ever thought of putting such a burden upon division of labour. With Adam Smith it is practically the only factor in economic progress”.

Division of labour increases the productivity of labour through specialization of tasks. When a work is sub-divided into various parts and the worker is asked to perform small parts of whole job, his efficiency increases as now he can focus his attention more carefully. Thus, the concept of division of labour means the transference of a complex production process into number of simpler process in order to facilitate the introduction of various methods of production.

Adam Smith concentrated upon the social division of labour which emphasized the co-operation of all for satisfaction of the desires of each. It is the process by which different types of labour which produce goods to satisfy the individual needs of their producers are transformed into social labour which produces goods for exchanging them for other goods.

Adam Smith in his book 'Wealth of Nations' pointed out three benefits of division of labour:

1. Increase of dexterity of workers.

2. Saving time required to produce commodity.

3. Invention of better machines and equipment.

The third advantage implies that invention is the result of worker's intelligence. But Smith wrote that workers become 'as stupid and ignorant as it is possible for human creature to become as a result of division of labour'. Division of labour necessarily leads to exchange of goods, which highlights the importance of trade. In short, division of labour leads to exchange of goods which, in turn, promotes trade and widens the extent of market. Wide extent of market is an essential pre- requisite for economic development.

Capital Accumulation:

It is the pivot around which the theory of economic development revolves. The growth is functionally related to rate of investment. According to Smith, "any increase in capital stock in a country generally leads to more than proportionate increase in output on account of continually growing division of labour".

Capital stock consists of:

(a) Goods for the maintenance of productive workers.

(b) Goods for helping the workers in their productive activities.

Adam Smith distinguished between non capital, circulating capital and fixed capital goods. Non capital goods refer to those which are useful directly and immediately to their owner. Fixed capital refers to those goods which are directly used in production processes, without changing hands. Fixed capital consists of all the means of production.

Capital is increased by parsimony and diminished by prodigality and misconduct. The rate of investment was determined by the rate of saving and savings were invested in full. The classical economists also believed in the existence of wage fund. The idea is that wages tend to equal to the amount necessary for the subsistence of labourers.

If the total wages at any time become higher than subsistence level, the labour force will increase, competition for employment will become keener and the wages come down to the subsistence level. Thus, Smith believed that, "under stationary conditions, wage rate falls to the subsistence level, whereas in periods of rapid capital accumulation, they rise above this level. The extent to which they rise depends upon the rate of population growth". Thus, it can be concluded that wage fund could be raised by increasing the rate of net investment.

According to Smith, "investments are made because the capitalist want to earn profits on them. When a country develops and its capital stock expands, the rate of profit declines. The increasing competition among capitalists raises wages and tends to lower profits". So it is a great difficulty of finding new profitable investment outlets that leads to falling profits.

Regarding the role of interest, Smith postulated a negatively sloped supply curve of capital implying that supply of capital increased in response to decline in interest rate. Smith wrote that with the increase in prosperity, progress and population, the rate of interest falls and as a result, capital is augmented. With the fall in interest rate, the money lenders 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 rate of interest. But when the rate of interest falls considerably, the money lenders are unable to lend more in order to earn more to maintain their standard of living. Under these circumstances, they will themselves start investing and become entrepreneurs. 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 interest of land owners is closely related to general interest of the society.

Agents of Growth:

Smith has observed that farmers, producers and businessmen are the important agents of economic growth. It was the free trade, enterprise and competition that led farmers, producers and businessmen to expand the market and which, in turn, made the economic development inter-related. The development of agriculture leads to increase in construction works and commerce. When agricultural surplus arises as a result of economic development, the demand for commercial services and manufactured articles arises.

This leads to commercial progress and establishment of manufacturing industries. On the other hand, their development leads to increase in agricultural production when farmers use advanced techniques. Thus, capital accumulation and economic development take place due to the emergence of the farmer, the producer and the businessmen.

Process of Growth:

"Taking institutional, political and natural factors for granted, Smith starts from the assumption that a social group may call it a 'nation' will experience a certain rate of economic growth that is accounted for by increase in numbers and by savings. This induces a widening of market which, in 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 continuously and steadily.

Each situation grows out of preceding one in a uniquely determined way and the individuals whose act combine to produce each situation count individually for no more than the individual cells of a tree". The process of growth is cumulative. Division of labour made possible by accumulation of capital and expansion of market, increases national income and output, which in turn, facilitates saving and further investment and in this way, economic development rises higher and higher. Smith's progressive state is in reality the cheerful and hearty state to all the different orders to the society. But this progressive state is not endless. It ultimately leads to stationary state.

It is the scarcity of natural resources that stops growth. An economy in stationary state is characterized by unchanged population, constant total income, subsistence wage, elimination of profit in excess of the minimum consistent with risk and absence of net investment. In his opinion, an economy is stationary state finds itself at the highest level of prosperity consistent with its natural resources and environment.

The competition for employment reduces wages to subsistence level and competition among the businessmen brings profits as low as possible. Once profit falls, it continues to fall. Investment also starts declining and in this way, the end results of capitalist is stationary state.

When this happens, capital accumulation stops, population becomes stationary, profits are minimum, wages are at subsistence level, there is no change in per capita income and production and the economy reaches the state of stagnation. The stationary state is dull, declining, melancholy life is hard in stationary state for different sections of the society and miserable in declining state. Smith's theory is explained with the help of a diagram 1.

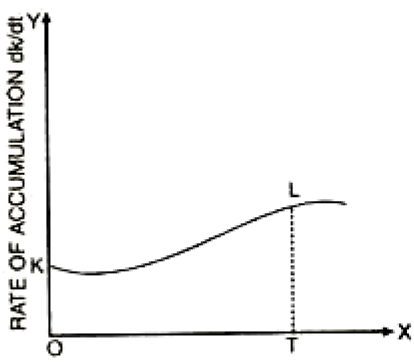

Fig. 1

Time is taken along the X-axis and the rate of accumulation along the Y-axis. The economy grows from K to L during the time path T. After T, the economy reaches stationary state. Linked to L where further growth does not take place because wages rise so high that profits become zero and capital accumulation stops.

Conclusion:

It can be concluded that Prof. Adam Smith did not propound any specific growth theory. His views relating to economic development are part of general economic principle propounded by him. R. Lekachaman says, “A good deal of Smith’s analysis reads as though written with todays UDC’s in mind”. In a very important aspect then this book (Wealth of Nations) was the theory of economic development.

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TOPIC: ADAMSMITH THEORY OF VALUE AND DISTRIBUTION

Adam Smith’s theory of distribution and value Smith's theory of distribution is key to understand his theory of (exchange) value. Even though Smith explains the “natural prices” and “real prices” before detailing how the “natural rates” of wages, profits and rent of land are determined, I believe that for a clear understanding of Smith's theory of the determination of exchange value one better fully understand how he determined the distributive shares before a full judgment of the theory on the determination of relative prices. The “natural price” of any commodity – formed by the sum of the natural rates of profit, wages and land rent, by “adding then up” – is a consequence of distribution. This is important because the “adding up” interpretation implies that because Smith added up the distributive shares to reach value he was led to determining them separately and independently. But I believe the opposite is true: the “adding up” theory of value was a manifestation of a broader attempt to “root” exchange value in the production of a material commodities. If a revenue is generated in the production process of a commodity, it had as a counterpart this material commodity whose exchange value exactly mirrors the value of the sum of all revenues payed in the production process. Therefore, the sum of money payed as original revenue is leveraged by a real wealth, being therefore an original source of value. All other revenues, although allowing its receivers to consume commodities – and thereby to destroy a stock of past produced commodities – does not have as a counterpart the creation of a new commodity, and must therefore oblige a redistribution of the existent commodities, of the existent original sum of exchange values. As a consequence, all taxes are derived from the original sources of values:

Wages

In Smith's WN the wage rates are determined by institutional elements in the labor market, mainly the higher bargaining power of the masters in relation to the workers, that forces the wages to a minimum subsistence level. This minimum allows for the reproduction of the working class and includes not only physiological necessities (like food and shelter), but also some socially determined necessities (for example a linen shirt and leather shoes in the case of the English working class). This subsistence wage rate will be different from actual market wage rate if the country experiences either a rapid capital accumulation or a declension of its stock. If the rate of accumulation is high, a temporary shortage of workers would follow which in turn would trigger a dispute among masters to hire the available workers, breaking their tacit arrangement to never raise wages. If, otherwise, the country was consuming its capital stock, there would be ever fewer job than workers, and the workers would not be able to receive even the minimum subsistence wage, being therefore left to a miserable condition. The labor market adjustment mechanism is based on population growth, the quantity supplied of workers adapting to the quantity demanded. The transmission channel is the infant mortality rate, and the argument, straightforward: the better the workers are fed and lodged, the higher the proportion of the surviving offspring, and being the birth rates somewhat constant, the faster the population growth5 . The key aspect in the adjustment mechanism is demographic growth determined by the actual, concrete conditions of living of the laboring class (I.xiii.15). Therefore, the labor market sets the real wage rate, the amount of commodities on which labor class will survive upon. This conclusion is explicit in Smith's text: The money price of labour is necessarily regulated by two circumstances; the demand for labour, and the price of the necessaries and conveniencies of life. The demand for labour, according as it happens to be increasing, stationary, or declining, or to require an increasing, stationary, or declining population, determines the quantity of the necessaries and conveniencies of life which must be given to the labourer; and the money price of labour is determined by what is requisite for purchasing this quantity. (WN, I.xiii.52) Smith coherently treats the monetary wage rate as being determined by the real wage rate along with the monetary prices of the wage basket.

Profits

Smith believes that the rate of profit is determined by the expansion or contraction of the amount of capital in a society. The “increasing or declining state of wealth of the society” affects profit in the opposite direction that it affects wages. “The increase of stock, which raises wages, tends to lower profit” (WN, I.ix.2). It is the increase of capital that affects the profit rate (and also the wage rate as seen above) and not the absolute amount of capital6 . Smith is clearly thinking in a dynamic context. It is as if the expansion of capital accumulation would be always temporarily constrained:

Smith also believes that there is a maximum amount of capital that a country could theoretically absorb, the “complement of riches” in relation to “the nature of its (the country) soil and climate, and its situation with respect to other countries”. The productivity in husbandry determines, once the total agricultural land of the country is used, a maximum population that the country can sustain. This gives a maximum number of surplus workers that can be set to productive or unproductive roles. Being the capital-labor relation in each branch of trade given by technology, the composition of demand will determine the maximum amount of capital that the country is able to withhold, its “full complement of riches”8 . Since this maximum implies in the impossibility of a further accumulation of capital once it is reached, the profits of capital must fall to a very low level

The determination of the rent of land

To determine the rent of land in Smith theory one has to seek the determination of the rent of land in the production of corn since it's the “corn rent” that determines the level of rent that all other products that can be produced in the “most common lands” – be it food or not – have to pay in order to be produced. It sets the “cost of use” of the most common land:

Then, to ascertain how the rent of land is determined in Smiths theory of distribution, one has to identify its explanation for the determination of rent in corn production. But Chapter XI on the rent of land is a long chapter that deals with a variety of subjects. For example, most of the discussion on the determination of rent deals with the explanation of how other agricultural produce converge or not to the rent of corn production, about how the silver value of commodities have varied and how relative prices of different types of agricultural produce can be used as a capital accumulation index. Therefore, singling out the corn determination requires attention. Nonetheless, it is possible to clearly identify three “parameters” determining the level of rent in corn production: technology – the physical inputs as well as the labor inputs of production –, the real wage rate and the profit rate. The real wage rate is determined in the labor market and the profit rate depends on the increase of capital stock, both outside the realm of corn production. It is then productivity, the physical inputs, that are mainly discussed on the chapter on rent. Relative prices plays no active role in the determination of the land of rent payed in corn production since the relative price of corn – compared to labor or to any other commodity – is not altered as a consequence of a change in the productivity of corn. Consider almost any other commodity other than corn in Smith's book and an increase in productivity, reducing directly or indirectly the labor inputs, will decrease its price compared to all other commodities. In fact, one of Smith's most underlined conceptions throughout WN is that the only way to augment wealth for all, to make all prices go down in relation to income, was to augment the productivity of labor (see for example the Introduction and Plan of Work). “If in any country the common and favorite vegetable food of the people should be drawn from a plant of which the most common land, with the same or nearly the same culture, produced a much greater quantity than the most fertile does of corn, the rent of the landlord, or the surplus quantity of food which would remain to him, after paying the labor and replacing the stock of the farmer together with its ordinary profits, would necessarily be much greater”

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TOPIC : NATURALISM AND OPTIMISM OF ADAMSMITH

Adam smith main theories are based on these two fundamental concepts.Whereas,naturalism indicates the natural or spontaneous origin of economic institutions ,optimism explains their beneficent character.

When he described the spontaneous or natural origin of economic institutions ,he thought that he had shown their beneficent character also .whereas all great economists approve of the concept of natural origin of economic institutions ,majority of them have rejected the concept of their beneficent character.

In so far as the spontaneous origin of economic institutions is concerned, both smith and physiocrats were at one .They thought that there was no need for any organisation or intervention from any quarter. The present economic state of the world is the result of the sweet will of the millions of individuals who under take economic activities of their own choice ,and not dictated by any organisation or supreme authority.

Adam Smith has given a number of examples of economic institutions which are spontaneous in origin and are beneficial in character. It is the instinct to barter and exchange one thing for the other that men resorted to specialization and division of labour. But division of labour gives rise to opulence and is hence beneficial. The institution of money arose as a spontaneous institution; but it removed the difficulties of barter system and facilitated trade, exchange and commerce and thus became useful. Adam Smith extended his principles of spontaneity to the supply of money and the distribution of gold and silver stocks between different countries of the world. There was a mechanism which automatically corrected any imbalance here. In the same say we may look at his contribution to the theory of capital accumulation where again the natural instincts of man lend a spontaneity of man lend a spontaneity to it and make it useful to the society. Another example of Smith's naturalism and spontaneity of economic institutions is his theory of demand and supply. Like Marshall, Smith pointed out that in the market, an excess of supply over demand would push down the price of the good under consideration and the price would rise in the opposite case. In this way a continuous process is always in operation whereby the balance between demand and supply gets restored. Smith also extends his "spontaniety'' in the case of population. He maintains that it is the variation in the wage rate that regulates the supply of labour through a variation in population

optimism

As economic institutions are governed by self-interest ,they are not merely good but providential also.In connection with the employment of capital he wrote--- ‘man is in this as in many other cases ,led by an invisible hand to promote an end which was no part of his intention .money division of labour ,capital, investment,etc .,are all good because they increase the scope of economic activity .lead to industrial development, and promote economic welfare. Industrial activity or commercial organisation ,keeping in view its advantages to the nation.

Optimism which is based on the universal experience of history of neither ,absolute nor universal. In distribution ,it has failed because of clash of interests – those of landed properties ,capitalist and wage earners .In this connection he observed. Thus, in the Wealth of Nations the concept of ‘naturalism’ is combined with ‘optimism’. Smith maintains that economic institutions are not only natural, but also beneficial. The institutions which have come into existence spontaneously through self interest of individuals are natural and beneficial, as these institutions ensure progress towards wealth and prosperity

. **Criticisms**

His theory of optimism seems to be correct in the area of production. But in the area of distribution, there is hardly any scope for optimism and harmony of interest. Smith himself has shown that in the field of distribution there is the possibility of a class of interest between labour and capital. His theory of optimism is not based upon completely scientific foundation. Individual interest and social interest may not coincide with each other all the time. Similarly, the private sector and public sector do not have the same common interest and the same efficiency. The conclusion drawn by Adam Smith with respect to naturalism and optimism is based on insufficient inductive or empirical study. These are not based on any casual relation or a prior theorising. It has been found that with the progress of capitalism, class division in society grows sharper and sharper. Smith is not right when he says that naturalism and optimism can be obtained without the help of the state. In fact, in many cases, state help will be necessary for obtaining optimism and naturalism.

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Topic: **JB SAY THEORY OF VALUE AND LAW OF MARKETS**

Jean-Baptiste Say (1767-1832) was a French classical, liberal economist and scholar. Say was born in Lyon in 1767, and had a distinguished career. He served on a government finance committee under Napoleon, taught political economy in France at the Athénée, the Conservatoire National des Arts et Metiers, and later at the College de France, where he was named as its chair of political economy.Jean-Baptiste Say was a French classical liberal political economist who greatly influenced neoclassical economic thought.He argued strongly in favor of competition, free trade, and lifting restraints on business.demand for something if it is supplied, given the right price. Say's law suggests that all markets will clear because there will always be.

Value

Say gave more importance to utility in his theory of value than his English contemporaries. He believed that we seek a thing because it possesses utility that determines value. Thus say tried to give a psychological theory of based on utility. But we must note that he did not speak of 'marginal utility'. While referring to reward for means(factors) of production. Say states that 'the value of the means of production comes from the value of the product which may result, Which may result,which is founded on the use which can be made of this product or the satisfaction which can be drawn from it.''

Say's Law of Markets

Say's Law of Markets was developed in 1803 by the French classical economist and journalist, Jean-Baptiste Say. Say was influential because his theories address how a society creates wealth and the nature of economic activity. To have the means to buy, a buyer must first have sold something, Say reasoned. So, the source of demand is prior to the production and sale of goods for money, not money itself. In other words, a person's ability to demand goods or services from others is predicated on the income produced by that person's own past acts of production.

Say's Law ran counter to the mercantilist view that money is the source of wealth. Under Say's Law, money functions solely as a medium to exchange the value of previously produced goods for new goods as they are produced and brought to market, which by their sale then, in turn, produce money income that fuels demand to subsequently purchase other goods in an ongoing process of production and indirect exchange. To Say, money was simply a means to transfer real economic goods, not an end in itself.

According to Say's Law, a deficiency of demand for a good in the present can occur from a failure of the production of other goods (which would otherwise have sold for sufficient income to purchase the new good), rather than from a shortage of money. Say went on to state that such deficiencies of production of some goods would, under normal circumstances, be relieved before long by the inducement of profits to be made in producing the goods that are in short supply.

However, he pointed out that the scarcity of some goods and glut of others can persist when the breakdown in production is perpetuated by ongoing natural disaster or (more often) government interference. Say's Law, therefore, supports the view that governments should not interfere with the free market and should adopt laissez-faire economics.

Implications of Say's Law of Markets

Say drew four conclusions from his argument.

1. The greater the number of producers and a variety of products in an economy, the more prosperous it will be. Conversely, those members of a society who consume and do not produce will be a drag on the economy.
2. The success of one producer or industry will benefit other producers and industries whose output they subsequently purchase, and businesses will be more successful when they locate near or trade with other successful businesses. This also means that government policy that encourages production, investment, and prosperity in neighbouring countries will redound to the benefit of the domestic economy as well.
3. The importation of goods, even at a trade deficit, is beneficial to the domestic economy.
4. The encouragement of consumption is not beneficial, but harmful, to the economy. The production and accumulation of goods over time constitutes prosperity; consuming without producing eats away the wealth and prosperity of an economy. Good economic policy should consist of encouraging industry and productive activity in general, while leaving the specific direction of which goods to produce and how up to investors, entrepreneurs, and workers in accord with market incentives.

Say's Law thus contradicted the popular mercantilist view that money is the source of wealth, that the economic interests of industries and countries are in conflict with one another, and that imports are harmful to an economy.

Criticism of says law

J.M. Keynes in his General theory made a frontal attack on the classical postulates and say’s law of markets

1. Supply does not create its Demand:

Say’s law assumes that production creates market (Demand) for goods. Therefore ,supply creates its own demand. But this proposition is not applicable to modern economies where demand does not increase as much as production increases . It is also not possible to consume only those goods which are produced within the economy.

2. Self-adjustment not Possible:

According to Say’s law, full-employment is maintained by an automatic and self-adjustment mechanism in the long run. But Keynes had no patience to wait for the long period for he believed that “In the long-run we are all dead.” It is not the automatic adjustment process which removes unemployment. But unemployment can be removed by increase in the rate of investment.

3. Money is not Neutral:

Say’s law of markets is based on a barter system and ignores the role of money in the system. Say believes that money does not affect the economic activities of the markets. On the other hand, Keynes has given due importance to money. He regards money as a medium of exchange. Money is held for income and business motives. Individuals hold money for unforeseen contingencies while businessmen keep cash in reserve for future activities.

4. Over Production is Possible:

Say’s law is based on the proposition that supply creates its own demand and there cannot be general over-production. But Keynes does not agree with this proposition. According to him, all income accruing to factors of production is not spent but some fraction out of it is saved which is not automatically invested. Therefore, saving and investment are always not equal and it becomes the problem of overproduction and unemployment.

5. Underemployment Situation:

Keynes regards full employment as a special case because there is underemployment in capitalist economies. This is because the capitalist economies do not function according to Say’s law and supply always exceeds its demand. For example, millions of workers are prepared to work at the current wage rate, and even below it, but they do not find work.

6. State Intervention:

Say’s law is based on the existence of laissez-faire policy. But Keynes has highlighted the need for state intervention in the case of general overproduction and mass unemployment. Laissez-faire, in-fact, led to the Great Depression.

Had the capitalist system been automatic and self-adjusting. This would not have occurred. Keynes, therefore, advocated state intervention for adjusting supply and demand within the economy through fiscal and monetary measures.

7. Equality through Income:

Keynes does not agree with the classical view that the equality between saving and investment is brought about through the mechanism of interest rate. But in reality, it is changes in income rather than the rate of interest which bring the two to equality.

8. Wage-cut no Solution:

Pigou favoured the policy of wage-cut to solve the problem of unemployment. But Keynes opposed such a policy both from the theoretical and practical points of view. Theoretically, a wage-cut policy increases unemployment instead of removing it.

9. Demand creates its own supply:

Say's law of market is based on the proposition that "supply creates its own demand". Therefore, there cannot be general overproduction and mass unemployment. Keynes has criticized this proposition and propounded the opposite view that demand creates its own supply.

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