CHAPTER 5  INCOME DISTRIBUTION AND GROWTH

It followed from the discussions in Chapter 2 that four main problems were associated with Ricardo's theory, namely

(1) There was no satisfactory solution of the income distribution problem. This problem was solved by Sraffa as was discussed in Chapter 3.

(2) Ricardo did not completely understand problems associated with effective demand, as did Malthus, but not until the great depression was the problem clearly formulated and generally understood.

(3) The wage rate was predicted to remain at the subsistence level since higher wages would mean that the workers got more children. Ricardo had no explanation of and increased standard of living among the workers.

(4) There was a definite limit to population growth. A new human being brought two new hands to the world but they had to be employed on less fertile soil than the previous ones. Ricardo had no explanation of technological development and population growth.

As far as effective demand is concerned, Malthus attacked the opinion that every new human being is a benefit to society and he stressed that if production is much larger than consumption then we must reach a stage where the willingness to save and produce ceases because of the lack of sufficient consumption. ¹)

The basic principle which Ricardo did not understand was the difference between a primitive economy where every peasant and artisan produces what he can and want to produce. What is left he takes to the market where he sells it for whatever price he can get.

¹) Malthus, T.R., Principles of Political Economy Considered with a View to their Practical Application, London 1820.
In a modern capitalistic economy things do not happen this way. Prices and wages are rigid and corporations react on changes in demand largely by altering volume. Demand determines how large production will be. If demand goes down then buildings, machines, and workers will have to remain idle. This causes further decline of demand and a depression develops. The important thing is to keep demand at a high level which was Keynes' message.

Concerning the theory of the growth of population and diminishing return, Ricardo's problem was more influenced by historical factors. In those days land was much more important than it is now and when land became less important some "failures" of the Ricardian theory were due to the followers of Ricardo who extended the concept of marginal rate of return to "capital". The only thing necessary to make Ricardo's theory function was to incorporate technological development, i.e. instead of assuming that marginal return is declining over time, it is possible that production is always rising due to technological development.

5.1 **Conditions for long run growth**

If we accept the central role of effective demand, the problem however is what determines it and how it can be sustained over time. Domar (1947), like Keynes, assumed that the willingness to invest, \( I \), was decisive and that if the propensity to save, \( s \), is known then demand, \( Y \), is determined by

\[
\frac{I}{s} = Y \tag{5.1}
\]

but if investment is increased then total capacity will go up

\[
\frac{IV}{K} = \frac{dQ}{dt} \tag{5.2}
\]

where \( Q \) is production capacity and \( K \) is capital.

The important thing now is to investigate the conditions under which effective demand and production capacity grow at the same pace.