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A SMITHEAN PERSPECTIVE ON INCREASING RETURNS

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Despite its recent re-emergence to analytical importance, the phenomenon of increasing returns remains outside the central core of neoclassical economics. The history of this idea (or set of ideas) might have been quite different if Adam Smith's explanation of the origins of trade had not been replaced by that of David Ricardo. To Adam Smith, mutually beneficial exchange emerges because of specialization, which, in its turn, implies the presence of increasing returns to the size of the exchange nexus. Even in a world of equals, trade offers mutuality of gain. There is no need for participants in the economic nexus to differ one from another. In the Ricardian logic, by contrast, trade presumably emerges because productive resources differ in their capacities to create economic value, at least among separate "goods." Specialization is a "natural" feature of resource endowments—a feature that is exploited by trade. Comparative advantage ensures the mutuality of gain. But, in this explanation, there is no direct linkage between the size of the exchange network and the degree of specialization that is viable. There is no need to introduce increasing returns. Comparative advantage may be present even if there are constant returns to scale, both for the economy and for its separate productive sectors.

Partisans may quarrel over whether the Smithean or the Ricardian explanation best satisfies Occam's criterion for scientific reductionism. But there is no disputing the historical fact that neoclassical theory, as it developed in the late nineteenth century, was basically Ricardian. The marginal productivity theory of distribution, and especially in its elevation of a mathematical theorem (Euler's) to explanatory purpose, with the side advantage of offering a counter to Marxian charges of exploitation, locates its roots in Ricardo's theory of rent. This latter theory, in turn, is based on the presumed fixity of one resource, land, which generates decreasing returns as labor is successively applied. And, almost as if by legerdemain, the diminishing returns model is converted into a constant returns logic by allowing for variability along all input dimensions. There is simply no analytical space for increasing returns in the orthodox neoclassical construction which, reduced to its essentials, retains the Ricardian stylization (two factors: labor, land; one product: wheat or wool). Adam Smith's elementary notion that the division of labor must depend on the extent of the market, a

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