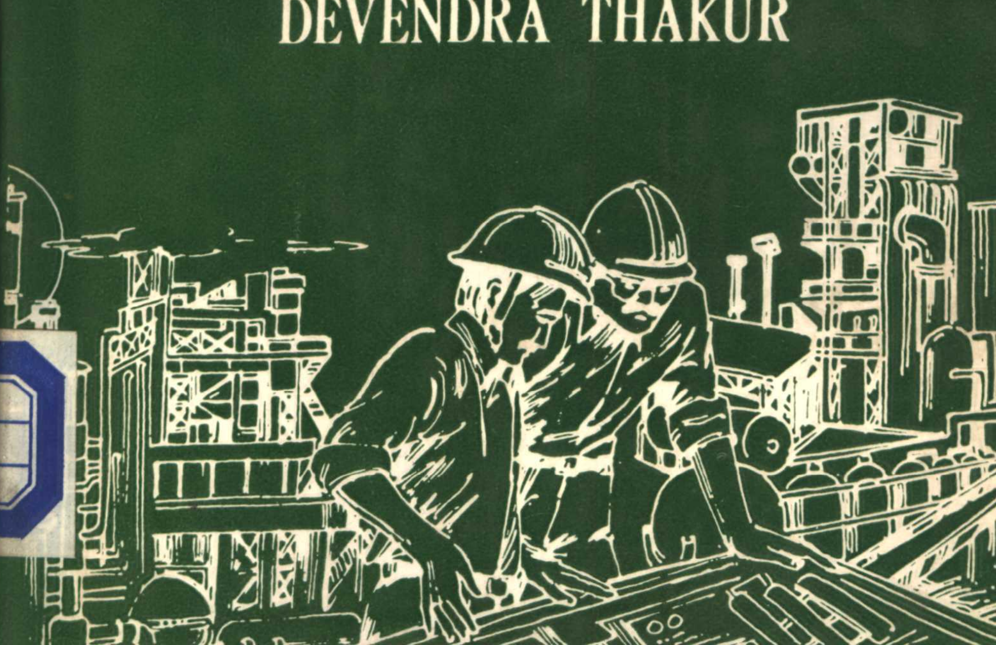
Planning for Economic Growth of Third World Countries

EDITED BY

DEVENDRA THAKUR



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DEEP & DEEP PUBLICATIONS
D-1/24, Rajouri Garden. New Delhi-110027

ISBN 81-7100-055-X

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Printed in India at Print India, A-38/2, Mayapuri, New Delhi-110064.
Published by DEEP & DEEP PUBLICATIONS, D-1/24, Rajouri Garden,
New Delhi-110027. Phone : 504498, 5435369.

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PREFACE

The problem of economic growth though dates back even to the birth of economics, yet it has got multidimensional interest and scientific approach after the World War II and since then economists are expatiating about economic growth by developing new theories. These theories, mainly propounded by western economists, are suitable for capitalistic economies which are industrially well advanced. So the expediency of these theories is highly sceptical in LDCs and in true sense they are incompetent in changing the outlook of the low developed countries (LDCs). The third world countries or LDCs—where economic growth is guided more by non-economic variables and less by economic variables —it is very difficult task to give impetus to economic growth by removing social, political, institutional and cultural hurdles. Thus for a formulation, which will emancipate the economies of the third world countries from the obsession of stagnancy, unemployment, persisting poverty and many other crucial problems; more tentative approach is needed.

With the aforesaid view, the present volume depicts some important economic formulations about the growth and development of the Third World countries. The discussion about the problems of economic growth begins with the classical theory. Then some very interesting analyses are added. Overall, various theories are well arranged and justify their position.

Now, I am heavily indebted to the Institute for Studies on Economic Development (ISVE), Napoli (Italy) and to "Journal of Economic Literature", without whose help this volume migh not been published. I am also very much thankful to Mr. Kamal Kumar Pandey, who helped me alot. At last I must pay my gratitude to Deep and Deep Publications, New Delhi, who published this volume.

Muzaffarpur DEVENDRA THAKUR

1

THE CLASSICAL THEORY OF THE LEVEL OF OUTPUT AND EMPLOYMENT

EVERETT E. HAGEN

During the century and a half following the publication of Adam Smith's *Wealth of Nations* (1776), a body of economic theory was developed step-by-step which has become known as the classical theory. Its main architects were David Ricardo, John Stuart Mill, and Alfred Marshall.[1] It did not concern itself primarily with the problem of employment. In the main it took full employment for granted, and discussed the forces which determine what goods would be produced, what the relative value of different types of goods and of different types of resources would be, and how the income from production would be distributed among the productive factors.

The classical economists took full employment (without inflation) for granted because they accepted an underlying theory of employment. This classical theory of employment leads to the conclusion that forces operate in the economic system which tend to maintain full employment, and hence tend to maintain output at the level which can be produced under conditions of full employment.

Full employment of course does not imply that there are no unemployed. Even at "full employment" there will be frictional or transitional unemployment-temporary unemployment between jobs or on entry into the labor force while searching for a job, unemployment due to lack of knowledge of available job opportunities, etc. Involuntary unemployment above this level, the classical theory of employment concludes, can occur only as a result of unusual disturbances. The term "involuntary unemployment" may be used, without rigorous definition, in the commonsense meaning of a state of being unemployed in spite of willingness to work at the going wage rate.

If involuntary unemployment occurs, the theory states, natural economic forces will tend to eliminate it and to restore full employment. Depressions can therefore be expected to be only infrequent, and when they occur, short lived.

This conclusion may puzzle a reader who knows of the severe and prolonged depressions of the 1930's, the 1880's, the 1870's, and other periods. Nevertheless, this conclusion of the classical school of economists rested upon careful reasoning and deserves serious study.

A. SAY'S LAW OF MARKETS

The central pillar of the classical theory of employment is commonly known as "Say's law", because it was first clearly and definitely stated by the early nineteenth century French economist Jean B. Say. Persons not versed in classical economic theory had asserted in Say's day, just as they assert in our day, the depressions are caused by "general overproduction", the production of more goods than people can afford to buy. Say said that this is impossible, because when any unit of goods is produced, that act increases the supply of goods and the demand for goods by equal amounts, so that aggregate demand always equals aggregate supply.

Say's Law of Markets in a Barter Economy

In expounding this principle, Say "to reaside the monetary veil", to "get at the realities behind it", in the belief that this would permit a sounder analysis of economic truths. That is, he analyzed the economic system as it would operate if there was no money and all exchange of goods was by barter. Like almost all of the classical economists, he believed that money facilitates exchange and thus increases the efficiency of production but causes no essential change in the operation of the economic system.

It is easy to see that in a barter economy, Say's law of markets is correct. When a seller offers an item for barter, he increases the supply of goods, but since he is seeking other goods in exchange for his, he increases the demand for other goods correspondingly. Aggregate supply is always not only equal to, but identical with, aggregate demand. If there is an "oversupply"

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of one type of goods, this means that the supplier of that good cannot find suppliers of other goods who are willing to offer him enough of their goods in exchange for his to justify his continuing to produce so much. From his point of view, there is a scarcity of other goods. These are not available in sufficient quantity to meet the demand. The lack of demand for the good he is producing may cause him to curtail production of that good, but it cannot cause involuntary unemployment (except transitionally), for the same situation which motivates him to curtail production of the good which is in relative oversupply will motivate him (or his employees) to shift to production of the goods whose supply is inadequate to meet the demand for them.

If there is increased production of all goods, all suppliers will have more to offer. This however constitutes an increase in aggregate demand as well as in aggregate supply. Human wants being insatiable, persons with goods to offer will gladly accept in exchange more of some other things. Their increased demand will probably not be for additional quantities of the types of goods they have obtained previously, in the same proportions, but if not, it will be for these goods in different proportions or for different types of goods to whose production the added demand will cause a shift of productive efforts. Thus, an increase in total output can never cause general unemployment, but at worst only transitional or frictional unemployment. (...).

Say's Law in a Money Economy : Will Demand Equal Total Income?

The classical economist's thesis that production creates income sufficient to purchase all the output at prices high enough to cover both the accounting costs and a profit margin has been seen to be correct, with certain qualifications in the case of an economy with expanding value of output. The fact that this is true is not, however, sufficient to prove that Say's law is true in a money economy, even at a constant level of output. For Say's law states that aggregate demand is always equal to value of aggregate output. All that has been shown above is that aggregate income is equal to the value of aggregate output. If total demand (by consumers, government, and for planned of intended investment) is less than total current income; then aggregate demand will be less than aggregate income; and aggregate demand will therefore be less than the value of total output. Some output will be left on the hands of producers who had produced it for sale; there will be either an unintended increase in inventories or sales at a loss.

At this point the reader must be careful to avoid confusion in terminology. Total spending is always equal to the value of total output, in one sense, since if someone had not paid or contracted to pay to have the output produced. But if a business enterprise produces goods for sale and then has them on its hands because there are no buyers at a price equal to the cost of production, demand for its goods cannot be said to be equal to the cost of production. The enterpriser who invests in inventories because he cannot get rid of them at profitable prices is, so to speak, an unintentional buyer. Aggregate demand in the economic system is equal to the cost of production (including profits) of output, only if aggregate spending by intentional buyers is equal to the cost of production. That is, personal consumption expenditure plus government purchases of goods and services plus planned investment must equal the aggregate cost production of output. To show that this will be true at any level of output, it is necessary to show that savings will equal planned investment at any level of output.

This equality between demand and the cost of production of course does not mean that every individual producer will receive the cost of production of his total output, but only that producers in the aggregate will do so. Some producers may be facing inadequate demand, so that they are curtailing output, while others are facing more than sufficient demand and are induced to expand.

The belief that aggregate demand will equal aggregate income, i.e., that all saving will find investment outlets, no matter how great the volume of output and income, was held almost universally by economists from the time when classical economic theory was first expounded in full form by John Stuart Mill, down through the time of Alfred Marshall and his followers to very recent years. A few theorists, most notably Malthus, dissented, but until Keynes wrote the General Theory they were unable to formulate a full-blown theory expressing the theoretical basis for their dissent, and their voices were lost in the general chorus of agreement. The basis for this belief is a theory that interest rates will behave so as to bring saving and investment into equality, at any level of income and of saving. This theory of the equilibrating action of interest rates is summarized in the paragraphs which follow.

Consumers and business enterprises find it convenient to hold on hand a certain amount of money. The term money is used here to include demand deposits as well as currency and coin. The amount of money held will be the amount required for the current operations of the business, or in the case of consumers to make disbursements between pay periods; to meet emergencies which may arise; and for related purposes. The amount held will be a determinate amount, related in the case of a consumer to the size of his income and to his spending habits, and in the case of a business enterprise to the size and nature of the business operations.

If a consumer saves part of current income, he will not accumulate any part of the savings in the form of increasing money balances—unless his income and expenditures are rising, so that he desires larger cash balances for purposes such as those mentioned above. Similarly, an enterprise will not accumulate any part of its revenues in the form of increasing money balances, unless its volume of activity is expending. For to do so would be to sacrifice the income which could be earned by lending the money out at interest. Typically, therefore—so the classical theory runs—current savings will be put to work earning interest; for example, they may be used to buy bonds or stocks, or may be placed on deposit in savings banks, building and loan associations, or other institutions which pay interst on deposits.[2]

Government may of course decide to hoard any surplus of revenues above expenditures—that is, simply to hold funds idle. But in a period of stable full employment without inflation, such as would normally exist if the classical theory is correct, there would be no occasion for this. It may therefore be assumed that if any government had a surplus of revenues, it would use them to retire outstanding debt, so as to save the interest outlay. This debt retirement would place government savings in the hands of the bond holders, and presumably the funds would thereafter be handled like any private savings. If the government had no debt it could be expected to reduce taxes, thus eliminating its saving.

Thus, all current savings, the classical theory argued, can be expected to be placed on the market as funds available for loan. The financial institutions entrusted with them will of course not hold them idle, thus losing the potential income from them but will lend them out. These loans will be made at the going rate of interest, if possible. But if there are not enough borrowers at the going rate, rather than hold loan funds idle the institutions will offer them for loan at a lower rate—thus reducing the going rate to a lower level. Can it be expected that enough borrowers will appear to take all of the funds and put them to use ?

Since the great bulk of all borrowing is done by business enterprises, the discussion will be confined to them; for simplicity, borrowing by consumers will be ignored. Business enterprises borrow in order to invest the funds. At any given time, various investments—new enterprises, or expansion of existing enterprises —will be expected to yield various rates of return. To the persons considering them, some projects may seem to offer the prospect of a 6% return, others 5½%, 5%, as so on, down to some conceivable investments which do not offer the prospect of yielding any return on the money invested and, hence would not be undertaken under any circumstances.

If funds can be borrowed at an interest rate below the expected rate of return on any given investment, it will pay to borrow money and make the investment. (If funds can be borrowed at an interest rate exactly equal to the expected rate of return, there will be neither a gain nor a loss in undertaking the investment, and it is a marginal question whether or not the enterpriser will decide to undertake it.) At any given going rate of interest, it may be presumed that all investment projects promising rates of return down to that rate are being undertaken. That is, current investment at any time consists of all projects which offer prospects of a rate of return over cost equal to, or greater than the going rate of interest.

Under these circumstances, any reduction in the rate of interest may be expected, the classical theorists argued, to induce an expansion of the current flow of investment. Further, on both empirical; and theoretical grounds, many classical economists argued that a large amount of added investment would be induced by each small reduction in the rate of interest.

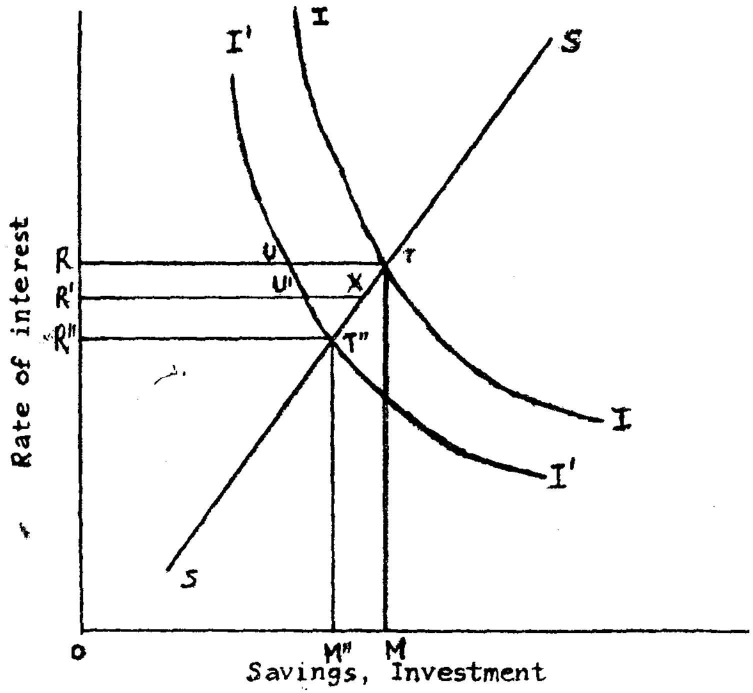
This chain of reasoning ignores some of the complexities of real life, but these were believed by classical economists not to impair the applicability of the theory to the real world. One of these complexities is that there is not one but many rates of interest on different types of loans. This was dealt with by noting that whenever "the rate of interest" is mentioned for simplicity, what is referred to is the entire complex of rates of interest, which in general move up and down together. Usually, a rate of interest on "riskless" loans was conceived of as the basic rate, and the excesses of other rates above it as margins for risk.

Another complexity is that in real life no one rate of return on an investment project is anticipated with certainty. There is always a greater or less degree of uncertainty concerning the future. While the enterpriser considering the project may view some rates of return as more probable than some others, uncertainty is a prominent characteristic of his anticipations. Classical theorists recognized this fact, but argued that it may be assumed for simplicity of discussion that the enterpriser behaves, as a result of the various possible rates of return which face him, just as he would if some one rate of return—sort of an average of the probable rates—faced him.

Assume that the economy is in a period of full employment. This implies that the full employment flow of saving, is being invested, so that aggregate demand equals the cost of production, including profit margins, of aggregate output. Now assume that because of some change in conditions, the flow of saving becomes for the moment greater than the flow of investment. This may become true because investment declines. Or, consumers may become stocked up with consumer durable goods, and may reduce their consumption expenditures and increase their saving. In either case, the flow of loan funds will not be able to find takers at the going rate of interest. According to the classical theory, what would happen ?

Because they had funds available for loan for which there were no takers, the institutions holding these funds would reduce the interest rate at which they offered loans. This would probably reduce the flow of saving. (Present day economists are not so sure that if the interest rate were reduced, consumers would find saving less attractive and would consume a larger proportion of their income). But, regardless of its effect on saving, the reduction in interest rate would increase the number of investment projects regarded as profitable and would increase investment activity. Inability to find borrowers would induce financial institutions to lower the rate of interest to the rate at which investment demand was equal to the flow of savings, so that all loan funds found takers. Thus, at any level of income and of saving, the interest rate mechanism can be expected to equilibrate the flows of saving and investment, and by doing so to insure that there will be demand for the aggregate output of the economic system, no matter how large.

This theory can be illustrated diagrammatically. In the following diagram, curve SS is the schedule of aggregate saving at full employment in an economic system It has been drawn so as to indicate that the flow of saving per time period (measured along horizontal axis) will be slightly higher at higher interest rates (which are measured along the vertical axis). If it were assumed that saving remained the same at any rate of interest, so that SS were vertical, the analysis would not be altered in any significant way. The investment curve (II) indicates that the flow of investment per time period (also measured along the horizontal axis) will be greater, the lower the interest rate.



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