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ECONOMIC THEORY AND THE UNDERDEVELOPED COUNTRIES

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Economic Theory and the Underdeveloped Countries

by

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How far is the economic theory of the industrially advanced countries applicable to the underdeveloped countries? This question has been raised, at one time or other, by a variety of people. Some of the sociological writers have questioned the applicability of the concept of the "economic man" to the underdeveloped countries where traditional values and attitudes still prevail. The Historical and Institutional economists have argued that the generalizations of economic theory are based on the particular circumstances of the advanced countries and are therefore not "universally valid". Finally, there has been a long line of critics from the underdeveloped countries. In the 19th century, Hamilton, Carey and List questioned the applicability of the English classical free trade theory to the underdeveloped countries of that period, viz. the United States and Germany. They have been followed, amongst others, by Manoilesco from Southeast Europe and Prebisch from Latin America. With the emergence of the underdeveloped countries of Asia and Africa, the questioning of the usefulness of the "Western" econom ic theory to these countries has become widespread. Now, many Western economists, not normally regarded as Historical or Institutional economists, have joined the ranks of the critics.

There are two main lines of criticism currently adopted against economic theory. The first is to elaborate the older line of criticism, stressing the differences in the social and institutional settings and stages of development between the advanced and the underdeveloped countries. This may be described as attacking the "realism" of economic theory. The second and newer line of attack is to question the "relevance" of economic theory to the underdeveloped countries. It is argued that "Western" economic theory is geared to the preoccupations of the advanced countries which, having already achieved sustained economic growth, are concerned with other problems, such as the optimum allocation of resources, the maintenance of full employment and perhaps the prevention of "secular stagnation". Thus the conventional economic theory is likely to be out of focus, if not largely irrelevant, for the central problem of the underdeveloped countries which is to initiate and accelerate the "take-off" into sustained growth.

Critics vary considerably in the emphasis they attach to these two different lines of attack.[1] But they share a common viewpoint on other issues. First, their attack on the applicability of economic theory to the underdeveloped countries is closely linked up with their attack on the applicability of free trade and laissez-faire policies to these countries. Thus, their sharpest attack on "Western" economic theory is reserved for the "orthodox" classical and neo-classical theory associated with the laissez-faire approach. The "modern" Keynesian and post-Keynesian economics is accepted less critically and is frequently used in support of deficit financing for economic development or as a basis for overall economic planning in terms of aggregate capital requirements to achieve a target rate of increase in national income,

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[1] D. Seers, The Limitations of the Special Case, The Bulletin of Oxford Institute of Economics and Statistics, May 1963, stresses the "realism" aspect while G. Myrdal, Economic Theory and Underdeveloped Regions, London, 1957, stresses the "relevance" aspect.

assuming a fixed capital output-ratio. Other modern developments of the neo-classical General Equilibrium theory, such as welfare economics, input-output analysis, linear programming, etc. are also acceptable provided they are used not as techniques for studying the performance of the market economy but as techniques . of planning.

Further, all the critics share a common suspicion of the dispassionate "positivist" approach advocated by some of the orthodox economists.[2] The critics feel strongly that something should be done very urgently to relieve the poverty in the underdeveloped countries. They are also sceptical of the possibility of maintaining strict ethical neutrality in economics, and regard "positivism" merely as a cloak for inertia and an underdeveloped social conscience. Thus they feel that economists should give up the pretence of traditional academic detachment and become the champions and spokesmen for the underdeveloped countries. Some of them have come to look upon the economics of the underdeveloped countries, not as a subject of impartial study but as an exercise in making out a persuasive case for increasing international economic aid to these countries.

The aim of this paper is to clarify and appraise some of the issues which have arisen at the present stage of the discussion on the question of the applicability, particularly the "relevance" of economic theory to the underdeveloped countries. Since this is closely bound up with the further question of the applicability of the lasissez-faire policy to these countries, we shall make use of the arguments directed against the market

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[2]E.g. Myrdal, <u>op. cit</u>., Ch. 12; Seers, <u>loc. cit.</u>, p. 83.

mechanism to illustrate the arguments directed against economic theory. To clear the air, the underlying standpoint adopted in this paper towards planning and private entreprise in the underdeveloped countries may be stated as follows. There is no reason to suppose that economic policies considered appropriate for the advanced countries will prove to be equally appropriate to the underdeveloped countries. But this "realistic" objection to generalizations should apply not only to the laissez-faire but also to the planning policies in the underdeveloped countries. Further, given the wide differences which exist among the underdeveloped countries themselves with respect, say, to the degree of population pressure, the overall size of the economy, the general level of administrative efficiency and the coherence of the institutional framework, etc. it is highly unlikely that any single standard model of development planning will be appropriate for all of them.[3]

The plan of this paper is as follows. In section 1 we shall examine the various arguments directed against the market mechanism in the underdeveloped countries and use them to illustrate and clarify the various arguments directed against the applicability of economic theory to these countries. In section 11 we shall argue that while the need for a greater "realism" is fully conceded, the arguments directed against the "relevance" of the "Western" economic theory to the underdeveloped countries are more debatable. In particular, we shall argue that the orthodox static theory of the optimum allocation of resources is as relevant as any other part of the existing economic theory. In section 111 we shall argue that a

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[3]For a fuller development of this argument, see my book, The Economics of the Developing Countries, Hutchinson, London, 1964.

realistic approach to the underdeveloped countries has been hindered not only by the tendency to generalize from the "special case" of the advanced countries (as some critics have maintained) but also from the tendency to generalize from the "special case" of a particular underdeveloped country, such as India; and that this has been aggravated by the popularity of the "take-off" theory and by the tendency of some of the modern writers to treat the subject not as an academic discipline but as an adjunct to making out a persuasive general case for increasing international economic aid to the underdeveloped countries.

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When the sociological writers questioned the applicability of economics to the underdeveloped countries on the ground that people there do not behave like the "economic man", they were questioning the "realism" of economic theory. It is not difficult to meet this type of criticism by showing that, with suitable adaptations to take into account local circumstances, the demand and supply analysis can be made to explain the behaviour of individuals in the market and the prices and quantitites bought and sold, etc. in the underdeveloped countries as well as in the advanced countries. For instance the much cited case of the "backward-bending" supply curve of labour in the underdeveloped countries (even if it really exists) can be explained in terms of the demand and supply apparatus, not to speak of refinements such as the "income effect" and the "substitution effect". Similarly, even the reaction of the "subsistence sector" to the impact of the exchange economy can be dealt with by extending the concept of "retained" demand and supply and the factor-proportions analysis of the international trade theory.[4] But this type of defense does not impress

[4]Cf. H. Myint, "The Classical Theory of International Trade and the Underdeveloped Countries, Economic Journal (1958).

some of the modern critics who are questioning the "relevance" of economic theory to the underdeveloped countries. They are not really concerned with the question whether the basic tools of economic theory, such as the demand and supply analysis, can explain economic behaviour in a wide range of underdeveloped countries. What they are concerned with is whether it is important for the underdeveloped countries to give a central place to the study of the market mechanism and how far the theory of the optimum allocation of resources which goes with this approach is relevant for countries seeking rapid economic development.

Now, the discussion would have been much simpler if the critics had simply concentrated on this suggestive line of attack. We could then go on to discuss the usefulness or otherwise of the concept of the static optimum for economic development. But what they usually tend to do is: first to identify the existing "orthodox" theory with the laissez-faire approach; next to argue that the free play of market forces in the underdeveloped countries will not lead to an optimum allocation of resources because the conditions of Perfect Competition, such as, perfect mobility and divisibility of resources and perfect knowledge, are lacking; and finally to emerge with the twin conclusion that both the existing economic theory and the laissez-faire policy are inapplicable to the underdeveloped countries. This type of argument tends to obscure a number of issues.

First, take Perfect Competition. It may be taken for granted that the ideal conditions required by it will not be fulfilled in any real life situation, whether in the advanced or the underdeveloped countries. What is more interesting is to find out how far these two types of country suffer from the same types of market imperfections and how far the existing theories of imperfect competition arising out of the problems of the mature industrial economies are relevant to the underdeveloped countries at a much earlier stage of development in market institutions. Further, given the important differences in population pressure, the overall size of the economy, and the general stage of development etc. among the underdeveloped countries, it would be interesting to find out how far the different types of underdeveloped country suffer from different types of market imperfections. But many critics have been distracted by the easy target offered by the Perfect Competition model from making a "realistic" exploration of how the market mechanism actually works or fails to work in the different types of underdeveloped economic framework.

This has an interesting consequence on current writings on "planning" in the underdeveloped countries. On the one hand, we have the rejection of the Perfect Competition model. On the other hand, it is quite fashionable to formulate "pure" planning models, with given target figures of outputs, given production functions with constant sectoral capital-output ratios and given supplies of resources and make a great show of testing the formal consistency of the plan. Such a plan is supposed to cover the economy as a whole, but the fact that most governments of the underdeveloped countries control a relatively small part of their G.N.P. (say 10 to 20%) through taxation is used as evidence that there is a larger scope for the expansion of the state sector rather than as the evidence of a need for a more systematic analysis of how the private (including the subsistence) sector will react to government policy. Although some lip service is paid to the role of the fiscal, monetary and commercial policies of the government, the attention is focussed mainly on the "quantifiable" aspects of the plan. Thus much in the same way as the Perfect Competition model fails to tell us how the market mechanism will actually overcome the existing immobility of factors and particularly existing imperfect knowledge, the "pure" planning model fails to tell us how the state mechansim will actually perform these tasks in the given administrative and institutional framework of an underdeveloped country. The substitution of the world "planning agency" for "the market mechanism" merely glosses over the actual problems of the mobilization and allocation of resources according to the plan and above all the problems of co-ordination and flexible readjustments. Thus the failure to study systematically how the economic forces work in the private sector of the underdeveloped countries, which produces the bulk of their GNP, has contributed to the failure to develop a satisfactory analysis of the "mixed economy" in the underdeveloped countries.

Next, take the optimum. Much confusion has been caused by the habit of identifying the laissez-faire approach with the theory of the optimum allocation of resources. Although there is a historical association, there is no necessary logical link between the two. Thus it is possible to accept and work on the basis of an optimum allocation of resources without accepting the laissez-faire policy: for instance, welfare economics is mainly concerned with correcting the market forces to get closer to the optimum. Conversely, it is equally possible to reject the concept of the optimum as being too "static" and yet advocate a laissez-faire policy. The case for laissez-faire can then be made on other economic grounds, such as that it is likely to impart a "dynamism" to the economy by stimulating enterprise, innovation and investment. Thus in criticising the working of the market mechanism in the underdeveloped countries, it is necessary to distinguish clearly whether we are concerned with its defects as the means of attaining the (accepted) norm of the optimum allocation of resources or whether we are concerned withthe inadequacy of the concept of the optimum itself for the purposes of promoting the economic development of these countries.

Few critics have done this. Instead, they tend to bring out further objections against the market mechanism in the underdeveloped countries which are also used as the arguments against the applicability of the existing conventional economic theory to these countries. These various arguments may be grouped under four main lines of attack on the market mechanism.

(1) The first type of criticism runs in purely relative terms.[5] It is argued that the market mechanism works more imperfectly in the underdeveloped than in the advanced countries for various reasons, such as, a greater degree of immobility and indivisibility of resources and imperfect knowledge. Thus free market forces will lead to larger deviations from the optimum, requiring a correspondingly greater degree of state interference in the underdeveloped countries compared with the advanced countries. This type of criticism implies that the market imperfections in the advanced and the underdeveloped countries differ in degree rather than in kind and that the existing theory of the optimum and the deviations from the optimum may be usefully extended and adapted to deal with the problems of the economic development in the latter countries.

(2) The second type of criticism is based on the view that the most important problem facing the overpopulated underdeveloped countries is that they suffer from a surplus of labour and a shortage of other factors, viz. capital and natural resources. It is argued that this fundamental disequilibrium in factor proportions cannot be corrected merely by improving the allocative efficiency of the market mechanism on the basis of given resources, techniques and pattern of consumers' demand.[6]

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[5] Most critics have put forward this argument at one time or another. For a clear exposition of this view, see T. Balogh, Economic Policy and the Price System, United Nations Economic Bulletin for Latin America, March, 1961.

[6] Cf. e.g., R.S. Eckaus, The Factor-Proportions Problem in the Underdeveloped Countries, American Economic Review, September, 1955.

So long as these structural determinants of the economy remain unchanged perfect competition even if it were attainable would merely bring out this problem sharply: according to the logic of the optimum theory, since labour is redundant relatively to given wants and technology, it should have zero wages. This type of criticism implies a rejection of the concept of the static optimum. But unfortunately, in the absence of a thorough-going dynamic theory, many exponents of this view revert to the conventional methods of correcting the deviations from the static optimum. This can be best illustrated by the argument that the manufacturing sector of an underdeveloped country should be subsidized or protected because it is having to pay positive wages to labour whose social opportunity cost in agriculture is zero.[7]

In this connection, it may be noted that current writings tend to restrict the market mechanism too narrowly to its role of allocating given resources, neglecting its possible longer-term effect on the supply of factors, particularly capital.[8] Private savings may increase through improvements in the market for finance or through a rise of a capitalist class ploughing back profits. Even if it is decided that savings should increase only through public channels, such as taxation, marketing boards and the issue of government securities, the success of such a policy will still depend considerably on the market factors including the stage of

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[7]Cf. e.g. W.A. Lewis, Economic Development with Unlimited Supplies of Labour, The Manchester School, May, 1954, p. 185.

[8]In international trade theory, there has been some discussion of how far the expansion of primary exports of the underdeveloped countries tends to aggravate the initial "skewness" of their factor endowments. Cf. C.P. Kindleberger, Foreign Trade and the National Economy, Ch. 3.

development of the exchange economy and the development of a capital market.

(3) The third type of criticism is based on the view that the underdeveloped countries are trapped in a very stable low-income equilibrium and that they can be jerked out of this only through a "balanced growth" development programme big enough to overcome the smallness of the domestic markets and to take advantage of the economies of scale and complementarities. It is argued that at its best, the market mechanism can only make one-at-a-time "marginal" adjustments whereas an effective development programme requires large "structural" changes introduced by a simultaneous expansion of a wide range of complementary industries.

Without going into all the different versions of the "balanced growth" theory, it is sufficient to point out that we can adopt at least two different attitudes towards the role of the optimum allocation of resources in economic development, depending on the version of the theory we favor. (a) One version emphasizes the overall size of the investment programme which must be large enough to overcome technical indivisibilities and the smallness in the size of domestic markets caused by the low levels of purchasing power in the underdeveloped countries.[9] Those who adopt this version tend to attach a greater importance to the problem of the aggregrate level of investment and effective deman d than to the problem of better allocation of resources at a given level of economic activity. Professor Hirschman has justifiably described this as "a variant of the

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[9]The most notable exponent of this version is P.N. Rosenstein-Rodan. Contrast, however his early paper, Problems of Industrialization of Eastern and South-Eastern Europe, E.J., 1943 with his Notes on the Theory of the "Big Push", 1951.

Keynesian analysis of the slump".[10] Many of the "balanced growth" economists of this school would, for instance, be willing to put up with the possible distortion in the allocation of resources through inflationary methods of financing development rather than cut down the overall size of the investment programme. (b) This may be contrasted with the other version of the "blanced growth" theory which stresses the interrelationships between investment in different sectors of the economy and the need for a government "planning agency" to co-ordinate the investment plans so as to achieve an optimum allocation of resources.[11] Those who adopt this version believe that the market mechanism is ineffective in the under-developed countries, not because the people there do not behave like the "economic man" in responding to its signals, but because the market signals themselves are defective and cannot accurately forecast what the future economic situation would be, after a complex of large-scale interrelated projects has been carried out. Thus, far from belittling the importance of the optimum, this second group of "balanced growth" theorists have made important contributions to the theory of the optimum involving complex inter-relations between investment in different sectors of the economy over a period of time.

(4) Finally, there is the criticism which is based on the view that the free play of market forces tends to fossilize or exaggerate the existing

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[10] A.O. Hirschman, The Strategy of Economic Development, p. 54.

[11] Cf. e.g., T. Scitovsky, Two Concepts of External Economies, J.P.E. April, 1954 and H.B. Chenery, "The Interdependence of Investment Decisions," in Abramovitz et al, The Allocation of Economic Resources, Stanford, 1959.

market imperfections and the inequalities in income and bargaining power which are to be found in many underdeveloped countries.[12] The idea of the cumulative disequalizing forces has been applied both to the international economic relations between the advanced and the underdeveloped countries and to the internal economic relations between the "advanced" and the "backward" sectors or groups of people within each underdeveloped country. This type of criticism attempts to break sharply away from the conventional ideas of a stable equilibrium and the optimum and focus attention on the concept of the "dualism" in the economic structure of the underdeveloped countries which underlies most other types of criticism of the working of market mechanism in these countries.

Although the ideas contained in this line of attack are suggestive they have not been satisfactorily formulated so far. The concept of "dualism" needs more systematic study and the theoretical mechanism of how the cumulative disequalizing factors work has been sketched out in a rather impressionist manner. For instance, while the fragmentation of an economy into a "advanced" and a "backward" sector will lead to a deviation from the optimum in a static sense, might not "dualism" have certain dynamic advantages enabling the "leading" sector to drag the "lagging" sector in its wake? Following the trend of thought suggested by Professor Hirschman's "unbalanced growth" approach, might not an attempt to impose a dead-pan uniformity and equality between the different sectors of the economy lead to the elimination of "growth points" and dynamic tensions for further

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[12] Cf. e.g., T. Balogh, "Static Models and Current Problems in International Economics," Oxford Economic Papers (June, 1949); also H. Myint, "An Interpretation of Economic Backwardness," Oxford Economic Papers (June, 1954) and G. Myrdal, op. cit., ch. 3.

economic development? These questions bring us to the difficult problem of choice between economic equality and rapid economic development. Here the critics are not always clear whether they object to the free play of market forces because they want to prevent economic inequality for its own sake or whether because they think that this inequality will in its turn inhibit the growth of the economy as a whole.

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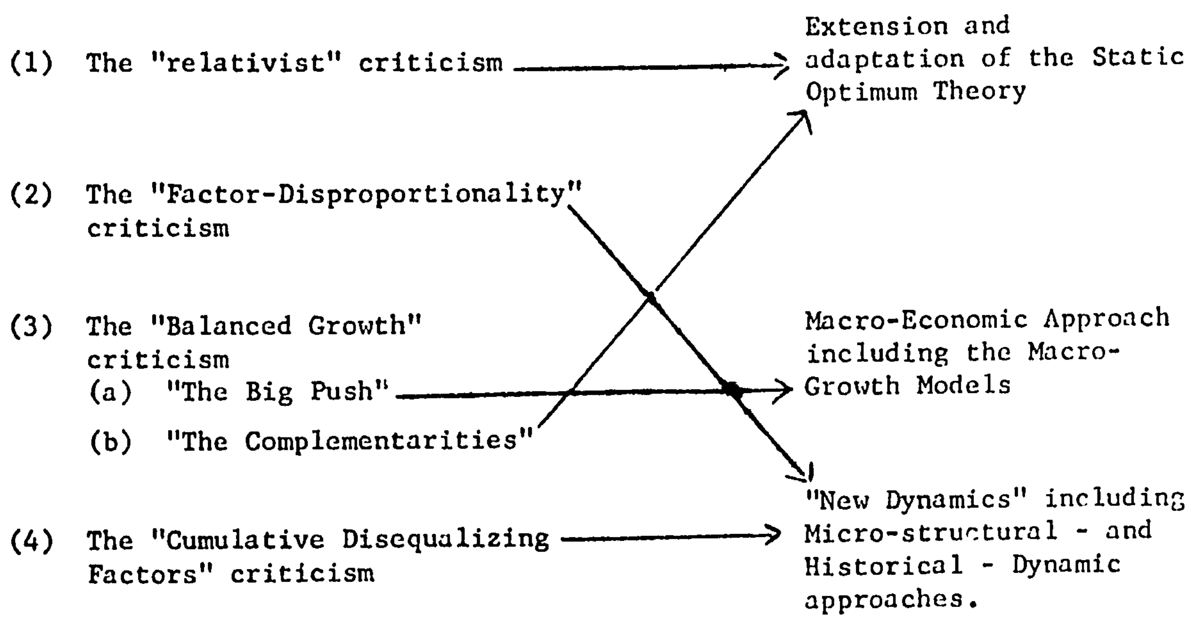
The relations between the four main types of criticism of the market mechanism in the underdeveloped countries and the theoretical approaches they suggest for development economics may be summed up schematically as follows:



We are now in a position to appraise the criticisms directed against economic theory (as distinct from those directed against the market mechanism) in the context of the underdeveloped countries. There can be no serious quarrel with those critics who stress the need to increase the "realism" of economic theory by taking into account the various social, historical and institutional differences between the advanced and the underdeveloped countries. If anything, our analysis has suggested the need also to take into account the differences between the underdeveloped countries themselves with respect to the degree of population pressure, the overall size of the economy, the general level of economic development and institutional framework and various other factors which may be expected to introduce significant differences in the structure and texture of their economic life. In particular, we have suggested that a failure to study systematically how the market forces actually work or fail to work in the different types of underdeveloped framework has contributed to the failure to develop a satisfactory analysis of the "mixed economy" in the underdeveloped countries. A study of the different patterns of market imperfections in different types of underdeveloped country is a largely unexplored subject.[13]

The argument of those critics who question the "relevance" of "Western" economic theory, in particular, the relevance of the "orthodox" static theory of the optimum allocation of resources to the underdeveloped countries is more debatable. In the light of the criticisms (2) and (4) above, few will question the need for a thorough-going "new" dynamic approach to economic development involving changes in the supplies of factors, techniques of production and the "transformation" of the whole organizational structure of the economy. It may be that such a new approach means widening the scope of conventional economics to take into account the broader sociological factors which made up "Political Economy" in the classical sense. But

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[13]For a pioneer effort in this field, see Morton R. Solomon, "The Structure of the Market in Underdeveloped Economies," Quarterly Journal of Economics (August, 1948).

there is no need to argue about this since orthodox opinion has never imposed a methodological interdict on such a process. As Marshall wrote: "each economist may reasonably decide for himself how far he will extend his labour over that ground".[14]

What is really at stake is how far we should discard the existing static optimum theory before we have time or are clever enough to build up a satisfactory "dynamic" approach to the underdeveloped countries. That is to say how far are we to follow Professor Myrdal's advice to the "Young Economists in the Underdeveloped Countries" "to throw away large structures of meaningless, irrelevant and sometimes blatantly inadequate doctrine and theoretical approaches".[15] There are a number of considerations against following this advice, if this means throwing away the static optimum theory.

The first and most powerful is that the underdeveloped countries are too poor to put up with the burden of preventable waste which arises even within the static framework of given wants, techniques and resources. As Professor Galbraith has suggested in his Affluent Society, only the richer advanced countries can afford to take an indulgent view towards the misallocation of resources. There is a real danger that in searching for newer approaches and more advanced techniques of analysis, the economist (particularly if he is a visitor) in the underdeveloped countries may easily overlook quite glaring sources of wastage through misallocation, whether due to spontaneous market imperfections or inept state interference.

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[14] Principles, p. 780; see also Robbins, Nature and Significance of Economics, 2nd ed., p. 150.

[15] G. Myrdal, op. cit., p. 101.

To give an example of the latter: after her independence, Burma followed a policy of cutting out all private middlemen from her rice marketing board operations and opening numerous state buying stations all over the country to purchase rice directly from the peasant producers. Until very recently, the government also insisted on paying the same fixed price all the year round, to cut out "the speculators". It also insisted on paying the same fixed price to all inland rice cultivators, irrespective of their distance from the main seaports (on grounds of regional justice). The consequences of conducting a marketing board on the basis of zero rate of interest and storing cost and zero transport cost are apparent from elementary optimum theory. As it happened, the rice crop which normally took about four to six months to be cleared under free market conditions now had to be cleared almost at once, since no one had any incentive to hold the rice stocks. This would have wrecked a very much more efficient marketing machinery than the government had been able to provide: the wastage and deterioration of the rice through bad storage e.g., fire, rain, theft, mixing of different grades, etc. was enormous. Further, the remoter regions which used to grow rice for local consumption, now sold their crop to the state buying centre which sent it down to seaports for export so that consignments of milled rice from the seaports had to be sent back to those remoter regions to prevent food shortages, entailing two useless journeys on the country's limited transport system. Yet, many economists visiting Burma during this period characteristically overlooked this "simple" but extremely wasteful misallocation of resources in their preoccupation with the more elaborate development plans, including the expansion of investment in "infra-structure". It is hard to believe that this is an isolated instance.[16]

If the underdeveloped countries are too poor to put up with the waste from preventable misallocation or resources, they are presumably also too poor to forgo immediate sources of relief from poverty for the sake of larger benefits promised in the futre. Here, the time-preference which the critics have adopted on behalf of the underdeveloped countries shows a curious kink. In arguing for more international aid, they stress the urgent need to do something to give immediate relief to the underdeveloped countries; but in other contexts, they tend to adopt a much lower valuation of the present in favor of the future. Thus they generally stress the longer-run social benefits from various forms of development expenditure to justify their immediate cost to the developing countries. Again, as against the orthodox presumption that the underdeveloped countries should choose less capital intensive methods of production with quicker returns, some of the critics would defend capital intensive methods on the ground that these are necessary for a higher rate of economic growth in the future. Thus the critics may be regarded as exercising the same pattern of time-preferences in the choice of theoretical techniques when they urge that the existing

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[16] See however, A.C. Harberger, Using the Resources at Hand More Effectively, American Economic Review, May, 1959. Harberger aruges that for economies like Chile, Brazil, and Argentina, reallocating resources, with existing production functions, "would raise national welfare by no more than 15 per cent". He considers that although substantial, this is relatively small compared with the large potential dynamic gains to be obtained from technical improvements raising labour producitvity. One may reply that any source of gain is likely to appear small compared with the gains from technical improvements. But from the point of view of this paper Harberger's article remains an interesting attempt to apply the optimum analysis in a quantitative manner to the underdeveloped countries.

static theory should be discarded in favor of a new dynamic theory which is rather sketchy at present and which promises to yield results in the somewhat indeterminate future. There are strong reasons to be worried about the future of the underdeveloped countries; but there are equally strong reasons to be worried about their present poverty and the former should not be stressed almost to the exclusion of the latter. If it is urgent to give immediate relief to the underdeveloped countries by stepping up international aid, it is equally urgent ot find out how far they can help themselves by stopping obvious sources of waste through misallocation of resources. The significance of the conventional static theory of the allocation of scarce resources to the underdeveloped countries can be properly appreciated only in this perspective.

So far we have been concerned with criticisms (2) and (4). Let us now turn to criticism (3a) which may be regarded as the Keynesian criticism of the orthodox economics. The tendency to neglect the problem of allocating scarce resources in the writings on the underdeveloped countries has been aggravated by the "backwash" effect of the Keynesian Revoluation. In the early postwar years at least, the Keynesian reaction against orthodox economics was automatically extended from its original context in the advanced countries to the underdeveloped countries. The Keynesian approach was enthusiastically adopted both as a basis of economic planning at a macro-economic level and also as an argument for the deficit financing of development plans. Since then there has been an increasing realization of the need to probe below the macro-economic approach into the "structural" and "frictional" factors in the underdeveloped countries. Nevertheless, the point raised by criticism (3a), viz. how far we should put up with the possible distortion effect of inflation on the allocation of resources before cutting back the overall size of the investment programme, still remains a live issue dividing the expansionist and the orthodox economists. But even here an important change is noticeable. In the earlier days, the case for deficit financing of economic development was made mainly at the macro-economic level. Thus it was argued that the investment expenditure financed by pure credit creation would expand the money incomes but keep them stabilized at a certain level according to the Multiplier theory. Thus the increase in physical output from the newly created capital goods would have a chance to catch up with the increase in money incomes until at last prices were restored to the initial level and inflation destroyed itself.[17] More recently, however, the structural and allocative factors have been brought into the forefront. It is now argued that a mere negative elimination or ending of the inflationary pressure will not lead automatically to an optimum allocation of resources and that what is really needed are "carefully discriminatory policies" designed to correct the structural imbalance and market imperfections in the underdeveloped countries.[18] One can follow up this point by asking how far the government of an underdeveloped country will in fact be in a position to pursue such discriminatory policies effectively and consistantly after the inflationary pressure and balance of payments difficulties have got beyond a certain point.[19]

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[17] W.A. Lewis, Economic Development with Unlimited Supplies of Labour, Manchester School, May, 1954, p. 165. Lewis himself points out "the usual objections against applying multiplier analysis to inflationary conditions, namely the instability of the propensity to consume, the effect of secondary investment and the dangers of cost inflation".

[18] T. Balogh, Economic Policy and the Price System, U.N. Economic Bulletin for Latin America, March, 1961, p. 53.

[19] For instance, the differential advantages offered by tariff protection to "infant industries" are likely to be swamped under random short-term speculative rises inprices of the non-protected imports when successive rounds of quantitative import restrictions have to be imposed because of a balance of payments crisis. For a fuller treatment see my paper, Ch. 7 in International Trade Theory in a Developing World, eds., R. Harrod and D.C. Hague, Macmillan, London, 1963.

But for our present purpose, it is sufficient to point out the shift of emphasis from the Keynesian approach to the optimum approach.

We can now pull together the treads of our argument so far. As shown by our chart, the various criticisms of the working of the market mechanism in the underdeveloped countries have suggested three types of theoretical approach to these countries: viz. (i) The extension and adaptation of the existing static theory of the optimum allocation of scarce resources; (ii) the extension of the Keynesian macro-economic approach, including the macro-growth models of the Harrod-Domar type; and (iii) the introducion of a new thorough-going dynamic approach which is capable of dealing with the changes in the long-run supplies of factors of production and changes in the techniques of production involving the "transformation" of the whole organizational structure of the underdeveloped economies. In the post-war writings on the underdeveloped countries there has been some progress made in the application of the optimum theory to development economics, particularly on the problems of complementary investment and of optimization over a given plan period.[20] But nevertheless, the optimum approach to the underdeveloped countries has been unduly neglected by the critics of the "orthodox" economics, partly because they identify this with the laissez-faire type of liberal economics, partly because they feel that anything short of a thorough-going dynamic approach should be discarded and partly because of the "backwash" effect of the Keynesian Revolution.

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[20] E.g., H.B. Chenery, loc. cit., in Ambromovitz et al. The Allocation of Resources, and also Comparative Advantage and Development Policy, A.E.R. Proceedings, March, 1961; also A.K. San, The Choice of Techniques, 1961 and O. Eckstein, Investment Criteria for Economic Development and Intertemporal Welfare Economics, Q.J.E., February, 1957.

While fully admitting the need to develope a new dynamic approach to the underdeveloped countries, we have tried to show: (1) that the orthodox static theory of allocation of scarce resources remains as "relevant" to these countries as any other part of economic theory so long as they suffer from serious misallocations of resources which they can ill afford and (2) that the optimum approach can be made more fruitful by a "realisic" study of how the market forces actually work or fail to work in the different settings of the different types of underdeveloped country.

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Some critics have attributed the lack of "realism" in the current writings on the underdeveloped countries to the tendency of the Western economists to generalize from the "special case" of the advanced countries.[21] But this is only half the trouble; the other half of the trouble must be traced to the tendency to generalize about all underdeveloped countries from the "special case" of a particular type of underdeveloped country; and this has been aggravated by the tendency to treat the whole subject as an adjunct to making out a persuasive case for increasing international aid. Thus it is no accident that the theory of economic development of the underdeveloped countries should come to be dominated by a "conventional" model of the underdeveloped country which most closely resembles India. For, the case forincreasing international aid to the underdeveloped countries is strongest when we have a country like India. Given India's acute population pressure on natural resources and material poverty, the case for increasing

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[21]E.g., Sears, loc. cit., pp. 79-83 and passim.

aid to her on purely humanitarian grounds is obvious. Given her low ratio of foreign trade to national income, she cannot hope to earn enough foreign exchange through the expansion of her exports even if the market prospects for them were brighter and when she has reached the limits of borrowing on commercial terms, there is little alternative but to rely on aid. One further consequence of a low ratio of foreign trade to national income is that foreign exchange shortage cannot be overcome by increasing domestic saving. Again, given the very large overall size of her economy, it is reasonable to suppose that she will be able to reap the economies of scale from setting up a large and interrelated industrial complex, including a capital goods sector orientated towards the domestic market. Finally, whatever our views about India's chances of ultimate success in achieving economic development through integrated economic planning, it is generally admitted that her general institutional framework and her administrative and planning machinery are well in advance of other developing countries. Thus in India's case, both the need to receive material aid and the ability to absorb aid for successful economic development are stronger than in most other underdeveloped countries. Only Mexico and Brazil at about the same stage of general development as India, but without her population pressure, seem to have a comparable capacity to absorb material aid.

Now there is nothing wrong with concentrating on such a type of underdeveloped country, provided it is clearly recognized as a very "special case". The danger arises from trying to generalize from the Indian case and in particular, trying to apply the standard Indian model of development planning to other underdeveloped countries. Here are some of the more obvious limitations of this "special case". (i) Although population is growing very rapidly all over the underdeveloped world, there are still many sparsely populated countries, covering most of Latin America, considerable parts of Africa and most of Southeast Asia, where the Indian type of extreme pressure of population on natural resources does not apply. The concept of "disguised unemployment" has limited application for these countries and their problem is how to make the best use of the available elbow room of natural resources before plunging into the more heroic measures of development required by the Indian situation. (ii) Even among the overpopulated countries, the overall size of the population and area of India has no peer except for China. Many of the overpopulated countries are much smaller countries, which, unlike India, have a high ratio of foreign trade to national income and which because of their smallness cannot hope to imitate the Indian model of industrialization based on a substantial capital goods industry and orientated mainly towards the domestic market. Short of organizing themselves into larger common market units for which they are not politically ready, exports, particularly export of primary products, must continue to play an important part in their economic development. In this respect the position of the smaller overpopulated countries, some of them overcrowded islands, is harder than that of a big overpopulated country like India with a domestic market potentially large enough to yield the economies of scale. While a few small countries like Hong Kong and Puerto Rico may have found an escape route in the export of "simple manufactures" and/or emigration, this is not likely to be open to the others because of various obstacles, partly of their own creation, and partly created by the advanced countries. (iii) Above all, it should be stressed that the underdeveloped countries are at widely varying stages of general social, political and economic development. At one end of the scale are a few countries like India, Mexico and Brazil which have reached a stage of development where they may be considered to be within a reasonable striking distance of the "take-off". The rest of the underdeveloped countries are at different sub-stages of the "pre-take-off" phase, tailing off into a considerable number of countries which are hard put to maintain even the minimum of law and order, political stability and public services and which clearly do not yet possess the necessary institutional framework to carry out elaborate economic development planning.

Given the popularity of the conventional Indian model of economic development, however, most underdeveloped countries have tried to fulfill the first and the secor of Professor Rostow's conditions for the take-off: viz. "(a) a rise in the rate of productive investment from (say) 5 percent or less to 10 percent of national income (or net national product); (b) the development of one or more substantial manufacturing sectors, with a high rate of growth". But in their preoccupation with quantitative planning and target figures, they have neglected his third elusive condition: "(c) the existence or quick emergence of a political, social and institutional framework which exploits the impulses to expansion in the modern sector and the potential external economy effects of the take-off and gives to growth an on-going character".[22] It turns out that condition (c) is the most important of the three in the sense that unless it can be fulfilled it is not possible to keep the two other conditions fulfilled for long. It

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[22] W.W. Rostow, The Take-Off into Self-Sustained Growth, E.J., March, 1956, p. 32 and The Stages of Economic Growth, p. 39.

is also the most important factor determining an underdeveloped country's capacity to absorb aid productively.

Yet in spite of the fact that the majority of the underdeveloped countries are either just emerging from the "traditional society" or are somewhere in the "pre-take-off" stage, the discussion of this earlier phase is perhaps even more unsatisfactory than the rest of the take-off theory.[23] The central problem of these countries is not how to plan for an immediate take-off but how to compress the pre-take-off phase into a few decades instead of "a long period up to a century or conceivably more" which the Western countries are said to have taken. Here, one may agree that if these countries are not yet ready for the final "big push" into take-off, they need not rely solely on the unaided working of the market forces to shorten the preliminary period. In the past, even the so-called "laissez-faire" colonial governments encouraged the growth of the exchange economy, particularly through the provision of better transport and communications. But beyond this, analysis has not proceeded very far.

For instance, the success of a policy of concentrating on "infra-structure" investment will depend on the various economic factors determining the structure and behaviour of the "subsistence sector" and on the question how far its persistence is due to the limitations on the demand side, i.e. lack of marketing facilities and outlets and how far it is due to limitations on the supply side, i.e. lack of a marketable surplus. Yet there is little systematic study of the mutual interactions between the "subsistence sector" and the "money economy" (including the government sector) in the

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[23] Cf. S. Kuznets, Notes on the Take-Off, in the Economics of Take-Off into Sustained Growth, Rostow, et.al, Macmillan, 1963.

different types of underdeveloped country, taking into account the differences in the degree of population pressure, the nature and extent of the export production and the urban manufacturing sector. In this context, we may also ask how far the more sophisticated monetary policy of deficit financing is really suitable for the earlier stages of the development in the money economy when we should be concerned with encouraging the people from the subsistence economy to use money, not only as a medium of exchange, but also as a unit of account for a rational economic calculus and as a store of value. Recently, there has been a shift of interest from investment in material "infra-structure " to "investment in human capital", particularly in education. Yet so far this line of approach has been limited by too much emphasis on what the government should do in the way of a "crash programme" in education combined with too little analysis of the demand and supply factors affecting the market for skilled labour at various stages of economic development.[24]

All this is merely another way of stating our argument at the end of the last section that we need to have a more systematic study of how the market forces actually work or fail to work in the different types of underdeveloped country. Applied to the majority of the underdeveloped countries at the earlier "pre-take-off" stages of economic development, this now assumes a special significance. The degree of effective control which the government of such a country can exercise over the rest of the economy depends more clearly than elsewhere on the growth of suitable

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[24] For further discussion, see my papers, The Universities of Southeast Asia and Economic Development, Pacific Affairs, Summer, 1962 and Social Flexibility, Social Discipline and Economic Growth, International Journal of Social Science, Paris, 1964.

monetary, fiscal and market institutions through which it can extend its control. Thus we may reasonably suggest a more systematic study of the market forces in such an underdeveloped country even to the most planning-minded economist.

To sum up: current writings on the underdeveloped countries have been vitiated not merely by the tendency to generalize from the "special case" of the advanced countries but also by the tendency to generalize from the "special case" of a particular type of underdeveloped country, notably India. This in its turn has been aggravated by the Popularity of the idea of development planning based on the "take-off" theory and by the tendency to treat the subject, not as an academic discipline but as an adjunct to making out a persuasive general case for increasing international aid to the underdeveloped countries. The new crusading spirit has rendered a valuable service in getting the idea of giving aid to these countries firmly established in the advanced countries. But now that the general good will towards these countries seems to have outstripped an accurate knowledge of how the economic systems of these countries really function, one may venture to urge the revival of the traditional academic approach to the subject.