CHAPTER 1

INTRODUCTION TO THE THEORY OF GROWTH AND DEVELOPMENT

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INTRODUCTION TO THE THEORY OF GROWTH AND DEVELOPMENT

1.1 CONCEPTS OF DEVELOPMENT AND GROWTH

Generally speaking, economic development refers to the problems of underdeveloped countries and economic growth to those of developed countries. Maddison makes the distinction between the two terms in the sense when he writes, “The rising of income level is generally called economic growth in rich countries and in poor countries it is called economic development.” But this view does not specify the underlying forces, which raise the income levels in the two types of economies.

In fact, the terms “development” and “growth” have nothing to do with the type of economy. Schumpeter relates the distinction between the nature and causes of the two, when he defines development as a discontinuous and spontaneous change in the stationary state which forever alters and displaces the equilibrium state previously existing; while growth is a gradual and steady change in the long run which comes about by a gradual increase in the rate of savings and population. This view of Schumpeter has been widely accepted and elaborated by the majority of economists.

According to Kindleberger; “Economic growth means, more output and changes in the technical and institutional arrangements by which it is produced and distributed”, Friedman defines growth as an expansion of the system in one or more dimensions without a change in the structure and development as an innovative process leading to the structural transformation of social systems.

Thus, economic growth is related to a quantitative sustained increase in the country’s per-capita output or income accompanied by expansion in its labour force, consumption, capital and volume of trade. On the other hand, economic development is a wider term. The concepts of development are not only quantitative but are qualitative also. In the qualitative aspects, it coincides with the welfare objectives. Thus, it is not enough to see what is produced but also to see how it is produced and distributed; it is related to qualitative change in economic wants, goods, incentives and institutions. It describes the underlying determents of growth such as technological and structural changes. Development embraces both growth and decline. An economy can grow but it may not develop because poverty, unemployment and inequality may continue to prevail due to absence of technological and structural changes.
But it is difficult to imagine development without economic growth in the absence of an increase in output per capita particularly when population is growing rapidly.

1.2 THEORIES OF DEVELOPMENT

In the context of the definition of development, it may be useful to refer to the term “sustainable development” which is now in common use. The term means, “Meeting the needs of the present generation without comprising the needs of future generations”. In other words, it envisages a “development that meets the needs of the present without comprising the ability of the future generations to meet their own needs”. The ability to meet the needs is largely determined by the accumulation of human capital. Hence what matters is, that the overall productivity of the accumulated capital including its impact on human health and aesthetic pleasure as well as income – more than compensates for any loss from depletion of natural capital.

The cost is one of the major issues that should be considered when developmental projects are decided upon. The depletion of natural resources does take place so efforts should be made to preserve natural capital.

In uplifting a low level economy to a high-level progressive economy, efforts of various sorts have to be made like;

a. Increasing capital formation.
b. Improving human capital.
c. Raising entrepreneurial ability.
d. Enhancing natural resources.
e. Upgrading technology.
f. Market-orientation of economy.
g. Well defined planning.
h. Role of the state.

1.2(A) ADAM SMITH

Adam Smith, a classical economist was primarily concerned with the problem of economic development. He believed in the doctrine of ‘natural law’ in economic affairs. According to him, each individual was led by an ‘invisible hand’ which guided market mechanism. Every man left free to maximize his own wealth would lead eventually to increase in aggregate wealth. He advocated the policy of laissez-faire in economic affairs. Like modern economists, Smith regarded capital accumulation as a
necessary condition for economic development. So the problem of economic development was largely the ability of the people to save more and invest more.

Smith believed, the process of growth is cumulative. When there is prosperity as a result of progress in agriculture, manufacturing industries and commerce, it leads to capital accumulation, technical progress, increase in population, expansion of markets and rise in profits continuously-which he calls as progressive state. But this progressive state is not endless. It ultimately leads to a stationary state. In the scarcity of natural resources, employment, wages, competition, profits of businessmen, investment would all continue to fall.

Still Smith’s theory had some weaknesses like:

1. **Rigid division of society:**
   Smith’s theory is based on the socio-economic environment prevailing in Great Britain and certain parts of Europe. Thus, this theory assumes a rigid division of society between capitalists (including landlords) and laborers and has neglected the role of the middle class which provides the necessary impetus to the economic development.

2. **One sided saving base:**
   According to Smith, capitalists, landlords and moneylenders save. This is however, one-sided base of savings because it did not occur to him that the major source of savings in an advanced society was by the income-receivers and not the capitalists and landlords.

3. **Unrealistic assumption of Perfect competition:**
   The laissez-faire policy of perfect competition is not to be found in any economy. Rather a number of restrictions are imposed on the primary sectors and on internal and international trade in every country of the world.

4. **Neglect of Entrepreneur:**
   The Entrepreneur is the focal point of development, as pointed by Schumpeter. It is the entrepreneur who organizes and brings about innovations thereby leading to capital formation. This point has been neglected by Smith.

5. **Static Model:**
   According to Hicks, Smith’s model though it looks like a growth model, is not a growth model in the modern state; it does not exhibit a sequence.

6. **Unrealistic assumption of Stationary State:**
   Smith is of the view that the end result of a capitalist economy is the stationary state. This implies that there is change in such an economy, but around a point of
equilibrium. But this explanation of the process is not satisfactory because development takes place by fits and starts' and is not uniform and steady. Thus, the *Smith* theory of economic development has limited validity for underdeveloped countries.

1.2 (B) **THE SCHUMPETERIAN THEORY**

Joseph Alois Schumpeter, first presented his theory of economic growth in the “THEORY OF ECONOMIC DEVELOPMENT” published in German in 1911. He assumes a perfectly competitive economy which is in stationary equilibrium. In such a stationary state there is no profit, no interest rates, no savings, no investments and no involuntary unemployment. This equilibrium is characterized by the term “circular flow” which continues to repeat itself in the same manner year after year. In the ‘circular flow’, the same products are produced year after year in the same manner. ‘For every supply there is some corresponding demand, and for every demand the corresponding supply’.

1.2(C) **HARROD - DOMAR GROWTH MODEL**

According to this model, everyone must save a certain proportion of its National income, if only to replace worn out or impaired capital goods. However, in order to grow, new investments representing net additions to the capital stock are necessary. It states that the rate of growth of GNP \( \frac{AY}{YO} \) is determined jointly by the National savings ratio ‘S’ and the National capital output ratio ‘K’– more specifically, it says that the growth rate of National income will be directly or more positively related to the saving ratio [i.e.- the more an economy is able to save –and invest , out of given GNP , the greater will be the growth of that GNP] and ‘inversely’ or ‘negatively’ related to the economy’s capital output ratio [i.e., the higher the ‘K’ , the lower will be the rate of GNP growth].

The theory explains the significance of National savings and investment. The main obstacle to, or constraint on development according to this theory was the relatively low level of new capital formation in most poor countries. However experiences of several countries over the time indicates the fact that saving and investment is not a necessary condition for accelerating rate of economic growth.
1.2 (D) INTERSECTORAL RELATIONS AND ECONOMIC GROWTH

It is usually found that, the growth process of economy primarily reflects shift of its majority of population from agriculture to industry of rural to urban setting. This process virtually demonstrates change in the value addition of industrial sector and there by its contribution to National income. This trend is explained theoretically with the help of Engel’s law. He discovered that, with the rise in the income of family, the proportion of their budget spent on food declined. As the main function of the agricultural output would not grow as rapidly as demand for industrial products and services, the share of agriculture in National product would decline. The second reason is that the productivity in the agriculture sector gradually leads to the rise in the demand for the use of machinery and new modes of cultivation, bringing change in the industrial sector.

Chernery and Syrquin explain that, in reality a deviation in trend of development should be regarded as average pattern. He has tried to examine this relationship with the actual historical performance of several European countries plus Japan.

Even before the concept of Gross National Product was invented, the industry agriculture relations appeared to have been found in David Richardo’s, ‘The Principles of Political Economy and Taxation’ – published in 1870, He has tried to explain in his own model, this concept in respect of assumption of ‘diminishing return’ and ‘labour surpluses. Later on the concept of labour surplus in context of sectoral relationship is found redefined in the literature of W.Arthur Lewis Rugar Nurkse, John Fri, and Aster Rains.

These various models provide as some important understanding. If an economy starts with its entire population in agriculture, it can move a large part of that population to industry or other employment without any reduction in farm output. Industrialization can proceed, without putting any demands on agriculture completely. As industry continues to grow however, it will have excess supply of labour, i.e. the agricultural labourers, which will eventually affect the agriculture output. This entire relationship i.e. ‘Two sector labour surplus model’ is illustrated by Gillis, Parkins, Romer, and Snodgrass illustrate this entire relationship i.e. “Two sector labour surplus model”.

Graph - 1.1
The Two Sector Labour Surplus Model

Direction of increase of labor input in industry

Direction of increase of labor input in agriculture
How fast agricultural production must grow, depends on what happens to a number of different variables. If industry is growing very rapidly, agricultural productivity must grow rapidly enough to keep the terms of trade, thereby cutting into industrial profits and slowing or halting industrial growth. On the other hand, as long as there is a surplus of labour and no population growth, it is possible to ignore agricultural productivity growth and concentrate one's resource on industries.

The neoclassical model is quiet different in respect of examining the implications of populations or labour force growth. According to this model an increase in population and labour in agriculture will itself raise farm output. If industry is to develop successfully, similar effort must be made to ensure that agriculture grows fast enough to feed workers in both the rural and urban sectors at ever higher level of consumption and to prevent the terms of trade from turning sharp against industry. Thus the neoclassical model explains the balance between industry and agriculture from the beginning.
A "Neo classical" Two Sector Model

GRAPH - 1.2

A labor supply curve with worsening terms of trade

In QUANTITY OF LABOR IN INDUSTRY

WAGES IN INDUSTRIES

n

zero'

r

labor supply curve in absence of worsening terms of trade

labor supply curve with worsening terms of trade

QUANTITY OF LABOR IN INDUSTRY

MARGINAL PRODUCT OF LABOR IN AGRICULTURE

TOTAL AGRICULTURE (for grain) OUTPUT

QUANTITY OF LABOR IN INDUSTRY

zero
Under-developed countries are very much concerned about their attainment or economic development. Sectoral shift also necessitates a suitable environment for initiating, maintaining and accelerating the pace of economic development. Prof. Arthur Lewis, in this connection rightly observed, the proximate causes of economic growth are, the effort to economize, the increase of knowledge or its application in production and increasing the amount of capital or other resources per head.

Economic growth process, which envisages structural transformation, is not concerned with monetary aspects only. Besides terms of trade and investment aspects this process is very much related to social attitudes, political condition, human resources, and psychological social and cultural requirements of the country. Prof. A. K. Cairn cross has rightly observed that economic development is not just a matter of having plenty of money or it is purely an economic phenomenon. It embraces all aspects of social behavior the establishment of law and order, scrupulousness in business dealing, including dealings with the revenue authorities, relationships between the family literacy, familiarity with mechanical gadgets and so on.

1.2 (E) LESSONS AND COMMENTS IN RESPECT OF GROWTH

The new economic view of development largely evolved after the experience of 1950-60 is, when a large number of third world nations did achieve the overall UN growth target, the levels of the living of the masses remained for the most part unchanged. Therefore, the redefined context of development includes reduction of poverty, inequality and unemployment.

Denis Gouler says, “Underdevelopment is shocking phenomenon. It is in a way the culture of poverty. Development must therefore be considered as a multidimensional process involving major change in social structure, popular attitudes and national institutions, as well as acceleration of economic growth, the reduction of inequality and the eradication of absolute poverty.

Looking globally, one finds very clearly that stages of economic growth theories and related models of rapid industrialization gave too little emphasis on the very different and less favorable initial economic, social and political conditions of today’s developing countries. Very close examination of the growth process of less developed countries highlights the facts that the growth process and position of these countries today, is in many important ways significantly different from that of the currently developed countries- as they embarked on their era of modern economic growth.
Michel Todaro has elaborated eight significant differences in initial conditions, which requires addressing and understanding to accelerate the growth the process of less developed countries.

These points of differences in the initial conditions of respective nations can be examined in brief as under:

[I] RESOURCE ENDOWMENTS, PHYSICAL AND HUMAN

Looking at the recent past of the growth process that existed between developed and less developed nations, it is clearly found that the Third World Countries in 80’s were not found well endowed with natural resources, than were the currently developed nations when they began their growth. From amongst less developed countries except few countries which were blessed with plenty of petroleum and other natural resources - most of the Asian nations were having plenty of population on one hand, and were holding very little natural resources on the other hand. Finance was a major constrain for less developed countries, to exploit the less available resources in comparison with developed nations.

The key differentiation was found in respect of available skilled human resources. Country has to depend on human resource having managerial and technical skills to exploit the available resources. Western developed nations are better than the Asian less developed countries, in this respect.

[II] RELATIVE LEVELS OF PER CAPITA INCOME AND GNP

At present three fourths of the world population, living in developing countries have on the average a much lower level of real per capita income than their counter parts had in 19th century. 755 of the third world countries, even in the mid of 90’s, were found to be living below the level of subsistence. It is also important to note, that at the initiation of growth process, developed countries were economically well advanced, in comparison to the initial condition of less developed countries.

[III] CLIMATIC DIFFERENCE

The most important fact to take into consideration is that almost every successful example of modern economic growth has occurred in a temperature zone country while all the Third World Countries are situated in tropical or subtropical climatic zones. Difference in the climatic conditions has stronger influence on the level and nature of growth. Extreme heat and humidity in most poor countries contribute to deteriorating soil qualities and rapid depreciation of many natural goods. While countries in temperate zone have also added advantage of sound yielding and more efficiency to promote productivity.
[IV] POPULATION SIZE, DISTRIBUTION AND GROWTH

Third World population size, density and growth constitute another important difference between less developed and developed countries. While this population syndrome in developed countries- before and during their growth process was not found hurdle some, as the rate of population growth, in such countries was very low and slow. Most of the third world countries population was found increasing at the annual rate in excess of 2.55 in the later part of 80’s and early part of 90’s even the later part of 90’s this tend to have an increase at the rate of about 25 per year.

[V] ROLE OF MIGRATION

One of the most striking facts pertaining to the differing rates of natural population increase is of international migration, which began late in the 19th and 20th century. International migration was found both widespread and large in scale. Because of severe famine periods and years rural unskilled workers from Italy, Germany and Ireland migrated heaving in labour search nations of North America and Australia. This has been widely depicted by Brinley Thomas in his treatise on migration and economic growth. It is also important to know that the Asians and Africans have not shown so many tendencies for migration towards western nations in comparison with European nations.

Besides institutional factors – geographical distance leading to economic distance and strict modern immigration laws have also effected the nature and rate of migration from developing nations to the developed nations.

1.3 THE GROWTH STIMULUS OF INTERNATIONAL TRADE

International trade is known as ‘engine of growth’ as it has propelled the development of currently economically advanced nations since 19th and 20th centuries. Rapidly expanding export market works as stimulant to growth. In early 19th century, developed nations were relatively in a sound position because of stable political structure and flexible social institutional. This enabled such countries borrowing capacity, which in turn influenced international trade. This capital accumulation stimulated exportable production. As against this scenario today, less developed countries face formidable challenge in generating rapid economic growth on the basis of international trade. Their terms of trade as against the then developed nation’s terms of trade, have declined steadily amounting to reduction in export capacity. It is also found that in certain products, were LDC’s are in a sound position
by lowering cost of production, the developed nations have played unfair attitude by way of entering into tariff and non-tariff etc.

**BASIC SCIENTIFIC – TECHNOLOGICAL RESEARCH AND DEVELOPMENT CAPABILITIES**

It is but the fact, that scientific and technological research plays crucial role in augmenting and diversifying growth process of the economy. History says that the developed economies were having the sound position at the initiation in growth by way of relatively better economic position and also in terms of skilled human resources. Their position in this respect seemed to be much stronger as against the position of less developed countries at the initiation in this respect. This gap has obviously influenced the rate and nature of progress of currently developing countries. Third world nations are in general, at much disadvantageous situation, which restricts the growth process and affects the speed of the progress.

**STABILITY AND FLEXIBILITY OF POLITICAL AND SOCIAL INSTITUTIONS**

Looking at the initial condition of developed nations and third world nations, important difference is found in the nature of political and social institutions. The most important difference to note is that currently developed nations were having political freedom and consolidations much before they entered into the growth process – while third world nations are relatively late free countries in respect of political freedom. Because of late freedom the process of consolidation, the form of political maturity is yet to be gained which slows the progress. Socially and culturally too, developed nations have obtained homogeneity within and between them. This element is also less present in case of less developed countries. Their limitations in this regard has restricted the horizon, outlook towards material progress, influence of rationality in the decision making updating in work ethics – which have in combined affected the growth process of Third World Nations.

**1.4 SUMMARY**

From the above discussion, it can be stated that there had been vast differentiation found at the initial period of growth between developed Western nation and developing Asian nations. The most important difference is the gap between the globes especially, existed and which prevails even today in respect of required technological, social and institutional changes. Such transformations should be taken into consideration within the Nation at micro level and between the Nations
at macro level. This leads to the emerging demand for ‘New International Economic Order’ for the Third World Nations.

We find much discussion in depth on the concept of stages of economic growth during the 1950’s and early 1960’s. This concept largely manifested a series of successive stages through which all countries must pass. This mainly focused on the theory of development which insisted for the right quantity and an appropriate mix of saving, investment and foreign aid necessary for the Third World Nations to enable them for rapid development – the process through which developed countries in the recent past have undergone. It calls for the development synonymous with rapid – aggregate economic growth.

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