CHAPTER 1

INTRODUCTION
CHAPTER ONE

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The issue of economic growth has been of great interest to economists for long. Classical economists like Smith, Ricardo and Marx have all tried to understand and analyse different aspects of this issue. In the modern literature, a large volume of work was produced on issues related to growth, right from the post war period till the early nineteen seventies. For a number of reasons, this was followed by a significant period of time when interest dwindled in this area and issues related to the short run gained the focus of attention. There has been a renewed interest in this area in the last ten years or so. This has given rise to the "Endogenous Growth" literature as well as a large number of other studies. One common characteristic of most of these recent studies is that they envisage a close and interactive relationship between a theoretical and an empirical approach to this issue. Consequently, most of the theoretical models in the recent literature try to explain some empirical findings and a large number of empirical studies look for evidences that support these theoretical models. All this has given rise to a voluminous literature - both theoretical and empirical. A large part of this literature is associated with the analysis and formalisation of cross-country growth experiences. Significantly, this formalisation is being interpreted by a number of economists, not merely as a theory of growth of a capitalist economy but as a theory of development. Considered from this perspective (i.e., as a theory of development), however, there are two questionable aspects about the methodology of these studies - one empirical and the other theoretical. Empirically,
aspect of this approach has been the use of cross-country growth regressions involving a large number of countries, including the low-income, the middle-income, as well as the high-income countries. This makes the group of countries heterogeneous in character, in terms of the stage of development that they have attained. It also tells us something about the assumptions underlying these studies. Simply put, these studies assume that the process of growth is identical in all economies, irrespective of the stage of development that they have attained. However, this is entirely against the conventional wisdom from development economics according to which, low-income and less developed economies have certain characteristics that make the nature of the growth process in these economies significantly different from the ones in the developed economies. In the light of this assertion, any analysis of the development process that ignores this difference becomes questionable, unless the results of these analyses are shown to be robust enough to hold true, even for a sample consisting of developing economies only. In other words, it must be demonstrated that the trends and results that emerge from a study based on a sample including only developing countries do not contradict the ones based on a heterogeneous sample including both developed and developing economies. If it does contradict (as we find in our thesis), then it must be concluded that a characterisation of the process of development on the basis of a heterogeneous sample is misleading, in as much as it does not reveal important trends and results that are characteristic of countries that are at the earlier stages of the development process. Thus, it is of obvious interest to find out whether the above results are robust enough to hold for a group that includes only developing economies. As mentioned above, apart from the empirical problem, there is a theoretical problem as
well. In these studies, the formalisations of the empirical results are in terms of growth models that are based on assumptions, which are not appropriate for developing economies. Clearly, this implies that even if the "stylised facts" from the empirical analysis are correct, the theoretical explanations, though consistent with these facts, are not correct.\footnote{This conclusion is methodologically opposed to Friedman's idea that a theory should be acceptable if it explains an empirical result.} In our opinion, these two aspects of the methodology of these recent studies make them questionable as theories of development. Consequently, it provides the motivation for our research, which involves, (a) empirically testing a number of hypotheses related to the issues dealt with in these studies, to see whether they are robust enough to hold for a sample of developing economies and, (b) explaining these empirical results in terms of theoretical models that are based on more appropriate assumptions about these economies. This is the objective of our thesis as well as its methodological approach.

Broadly speaking, there are two questions that have been thrown up by the recent literature and analysed in our thesis. Firstly, what is the nature of economic growth? Secondly, what are the sources of economic growth? The first question is in the context of international inequality and looks at whether the process of growth decreases such inequalities or not. According to the Solow model of growth, for a given savings ratio, the per capita growth rate falls with the accumulation of capital. This idea can be used to argue that richer countries grow at a slower rate, and hence the poorer countries – with their faster growth rates – are continuously catching up with the richer ones. This implies that growth rates show convergence and the nature of the growth process is inequality reducing. This argument is however contradicted by cross country growth evidences from a
large number of developed and developing economies, which show that on an average, rich countries grow as fast as poor countries. A large section of the recent literature tries to resolve this contradiction, and two distinct explanations have emerged. The first explanation claims that growth rates do not exhibit convergence at all. According to this explanation, there are certain aspects of the production process (like knowledge spillovers, innovations etc.) that are ignored in Solow’s model and once these are taken into account in a theory of growth, it is possible to generate a constant (as opposed to convergent) growth rate even as accumulation of capital takes place. Theories that belong to this genre are known as the Endogenous Growth Theories.

The second explanation puts forward an augmented version of the Solow model, according to which, only within a group of countries which have similar long run growth rates, the comparatively richer countries would grow at a slower rate, resulting in convergence within that group. The long run growth rate of a country depends, according to this version, on some variables like the stock of Human Capital etc. Thus according to this explanation, the empirical evidence does not contradict (an augmented version of) the Solow model, as a rich country may grow as fast as a poor country simply because the former has a higher long run growth rate. Clearly, the difference between the two explanations\(^2\) is that the first one rejects the possibility of convergence, while the second one claims that convergence does take place within a group of countries which have similar long run growth rates. It is clear from all this that the question about the nature of the growth process remains unresolved and this is the first issue that we shall take up in our thesis.

\(^2\) The distinction between the two approaches will be dealt with in more details in chapter three.
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The second question posed by the literature tries to identify the sources of economic growth and here, a very large number of variables have been found to be significant. As we shall see, the methodology used in these findings are questionable. As an alternative, we choose three possible sources of growth on the basis of certain objective criteria. These three sources are investment, human capital and international trade. The rest of our thesis tries to analyse the role of these variables in the process of growth. It should be mentioned here that even though we have chosen to differentiate here between the two issues (i.e., the nature of growth and the sources of growth) for analytical convenience, our analysis tries to put all these parts together to build a whole – a theory that throws light on different aspects of the growth process of a developing economy.

Our thesis starts with Chapter one, which is the introduction. The rest of the thesis is divided into three parts. The first part reviews the theoretical and empirical literature in growth economics. Chapter two is a review of the theoretical literature. Chapter three is a review of the empirical literature. The second part deals with the nature of the growth process and the role of investments. Chapter four presents some empirical analysis of these issues. Chapter five presents some theoretical formalisations of the results of chapter four. Chapter six empirically tests some aspects of the theoretical model in chapter five. The third part of our thesis deals with the sources of economic growth – in particular the role of human capital and international trade. Chapter seven reviews the theoretical literature in this context. Chapter eight presents some empirical results as well as a theoretical explanation of these results. Chapter nine concludes the thesis.