CHAPTER 2: Employment And Unemployment Under Capitalism With Special Reference To The Developing Countries

2.1 Introduction

The present chapter essentially tries to address three sets of issues:

As has been discussed in the last chapter, sustained growth under capitalism cannot be explained on the basis of endogenous stimuli alone. It needs exogenous stimuli for sustained growth. In this respect, innovations and technological progress cannot be conceived as an entirely exogenous stimulus. Then the question is what explains sustained growth under capitalism? It is our contention that external markets provide the exogenous stimuli for sustained growth under capitalism. Section 2.2 of the chapter presents the argument that historically external markets have provided the exogenous stimuli for sustained growth under capitalism.
Secondly, it was seen that there is no mechanism under capitalism to spontaneously eliminate any tendency of rising unemployment. However, capitalism did not witness any secularly increasing unemployment or labour shortage during the period before the World War I, when capitalism witnessed a sustained boom. How to explain this phenomenon? It will be seen that the interaction of metropolitan capitalism with the external markets, also ensured that capitalism did not witness any problem of rising unemployment or labour shortage. It will be argued, in Section 2.3, that the fact that capitalism in the period before the First World War, which experienced a long boom, did not witness any significant or sudden rise in unemployment was again because of its interactions with the pre-capitalist markets.

If the interaction of capitalism with external markets, which are today's developing countries, have provided capitalism with the exogenous stimuli for growth, what has been the impact of this interaction on the developing countries? It will be evident from the discussion of Sections 2.2 and 2.3 that the problems of the developing countries in terms of a retarded production structure as well as the presence of massive labour reserves are a result of the colonial exploitation of these countries by metropolitan capital.

If the interaction of capitalism with pre capitalist markets resulted in retarded production structure and massive labour reserves in the developing countries, then two sets of questions need to be answered. Firstly, what does economic theory suggest for improving the condition of these economies? Secondly, what
have been the historical experiences of the developing countries with regard to solving their problem of labour reserves? These two questions comprise the third set of issues addressed in this chapter.

Theoretically, it is suggested that since the labour reserves, in the developing countries, were mainly in agriculture, the taking away of these reserves to other higher productivity sectors was necessary. Therefore, the key to development for the underdeveloped countries is industrialization, which will generate higher levels of income while absorbing the surplus labour from the agricultural or the traditional sector of the developing countries. This is the crux of the Lewis Model. Section 2.4 provides a theoretical critique of the Lewis Model.

While the Lewis Model suggested that industrialization should be undertaken by the developing countries to get rid of their problems, the historical experience of these countries showed that this process of industrialisation cannot be undertaken while the economy is subjugated to the domination of metropolitan capital. Therefore, with decolonisation, the developing countries' quest for development sought to de-link these economies, albeit to a limited extent, from global capitalism. This policy of industrialization that the developing countries pursued, autonomous to world capitalism, is called Import Substituting Industrialisation (ISI). Section 2.5 critically evaluates the policies and the impact of ISI on the development of these economies, particularly with respect to the question of absorption of labour reserves.
Chapter 2

While ISI improved the conditions of the developing economies, compared to what prevailed in the colonial period, it was a far cry from absorption of their labour reserves. On the other hand, the only underdeveloped countries which managed to actually industrialize their economies while completely absorbing their labour reserves were the erstwhile socialist countries, particularly the USSR. Section 2.6 tries to locate the causes of such absorption of labour reserves in the socialist countries.

The policies of ISI and planning did not last long and were abandoned in favour of the policies of globalization and liberalization. It was suggested to the developing countries to embrace the policies of opening up, export orientation, financial liberalisation, in accordance with the neo-liberal policies of IMF-World Bank. Section 2.7 of the chapter critically evaluates the neo-liberal policies and concludes that they cannot solve the problem of labour reserves faced by third world countries. Section 2.8 enumerates the main conclusions of the chapter.

2.2 External Markets As Exogenous Stimuli For Sustained Growth Under Capitalism

The importance of external markets for the growth of capitalism was first emphasised by Rosa Luxemburg. Her theory pointed towards the fact that there was a problem of realization of surplus value in a closed capitalist system. A
portion of the surplus value is used up for the consumption demand of the capitalists. The other unrealized portion of it must be invested in order to realize the entire surplus value. The question remains as to what is the inducement to invest? According to Luxemburg, there is no reason *a priori* how this problem can be solved endogenously.¹ In other words, we are back to the case where in a demand constrained system there cannot be an explanation for sustained growth on the basis of endogenous stimuli alone.

With the availability of the external markets it is not essential that the entire surplus value should be realized in the external pre-capitalist market or that there should be an export surplus. The existence of the pre-capitalist market is sufficient for the inducement to invest. This is because some investment would be essential to open up the external markets.² Moreover, the knowledge that there exists external markets which can be tapped in case of an economic downturn in the capitalist core, would itself sustain the urge of the capitalists to invest.

The intrusion into the external markets for accumulation has been intrinsically linked with capitalism particularly during the period of colonialism when resources were drained out of colonies and a market for the finished products of the capitalist countries was made readily available there. This coercive opening up of the colonial market was carried out under the slogan of free trade. The Indian market for instance was flooded with finished cotton products from

---

¹ Mitra (1977)  
² Patnaik, P (1972)
Chapter 2

England, by maintaining a zero tariff rate for all practical purposes. The first instance of colonial exploitation consisted of the primary accumulation of capital; the second instance consisted of obtaining a market for the finished metropolitan goods at the cost of indigenous industry in the colonies, causing de-industrialization in the latter.

"The existing estimates of the external 'drain' or unrequited exports from Bengal or British dominions in general put it at an average of 38 million pounds for the period 1757-80, 1.78 million pounds annually over the decade from 1783-84 to 1792-93 and between 3 million and 4 million pounds per annum around the years 1813 to 1822. ...the external drain from Bengal could be put at about 3 to 4 per cent of the gross domestic material product." 3 Along with this massive drain of surplus from the colonies, India was subjected to a process of de-industrialization through the policy of 'one way free trade'. The entry of cotton manufactures into India, exclusively from Britain, destroyed the indigenous cotton industry in the country and resulted in massive de-industrialization and misery for the people. 4

This exploitation of India and other colonies, both in terms of siphoning off of resources to the metropolis as well as selling manufactured goods into these countries served capitalism in two ways. Firstly, the drain in terms of land revenue which the British extorted from India paid for the exports of primary commodities from India. In other words these exports were basically free for the British economy. Secondly, Britain's exports to India of the manufactured

3 Bagchi (1989b)
4 Bagchi (1989b)
products provided an expanded market which kept up the growth rate of the British economy. At the same time, the primary commodities imported from India and the colonies, were exported to the newly industrializing countries whereby the merchandise current account deficits with these countries were met. Thus over all, with the colonies, capitalism sustained a higher growth rate and found an extended market.

It was however not only the tropical colonies that were important for the growth process of capitalism. The founding of the 'New World' in terms of the founding of USA and Australia and New Zealand provided capitalism with a tremendous stimulus to invest. These provided capitalism with empty spaces where more and more capital was invested to clear out the land and establish industries. This export of capital to the 'New World' which was an important reason behind the boom of capitalism before the World War I was financed largely by the "drain" from the colonies. As a result of the massive drain from India, there was no investment of the surplus in the Indian economy thereby limiting to a great degree the scope of capitalist development in the country. As Marx put it, the British rule in India "broke down the entire framework of Indian society, without any symptoms of reconstitution yet appearing. This loss of his old world, with no gain of a new one, imparts a particular kind of melancholy to the present misery of the Hindoo and separates Hindostan, ruled by Britain, from all its ancient traditions, and from the whole of its past history." 5

5 See Karl Marx's article, British Rule in India, in Husain (2006).
Chapter 2

The above discussion shows that the development of capitalism and its growth necessarily entails an intrusion into the pre capitalist market. This intrusion into the pre-capitalist market has a mirror image in terms of underdevelopment of these economies. This is manifested in the fact that the industrialisation of the developing countries has been retarded as a result of their interaction with the developed countries. Moreover, capitalism expands not only by “accumulation through expansion” but also by “accumulation through encroachment”. It is in the immanent tendencies of capitalism to expand by “accumulation through encroachment” of the pre-capitalist sectors. This is because at a base price, the requirement of capitalism entails a certain amount of material resources which are produced in the pre-capitalist sector. Now the supply of these materials cannot, in the normal course, grow to satisfy the demands of the capital accumulation. This excess demand can be countered by cutting down the wages of the workers directly employed by the capitalist sector. But this will be resisted by the workers in the core who are more organized and lead to social tensions within the capitalist core. As a result, the demand of the pre capitalist sector is compressed to neutralize the pressure of excess demand on the prices. This need not have been the case if the production of the pre-capitalist sector could be augmented to take care of the tendency towards excess demand. This possibility however is foreclosed by the very nature of capitalism requiring an external pre-capitalist market where it has to sell its products. The intrusion of capitalist products into the pre-capitalist market causes unemployment in the traditional

---

6 Baran (1962)
7 For a definition of accumulation through expansion and accumulation through encroachment see Patnaik. P (2005a)
sector and releases resources for the capitalist core. The availability of 'empty spaces' to metropolitan capital in the 'New World' provided capitalism with some possibilities of augmenting the supply of the resources. But even then, predominantly the basic mechanism was a compression on the pre-capitalist sector through 'accumulation through encroachment' which caused massive de-industrialization in the colonies.

As a result of this "accumulation through encroachment" and a siphoning off of the resources of the colonies, industries could not develop within these countries. The entire history of the policies of planned development after de-colonisation was an attempt to de-link the ex-colonial economy from this rapaciousness of metropolitan capitalism and build an autonomous growth trajectory, which will be discussed in Section 2.5.

A criticism can be made against the above discussion, which is the following. It has been pointed out in the preceding discussion that capitalism cannot develop the traditional sector in terms of augmenting the supply of the raw materials required for capitalist accumulation. Now, this traditional sector mainly consists of agriculture or peasant agriculture. Is this a valid argument that capitalism cannot develop agriculture?

Historically speaking it has been the case that capitalism in England could not develop agriculture to the extent that it could even provide sufficient food for the

---

8 Patnaik, P (2008a)
population of the country. In this case too, England had to depend on food imports for meeting the growing food demands of its population by importing food from the colonies starting with Ireland. 

It can however be argued that with the de-colonization of the third world countries following the World War II, this process of exploitation of the colonies came to a stop and should have resulted in a capitalist crisis, with the metropolis losing the shock absorbers of the system. The fact that this did not occur does not invalidate the above argument. This is because of the following.

After the World War II, the metropolitan capitalist economies were faced with a massive problem of reconstruction. In these efforts they were significantly aided by the state, which accessed the massive amounts of aid released by the US for European reconstruction through the Marshall Plan. By that time however, socialism was a major force in the world, with rapid strides in development in a very short span of time. The working class under socialism improved their living standards and real wages in a situation where no unemployment existed. At the same time, the option of pre-capitalist markets for sustaining the growth in the metropolis was restricted because of the de-colonisation and the pursuit of policies of planned development under the dirigisme regime in the developing countries. Thus capitalism had to rely on state expenditure and demand management policies to sustain a higher growth path after World War II which ushered in the so called Golden Age of Capitalism.

---

9 Patnaik, U. Was there an Agricultural Revolution in Britain? mimeo, CESP/JNU
This high growth period of capitalism sustained on the basis of state led demand management policies however came to an end in the 1970s. The most important reason being the rising to dominance of international finance capital. This essentially entailed hot money flowing from one country to another in search of quick profits. This finance capital was different from what Lenin had talked about in *Imperialism* in the sense that the present form of finance capital was not national but constituted an international finance capital. The policies of governments in this period were formulated essentially to serve the interests of this new form of international finance capital, which entailed the adoption of deflationary policies in order to avoid any possibility of inflation. With the adoption of deflationary policies, the role of the state in demand management for sustaining high growth in metropolitan capitalism came to an end.

These deflationary policies on the other hand entailed a cut back on government expenditure, which was essential for the improvement of the living conditions of people, particularly in the developing countries. The deflationary policies also served the purpose, of metropolitan capital, of squeezing the demand of the workers all over the world, in a situation where there existed limited possibilities of augmenting supply of a range of primary commodities. The burden of this compression of demand has to fall on the workers of the developing countries, who are less organized and are situated amidst huge labour reserves limiting their bargaining power. This compression in turn is a result of the cut in state expenditure and withdrawal of protection offered to the producers in the developing countries in the *dirigiste* regime. In other words, the policies of neo-
liberalism pursued at the global level, entail accumulation through encroachment without the political domination of the colonies.\textsuperscript{10}

At the same time, the fact that the developing countries are technologically backward is also linked with the exploitation of these colonies by advanced capitalism. This is because of the following reasons. Generation of new technologies requires incurring an expenditure for it, incorporation of the technology as well as replacing the old products with the new one. These expenditures are what is referred to as innovation promoting expenditures. However, given that the generation of new technologies requires a host of expenditures, apart from investment expenditure, typically a large part of such expenditures is incurred by the state. The capacity of the developing countries in terms of incurring such huge expenditures is very limited, since a large part of the surplus of these countries has been traditionally siphoned away by advanced capitalist countries.

Moreover, even with an identical stream of innovation promoting expenditure for two countries, the result will be different, which in its turn will depend upon a host of other factors, starting from the education level, infrastructure, etc. Now in most of the developing world, such infrastructure, does not exist, thereby limiting the possibility of these countries to emerge as major innovators in the world. Most significantly the developing countries are late starters in the race to innovate. So, even if the developing country innovates a product, the world

\textsuperscript{10} Patnaik, P (2008a)
economy led by the metropolis, innovates a more sophisticated product, whereby the developing countries remain perpetually behind in the race to innovate.

The above discussion showed that historically speaking capitalism's sustained growth was a result of the exploitation of the external markets, which are the developing economies of today. The legacy of this process for the developing countries was in terms of a retarded production structure. It is also true that capitalism did not experience any problem of rising unemployment or labour shortages during the period before the First World War. Was this also because of capitalism's interaction with the external markets? We now turn to this question.

2.3 External Markets And Employment Under Capitalism

In the last chapter it was shown that capitalism cannot exist without unemployment. Moreover, there is no mechanism within capitalism which can spontaneously eliminate rising unemployment. However, the historical experience of capitalism, in the advanced capitalist countries, in the period before the World War I which witnessed a period of boom, did not witness secularly growing unemployment or acute labour shortage as was predicted by the theoretical discussion in the last chapter. In fact advanced capitalism has reduced greatly the problem of labour reserves as compared with the developing countries, where we find large masses of people unemployed or underemployed. How to explain this dichotomy of development, with respect to employment, in
the different regions of the world? It will be shown in this section that the exploitation of the pre-capitalist markets by metropolitan capitalism, while precluding the possibility of any rising unemployment in the core, also gave rise to massive labour reserves in the developing countries.

Theoretically speaking, the Solow model showed that capitalism can never experience rising unemployment. We have argued in the last chapter that the Solow model does not depict a realistic picture of a capitalist economy. How did capitalism manage to experience growth without experiencing any problem of rising unemployment is the question that should be answered if one were to argue that the Solow Model's predictions are incorrect.

The essential result of the Solow model is that the growth rate of capital in an economy is constrained by the exogenously given rate of growth of labour force in efficiency units. In other words, if there exists unemployment in the economy, wage rate will be pushed down to eliminate it within the single period that constitutes the unit of analysis, and this will raise the rate of accumulation of capital, so that a steady state equilibrium with $g=n+m$ is reached. But this model, assumes that unemployment under capitalism exists within a particular national boundary. But the entire labour force of the world can be put to use by capitalism.

Hence, contrary to Solow, with the existence of huge labour reserves throughout the world, labour shortage as a constraint on growth of capitalism is actually
incomprehensible. In fact in history, capital has always drawn on the labour reserves of the periphery for expanding capitalist production. The migration of Europeans to the temperate regions and migration of tropical labour from Asia and Africa to the plantations and mines of European colonies are a testimony to the huge amount of labour drawn in by capitalism for its expansion. On the other hand, even during the post war period of the so called Golden Age of Capitalism, such migrations took place, from the periphery to the advanced capitalist countries.\textsuperscript{11} This migration flow from the pre-capitalist sector to the capitalist core is triggered by market signals from the core. This market signal is the unemployment rate in the capitalist core. When the unemployment rate in the core is high, migration from the periphery to the core decreases, and when the unemployment rate in the core is less then the migration rate rises.

This can be mathematically denoted as follows\textsuperscript{12}:

\begin{equation}
g^k = \text{growth rate of the working population depending on both natural increase as well as on migration.}
\end{equation}

\begin{equation}
g^p = \text{growth rate of productivity}
\end{equation}

\begin{equation}
g = \text{trend rate of growth}
\end{equation}

Now, the growth rate of the working population is a function of the unemployment rate in the core.

\begin{equation}
g^k = m \cdot nu_{-1}, \text{ where } v \text{ is the rate of unemployment.}
\end{equation}

\textsuperscript{12} The argument is based on the discussion in Patnaik, P. (1997a).
By definition,
\[ g = (1 + g^k)(1 + g^k) - 1 \]

As has been pointed out by Kaldor,
\[ g^e = g(g) \]

if \( g > g^k \), assuming that the labour requirement in efficiency units per unit of output remains the same then, unemployment rate \( v \) falls, which increases \( g^k \), by the above equation. Again, if \( g < g^k \), then \( v \) rises, leading to a fall in \( g^k \). Thus, there exists an equilibrating mechanism which ensures that the capitalist economy will experience steady growth. However, the existence of this steady state crucially depends on the existence of a pre-capitalist sector, which can provide the requisite labour when capital accumulation in the core requires more, and dispose off the labour when it requires less.

Capitalism did not witness any secular increase in unemployment during the period preceding the World War I precisely because capitalism was not an isolated system but had the pre-capitalist economies in its surroundings to use for its own benefit. The problem of unemployment was kept at tolerable levels in essentially two ways.

Firstly, capitalist accumulation in the years before World War I witnessed massive labour migration to the "empty spaces" of white settlement areas, particularly to the USA. The extent of migration to these areas is given in the
following table:

Table 2.1: Emigration and Immigration to Lands of European Settlement (Millions of Persons)

<table>
<thead>
<tr>
<th>Year</th>
<th>Emigration to Lands of European Settlement</th>
<th>Immigration to Lands of European Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1871-80</td>
<td>3.1</td>
<td>4.0</td>
</tr>
<tr>
<td>1881-90</td>
<td>7.0</td>
<td>7.5</td>
</tr>
<tr>
<td>1891-1900</td>
<td>6.2</td>
<td>6.4</td>
</tr>
<tr>
<td>1901-1911</td>
<td>11.3</td>
<td>14.9</td>
</tr>
</tbody>
</table>

Source: Hobsbawm (1987)

Note: The difference between the total for immigration and emigration questions the reliability of the estimates.

The above table shows that more than 32 million people immigrated into the lands of new European settlement, between 1871 to 1911. The direction of this migration was predominantly from Europe to the USA. “The bulk of total intercontinental migration, for which we have estimates since the 1880s, was from Europe – over 95% between 1846 -1932; and the bulk of intercontinental immigration was to the United States until the very recent years –almost 58% of the total for 1821-1932.”

Thus we can see that there was massive migration of people from Europe to the new world during this period. How did this massive migration of people ease the

---

13 As quoted in Bagchi (1972)
problem of unemployment? This phenomenon served two purposes. On the one hand, those persons, who could not be absorbed in employment in the capitalist core migrated to these regions thereby negating the possibility of mass unemployment in the core. This has been put forth in the most lucid manner by Hobsbawm:

"The more of them that were shipped abroad, the better for them (because they would improve their conditions) and for those left behind (because the labour market would be less overstocked). Benevolent societies, even trade unions, arranged to subsidize the emigration of their clients or members as the only practicable means of dealing with pauperism and unemployment"\(^{14}\)

The fact that the biggest industrializing countries of the epoch, Britain and Germany were also the biggest exporter of men\(^{15}\) only shows that the growing capitalism could not sustain a higher level of employment for the masses. Hobsbawm however disagrees with this and rather contends that these countries would have benefited by employing these people. But he however misses the point that the growth of these economies could not uplift the conditions of the people. It was not a question of consciously deploying them abroad rather than at home (in which case the issue of employing them for the benefit of the country arises). Rather it was the working of capitalism which could not provide enough employment opportunities to the people. If the emigration of the people was not


\(^{15}\) Hobsbawm (1996)
there, since no evidence of labour shortage at the core can be cited, then the capitalist core would have been saddled with a large mass of unemployed workers.

At the same time, the real wages of these workers in the temperate region were high since the poor shifted to these areas and earned a higher living than what was available in their home countries, because they occupied virgin territory by driving off local inhabitants. Along with this as a result of the shifting out of this mass of workers from the capitalist core, the real wage increased even in the capitalist core also. This provided a growing market for the industrial commodities produced in the capitalist core. Again, as has been discussed in the last section, the investment in the 'New World' sustained a higher growth rate of capitalism during this period. The 'New World' was thus of paramount importance for capitalism so much so that many writers including Keynes saw one of the causes of the Great Depression in the closing of this frontier for capitalism.¹⁶

This migration of Europeans to the temperate regions was accompanied by another type of migration. This entailed the migration of tropical labour from the colonies, particularly from India and China to the plantations in the West Indies and in other such areas. These two streams of migration were kept separated from each other, with the real wage of the tropical labour being much lower.¹⁷

---

¹⁶ Patnaik, P. (2007a)
¹⁷ Patnaik, P. (2007a)
Secondly, the capitalist core exported unemployment to the colonies and thereby also maintained a higher level of employment domestically. This export of unemployment was done in at least two different ways. Firstly, the colonies were flooded with manufactured cotton textiles from England and a one way tariff system was imposed whereby goods from colonies like India could not find market in England. This resulted in large-scale de-industrialization and unemployment for the colonial economies. Secondly, the surplus extracted from the colonies, like India, was used to finance England's balance of payment deficits which retarded the possibilities of industrial development in the colonies.

Therefore, the non-existence of rising unemployment and the concomitant shift in the labour force from agriculture to industry, in the capitalist core, was not a result of any immanent tendency of capitalism. Rather it was because of the fact that capitalism could exploit the pre-capitalist markets which ensured that it did not witness the problem of rising unemployment. The labour migration solved any problem of rising unemployment for these advanced countries, the export market of the colonies provided the necessary inducement to invest, while the surplus itself was greatly enhanced by the surplus siphoned off from the colonies. However, in the process of doing so, capitalism inflicted large scale unemployment in the colonies and decimation of the indigenous population in the temperate regions. In other words, the existence of large scale unemployment, and the retarded production structure of the developing countries are obverse of the fact of capitalist core not experiencing rising unemployment with a developed industrial structure.
To be sure, capitalism even during this period of rapid growth did not experience full employment. If capitalism cannot generate full-employment at the core, then it cannot do so in the underdeveloped countries also. Now, we have already seen metropolitan capitalism could thwart any tendency towards rising unemployment by exporting unemployment both by migration of people as well as by capturing the pre-capitalist markets. For the present day developing countries, these possibilities simply do not exist. The population of these countries cannot simply migrate to other places. Neither can they avail of external markets as was the case with metropolitan capitalism. Thus, the developing countries today are faced with bleak prospects of solving the problem of labour reserves.

2.4 A Critique Of The Lewis Model

The existence of massive labour reserves in the underdeveloped countries is then a legacy of the colonial exploitation of these countries. On the one hand, the indigenous industries were destroyed as a result of the one-way free trade policy pursued by the imperialist powers. On the other hand, the surpluses of these countries were siphoned off thereby generating the problem of a paucity of capital stock to absorb the unemployed. The manifestation of this problem was in the form of the developing countries having a large share of employment in the agricultural sector, which is the repository of labour reserves, while the developed countries had a smaller share of workers in the agricultural sector.
along with a smaller share of the agricultural sector in the GDP. In order to improve the growth of the developing countries as well as the condition of the people, it was thought that the population should be employed in industry rather than in agriculture. This was because industry being a higher productive sector compared to agriculture, (having a higher value of output per worker, compared to agriculture) a shift of the labour force to this sector will increase the total output. At the same time, this sector having a higher productivity will have higher wages.

Lewis\textsuperscript{18} provided a theoretical model of the above phenomenon. The starting point of the Lewis Model was to increase the capital accumulation in the developing countries. Lewis perceived the goal of the development process to be the increase in the savings rate in the underdeveloped economies from 5% to 15% of GDP. The unemployment problem in a labour surplus developing country is a result of a lack of adequate capital stock to employ the labour force.\textsuperscript{19} If the capital stock can be increased and meaningfully employed then the unemployment problem will get solved.

The Lewis model characterizes a developing economy as consisting of a dual economic structure, where there is a small modern or capitalist sector and a

\textsuperscript{18} Lewis (1954).
\textsuperscript{19} In this formulation of the major reason of the unemployment problem of the developing countries Lewis' position is similar to that of Kalecki. According to Kalecki, Unemployment and underemployment in underdeveloped countries are of an entirely different nature [from unemployment in the developed countries]. They result from the shortage of capital equipment rather than from a deficiency of effective demand ---Quoted from Kalecki (1976)
traditional or pre-capitalist sector, saddled with labour reserves. Any withdrawal of labour from the traditional sector to the modern sector will increase the output provided that the traditional sector’s output does not fall as a result of this withdrawal. Lewis therefore identifies different sections of this labour force, which can be designated as surplus labour in the sense that their withdrawal from the traditional sector would not adversely affect the output of this sector. The other people left behind in this sector can then work harder and produce the same level of output. This provides an unlimited supply of labour to the modern sector in the sense that the supply of labour exceeds the demand at the prevailing wage rate.

Lewis assumes that the wage rate in the modern sector is a mark up over the wages in the subsistence sector. The higher wages in the capitalist sector acts as an incentive for the workers in the pre-capitalist sector who seek employment in the modern sector. The equilibrium employment in the capitalist sector is determined by the equality between the marginal productivity of labour with the wage rate prevailing in the capitalist sector, since it is assumed that the capitalist sector consists of profit maximizing firms.
This is diagrammatically represented as follows:

In the diagram, $W_m, W_L$ are the wages in the modern and the traditional sectors respectively. $E^*$ is the equilibrium level of employment in the modern sector.

With employment $E^*$ in the modern sector, the profit is given by the triangular area $AW_m X$. A part or whole of this profit, is invested by the capitalist sector which enlarges the capital stock in the next period. With this investment, the $MP_L$ curve shifts to the right. With the shift in the $MP_L$ curve, the demand for labour in the modern sector rises. Given that there is surplus labour in the traditional sector, this excess demand for labour is met by the movement of labour from the traditional to the modern sector, which is shown in the following diagram.
With the expansion of the capitalist sector, the $MP_L$ curve continuously shifts to the right, absorbing more and more surplus labour from the traditional sector. This process goes on until all the surplus labour available in the traditional sector gets exhausted, or the wage rate in the modern sector equals the $AP_L$ in the traditional. This is what is referred to as the 'turning point' in the Lewisian scheme.

However, according to Lewis himself, there are at least four reasons why the process of expansion of the modern sector and the consequent increase in absorption of labour from the traditional sector may stop before the turning point is reached. These are enumerated as follows: Firstly, with the withdrawal of labour from the traditional sector, when the pace of capitalist accumulation exceeds population growth, the average product in the traditional sector rises. This in turn pushes up the wage rate in the modern sector, since the modern
sector wage is a mark up over the average product in the traditional sector. With this increase in the real wage in the modern sector, profit falls, hence investment of the capitalists falls leading to a fall in employment. Secondly, the terms of trade may turn against the capitalist sector because of which the process ends. Thirdly, the productivity in the traditional sector may itself increase due to better techniques. This raises the wage rate in the capitalist sector and reduces the pace of capital accumulation and employment growth. Lastly, the workers in the capitalist or modern sector may try to emulate the capitalist way of life and thus demand higher wages. This in the case of a constant productivity in the capitalist sector, will reduce the capitalist surplus and thereby slow down the process of capital accumulation and employment generation.

Many other economists have expounded the idea with reference to the exact dynamics of the shift in labour from the traditional to the modern sector, or the dynamics of population growth highlighting the basic minimum effort required to ensure that labour is absorbed in the modern sector. However in these models, the basic structure remains essentially the same.

The Lewis Model essentially postulates that given the level of productivity in the modern sector, the growth rate of employment is dependent on the growth rate of output of the modern sector, assuming excess supply of labour at a given wage rate. He assumes that given this excess supply of labour and the assumption that all or a part of the surplus in the modern sector is invested, as long as the growth

20 Fei and Ranis (1961).
rate of employment exceeds the rate of growth of work force, the economy will witness growing employment, but will reach a point when all the surplus labour from agriculture is absorbed.

The above however might not be necessarily the case. This is because of the following reasons:

Firstly, the Lewis model makes the classical assumption that savings are automatically invested, thereby completely assuming away the issues of demand deficiency$^{22}$. Unemployment in the Lewisian scheme is classical in the sense that it exists because of a paucity of capital rather than a deficiency of demand. Therefore with capital accumulation, the problem of unemployment will get resolved. However, the Keynesian revolution provided the insight that decisions to save and decisions to invest are two separate sets of decisions. In such a world, there is a need for explaining the investment behaviour of the capitalists or the so called 'inducement to invest'. There are at least two possibilities where the inducement to invest may dry up for the capitalist sector and the profits need not be invested. Firstly, suppose that there are three types of assets, money, bonds and physical assets. Now, if due to some reason, peoples' preference for money increases, then this higher liquidity preference will result in a reduction in the inducement to invest.$^{23}$ Secondly, there exists a host of parasitic classes which feed on the economic surplus, without contributing in any significant way in the

---

$^{22}$ See the article Development Economics in Perspective in Chakravarty (1998).
$^{23}$ See the article Keynes, Classics and the Developing Economies in Chakravarty (1998)
production process.\footnote{Baran (1962).} In both these cases, the growth rate of employment may be too small to absorb the surplus labour.

Let us however, assume like Lewis that there is no demand constraint in the system and all savings are necessarily invested. Even in this case the development as envisaged by Lewis may not materialize because of the following reason. If the modern sector is dependent on the traditional sector for the supply of food and the wage earners in the modern sector spend a part of their wages to consume the product of the traditional sector, presumably food, then with increase in employment, the workers will demand more food from the traditional sector. If the supply of food is not forthcoming to the requisite degree from the traditional sector, then the system will witness either a squeezing of the real wages of the workers, or a decline in the rate of profit. The former, apart from being perhaps infeasible will also go against social justice.\footnote{Kalecki (1976)} In the absence of such a squeeze on the real wage, the profit rate of the modern sector will decline, since the terms of trade will move against it and the accumulation in the modern sector will decline leading to a decline in the growth rate of employment.

To be sure Lewis considered this case in his model while discussing the adverse impact of the terms of trade on the expansion of the capitalist sector. However, Lewis’ treatment of the agricultural bottleneck is only supposed to be a special case, with the original assumption being of a self-sustained modern sector even with respect to food. Moreover, the causes attributed by Lewis to any tendency of
the agricultural prices to rise or a stagnation in the agriculture are completely
based on the Ricardian notion of a diminishing return to land, as a result of
which rent increases eating into the profit of the capitalists.\textsuperscript{26}

There is however a completely different set of reasons, which are not based on the
Ricardian notion, for which the agricultural bottleneck will exist leading to a halt
in the expansion of the modern sector. Firstly, Kalecki had argued that the prices
of agricultural products, at least in the short run, are demand determined. This
can be visualized as the supply of the agricultural commodities being completely
inelastic to price in the short run. In this case, any rise in demand necessarily
leads to a rise in prices. Secondly, agriculture in the developing countries has
certain institutional barriers to growth in the absence of land reforms which act
as an disincentive for the farmers to improve the production of agricultural
commodities.\textsuperscript{27} In most developing countries, such radical land reforms to release
the agricultural bottleneck have not taken place. In this case, even in the long
run, the food bottleneck will be hit, resulting in inflation leading to an atrophy of
the growth process itself. Thirdly, it can also be the case that rural rich through
their political clout might tilt the terms of trade in the favour of agricultural
commodities that they produce, in which case also, the growth of the modern
sector will peter out.\textsuperscript{28}

\textsuperscript{26} Ricardo's problem of increasing rents is first cousin to this conclusion: he worried about rents increasing
inside the capitalist sector, whereas we are dealing with rents outside the sector --Quoted from Lewis (1954)
\textsuperscript{27} Kalecki (1972)
\textsuperscript{28} Mitra (1977)
Chapter 2

It can however be argued that in the case of any such supply bottleneck, the country can import food and ensure the expansion of the modern sector. However, this is not a feasible option because of the following reason. If food is imported from abroad, then there has to be a sustained export earning to import the food. For many developing economies, such sustained export earning is non-existent. This is because on the one hand the modern (industrial) sector's products from the developing countries do not find a substantial export demand in the world market. Secondly, even if the developing country has natural resources which can be exported, it presents two sets of problems. Firstly, these natural resources will witness continuous depletion in the hands of the foreigners. Secondly, for a very big country like India, in order to feed its people, the magnitude of natural resources that is required, to earn sufficient export earning, is too large. If the import of food to carry forward the growth process is done with the help of foreign aid, then the developing country has a chance of becoming politically subservient to the donor country.

Therefore, it is seen that the growth of the modern sector which has to cater to the employment generating need of the economy, has to be based on improvements in the agricultural sector, particularly consisting of land reforms. It can therefore be said on the basis of the above discussion that any policy of industrialization with non-inflationary growth rate and rising employment for the developing country, has to be on the basis of a thoroughgoing agricultural revolution, based particularly upon radical land reform.
On the other hand, the rate of growth of employment in Lewis might decline as a result of an increase in the rate of growth of labour productivity. Lewis assumes constant technology and a given level of productivity in the economy. However, if there is technological progress then, the increase in the growth rate of the modern sector is not a sufficient condition for the improvement in the growth rate of employment. This is because, growth rate of employment \( g_E \) is the difference between the growth rate of output \( g_Y \) and the growth rate of labour productivity \( g_P \). If the growth rate of labour productivity increases as a result of the growth in the modern sector, as per Kaldor’s law, then the employment growth rate necessarily slows down. If on the other hand, this growth rate is greater than \( g_Y \) then employment growth rate becomes negative.

Suppose, like in Lewis, the traditional sector consists of artisans, handicraft production too. If the modern sector produces products which displace these commodities, then that will cause an increase in the number of labourers unemployed in the traditional sector, which again become surplus labour\(^{29}\). In this case then, even with a high growth rate of the modern sector, the surplus labour will not get exhausted. Lewis gets rid of this argument by postulating that ultimately all these workers will be absorbed in the capitalist sector through the process of capital accumulation. This is not necessarily true. If in the capitalist sector there exists continuous technological progress of a labour saving nature,

\(^{29}\)It was in order to avoid this sort of a situation that the Indian Government during the early years of planning reserved certain commodities, which were to be produced by the small scale or the so called traditional sector only.
then the growth of the capitalist sector will not absorb the labour reserves and perpetuate unemployment.

This adoption of continuous labour saving technological progress can be envisaged in the following manner. The elites of developing countries have a preference for goods produced in the metropolis. Now, if it is the case that in order to access these commodities a growing share of the surplus instead of being invested is used to purchase the goods from the metropolitan countries, then the growth rate of the modern sector will slow down, since a part of the surplus will not be reinvested in the economy, thereby slowing down the growth rate of employment.

On the other hand, the demand of the capitalists for the metropolitan goods continuously exerts pressure on the production structure of the economy shifting it towards producing such commodities produced in the metropolis, incorporating continuous labour saving technological progress. There is however continuous innovations in the metropolis. In this case, therefore, because of the demand of the elites for the metropolitan commodities, the increasing rate of labour productivity is continuously replicated in the developing country, restricting the labour absorption in the modern sector. With the fixed real wage in the modern sector, this increase in labour productivity results in a higher surplus for the capitalists. The reinvestment of this surplus will result in higher growth of the modern sector, which can improve the employment growth rate of the economy. This is however not necessarily the case. If in every period, the surplus is
invested for producing commodities, the production of which necessitates even higher growth in labour productivity, then the employment growth may not rise even with a higher growth in the modern sector.

Notwithstanding all these problems mentioned above, the basic idea of Lewis Model in terms of shifting the work force from agriculture to industry in a developing country through industrialisation, we believe, is correct. The critique merely pointed out the fact that factors, other than those mentioned by Lewis, should be kept in mind in order to ensure that this transformation actually takes place in a developing country. What has been the actual experience of the developing countries in their efforts towards industrialisation and generating employment for the people? We take up this question in the next section.

2.5 Import Substituting Industrialisation In Developing Countries And Its Impact On Employment Generation

We have seen in the last section that industrialization is essential for the developing countries to improve the living condition of the people. However, the agenda of industrialization for these countries was difficult to attain under the auspices of metropolitan capitalism because the legacy of colonialism in the third world left a distorted production structure which specialized mainly in the production of primary commodities. At the same time, the policies of free trade
advocated and implemented by metropolitan capital resulted in a situation in which large-scale de-industrialization occurred in the developing countries. Given the experience of free-trade and the coupling of the developing countries with world capitalism, which resulted in stagnation in their economies, the third world countries after independence sought to industrialize their economies by de-linking themselves, at least to a limited extent, from the world capitalist system by pursuing a relatively autonomous development path led by the state under the policies of import substitution. As early as 1949, Prebisch advocated policies of industrialization for Latin American countries. The main argument of Prebisch was precisely the fact that if these economies are stuck in a division of labour, where they export only primary commodities, then the terms of trade of these commodities will witness a secular decline owing to the technical progress in the advanced countries. On the other hand, it was also ascertained by him that

"Formerly, before the great depression, development in the Latin-American countries was stimulated from abroad by the constant increase of exports. There is no reason to suppose, at least at present, that this will again occur to the same extent, except under very exceptional circumstances. These countries no longer have an alternative between vigorous growth along those lines and internal expansion through industrialization. Industrialization has become the most important means of expansion."

This urge for industrialization of the third world countries was an attempt to break loose from the production structure imposed on them by centuries of

31 Quoted from Hirschman (1968).
colonial subjugation. In order to carry forward this policy of import substitution, the role of the state became crucial, albeit in varying degrees, depending upon the characteristics of the strategy. We now discuss the experiences of two different regions of the developing world which were pioneers in the policies of ISI—India and Latin America.

2.5.1 The Case Of India

One of the major initiatives under planning and development was witnessed in our country under the second five year plan which was based on a strategy known as the Mahalanobis strategy.

At the time of independence, India inherited an economy which had been most exposed to the policies of free trade and *laissez faire* till the World War I, which caused massive drain of wealth and de-industrialization as has been discussed earlier. As a result, at the time of independence, the Indian economy was faced with a number of constraints. The basic constraint was perceived to be a lack of adequate capital necessary for introduction of more productive technology. Secondly, it was perceived that the market mechanism would result in excessive consumption of luxuries on the part of the upper income group and under-investment in crucial sectors, thereby not solving the problem of India's underdevelopment.\textsuperscript{32} Added to this there was another reason for relying on the state sector, namely the infancy of the Indian capitalist class to carry forward the required massive investments in infrastructure and certain basic industries.

\textsuperscript{32} Chakravarty (1987)
Therefore the policy makers in India opted for a strategy of state planning in accordance with a strategy laid down by Mahalanobis, which is sometimes referred to as the Nehru-Mahalanobis strategy. The Mahalanobis model for the Indian Plan postulates a two sector model and shows that the long run growth rate of the economy is increased if more investment is allocated to the Department producing capital goods (Department I). It was argued that in order to have a higher rate of growth, the investment GDP ratio had to be increased, and, given the limited possibility of transformation of one set of commodities into another through international trade, this could be done only by shifting the domestic investment allocation towards capital goods. This emphasis on the role of the investment good sector and the closed economy assumption of the Mahalanobis model have been criticized by many economists as export pessimism. However, Mahalanobis had a more sophisticated position. He essentially envisaged the production structure of India as being backward and specializing in the production of primary commodities. If India had to grow in the context of an open economy, then India would essentially have to depend on the export earnings to finance its developmental needs. Given a backward production structure, Indian goods will be basically out competed from the world market and hence the country as a whole will face a growing problem in maintaining a growth rate as well as financing its development needs, since export earnings will dry up. The Mahalanobis strategy can be justified in terms of developing a dynamic comparative advantage for more technologically improved goods, which can earn more export earnings for India in the long run.

33 Chandra (1997).
Indian planners, as has been mentioned, looked upon the development problem as one of inadequate capital stock to modernize the economy as well as employ more people. In this sense the Indian planning exercise can be thought of a variant of the Lewis Model. However, as has been mentioned in the discussion of the Lewis Model, a criticism of the strategy of relying on heavy industries sector can be made at this point. If wages in the manufacturing sector, which are at a subsistence level, are spent on agricultural commodities and the manufacturing sector output needs a fixed proportion of agricultural commodities as inputs, determined by technology, then the maximum manufacturing output is determined by the surplus of the agricultural sector. In the absence of a sizeable surplus from the agricultural sector then, the growth process will be jeopardised. The Indian planners were aware of this. In order to take care of this problem, the planners advocated thoroughgoing land reform in the country as well as highly labour intensive methods of production for all other sectors apart from the capital goods sector. It was emphasised that land reform will reduce the capital-output ratio in agriculture, where even without much planned investment going into that sector, its output will expand. At the same time the small scale sector will provide for the employment to the vast masses of people, as well as provide wage goods for the employed population in the heavy industry sector. It was in cognizance of the importance of the small scale sector that it was protected by prohibiting entry of big firms in the production of commodities earmarked for the small-scale sector. In other words, the Indian planners envisaged an economy where the modern sector is designed to take the

---

35 Chakraborty (1987)
Chapter 2

economy to a higher growth trajectory by increasing the investment-GDP ratio while the small scale sector will generate employment for the masses together with wage goods and land reform will ease out the agricultural constraint, which will also contribute to higher wage good output.

However, the actual experience of the Planning process in India was such that it could not generate adequate employment for the people, with the bulk of them still living under poverty and hunger. This is evident from the fact that employment growth averaged at around 2% per annum in the 1950s and 1960s, while the labour force grew at a rate of 2.5% per annum.\footnote{Papola (2007)} The question is why could not the Second Five Year Plan generate adequate employment for the people?

The basic problem with the Mahalanobis model was that it visualized the role of the state transcending all class antagonisms. As a result of the basic class character of the Indian state, land reforms were never undertaken. As a result of this, as Kalecki had argued, the productivity per acre in agriculture could not be increased and soon a bottleneck would be reached resulting in a wage good constraint for the non-agricultural sector. Any increase in the growth rate beyond this point becomes necessarily inflationary and hence socially unsustainable. The agrarian impasse in India in the 1960's was a result of this phenomenon. The agrarian impasse affected the economy in two ways. Firstly, as a result of the impasse, the agricultural surplus necessary for the modern sector to grow\footnote{Papola (2007)}
actually dried up, leading to a supply constraint, which caused the industrial output to stagnate. Secondly, this supply bottleneck also manifested itself in the form of rising food prices. Food being an essential commodity has an inelastic demand for vast masses of the people. Therefore, with rising food prices, the demand for food could not be reduced. Hence, given a fixed wage, the portion of money which was earlier allocated by the worker households for the purchase of industrial goods and the produces of the small scale sector was lowered, resulting in further stagnation in the output of these sectors. Both of these resulted in stagnation in the economy and therefore non-absorption of labour reserves.

However, after the Green Revolution, the agrarian sector sustained the growth rate, but there was lowering of the growth rate in the industrial sector. This was because of the movement of the terms of trade in favour of the rural rich, who obtained a higher price for its produce through its class position and relation with the state. Therefore, with lack of land reforms as well as a shift in the terms of trade against industry resulted in stagnation of Indian industry, which thereby failed to increase employment in the economy.

In this situation of high inequality in land asset resulting in a narrowed domestic market, state spending was crucial for the growth of the market in the Indian economy. This state spending was severely constrained because of the fact that the state in order to provide fillip to the development of capitalists continuously provided tax and other concessions to them, which in turn enmeshed the state in

38 Mitra (1977)
39 Chandrasekhar and Ghosh (2002)
a fiscal crisis and greatly constrained its capacity to continue financing the development plan model.\textsuperscript{40} At the same time, the state also failed to impose a minimum level of discipline on the capitalists which resulted in large scale evasion of tax payments further limiting the capacity of the state to spend. All this in turn meant a tendency towards stagnation in the economy, which therefore could not lead to significant improvement in employment level, and could not make a dent on the problem of labour reserves in India.

Moreover, in India, as has been already mentioned, there existed very significant asset and income inequality. In such a society, the ruling elites have a latent demand in favour of newer commodities produced in the advanced capitalist countries, which entail progressively lower levels of labour input. With rising sops to the capitalists, increasing their income, this latent demand increases in magnitude, which after crossing a threshold level entails a situation where the demand for producing these commodities in the country increases, pushing the economy towards more liberalization.\textsuperscript{41} Since the labour absorption capacity of these commodities is less, the production of these commodities in India could not take care of the problem of unemployment. It must however be added that the probability of accessing these commodities is higher in the case of a liberalized economy. But what the preceding discussion points to is the fact that the latent demand for these commodities can in fact tilt the economy towards more liberalization enabling the elites to access these commodities.

\textsuperscript{40} Patnaik and Chandrasekhar (1995).
\textsuperscript{41} Patnaik, P. (1998).
Chapter 2

The Mahalanobis strategy envisaged a solution to the problem of the Indian economy both in terms of growth as well as employment. It however failed to do so. This we believe is not because of any fundamental theoretical problems with the model per se. Rather the failure of the model is precisely in terms of implementing it in a class divided society as has been argued earlier. But the theoretical insight of the model in terms of arguing for 'walking on two legs' (to borrow Mao's words) is fully justified. It is in the nature of capitalism that technological progress is essentially labour saving. In a labour surplus country like India, relying only on spontaneous development of capitalism is never going to solve the problem of unemployment. One has to ensure the growth of the sectors which produce goods which are labour intensive, like agriculture, small scale sector etc. and for this create a pattern of income distribution and demand which tilts towards such growth. If it is left to spontaneous capitalism, which necessarily impoverishes the majority of the people, while enriching a few, the production structure of the economy will shift towards goods which are demanded by the elites, who have an increasing weight in the economy. These commodities are essentially labour saving in nature and hence will not be able to absorb the labour reserves. Thus in order to ensure that employment is generated in the economy, a degree of state intervention is essential; in terms of restricting the production of goods which are labour saving and putting purchasing power in the hands of the poor, whose demand primarily consists of the mass consumption goods which generate more employment.

As opposed to the line of criticism of the Mahalanobis model discussed
previously, the mainstream argument against it emphasizes the fact that it assumes away trade. The correct strategy, it is argued, would have been to rely on international trade to develop the Indian economy. This would have resulted in more growth for the economy as the producers would have been catering to a larger market at the world level. Secondly, according to the theories of comparative advantage, India should have specialized in the labour intensive sectors for exports. Therefore, a higher export growth, by virtue of the exporting sectors being labour intensive, would have taken care of the problem of unemployment also. Thus it is argued that the appropriate strategy for all developing countries including India is to open up their markets which will result in higher growth and employment.

The agenda of globalization and liberalisation of the Indian economy promised precisely this to the Indian people, that it will usher in a new trajectory of growth and employment in the country. The impact of these policies on the growth and employment condition in India will be analysed in a separate chapter on India.

As far as the Mahalanobis strategy is concerned, it can be said that the planning exercise with import substitution in India, while it improved the growth rate and the conditions of the people, compared to the devastation unleashed during the colonial regime, was still not enough to absorb the labour reserves in the country and improve the standard of living of the vast majority of the people.
2.5.2 The Case Of Latin America

The experience of the Latin American countries speaks a similar story. The first impetus to the process of industrialization in Latin America was a result of an expansion in primary exports witnessed before the Great Depression in 1929. With the expansion of exports, there was a rise in productivity and income which facilitated the formation of a home market. With the formation of home market, certain industries developed in these countries which however produced low end manufactures, though the bulk of the manufactured goods used in these countries were imported. With the collapse of the export market in the wake of the Great Depression, the Latin American countries lost the means of financing their imports as well as the impetus for industrialisation through an expanding export sector. In response to these, the Latin American countries embarked on a path of import substitution.

The Latin American countries embarked upon industrialization by focusing upon light consumer goods industries, which consisted of imitation of products from the developed countries. However, this reliance on the consumer goods sector resulted in neglecting the capital and intermediate goods industries, particularly in the smaller countries. In the smaller countries of Latin America, even with high growth under ISI, the proportion of capital goods supplied by domestic producers was quite low. Brazil, Argentina and Mexico were the only exceptional countries which developed a domestic capital goods industry. This resulted in

44 Hirschman (1968).
very high import component in the industrialization process, which resulted in
difficulties in terms of generating enough foreign exchange to pay for the
imports. Moreover, with the policies of industrialization, leading to a rising
demand for the intermediate and capital goods, structural inflation started
afflicting these economies for the following reasons.\textsuperscript{45} Firstly, with the import
substituting industrialization, the agricultural sector could not adapt itself to
augment its supplies for the domestic market. This was because the agricultural
sector was mainly adapted to production for the export market. With rise in
domestic demand, productivity per acre on land used for domestically oriented
production needed to be increased adequately. Alternately, the land used for
producing for the export market needed to be used for cultivation for the
domestic market. Neither of these took place resulting in inflation. Secondly, the
Latin American countries did not have adequate infrastructure. Thirdly, these
countries faced growing difficulties in terms of financing the imports necessary
for sustaining the industrialisation, since exports were sluggish. This resulted in
the cost of equipments to rise, which resulted in inflation.

At the same time, the Latin American society was marked by severe inequalities,
which resulted in the elites exerting a demand for high technology goods from
the developed countries. This demand was manifested in import of high end
technologies from the developed countries\textsuperscript{46}, which limited the possibilities of
development of an indigenous technological base in these countries and retarded
the capacity of these economies to absorb labour reserves even with a higher

\textsuperscript{45} Furtado (1970)
\textsuperscript{46} Palma (1994)
growth of the modern sector.

Given the fact that import substitution could not solve the problems of the developing countries, it can be argued that if the modern sector produces for the export market, then the growth of the modern sector will reduce unemployment and absorb labour reserves. In other words, the limitations of the strategies of import substitution were that they relied exclusively on the domestic market, exhibiting complete export pessimism. The correct strategy would have been to go for an export oriented growth strategy which would have taken care of the problem of lower growth rates as well as unemployment, as is supposed to have been the case with the East Asian countries.

The experience of the East and South-East Asian countries is often projected as the model for development for the developing economies. It is argued that opening up of the economy along with rapid export promotion is the key to success for these economies which needs to be replicated by one and all. There is however more to the East Asian story than merely export led growth. The state played a crucial role in these economies, in terms of protecting the domestic market while encouraging export activities. Secondly, prior to the export thrust, extensive land reforms were undertaken in these countries, providing a broad base of domestic demand. At the same time, the large scale land reform ensured that the land lord class, as a ruling class, was completely done away with, thereby enabling the state to completely ally with capital while not having to share the surplus with the parasitic class of landlords. In contrast to this, in
India, the landlord class does exist as a constituent of the ruling class and demands its own share from the national surplus, thereby reducing the possibility of a complete capitalist transition.\footnote{Patnaik, P. (1997a).} Thirdly, the market to which these countries catered was a fall out of a particular context in the international economy, where advanced capitalist world, especially the U.S., in order to counter the socialist challenge had to come up with success stories, particularly for the developing world. In this context, market access to these economies was provided by the advanced capitalist countries, which far exceeds what may be willingly provided to any particular group of countries today.\footnote{Patnaik, P. (1997a).} Fourthly, the success of the East Asian countries with regard to exports was so dramatic because they were so few in number. If all the developing countries had the same export share in GDP as the East Asian countries, then the developing countries would have had a total share in world manufacturing export of 45% in 1977, which would have been definitely resisted by metropolitan capital.\footnote{Patnaik, P. (1997a).} It should be clear from the above discussion that even the success of these countries with regard to their exports and growth rate, were a result of certain specific conjunctures and cannot be replicated, when it comes to labour absorption, for the developing countries as a whole.

While it is observed that the developing countries even with import substitution

\footnote{Patnaik, P. (1997a). It is however the case that China's export share in the world market has increased significantly in the recent past. This is not because of any strategic considerations, as was the case for the East Asian countries. Rather the Chinese export success is a result of following policies aimed at increasing the export share. These policies are based on the fact that China has cheap labour with adequate infrastructure to produce cheaply for the world market. The Chinese export story will be analysed in details in the chapter on China.}

\footnote{Patnaik, P. (1997a).}
could not solve the problem of labour reserves, the socialist countries, actually solved the problem of labour reserves. In the next section we try to analyse the causes for such absorption of labour reserves in the socialist countries.

2.6 Absorption Of Labour Reserves In Socialist Countries

In contrast to the experiences of both the developing countries as well as the countries of advanced capitalism, the socialist countries managed to use up their labour reserves. This has been pointed out as one of the most important and historic achievements of socialism.50 The fact that socialism witnessed full-employment, while capitalism (both in advanced as well as developing countries) could not attain it, points to the fact the causes which led to unemployment in capitalism were absent under socialism. What are those causes?

It was pointed out by Keynes and Kalecki, as already mentioned in the last chapter, that unemployment in developed countries was a result of the problem of deficiency of aggregate demand. Therefore, in order to ensure that full employment is established, there is a need to get rid of the problem of deficient aggregate demand. This cannot be achieved by the spontaneous functioning of the capitalist system. This is because, in a spontaneous capitalist system, investment, undertaken by individual capitalists, is the key determinant of output and employment.51 Now, in a world with uncertain future, there is no

50 Kornai (1979)
51 Keynes (1937).
mechanism under capitalism which can ensure that investment is at the level that is sufficient to attain full-employment output. Therefore, the key question is how does socialism overcome the problem of the demand constraint? Kornai gave an answer to the question, which is summarized below.

There are fundamental differences between a firm under socialism and a firm under capitalism. The budget constraint facing a capitalist firm is hard and that of a socialist firm is soft. This essentially means that for a capitalist firm’s investment decision, it has to keep in mind the finances available to it, as well as the prospects for profits from the investment. In case of loss, the firm has to leave the market. Thus, its choices are strictly within the budget constraint. In other words, the firms face a hard budget constraint. However, in case of a socialist firm, the budget constraint is soft. This means that the firm knows that the state will bail it out in case its investment decisions cross the budget constraint. \(^{52}\)

In the case of capitalism, given that the budget constraint is hard and binding, the system becomes demand constrained and therefore, the firms normally do not employ all the available resources, including labour, thereby creating the problem of unemployment. However, under socialism, given that the budget constraint is soft, there is practically an un-satiated demand for the inputs which the firms try to employ for meeting or even exceeding production targets. Since all the firms in the economy do the same, the economy becomes resource

---

\(^{52}\) Kornai (1979)
constrained with full employment of labour. This full-employment of labour however is accompanied by a shortage economy since resources are sucked in by the firms in order to meet their production targets.\textsuperscript{53}

This formulation of Kornai, is however based on a micro-theoretic approach to the question of state and employment under socialism. It is not only the case that the behaviour of the firms in terms of their insatiable demand, underwritten by the state, leads to full-employment. Over and above this, the state has to provide for a huge social service sector, in terms of providing the people with universal health, education etc. In order to provide these to the people, a large number of people were employed, which also served the purpose of attaining full-employment.\textsuperscript{54} At the same time, the state under socialism is committed to take up large scale investments to employ more people and industrialize the country. Under capitalism, firms function with the profit motive. This spontaneous functioning of capitalism results in unemployment, which is a cost to society but treated as an externality by individual firms. Under socialism however, these externalities become a part of the social costs for the socialist planner. In this case providing employment to people is rational from the point of view of minimizing social costs under socialism.\textsuperscript{55}

The problem of demand constraint is not present in socialism as a result of planning where through planning, savings and investment are always equated,

\textsuperscript{53} Kornai (1979)
\textsuperscript{54} Ellman (1979)
\textsuperscript{55} Ellman (1979)
aimed at attaining a target growth rate and full-employment. However, demand constraint is only one of the problem, particularly in the context of a developing economy. We have already seen that in order to have a high growth in a developing country with limited capital stock, the realization of an agricultural surplus was essential for growth. This was not possible in the non-socialist developing countries because of the absence of land reforms which gave rise often to an adverse movement in the terms of trade for the manufacturing sector, or to high inflation (where manufacturing prices were prime cost plus) under the state led growth regime. In socialism, on the contrary, extensive land reforms were carried out. Secondly, the terms of trade was tilted in favour of the industrial sector in order to ensure a growing surplus from the agricultural sector. 56

In addition, the socialist countries controlled the spontaneity of technological change, through which they had a control on the rate of growth of labour productivity in the economy. In other developing countries, the demand of the elites and capitalists for the goods produced in advanced capitalist countries, introduced a production structure, in the economy which witnessed a rapid transformation in a labour saving direction. This problem was avoided in the socialist countries, where the strength of the capitalist class was greatly reduced, if not eliminated, with the state controlling the pace of technological progress in accordance with the goal of maintaining full employment in the economy.

56 For a detailed discussion on the issue of terms of trade under socialist construction see Mitra (1977) and Dobb (1966)
2.7 Employment Problem In The Era Of Neo-liberalism

Let us first summarize the discussion so far. We have seen that capitalism as a system cannot generate full-employment. In fact theoretically, capitalism has no mechanism to spontaneously eliminate rising unemployment. The fact that capitalism in the pre World War I period did not witness any problem of rising unemployment does not invalidate the theory. Rather, capitalism's penetration into the pre-capitalist markets and the availability of open spaces in the 'New World' ensured that the system did not witness a rising rate of unemployment, since the problem was exported to the colonies, as a result of which the erstwhile colonies witnessed massive de-industrialization and a siphoning of the economic surplus to the capitalist core. This resulted in retarded development and the genesis of labour reserves in the developing countries of today.

After de-colonisation, the control of global capital on the colonies was reduced. This should have according to the above theory resulted in a slowing down of the growth rate of the capitalist economies. The fact that it did not do so however was because of the reliance of capitalism on state expenditure and demand management as has been discussed in a previous section. However, the period after the 1970s was marked by a rising to dominance of finance capital, which entails deflationary policies being pursued all over the globe. This consequently reduced the growth rate of the world economy as is evident from the following table:
Table 2.2: Average Annual Rates of Growth of World GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Growth Rate (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1913-50</td>
<td>1.85</td>
</tr>
<tr>
<td>1950-73</td>
<td>4.91</td>
</tr>
<tr>
<td>1971-80</td>
<td>3.7</td>
</tr>
<tr>
<td>1981-90</td>
<td>3.0</td>
</tr>
<tr>
<td>1991-2000</td>
<td>2.6</td>
</tr>
<tr>
<td>2001-05</td>
<td>2.5</td>
</tr>
</tbody>
</table>

Source: First two rows from Maddison (2003) Table B-19 and the rest from Chandrasekhar (2007)

From the above table it is clear that the average annual growth rate of world GDP which was close to 5% in 1950-73 witnessed a secular fall in the subsequent periods when the policies of globalization were being pursued all over the world, with the growth rate coming down to 2.5% in the period 2001-05.

Added to this slow pace of growth of the world economy is the fact that there has been an increase in the rate of growth of labour productivity in the world economy based on the introduction of new technologies, particularly that of electronics and information technology.57 This reduction in the trend rate of growth of the world GDP along with a rise in the rate of growth of labour productivity, resulted in a rise in the unemployment rate for the OECD countries taken as a whole. This is shown in the following chart:

---

57 Chandrasekhar (2007)
Chapter 2

From the above chart it is seen that during the period of the so called Golden Age of Capitalism, the unemployment rates in the OECD countries, which are basically the advanced capitalist countries, decreased drastically from around 6% to slightly more than 2%, (1960-1973). However, since 1973, with the pursuit of the policies of demand deflation under the neo-liberal dispensation, the unemployment rate has increased steadily, presently being almost the same as what prevailed before the commencement of the so called Golden Age of Capitalism.

This problem of slow growth in the world economy along with a rising growth rate of labour productivity must be affecting the developing countries adversely in terms of using up its labour reserves. It should be however noted that the growth rate in most of the developing countries is higher than what prevails in the advanced countries, if we consider the last two decades. This is shown in the

---

**Chart 2.1**

Unemployment Rate for OECD Countries

Note: Unemployment Rate is calculated for all persons in the 16-64 age group.
following table:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>World Real GDP</strong></td>
<td>3.1</td>
<td>3.8</td>
</tr>
<tr>
<td><strong>Advanced Countries</strong></td>
<td>2.7</td>
<td>2.7</td>
</tr>
<tr>
<td><strong>Developing Countries</strong></td>
<td>3.7</td>
<td>5.3</td>
</tr>
</tbody>
</table>

Source: World Economic Outlook, October 2007, IMF

From the above table it is evident that the growth rate of the world has been sustained and marginally increased solely because of the growth rate of the developing countries, since the growth rate of the advanced countries is stagnant. However, this increase in the growth rate of the developing countries has not been accompanied by any improvement in the unemployment problem for a majority of these countries. This is shown in the following table:
Table 2.4: World and Regional Estimates of Unemployment Rates

<table>
<thead>
<tr>
<th>Unemployment Rate</th>
<th>1996</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006*</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>6.2</td>
<td>6.6</td>
<td>6.5</td>
<td>6.5</td>
<td>6.4</td>
<td>6.3</td>
</tr>
<tr>
<td>Developed</td>
<td>7.8</td>
<td>7.3</td>
<td>7.4</td>
<td>7.2</td>
<td>6.9</td>
<td>6.4</td>
</tr>
<tr>
<td>Economies &amp; E.U.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Central &amp; South-</td>
<td>9.8</td>
<td>9.8</td>
<td>9.4</td>
<td>9.3</td>
<td>9.0</td>
<td>8.8</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(non-EU) &amp; CIS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>East Asia</td>
<td>3.8</td>
<td>3.9</td>
<td>3.8</td>
<td>3.7</td>
<td>3.7</td>
<td>3.6</td>
</tr>
<tr>
<td>South-East Asia &amp;</td>
<td>3.7</td>
<td>6.1</td>
<td>6.2</td>
<td>6.4</td>
<td>6.1</td>
<td>6.2</td>
</tr>
<tr>
<td>Pacific</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>South Asia</td>
<td>4.6</td>
<td>5.1</td>
<td>4.8</td>
<td>5.4</td>
<td>5.3</td>
<td>5.1</td>
</tr>
<tr>
<td>Latin America</td>
<td>7.9</td>
<td>8.8</td>
<td>8.7</td>
<td>8.3</td>
<td>8.4</td>
<td>8.6</td>
</tr>
<tr>
<td>North Africa</td>
<td>14.0</td>
<td>13.7</td>
<td>13.4</td>
<td>12.5</td>
<td>11.6</td>
<td>11.5</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>9.2</td>
<td>10.2</td>
<td>10.1</td>
<td>9.7</td>
<td>9.7</td>
<td>9.7</td>
</tr>
<tr>
<td>Middle East</td>
<td>12.4</td>
<td>13.0</td>
<td>12.4</td>
<td>11.7</td>
<td>12.2</td>
<td>12.1</td>
</tr>
</tbody>
</table>

Source: Key Indicators of Labour Market-8, 5th Edition, ILO

*preliminary estimates

From the table it is clear that the unemployment rate for the world increased marginally comparing the period 1996 and 2006. At the same time however it is seen that while the unemployment rate for the developed countries declined during this period, the unemployment rate for the developing countries, particularly the countries of South-east Asia, South Asia, Sub-Saharan Africa and Latin America increased, while for the other developing countries the unemployment rate improved only marginally (East Asia) or remained very high (North Africa and Middle East). Hence it is seen that the developing countries
even with a high rate of growth of GDP could not manage to improve its unemployment rate. The question is why?

With the coming to dominance of finance capital since the 1970s, there was also the withdrawal of the \textit{dirigiste} policies in the developing countries. By that time, the contradictions of the import substituting industrialisation also came into the fore, resulting in rejecting these set of policies for the development of the third world countries. Instead what was proposed was that in order to grow, the developing countries must be outward oriented and rely on export led growth, while opening up their financial sector to the flow of international finance capital.

The basic prescription for developing countries in terms of a higher export growth is postulated on the premise that even if the domestic market is demand constrained, the world market is never demand constrained, so a developing country can sell any amount in the world market, thereby overcoming the problem of demand constraint. Unfortunately, however, this is not true. To assume that there is no demand constraint in the world economy cannot explain the phenomenon of world depression or unemployment existing at a world level. Moreover, the world taken as a whole is indeed a closed economy. Therefore if problem of aggregate demand can exist in a closed domestic economy then it can of course exist in the world as a whole.\textsuperscript{58} In fact with the coming to dominance of international finance capital, deflationary policies have been implemented all

\textsuperscript{58} Patnaik, P. (2005b)
over the world resulting in a slow down of the growth rate of the economy. Now, the growth rate of exports of developing economies depends on growth rate of the world economy. If the latter has slowed down then the developing countries have to compete against each other to capture a greater share of a shrinking market.

In this situation, it may so happen that the export surplus of some developing countries be balanced by the import surplus of some other countries. In other words it is highly improbable that all the developing countries can increase their export share in the world market through higher export growths. This is shown in the following table:

Table 2.5: Export Growth and Share in World Exports of Select Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Value (US$ billion)</th>
<th>Growth rate (%)</th>
<th>Share in World Exports (%)</th>
<th>Change in shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 China</td>
<td>969</td>
<td>24.2</td>
<td>28.5</td>
<td>27.2</td>
</tr>
<tr>
<td>2 Hong Kong</td>
<td>317</td>
<td>6.4</td>
<td>11.6</td>
<td>9.7</td>
</tr>
<tr>
<td>3 Malaysia</td>
<td>161</td>
<td>6.4</td>
<td>12.1</td>
<td>14.0</td>
</tr>
<tr>
<td>4 Indonesia</td>
<td>104</td>
<td>2.0</td>
<td>22.9</td>
<td>19.0</td>
</tr>
<tr>
<td>5 Thailand</td>
<td>131</td>
<td>8.6</td>
<td>14.6</td>
<td>19.1</td>
</tr>
<tr>
<td>6 Singapore</td>
<td>325</td>
<td>10.2</td>
<td>11.8</td>
<td>14.4</td>
</tr>
<tr>
<td>7 India</td>
<td>120</td>
<td>15.9</td>
<td>29.8</td>
<td>21.0</td>
</tr>
<tr>
<td>8 Brazil</td>
<td>138</td>
<td>15.2</td>
<td>22.7</td>
<td>16.0</td>
</tr>
<tr>
<td>9 Mexico</td>
<td>250</td>
<td>3.2</td>
<td>13.2</td>
<td>16.8</td>
</tr>
<tr>
<td>10 Russia</td>
<td>305</td>
<td>14.7</td>
<td>33.3</td>
<td>25.0</td>
</tr>
<tr>
<td>11 Korea</td>
<td>272</td>
<td>9.6</td>
<td>15.6</td>
<td>18.4</td>
</tr>
<tr>
<td>12 Developing countries</td>
<td>5458</td>
<td>12.1</td>
<td>22.0</td>
<td>19.7</td>
</tr>
<tr>
<td>13 World</td>
<td>12040</td>
<td>9.4</td>
<td>14.1</td>
<td>15.7</td>
</tr>
</tbody>
</table>

Source: Economic Survey, 2007-08, Government of India

From the above table it is clear that the share of exports for the developing countries increased from 36.8% in 2001 to 45.0% in 2007. However, a closer look
at the table also shows that while the developing countries' share has increased by 8%, China's share alone has increased by 4%. In other words, 50% of the total increase in developing countries' share in world exports is accounted for by China and the remaining 50% is taken care of by all other remaining developing countries. Hence, all other individual developing countries must have managed to increase their share of world exports only marginally. This essentially means that the developing countries are facing competition from each other with China clearly managing to increase its share in the export market. Thus, for a majority of the countries, the option of relying on export led growth to solve the problem of growth and unemployment has not materialized.

While it is the case that a majority of the developing countries has not managed to increase their share in the world exports market, the policies of globalisation themselves impose constraints on using up the labour reserves in these countries. This is because of the following. Globalisation entails a cut back in the government expenditure in accordance with the policies of demand deflation. With demand deflation at a global level, the prices of primary commodities are reduced, which then gets imported into the developing countries through the route of agricultural trade liberalisation. These depressed prices of agricultural commodities push the primary producers into distress. On the other hand, the reduction in public expenditure adversely affects the rural sector, where viability in agriculture in the developing countries is crucially dependent on the investment of the state. At the same time, reduction in state subsidies to the agricultural sector increases the price of inputs for agricultural production,
which ultimately leads to a situation where agriculture itself becomes non-viable. All these have presently manifested in a world food price inflation, where as a result of continued demand deflation, even simple reproduction in the case of petty production have become non-viable, leading to a decline in the supply of these commodities.  

At the same time, the import liberalization advocated by this set of policy measures, brings the petty production (or small scale production) prevalent in the developing countries into direct competition with foreign products. As a result, in the absence of governmental support for this sector, de-industrialization is witnessed, which again results in job loss, limiting the possibility of absorption of labour reserves. All these only reduces the employment generating potential in the developing countries, where the source of livelihood for the bulk of the population gets adversely affected due to the pursuit of the policies of globalisation.

On the other hand, if it was the case that the modern sector of the economy could absorb the labour reserves from agriculture, then the problem of unemployment would have been reduced in the case of the developing countries. This possibility is however precluded because of the fact that labour saving innovations are continuously introduced in the developing countries through the following routes. Firstly with all the countries facing stiff competition in the export market, there is a need of constantly increasing the labour productivity of the export sector, which in turn reduces the possibilities of using up the labour reserves through a growth in this sector. Secondly, developing countries are characterised by the

---

59 Patnaik, P. (2008a)
existence of substantial income and asset inequality. With the opening up of the
economy, the elites of the developing countries find easy access to the 'newer
goods' produced in the advanced capitalist countries, either by importing these
products or by shifting the production structure in these economies towards
producing these 'newer goods' entailing continuous replication of the labour
saving technological progress of the advanced countries. In the first case, the
economy is adversely affected through an import leakage. In the second case, the
production structure of the developing countries fails to generate sufficient
employment to absorb the labour reserves, even if the modern sector experiences
high growth rates.

Therefore, it is seen that the policies of globalization while on the one hand,
restricts the state in developing countries from undertaking demand
management policies to improve growth and employment situation in the
countries, the export oriented strategy in most of the cases fails to improve the
growth rate of these economies, while replicating the labour saving technologies
in the underdeveloped countries. Since the latest technologies are introduced in
the developing countries, which have a relatively primitive technological base,
the gap that the developing countries have to traverse is very high, compared to
the developed countries. Therefore, such replication of the technologies from the
advanced capitalist countries increases the growth rate of labour productivity
even more than that of the developed countries.

Added to all this, there exists another problem of the neo-liberal policies which is
enumerated as follows: The policies of globalization entail the liberalization of the financial sector of the country. This entails privatization of the banking sector, removal of restrictions on the free flow of FDI or FII, a rising to dominance of finance capital in the economy. This in its turn creates the condition for speculative activities in the economy, particularly the share market and real estate and other such sectors. As a result of this domination of the speculative element, productive resources which could have been employed for creating more jobs for the people are essentially used for creating and fuelling a speculative bubble. This boom in the share market, greatly increases the surplus of the capitalist sector, albeit helped by the state, which refuses to even tax the income coming out of such windfall gains in the stock market. The existence of unemployment as well as the increase in the profits of the capitalists further increase the inequality in the domestic economies. With the increase in inequality and windfall gains to the capitalists in the form of sops given to them, the demand pattern of the country, tilts towards consumption of commodities preferred by the elites, who invariably emulate the life-styles of the elites in advanced countries, as mentioned earlier. Financial liberalisation therefore, also accentuates the problem of employment generation in the developing countries.

While this section provided a rough sketch of the problem of absorption of labour reserves in the developing countries under the neo-liberal dispensation, we need to look at the exact nature of the problem in more details. In order to do this, we concentrate on the problem of employment and growth in the two fastest growing economies of the world, namely, India and China, which will be discussed in the
Chapter 2

2.8 Conclusion

The discussion in this chapter showed that historically, sustained growth under capitalism was a result of the exploitation of the pre-capitalist markets. At the same time, capitalism did not experience rising unemployment during the period preceding the World War I. This was not a result of the immanent tendency of capitalism per se but a consequence of capitalism's exploitation of the pre-capitalist markets, which are the developing countries of today. As a result of this exploitation, while capitalism reduced its problems of unemployment, the developing countries were saddled with huge labour reserves and inherited a backward production structure following de-colonisation.

Since the legacy of the developing countries' coupling with world capitalism was one of devastation of the economy, it was thought appropriate by the planners of these countries to de-link their economies from capitalism at least to a limited extent and pursue a policy of import substituting industrialisation. While the developing countries managed to improve their production structure and conditions of the people, compared to colonial period, it still could not solve the problem of labour reserves due to inherent contradictions in the policies of import substitution itself. Socialist countries on the other hand managed to solve the problem of labour reserves by essentially doing away with the problem of effective demand and controlling technological progress through the instrument
of planning.

While the failure of the import substituting policies was because of the fact that it could not increase the growth rate sufficiently, the policies of neo-liberal reforms presented another set of problems. These policies entail a situation where the scope for labour absorption of the developing countries gets constricted through the process of withdrawal of the state from crucial sectors and that the labour saving technological progress of the advanced capitalist countries gets rapidly replicated in these countries. In this case then, even with a higher rate of growth, the problem of unemployment may actually show no sign of improving and might actually deteriorate.

It is suggested that India and China with very high rates of growth of GDP will be able to take care of the problem of labour reserves. Are there any tendency in these two economies which point to the eventual using up of their labour reserves? We now turn to an analysis of the growth process in India and China and see whether these two countries have been able to solve the employment problem or has the possibility of solving the problem of labour reserves with a higher growth rate.

The next two chapters focus on the issue of employment and growth in India while the fifth chapter focuses on the employment problem in China.