GROWTH IN UNDERDEVELOPED COUNTRIES

SOME INTERNATIONAL ASPECTS OF THE PROBLEM OF ECONOMIC DEVELOPMENT

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"A country is poor because it is poor." This seems a trite proposition, but it does express the circular relationships that afflict both the demand and the supply side of the problem of capital formation in economically backward areas. This paper will discuss some international aspects of the difficulties on both sides. It will take up only a few points and cannot even attempt to give anything like a balanced picture.

I

The inducement to invest is limited by the size of the market. That is essentially what Allyn Young[1] brought out in his reinterpretation of Adam Smith's famous thesis. What determines the size of the market? Not simply money demand, nor mere numbers of people, nor physical area. Transport facilities, which Adam Smith singled out for special emphasis, are important; reductions in transport costs (artificial as well as natural) do enlarge the market in the economic as well as the geographical sense. But reductions in any cost of production tend to have that effect. So the size of the market is determined by the general level of productivity. Capacity to buy means capacity to produce. In its turn, the level of productivity depends—not entirely by any means, but largely—on the use of capital in production. But the use of capital is inhibited, to start with, by the small size of the market.

Where is the way out of this circle? How can the market be enlarged? Although in backward areas Say's Law may be valid in the sense that there is generally no deflationary gap, it never is valid in the sense that the output of any single industry, newly set up with capital equipment, can create its own demand. Human wants being various, the people engaged in the new industry will not wish to spend all their income on their own products.[2] Suppose it is a shoe industry. If in the rest of the economy nothing happens to increase productivity and hence buying power, the market for the new shoe output is likely

[1] "Increasing Returns and Economic Progress," *Economic Journal*, December, 1928.
[2] See Paul N. Rosenstein-Rodan, "Problems of Industrialization of Eastern and South-Eastern Europe," *Economic Journal*, June-September, 1943, p. 205.

to prove deficient. People in the rest of the economy will not give up other things in order to buy, say, a pair of shoes every year, if they do not have enough food, clothing, and shelter. They cannot let go the little they have of these elementary necessities. If they were willing to give up some of their present consumption in exchange for an annual pair of new shoes, these things would be available for the shoe workers to make up the balance in their own consumption needs. As it is, the new industry is likely to be a failure.

The difficulty is not due fundamentally to discontinuities in the technical forms of capital equipment, though these may accentuate it. It is due above all to the inevitable inelasticity of demands at low real-income levels. It is in this way that lack of buying power cramps the inducement to invest in any individual industry.

The difficulty is not present, however, in the case of a more or less synchronized application of capital to a wide range of different industries. Here the result is an over-all enlargement of the market and hence an escape from the deadlock. People working with more and better tools in a number of complementary projects become each other's customers. Most industries catering for mass consumption are complementary in the sense that they provide a market for, and thus support, each other. This basic complementarity stems, of course, from the diversity of human wants. The case for "balanced growth" rests ultimately on the need for a "balanced diet."

The notion of balance is inherent in Say's Law. Take Mill's formulation of it: "Every increase of production, if distributed without miscalculation among all kinds of produce in the proportion which private interest would dictate, creates, or rather constitutes, its own demand."[3] Here, in a nutshell, is the case for balanced growth. An increase in the production of shoes alone does not create its own demand. An increase in production over a wide range of consumables, so balanced as to correspond with the pattern of consumers' preferences, does create its own demand.

How do we get balanced growth? Ordinary price incentives may bring it about by small degrees, though here the technical discontinuities can be a serious hindrance; besides, slow growth is just not good enough where population pressure exists. In the evolution of Western industrial capitalism, rapid growth was achieved, in Schumpeter's view, through the action of creative entrepreneurs producing spurts of industrial progress. Even though innovations originated each time in a particular industry, the monetary effects and other circumstances were such as to promote each time a wave of new applications of capital

[3] J. S. Mill, *Essays in Some Unsettled Question of Political Economy* (London School of Economics reprint, 1948), p. 73.

over a whole range of industries. It is easy to see how a frontal attack of this sort can succeed while yet any sizable investment in any particular industry may be discouraged by the limits of the existing market.

Other types of society may feel a need for some degree of central direction to produce the desired effect—at any rate initially. But whether balanced growth is enforced by government planning or achieved spontaneously by private enterprise is, in a sense, a question of method. Whichever method is adopted, the nature of the solution aimed at may be the same, though the "miscalculation" Mill warned against seems hard to avoid in either case.

II

On the international plane, these general considerations apply first of all to the problem of international investment. Why is it that private business investment abroad has tended in the past—in the last few years as well as in the nineteenth century—to shy away from industries working for the domestic market in underdeveloped areas and to concentrate instead on primary production for export to the advanced industrial centers? The facts do not support the view that the so-called "colonial" type of investment—in mines and plantations producing for export to the industrial creditor countries—was typical of nineteenth century foreign investment as a whole. They do suggest, however, that it was, and still is, fairly typical of private business investment in backward areas. American direct investments abroad definitely conform to this pattern. In underdeveloped countries, they work mostly in extractive industries—oil fields, mines, and plantations—producing for export markets; only in advanced areas (Canada and Western Europe) do they, significantly, show any great interest in manufacturing for local consumption.[4]

The reluctance of private business capital to go to work for domestic markets in underdeveloped countries, in contrast with its eagerness in the past to work there for export to the industrial nations, reflects no sinister conspiracy or deliberate policy. There is the obvious economic explanation: on the one hand, the poverty of the local consumers in the backward countries; on the other, the large and, in the nineteenth century, vigorously expanding markets for primary products in the world's industrial centers. In these circumstances it was natural for foreign business investment to form mere outposts of the industrial creditor countries, to whose needs these outposts catered.

[4] See H. J. Dernburg, "Prospects for Long-Term Foreign Investment," *Harvard Business Review,* July, 1950, p. 42.

Incidentally, the weakness of the market incentive for private investment in the domestic economy of a low-income area can affect domestic as well as foreign capital. It may help in some degree to account for the common observation that such domestic saving as does take place in underdeveloped countries tends to be used unproductively: hoarded, exported, or put into real estate.

Private investment generally is governed by the pull of market demand, and private international investment is no exception to this. A particular instance of the relation between investment incentives and market demand appears in our old friend the acceleration principle. The relation holds, albeit in a different way, in space as well as in the time dimension. The conventional theory of factor proportions and capital movements is that in countries where there is little capital in relation to land and labor, the marginal productivity and hence the yield of capital will be high, and that, if it were not for extraneous impediments, capital would move to these countries from the areas where it is relatively abundant. This view is subject to the qualification that the high potential yield of capital in capital-poor areas may be capable of realization only through investment undertaken simultaneously in a number of complementary industries (or in public overhead facilities that serve to raise productivity in a number of different lines). A balanced increase in production generates external economies by enlarging the size of the market for each firm or industry. There is on this account as well as for other possible reasons, a discrepancy between the private and the social marginal productivity of capital. Even if we abstract from political and other risk factors, there is no guarantee that the motives that animate individual businessmen will automatically induce a flow of funds from the rich to the poor countries. The marginal productivity of capital in the latter compared with the former may be high indeed, but not necessarily in private business terms.

While the doctrine of balanced growth leaves plenty of room for international investment, it does reveal limits to the role of direct business investment. An individual foreign investor may not have the power, even if he had the will, to break the deadlock caused by low productivity, lack of real buying power, and deficient investment incentives in the domestic economy of a backward area. Even in the heyday of private foreign investment, however, capital outlays carried on by public authorities by means of private foreign loans were an important form of international investment. Loans to governments accounted for 30 per cent of Britain's total overseas investments outstanding in 1914, with another 40 per cent in railway securities and

5 per cent in public utilities.[5] Clearly this does not leave any major proportion for the strictly colonial type of investments—in mines and plantations producing for the creditor countries.

Investment by public authorities financed from private—or public—foreign funds is a form of "autonomous" investment, since it does not depend closely, if at all, on the current state of market demand. By contrast, direct business investment must be classed as a form of "induced" investment since it generally has to be induced by tangible market demand, already existing or visibly coming into existence. Thus the general distinction between autonomous and induced investment is applicable in a certain sense to international investment as well.

International investment on private business account is attracted by markets, and for the poorer countries the big markets in the past were the markets for export to the great industrial centers. Investment was induced by the investing countries' own demand. Foreign investment in extractive industries working for export is not to be despised, since it usually carries with it various direct and indirect benefits to the country where it is made. Why is even this type of investment now flowing out in only a small trickle? Aside, again, from the obvious political impediments, perhaps the answer is that the export markets for primary commodities have not been enjoying anything like the same rate of secular expansion as that which came about in the nineteenth century from the extraordinary growth of population as well as productivity in the Western industrial countries, and also from Britain's willingness to sacrifice her own agriculture to the requirements of international specialization. In recent decades, synthetic substitutes have affected unfavorably the demand for a number of staple products. The present raw-material boom is widely regarded as being due to special circumstances which may not last. In any case, it may take more than a boom—it may take something like a secular expansion of demand—to induce private foreign investment in underdeveloped areas for the production of primary commodities for export.

Reliance on direct business investment for the capital needed for economic development is therefore liable to a double disappointment. Not only is there little or no incentive for private business capital to go to work for the expansion of the domestic economies of low-income countries; even for the expansion of raw-material supplies for export, private business funds may not want to move out in any steady or sizable flow. But this, I repeat, applies to induced investment. It does not, or need not, affect international investment of the autonomous sort.

[5] H. Feis, *Europe, the World's Banker, 1870-1914* (Yale University Press, 1930), p. 27.

III

The case which the underdeveloped countries advance in favor of their "balanced growth" and "diversification" is not always well received. Does it not mean turning away from the principle of comparative advantage? Why do these countries not push their exports of primary products according to the rules of international specialization, and import the goods they need for a balanced diet? The answer is: because the notion of balance applies on the global scale as well. For fairly obvious reasons, expansion of primary production for export is apt to encounter adverse price conditions on the world market, unless the industrial countries' demand is steadily expanding, as it was in the nineteenth century. To push exports in the face of an inelastic and more or less stationary demand would not be a promising line of development. If it is reasonable to assume a generally less than unitary price elasticity of demand for crude foodstuffs and materials, it seems reasonable also to contend that, under the conditions indicated before, economic growth in underdeveloped countries must largely take the form of an increase in production for the domestic market.

These are some of the considerations that explain the desire for balanced growth and provide some economic justification for it. They do not constitute a case for autarky. As productivity increases and the domestic market expands, while the composition of imports and exports is bound to change, the volume of external trade is more likely to rise than to fall. But even if it remains the same there is not necessarily any harm in balanced growth on the domestic front. Take a country like Venezuela: petroleum accounts for about 90 per cent of its exports but employs only about 2 per cent of its labor force; the majority of the people work in the interior for a precarious subsistence in agriculture. If through the application of capital and increased productivity the domestic economy were to grow so that people working formerly on the land alone would now supply each other with clothing, footwear, houses and house furnishings as well as food products, while all the time petroleum exports remained the same and imports likewise constant in total volume, nothing but gain would result to the inhabitants without any loss to the outside world. No doubt there would be a fall in the proportion of foreign trade to national income. But could it not be that this proportion, in the many peripheral countries of this type, has been kept unduly high in the past simply by the poverty of the domestic economy? World income is a more basic criterion of world prosperity than the volume of international trade.

The characteristically important role which international trade played in the world economy of the nineteenth century was partly due to the fact that there was a periphery—and a vacuum beyond. The trade pattern of the nineteenth century was not merely a device for the optimum allocation of a given volume of resources; it was, as D. H. Robertson put it, "above all an engine of growth,"[6] but of growth originating in and radiating from the early industrial centers. Even in this country we have been so accustomed to regard the early nineteenth century pattern as normal that we seldom stop to notice that the economic development of the United States itself has been a spectacular departure from it.

With the spread of industrialization, we have, however, noticed that the major currents of international trade pass by the economically backward areas and flow rather among the advanced industrial countries. Balanced growth is a good foundation for international trade, as well as a way of filling the vacuum at the periphery.

IV

Let us turn now to the supply side of the problem of capital formation for economic development. Here the circular relationship runs from the low-income level to the small capacity to save, hence to a lack of capital, and so to low productivity. It seems to be a common view that the capacity for domestic saving in underdeveloped countries depends on an initial increase in productivity and real income, because the existing level is too low to permit any significant margin of saving, and that some form of outside help—say, foreign investment—is required to bring about this initial improvement and so break the vicious circle.

This theory begins to look a bit shaky as soon as we realize that it is not only the absolute but also the relative level of real income that determines the capacity to save. Although the absolute level of even the poorest countries has risen, it is doubtful whether saving has become any easier; on the contrary, it may have become more difficult for them, because there has occurred at the same time a decline in their relative income levels in comparison with those of the economically advanced countries. The hypothesis seems to me plausible and, at any rate, worth considering. The great and growing gaps between the income levels of different countries, combined with increasing awareness of these gaps, may tend to push up the general propensity to consume of the poorer nations, reduce their capacity to save, and incidentally strain their balance of payments.

As we have seen from J. S. Duesenberry's recent book, *Income, Saving and the Theory of Consumer Behavior,* the hypothesis that

[6] "The Future of International Trade," *Economic Journal,* March, 1938, p. 5.

individuals' consumption functions are interrelated rather than independent helps to account for certain facts that have seemed puzzling. The interdependence of consumers' preferences can affect, in particular, the choice between consumption and saving. The reason, for instance, why 75 per cent of families in the United States save virtually nothing (see page 39) is not necessarily that they are too poor to save or do not want to save; the main reason is that they live in an environment that makes them want new consumption goods even more. The reason is largely what Duesenberry calls the "demonstration effect" (page 27) of the consumption standards kept up by the top 25 per cent of the people. When individuals come into contact with superior goods or spending patterns, they are apt to feel a certain tension and restlessness: their propensity to consume is increased.

These forces, it seems to me, affect human behavior to a certain extent in international relations as well. The consumption functions of different countries are in some degree interrelated in a similar way. On the international plane, also, knowledge of or contact with superior consumption patterns extends the imagination and creates new wants.

The leading instance of this effect is at present the widespread imitation of American consumption patterns. The American standard of living enjoys considerable prestige in the world. And it is always easier to adopt superior consumption habits than improved production methods. True, American production methods are also widely imitated; sometimes, indeed, too closely. But generally this requires investible funds. The temptation to copy American consumption patterns tends to limit the supply of investible funds.

The intensity of the attraction exercised by the consumption standards of the economically advanced countries depends on two factors. One is the size of the gaps in real income and consumption levels. The other is the extent of people's awareness of them. Even though the poorer countries have probably all increased their per capita income over the last hundred years, the gaps have tended to widen. The position we have now reached is that two-thirds of the world's income goes to less than a fifth of the world's population in the most advanced countries, while at the bottom of the scale two-thirds of the world's population receives less than a sixth of the world's income; and that the average per capita income of the former group is about seventeen times as high as that of the latter.[7] The estimates on which these calculations are based are in many cases extremely crude, but probably not

[7] *National and Per Capita Incomes in 70 Countries, 1949* (Statistical Office of the United Nations, 1950).

grossly misleading. They do not, of course, take account of voluntary leisure, which is one way in which the advanced nations have taken out their gains.

The gaps are great, but equally important is the fact that contact and communication are closer than ever before, so that knowledge of these gaps has increased. Think of such recent inventions as the radio, aviation, and the American movies. Communication in the modern world —in the free world at any rate—is close, and so the attraction of advanced consumption standards can exert itself fairly widely, although unevenly, in the poorer parts of the world.

This attraction is a handicap for the late-comers in economic development. It affects not only voluntary personal saving but also makes it politically more difficult to use taxation as a means of compulsory saving and to resist demands for government spending on current account. Some of the backward countries have large masses of disguised unemployment on the land, which could be mobilized for real capital formation, but not without strict curbs on any immediate rise in consumption. Others may hope to introduce improvements in agricultural techniques so as to release labor from primitive subsistence farming and make it available for capital works, but again not without restraints to prevent the increment from being immediately consumed. The use of potential domestic sources of capital can be seriously hampered by the dissatisfaction and impatience which the demonstration effect tends to produce.

The traditional view of international economic relations generally implies that a high level of productivity and real income in one country cannot hurt other countries and that, on the contrary, prosperity tends to spread. Of course there are many ways in which a country's prosperity will help its neighbors. But the particular effect now discussed is unfavorable. It puts an extra pressure on countries with a relatively low income to spend a high proportion of it. (This is quite apart from and in addition to the fact that some nations suffer from a cultural aversion to saving, due to the presence of traditional forms of conspicuous consumption. However, the "demonstration effect" imposes no additional strain on saving capacity when it leads merely to a switch from native to imported forms of consumption.)

A very poor society might find it extremely hard to do any saving even if it knew nothing about higher living standards in the outside world. The vicious circle that tends to keep down the volume of saving in low-income countries is bad enough by itself. The point is that it is made even worse by the stresses that arise from relative as distinct from absolute poverty.

V

The poorer nations, in contact with the richer, feel continually impelled to keep their money incomes and outlays above what is warranted by their own capacity to produce. The result is an inflationary bias at home and a persistent tendency towards disequilibrium in the balance of payments. The doctrine of comparative advantage is, in my opinion, an effective answer to the simpler forms of the productivity theory of the dollar shortage. Yet here we seem to have reached, by the back door as it were, a theory of balance-of-payments disequilibrium based similarly upon differences in general levels of productivity. However, the comparative cost principle is fully respected. Disequilibrium results, not because productivity determines a country's export costs and competitive strength in the world market, not because the most productive country necessarily undersells all the others in all lines; disequilibrium results because a country's productivity determines its real income and consumption level and because differences in levels of living, when they are very large and widely known, exert an upward pressure on the consumption propensity of the poorer countries. In the classical view, a lack of balance in international trade can persist only because some countries try to "live beyond their means." We have now a simple explanation of why some countries do, in fact, persist in trying to live beyond their means.

The inflationary pressures and balance-of-payments difficulties are not, as such, the basic trouble. They could conceivably come from increased capital outlays and not from consumer spending. The trouble is that the demonstration effect leads directly to increased consumption, or attempts at increasing consumption, rather than investment. At least it makes an increase in saving peculiarly difficult as and when incomes and investment increase. It is for this reason that international income disparities may have to be treated not merely as a source of strain in the balance of payments but actually as an impediment to capital formation in the poorer countries.

VI

The almost universal countermove of the underdeveloped countries both to suppress the disequilibrium in their balance of payments and, what is more important, to offset the attraction of superior consumption patterns is the restriction of imports and especially of imports of a so-called "luxury" or "semiluxury" character. There is a widespread notion that a country, by cutting down imports of consumption goods through direct controls or prohibitive duties, can make more real capital available for its economic development in the form of imports of capital goods. Governments seem convinced that they are promoting the formation of capital whenever, in their commercial policy, they banish consumable imports in favor of imports of machinery and equipment.

This simple idea that more capital can be got merely by pinching and twisting the foreign trade sector of the economy seems to me to be an instance of the fallacy of misplaced concreteness. The foreign trade sector of the economy enters into the circular flow of income. Every piece of capital equipment imported represents an act of investment which, in the absence of external financing, presupposes and necessitates a corresponding act of saving at home. If this act of saving is not forthcoming, the capital equipment imported may be offset by reduced investment or by disinvestment in the domestic economy, if the expenditure of money previously spent on consumable imports now draws away domestic factors from capital construction or maintenance. Only if this money is left unspent is the requisite saving generated quasi-automatically; this is possible but quite improbable. It is more likely that any net investment that may result from the increased imports of capital goods will be financed by the forced saving of inflation, as long as inflation has not yet passed the point where it ceases to be effective as an instrument of forced saving. It is possible, therefore, although not certain, that "luxury import restrictions" will lead to some increase in the rate of capital formation in an underdeveloped country.

Besides the quantity of investment, however, there is also a question of quality. Import restrictions unaccompanied by corresponding domestic restrictions will set up a special inducement to invest in domestic industries producing the goods—or substitutes for the goods—that can no longer be imported. If the domestic market is considered at all sufficient to warrant the establishment of such industries, the inducement may prove effective. But since it applies to the luxury and semiluxury type of goods, whose imports are restricted, the result will be that the country's capital supplies, scarce as they are, and painfully brought into existence, will be sucked into relatively unessential uses.

The luxury import restrictions of the underdeveloped countries in the world today seem to represent, in the last analysis, a desperate effort to offset the handicap which the demonstration effect imposes on the poorer nations—an effort to isolate the local consumption pattern from that of the advanced countries and so to make possible more domestic saving and capital formation. This effort deserves our sympathy. But it attacks only the surface of the problem. It attacks only that part of the propensity to consume which directly involves expenditure on imported goods. The demonstration effect tends, however, to operate through an upward shift in the general consumption function and not in the import consumption function alone. Luxury import restrictionism does not stop this pervasive indirect influence of international discrepancies in consumption levels. A more basic attack would be compulsory saving through public finance, although this is precisely one of the things that is made politically more difficult in the poorer countries by the great discrepancies in living standards.

Far more radical forms of isolation than luxury import restrictions have played a part in the development of two important countries. It is well known that Japan, in the early course of her industrialization, imitated the Western World in everything except consumption patterns. She had kept herself in a state of isolation for centuries, and it was comparatively easy for her to maintain this isolation in regard to consumption patterns. There is no doubt that this was part of the secret of her success in domestic capital formation.

The other instance of radical isolation is Soviet Russia's iron curtain (which of course is not merely a result of the present tension but was well established before World War II). While it certainly has other reasons for its existence, I am inclined to attach significance also to its economic function; that is, to the possible "materialist interpretation" of the iron curtain. Anyway, it illustrates the possibility that isolation may help to solve the economic problem of capital formation, in a world of great discrepancies in national living standards, by severing contact and communication among nations. Without communication, the discrepancies, however great, may become of little or no consequence and the "demonstration effect" may lose at least some of its potency.

That this might be a possible and perhaps a necessary solution is a disquieting thought, and one naturally turns in search of an alternative.

VII

Could it be that the alternative lies in unilateral income transfers or, in plain English, gifts from rich to poor countries? The foreign aid programs of the United States have certainly departed from traditional practices, and it may be that we have seen the beginnings of a system of international income transfers, comparable to the transfers that take place within a country as an automatic result of taxation proportional to income or, still more, of progressive taxation. A system of international grants-in-aid does not stem from any economic mechanism of the market place; nor does the principle of progressive taxation. Both are based on political value judgments, and both arise from pressures having to do with the coexistence and increasingly close association of people at widely different levels of material welfare.

Suppose we have a model, then, where on the one hand international income disparities open up gaps in the balance of payments and on the other unilateral income transfers come in to fill these gaps. Is this a sufficient and satisfactory solution to the problem of capital formation in the poorer countries? Clearly it is not. If nature is left to take its course, the income transfers coming in will be used in these countries for the satisfaction of the higher propensity to consume that is brought about by the disparity in real-income levels. No permanent basis will be created within the country for higher living standards in the future. It is nearly always possible to some extent to substitute foreign aid for domestic saving so that consumption is increased and no net contribution is made to the rate of total capital formation. It can happen even if the foreign resources are tied to specific productive projects. The point is not, of course, that this is bad, but that it fails to contribute to the foundations of economic development. The attraction of advanced living standards can thus interfere, not only with the harnessing of domestic saving potentials, but also with the effective use of external resources for economic development. It makes it more than ever necessary for an underdeveloped country to keep a tight rein on the national propensity to consume.

This applies obviously to autonomous international investment and, perhaps less obviously, also to improvements in the terms of trade. An improvement in the terms of trade puts at the country's disposal additional outside resources that can be used to promote economic development. By itself, however, it means simply an increment in the country's current income, derived from foreign trade. Without the corresponding domestic saving, this increment cannot lead to any net increase in the rate of investment. Here again the real task is not to extract more capital goods from foreign trade but to extract more saving from the national income.

The upshot is that external resources, even if they become available in the most desirable forms, are not enough. They do not automatically provide a solution to the problem of capital accumulation in underdeveloped areas. No solution is possible without strenuous domestic efforts, particularly in the field of public finance.