Quadrant II – Transcript and Related Materials

Programme: Bachelor of Arts (Third year)

Subject: Economics

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Paper Title: Growth and Development Paper I

Unit: 4

Module Name: Balance and Unbalance Growth Theory

Notes

Balanced Growth Theory

Prof. Nurkse has given a proper explanation of the theory of balanced growth. He holds that the major obstacle to the development of the underdeveloped countries is the vicious circle of poverty. Ranger Nurkse is of the view that economic development is adversely affected by vicious circle of poverty. The economic development can take place only if vicious circle of poverty is broken. The vicious circle of poverty operates both on the demand and supply side.

(a) Demand Side:
Vicious circle of poverty affects the demand side of capital formation. The underdeveloped countries are poor because their level of income is low. Due to low level of income, their demand for low income goods is low. In UDCs the size of the market is limited. As a result, private investors do not get opportunities for more investment. This reduces investment and capita. Hence productivity of capital would fall.

This reduced per capita income as explained as follows:

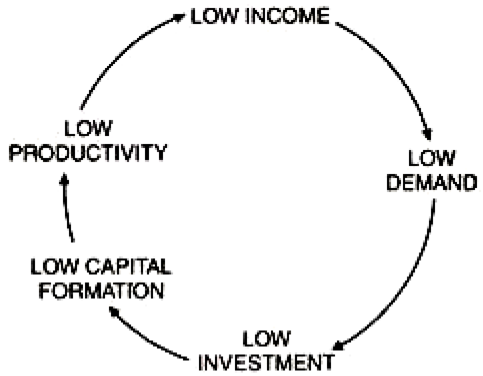

Fig. 1

Low Income → Low Size of Market → Low Investment → Low Productivity → Low Income.

(b) Supply Side:

Vicious circle of poverty affects the supply side of capital formation. In the underdeveloped countries, poverty exists because the per capita income of the people is low. Due to low per capita income, the level of saving is low. Since investment depends on savings, so investment would be low due to which capital formation would be low. Low capital formation would lead to low productivity which would result in poverty.

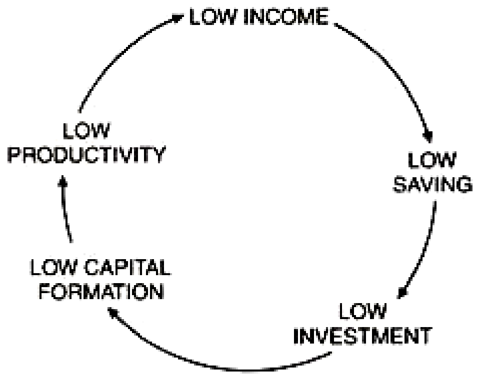

Fig. 1.1

This is how vicious circle from supply side completes **Low-Income → Low Savings → Low Investment → Low Capital → Formation → Low Productivity → Low Income**

The underdeveloped countries, can resort to capital formation and accelerate the pace of economic development only by breaking the vicious circle of poverty. Once the vicious circle of poverty is broken, the economy would be on the rails to development. Now the question is how to break the vicious circle of poverty.

How to Break Vicious Circle of Poverty?

(i) Complementary Demand:
The vicious circle of poverty cannot be broken with industrial investment decisions. This means vicious circle of poverty cannot be broken only by making investment in one industry or one sector.

(ii) Government Intervention:
Nurkse is of the view that the government must intervene in productive activities through economic planning. He is of the view that when government participates in productive activities, it will help in breaking the vicious circle of poverty

(iii) External Economies:
Balanced growth also leads to external economies. External economies are those which accrue because of the setting up of new industries and expansion of the existing industries. The accruing of external economies lead to the law of increasing returns to scale.

(iv) Enlarging market: The market size can be enlarged by monetary expansion, salesmanship and advertisement, removing trade restrictions and expanding social other heads i.e., infrastructures. It can be widened either by a reduction in prices or by an increase in money while keeping constant prices.

Therefore, investment in productive equipment and in human capital should be simultaneous while investment will be fruitless unless people are educated. But Prof. Nurkse pleads that private enterprise can achieve the desire effect under the stimulus of certain incentives. Price incentives may bring about balanced growth to some extent. It is further promoted by monetary and other effects.

Unbalanced Growth Theory

Albert O. Hirschman in his strategy of economic development goes a step further from Singer when he says that for accelerating the pace of economic development in the underdeveloped countries, it is advisable to create imbalances deliberately. He also recognized the inter-relatedness of different economic activities as done by Ragnar Nurkse. But he asserts that investment in selected industries or sectors would accelerate the pace of economic development.

Process of Unbalanced Growth:
The strategy of unbalanced growth is most suitable in breaking the vicious circle of poverty in underdeveloped countries. The poor countries are in a state of equilibrium at a low level of income. Production, consumption, saving and investment are so adjusted to each other at an extremely low level that the state of equilibrium itself becomes an obstacle to growth. The

only strategy of economic development in such a country is to break this low level equilibrium by deliberately planned unbalanced growth.

Prof. Hirschman is of the opinion that shortages created by unbalanced growth offer considerable incentives for inventions and innovations. Imbalances give incentive for intense economic activity and push economic progress.

According to Prof. Hirschman, the series of investment can be classified into two parts:

1. Convergent Series of Investment:

It implies the sequence of creation and appropriation of external economies. Therefore, investment made on the projects which appropriate more economies than they create is called convergent series of investment.

2. Divergent Series of Investment:

It refers to the projects which appropriate less economies than they create.

These two series of investment are greatly influenced by particular motives. For instance, convergent series of investments are influenced by profit motive which are undertaken by the private entrepreneurs. The later is influenced by the objective of social desirability and such investment are undertaken by the public agencies.

Development, according to Hirschman, can take place only by unbalancing the economy. This is possible by investing either in social overhead capital (SOC) or indirectly productive activities (DPA). Social overhead capital creates external economies whereas directly productive activities appropriate them.

(i) Excess of investment in Social Overhead Capital:

Social over-head capital are concerned with those series without which primary, secondary and tertiary services cannot function. In SOC we include investment on education, public health, irrigation, water drainage, electricity etc. Investment in SOC favorably affect private investment in directly productive activities (DPA).

Investment in SOC is called autonomous investment which is made with the motive of private profit. Investment in SOC provide, for instance, cheap electricity, which would develop cottage and small scale industries. Similarly irrigation facilities lead to development of agriculture. As imbalance is created in SOC, it will lead to investment in DPA.

(ii) Excess of Investment in Directly Productive Activities:

Directly productive activities include those investments which lead to direct increase in the supply of goods and services. Investment in DPA means investment in private sector which is done with a view to maximize profit. In those projects, investment is made first where high profits are expected. In this way, DPA are always induced by profits.

Priorities: Excess SOC or Excess DPA:

(a) Unbalancing the economy with SOC:

Imbalance can be created both by SOC and DPA. But the question before us is that in which direction the investment should be made first so as to achieve continuous and sustained economic growth. The answer is quite simple. The government should invest more in order to reap these economies, the private investors would make investment in order to enjoy profits. This would raise the production of goods and services. Thus investment in SOC would bring automatically investment in DPA.

(b) Unbalancing the economy with DPA:

In case investment is made first in DPA, the private investors would be facing a lot of problems in the absence of SOC. If a particular industry is setup in a particular region, that industry will not expand if SOC facilities are not available. In order to have SOC facilities, the industry has to put political pressure. That is really a tough job. Thus, excess DPA path is full of strains or pressure- creating whereas excess SOC path is very smooth or pressure relieving.

Hirschman pin points the absence of interdependence and linkage in less developed countries as a result of which the primary production activities for exports have very little development effects on the economy of an underdeveloped country. He therefore puts forth a tactic and advocates the setting up of “last stage industries first” in order to resolve the problem. He stresses on export promotion and import substitution and favors a mixed economy owing to the fact that unless the SOC pathway of economic development is adopted by the state, it will not encourage any form of private investment in DPA, as private investments in underdeveloped countries fail to create the necessary economic surplus that is a prerequisite for development to continue and even for the sustenance of losses.