CHAPTER III

THE STANDARD OF LIVING AND THE CAPACITY TO SAVE

ON the supply side of the problem of capital formation the vicious circle of poverty runs from (*a*) the low income level to (*b*) the small capacity to save, hence to (*c*) a lack of capital, leading to (*d*) low productivity and so back to a low real income per head. The preceding chapter, while not conflicting with this notion, appeared to give some ground for optimism by exploring possible ways and means by which even a poor subsistence-farm economy might achieve an increment in the flow of real income capable of being directed into capital formation. Now we shall have to face a set of circumstances whereby the self-perpetuating tendency for capital to be in short supply in low-income areas is aggravated rather than allayed.

It is natural to seek, at least in theory, an escape from the dead-lock by maintaining that outside help in one form or another—in the form, say, of foreign investment—is necessary to bring about the initial improvement in productivity and real income that is required for any substantial domestic saving to come about. Foreign investment, according to this widely held opinion, is the redeeming force that has to be invoked to break the circle on the supply side of capital formation in low-income countries. Foreign investment is regarded as necessary to bridge the transition period; once an increase in productivity has been achieved, a flow of saving will result, or can be extracted, from the increased real income.[1]

This theory begins to look somewhat dubious 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 appears to have risen, it is doubtful whether saving has become any easier; on the

[1] See, e.g., Raul Prebisch, *The Economic Development of Latin America and its Principal Problems* (United Nations, 1950), p. 5, and Donald B. Marsh, *World Trade and Investment* (New York, 1951), p. 75.

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 and therefore living standards 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.

A New Theory of Consumption and Saving

The unequal income distribution in the world, which both theory and international economic policy have too often tended to ignore in the past, is our point of departure. From this crucial fact we shall proceed to develop a hypothesis that throws some light on the problems of economic development in their international setting. I should like here to draw upon a theory put forward in a recent book by James S. Duesenberry.[1] I believe that this theory, which in its original form relates to individual consumers, has some explanatory significance on the international plane also.

This view of consumer behaviour places great emphasis on the fact that individual consumption functions are interrelated, not independent. They are interrelated, first, through the desire for social emulation by means of conspicuous consumption. Over a hundred years ago, Nassau Senior called the desire for distinction 'the most powerful of human passions.' The point, made familiar especially by Thorsten Veblen, may be important in inter-personal relations and perhaps, as we shall see, of some use in the explanation of consumption and saving habits that prevail in economically backward countries. But it is not the point on which we are going to concentrate.

There is another way in which individual consumption functions are interrelated, and this will be our main concern. Duesenberry calls it the 'demonstration effect.'[2] When people

[1] *Income, Saving and the Theory of Consumer Behavior* (Cambridge, Mass., 1949). [2] Ibid., p. 27.

come into contact with superior goods or superior patterns of consumption, with new articles or new ways of meeting old wants, they are apt to feel after a while a certain restlessness and dissatisfaction. Their knowledge is extended, their imagination stimulated; new desires are aroused, the propensity to consume is shifted upward.

In the United States we find from family budget studies what everybody would expect to find, namely, that higher income groups save a larger proportion of their income. In fact, the upper income groups comprising about 25 per cent of the population seem to account for all of the personal saving in the country; about 75 per cent of American families save virtually nothing.[1] Economists have long been puzzled by the fact that the positive correlation between income size and saving ratio, which family budget data so clearly bring out for any given point of time, fails to appear when we consider changes through time. It certainly does not appear in the national income as a whole. The Kuznets estimates by decades, starting from the 1880s, show a big increase in real national income but no increase in the percentage share that went into capital formation. On the contrary, from the 1890s to the 1920s, when real income expanded more than three-fold, there was actually a slight downward tendency in the national saving ratio. (In the 1930s the ratio dropped sharply as a result of the depression.)

Family budget data available for different periods also show certain puzzling features. The average urban family in the United States in 1917–19, earning 1500 dollars a year in terms of 1941 prices, saved 120 dollars or 8 per cent. An average family with the same real income in 1941 saved practically nothing.[2] How are we to explain this extraordinary change? The new theory of consumer behaviour explains it mainly by pointing to the fact that, although the absolute amount of the family's real income under consideration remained the same, there is no doubt that this amount in 1941 occupied a lower rank in the nation's income scale than it did in 1919. Average national income per head had increased. Therefore this family's friends and neighbours in 1941 were, on the whole, better off than in 1919; they were using

[1] Ibid., p. 39. [2] Ibid, pp. 26 and 80.

many new goods and services and altogether keeping up more ample and complex patterns of consumption. Naturally our family's temptation to spend was greatly increased. Its contact with 'superior' consumption goods and more 'advanced' ways of living had become more frequent. This wore down its resistance to new forms of spending, and accounts for the fact that its saving dropped to zero.[1]

We can construct a slightly different case, a hypothetical illustration which, though not based on actual statistics, is consistent with the facts. Suppose a man earned 1500 dollars in 1919, and his income increased to 2000 in 1941. (Let the income be valued at constant prices again so as to reflect a change in real volume.) He saved 120 dollars in 1919, or 8 per cent of his income. Because of the forces just discussed, his saving goes down to 100 dollars in 1941, or 5 per cent of his income. In spite of the increase in real income, there is a decline in the amount as well as the proportion saved. The man's friends and neighbours may have had their incomes increased even more; new goods consumed by others may have created new desires in him; or he may have simply become more familiar with superior forms of consumption.

Thus the interdependence of consumers' preferences, stressed by this theory, may significantly affect the choice between consumption and saving. The amount of saving performed by an individual depends not only, and perhaps not even mainly, on the absolute level of his real income, but also on the ratio of his income to the superior income level of other people with whom he may come in contact. (Whether it is the ratio or the absolute distance that matters is a question for further consideration. There is something to be said for treating the absolute gap rather

[1] The explanation concentrates on what is believed to be the principal factor: the decline in relative income rank. There is no denying that other factors may have played a part. For instance, the social security system may have reduced the propensity to save in 1941 as compared with 1917–19. One might object that the rate of saving may have been abnormally high in 1917–19 because of war-time restrictions, but this factor does not seem to have been important. The family budget data permit comparison over an even longer period, namely, from 1901 to 1941; and it is found, for example, that the average family with an income of 2,000 dollars a year, valued at 1941 prices, saved about 18 per cent in 1901 and only about 3 per cent in 1941 (see the diagram shown in Duesenberry's book, p. 80).

than the ratio between the consumption levels of different people as the factor that creates the tension and the change in the propensity to consume. In either case a statistical index problem presents itself, which has to be solved by some arbitrary convention, but this will be the same whether one chooses the ratio basis or the absolute distances in measuring inter-personal income discrepancies.)

When the interdependence of consumers' preferences is taken into consideration, we realize that a more unequal distribution of income may reduce the average saving ratio, instead of increasing it as is commonly supposed. The Kuznets data, mentioned earlier, appear no longer anomalous (though an adequate interpretation of these data would have to take many other factors into account). The reason why 75 per cent of American families save nothing is not so much that they are too poor to save. It is rather that the example of the consumption patterns kept up by people in the top 25 per cent income groups stimulates their wants to such an extent that virtually nothing is left over for saving. All this is only a hypothesis, but it seems to be consistent with the facts.

Growing Awareness of Advanced Living Standards

The question I would like to raise is whether a hypothesis of this sort might not usefully be applied to international economic relations. Could it not be that the consumption functions of different countries are interrelated in a similar way? Human behaviour on the international as well as the inter-personal level may be affected by the forces just described. Here we can leave out Veblen's point that the propensity to spend is partly based on the desire for conspicuous consumption. I do not think that on the international plane the effect of unequal living standards depends on the idea of 'keeping up with the Joneses'. All it depends on is demonstration leading to imitation. Knowledge of or contact with new consumption patterns opens one's eyes to previously unrecognized possibilities. It widens the horizon of imagination and desires. It is not just a matter of social snobbishness.

New products constantly emerge from the course of technical progress, which modify existing ways of life and frequently become necessities. In the poorer countries such goods are often imported goods, not produced at home; but that is not the only trouble. The basic trouble is that the presence or the mere knowledge of new goods and new methods of consumption tends to raise the general propensity to consume. New goods, whether home-made or imported, become part of the standard of living, become indispensable or at least desirable, and are actively desired as the standard of living rises. We should distinguish here between two senses of the term 'standard of living': first, standard simply in the sense of aspiration, the norm to which one aspires, or the measuring rod; secondly, standard in the sense of what a country or a community can afford on the basis of its own productive efforts. Some articles of luxury consumption may well be a part of a country's standard of living in the first but not in the second sense.

The outstanding example of this effect of disparities in consumption levels is at present the widespread imitation of American consumption patterns. It is partly perhaps a result of American methods of advertising. Advertising is the art of creating new wants, and Americans are supremely good at it; no wonder the rest of the world has a dollar shortage! It is much easier to adopt superior consumption habits than improved production methods. Hence fashions in consumption can spread more quickly than techniques of production. It is true that American production methods are also widely imitated; sometimes, indeed, too closely; the highly mechanized equipment that is suited to American conditions, where labour is the scarcest factor of production, need not be well suited to conditions elsewhere. But imitation of American production methods generally requires investible funds. The temptation to copy American consumption patterns tends to limit the supply of investible funds by inhibiting the willingness to save.

The goods that form part of American consumption patterns are 'superior' not necessarily in any objective sense, but because they are regarded as such. There may be people of ascetic bent who have no use for American gadgets; most people seem to like them. Besides, it has come to be noticed that American con-

sumption patterns include, not unnecessary luxuries alone, but also things that diminish suffering and prolong life. The American standard of living enjoys considerable prestige. This presents a serious problem for the poorer countries in the world to-day.

New wants, it is true, can be important as an incentive, making people work harder and produce more. But even so there is no assurance whatever that the extra output will be saved and invested, rather than immediately consumed.

The intensity of the attraction exercised by the consumption standards of the advanced countries—the demonstration effect on the international plane—is determined by two factors. One is the size of the disparities in real income and consumption levels. The other is the extent of people's awareness of them.

The disparities are greater than ever before. They are certainly greater in terms of absolute gaps, perhaps not when defined in terms of ratios. Probably all the poorer countries have made some headway in real income and consumption per head over the last hundred years or so; and yet over the same period the gaps have tended to widen.[1] The position we have now reached is reflected in the following table based on national income estimates for 70 countries, compiled by the United Nations Secretariat and expressed on the common basis of United States dollars of 1949 purchasing power:

World Income Distribution in 1949

	World Income	World Population	Income Per Head
High-income countries ...	67%	18%	$915
Middle-income countries ...	18%	15%	$310
Low-income countries ...	15%	67%	$ 54

Source: A calculation based on *National and Per Capita Incomes in 70 Countries, 1949*, Statistical Office of the United Nations, 1950.

It appears that two-thirds of the world's income goes to the top 18 per cent of the world's population. This group consists

[1] P. N. Rosenstein-Rodan, 'The International Development of Economically Backward Areas,' *International Affairs*, April 1944, p. 158. There is some evidence in Colin Clark's *Conditions of Economic Progress* to support this generalization.

of the United States, Canada, Western Europe, Australia and New Zealand. Then there is a small middle class, including Argentina, Uruguay, South Africa, Israel and some countries in Eastern Europe, especially Soviet Russia. In Russia's case it is particularly necessary to bear in mind that the underlying data are intended to measure the value, not of personal consumption alone, but of all goods and services produced, including those produced for investment and for military purposes.

The lowest income group represented in the table comprises two-thirds of the world's population and receives less than one-sixth of the world's income (that is, produces less than one-sixth of the world's output). It covers most of Asia, Africa, south-eastern Europe and Latin America. That the so-called backward countries of the world make up two-thirds of the human race is in itself a momentous fact that should never be forgotten.

Japan is included in the low-income group, but this is doubtless due to temporary post-war conditions. Normally Japan would now be classed probably as a middle-income country.

The last column of the table gives some idea of the average income levels in the three groups of countries. It will be seen that the per capita income of the first group is about seventeen times as high as that of the third. The figures have an air of precision which is, of course, illusory. The estimates on which they are based are in many cases extremely crude. They are subject to all kinds of doubts and reservations. Yet there is no reason to believe that the picture they give is grossly misleading. Let us remember that they do not take account of voluntary leisure, which is one way in which advanced nations have taken out their gains.

International discrepancies in levels of living are very great. But that is not all. Just as important is the fact that communication is so much closer than ever before, with the result that knowledge of these discrepancies has greatly increased. It is enough to mention such recent inventions as the American movies, the radio and aviation. There has also been an increase in education, which may tend at first to stimulate desires before it improves productivity. Anyway, contact in the modern world, in the free world at any rate, is very close. The attraction of

consumption standards of the advanced countries may exert itself unevenly in different income groups in underdeveloped areas. It may be concentrated among the upper income groups in the cities; but it need not be confined to them by any means. It may be diffused, though faintly, even among the lower income groups, thanks to education and mass media of communication. It may affect the demand for social legislation and industrial labour standards as well as the demand for modern luxuries. I would therefore hesitate to make any class distinctions in this connection.

We can readily admit that the strength of the demonstration effect varies a great deal as between countries. I believe it is an important factor in most parts of Latin America. In India, on the other hand, it may be weak and relatively insignificant. I do think that practically all low-income countries to-day are to some degree affected by the attraction of the consumption patterns of economically advanced countries. And even within the group of high-income countries the demonstration factor may be operative: it probably affects Western Europe in relation to the United States.

Here we are dealing with the low-income nations. The factor we have discussed has undoubtedly contributed to produce what President Truman called 'the great awakening' among these nations. Their concern for economic development is itself, in an obvious sense, a demonstration effect; it would hardly be so pronounced if the high-income nations lived on a different planet. But let us try to keep away from the more nebulous regions on which our subject borders. Let us stick to the simple fact that in the world to-day the attraction of advanced consumption standards exerts itself fairly widely, though of course unevenly, among the poorer two-thirds of mankind.

Effects on the Propensity to Save

This attraction is a handicap for the late-comers in economic development. It affects not only voluntary personal saving but also renders 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 industrially 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 labour 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 impatience and dissatisfaction which the demonstration effect tends to produce.

When we take into account that it is not only the absolute but also the relative level of real income that determines the capacity to save, we begin to realize that foreign aid or foreign investment may not be capable of removing this handicap. An increase in relative income in the industrially backward countries is not simply a matter of increasing productivity in these countries; it is a matter of diminishing the gap between their income level and that of the advanced countries. Foreign investment does not guarantee a reduction in this gap. The rate of saving and investment in an advanced industrial economy is not a fixed magnitude. If it were, then increased foreign investment would mean a reduction in domestic investment. But advanced countries have sometimes been subject to conditions of underemployment, in which an increase in foreign investment need not be at the expense of domestic investment at all, but may, on the contrary, increase the volume of domestic investment and saving. Even if we disregard the possible returns from foreign investment, we must conclude that foreign investment is no guarantee of diminishing the distance between the rich and the poor; it may increase it.

Moreover, there is the disturbing possibility that, even if the gap should remain unchanged, a rise in the living levels of the poorer countries, accompanied by an equal rise in those of the richer, may tend to increase the intensity of contact and communication between them and hence the strength of the demonstration factor. A country may be, in absolute terms, too poor to have much contact with the outside world. According to the United Nations statistics, Uruguay, one of the most prosperous countries in Latin America, has a per capita income eight times as

high as Ecuador, one of the poorest in this area. From this it does not follow that the demonstration effect of United States living standards is stronger in Ecuador than in Uruguay. On the contrary, it may well be stronger in Uruguay. The people of Ecuador may be too poor to be affected by it to the same degree (too poor, for instance, to have radios and cinemas). In short, the strength of the demonstration factor may be partly a function of the absolute level of real income, since the degree of contact and communication depends to some extent on the absolute income level which a country has attained. It is for this reason that American consumption patterns may have a considerable effect on Western Europe.

The conflict between the desire to consume and the need to save is made more difficult in the underdeveloped countries by the international disparities in real income levels, though we must remember that a conflict of this sort is inherent in the accumulation of capital, and always exists in the minds of individuals weighing the attractions of current as against greater future consumption. Raul Prebisch in his stimulating essay places great emphasis on the familiar point that the level of productivity in Latin America is low because of lack of capital, and that capital is scarce because of the small margin of saving, which is due, in turn, to low income and low productivity. He also recognizes the importance of the attraction exercised in the poorer countries by the consumption patterns of the more advanced.[1] This second point, however, substantially modifies the first. The small rate of saving is due not only to the low absolute level of real income but also to the high propensity to consume, caused by the allurement of superior forms of consumption. Remember : the reason why even in the United States 75 per cent of the people save nothing is not that they cannot afford to save, or do not want to, but that they live in an environment which makes them want new consumption goods even more.

In spite of the absolute increase in levels of real income per head in most, if not all, of the poorer nations over the past century, it may have become harder rather than easier for these nations

[1] *The Economic Development of Latin America and its Principal Problems*, Op. cit., pp. 5, 6, 37.

to do any saving out of their increased incomes, as a result of the decline in the relative position of their income levels. (While their ability to save should have increased, their willingness to save has been adversely affected. The old distinction between ability and willingness to save becomes, however, somewhat blurred when relative as well as absolute income levels are recognized as an important governing factor.) There has been an increase in the tension, impatience and restlessness which causes an upward shift in the consumption function, and which acts as an impediment to saving.

Here we have the problem of economic development in its international setting. It is perhaps not a problem of 'pure' economics—not, at any rate, until the pure theory of international economics has taken notice of elements hitherto neglected. The fact that the elements which I am introducing into the discussion might be classed as matters of international *political* economy, or even international sociology, does not make them any less relevant to our theme. No good purpose is served by keeping these matters under a shroud of silence. They must be brought out into the light of day and considered dispassionately in relation to the economic problem that concerns us.

The conventional view of international economic relations generally implies that a high level of productivity and real income in one country cannot possibly hurt other countries and that, on the contrary, prosperity tends to spread. Of course there are many ways in which one country's prosperity will help its neighbours. The late-comers can benefit, for instance, from scientific advances made by the leaders. But the particular effect now discussed is unfavourable. A high income and consumption level in an advanced country can do harm in that it tends to reduce the domestic means of capital formation in the underdeveloped countries; it puts extra pressure on countries with a relatively low income to spend a high proportion of it.

This is quite apart from the possibility that some countries—for instance, in the Middle East—may suffer from a cultural aversion to saving, due to the presence of traditional domestic forms of conspicuous consumption. The demonstration factor creates an added difficulty. Only when it leads to a switch from

native to imported forms of consumption does it impose no additional strain on saving capacity. (Whether the imported forms of consumption directly involve imported goods as well is a separate question, which will be touched upon later.) The traditional and modern forms of consumption can interact in a variety of ways. In some countries land ownership is a means to superior social status and prestige, and so the savings of traders and industrialists are habitually devoted to a considerable extent to the purchase of landed estates. The sellers of the land, in turn, often use the funds for urban forms of consumption or need the money to pay off debts because they have already succumbed to the temptations of modern ways of living.

In the most general terms the possible significance of the demonstration factor can be considered in conjunction with a well-known classical model. In Ricardo's famous illustration of the comparative cost principle, it takes Portugal 80 hours of labour to produce a gallon of wine and 90 hours to produce a yard of cloth, whereas in England the labour cost of wine and cloth is 120 and 100 hours respectively. Thus England has a somewhat lower absolute level of productivity and must be content with a lower real income than Portugal. Yet trade will take place in accordance with comparative costs (Portugal exporting wine, England cloth), and there seems no reason why trade should not balance. With a moderate difference in productivity and income levels, the possible interdependence of national consumption functions can be ignored. The trade model—that is, the pattern of comparative advantage—would still be the same if productivity, while remaining unchanged in England, increased in Portugal to a point where only 8 hours of labour were needed for wine and 9 hours for cloth. But as a result of so great a discrepancy in levels of productivity and hence real income, it may be that, while Portugal has a large margin of saving available for capital formation, the English—faced with the attractions of the Portuguese living standard—find themselves unable to save any part of their income. Incidentally, as will be explained in a moment, England would probably suffer in these circumstances from persistent difficulties in balancing her external accounts.

The interdependence of consumption functions can significantly affect the choice between consumption and saving. The hypothesis seems applicable to some extent on the international as well as on the inter-personal plane. As already indicated, the international disparities can inhibit not only voluntary private saving but also the use of public finance as an instrument of capital formation. I do not wish to exaggerate the effect of the international disparities. A very poor country might find it extremely hard to produce any saving for its economic development even if it knew nothing about higher living standards in the outside world. The vicious circle that keeps down the domestic supply of capital in low-income areas is bad enough by itself. My point is that it tends to be made even worse by the stresses that arise from relative as distinct from absolute poverty. How much worse is a question that cannot be precisely determined; it is a matter of judgment and one that presumably varies from country to country.

Effects on the Balance of Payments

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 pressure at home and a persistent tendency towards disequilibrium in the balance of payments.

A popular theory of the postwar 'dollar shortage' ran in terms of differences in the general level of productivity between countries. It seemed a common-sense approach. The explanation was that the United States had acquired such a commanding superiority in all lines of production, especially in manufacturing industry, that it could out-sell all other countries in the world market and so develop an export surplus, which of course was an inport surplus, a balance-of-payments deficit, for the other countries. This theory, which was held by some professional economists, gained a wide circulation since most laymen found it an easy and obvious explanation.

The classical school of international economics has a devastating answer to this theory: the doctrine of comparative costs. International trade is governed not by absolute, but by comparative differences in productivity, in conjunction with the rate of exchange. With a proper exchange rate a country can always balance its external accounts, even if in relation to other countries it has a much lower over-all level of productivity. At a certain rate of exchange, it should be able to export articles in which it has the least absolute disadvantage, while importing those in which it has the greatest disadvantage in terms of productivity.[1]

I myself find the classical answer convincing, except for special cases where the elasticities of demand and supply are such that no change in the exchange rate, either upward or downward, can bring the balance of payments into equilibrium. Although theoretically conceivable, it seems in practice unlikely that the elasticities over the whole relevant range should happen to be precisely at or near the critical point at which the price system is incapable of restoring balance. To build the explanation of a persistent, or persistently recurrent, international disequilibrium on such special cases does not seem plausible. There must be, one would think, a wider explanation of such a disequilibrium if, in fact, it should persist or recur.

The classical view was that a lack of balance in international trade can continue only because some countries insist on trying to live beyond their means, and are constantly tending to expand money income above their level of productivity. We may accept this proposition; but we must note that it is only a statement of fact. What is the explanation of it?

We have found a simple general hypothesis to account for the tendency of some countries to 'live beyond their means.' We reject the simpler forms of the productivity theory of the dollar shortage; yet we seem to reach—by the back door, as it were—a theory of balance-of-payments disequilibrium based similarly upon differences in general levels of productivity. But here the comparative cost principle is fully respected. Discrepancies in productivity as such are no explanation of balance-of-payments disequilibria. However, productivity determines real income. International discrepancies in levels of productivity are reflected

[1] For recent applications of this principle to the problem of the dollar shortage, see, for example, Gottfried Haberler's essay in *Foreign Economic Policy for the United States* (edited by Seymour E. Harris, New York, 1948) and Howard S. Ellis, *Economics of Freedom* (published under the auspices of the Council on Foreign Relations, New York, 1950), pp. 69–71.

in discrepancies in real income levels of different countries and hence in their consumption levels as well. Disequilibrium in the balance of payments does tend to result indirectly from differences in general levels of productivity, not because productivity determines a country's export costs and competitive power in the world market, not because the most productive country necessarily out-sells all others in all lines, but because a country's productivity determines its real income and consumption levels, and because differences in levels of living, when they are very large and widely known, exercise an upward pressure on the consumption propensity of the poorer countries.

I have been impressed for some time with the importance of unequal wealth and income distribution in the operation of the international monetary mechanism. The gold standard was never universal. Many countries were too poor to hold reserves adequate to tide them over cyclical and other short-term fluctuations in their balances of payments, and hence found it peculiarly difficult to adhere to a system of stable and unrestricted exchanges. The poorer countries are naturally impatient to spend their foreign earnings on badly needed imports, and tend to place a low priority on the maintenance or accumulation of a foreign exchange reserve. To some extent again we find on the international plane what we find among individuals. The holding of a cash balance of a size that would be considered normal by a rich man might be felt by a poor man as a wasteful luxury.[1]

The persistent tendency of the poorer countries to overspend on international account is only another aspect of the low priority they place on international cash reserves and, indeed, of their relative poverty. There seems to me to be some basis for the idea, therefore, that there is something like a natural tendency towards disequilibrium in the balance of payments between a rich and a poor country.[2] I would only add once more that this is so, not because of the rich country's high productivity making for low

[1] See my essay, 'Conditions of International Monetary Equilibrium,' *Essays in International Finance*, Princeton University, 1945, pp. 15–17 (reprinted in *Readings in the Theory of International Trade*, op. cit.), The point is also made, in more than one place, in *International Currency Experience* (League of Nations, 1944).

[2] Cf. Paul A. Samuelson, 'Disparity in Postwar Exchange Rates,' in *Foreign Economic Policy for the United States*, op. cit., p. 408.

export prices and great competitive strength, but because of the poor country's propensity to spend, which, for the reasons described, tends to be excessive in relation to its own capacity to produce.

In these circumstances the classical prescription—'stop inflation and adjust the exchange rate'[1]—does not seem to work. Many countries seem to find it peculiarly difficult to apply. When tried, it may help for a while, but then the inflationary pressures continue, the balance-of-payments disequilibrium re-appears, or at least tends to re-appear, being possibly held in check by import restrictions and exchange controls. International income disparities can affect the balance of payments by causing a direct increase in the demand for imported goods. The imitation effect can, however, operate equally well on the demand for leisure, services or goods that cannot enter into international trade, and can indirectly affect the balance of payments in much the same way as where imports are directly involved. The theory does not depend on demand for imports from advanced countries, though in reality this is undoubtedly an important factor. The demonstration factor on the international plane operates in part directly on the demand for American products.[2]

One might ask why a persistent disequilibrium of this sort did

[1] This is how Charles P. Kindleberger in his book on *The Dollar Shortage* (New York, 1950) characterizes the classical prescription. In reality most adherents of the classical view have been ready to make allowance for various qualifications and complications in practice. Thus Haberler writes: 'It would be a serious misunderstanding to believe that the problem is simple or easy to solve, because we have reduced it to a short formula' (op. cit., p. 444).

[2] This has nothing in common with Kindleberger's thesis (op. cit., p. 14) that American exports encounter a high income elasticity of demand in the rest of the world so that any increase in income abroad creates a more than proportionate increase in the demand for American exports. In the theory here presented, what induces the increased demand for American exports is not a rise in the level of income in the poorer countries but rather a widening (or an increased awareness) of the real income gap between them and the United States. Kindleberger's book is full of ideas, but I have found no systematic exposition of this point in it. There is, however, a passage at the end of his earlier essay on 'International Monetary Stabilization', in *Postwar Economic Problems* (edited by Seymour E. Harris, New York, 1943), which comes fairly close to the theme with which I am dealing here. Thomas Balogh in *The Dollar Crisis* (Oxford, 1949) occasionally speaks of the dollar problem as being caused by the widening discrepancy between the standard of life, as well as productivity, of the United States and of other countries (e.g., p. 149). He may have had the 'demonstration effect' in mind, but I cannot find any clear statement of this in his book.

not arise in the nineteenth century when, similarly, one country was far ahead in productivity and real income, namely, Great Britain. One could point to certain episodes of 'sterling shortage' in the nineteenth century, but there was no persistent disequilibrium, and the term 'sterling shortage' was not known. Why not? First, the absolute discrepancies in real income levels must have been smaller, and the discrepancies in consumption standards were probably still smaller, in view of England's high propensity to save, which was favoured by the puritan mentality of the new industrial middle class. Secondly, contact and communication among nations was not nearly as close as at present; the cinema, the radio and aviation did not exist. Thirdly, Britain practised a commercial policy that culminated in the unilateral abolition of all tariff protection and was not bound by the principle of reciprocity in tariff bargaining. Fourthly, Britain exported capital almost continuously and on a relatively very large scale.

A hundred years ago, for all these reasons, the acceptance of equilibrium as the normal state towards which the international balance of payments always tended to move was not wildly unrealistic. Thus J. S. Mill spoke about 'foreign commerce in its natural state of equilibrium.'[1] More recently, Barrett Whale[2] expressed the classical view as follows: 'The idea that there exists a natural tendency to equilibrium in international trade is the central principle of the whole theory of our subject.' He added a note of scepticism: 'Just for that reason, however, its truth must not be taken for granted too readily.' Even the income approach to the adjustment mechanism of the balance of payments, although it discloses a possibility of persistent imbalance due to saving leakages in the multiplier process, still confirms the idea that there is at all events a tendency towards equilibrium. In the world we live in to-day, it may be that this idea had better be consigned to a subsidiary position. Is it not at least equally plausible to say that, in such a world, disequilibrium is the normal state and the natural tendency in international trade?

The inflationary pressures and balance-of-payments difficulties, which nowadays tend to result from the discrepancies in

[1] See the passage quoted on p. 122, below.
[2] *International Trade* London, 1934), p. 86.

income and consumption levels, are not as such the basic trouble. They are a symptom. They could conceivably come from increased domestic capital outlays and not from consumer spending. The real trouble, from the view-point of capital supply, is that the growing disparity between the real income levels of different countries tends to lead in the poorer countries to increased consumption or attempts at increasing consumption, rather than to increased investment. At any rate it puts a brake on any increase in saving, 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 international payments, but actually as an impediment to domestic saving and capital formation in the poorer countries.

The Defeatist Solution: Economic Isolation

The attraction of advanced consumption standards represents a handicap for the late-comers in economic development. What can be done about this handicap? We must face the fact that isolation is one possible remedy, and that it has 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.[1] She had kept herself in a state of complete 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 and industrial development. According to such estimates as are available,[2] Japan managed to save between 12 and 17 per cent of her national income at the beginning of the present century. Government borrowing from abroad was comparatively unimportant, and hardly any foreign business investments came in until the 1920's. Japan did all her capital formation virtually unaided.

[1] E. P. Reubens, 'Foreign Capital in Economic Development: a Case Study of Japan,' in *Modernization Programs in Relation to Human Resources and Population Problems* (Milbank Memorial Fund, New York, 1950), p. 118.
[2] See, e.g., E. Staley, *World Economic Development* (International Labour Office, 1945), p. 72.

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. Needless to say, it is only the economic aspect of the iron curtain that concerns us here, purely from the point of view of the theory we have considered. It may be that the iron curtain is necessary for the maintenance of a high rate of saving and investment in the Soviet Union. From the estimates that have been made, however doubtful they may be, it seems that something like 25 per cent of the Soviet Union's national income has in recent years been directed into capital formation, apart from purely military expenditure.[1] To maintain such a high rate of investment may not be possible without isolating the country from the Western world. A free and open view of the consumption standards in the West might mean a psychologically intolerable and politically ignominious contrast. (While an important function of the iron curtain is to prevent the insiders from looking out, a useful subsidiary function may be to prevent outsiders from looking in, so as to preserve the legend of the workers' paradise.)

Isolation alone is incapable of promoting development; Japan was isolated for centuries without experiencing any significant economic advance. Isolation by itself rather promotes stagnation. And yet the two cases illustrate the possibility that isolation might 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 in living standards, however great, may become of little or no consequence. They do not affect people's desires, aspirations and activities; they do not constantly enter into the consciousness and the imagination of consumers. In this way the demonstration effect may lose at least some of its potency.

That this should be a possible, and perhaps a necessary, solution is a disquieting thought. The cost of isolation may be tremendous, not only in political relations, but in purely economic

[1] See, e.g., Howard S. Ellis, *The Economics of Freedom*, op. cit., p. 18.

terms also. The economic cost alone would be prohibitive for any small country. Isolation is a defeatist solution. One naturally turns in search of an alternative.

INTERNATIONAL AND INTERREGIONAL INCOME TRANSFERS

Could the alternative be for the richer countries to provide, to some extent, for the needs of the poorer? So far we have discussed international income disparities and their effects, on the one side. On the other side, there may exist certain deep-seated forces making for unilateral income transfers—in plain English, gifts—from rich to poor countries. The desirability of such transfers need not be questioned, at least so long as they are compatible with the maintenance or, better still, expansion of world income. Besides, we need not entertain any exaggerated notions about the size of such transfers. Let us remember, for example, that 2 per cent of the United States national income would be equal to about 7 per cent of the combined national income of all low-income countries outside the Soviet orbit and would probably be as much as or more than these countries could at present effectively absorb from abroad for investment purposes.

The foreign aid programmes of the United States have certainly departed from traditional practices. It is possible that we have seen the beginnings of a system of international income transfers. The pressures for such a system come from both sides, not only from that of the low-income countries. As a result of closer contact and communication, some of which has been a by-product of the war, people in the United States have become increasingly conscious of the discrepancies in living standards; the humanitarian aspects of Point Four make no little appeal to a nation with an early tradition of giving protection to the economic underdog as well as the political and religious outcast. There has been an emotional tone in the reports and official pronouncements concerning these problems, with frequent reference to the hunger, poverty, disease and illiteracy that prevail in two-thirds of the world. Both the Gray Report of November 1950[1] and the

[1] *Report to the President on Foreign Economic Policies*, U.S. Government Printing Office, 1950.

Rockefeller Report of March 1951[1] came out in favour of a sizable flow of governmental grants from the United States to the low-income areas of the world.

In the United States, however, as elsewhere, isolation also has its advocates and is indeed, as we have noticed, a conceivable alternative in a world of wide discrepancies in income levels.

There exists a mechanism that tends automatically to produce transfers of resources from the richer to the poorer regions within a given country. Suppose that government expenditure on public works and welfare is approximately the same per head of the population in all regions, but that taxation is proportional to income. The point comes out even more strongly if taxation is progressive, but all we have to assume is that taxation per head varies with income per head. The result is a tendency towards automatic transfers of public funds from the richer to the poorer regions. The point is hard to verify, though often brought up in countries with a federal structure. In the United States we observe a persistent tendency for funds to be transferred through the Federal Treasury from the northern and eastern to the southern and western parts of the country. In Brazil there is a marked tendency for such transfers to take place from the fairly prosperous southern states to the primitive tropical northern regions. Another federal country where the interregional aspects of the fiscal system have received a good deal of attention is Canada.

I introduce this fiscal mechanism not simply for the sake of analogy, but because it is a significant way in which economic development may be financed in the poorer regions of a given country. It depends on the fact that taxation is not a constant sum per head, but varies with income.[2] The principle of ability to pay, or equal sacrifice, is not satisfied with a constant sum of taxation per head or even with a constant proportion of income; according to what has long since become orthodox doctrine, it requires progressive taxation. The resulting interregional income transfers are admitted by people living in the rich as well as in the

[1] *Partners in Progress*, Report of the International Development Advisory Board, U.S. Government Printing Office, 1951.

[2] This refers not simply to an income tax, but to the combined effect of all forms of government taxation.

poorer regions. They are acknowledged as a natural consequence of the principle of ability to pay and as part of the fiscal system in which this principle is embodied. They are accepted in the last resort because people live in fairly close contact culturally and politically; because they recognize a common interest and are, more or less, agreed on the need for a fair allocation of the costs of governmental investment and welfare activities.

Could it be that what we have had in international relations by way of unilateral income transfers is nothing but a groping and imperfect approximation to what happens within a country quite automatically, and would happen similarly between different countries if they were under a world government? Is the principle of ability to pay, carrying with it this fiscal mechanism of inter-regional transfers, waiting to be extended beyond national boundaries? The pressures that lead to interregional transfers through proportional or progressive taxation within a country also exist in some degree on the international plane. They have to do with the co-existence and increasingly close association of people on widely divergent levels of living.

In the past, international unilateral transfers may have occurred to some extent under the guise of foreign investment. It has been argued that foreign investments have, in part, turned out to be haphazardly distributed gifts, because of subsequent default.[1] But this is a very awkward solution since default interferes with the continuity of the flow. Default is therefore considered unwise as well as immoral.

We encounter the basic pressures that make for income transfers from rich to poor when relatively advanced countries are associated with economically backward areas in the form of colonies. In Western European countries in the last two or three decades it has been a fashionable question to ask: do colonies pay? The answer of the experts has usually been in the negative. Recent colonial history seems, on the whole, to support this view. For example, M. M. Knight, the American economic historian,

[1] A. E. Kahn, 'Investment Criteria in Development Programs,' in *Quarterly Journal of Economics*, February, 1951, p. 61. For an outspoken complaint that many of Britain's foreign investments in the nineteenth century were undesigned gifts, see A. M. Samuel, 'Has Foreign Investment Paid?' in *Economic Journal*, 1930. Cf. also T. Balogh, op. cit., p. 166.

who has worked on this question in North Africa, finds that in Algeria the local government's budget deficits were covered directly by the French Treasury and that 'the framework of a system of railways, roads and ports was laid down . . . as an outright gift from the French taxpayer.'[1] The tendency for the metropolitan country to subsidize its colonies appeared in the 1920's even in Portugal.[2] While in earlier centuries there is no doubt about the fact of colonial exploitation, in recent times we find that colonies probably do not pay. But why should they pay? A transfer of current resources from the relatively wealthy metropolitan countries to their dependent territories is a natural application of principles long accepted and practised within any civilized country. The grants which Puerto Rico receives from the United States Treasury are an instance of such a relationship established on a steady and regular basis.

Generally, whenever nations enter into an increasingly intimate association and recognize a vital community of interests, the problem of pooling and allocating economic resources tends to arise, just as it does between different areas of the same country.[3] If we lived under a world government, automatic transfers from the richer to the poorer parts of the globe would occur as a matter of course through the fiscal mechanism. We have no world government. On the other hand, if we depart from the automatic market mechanism of private capital movements, or if this mechanism fails to function, there are no objective, non-political criteria for guiding the flow of funds. The problem of devising a system of international grants is a political problem and, in the nature of the case, political considerations cannot be kept out of it. A system of international grants-in-aid does not stem from the economic mechanism of the market; nor does the principle of progressive taxation. Both are based of necessity on political value judgments.

Inter-governmental grants are inevitably matters of inter-

[1] M. M. Knight, *Morocco as a French Economic Venture* (New York, 1937), p. 16.

[2] *The Course and Control of Inflation: A Review of Monetary Experience in Europe after World War I* (League of Nations, 1946), p. 41.

[3] H. Mendershausen, 'Foreign Aid With and Without Dollar Shortage', *Review of Economics and Statistics*, February 1951, pp. 41–2.

national political economy; if not deliberate instruments of foreign policy, they are at any rate shaped by the totality of a country's relations with other nations. If we are realists, we can hardly expect a pure, automatic and non-political mechanism of international income transfers to come into existence. Such transfers as may occur will inevitably be based in part on the shifting grounds of political expediency. It seems to me therefore that there is little or no foundation for the belief, which some economists express as a matter of course, that inter-governmental capital transfers are inherently more stable and reliable than the private capital movements of the era that ended in 1929.

Quite apart, however, from the inconvenient but inevitable political aspects of international gifts and grants, do such transfers provide a sufficient and satisfactory solution to the problem of capital accumulation in underdeveloped countries? Even if they fill the gaps in the balances of payments of low-income countries, do they offset the handicap which the demonstration factor imposes on the domestic saving capacity of these countries? Such transfers may be desirable on general grounds. They spring in part from the tensions produced by the disparities in living levels and serve to mitigate these disparities But do they meet the needs of capital development? That is one of the questions to be considered in the next chapter.