ABSTRACT

Does Investment Cause Growth? A test of an endogenous demand-driven theory of growth applied to India 1950-96.

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Supply-side theories that emphasise the driving force of capital accumulation in the process of growth and development have tended to dominate the post-war literature and to exert a strong influence on development policy, not least in India from the time of the famous Nehru-Mahalanobis plan of 1956-61. This capital-centred approach was in the Harrod-Domar tradition (Harrod 1939; Domar 1946) in which growth is dependent on the savings rate divided by the capital-output ratio; on Ragnar Nurkse's influential *Problems of Capital Formation in Underdeveloped Countries* (1953); on W Arthur Lewis's (1954) model of the labour-surplus economy in which the key to accelerated growth was a greatly increased share of reinvested profits in income; and on the neo-classical growth models of Robert Solow (1956) and others in which the level (though not the long-run rate of growth) of output per head depended crucially on capital accumulation, coupled with whatever *exogenous* growth of factor productivity an economy might be blessed with.

From the late 1980s "new growth theorists" have offered "endogenous" explanations of productivity growth by focusing on human as well as physical capital accumulation. In particular they suggest ways in which investment in research and development may yield externalities that offset any tendency to diminishing returns from capital deepening. They retain the conventional neo-classical framework in which output depends on capital inputs but suggest that this supply-side dependency is even more critical than in earlier models, in that capital accumulation and investment in R&D also help explain the previously "unexplained residual" of neo-classical growth-accounting exercises.

A competing body of endogenous growth theory stems from the seminal paper of Allyn Young (*Economic Journal* 1928) on increasing returns and economic progress that stressed the role of market size, or real demand (to be distinguished from the concept of demand in short-term Keynesian demand management theory), in motivating and facilitating innovation as the main driving force in the explanation of long-run growth. Young's students Nicholas Kaldor and Lauchlin Currie subsequently developed endogenous demand-side theories of innovation and growth in which investment is as much the consequence as the cause of growth. This paper, building on Sandilands (2000), seeks to highlight the differences between Youngian demand-side theories and the input-driven supply-side theories outlined above, and to test these theories against the evidence from the Indian record of investment and growth in the post-war period. Also highlighted are the radically different policy implications that emerge from these alternative theories and empirical tests.

Reference:

Sandilands, Roger J (2000), "Perspectives on Allyn Young in Theories of Endogenous Growth", *Journal of the History of Economic Thought*, 22:3 (September), pp. 309-48.