## Subject

**ECONOMICS**

### Paper No and Title

12: **ECONOMICS OF GROWTH AND DEVELOPMENT - I**

### Module No and Title

33: **PARTIAL THEORIES OF GROWTH AND DEVELOPMENT: VICIOUS CIRCLE OF POVERTY**

### Module Tag

ECO_P12_M33

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**Economics**

**Paper 12 : Economics of Growth and Development I**

**Module 33: Partial theories of growth and development: vicious circle of poverty**
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1. Learning Outcomes

After studying this module, you shall be able to –

- Know the concept of Vicious Circle of Poverty
- Understand the working of the Vicious Circle of Poverty in Under-developed countries
- Critically appraise Nurkse’s Vicious Circle of Poverty
- Know the meaning of circular causation
- Learn the evolution of the theory of circular causation
- Development of theory

2. Introduction

The concept of vicious and virtuous circle of poverty as formulated by Ragnar Nurkse describes the state in which the underdeveloped countries (UDCs) are entrapped in, where poverty seems to be the cause and effect of poverty. It means that if you are poor, you are bound to remain poor. This holds true for both individuals and societies. Nurkse argued that it is due to the impoverish state of these economics that any development effort to shift these economics to a higher growth path fails to fructify. “Poverty, according to Nelson, is a circular constellation of forces tending to act and react upon one another in such a way as to keep a country in a state of poverty”. It implies that in the presence of such forces, achieving higher levels of economic growth becomes no longer automatic or spontaneous. This is because poverty hinders the inducement to invest, especially given the small size of the markets in the UDCs. Thus it results in a shortage of capital accumulation in these economies. Due to this reason, lack of capital accumulation is the central problem faced by the UDCs in their path of development. Capital investment especially social overhead capital is ‘lumpy’ in nature i.e. it cannot be acquired in small increments but must be obtained in large, discrete units and has a long gestation period. This works as a deterrent for the private investor to invest in capital formation in the small market economy. Another factor contributing to the vicious circle of poverty is the inelasticity of demand faced by the UDCs at the early stages of development.
3. Working of the theory of the Vicious circle of poverty

Nurkse looked at the problem of vicious circle of poverty from both sides: the supply side and the demand side wherein he gave more emphasize to the supply side problem.

The supply side argument explains that the capacity to save of UDCs is severely limited by their low level of income earned. Hence, the mobilisation of savings into investment generates low levels of investment in an economy. Due to shortage of investment in the economy, productivity levels are also adversely affected which in turn results in an overall low level of income produced.

The demand side argument on the other hand explains the low level of income resulting in a lack of demand by the consumers and producers leading to a limited size of the market. The small size of the market works restraints the incentive to invest in that market. Hence the lack of effective investment results in low levels of income.

According to Nurkse, in addition to these two vicious circles of poverty, the UDCs also face one other circle of poverty that operates in terms of Market Imperfections. These economies work in a manner that resources are not optimally utilised. There are no economies of scale. The scale of production is low and cost of production is high. There is lack of competitiveness and thus the UDCs are losers in international market.

So in such a scenario the question is how the UDCs will break the vicious circle of poverty and move to higher path of growth. Nurkse borrowed the idea from ‘Allyn Young’ to provide the solution for the same. He quoted the famous example of the Shoe
Factory which highlights that if a firm is only producing one product i.e. shoes then it is bound to fail. This is because the workers (then consumers) engaged in the factory will not spend their income entirely on the purchase of shoes. This is so because human wants are diverse. So the demand for shoes will be less than the supply of shoes and hence a glut of shoes will be created which will result in the price to fall. Thus the firm will suffer losses. He said it might be acceptable in the Short run but not in the Long run.

So the way out is to set up a number of factories producing different goods that are market-wise and technologically interdependent so that workers working in one firm are the buyers of another firm and vice-versa i.e. there should be a synchronized application of capital in a number of factories simultaneously so as to cater to the complementarities of demand. If such kind of investment is made then the size of the market will expand, there’ll be no deficiency of demand and all benefits will be realized in terms of cheap goods both domestically and internationally. He said this will result in a FRONTAL ATTACK on poverty. According to him a single factory fails and many factories succeed to come out of the vicious circle of poverty through their forward and backward linkages. Backward linkages can be defined as "the growth of an industry leads to the growth of the industries that supply inputs to it". Forward linkages exist when the growth of an industry leads to the growth of other industries that uses its output as input.

Before Nurkse, Adam Smith propagated the idea of division of labour and expansion of the size of the market to accelerate the process of economic development. Nurkse seems to have been influenced by his ideas also.

4. Critical Appraisal of the theory

- The approach promotes practices like Division of Labour that ensure economies in terms of time, money and effort.
- It promotes development of various ancillary industries through working of vertical linkages.
- It accelerates the pace of economic development by developing a large number of sectors simultaneously.
- The approach suggests that the UDCs can move on the path of economic progress by massive investment simultaneously in all sectors appears totally impractical because the central problem faced by the UDCs is the dearth of capital and other resources.
- There could be problems of coordination. If large number of interdependent industries will be established then underperformance of few might disrupt the whole chain.
Hence this theory is good on paper only but in practice lack of technical knowledge and skills will restrain growth.

“The thesis of a general vicious circle of poverty thus conflicts with the most elementary empirical evidence” (Bauer, 1965).

Circular Causation
The classical economists are of the view that the expansion of international trade can be taken as an important source of economic development as it has equalizing effect i.e. it has developed both export and import countries irrespective of type of goods traded. But some of the recent economists have argued that international trade cannot encourage growth especially in underdeveloped countries. It may only help to the developed country. The theory of circular causation is one of the explanations to this.

5. Meaning and evolution of circular causation

5.1 Meaning of Circular causation
Circular causation can be defined as a common complex situation with several interconnected causes and effects, where an action is controlled or affected by its own outcome or results. Circular causation is a theory developed by Swedish economist Gunnar Myrdal in the year 1956. It is a multi-causal approach where the core variables and their linkages are delineated. The idea behind it is that a change in one form of an institution will lead to successive changes in other institutions. These changes are circular in that they continue in a cycle, many times in a negative way, in which there is no end, and cumulative in that they persist in each round. The change doesn’t occur all at once but in small changes because that would lead to chaos.
5.2 The theory

According to Gunnar Myrdal “Economic development results in a circular causation process leading to rapid development of developed countries while the weaker countries i.e. underdeveloped countries in Asia and Africa continent tend to remain behind and poor”. He further argues that “economic theory has disregarded these so called non-economic factors and kept them outside the analysis. As they are among the main vehicles for the circular causation in the cumulative processes of economic change, this represents one of the principal shortcomings of economic theory” (Myrdal, 1957).

Evolution of Theory

Gunnar Myrdal developed the concept from Knut Wicksell and developed it alongside with Nicholas Kaldor when they worked together at the United Nations Economic Commission for Europe. Myrdal concentrated on the social provisioning aspect of development, while Kaldor concentrated on demand-supply relationships to the manufacturing sector. About Economic Theory and Underdeveloped Regions Myrdal wrote that ‘the argument moves on a general and methodological plane in the sense that the theory is discussed as a complex of broad structures of thought’. His aim was to submit ‘broad generalizations, as a ‘theory’ is permitted to be, grasp the social facts as they organize themselves into a pattern when viewed under a bird’s-eye perspective into this general vision, the specific characteristic. Myrdal developed further the circular cumulative causation concept and stated that it makes different assumptions from that of stable equilibrium on what can be considered the most important forces guiding the evolution of social processes. These forces characterize the dynamics of these processes in two diverse ways.

It is generally recognized that Myrdal’s work on development and underdevelopment made three important contributions. He proposed accumulative causation approach in opposition to the dominant one, which he called the stable equilibrium approach. He pointed out that analyses of development processes, which only focus on economic factors, are irrelevant and misleading because historical, institutional, social and cultural factors also matter. He disputed the existence of a body of economic thought that is ‘objective’ in the sense that it is value-free.
6. Development Processes and Cumulative Causation

Myrdal’s cumulative causation theory is the theory of development. His theory includes institutional and political factors to determine the development process besides demand and supply factors of an economy. Concerning institutional factors he insisted both economic and non-economic factors should be included in the analysis of causes of development as both have substantial importance. Again, Myrdal’s cumulative causation theory allows the possibility and necessity of the social reform by introducing policies. Myrdal’s methodology on policies is so unique that it might as well be called “the political implications in the evolutionary economics”. Myrdal’s cumulative causation theory can be a kind of indicator of the direction for the further development of cumulative causation theory.

7. Summary

- The concept of Vicious Circle of Poverty is defined as the state of UDCs at the subsistence level of output. The UDCs are poor because they are poor. They seem to be trapped in the vicious circle of poverty where poverty is the cause and effect of poverty. And any developmental effort to pull the economy out of this trap requires synchronized application of capital to cater to complementarities of demand.
- It propagates that piece-meal effort is bound to fail in the UDCs and hence there is a need for simultaneous investment in a number of projects/sectors.
- Circular cumulative causation is a multi-casual approach, where core variables are interlinked to each other.
- The theory states that a change in one form of institution will lead to successive changes in other institutions.
- These changes are circular in the way that they continue in a cycle many times in a negative way and there is no end it functions in a vicious circle.
- This model combines both national and international forces which tend to keep backward countries in the morass of cumulative process where poverty becomes its own cause.