

BEYOND CAPITAL FUNDAMENTALISM:
HARROD, DOMAR AND THE HISTORY OF
DEVELOPMENT ECONOMICS

BY

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Beyond capital fundamentalism: Harrod, Domar and the history of development economics

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Abstract. The origins of “capital fundamentalism” – the notion that physical capital accumulation is the primary determinant of economic growth – have been often ascribed to Harrod’s and Domar’s proposition that the rate of growth is the product of the saving rate and of the output-capital ratio. It is argued here that development planners in the 1950s reinterpreted and adapted the growth formula to their agenda in order to calculate “capital requirements”. Development economists at the time (Lewis, Hirschman, Rostow and others) were aware that Harrod’s and Domar’s growth models addressed economic instability based on Keynesian multiplier analysis, which differed from their concern with long-run growth in developing economies. Harrod eventually applied his concept of the natural growth rate to economic development. He claimed that the growth of developing economies was determined by their ability to implement technical progress – not by capital accumulation, subject to diminishing returns. Domar pointed out that the incremental capital-output ratio was more likely a passive result of the interaction between the propensity to save and technological progress, instead of a causal factor in the determination of growth.

Key words. Capital fundamentalism, Harrod, Domar, development economics, saving

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If an attempt were made to get growth in output per head merely by increasing the capital/labor ratio, when no other factors of increase were operating, it is likely that one would run into sharply diminishing returns, and very soon a nil return, from any further rise in the capital/labor ratio. (Harrod 1966)

Economic development is a difficult and complex process, hard to deal with, because contrary to some of our favorite models, it is essentially not a capital but a human problem. (Domar 1966)

1. “Capital fundamentalism is wrong”

That is the title of chapter 15 of Deirdre McCloskey’s (2010) *Bourgeois dignity*, who borrowed the expression from William Easterly (2001, p. 48). The notion of “capital fundamentalism” became well known after Easterly (1999, 2001) turned it into the main target of his critical assessment of foreign aid policy, following an early study by Robert King & Ross Levine (1994) about capital and growth. Pan Yotopoulos & Jeffrey Nugent (1976, p. 12) introduced the term as one of the “fundamentalist dogmas” that, as they claimed, had beset development economics since its start as a new field in the 1950s. According to Yotopoulos & Nugent, development economists had tended toward two methodological poles – introspective generalization and immanent criticism – which made the field replete with “dogmas” but lacking in operational theories (other listed dogmas included industrial, import-substitution and planning fundamentalisms). “Capital fundamentalism” described the monist preoccupation with physical capital accumulation as the primary determinant of the rate of economic growth. It reflected the “abortive crossing of introspective generalization with immanent criticism”, which resulted from a direct transference of approaches designed for developed countries with slight changes to fit the peculiarities of developing economies. As pointed out by Yotopoulos & Nugent (ibid), the theoretical cornerstone of capital fundamentalism was the “Harrod-Domar model” proposition that the rate of economic growth is the product of the saving rate and of the output-capital ratio. The return of capital fundamentalism and the Harrod-Domar growth model as topics of discussion in the 1990s was largely motivated by

the advance of endogenous growth theory, particularly under the guise of the so-called *AK* models and their challenge of the Solow-Swan neoclassical growth model with diminishing returns to capital (King & Levine 1994; Easterly 2001, chapters 2 and 3; Ray 1998, chapters 3 and 4; Barro & Sala-i-Martin 1995, pp. 46-49; Aghion & Howitt 1998, pp. 24-29).

Yotopoulos & Nugent (*ibid*) did not cite passages from Roy Harrod (1939, 1948) or Evsey Domar ([1946], [1947] 1957a) to support their claim. Indeed, they absolved Harrod and Domar from the “capital fundamentalism” sin and suggested instead that its influence in less developed countries was based upon an “excessively mechanical interpretation” of the Harrod-Domar model, but did not elaborate further. They referred to Nurkse (1953) and the United Nations (1960) as examples of recommended sets of growth policies that embodied the principles of capital fundamentalism. In the same vein, King & Levine (1994, pp. 4-6) and Easterly (2001, pp. 28-30), despite ascribing the origins of capital fundamentalism to the Harrod-Domar growth equation, did not quote from Harrod or Domar but from W. Arthur Lewis’s (1954, p. 155) well-known statement that an increase in the saving and investment ratio is the “central fact” of development, as well as from W.W. Rostow’s (1956, p. 34; 1960, p. 41) similar description of the “take-off”. McCloskey’s (2010, pp. 136, 139) too cited passages from Lewis and Rostow in her criticism of capital fundamentalism, but not from Harrod or Domar.

As discussed in the present paper, the absence of textual evidence that Harrod (1939, 1948) or Domar ([1946], [1947] 1957a) endorsed what has become known as the “capital fundamentalism” dogma reflects the fact that the proposition was not really part of their growth theoretical frameworks. This has been noted by some attentive readers, like Solow (1999, p. 641): “The Harrod-Domar model tempted many – though not its authors – to the mechanical belief that a doubling of the saving-investment quota would double the long-term growth rate of a developing or developed economy” (see also Solow 2006, p. 137, last paragraph). Harrod and Domar formulated the growth problem in the context of Keynesian macroeconomics. They shared a demand approach to economic growth, dominated by the investigation of the conditions under which the economy is able to bring about sufficient aggregate demand to allow for persistent expansion. Capital accumulation was perceived as a possible inhibitor of growth and generator of economic fluctuations.

Development economists, writing in the 1950s at the apex of the influence of the “Harrod-Domar model”, were not oblivious to its main features, and more often than not rejected its application to the interpretation of economic development. Lewis (1954, pp. 139-40), for instance, criticized the Keynesian (multiplier) view that capital supply does not pose a restriction to economic expansion, and argued for a “classical” (Ricardian) approach instead. Development planners – especially after Hans Singer’s ([1952] 1958) path breaking article on the “mechanics of development” – deployed a version of the Harrod-Domar growth equation that tended to assume away Harrod’s distinction between actual, warranted and natural growth rates. They were aware that the use of the Harrod-Domar formula to calculate “capital requirements” to reach a target growth rate differed from the original texts, but adapted it to their own agenda. From that perspective, they formed an “interpretative community” (Fish 1980) that changed the way the “model” was understood and used. This is well illustrated by planning techniques developed at the United Nations Economic Commission for Latin America (known as CEPAL; see United Nations 1955), which originated the basic insights about the two-gap model in an open economy, later formalized by Hollis Chenery and co-authors (Chenery & Bruno 1962; Chenery & Strout 1966).

Doubts about the usefulness of the Harrod-Domar equation for development planning started to come up in the 1960s, when development economists (e.g. Leibenstein 1966; Streeten 1968; Morgan 1969) questioned on empirical and logical grounds the assumption that the incremental capital-output ratio (ICOR) is an independent causal factor of economic growth. The ICOR came to be seen by some as a function, not a determinant, of the growth rate decided by other factors such as technical progress. However, this remained a minority view and the equation continued to be widely used to calculate capital requirements, which led Easterly (1999, 2001) to carry out similar statistical tests of causality and reiterate the criticism voiced by Leibenstein and others. As documented below, Domar (1955; 1961) had mentioned the causality issue in his empirical investigations about the behavior of the capital-output ratio over time in the American economy.

Harrod (1960; 1963a, b) took an interest in economic development in the 1960s, when he introduced the notion of “optimum saving” as the saving ratio corresponding to the “natural” growth rate decided by population dynamics and technical progress. Diminishing returns to capital accumulation played a role in Harrod’s framework (although not necessarily in his equations), in contrast with most

of the economic development literature at the time. Domar's (1957b) main contribution to development economics was his restatement of the two-sector growth model originally put forward by Russian economist G.A. Fel'dman in 1928. Like Harrod (1960; 1963a), Domar (1957b) may be seen as an exercise in optimal capital accumulation and dynamic welfare economics. Differently from Domar's 1940s articles on growth economics, and closer to 1950s development economics, Fel'dman's model assumed a perfectly elastic labor supply, and the absence of cyclical fluctuations and effective demand problems. Both Harrod and Domar eventually pointed to the qualification of workers, not physical capital, as the main determinant of the growth pace of underdeveloped countries. This comes out clearer in Harrod than in Domar, who lacked a well-defined concept of the natural growth rate.

2. Is saving a virtue?

It is often suggested in the literature that the Harrod-Domar growth model restored thriftiness to the "place of honor" it held before Keynes (see e.g. Brems 1968, p. 427). Indeed, that is how development economists (Sen 1983, p. 750; Stern 1991, p. 124; Ray 1998, p. 55; Easterly 2001, p. 29) have generally interpreted the model. As put by Daniel Hamberg (1971, p. 141), it is ironic that the extension of Keynesian macroeconomics to the long run by Harrod and Domar and its reception by economists led to saving's revival as a main determinant of growth (see also Cesaratto 1999, p. 775). However, a close reading of Harrod and Domar shows that, despite the deceiving simplicity of their growth equation(s), the relation between saving and economic growth is anything but straightforward.

As it is well-known, Harrod (1939, 1948) distinguished between the *actual* growth rate per unit of time $G = s/C$, the *warranted* rate $G_w = s/C_r$, and the *natural* rate G_n , where s is the fraction of income saved, C is the accretion of capital divided by the increment of goods produced in the same unit of time, and C_r is the requirement for new capital divided by the increment of output to sustain which new capital is required, that is, the required ("accelerator") capital coefficient. The definition of C_r followed from the assumption that the capital/output ratio is constant

because inventions are Harrod-neutral and the rate of interest is given. The expression for the actual rate G is necessarily true, that is, a tautology based on the identity between ex-post investment and ex-post saving. The warranted rate, on the other hand, expresses the equilibrium of steady growth, in the sense that entrepreneurs are satisfied with their production and investment decisions, so that the market for goods (but not necessarily the labor market) is in equilibrium. Harrod (1939, p. 17) called it the “fundamental equation” of economic dynamics. G_n is the sum of the rates of growth of population and (Harrod-neutral or labor-augmenting) technical progress. It represents the ceiling or full-employment output path.

Instead of the backward relation between a given rise in income and the induced amount of investment assumed by Harrod’s accelerator, Domar ([1946] 1957a) focused on the forward one between investment and the resulting increase in capacity. Equilibrium over time requires that aggregate supply (productive capacity) and aggregate demand (determined by investment I and the Keynesian multiplier) change at the same pace: $\sigma I = \frac{dI}{dt} \frac{1}{\alpha}$, where σ and α stand for the potential social productivity of investment and the marginal (= average) propensity to save, both assumed to be stable. This is Domar’s ([1946] 1957a, p. 75) “fundamental equation”. The stability of σ reflected Domar’s assumption about the existence of limits to capital deepening (see Boianovsky 2015a). The solution of the differential equation is given by $I = I_0 e^{\alpha\sigma t}$. Thus, investment must grow at the exponential rate $\alpha\sigma$ for continuous maintenance of macroeconomic equilibrium without deflation or inflation. Since the marginal and average propensities to saving are assumed equal and constant, income must also grow at the rate $r = \alpha\sigma$ in equilibrium. This is a formula for the *required*, not actual growth rate. In particular, the larger the saving propensity α , the larger is the increase in income required to avoid excess capacity. In the same vein, a high s in Harrod’s equations means that the rate G_w is high, because only with a high rate of growth there will be enough investment to absorb (through the accelerator mechanism) the available saving. Hence, in both Harrod’s and Domar’s frameworks a higher propensity to save is accompanied by a higher growth rate along the *equilibrium* path only, supposing it is achieved in the first place. Whether a high s or α brings about a high *actual* growth rate is a different matter, pertaining to the

stability properties of Harrod's and Domar's models (see also Hahn and Matthews 1964, p. 786).¹

For a given actual growth rate of income and investment, a higher propensity to save brings about, in Keynesian fashion, excess capacity and unemployment in Domar's model, where saving is generally a "curse" (Domar (1957a, p. 9). As put by Domar ([1947] 1957a, p. 100), "in general, a high α presents a serious danger to the maintenance of full employment, because investment may fail to grow at the required high rate". Harrod (1948, pp. 17-19) tackled upfront the matter of the relation between saving and growth. He identified a "stark contradiction" between old classical economics, in which saving was a "virtue" and accumulation the "motive power", and the Keynesian doctrine that saving is always tending to "retard advance". Harrod's (p. 88) solution to the contradiction involved a comparison between his three growth rates. Apparently, $G_w > G_n$ should produce excess demand for labor and boom conditions, whereas the opposite condition $G_w < G_n$ should lead to unemployment and stagnation. Harrod (ibid) argued, however, that it is not the value of G_w that matters, but disequilibrium departures of G from G_w and their influence on production decisions. If $G_w > G_n$, G must be lower than G_w , since the average value of G over time cannot surpass full-employment G_n . Hence, $G_w > G_n$ implies paradoxically that the economy will be prevailingly depressed, and vice-versa if $G_w < G_n$. Such paradox, claimed Harrod, was central to the contrast between classical and Keynesian economics, which were seen as particular cases of his more general framework. "Saving *is* a virtue and beneficial so long as G_w is below G_n ", since by rising G_w it enables the economy to obtain full employment without inflation. On the other hand, if G_w is above G_n , saving is a "force making for depression".²

¹ Although, as discussed below, Harrod's and Domar's approaches differed in important aspects, there is a formal equivalence between their equilibrium growth equations, based on the notion that both capital coefficients assume that new investment is "properly utilized" (Harrod 1959, p. 452). If Harrod's warranted rate $G_w = s/C_r$ is really an equilibrium rate, his accelerator coefficient C_r must be the technical incremental capital-output ratio, not just a behavioral coefficient (see Hamberg 1971, pp. 10-11).

² Harrod (1939, p. 31) had commented on the widespread opinion that a high propensity to save should warrant a great increase in output, and the associated "extreme aversion to accept Mr. Keynes' view that excessive saving in the modern age is hostile to prosperity". According to Harrod, "the feeling is justified to the extent that higher propensity to save does, in fact, *warrant* a higher rate of growth".

Harrod's contention did not make for easy interpretation. Joan Robinson (1949, p. 81) – in what may be called the first installment of a debate with Harrod about the proper interpretation of the latter's model that would last for more than two decades – put forward some implications of Harrod's discussion of the case $G_w < G_n$. She understood it as implying that the capital stock is growing more slowly than the labor force, with ensuing progressive increase in unemployment. This is not “Keynesian” unemployment caused by deficiency of effective demand, but “Marxian” unemployment resulting from scarcity of capital relative to the labor supply. Although “nothing is farther from his thought, Mr. Harrod has led us to Marx's theory of the reserve army of labor, which expands and contracts as the growth of population runs faster or slower than the rate of capital accumulation”. Robinson (ibid) suggested that such analysis of deficient thriftiness applied to backward over-populated countries, as opposed to the Keynesian case of excessive thriftiness devised for industrialized economies. Robinson's interpretation was further elaborated by Hamberg (1956, pp. 163-66) in a criticism of what he saw as Harrod's and Domar's neglect of the distinction between full-employment and full-capacity growth rates over time.

Interestingly enough, Solow's (1956, pp. 73-76) influential interpretation of “Harrod-Domar” as a fixed proportions growth model has implications that are somewhat reminiscent of Robinson's point about Harrod's “reserve army”. Whereas Harrod had claimed that the excess of the natural rate over the warranted rate is conducive to high employment and inflationary boom conditions, Solow argued instead that this is a condition for a *labor surplus* economy (see Wan 1971, p. 14). Claiming that the production side of the Harrod-Domar model is described by a Leontief production function $Y = F(K, L) = \min(K/a, L/b)$, where a and b are constants, Solow expressed Harrod's case $G_n > G_w$ as $n > s/a$ where n is the rate of population growth (assuming away technical progress). He showed that under those conditions the capital-labor ratio k and income per-capita y decrease continuously toward zero, accompanied by permanent and increasing unemployment. As later put by Solow (1970, p. 10), the economy in that situation “saves and invest so little that it fails to create enough new capital” to employ the annual increment to the labor force. The converse case $G_w > G_n$ or $n < s/a$ featured convergence to a steady state with

The problem is that the rate of growth which it warrants may exceed the rate made permanently possible by the increase of population and technical progress.

stable capital-labor ratio and increasing excess capacity (see also Wan 1971, pp. 40-42; Barro & Sala-i-Martin 1995, pp. 47-48). Solow's reformulation implies that an increase in the saving propensity will raise the rate of economic growth permanently only if $G_n > G_w$ and income per capita is falling, for in that case diminishing returns will not come by, as the faster growth of capital will be accompanied by even faster growth of labor (see Aghion and Howitt 1998, p. 25). Whereas Solow regarded fixed-proportions as a particular case of a more general production function, his MIT colleague R.S. Eckaus (1955) argued that it described the limited opportunities for technical substitution in developing countries beset by "technological" or "structural" unemployment (see also Bruton 1955, pp. 328-29 on Marxian unemployment in developing countries).

Robinson's (1949) and Solow's (1956) interpretations of Harrod's contrast between the warranted and natural rates did not take into account the instability caused by discrepancies between the actual and warranted rates. They both portrayed it imprecisely as a "knife-edge" equilibrium (see Kregel 1980; Halsmayer and Hoover 2015). William Fellner (1956) repeated Robinson's distinction between different kinds of unemployment caused respectively by excess and deficient saving, which led Harrod (1957, p. 6) to reaffirm his view that if the warranted rate is below the natural rate "there will be a tendency to over-full employment, not unemployment". Under these circumstances, differently from Robinson's (1949) or Solow's (1956) reading, higher saving propensity could play a role in preventing inflationary excess demand for labor, but would not affect the permanent rate of economic growth. Harrod's depiction of two distinct disequilibrium tendencies (stagnation and exhilaration) raised Sunkel's (1970, p. 268) objection that developing regions like Latin America featured both inflation and (structural) unemployment, a scenario discussed by Hamberg (1956, p. 162). Such Robinsonian outlook was elaborated by Kurihara (1959, esp. chapter 6), and may be also found in Thirlwall (1987, pp. 20-21) and Harcourt (2006, pp. 222-23), who have argued that Harrod's $G_n > G_w$ describes the coexistence of inflation and unemployment in low saving countries.

Development economists at the time were often aware of the intricacies of Domar's and (especially) Harrod's analyses. The first primers on development economics started to come out in the 1950s, before growth economists produced their own textbooks in the early 1970s (Boianovsky and Hoover 2009a). Some authors (e.g. Meier & Baldwin 1957, chapter 5; Higgins 1959, chapter 6; Enke 1963, pp. 171-77)

discussed in detail several aspects of Harrod's and Domar's contributions, including instability issues and differences between their respective approaches. Naturally, the Harrod-Domar growth model attracted as well the attention of economists from underdeveloped countries interested in development planning, particularly at CEPAL, as illustrated by Osvaldo Sunkel's (1956) careful study of Domar's methodology and its Keynesian foundations – the first of its kind in any language – further elaborated in Sunkel (1970, chapter V.2).³

As noted by Sunkel (1956, p. 206), both Harrod's and Domar's goal was to find the equilibrium rate of growth that would prevent cyclical fluctuations. The cyclical dimension is stronger in Harrod because of his use of the accelerator, whereas Domar was deemed closer to the economic development agenda because his use of the capital coefficient led him to pay more attention to capital accumulation and the production function. The observed difference between the (expectational) accelerator and the (technological) capital-output coefficient reflected mistakes made by entrepreneurs in their investment decisions and the waste of capital in respect with its social productivity (p. 212). Despite his enthusiasm for Harrod's and (especially) Domar's models, Sunkel (1970, p. 246) observed that the economic reality they were trying to explain was distinct from the Latin American socio-economic context. The excessive emphasis on formal modeling and the corresponding use of a single equation – the “Harrod-Domar model” – had led, according to Sunkel (*ibid*), to downplay the aspects of reality the models attempted to illuminate, to stress their formal similarities and to hide their theoretical differences.

Meier & Baldwin (1957, p. vii) acknowledged comments from Domar. Their thorough presentation of Domar's model included the notion that the larger the propensity to save, the larger must be the amount of investment if growth is to be maintained (p. 105). The effect of higher saving on growth was anything but straightforward, according to Meier & Baldwin. Domar's and Harrod's theoretical frameworks shared the seemingly paradoxical result that, if the actual rate of growth exceeds the required or warranted rate, the economy will in fact produce too little, and vice-versa. Domar's paradox – that, to eliminate idle capital, more capital should be

³ Development planning also played a key role in India at the time. However, Indian multi-sector planning models were elaborated by P.C. Mahalanobis (1953, 1955) independently of Harrod or Domar and possibly under the influence of Fel'dman's similar 1928 contribution (Little 1992, pp. 47-51; Streeten 1968, pp. 1978-81).

built, and that, to avoid capital shortage, investment should be reduced – reflected the multiplier effect of investment on aggregate demand. Higgins (1959, chapter 6 on “Cumulative movement away from equilibrium: Harrod”) restricted his discussion to Harrod’s formulation, which he found “more fruitful when applied to underdeveloped areas” than Domar’s similar analysis, despite the fact that Harrod (1939, 1948) himself had not done so (Higgins, pp. 146, n. 2; 161). Harrod’s conclusion that saving is a “good thing” in an inflationary gap economy, and a “bad thing” in a deflationary gap one was hardly surprising, according to Higgins (pp. 157-58). After playing with Harrod’s equations for the actual, warranted and natural rates under different assumptions about sources of exogenous changes that could start economic growth in hitherto stagnant underdeveloped economies, Higgins (pp. 165-66) concluded that Harrod’s analysis was “too general” and that his fundamental equations were essentially tautologies that did not provide many facts or functional (causal) relations determining the magnitudes of the variables.

An important difference, between Harrod and Domar, pointed out by Enke (1963, p. 175), was that Harrod’s warranted rate referred to a *point in time*, with no supposition that the values of s and C_r are constant parameters, in contrast with the assumed stability *over time* of Domar’s α and σ . There can be a steady growth rate in Harrod even if s and C_r vary over time, provided they change in the same proportion and direction. Neither did Harrod assume that the average propensity to save is equal to the marginal one. The use of Harrod’s formula for economic projections was made difficult by the fact that there is no assurance that the rate of growth of output in the future will be equal to the past value of s divided by the past value of C_r . Some development economists, noted Enke (ibid), treated the warranted growth rate as an identity “restated in a way that seems to imply that s and C_r are parameters”. The relevant question was whether such ratios are *ex post* observations or *ex ante* guides. Although logically they are only the former, their use for extrapolation in order to calculate “capital requirements” was widespread at the time, as discussed next.

3. Capital requirements and development planning

Following their literature review of Harrod's, Domar's and other "theories of economic development", Meier & Baldwin (chapter 16) and Higgins (chapter 27, pp. 642-53) discussed development planning techniques, broadly based on the calculation of capital requirements according to three steps: estimate of the likely rate of population growth, setting of a target for the desired rate of increase in per capita income, and application of some figure for the ICOR (Meier & Baldwin, pp. 338-39). The resulting required saving rate provided an "instrument" variable for planning, as called by Tinbergen (1958). The complexity of Harrod's and Domar's analytical frameworks was gone, and instead a direct linear relation between saving and growth was assumed. Higgins (p. 642) made clear that the first question in development planning was "how much total investment is needed to produce target increases in per capita income?" Harrod and Domar were conspicuously absent from Higgins's discussion of development planning. Meier & Baldwin (p. 339, n. 5) did mention that their method for measuring capital requirements was "an alternative" to Harrod's and Domar's. Whereas the Harrod-Domar approach assumed a given saving ratio and undirected growth, the method deployed by Meier & Baldwin and other development economists was supposedly relevant for economies in which development is governmentally planned.

That was a crucial distinction, as Joan Robinson (1962, chapter 5) pointed out. The misleadingly simple Harrod-Domar formula $g = s/v$ (where v is the ICOR and g the rate of growth of output) seemed to suggest that the rate of growth g is determined by technical conditions and saving, not by effective demand. However, "greater thriftiness requires a higher rate of growth, but does not provide any motive for it", observed Robinson (1962, p. 100, n. 1). That changed if government took upon itself to direct economic development and investment was decided by a conscious plan, for propositions derived from the growth formula $g = s/v$ "then have something to say" (ibid, p. 110). Although Harrod and Domar originally had the business cycle problem in mind, the concept of capital-output ratios was "easily transferable" to growth problems in underdeveloped areas, as argued by Leibenstein (1957, p. 176) when

deriving the growth formula as a tautology.⁴ Hirschman (1958, p. 29) saw the application of growth models, originally devised for advanced industrial countries, to the discussion of the economic development of primitive economies as one of the “astounding feats of modern economics”. The Harrod-Domar analysis had found its main field of application in the planning of development for underdeveloped countries. According to Hirschman (p. 31), this reflected the fact that the models had been designed to explain a condition of secular stagnation in the postwar period that was not confirmed. Instead, they were adapted and deployed in a completely different setting and for other purposes.

Apparently, Hans Singer, an economist at the UN headquarters in New York, carried out the first application of the Harrod-Domar equation to development planning. His article came out in India in 1952, with concomitant Spanish and Portuguese versions in Mexico (*El Trimestre Económico*) and Brazil (*Revista Brasileira de Economia*). It was reproduced – together with other classic contributions by W. A. Lewis, W.W. Rostow, J. Viner, P. Rosenstein-Rodan, R. Nurkse, C. Furtado etc. – in the first collection of readings in development economics, edited in 1958 by Indian economists A. Agarwala and S. Singh. When applying the Harrod-Domar “very simple, almost tautological” equation to the interpretation of the “mechanics of development”, Singer ([1952] 1958, p. 396) made an important change in the original formula. He was interested in “economic development”, defined as growth of per capita income and expressed by his equation $D = sp - r$, where D , s , p and r stand for growth per capita, saving ratio, productivity of new investment per unit of capital and the rate of population growth, respectively.

That was not just an innocent algebraic modification. It represented a curious mix of classical (Malthusian) and Keynesian insights. The Keynesian view of population growth in industrialized economies was that it stimulates the economy through its effect on the demand for investment (“capital widening”), as claimed by Keynes (1937) in an article that anticipated the core of Harrod’s (1939) concept of the warranted and natural rates of growth. Alvin Hansen (1941) based his analysis of

⁴ Leibenstein (p. 177, n. 1) wrote the identity $\frac{I}{Y} \cdot \frac{\Delta Y}{I} = \frac{\Delta Y}{Y}$, that is, the rate of investment times the inverse of the ICOR is equal to the rate of growth. This corresponds to Harrod’s (1948, p. 80, n. 1) tautological expression for the actual growth rate, based on the *ex post* identity between saving and investment. See also Ray (1998, pp. 54-55, 90-91) for a similar derivation of the “Harrod-Domar equation”.

secular stagnation on the perverse effects of declining demographic growth (and falling pace of technical progress) on investment, which Domar (1948) incorporated into his framework. Indeed, as later suggested by Hansen, Harrod's G_n may be interpreted as providing the sources of long-run demand for capital at a given rate of interest (see also Hamberg 1956, p. 102; 1971, p. 17). Singer ([1952] 1958, p. 399) pointed out that the fact that r appears with a minus sign should not be interpreted as proof that population is an obstacle to economic development. He contemplated the possibility that a high r may have an effect on s and especially on p . The idea behind the formula, as clarified by Singer (1955), was that increased population, while requiring capital for its productivity, would not in itself contribute to production and capital accumulation. Because of the assumption of a given exogenous capital-output ratio, the formula disregarded the possibility that additional labor, even without additional capital, could yield significant (but not proportional) increases in output through induced innovation and factor substitution.⁵

Singer's comments about factor substitution were only side remarks, though. The formula was used by him – and by many others ever since – to calculate the resulting value of any of the four variables by assuming parametrical values for the other three. For instance, given the target rate of economic development D , and given p and r , the equation provided the saving ratio s necessary to support the stipulated rate of development (Singer [1952] 1958, pp. 396-98). Jan Tinbergen adopted that same framework in his 1958 book and in the 1960 UN document prepared by a group of experts chaired by him. Tinbergen (1987, p. 134) would recall in an interview years later: “We followed what at the time was the most usual approach, namely to determine the needs for investments in order to attain a certain rate of development and then try to find out what [developing countries] could finance themselves and to finance the shortage by foreign aid. So that was the line of reasoning that was followed by people like Hans Singer...” Despite his early pioneer exercise in

⁵ The notion of a rigid capital-output ratio implies that only capital accumulation, not increased population, raises output. In the Solow-Swan growth model, on the other hand, under the assumption of a production function with factor substitution, the steady-state rate of output *growth* is independent of the rate of saving (= rate of investment) and of the rate of population growth. The *level* of output, however, varies positively with the saving ratio and the rate of demographic growth (see Ray 1998, p. 328). According to the Solow-Swan model, an increase of the rate of growth of population has no long-run effect on the growth of output per capita, but it reduces its level.

neoclassical growth modeling based on the Cobb-Douglas production function (Tinbergen 1942), Tinbergen assumed a given stable capital-output ratio in his contributions to development planning. Such long-run stability of the capital-output ratio (at a value around 3) was seen as based on solid empirical grounds, “one of the most useful parameters with a fair degree of stability” (United Nations 1960, p. 11).⁶ It was not interpreted as the result of factor substitution as in Solow’s (1956) model, where income per capita and the capital-labor ratio increase at the same rate (= rate of technical progress) in steady state. Rather, it was tentatively explained by complementarities of industrial activities or by compensation of increases in the capital-coefficient in some sectors by decreases in others.

Tinbergen did discuss in passing the assumption that output is a linear function of capital only. In general, output should be treated as a function of capital and labor and the changing relation between them. To base the projection of national output on the (stable) capital-output ratio implied a “certain type of technical change in the relevant future”. The Cobb-Douglas function was mentioned as an alternative econometric model, but not pursued (United Nations 1960, p. 11, n. 1). The notion – that the observed long-run stability of the capital coefficient resulted from the effect of technical progress offsetting diminishing returns to capital accumulation – was introduced by William Fellner (1951, p. 115) and endorsed by Domar ([1952] 1957a, pp. 26-27). Development economists (e.g. Hirschman 1958, p. 31; United Nations 1955, p. 23) referred often to US data, calculated by Fellner (1951, 1954) and others, as vindicating the assumption of a given capital-output ratio, and occasionally (e.g. Bruton 1955, pp. 326-27; Sunkel 1956, p. 211) used the Fellner-Domar argument about technical progress to interpret such stability. Hence, the steadiness of the capital coefficient was often regarded a feature of the time series, not of the production function itself.

Capital requirements were dealt with not just in the context of the development planning of poor countries, but also in discussions about economic growth of advanced economies. Indeed, Ernest Stern’s (1945) examination of capital requirements in the US, UK and South Africa was the first exercise of that kind. It came out before Harrod’s 1948 book and Domar’s 1946 and 1947 papers, with no reference to Harrod (1939). Stern started from Carl Snyder’s (1936, 1940) statistical

⁶ The stability of the capital-output ratio would soon be listed by Kaldor (1961) as one of the “stylized facts” about economic growth in the long run or steady state.

work on the relation between capital and output in American industries. Snyder had interpreted his finding of proportionality between the rates of growth of output and capital as proof that the increase of the capital-labor ratio was the source of “national well-being”. Using time series from S. Kuznets and other sources, Stern (p. 169) computed the “capital investment per unit of growth of national income” (that is, the ICOR) and used it to estimate capital requirements: “Multiplying it by the *rate* of growth provides a numerical expression of the annual capital requirements as % of National Income, in other words, the required savings rate”. This is not exactly the same as Singer’s ([1952] 1958) target rate, since Stern used the observed growth rate as a basis for the projected one.

Fellner (1954) carried out a similar but more detailed study about US economic growth in section 4 (“Projecting the rate of increase of output and the capital requirement for achieving it”) and other parts of his NBER report. Differently from Stern (1945), Harrod’s and Domar’s contributions were now well-known and influential. But this did not make Fellner’s approach significantly distinct from Stern’s arithmetical insight. Fellner’s (p. 284) formula for capital requirements, like Stern’s, was based on the *ex post* identity between saving and investment (see also Fellner 1951). He claimed that such tautological relation could provide useful information if it was possible to “appraise the conditions in which the values in question would tend to repeat themselves” in the future, which applied to long-run average values when all adjustments to changing conditions had been made. Fellner did not make use of Harrod’s analytical distinction between three growth rates. He was concerned with “observable long-run values involved in Harrod’s $GC = s$ ” and assumed that “these tend to be the warranted values at the same time” (Fellner 1954, p. 294). He, therefore, interpreted the long-run actual values as first approximations to the warranted values. Moreover, Fellner (*ibid*) assumed away the existence of a definite natural growth rate, on the grounds that the marginal capital-output ratio – which depends on production methods – may adjust in the long run. The element of truth “overstated” by Harrod’s G_n concept, argued Fellner, was that diminishing returns, caused by capital accumulation at a faster rate than population growth, might interrupt the economic growth process. Economic growth required that such a tendency should be counteracted in the long-run by technical progress induced by relative factor scarcity, as Fellner believed was the case (see also Fellner 1961).

Development planners generally shared Fellner's approach to disregard differences between the actual and warranted growth rates.⁷ They also often ignored Harrod's natural growth rate as long as it was assumed an unlimited supply of labor, as in the Marxian notion of "reserve army" of unemployed or Lewis's concept of perfectly elastic labor supply (see Little 1982, p. 42; Marglin 1984, p. 108). The assumption of permanent "structural" excess supply of labor permeated CEPAL's reports about development planning, coordinated by Celso Furtado. Planning techniques took as their starting point Singer's ([1952] 1958) version of the Harrod-Domar formula, regarded as a "most valuable instrument for the analysis and programming of development" (United Nations 1955, p. 20; see also Boianovsky 2010, pp. 244-48). The production process illustrated by that equation focused upon one single factor (capital), but a closer look indicated that other factors like natural resources, technical progress and labor were taken into account through their influence on the productivity of capital investment (United Nations 1955, p. 20; Sunkel 1956, p. 211). This corresponded to Domar's ([1947] 1957a, p. 90) original formulation of that concept, which he distinguished from the marginal productivity of capital.

The application of the Harrod-Domar framework to an open developing economy raised new questions, since a substantial part of the supply of capital goods was imported from abroad. CEPAL defined the "foreign exchange constraint" as the amount of exports upon which Latin American countries depended to transform their savings into imports of capital goods. The development bottleneck may consist of foreign exchange rather than domestic saving if the rate of growth allowed by exports is lower than the rate allowed by saving. As put in a report about the Brazilian economy drafted by Furtado,

It is pertinent to consider a problem specific to under-developed countries – namely, that of the possibility of transforming saving into real investment. It is well known that in a developed economy saving does not necessarily imply growth, since in this case it is the level of effective demand that conditions the

⁷ Hamberg (1971, p. 12) maintained that, since the Harrod model only makes sense if its accelerator behavioral coefficient is equal to the technical marginal capital coefficient, it is advisable to concentrate on its purely equilibrium aspects (as Fellner did). Hamberg believed that "failure to do so has led to a good deal of unnecessary confusion in the arena of public policy, especially in regard to the underdeveloped economies".

process of accumulation. Similarly (but for other reasons), saving in an under-developed economy is not always an effective cause of growth. There must also be the possibility of converting this saving into real investment – a possibility dependent upon the capacity to import (United Nations 1956, p. 9).

CEPAL's analysis of the foreign exchange constraint marked the beginning of the two-gap approach to the balance of payments and growth (see also Boianovsky and Solís 2014, section 4), later formalized in nonlinear programming models by Chenery & Bruno (1962) and Chenery & Strout (1966). Such models investigated whether foreign capital inflows were needed to supplement domestic savings or purchase imported capital goods. Chenery & Bruno (pp. 84-85) provide additional illustration of how Harrod's original framework was changed and adapted to development planning. They acknowledged that Harrod was mainly concerned with the cyclical implications of the different limits set by the growth of capital (warranted rate) and of labor (natural rate) to the growth process, but claimed that "his relations can be reinterpreted as a simple policy model of development alternatives" in which parameters are turned into policy variables. They saw their contribution as the addition of a third restriction to economic growth, represented by the balance of payments. Chenery & Strout (1966, p. 687) reinterpreted Harrod's natural rate as a skill-determined rate, that is, the rate of growth of skilled labor force, which was supposed to decide the ability of the economy to absorb capital productively. The concept of "absorptive capacity", put forward by development planners in the late 1950s and early 1960s, was based on the notion that the productivity of new investment depended on the supply of "cooperative factors" (natural resources, labor supply, technical skills etc.), which set a limit to the amount of efficient investment physically possible (Meier & Baldwin 1957, pp. 351-55; United Nations 1960, p. 10; Rosenstein-Rodan 1961b, pp. 108-09; for a historical survey see Guillaumont 1971). Harrod's (1963b) notion of diminishing returns to capital accumulation had some similarities with that concept, as discussed further below.

4. Development economists' criticism

For different reasons, capital formation played an important role in the early years of development economics (Arndt 1987, pp. 54-60; Meier 2005, chapters 4 and 5). Despite their distinct approaches to economic development, Rosenstein-Rodan (1943, 1954, 1961a), Nurkse (1953), Lewis (1954, 1955) and Rostow (1952, 1956, 1960) shared an emphasis on capital accumulation. This has led commentators to infer that their various theoretical frameworks were influenced by or at least consistent with Harrod's and Domar's approaches to growth. Referring to Lewis's (1954) path-breaking model of dual economic development, Gollin (2014, p. 82) writes that "Lewis's thinking was heavily informed by the Harrod-Domar model".⁸ However, Lewis (1954, p. 140) stated at the outset that he offered his classical framework of growth in countries with surplus labor as an alternative to both Keynesian (where there is also surplus capital) and neoclassical (full employment) approaches (see Hirschman 1981, p. 8). In the introduction to his 1955 volume – the first dedicated to the theory of growth and development – Lewis (p. 13) mentioned recent "elegant work" about the stability of economic growth in mathematical models. Such models sought to establish how far the relationships between economic coefficients are consistent with stable growth, with no investigation of what decides their values and how they change over time. The theory of economic growth should instead address long-term changes in propensities, especially the saving ratio, as Lewis set out to do.

In his discussion of the Victorian view that saving is a virtue, Lewis (1955, p. 215) considered the opposite perspective that an increase in saving may discourage investment. This argument depended upon the notion that the ratio between aggregate capital and total consumption was fixed, since, if this was not the case, capital accumulation could proceed faster than the rate of growth of consumption. The assumption of a given or stable ratio between capital and output (or consumption) played an important role in Domar's assessment of the controversy about secular stagnation, which provided the starting-point for his own growth model (see Boianovsky 2015a). Lewis (1955, pp. 296-97) doubted there were such fixed ratios between capital, income and consumption, as capital-intensity depended on variables like the rate of interest. He, therefore, rejected the secular stagnation hypothesis based

⁸ Tignor (2006, p. 97) has also suggested that Lewis (1954) fit comfortably within the Keynesian Harrod-Domar growth theory.

on rigid ratios. Neither did Lewis accept the application to labor surplus economies of the usual view that capital accumulation brings about diminishing returns and falling rates of profit. Since there is labor available, “capital accumulation does not alter the ratio of capital to labor in employment, and so there is no tendency for the rate of profit to fall” (p. 297).⁹ Unlimited capital widening was possible in labor surplus economies (Lewis 1954, p. 154).

It is against that background that Lewis’s (1955, pp. 201-13) section on “capital requirements” should be read. Lewis noted the “remarkable” stability of the observed value of the incremental capital-output ratio between 3 and 4. From a mathematical perspective, the (average) ratio was a function of the rate of investment, the rate of growth of income and the average life of capital goods.¹⁰ Assuming, moreover, a typical value of the rate of investment between 4 and 5 per cent, the corresponding rate of growth is about 1.25 %, which corresponded to India’s demographic growth. In order to increase India’s income per capita at the same pace as the U.S. (between 1.5 and 2 per cent), it would be necessary to raise the rate of investment to about 12 per cent. According to Lewis (1955, p. 208), all developed countries had gone in the past through a period of growth acceleration when their rate of investment moved from 5% or less to 12% or more – an “Industrial Revolution”. That was behind Lewis’s (1954, p. 155) oft-quoted statement that the “central problem of the theory of economic development” is to understand the process by which an economy modifies its rate of saving and investment from 4 or 5 per cent to 12 or 15 per cent. Lewis’s model of economic growth in a dual economy with perfectly elastic labor supply was designed to show how the increase of the share of profits in income brings about such changes in the rate of saving and investment. Harrod’s (1939, 1948) and Domar’s (1946, 1947) growth analyses are nowhere

⁹ This is a key analytical difference between Lewis’s and the Solow-Swan neoclassical model. As pointed out by Swan (1956), the positive permanent effect of a higher saving ratio on economic growth in Lewis’s model – as opposed to Solow-Swan – is due to the assumption that the supply of labor is elastic in the vicinity of a certain level of output per capita. The growth of the productively employed labor force depends on the rate of capital accumulation, which gives the model its classical flavor.

¹⁰ This corresponds closely to Domar’s ([1946] 1957a) expression $\lim_{t \rightarrow \infty} \frac{K}{Y} = \frac{\alpha}{r}$, where r is the rate of growth of output.

mentioned.¹¹ Lewis's use of the so-called "Harrod-Domar equation" without attribution indicates that it had become common knowledge by the mid 1950s. More than that, he clearly distinguished that equation from Harrod's and Domar's Keynesian models of growth, as documented above. Lewis's (1955, pp. 234-35) explained the growth of the capitalist sector and of the share of profits in income – and therefore of the saving ratio – as functions of the opportunities for investment (new inventions, institutional changes etc.). Labeling Lewis "capital fundamentalist" should be done *cum grano salis*.

Lewis (1954) contrasted his hypothesis of perfectly elastic labor supply at zero marginal productivity of labor with the working of the Keynesian multiplier, one of the building blocks of Harrod's and Domar's approaches to growth. Aspects of that contrast could be found already in the United Nations' (1951, pp. 41-43) influential report about economic development, drafted by Lewis, T.W. Schultz and three economists from underdeveloped countries. In such economies, an increase in effective demand has very small or null effect on output; its main impact is on prices (see also Lewis 1954, p. 161). Although unemployment may potentially allow for an immediate increase in output in capital scarce countries, "the opportunity cannot be seized until some new source of capital can be found to provide the equipment with which the under-employed are to work. Either domestic consumption must fall, relative to output, or foreign investment must become available" (United Nations 1951, p. 43).

In the same vein, V. Rao ([1952] 1958) – Keynes's student and Singer's colleague at Cambridge in 1933-35 – argued that inelastic aggregate supply (particularly in the agricultural sector) prevented the application of the multiplier concept to India and other underdeveloped countries. Rao (p. 218) claimed that such countries should follow instead the classical old-fashioned prescription – which he did not associate to Harrod or Domar – to "save more" and accumulate capital. Similar criticism came out in Latin America as part of Sunkel's (1957) detailed study of the Kahn-Keynes multiplier and its application to developing countries. The level of employment in underdeveloped economies, featuring "disguised unemployment" with

¹¹ Lewis (1955, p. 251) referred to Domar only in connection with the latter's well-known 1950 discussion of the effects of foreign investment on the balance of payments of a growing economy. That was also Nurkse's (1953, pp. 131-32) only mention of Domar. Harrod (1948, pp. 101-15) was mentioned by Nurkse (p. 125) in the related context of the relation between capital movements and trade.

zero marginal productivity of labor, was limited by the amount of capital, not by effective demand. Moreover, the main determinant of aggregate demand in Latin American economies, pointed out Sunkel, was not investment but exports.

Rostow's (1956, pp. 32-33; 1960, p. 41) numerical characterization of the take-off as requiring "by definition and assumption" an increase of the rate of investment from about 5% to about 10% or more was taken directly from Lewis (1954, 1955). As he acknowledged, it was essentially a "tautological" definition. Again, just like Lewis, Rostow's deployment of the arithmetical relation between growth, saving and the capital-output ratio did not mean an endorsement of Harrod's and Domar's growth models, which he clearly distinguished from the standard equation $g = s/v$. Formal work on growth modeling was mainly concerned with the instability of industrialized economies in the third stage of their growth process, that is, after the take-off into sustained growth. Development economists, on the other hand, focused on the first two stages – the economics of the pre-conditions and the take-off. A "serious theory of growth" should investigate closely the economics of the take-off, something Harrod, Domar and their followers had not done (Rostow 1956, pp. 31-32).¹²

Rostow (1952, pp. 87-92) had discussed carefully Harrod's (1948) approach to growth, formed by a formal statement of the conditions for steady advance and an analysis of deviations from that path. He found Harrod's framework well suited for showing the inherent instability of a growing economy, but not for investigating the determination of the growth rate itself and its changes in the long run. That depended on what Rostow (1960, pp. 12-16) called a disaggregated "dynamic theory of production" based on the interaction between different sectors as technical progress diffused throughout the economy. As put in the second edition of his *Stages* book, "without the leading sectors the fundamental connection between growth and new technologies disappears into the mists of the Harrod-Domar equation and statistical aggregates of highly ambiguous meaning" (Rostow 1971, p. 188). Like Lewis, Rostow's historical object was the Industrial Revolution.

¹² "Although couched in the language of growth, the theoretical exercises of Harrod, Domar and others have not been concerned with the variables determining differences in the rate and structure of growth. Their primary purpose has been to demonstrate that the growth process is likely to proceed in unstable cycles of unemployment" (Rostow 1955, p. 637).

Hirschman (1958, chapter 2) addressed upfront the ability of Harrod-Domar growth models to explain the development process. The success of Domar's simple model was measured by the fact that "we must pinch ourselves to remember that it is a theory rather than a faithful copy of reality", despite the fact that Domar limited himself to defining the rate of growth *required* for steady growth, independently of whether it is actually achieved or not (pp. 30, 34). That was related to the lack of a satisfactory theory of investment, the main defect of growth models in general. Moreover, Hirschman saw saving and investment decisions in developing countries as largely interdependent, in the sense that additions to saving are determined not so much by increased income but by new investment opportunities and the elimination of obstacles to investment. Harrod-Domar functional relations were useful in the limited domain of development planning, but, when deployed to interpret the development process, the model turned into a "hindrance rather than a help in the understanding of the reality of underdeveloped countries" (p. 32). Like Rostow, Hirschman criticized the way production decisions and their sectorial links are overlooked in Harrod-Domar formulations. The main element restricting economic development was the "ability to invest" – channeling existing or potentially existing saving into available investment opportunities – instead of the supply of saving per se. Hirschman's "ability to invest" was closely related to the notion of "absorptive capacity" (mentioned above in section 3), treated not as a deviation from the norm but as the standard case. It was in that context that Hirschman introduced his concept of unbalanced investment-stimulating projects through linkages brought about by complementarities and external economies effects.¹³

Such effects also played an important role in Rosenstein-Rodan's and Nurkse's theories of development, but – instead of Hirschman's unbalanced growth strategy via market incentives created by disequilibrium itself – they argued for balanced growth implemented by a coordinated wave of capital investments in different sectors, called Big Push by Rosenstein-Rodan 1961a (see Little 1982, chapter 3; Ray 1998, chapter 5; Alacevich 2015). Their emphasis on capital accumulation is well illustrated by Nurkse's (1953, p. 142) remark that "the country's marginal propensity to save is the crucial determinant of growth". Nurkse (p. 148)

¹³ Harrod seemed to agree with Hirschman's argument. In correspondence of 1963 with Hirschman, Harrod praised *Strategy* as the "most interesting book that I have read on economics for years" (Adelman 2013, p. 350).

contrasted that proposition with Keynes's ridicule of the Victorian virtues of thriftiness, regarded by Nurkse as "pernicious" when transplanted to underdeveloped countries. Nurkse did not refer to Harrod-Domar growth models; neither did Rosenstein-Rodan. This is hardly surprising, as indivisibilities and increasing returns – crucial to their interpretation of underdevelopment as a low-level equilibrium trap caused by a massive coordination failure – are not part of Harrod's or Domar's frameworks.¹⁴

Because of indivisibilities, a high minimum quantum of investment to start the development process required a high volume of savings, difficult to attain in poor countries. The way out of this "vicious circle", according to Rosenstein-Rodan (1961a), was to have first an increase of income due to higher investment that activates potential resources, followed by a second stage when the marginal propensity to save is greater than the average one in conditions of growing income. The English Industrial Revolution had not been preceded by a fall in consumption; instead, the proportion of income saved from the increased income was higher than before. This is not far from Lewis's and Rostow's interpretations of the behavior of the saving ratio in that historical episode. The main function of foreign capital inflow in developing countries was to increase the rate of domestic capital formation up to a level (he mentioned 12%, the same figure used by Lewis and Rostow), after which each country would move to self-sustained growth as the domestic marginal saving rate increased with higher income (Rosenstein-Rodan 1961b, p. 107). Capital inflow requirements for a 5 year period were calculated for several countries according to assumed values for income in the initial year, rate of output growth for the period (which depended on the absorptive capacity of each country), average saving rate, marginal saving rate and capital-output rate. The formula deployed by Rosenstein-Rodan (pp. 117, 135) for capital requirements was a variation of the so-called Harrod-Domar equation. Its role was not to provide an explanation of why the Big Push was necessary, but to calculate capital inflow once the theoretical argument had been put forward. Accordingly, Rosenstein-Rodan did not refer to Harrod or Domar while deriving his arithmetical formula for foreign aid.

¹⁴ As suggested by Krugman (1993), economists did not have in the 1950s the analytical tools to model economic growth under the assumption of increasing returns and imperfect competition. This started to change in the 1980s only.

Doubts about the proper interpretation of the ICOR and of the relation between capital accumulation and growth started to pop up in the 1960s, after empirical estimates by Solow (1957) and others had indicated the relatively small contribution of capital to the economic growth of the US and other advanced economies. Harvey Leibenstein (1966), who had previously used the ICOR as an important instrument of development planning (Leibenstein 1957), carried out the first investigation of the short-run association between ICOR and growth. In his opening paragraph, Leibenstein (1966, p. 20) stated that

One of the attractive aspects of the Harrod-Domar model is the magnificent simplicity of its variables. This is especially true of the incremental capital-output ratio (ICOR). It has served as a magnet for economists (including the present writer). Many have been unable to resist employing it as a major element in their attempts to understand economic growth. But are ICORs really helpful in understanding growth? How are ICORs and growth rates really related?

The empirical findings – based on observations for 18 developed and underdeveloped countries – showed that the correlation was negative. This implied that the ICOR was really a function of growth (determined mainly by technical progress) instead of the other way around. Further implications included serious doubts about the usefulness of the accelerator as an analytical tool and of the capital-output ratio as a planning instrument (Leibenstein 1966, p. 24; see also Bruton 1965, p. 357; Patel 1968; Hagen 1968, pp. 187-88; Morgan 1969, pp. 398-99).¹⁵ Paul Streeten (1968) reached similar results in his detailed study of the methodological foundations of economic models in general and of the Harrod-Domar model in particular (also called “capital/output model”), and of its application to development planning. Streeten (pp. 1975-77) used several diagrams to indicate the difficulty of measuring ICOR and interpreting the relation between changes in capital and output when output is dominated by autonomous technical progress. He concluded that ICOR could be used “neither to calculate investment requirements for given output increments nor to estimate

¹⁵ Correlation tests, between investment ratios and output growth in the short run, were also run by Hamberg (1971, pp. 169-73) to assess what he called the Harrod-Domar *Weltanschauung* that a rise in the saving-investment ratio s will permanently raise growth rates. Hamberg’s tests did not disprove the null hypothesis of a zero rank correlation coefficient.

additional output from given investment” (p. 1996). Such criticisms of the capital-output ratio model were put to rest until Easterly (1999; 2001, chapter 2) resumed them by investigating whether growth can be predicted with a constant ICOR. Easterly (2001, p. 295, n. 22) referred to Leibenstein (1966) and Patel (1968). Like those authors, he was interested in the short run causality – since the long-run positive relation between investment and growth, as well as the long-run stability of the capital-output ratio in steady state, were not controversial – but adopted the slightly distinct test of regressing growth against lagged investment. Easterly’s conclusions, that the ICOR is not an independent causal factor but just a ratio between two variables (investment and growth) loosely related, echoed the 1960s literature.

Reflecting in part the influence of the neoclassical growth model, development economists at the time gradually departed from the Harrod-Domar paradigm. Everett Hagen (1968, p. 175), a colleague of Solow and Domar at MIT, asserted that the problem of obtaining an increase in aggregate demand “is not a growth problem”, and that development economics should focus on the increment of potential output only. “We shall therefore give only briefly attention to the problem of demand; for example to the ‘Harrod-Domar’ problem of how an economy can be held at its capacity level of production as capacity increases”. In the same vein, Henry Bruton (1965) – who had earlier pointed to the Harrod-Domar analysis as the solution to the lack of formal modeling that beset development economics (Bruton 1955) – came to endorse the neoclassical growth model as the best apparatus to study economic development. Harrod and Domar, of course, were informed of the emerging development economics literature and considered how their respective theoretical frameworks could be (or not) applied) to economic development.

5. Harrod and Domar on economic development and capital

In contrast with previous theories by classical economists, Marx, Keynes, Hansen and others, the Harrod-Domar models did not feature any intrinsic tendency to stagnation or the stationary state. What attracted development economists to those models in the 1950s was precisely the idea of self-sustained growth through the reinvestment of part of the increased output through additional savings into additional investment at constant capital-output ratios with no exhaustion of investment opportunities, which

notably distinguished them from older approaches (Singer [1961] 1964, pp. 8-9; Furtado 1954, pp. 245-46). It is therefore ironic that Harrod (1948, pp. 19-20; 114; 1955a, p. 356; 1955b, pp. 336-39; 1973, pp. 24-26) – who assumed away in his dynamic economics the classical law of diminishing returns from land and the population doctrine that the supply of labor is infinitely elastic at a certain real wage – would suggest that “old classical analysis” and Malthusianism applied better to vast “poverty-stricken areas of the world today”, where population “is pressuring upon the means of subsistence” (1948, pp. 19 and 114). From that point of view, economic development of poor countries remained largely outside the terms of reference of Harrod’s dynamics.

Nevertheless, probably as a reaction to the widespread use of his and Domar’s equations by development planners, Harrod (1960; 1963a; 1963b) eventually discussed the application of his dynamic analysis (with exogenous population growth) to developing economies, which became an important topic of his agenda.¹⁶ Harrod (1963a, p. 421) declared in his presidential address to the Royal Economic Society that “many economists are finding, as I do, their attention attracted to the developing countries. That partly accounts for my continuing interest in growth economics”. In 1961 he organized for the International Economic Association a conference in Brissago (Switzerland) on trade and development (Harrod 1963c). Domar (1957a, p. 5) remarked that, despite the fact that his 1940s models treated growth mainly as a remedy for unemployment, they “can be, and have been, adapted to deal with growth as an end in itself”, as illustrated by the last (and only new) essay in his book, about Fel’dman’s Soviet two-sector model of development planning (Domar 1957b).

It was clear to Domar and Harrod that unemployment in developing countries was often not associated to insufficient effective demand, as in their models, or even to fixed coefficient technology. Domar (1953, pp. 562-63) doubted the possibility of substitution between factors could eliminate unemployment in poor economies, where

¹⁶ Harrod (1968) was aware that his equations were mostly used in the literature in their tautological form. However, there are no records of complaint by him against the (mis)use or adaptation of his ideas by development economists. Others, like Swan (1964), did complain. According to Swan (p. 4), Harrod “has been concerned mainly with the short-run implications of a conflict between warranted and natural growth rates ... Unfortunately, others took him up and all over the world people began eagerly calculating the components of $GC = s$ without enquiring either what the symbols really meant or whether their statistics had any meaning in relation to symbols”.

the “marginal product of labor can be so low as not to warrant the expense and trouble of hiring and training additional workers, even at a starvation wage”. Moreover, a member of a peasant household usually shared in family lodging and food and was therefore rewarded “in relation to the average, rather than his marginal, product”. If he moved to urban industries, he would have to pay for lodging and food, but his wage could not be expected to surpass his marginal product, which must then be significantly higher than average product in the rural activity. Hence, “he is apt to stay home and as a result the marginal product in agriculture can be very close to zero, or [if population increases] even below zero. Is this not unemployment, whatever production function the economist prefers to use?” Domar’s remarks anticipated some aspects of Lewis’s (1954) dual economy model, with the important difference that Domar did not allow for Lewis’s mechanism of labor transfer to “modern” capitalist industry and ensuing increase of profit share caused by the difference between marginal product in industry and average product in agriculture (which decides the wage rate). Harrod (1957, 1959) too mentioned, possibly under the influence of Nurkse (1953) and Lewis (1954), zero marginal productivity as a feature of (disguised) unemployment in developing countries, which differed from Keynes’s involuntary unemployment.

There is not a reserve of labor which could be brought to work in producing useful consumer goods if only demand were there. Much of the under-employed labor may be attached to agriculture, where the marginal physical productivity is more or less zero, so that the extra demand would not increase output. (Harrod 1959b, p. 104)

The Keynesian multiplier did not operate in that case (Harrod 1957, pp. 10-11; cf. Rao [1952] 1958 and Sunkel 1957).

Domar and Harrod did not assume perfectly elastic labor supply *à la* Lewis in their growth analyses. This is explicit in Harrod’s concept of the natural growth rate G_n as a ceiling and implicit in Domar’s ([1946] 1957a, pp. 73-74) discussion of the effects of labor scarcity on the productivity of capital. Harrod (1960, 1963a,b) introduced the notion of “optimum rate of savings” $s_r = C_r G_n$ as the propensity to save required to implement the maximum growth of production so that the natural and warranted rates are equal. As explained by Harrod, s_r is a dependent variable,

differently from the saving ratio s in the formula for the warranted or required growth rate (see Boianovsky 2015b). Domar ([1947a] 1957a, p. 97) had suggested a similar expression as a variant of his equation $r = \alpha\sigma$, which determined the required equilibrium growth rate for given α and σ . That equation could be solved for α (in terms of r and σ) and for σ (in terms of r and α), assuming that r was given, “for instance by technological progress”. Hence, $\alpha = r/\sigma$ was the propensity to save required to bring the economy to its full employment growth path.¹⁷ Harrod’s and Domar’s equations for s_r and α , with the propensity to save treated as a dependent variable, may look similar to development economists’ expression for capital requirements. However, instead of aiming at a certain target growth rate under perfectly elastic labor supply as in the development planning literature, Domar and (particularly) Harrod investigated the saving ratio consistent with the full employment growth path decided by population growth and technical progress.¹⁸

According to Harrod, developing countries suffered from insufficiency of saving to “finance natural growth”. However, one should be careful about this, as slow growth in those countries was often due not so much to a low saving ratio, as to “the difficulty of building up an increase of technological know-how and of personnel well qualified to implement it” Harrod (1973, p. 108). Harrod had been clear about that since the 1950s. In his review of Kurihara’s *Keynesian Dynamics*, Harrod (1957b, p. 193) criticized Kurihara (1956, p. 211) for suggesting that the major problem facing underdeveloped economies was “increasing capital accumulation”. “Is this not a wrong emphasis, not confined to Professor Kurihara?” asked Harrod. More important limitations came from factors deciding the natural rate of growth of per capita output. Harrod’s (1963b, p. 114) “dynamized version of the law of diminishing returns” asserted that the rate at which future income can be raised by saving depends

¹⁷ Domar also wrote the equation in the alternative form $\sigma = r/\alpha$. With this closure, the capital-output ratio became the dependent variable, just as in Solow’s (1956) and Swan’s (1956) formulations. The choice of how to close the model depended on the kind of problem addressed (see Boianovsky 2015a).

¹⁸ Planning for full employment – implicitly assumed as unreachable – was exceptional among developing countries (see Little 1982, p. 42). The United Nations (1960, p. 13) document drafted by Tinbergen considered in passing setting the rate of growth so as to achieve full employment, which corresponded to the sum of demographic growth and labor productivity increase.

on the availability of factors other than capital (labor and natural resources). In general, any attempt to accumulate capital considerably faster than the other factors “will add little to the rate of growth of income” (ibid). This was related to the notion of “absorptive capacity” mentioned above (see Guillamont 1971, pp. 55-57). Harrod was far from being a “capital fundamentalist”, although (optimal) saving did play a role in his discussion of economic development. Planning in developing countries was not so much a matter of reaching the natural growth rate, but changing the natural path itself.

The main determinant of G_n per capita in developing countries was the maximum rate at which qualified personnel could be increased and bring (mostly) imported technology to use. The supplement to entrepreneurship through planning may raise that rate and thereby cause an upward shift in the natural growth curve, accompanied by a higher s_r . If actual growth is below natural growth only because of the shortage of saving, there is available qualified personnel to implement the new technology. In these circumstances, to obtain “social optimum” it is necessary to raise s towards s_r by fiscal policy, bringing the economy to a “transitional period” in which actual growth is above natural growth, owing to the exploiting of previously underemployed skilled personnel. Once the limited fund of such personnel is taken up, transitional growth is merged into regular natural growth. There are clear limits to the effect of higher saving on the per capita rate of growth, since its “very essence ... is the education by practice and the gradual drawing out of the latent potentialities of personnel” (1960, p. 291).

It is important to avoid over-simplified ideas about the consequences of the mere provision of additional saving. This view might be regarded as pessimistic in that it sets a limit to what can be done by one simple recipe (more saving); but it is optimistic in that it enables us to curb the impulses of those who believe Utopia can be gained solely by the imposition of harsh austerity (ibid).¹⁹

¹⁹ The optimum flow of international lending should be such as to prevent capital from restricting economic growth, given the rates of growth of non-capital factors. Increasing domestic saving via the reduction of consumption would have perverse incentive effects on labor supply by skilled workers, which was also behind Harrod’s (1960, 1963b) case for foreign aid.

This may be read as a critical reaction to the way his equations were used by development planners at the time.

Like Harrod, Domar (1966, p. 10) pointed to skilled labor, instead of physical capital, as the main determinant of economic development. He had ascribed American economic growth in the period 1879-1928 to technological improvements and growth of the labor force (Domar [1944] 1957a), which corresponded to Harrod's (1948) "fundamental conditions" behind the natural growth rate. However, Domar did not articulate that as part of his model, as he lacked Harrod's G_n concept. In his formal restatement of Fel'dman's ([1928] 1964) Marxian two-sector growth model with given capital-output ratios, Domar (1957a, p. 244) noticed two assumptions that distinguished it from his own formulation: unlimited supply of labor and absence of cyclical disturbances or effective demand problems. The new element contained in Fel'dman's model was the notion that the crucial restriction to growth is represented not by saving but by the capacity to produce capital goods – otherwise saving cannot be translated into an increase in investment.²⁰ One of Domar's (1957a) main contributions was the determination of the optimal distribution of capital goods between the consumption and capital good sectors of the economy according to different goals. In particular, Domar established mathematically that an increase in the proportion of capital goods allocated to producing more capital goods eventually brings about a higher permanent growth of both consumption and investment (see Jones 1975, sections 5.6 and 5.7).

Despite his praise for Fel'dman's early model, Domar (1957b, pp. 256-57) was critical of its straightforward application to development planning by playing with the values of parameters. Russian development planners had failed to realize that those parameters (especially the capital coefficients) were "mere abstractions", useful in theoretical work, but dangerous in practical applications because of what they concealed about the actual working of the economy. The "problem of economic development" did not lie in "algebraic manipulations" à la Fel'dman but in overcoming the "administrative, technological and human obstacles that a rapid industrialization of a backward peasant economy was bound to create" – of course,

²⁰ As pointed out by Abramovitz (1952, pp. 155-56), Keynes's concept of the marginal efficiency of capital as a function of the cost of producing capital goods implied that the level of capital formation a country can attain depends on the capacity of the capital goods sector.

that was difficult to put in a model. Domar (1957a, p. 13) extended that piece of criticism to the widespread belief of development planners that, by assuming plausible values for the saving ratio and the capital coefficients, “economic development seems assured”.

Differently from Harrod, Domar did not refer to diminishing returns to capital accumulation as posing a limit to the effects of higher capital-labor ratio on output growth. This may reflect Domar’s belief that the stability of the capital-output ratio indicated the operation of technical progress compensating diminishing returns. When exposed, at the 1958 Corfu conference on capital theory, to the neoclassical result that, due to diminishing returns to capital, the permanent rate of economic growth is independent of the propensity to save, Domar expressed his surprise. He found it “striking”, although it did not prevent “economists from developed countries from pressing upon their colleagues in less-developed countries the standard question about the fraction of output which the less-developed countries invested” (Lutz and Hague 1961, report on the proceedings, p. 394). The debate that followed Domar’s remarks, involving Samuelson, Kaldor, Champernowne and Solow, brought out the distinction between rates and level effects of changes in the propensity to save. Domar closed the debate by suggesting that “so long as technological progress was ruled out when investment took place, capital accumulation was not important to growth in the long run”.²¹

The interpretation of the observed long-run stability of the capital-output ratio attracted Domar’s attention as well. As discussed above, development economists started to question in the 1960s the use of the ICOR to figure out capital requirements. Domar’s (1955, 1961) calculations of the American capital-output ratio confirmed its relative stability over time. Anticipating some of the later causality issues, Domar warned about the meaning of such stability.

This does not necessarily presuppose any specific causal relationship between these three variables. It is possible that the capital coefficient and the fraction of output invested have yielded a certain rate of growth of output. But it is also possible that other factors besides capital have been mainly responsible for the existing rate of growth of output, and the given capital coefficient has simply

²¹ Contrary to Domar’s intuition, vintage-capital models did not assure a positive effect of the saving ratio on output growth, as Phelps would show a couple of years later.

resulted from the interaction of the other variables. Thus the relative stability of the capital coefficient is not a sufficient indication of the role of capital formation in economic growth (Domar 1961, p. 103).

The matter was essentially empirical. In view of the findings by Solow and others about the contribution of technical progress to growth, the capital coefficient “will emerge as a relatively passive result of the interaction between the propensity to save and the rate of technological progress” (ibid, p. 117). This corresponded to Domar’s third closure $\sigma = r/\alpha$ mentioned above. Clearly, the description of Harrod and Domar as supporters or creators of “capital fundamentalism” is a simplification that hides more than reveals the complex history of development economics.

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