

Dualism and the Internal Integration of the Underdeveloped Economies

In this paper, we shall re-examine the nature and causes of economic dualism in the underdeveloped countries and consider some of its implications for development policy.

Dualism may be defined as the continuing co-existence of a "modern" sector and a "traditional" sector within the domestic economic framework of an underdeveloped country. One version of dualism identifies the modern sector with the exchange economy and the traditional sector with the subsistence economy. The other version, with which we shall be mainly concerned, defines the modern sector as consisting of large-scale economic units employing capital-intensive methods of production and the traditional sector as consisting of small-scale economic units employing labour-intensive methods of production.

Existing theories of dualism attempt to explain the differences between the two sectors in terms of sociological and technological factors. In contrast, we shall argue that the most significant aspect of economic dualism as it exists in the present-day underdeveloped countries is that scarce inputs such as capital funds, foreign exchange and public economic facilities, notably transport and communications and power, are being made available on excessively favourable terms to the larger units in the modern sector including the public sector, and on excessively unfavourable terms to the small economic units in the traditional sector. Our interpretation of dualism emphasizes the importance of domestic economic policies to promote internal economic integration between the modern and the traditional sectors of the underdeveloped countries by removing as far as possible the causes of unequal access to the scarce economic resources by the two sectors.

This conclusion is in sharp contrast with the policies of domestic industrialization and import substitution currently adopted in the underdeveloped countries. Here, in order to encourage the expansion

of domestic manufacturing industry, the whole apparatus of government controls has been used to discriminate in favour of the modern sector and to discriminate against the traditional sector thus aggravating the unequal access to economic resources which already exists because of the underdevelopment of the domestic economic organisation. The advocates of domestic industrialization moreover invoke the concept of dualism to support their argument and to attack the application of the "orthodox" theory of optimum allocation of resources to the underdeveloped countries. They maintain that the neo-classical model of an economic system making smooth and flexible adjustments cannot be applied to the underdeveloped countries because of their dualistic economic structure created by the various sociological and technological rigidities and by the existence of "disguised unemployment" and factor disproportionalities. They further maintain that the static norm of efficient allocation of resources has limited relevance for the purpose of promoting rapid economic development by introducing "dynamic" economic changes into the underdeveloped countries.

The drift of these arguments is to emphasize, not the importance of domestic economic policies to reduce dualism, but rather the impotence and limitations of the purely domestic economic policies which the underdeveloped countries can pursue on their own because of the "structural" difficulties created by dualism. The final effect is to emphasize the importance of external economic aid to the underdeveloped countries. Thus we have the familiar UNCTAD thesis (1) that the slow rate of economic growth in the underdeveloped countries is mainly due to the external economic factors beyond their control, notably the unfavourable trend in the world market demand for primary products. On the other hand, it is maintained that the current tempo of domestic industrialization must be maintained to provide acceptable target rates of economic growth, to absorb the "disguised unemployment" and above all to introduce "dynamic" economic changes. Thus the burden of promoting economic development is shifted from domestic economic policies to external economic assistance to finance the strategic imports required in fixed proportions as technical inputs for the expansion of the output of the domestic manufacturing sector. Given the implicit belief in the economic superiority and the "dynamic"

(1) Cf. *Towards a New Trade Policy for Development*, United Nations, New York, 1964.

effects of the large-scale modern manufacturing industry much attention is devoted to the formation of regional economic unions and multi-national economic integration while the more fundamental problem of promoting internal economic integration within each individual underdeveloped country is neglected.

In re-examining the concept of dualism, we are inevitably involved in a critical review of these arguments for domestic industrialization. In section I we shall argue that in order to understand the economic significance of dualism we have to go beyond the sociological and technological explanations and take our bearings from the theory of the optimum allocation of resources. Thus dualism may be interpreted as a species of distortion in the allocation of resources arising out of the unequal terms on which economic resources such as capital, foreign exchange and public economic services are made available to the two sectors. In section II we shall argue that the "financial dualism" which is aggravated by domestic industrialization policies, not only leads to a distortion in the allocation of capital funds but also tends to impede the longer-term growth of a more integrated domestic market for capital. In section III we shall examine dualism in relation to labour supply and "disguised unemployment". We shall argue that current views on domestic industrialization seriously underrate the possibilities of introducing labour-intensive methods both in agriculture and in manufacture and that in particular, the development of complementary relations between the large- and the small-scale industries offers a more promising prospect of absorbing abundant labour than the current policy of trying to expand large-scale manufacturing industry on its own. This will also lead us to re-examine the role of the modern sector in introducing "dynamic" changes into the traditional sector. In section IV, we conclude with a broad review of the implications of our analysis of dualism on the external aspects of development policy: on international trade policy; on the "absorptive capacity" for international aid and "economic enclaves"; and on the formation of regional or multi-national integration.

I

Let us begin with the concept of dualism based on the dichotomy between the exchange economy and the subsistence sector. Dualism in this sense may be said to exist as soon as a hitherto self-sufficient

traditional society is opened up to international trade. We then have the familiar process of the expansion in export production bringing the labour from the subsistence economy into the mines and plantations and inducing the peasants to devote their surplus land and labour to the production of export crops. At first, the exchange economy is mainly confined to the foreign trade sector, but gradually as the export producers spend a part of their cash earnings on home produced goods, a growing part of the domestic economic activities will be drawn into the exchange economy. There is also the well-known complementary relationship between the growth of the exchange economy and the fiscal system. The foreign trade sector initially provides the government with the revenues and the borrowing power to set up a modern system of administration and the basic framework of social overhead capital. Improvements in transport and communications widen the area of the exchange economy which in turn widens the scope of government revenue and expenditure. Thus, as the boundary line of exchange economy moves further outward, it draws a larger part of the national economic life into the organized domestic economic framework. In general, one would expect the position of the boundary line between the exchange economy and the subsistence sector to be influenced by a number of economic factors, such as the state of development of the tastes and preferences of the people in the subsistence sector for the goods and services available in the exchange economy, the state of export and domestic demand for the goods and services which can be produced by the resources still remaining in the subsistence sector and above all, the state of development in transport and communications.

What economic significance can we attach to the concept of dualism based on a boundary line between the exchange economy and the subsistence sector existing in an underdeveloped country at a given moment of time? Those who favour the "sociological" interpretation of dualism seem to look upon the mere co-existence of the exchange economy and the subsistence sector as evidence of sociological rigidities creating special obstacles to economic development (2). They tend to assume that there are two completely different groups of people, one in the exchange economy and one

(2) Cf. J. H. BOEKE, *Economics and Economic Policy in Dual Societies*, 1953, for a well-known exposition of these views.

in the subsistence sector, each living in separate worlds of their own. Thus the people in the subsistence sector are not supposed to respond to economic incentives in the normal way, either because they have limited wants for the commodities available in the exchange economy or because of their conservatism and ignorance. Now, in so far as it is true that the subsistence sector persists because people there do not want the goods and services in the exchange economy, there is no question of economic irrationality: they do not have "economic development" measured in terms of money income because they do not want it. However, this type of pure subsistence society insulated from outside influences must nowadays be regarded as a very small and shrinking part of the underdeveloped world. In the rest of the underdeveloped world, with growing contacts with the outside world, the tastes and preferences for the new commodities and the new ways of life have been developed only too rapidly. Once this happens there is no lack of evidence to show that people in the underdeveloped countries follow the normal economic behaviour of maximizing their utility according to their given tastes and preferences (3). What is even more important for our present analysis, in the general run of the underdeveloped countries, the majority of the people are neither in the pure isolated type of subsistence society nor are they completely absorbed into an organized wage economy. Rather they are in the vast intermediate zone of economic activity with a very low degree of economic specialization, devoting varying parts of their time and resources to subsistence activities and cash-earning activities.

Now assuming normal economic behaviour, this means that these people will make appropriate switches in the allocation of resources between subsistence and cash-earning activities until the balance of net advantages from these two types of activity are equal. Thus, although we may draw a statistical line to indicate the proportion of resources devoted to the exchange economy and the subsistence sector, there is no sharp discontinuity in the actual decision-making processes which have resulted in this boundary line. Thus if we wish to attach a special significance to the concept of dualism based on the dichotomy between the exchange economy and the subsistence sector, we must not merely show that a boundary

(3) Cf. P. T. BAUER and B. S. YAMEY, *Markets, Market Control and Marketing Reform*, 1968, Parts 1 and 2.

line can be drawn between the two, but also that the boundary line actually existing is in the wrong position because, say, the exchange economy has not expanded to the extent consistent with the economic factors governing the situation. In other words, there has been a genuine distortion in the allocation of resources between the exchange economy and the subsistence sector.

As a matter of fact, in many underdeveloped countries the expansion of the exchange economy is likely to be retarded, not because people in the subsistence sector behave irrationally, but because of economic policies which have distorted the relative attractiveness of subsistence and cash-earning activities. For instance, there may be no incentive to switch from subsistence to cash crops because of transport difficulties in bringing the produce to the market, although the expansion in production would have been profitable enough to pay for the cost of extending or improving the transport system. This is particularly likely to happen when there is a "dualism" in the provision of public services favouring the larger type of social overhead projects serving the modern sector located in the bigger towns to the neglect of the traditional sector located in the remoter parts of the country. Again, the incentive to switch from subsistence to cash crops may be reduced because domestic industrialization policies have turned the "terms of trade" against the agricultural products which can be produced by the subsistence sector. In each case, the expansion of the exchange economy has been retarded in a significant sense because there has been some distortion in the allocation of resources.

A similar reasoning can be applied to the "technological" concept of dualism based on the dichotomy between the modern sector consisting of the larger-scale economic units employing capital-intensive techniques of production and the traditional sector consisting of small-scale economic units employing labour-intensive techniques. The mere fact that the modern sector uses capital-intensive techniques while the traditional sector uses labour-intensive techniques is not significant in itself: the two sectors may be producing two entirely different non-substitutable types of product. Technological dualism becomes significant only when it is observed that the two sectors are producing similar or potentially substitutable products but using different techniques involving different scales of production and different proportions of the same type of factors of produc-

tion and inputs. The significance arises because there is a *prima facie* case for suspecting a distortion in the allocation of resources.

Now it is true to say that technological dualism in this significant sense seems to be more pronounced in the underdeveloped countries than in the developed countries. It can sometimes be found even in some export industries, notably rubber in Malaya and Indonesia, where small producers co-exist with larger plantations. But the most interesting case of economic dualism for our analysis is that which occurs in the manufacturing sector in the underdeveloped countries. Here the new import-substituting factories set up in the modern manufacturing sector are mainly confined to consumers' goods industries, notably food, drink, tobacco, textiles, etc. which are also produced by the traditional sector (4). There are of course considerable differences in quality, design and standardization of the product between the goods produced by the small-scale industries and those produced by modern style factories. But the case for regarding the traditional sector as producing the same type of "commodity" as the modern sector is stronger than it appears at first sight. It is true that the small-scale industries produce inferior quality products compared with the modern factories in the underdeveloped countries; but there is a similar quality gap between the products of the latter and the imported goods they seek to replace. Further, while the small-scale industries produce inferior quality goods, their prices are also lower. In contrast, the modern factories, set up under heavy protection in the underdeveloped countries, frequently produce goods which are not only inferior in quality but also higher in price compared with the imported goods. Thus, if we are prepared to accept the possibility of import substitution, we should also accept the possibility of substitution between the products of the modern style factories and the products of the small-scale industries.

If the modern and the traditional sectors produce a similar range of consumers' goods which are in some degree substitutes for each other, why do the economic units in these two sectors use such markedly different methods of production? Writers on dualism tend to explain this in terms of the sociological or technological rigidities. Thus the small-scale industries are supposed to employ the traditional labour-intensive methods because of conservatism and

(4) Cf. MASANORI KOGA, "Traditional and Modern Industries in India", *The Developing Economies*, September 1968, for a useful summary of the empirical data on this point.

technological backwardness. On the other hand, it is said that the capital-intensive methods in the modern sector are the inevitable result of the underdeveloped countries' need to adopt the ready-made advanced technology from abroad. But these explanations are unsatisfactory because they ignore the glaring differences in the prices of the factors of production in the two sectors. Thus, given the underdevelopment of the domestic markets for capital funds and labour, the level of interest rates is markedly higher while the level of wages is markedly lower in the traditional sector compared with the modern sector. In commonsense terms, this striking pattern of high interest rates and low wages in the traditional sector and low interest rates and high wages in the modern sector would be sufficient to account for a large part of the differences in the factor proportions used in the two sectors without introducing special assumptions about sociological and technological rigidities. What is however more significant is that in many underdeveloped countries trying to promote domestic industrialization, the gaps in the factor prices arising out of the underdevelopment of the factor markets tend to be widened artificially. In some countries where labour is strongly organized in the urban manufacturing sector or the mining sector, there are restrictions to free entry of labour from the traditional sector. In almost all countries, the apparatus of government controls tends to be used to divert the lion's share of capital funds and foreign exchange to the larger-scale economic units in the modern sector, including the public sector, while the small economic units in the traditional sector are starved of these vital resources. In particular, this has resulted in the maintenance of artificial factor prices in the modern sector which go against the pattern of factor endowments of the country taken as a whole. Thus interest rates are kept artificially low in flagrant contradiction to the general scarcity of savings and wages are maintained artificially high in spite of the abundant supply of labour. In terms of the optimum theory, this implies a distortion in the allocation of resources between the two sectors and the use of excessively capital-intensive methods in the modern sector. Thus the economic significance of technological dualism may be found, not so much in the differences in techniques of production by themselves, but in the fact that the two sectors are producing similar or potentially substitutable products but with markedly different factor proportions because of the artificially accentuated unequal access to economic resources.

II

Let us now consider "financial dualism" in the domestic market for capital funds in the underdeveloped countries. Given the well-known facts about the much higher risks and costs involved in lending money on a retail basis to a large number of small borrowers than in lending to a small number of large well-established borrowers, one would normally expect the rate of interest in the "unorganized" credit market in the traditional sector to be higher than the rate in the "organized" credit market in the modern sector. Further, one would expect this normal gap in the interest rates to be larger the more underdeveloped the domestic credit market and the financial institutions in a given country. Financial dualism in this sense has of course existed in the underdeveloped countries long before they embarked on their present policies of domestic industrialization. But there are two differences between the old financial dualism which existed in the "open economy" of the colonial period and the new financial dualism which now exists in the "closed economy" of the underdeveloped countries pursuing domestic industrialization policies.

First, under the colonial financial system, the disadvantage which the small economic units suffered compared with the big economic units was in obtaining credit in terms of local currency. Once that was obtained, the small economic units were at least on equal terms with big economic units in their access to foreign exchange. The automatic currency system ensured free convertibility at fixed rates of exchange; there was no balance of payments problem and no foreign exchange shortage. In contrast, domestic inflation and balance of payments difficulties have now become endemic in the underdeveloped countries. This means that the small economic units in the traditional sector not only have to face their previous handicaps in raising loans in local currency; they now have to face a new handicap in their access to foreign exchange and imports.

Second, under the colonial system, the organized credit market of the underdeveloped countries, made up of the branches of foreign banks, was closely linked with the international financial market. That is to say, the low rate of interest which prevailed in the organized credit market was not an arbitrary rate. It represented the market rate at which the modern sector of the economy, mainly

consisting of the mines, plantations and the export-import firms, could borrow from the international capital market. In the organized credit market at least the demand and supply of loans was equated at the equilibrium market rate. In contrast, since attaining financial independence, the organized credit market in many underdeveloped countries has become increasingly insulated from the international capital market. Given the increasing use of foreign exchange controls which restrict profit remittances and transfers of banking funds, the foreign branch banks no longer function as significant links channelling outside capital funds into the underdeveloped countries. This has been aggravated by the attempt of many underdeveloped countries to stimulate their economic development with the "cheap money" policy. Thus during the last two decades, we have frequently had the anomalous situation in which the official rates of interest in the organized credit markets of the capital-poor underdeveloped countries have been kept well below the prevailing level of interest rates in the capital-rich advanced countries (5).

Given the pressure of domestic inflation with fixed exchange rates, there is a chronic excess demand for foreign exchange at the overvalued exchange rates. Given the "cheap money" policy of maintaining artificially low interest rates in the organized credit market, there is a chronic excess demand for loans above the volume of domestic savings forthcoming at these rates of interest. The government in most underdeveloped countries attempts to cope with this disequilibrium situation by setting up a network of direct controls to ration the scarce capital and foreign exchange resources between rival claimants: and it is this rationing process through the apparatus of government controls which has aggravated the unequal access to scarce resources suffered by the small economic units in the traditional sector. Even if the government's policy towards the different sectors were neutral, there would be a considerable amount of unintended or unofficial discrimination against the small economic units. Compared with the larger economic units in the modern sector, they are notoriously at a disadvantage in coping with the complexities and delays of the bureaucracy which administers the various economic controls (6). But government

(5) For a vivid description and criticism of this anomalous situation see G. MYRDAL, *Asian Drama*, Vol. III, Appendix 8, particularly section II.

(6) Cf. *Economic Bulletin for Asia and the Far East*, Vol. XII, No. 3, December 1961, p. 7.

policy far from being neutral has the avowed aim of encouraging the larger economic units in the modern sector, including the public sector. With given resources, this implies discriminating against the small economic units in the traditional sector. This discrimination applies not only to access to capital funds and foreign exchange but also to public economic services supplied by the government. In particular, social overhead facilities such as transport and communications and power are more readily available and frequently on cheaper terms to the larger economic units in the modern sector than to the small economic units in the traditional sector. In this setting of rationing through direct quantitative controls, the extent of unequal access to economic resources can no longer be adequately depicted in terms of the gap in the rates of interest in the modern and the traditional sector. For instance, the use of the excessively capital-intensive methods by the large-scale economic units in the modern sector is encouraged, not only by the low rates of interest, but also by the easier availability of foreign exchange which enables them to import capital goods on very favourable terms at the overvalued official exchange rates. This is reinforced by easier and cheaper access to public economic services.

All this has the effect not only of distorting the allocation of resources between the modern and the traditional sectors but also of impeding the longer-term growth of an integrated domestic capital market in the underdeveloped countries. The development of an integrated domestic capital market requires two conditions: (a) the growth of a financial centre which can effectively collect the savings from both the modern and the traditional sectors as well as from the international capital market and channel these funds into different parts of the domestic economy according to the highest obtainable returns on investment; and (b) the growth of a financial network which links the financial centre with the lenders and borrowers in all parts of the country, including the public sector. The financial links may be branches and subsidiaries which are vertically integrated with the headquarters of the financial institutions located in the centre, such as the district branches of the commercial banks and co-operative societies. Or the links may be independent financial intermediaries such as a professional class of moneylenders who have access to the funds collected at the centre to be re-lent to the rest of the country. In any case it is clear that in order to reduce the financial dualism between the organized and the

unorganized markets for credit, there would have to be more effective links facilitating the mobility of funds between the two.

We have already seen that the policies followed by many underdeveloped countries since attaining financial independence have insulated their organized credit markets from the international capital market. But these policies also have the effect of insulating the organized credit market from the free market for credit within the country. Indeed, given the multiplicity of government controls, much of the unofficial or free market for credit is reduced to the status of the "black market". To begin with, given the pressure of domestic inflation with overvalued exchange rates, there is a chronic tendency for speculative flights of capital abroad. Where the government has succeeded in blocking these leakages, the funds, instead of remaining in the official organized credit market, are diverted into the purchase of gold and jewellery and real estate and into speculative activities. This is not surprising when, thanks to the "cheap money" policy, the official rates of interest offered to the lenders are so markedly below the returns on investment in any of these alternatives. Indeed, in many countries the rates of interest offered to the lenders by the organized credit market yield negative real returns because the rate of depreciation in the value of money exceeds the rate of interest. The growth of an unofficial market for credit may serve to relieve the shortage of savings in the traditional sector by diverting some of the capital funds into money-lending and trading. But the fact remains that the "cheap money" policy imposes the very heavy long-term cost of retarding the growth of an effective financial centre.

The growth of the financial intermediaries is also retarded by the way in which the governments of the underdeveloped countries usually exercise their controls to ration the scarce capital supply. These controls discriminate not only against the small borrowers but also against the moneylenders and others who are the chief source of credit to the small borrowers. There are two underlying beliefs behind these controls which are inimical not only to the growth of the capital market but also to the development of a domestic market economy in general.

The first is the belief that the only "productive" way of using capital funds is to invest them in durable capital goods and machinery embodying modern technology. The vital role of capital as the "subsistence fund" in agriculture is not understood and the

financing of trading activities is regarded as "unproductive". Credit discrimination against trading not only serves to widen the wholesale and retail prices because of the high costs of holding stocks but has a general consequence in undermining the development of the market economy in the underdeveloped countries which is not clearly appreciated. The truth of the matter is that most underdeveloped countries tend to hold a much lower level of stocks of commodities and circulating capital than is required to run their economies smoothly given the underdevelopment of their transport and communications and market organization. Consequently, their internal economic organization is extremely "brittle", liable to frequent breakdowns and speculative instability of prices in the face of unforeseen changes, such as an unfavourable harvest threatening famine conditions in a particular locality. Now while much has been said about the vulnerability of the underdeveloped countries to the instability in the world market demand for their exports and their need for adequate foreign exchange reserves, little has been said about their vulnerability to internal instability and their need to hold adequate stocks of circulating capital. It may well be that international trade and the opportunity to draw on an elastic world market supply of goods is a greater stabilizing force on the underdeveloped countries than is generally realised.

The second belief underlying government economic controls is the traditional belief in the wickedness of moneylenders and the need to suppress or curtail their activities by regulating the rates of interest at which they are permitted to lend. Few such regulations have succeeded because the moneylenders perform a genuine economic service in the unorganized credit market which the government cannot provide. There are two contradictory strands in the popular arguments against the moneylenders. The first is that the moneylenders, landlords and the village shopkeepers make use of their entrenched position in the local community to extract monopolistically high rates of interest from the peasant borrowers. If this is true, the logical remedy would be to increase the competition among the moneylenders, and this can be done by facilitating their access to the central funds of the organized credit market. The second argument states, not that there are too few moneylenders, but that there are too many middlemen intervening between the financial centre and the final borrowers in the traditional sector who are obliged to pay excessive rates to cover the middlemen's com-

mission. This argument really amounts to saying that it is always cheaper to cater for the small borrowers through the branches of the lending agencies which are vertically integrated with their headquarters located in the financial centre rather than through independent financial intermediaries who form the market links between the financial centre and the final borrowers. This is however not supported by the experience of the commercial banks which have generally found that the cost of opening sub-branches in the remoter districts of the underdeveloped countries is too high to compete with the lower overheads of the moneylenders. Yet the popular belief that the excessive profits of the middlemen and moneylenders can be cut by "direct" links with the official lending agencies persists. It seems to arise from ignoring or underestimating the costs of vertical integration between the central lending agencies and the numerous branches and sub-branches which are necessary to cater for the credit needs of the small borrowers: these costs include not only the overhead costs and salaries of the officials but also the relative inefficiency of the official employees dealing with small borrowers according to rigid rules of creditworthiness and inefficient co-ordination between the headquarters and branches by bureaucratic methods.

So far, apart from the abortive attempts to control the activities of the moneylenders, most underdeveloped countries have done little to improve the working of the unorganized credit market beyond ad hoc attempts to supply limited amounts of subsidized loans through co-operative societies to some favoured parts of the rural sector. The model villages enjoying the subsidized loans from the government may be "showpieces" like the steel mills, but they have very little general effect in lowering the prevailing high levels of interest rates in the rural sector. Indeed, frequently they benefit the moneylenders, who have managed to get themselves elected as members of the co-operatives. Moreover, the bona fide members of the co-operatives wishing to borrow more than the officially permitted amounts of cheap loans can now afford to pay a higher rate of interest on their extra borrowings from the moneylenders. This is not to deny that the co-operative societies may be able to compete with the moneylenders either because they are more efficient in collecting information about the creditworthiness of their members or because they can reduce risks better by mutual guarantees undertaken by their members. But the correct way of testing this is, not

by giving limited amounts of low-interest loans to the co-operative societies, but by giving unlimited access on equal terms at the ruling market rate of interest to both the co-operatives and the moneylenders so that they can compete to lower the rates of interest for the small borrowers.

The conclusion of this analysis is clear. In order to reduce financial dualism and build up a more integrated domestic market for capital, the underdeveloped countries should raise the official rates of interest in their organized credit market high enough to reflect their existing shortage of capital funds. This would encourage the growth of a financial centre which can effectively attract savings both from within the country and from abroad. It would also equate the available supply of savings to the demand for loans including the demand for funds by the moneylenders to be re-lent to the unorganized credit market. The granting of an equal access to capital funds by the traditional and the modern sectors would serve to reduce the distortion in the allocation of resources between the two sectors. The familiar argument that the raising of the official rate of interest would raise the cost of government borrowing has limited significance for the underdeveloped countries. Given the unattractively low rates of interest offered on government securities, there has been little public demand for them. The bulk of the government securities are in fact held by various government agencies and their affiliates so that the raising of the interest rate would mainly have the effect of changing the accounting relationships within the public sector. Indeed, the case for raising the rate of interest is strengthened, not weakened, by taking into account the longer-term effects on the government's ability to borrow from the public.

III

We have noted that the level of wages is generally higher in the modern sector than in the traditional sector of the underdeveloped country. How far does this imply the existence of a dualism in the labour market, discouraging the expansion of the modern sector and distorting the allocation of resources in the opposite direction from that caused by financial dualism? Without entering into a detailed enumeration of the possible causes of the wage differentials between the two sectors, we may consider them under three heads.

First, there are the wage differences which reflect genuine economic differences in skills, in costs of living, etc. which clearly do not distort the allocation of labour between the two sectors.

Next, there is the less well-recognized fact that in the underdeveloped countries the wage rate in the modern sector reflects the payment to the head of the family to induce him to move with his dependents on a permanent basis to the place of his work, whereas the wage rate in the traditional sector reflects the payment to a single worker on a casual or temporary basis. Now even in the absence of government regulations and trade union pressure, the larger-scale concerns in the modern sector may prefer to pay higher wages to obtain a regular labour force, for at least two reasons. First, the gains in productivity from a stable labour force and a low rate of turnover may more than pay for the higher wage bill. Second, if the concerns are run by foreign entrepreneurs or managers, they do not have the necessary local knowledge and skills in labour relations to cope with the casual type of labour. Indeed, from their point of view the cost of re-adapting their whole system of production and organization to make use of the cheaper casual labour would be much too high and they would be prepared to pay considerably higher wages to obtain a labour force approximately similar to the type of regular labour force they are used to in their own countries. Historically, this can be illustrated by the contrasting labour policies adopted in the development of the textile industry by foreign entrepreneurs in India and by indigenous entrepreneurs in Japan. The former recruited their labour force from adult males, paying them a wage rate sufficient to maintain their dependents; the latter took advantage of the cheaper, but equally efficient, labour of young farm girls available for a few years before they got married (7). The present-day expansion of the modern manufacturing sector in the underdeveloped countries relies heavily on foreign managers and technical experts, not to speak of the branch factories of international corporations set up to jump the tariff and import controls. Thus we have a pattern of wage policy and labour organization based on a high differential between the ruling wage rate

(7) For a comparative analysis of the labour policies adopted in the development of the textile industry in India and Japan see S. J. KON, *Stages of Industrial Development in Asia*, University of Pennsylvania Press, 1966, Chs. II and III; see also W. W. Lockwood, *The Economic Development of Japan*, Princeton, 1954, pp. 213-14; for a theoretical analysis of this point, see D. MAZUMDAR, "Underemployment in Agriculture and the Industrial Wage Rate", *Economica*, November, 1959.

in the regular labour market and that in the unorganized market for casual labour. How are we to interpret this type of wage differential between the modern and the traditional sector? In so far as the large-scale modern concerns are willing to pay a higher wage rate, voluntarily and without any external pressure, there can be no distortion of resource allocation originating from the labour market. Yet the wage differential is associated with a distinct dualism in industrial organization and may be a sign of managerial rigidity on the part of the modern sector failing to make a more effective use of the abundant supply of casual labour. In so far as this creates a distortion, it is not due to a high wage rate discouraging the expansion of the larger-scale economic units in the modern sector, but due to an insufficient development of the small-scale indigenous economic units which are more likely to be able to take advantage of the abundant supply of casual labour.

Lastly, we have the factors which arbitrarily widen the wage differential between the modern and the traditional sectors and clearly distort the allocation of labour between the two. However, these need to be disentangled from the concept of "disguised unemployment". A familiar argument for the protection of domestic manufacturing industry based on this concept may be summarized as follows. Because of heavy population pressure on existing land, the marginal product of labour in agriculture is reduced to zero. But the income level in the traditional sector is equal not to the marginal product but to the average product of labour on land because of the prevalence of the extended family system sharing the total output among its members. In recruiting labour from the traditional sector the modern sector must pay a wage rate equal to the income level in the traditional sector plus an incentive margin. Thus the modern sector is being penalized by having to pay a wage rate high above the social opportunity cost of labour as measured by its marginal product in agriculture, and in order to correct this distortion the modern manufacturing industry should be given tariff protection.

In order to argue that a person in the traditional sector can enjoy an income equal to the average product of labour even when his marginal product is zero we need, first of all, to assume that his family owns the land and that he is being supported in a state of "disguised unemployment" out of what is, properly speaking, rent from the land. Once we introduce the landlords into the picture,

then the income left to the family after paying economic rent must be wage income: i.e. the marginal product of family labour on land must be positive. Even if the family owns the land, the marginal product of labour on the farm will not be zero if there are alternative opportunities of using some part of the family labour elsewhere. Once we introduce some form of market for agricultural labour, the marginal product of labour on the family farm will approximately reflect the wage rate in the neighbourhood. Finally, even in the absence of landlords and a labour market, the marginal product of labour on the family farm will not be zero unless we are prepared to make the highly unrealistic assumption that the marginal disutility of work on the farm is zero. But the notion of the zero marginal product is not needed for the purpose of showing the existence of a distortion in the labour market. All that we need for the purpose is to show that there are certain factors arbitrarily or artificially widening the wage differential between the modern and the traditional sector beyond the extent required to reflect the genuine economic differences in the two sectors.

It is possible to find three such factors. The first consists of the various government regulations on labour and minimum wage rates. These exert a differential effect in that while they can be strictly enforced in the bigger economic units in the modern sectors they are unenforceable for the small economic units in the traditional sector. The second arises from the greater ease with which the urban labour force in the manufacturing sector can organize itself into strong trade unions restricting free entry of labour. The third factor is important in countries which have a prosperous foreign-owned export industry such as petroleum or copper. Here the high wage rates which the trade unions are usually able to extract out of the export sector tend to spread, by a series of sympathetic wage rises, into the rest of the modern sector, imposing a heavy burden both on the domestic manufacturing industry and on the public sector. While all these three factors can cause a serious distortion in the allocation of resources, none of them constitutes an argument for special protection of domestic industry. The distortions have to be cured by reforms within the labour market. In particular the third source of distortion is similar to the point we have discussed in connection with "disguised unemployment" in agriculture. Here also the distortion arises from the fact that the rent income which the government should have extracted from the

foreign companies in the extractive industries and kept for its own use has been unjustifiably permitted to inflate the wage level in the modern sector above the marginal productivity of labour.

Finally, we may turn to the main argument for domestic industrialization which underlies much of the current writings on economic dualism in the underdeveloped countries. This argument combines the concept of "disguised unemployment" with that of technological dualism and attempts to make out the case for the expansion of domestic manufacturing industry, not in terms of deviations from the static optimum but in terms of "dynamic" considerations. Thus it is argued that, given the heavy pressure of population on land, it is no longer possible for the underdeveloped countries to absorb any more labour in agriculture: the only way of absorbing the surplus labour is through the expansion of the manufacturing sector. But the underdeveloped countries are obliged to import modern technology in a ready-made form from the advanced countries: this means that the expansion of the manufacturing sector has to be based on methods of production which are not only capital-intensive but also require capital and labour in fixed proportions (8). In terms of the static optimum theory, this pattern of economic development goes against the grain of the factor endowments in the underdeveloped countries, but it is argued that it can be justified on two grounds. First, given the factor disproportionalities and technological rigidities which characterize the dualistic economic structure of the underdeveloped countries, there is really very little scope for smooth and flexible substitutions and adjustments assumed in a neo-classical model of the economic system. Second, the "dynamic" gains from the expansion of the modern manufacturing industry will tend to outweigh the static losses from the distortion in the allocation of resources. We shall now show that these arguments do not stand up to a critical scrutiny and that they seriously underestimate the scope for the introduction of labour-intensive methods of production both in agriculture and in the manufacturing sector by appropriate domestic economic policies.

Even the exponents of the population pressure argument recognise that the underdeveloped countries in Africa and Latin America are not so thickly populated as some of the Asian countries.

(8) Cf. R. S. ECKHAUS, "The Factor-proportions Problem in Underdeveloped Areas", *American Economic Review*, September 1955.

Thus they tend to use countries such as India or Pakistan as prime examples of agricultural overpopulation. But a broad survey of the Asian agricultural scene is sufficient to cast doubts on the assumption that the agricultural sector in these countries is so saturated with labour that there is no further scope for the introduction of labour-intensive methods along any known lines. As a matter of fact, the highest population densities on land and the smallest size peasant holdings are to be found in countries such as Japan, Taiwan and Korea. On the other hand, these countries are also outstanding illustrations of how agricultural output can be rapidly increased by intensive methods of farming based on small peasant holdings provided that appropriate economic policies are followed. These include (a) the adequate provision by the government of agricultural inputs, notably the irrigation facilities which enable multiple cropping on the same piece of land, reduce seasonal unemployment and encourage the use of fertilisers and improved seeds; and (b) improvements in agricultural credit and marketing. Compared with the genuinely intensive agriculture of Northeast Asia, the agriculture in the so-called overpopulated countries of India and Pakistan may not unfairly be described as an inefficient *extensive* type of farming offering great potentialities for the introduction of labour-intensive methods (9). In terms of our analysis, the agricultural backwardness of these countries may be attributed to two types of dualism: (a) unequal provision of government economic services to the modern manufacturing sector and to the agricultural sector with some degree of dualism within the agricultural sector itself, created by unequal access to public economic facilities between the larger and the small farmers; and (b) financial dualism, which is a serious obstacle to the adoption of improved methods by small farmers. Thus it is no accident that

"in Japan, where the rural and small-scale industrial sectors are more integrated in the organized credit market (more than half of all agricultural credit is provided by financial institutions), interest differentials are much smaller: on the average, interest rates are lower in the traditional sectors, but considerably higher in the fully organized sector, than in India and Pakistan". (10)

(9) For two very important recent contributions to this subject, see SHIGERU ISHIKAWA, *Economic Development in Asian Perspective*, Kinokuniya, Tokyo 1967, Ch. 2 and also chart 2-4, and G. MYRDAL, *Asian Drama*, 1968, Vol. I, Ch. 10 and Vol. II, Part. V.

(10) G. MYRDAL, *op. cit.*, Vol. III, Appendix 8, p. 2095.

Let us now turn to the argument that the scope for substitution of labour for capital is severely limited by the need to adopt modern technology in the manufacturing sector and that, given this technical rigidity, the only method of absorbing surplus labour is to expand the size of the manufacturing sector on a capital-intensive basis. This implicitly identifies the manufacturing sector with the larger-scale modern style factories. But in many underdeveloped countries small-scale industries of various types employ by far the largest proportion of the labour and contribute a substantial proportion of the output of the manufacturing sector (11). If we define the manufacturing sector to include both its modern segment of the larger-scale economic units and its traditional segment of the small-scale economic units, then one thing becomes clear: even if all the large-scale modern factories operated rigidly on the basis of fixed technical co-efficients, there would still be considerable scope for increasing the proportion of labour to capital in the manufacturing sector as a whole by substituting the output of the small-scale economic units for that of the larger-scale units. As we have seen, the possibilities in this direction are greater than generally allowed, for two reasons: first, the modern factories set up for the purpose of import-substitution in many underdeveloped countries are predominantly in the field of light consumers' goods which are also produced by the traditional sector; and second, the lower quality of the products of the small-scale industries is compensated for by their cheaper prices. But, as we have shown, this overlap in the range of goods produced by the larger and the smaller manufacturing units is associated with and attributable to the glaringly unequal terms on which capital funds, foreign exchange and the economic services provided by the government are made available to the two types of manufacturing industry by the prevailing policy of domestic industrialization. These policies may be said to protect the larger-scale modern factories not only from foreign competition but also from the domestic competition of the small-scale economic units. Thus it would seem reasonable to expect that a reduction in the unequal access to scarce economic inputs between the larger-scale and small economic units would make the latter more competitive

(11) For quantitative evidence for the importance of small-scale industries in the underdeveloped countries, see S. KUZNETS, *Modern Economic Growth: Rate, Structure and Spread*, 1966, Table 8.1 and pp. 417-420; also E. STALEY and R. MORSE, *Modern Small Industries for Developing Countries*, 1965, Ch. 1.

and increase their share of the manufacturing output, thereby raising the proportion of labour to capital employed in the manufacturing sector as a whole. A reduction of economic dualism in this sense would have the effect of encouraging a greater degree of economic specialization between the larger and smaller economic units and thus introduce a new pattern of complementary economic relationships between the two types of manufacturing industry.

Complementary relationships based on vertical linkages between different industries are a familiar theme in development economics. But so far the analysis has been handicapped by confining the concept of complementarity only to the modern segment of the manufacturing sector. Further, given the popularity of the input-output models, complementarity tends to be interpreted in purely technical terms: in terms of fixed technical co-efficients linking up insufficiently disaggregated sectors. When, however, we broaden the concept of complementarity to the possible economic linkages between the larger and smaller industries and apply the older Adam Smithian notions of division of labour and specialization (12) to the situation, we begin to have a richer understanding of the possible complementary relationships within the manufacturing sector which would have the effect of introducing a greater degree of economic flexibility into the domestic economic organization of the underdeveloped countries. With a reduction in dualism, the small economic units may be typically expected to take over a larger share of the output in the light consumers' goods industries while the larger-economic units shift into the production of inputs for the small industries. As a matter of fact, the small industries in the underdeveloped countries have shown considerable enterprise in changing over from their traditional materials to new imported materials in such inputs as dyes, yarns, plastics, etc. and this is the reason why they are so handicapped by foreign exchange controls which restrict their access to imports. But the division of labour between the larger-scale and the small economic units may take various other patterns: the larger economic units may sub-contract any part of their productive processes to the small economic units; the small economic units may set up repair shops and other servicing activities for the bigger economic units; and so on. In general,

(12) See G. J. STIGLER, "The Division of Labour is Limited by the Extent of the Market", *Journal of Political Economy*, June 1951.

given easier access to capital and foreign exchange, the small economic units may be expected to increase their share of economic activities in the manufacturing sector whenever their lower overhead costs and their access to cheap family and casual labour give them a comparative advantage over the larger economic units. These various possibilities are well illustrated by the history of the economic development of Japan, where the small industries have played a very important role. Significantly, the growth of the small industries was greatly facilitated by access to cheap electric power — a reduction of the dualism in the supply of public economic services. W. W. Lockwood describes the development of complementary economic relations between the larger-scale economic units and the small economic units as “a skilful utilization of Japan’s limited capital resources and technical experience to employ a large and expanding population in productive pursuits” (13).

But what about the “dynamic” effects of the modern manufacturing industry? We may examine this argument under two main heads.

First, there is the dynamic “educative” effect of the modern manufacturing industry in imparting new technical knowledge and skills and in building up a permanent pool of trained labour adjusted to the rhythm and discipline of factory production. This is clearly important. But we should also remember that successful economic development requires the adaptation of modern technology to the local economic conditions of the underdeveloped countries: detailed and intimate knowledge of local resource availabilities and local market conditions are as important as the imported “technical know-how” for this purpose. It is in the acquisition and the spreading of the relevant knowledge about the local economic conditions that the small-scale units are better placed than the large-scale modern factories. Thus if we accept the view that the underdeveloped countries suffer from a lack of indigenous entrepreneurs, the “educative” effect of the small-scale industries in providing the training ground for a large number of potential entrepreneurs must be rated at least as high as the “educative” effect of the modern manufacturing sector in training a regular labour force. Moreover, by insisting on the latest technology, many

(13) W. W. LOCKWOOD, *The Economic Development of Japan*, 1954, p. 211. See also the rest of his Ch. 4.

underdeveloped countries are in real danger of adopting techniques of production which are too advanced and specialized to be sustained and transmitted to the traditional sector. As Stigler points out, the vast network of auxiliary industries and educational facilities taken for granted in the advanced countries will not be available in the underdeveloped countries.

“At best, the small economies that imitate us can follow our methods of doing things this year, but not our methods of changing things next year; therefore, they will be very rigid”. (14)

Conversely, the role of small-scale industries in spreading innovations is emphasized by Lockwood.

“If Japan’s experience teaches any single lesson regarding the process of economic development in Asia, it is the cumulative importance of myriads of relatively simple improvements in technology which do not radically depart from tradition or require large units of new investment. The big, modern establishment with its concentration of capital in advanced forms of technology was essential in many fields, of course. — Much of the real substance of Japanese growth, however, is found in the more modest types of improvements which are more easily and pervasively adopted, more economical in cost, and often more productive of immediate returns in income. For any poor country beginning to industrialize, one of the crucial problems is to introduce and spread such innovations as widely as possible”. (15)

Second, there is the argument that the use of durable capital equipment embodying modern technology would *ipso facto* raise the productivity of labour in the modern manufacturing industry and that since the wage rate would be kept constant by the availability of “unlimited” supplies of labour from the subsistence sector, this would raise the share of profits. The reinvestment of these profits, it is argued, would generate a continuous process of dynamic economic expansion, absorbing the surplus labour from the subsistence sector. This is the familiar theme of various growth models, notably the “Lewis model” (16). When we try to apply this type

(14) G. J. STIGLER, *loc. cit.*, *Journal of Political Economy*, June 1951, p. 193.

(15) W. W. LOCKWOOD, *The Economic Development of Japan*, pp. 198-99.

(16) W. ARTHUR LEWIS, “Economic Development with Unlimited Supplies of Labour”, *The Manchester School*, May 1954.

of growth model to the actual process of domestic industrialization which has been brought about by import substitution policies in the underdeveloped countries, a number of difficulties become apparent. To begin with, the employment creating capacity of the modern manufacturing sector has not been impressive even during the so-called "easy" phase of import substitution; now that import substitution has entered into the "difficult" phase characterized by foreign exchange shortage, its capacity to absorb the abundant supply of labour is clearly very limited. On this ground alone, one would be justified in trying to promote a complementary development of the large- and the small-scale industries instead of trying to expand the modern segment of the manufacturing sector on its own. However, in the typical "closed economy" conditions of the present-day underdeveloped countries the larger economic units in the modern manufacturing sector frequently enjoy high profits. The question is how far are these profits due to a genuine increase in productivity arising out of the adoption of modern technology? The drift of our preceding analysis has been to cast doubt on this and to suggest that the profits of the larger-scale economic units in the modern manufacturing sector have been artificially inflated by government policies. On the one hand, the shortages created by import controls and domestic inflation provide the modern manufacturing sector with an easy and lucrative market. On the other hand, the modern manufacturing sector has a differential access to capital funds, foreign exchange and the public economic services on specially favourable terms. This suggests that the real economic resources which have gone into the expansion of the modern manufacturing sector in the underdeveloped countries have been obtained, not so much from a self-generating process of increase in productivity resulting in an expanding stream of re-investible resources, but from the transfer of resources from other sectors, notably from the export and domestic agricultural sectors. As we have seen, these transfers have been carried out mainly by deficit financing and cheap money policy combined with the apparatus of direct quantitative controls to channel resources into the modern manufacturing sector. So long as these policies continue, one may expect the larger economic units in the modern manufacturing sector to continue to make high profits — in terms of local currency. But their failure to use resources productively on the basis of capital-intensive modern technology will be increasingly reflected in terms

of a foreign exchange shortage. Given the buoyant expansion of international trade, both during the 1950-60 decade and the immediate post UNCTAD period of 1960-65, the familiar argument that the foreign exchange shortage of the underdeveloped countries is caused by stagnant world market demand for their exports is not convincing (17). A more satisfactory explanation of the foreign exchange shortage has to be sought in the failure of their domestic economic policies both in export expansion and in import substitution.

IV

We may round off this paper by reviewing the implications of our analysis of dualism on the external aspects of development policy. In current discussions, domestic industrialization policies are frequently described as "inward-looking", while free trade and export expansion policies are described as "outward-looking". Our analysis suggests that this terminology is unsatisfactory because it obscures the intimate relationship which exists between the internal and the external aspects of development policy. As we have seen, the advocates of domestic industrialization policies tend to underrate the potentialities of internal economic policies and seek to relieve the effects of domestic distortions in the allocation of resources by means of external aid. Thus it is paradoxical to describe such policies as "inward-looking" when their main underlying emphasis is on economic aid (and trade concessions) to be administered from outside. Conversely, the policy of internal economic integration reducing the dualism outlined in this paper is based on the building up of more integrated domestic markets for capital funds and labour realistically reflecting the factor endowments of the underdeveloped countries in terms of high interest rates and low wages both in the organized and unorganized sectors of the economy. This is nothing but the inverse application of the Heckscher-Ohlin theory of comparative costs: that is to say, the policy of internal economic integration is the other side of the coin to the policy of expanding international trade according to comparative costs. Again, it is

(17) See BELA BALASSA, "The First Half of the Development Decade: Growth, Trade and the Balance of Payments of the Developing Countries, 1960-65", in this Review, December 1968; also W. ARTHUR LEWIS's "Closing Remarks" in *Inflation and Economic Growth in Latin America*, eds. W. Baer and I. Kerstenetzky, 1964, pp. 27-8.

paradoxical to describe export expansion policies as "outward-looking" when their success vitally depends on domestic economic policies designed to reflect the comparative costs and factor endowments of the underdeveloped countries.

While the main drift of our policy of internal economic integration is towards freer trade, it is still of considerable importance even if the underdeveloped countries wish to pursue a protectionist policy. We have seen that the domestic industrialization policies as currently practised in the underdeveloped countries have the effect of protecting the modern segment of the manufacturing industry against the competition not only of imports but also of the domestic small-scale industries. It is therefore possible that in some line of simpler labour-intensive consumers' goods, the small industries may prove more competitive with the imports, at a given tariff rate, than the larger modern industries: provided that there is a more equal access to capital and foreign exchange. Thus the underdeveloped countries, in trying to encourage domestic industrialization by discriminating in favour of the modern segment of the manufacturing industry, may well be missing genuine opportunities of import substitution by the products of the small-scale industry which they have neglected. Our analysis is merely concerned with the reduction of the artificially created unequal access to economic resources between the larger and the smaller economic units. But it is possible to make out a stronger case for the positive encouragement of small industries if we take seriously the avowed aim of the governments of many underdeveloped countries to cut out "luxury" consumption both on grounds of economic equity and to increase savings. At present this has merely resulted in the restriction of imports of "luxury" consumers' goods while freely permitting the imports of the "capital goods" and inputs which are used for the domestic production of these luxury goods. A more effective way of restricting luxury consumption would be to impose a revenue tariff both on imports and on the higher priced factory products mainly catering for the wealthier urban population on those lines of consumers' goods in which the small-scale economic units can produce lower priced substitutes for them. Given the readiness of the small industries to change over to new materials and inputs and to imitate the factory products, the quality gap will tend to get narrower.

Let us now turn to the implications of our analysis for external aid. The policy of raising the rate of interest high enough to reflect

the capital scarcity in the underdeveloped countries would have the effect of setting up pressures on their domestic economic organization to make readjustments in the allocation of resources so as to raise the returns on investment. These adjustments are bound to be painful but, if successfully carried out, they would have the effect of raising the underdeveloped countries' "absorptive capacity" for aid. But the essential condition for success is the willingness and ability of these countries to make appropriate and flexible changes in their domestic economic organization. This conclusion differs sharply from the UNCTAD type of argument for aid which rules out beforehand any possibility of making flexible domestic readjustments. Aid is treated here as a means of providing the underdeveloped countries with strategic imports which they are supposed to require in fixed proportions as technical inputs for the expansion of their domestic manufacturing sector. In the earlier writings on the underdeveloped countries, it was frequently argued that foreign investment in the mines and plantations in the underdeveloped countries created "economic enclaves" because they relied heavily on imported capital equipment and foreign personnel and only required the natural resources and unskilled labour from the underdeveloped countries. The present-day expansion of the modern manufacturing industries in the underdeveloped countries on the basis of imported capital equipment, imported materials and frequently foreign technicians has obvious similarities with this notion of "economic enclaves". The mere fact that the foreign inputs are to be financed out of aid does not alter the basic fact that the modern manufacturing sector has limited "dynamic" impact in creating secondary rounds of economic activities precisely because its expansion requires the foreign inputs in so rigid a manner. From the point of view of our analysis the UNCTAD concept of aid as a method of financing import-substitution industries on a capital-intensive basis would have the effect of perpetuating the existing technological rigidities and the dualistic economic structure — the very problems which external aid is supposed to alleviate.

We now come to the final point on which our analysis differs from prevailing views on economic development. The UNCTAD notion of strategic imports is based on the proposition that the only "productive" way of investing resources is in the form of durable capital equipment embodying modern technology. This implicit identification of capital with durable capital goods and complex machinery

requires to be seriously qualified when applied to the underdeveloped countries. In the economic setting of these countries the older classical notion of capital as a "subsistence fund" to support labour engaged in producing future output still retains great importance. This applies with particular relevance to labour engaged in various construction work in agriculture and in social overhead capital projects. Further, if, as we have suggested, the reduction of economic dualism leads to an increasing share of economic activities by the small-scale economic units, this would expand the demand for simpler types of tools and equipment which the underdeveloped countries can more easily produce at home. However, given the idea that capital goods can be produced only by a complex of large-scale capital goods industries, current discussions on economic development tend to place a great emphasis on the formation of regional economic unions to overcome the limitations of scale imposed by the smallness of the domestic market in individual underdeveloped countries. But the trouble is that the "domestic market" of an underdeveloped country is not a single integrated market: and without a prior attempt to increase the internal economic integration within each member country, the economic union will be merely a collection of the advanced sectors of these countries, each with only a tenuous connection with its own traditional sector, not to speak of the traditional sector of another country. This is where the analogy between the European Common Market and the proposed Regional Common Markets for the underdeveloped countries breaks down. Given the economic dualism in the underdeveloped countries, internal economic integration is a prior condition for the success of external economic integration on a regional basis.

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