Date:- 27/5/2020
Content writer:-
Dr. Abhay Kumar Pathak
Deptt. of Economics,
Marwari College,
Darbhanga (LNMU)

Degree Part-II (Hons.)
Paper - III
Content of Paper:-
Macro Economics
Module:- 3

TOPIC:- FAILURE OF THE KEYNSIAN MULTIPLIER IN UNDERDEVELOPED COUNTRIES

Keynes' multiplier concept is based on the magnitude of the marginal propensity to consume (MPC). The higher the MPC, the greater is the multiplier and the vice-versa. In the underdeveloped countries like India, the MPC is always unity. Hence, the magnitude of the multiplier in underdeveloped countries should be very high but this is not so. The Keynesian multiplier concept is hardly observable in underdeveloped countries.

The theory of the multiplier is based on certain assumptions :-

(I) There is a sizable amount of involuntary unemployment and unutilised resources due to lack of effective demand.

(II) The economy is industrialised and possesses huge capital stock. As such, there is a high elasticity of supply of goods to meet the increase in demand.

(III) There is excess capacity in consumption goods industries which would permit an increase in output.

(IV) The economy has relatively elastic supply of working capital, such as power and raw materials.

These are the conditions prevailing in a developed economy, where the multiplier works. In the case of an underdeveloped economy, these conditions are not likely to be found. Dr. V.K.R.V. pointed out that involuntary unemployment of Keynesian type is essentially a feature of capitalist economy where the majority of workers work for money wages and where production is meant more for exchange rather than for self-consumption. Involuntary unemployment in this sense is rare in an underdeveloped economy. The fact is that a large part of the economy of the underdeveloped countries comprises the subsistence non-monetised sector which remains totally isolated from money transactions and the workers in this sector work mostly for the purpose of self-consumption. Dr. Rao opines that an underdeveloped and agrarian economy, with little capital equipment and primitive techniques, disguised unemployment is a normal phenomenon. Workers can be easily withdrawn from occupations without decreasing the total output; the existence of disguised unemployment in an underdeveloped country hinders the working of the multiplier.

As regards the second assumption on which the multiplier is leased, the supply curve of the output in a poor economy. In a poor country the policies of monetary expansion and deficit financing lead to an increase in money income but no corresponding increase in real income. This has an inflationary impact on the economy. The inelasticity of supply of goods in a poor economy is due to the fact that the economy is dominated by household enterprises producing mostly for self-consumption rather than for exchange.

The prevalence of self-consumption in poor countries acts as a leakage in the working of the multiplier. Moreover, the operation of the demonstration effect induces people of poor countries to increase their consumption of imported goods. This increase in imports means a leakage in the stream of expenditure.

As far as the last two assumptions of the multiplier principle are concerned, it may be said that there is a zero or insignificant capacity in consumption goods industries in underdeveloped countries. Since these countries are characterised by capital deficiency, the supply of working capital is also relatively inelastic. There is no increase in the supply of consumption goods to match increase in their demand which is a result of a rise in money income.

This rise in the money income without any corresponding rise in output leads to inflation. The multiplier has failed to work in underdeveloped countries like India in the Keynesian sense because of the inelasticity of real income.

Although the policy measures suggested by the Keynesian theory may not be suitable to the problems of under-developed countries, it does not mean the Keynesian economics has no significance. Indeed, Keynesian methodology of thinking in macroeconomic terms is very essential and appropriate in understanding the major problems of any economy, whether developed or underdeveloped. However, in view of the changing institutional set-up of the developing economies during the process of planning and socio-economic reforms, Keynesian tools have to be adopted with suitable modifications.