Lewis Model

Lewis model dual sector in based on classical ideas, as he considers the labour supply without constraints. He makes the following assumptions:

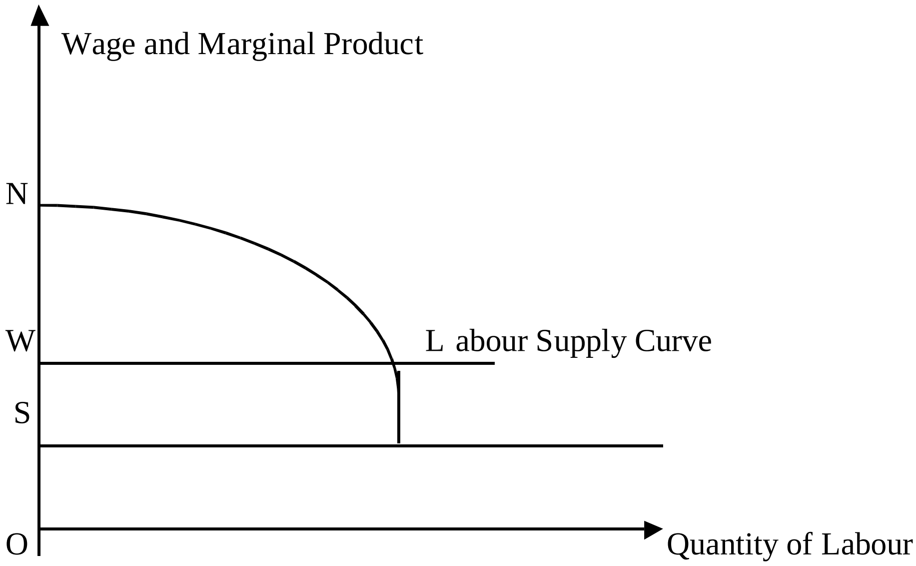
1.Unlimited supply of labour

2.Fixed wages

3.Profit reinvested

4.Employment growth depends on the rate of capital formation, which comes from savings.

Figure 1



- S is the subsistence wage, population in the traditional sector earn it.
- W is the industrial sector wage, which is higher in order to draw people into the manufacture sector, due to higher cost of living in the city, cost of moving etc. Consequently, the industrial wage is adjusted to the traditional one. As the latter increases or decreases, so the former does in order to maintain that gap, which ensures population flow into the industrial sector and a level of profitability.
- N is the marginal product of labour, where the law of diminishing returns is applied.

When does the economy achieve development according to the model?

Lewis model focus on the interaction between capitalist sectors (mainly manufacture sectors) and pre-capitalist sectors (mainly traditional sectors such a agriculture), giving more importance to those who hold the capital, and therefore, those who can save and invest the money to generate growth.

This model considers there is a surplus of labour in the traditional sector. As input-land is fixed, and due to the law of diminishing returns, the marginal product of those people who make up the surplus is equal to zero, so the fact of withdrawing them from the subsistence sector has no effect in the output. Labour is employed up to the point where marginal production equal wages, where W and the Labour Supply curve cross. After this point, profits will be invested, and then the labour supply curve will shifts upwards, and wages fixed, the industry could employ more workers, who will be drawn from the subsistence sector, which is assumed to have unlimited supply. This process of capital accumulation and employing more people enables the economy to grow, but this cycle is on as long as there is surplus of labour, once this is depleted, agricultural wages would tend to rise, so the industrial´s. Eventually both wages will converge, as both sectors would have to compete for workers.

Constraint to growth

As capital accumulation is the main source of growth, the rate of savings plays an essential role. In poor countries people are not able to save much, and landowners, who are an important fraction of the rich, consume their rent unproductively. The capitalists are the answer. Where a small nucleus of them exists, as well as a pool of cheap labour, they will reinvest their profits, increasing the capital stock. With each round profits go up, and wages fixed, capital sector expands. Increasing profits will generate the share of savings and the consequent investment to rise, resulting in growth.

Policy plan

Once the capitalist machinery has been set in motion, the following policies should be applied in order to maintain growth

- Taxing the subsistence sector in order to avoid premature increases in income, as it would affect the wages in the industrial sector, and consequently the profits obtained from it.
- Restrain the power of Unions, because they can put pressure on employers to increase the wages, pushing down profits.
- Expand the money supply carefully to finance the industrial sector.
- Protect the new capitalist sector from foreign competence, allowing it to grow.

Critics of the model

- It does not consider the rise in subsistence wages, which would push up industrial´s, reducing profits and investment. A policy of low wages in the agricultural sector would lower the wages in the modern sector, increasing industrial benefits at the cost of the population from the former.
- Profits could be invested in labour-saving new technology instead of hiring more people.
- It is assumed that only capitalists save money, putting aside workers, who, under certain

conditions, may want to save. E.g. Employees who want to imitate the life-style of capitalist may start to save in order to invest and create their own corporation.

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