

Political Economy of Development
Learning Material for Civics and Ethical Educations Second Year Students

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May 25, 2020

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Ethiopia

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Chapter One

1. The Evolution of International Political Economy

1.1. Introduction

The world is “globalized.” Among developed countries, international trade now accounts for nearly 38% of gross domestic product (GDP). For developing economies, imports plus exports comprise nearly 49% of all national output. Over the last two decades, global flows of foreign direct investment have more than doubled relative to GDP. Globalization now allows individuals, corporations, and nation-states to reach around the world farther, faster, deeper and cheaper than ever before (Thomas Friedman 2000, 9). The field of international political economy (IPE) pre-dates the current era of globalization, it was created by scholars trying to grasp the fundamentals of this nascent age.

International Political Economy (IPE) is a relatively new field of inquiry, albeit one with an old pedigree. It emerged in the late 1960s and early 1970s, partly as a result of the inadequacy of the discipline of International Relations (IR) in dealing with global economic changes in that era, but its antecedents can be traced back to the classical political economy of Adam Smith (1723–1790), David Ricardo (1772–1823) and Karl Marx (1818–1883).

During the twentieth century, economics and political science were consolidated as autonomous areas in the academy, and each expressed little interest in the subject matter of the other. This process had a negative impact on the utility of both disciplines, and the division extended into the international realm.

According to Held and Leftwich (Hay and Marsh 1999: 13) ‘politics is about power; about the forces which influence and reflect its distribution and use; and about the effect of this on resource use and distribution’. Economic agents ‘act’ politically, often attempting to influence and shape the policy process and the distribution of national resources. **The golden rule says “the one with the gold will make a rule”.**

1.2. Early Evolution of IPE

As a distinct field, IPE focuses on the politics of international economic exchange. IPE is a substantive topic of enquiry, rather than a methodology in which economic models are applied to political phenomena. The field is primarily informed by two sets of key questions.

1. How, when, and why do states choose to open themselves to transborder flows of goods and services, capital, and people? In other words, what are the political determinants of what we now call globalization? In this first set of questions, openness is the dependent variable, or outcome to be explained, and politics is the independent or causal variable. Economic theory posits that free and unrestricted international commerce is, with limited exceptions, welfare improving; many politically naive analysts, in turn, expect countries to evolve toward free trade. By contrast, IPE begins with the reality that openness is historically rare, politically problematic, and a phenomenon that needs to be explained.
2. How does integration (or not) into the international economy affect the interests of individuals, sectors, factors of production, or countries and, in turn, national policies? Here, government policy is the dependent variable and how the actor is situated in the international economy is the independent variable.

IPE emerged as a new and distinct interdisciplinary field beginning in the late 1960s and early 1970s as a result of two contradictory, real-world developments.

- ❖ First, the success of the postwar international economic regime constructed at Bretton Woods, and embodied in the postwar institutions of the International Monetary Fund, World Bank, and General Agreements on Tariffs and Trade (GATT), ushered in an era of increasing economic interdependence. Trade as a percentage of all economic activity began to rise rapidly in all advanced countries, leading to a new focus on the political impact of deepening economic ties (Cooper 1968; Keohane and Nye 1972). The nation-state is just about through as an economic unit.
- ❖ Second, at nearly the same time that interdependence was “taking off,” the political foundations of this open international economy began to crack. President Richard Nixon

in 1971 formally ended the convertibility of the dollar into gold, closing the door on the Bretton Woods regime¹ (Gowa 1983). Two years later, the postwar exchange rate regime collapsed when the major currencies began to float against one another. The Nixon created worldwide monetary instability.

The breakdown of the Bretton Woods system in the 1970s also contributed to the emergency of International Political Economy as a distinct field of study.

In response the Arab transformed oil into a coercive weapon; breathing through Organization of Petroleum Exporting Countries (OPEC) raising oil prices fifteen fold between 1973 and 1980. Suffering under higher oil prices, the developing world called for a New International Economic Order through which other commodity producers hoped to exercise similar market power hopefully in support of Western consumers. In response to the growth of imports unleashed by liberalization and rising interdependence, American industry began clamoring for increased or renewed trade protection. Trying to satisfy industry without undermining its commitment to free trade, the United States adopted a series of innovative non-tariff barriers to trade.

The mutual astigmatism that hid International Politics and International Economics from each other cleared in the 1970s as a number of dramatic international events made plain how tightly the two fields were intertwined. The oil embargoes of the 1970s and the breakdown of the Bretton Woods monetary system are frequently cited as key events in IPE's development as a field of study. These events posed practical and theoretical problems that necessarily forced scholars and policy-makers to consider economics and politics together.

The rise of the Organization of Petroleum Exporting Countries (OPEC) and the Arab oil embargo of 1973-74 illustrated dramatically at least four key dimensions of IPE.

- First, it showed the power and influence of economic tools in foreign policy. After OPEC no state could dare make political policy without taking into account potential foreign economic retaliation or reaction.

¹ It is a system generally interpreted as a system of economic governance constructed to support U.S. hegemony in the postwar era. Each of the main Bretton Woods institutions, the World Bank, the IMF, and the GATT, depended upon the United States to play a central leadership role.

- Second, the oil embargo showed that East-West issues were not always the state's most important concerns -- North-South political and economic problems could no longer be ignored or dealt with as ancillary to Cold War strategy. To the extent that economic issues were closer to the surface in North-South relations, this reinforced the notion that politics was really political economy.

- Third, the oil embargo revealed the complex interdependence between and among domestic politics, domestic economics, international politics, and international economics.

- Fourth, the oil embargo raised questions about the role of multinational corporations (MNCs) in international economics and politics. MNCs had previously been viewed by many scholars as agents of influence of their home country governments (this was especially true of US-based MNCs), but now their political allegiance appeared to be more ambiguous.

The rise of OPEC and the decline of US hegemony were just two events that broke down the artificial division of International Economics and International Politics that had in some respects characterized the Bretton Woods era. Other events such as the Third World debt crisis, the fall of communist regimes, the rise of the East Asian Newly Industrialized Countries (NICs), the expansion of the European Union, and the financial crises in Mexico, Russia, and East Asia all provided impetus for the growth and development of IPE studies. The simple divisions between state and market, domestic and international, and politics and economics were no longer applicable to a wide range of issues. An increasingly complex world required a complex approach to analysis, which IPE provided.

As international economic relations were politicized, it became apparent that inter-national exchange was not an autonomous sphere, a natural phenomenon beyond political machinations. As analysts struggled to understand the simultaneous growth and conflict in international markets, the field of IPE was born.

1.3.IPE: Definition

The growing prominence of IPE as a field of study is in part a result of the continuing breakdown of disciplinary boundaries between economics and politics in particular and among the social

sciences generally. IPE is the study of a set of related problems. The traditional IPE includes analysis of the political economy of international trade, international finance, North-South relations, multinational corporations, and hegemony and globalization added recently.

It is hard to imagine a world without International Political Economy because the mutual interaction of International Politics (or International Relations) and International Economics is today widely appreciated. The political actions of nation-states clearly affect international trade and monetary flows, which in turn affect the environment in which nation-states make political choices and entrepreneurs make economic choices. It seems impossible to consider important questions of International Politics or International Economics without taking these mutual influences and effects into account. The dynamic interaction between market and state characterize IPE.

Eg. The mission of the WTO, and before that the General Agreement on Tariffs and Trade (the GATT), is to progressively reduce the barriers to free trade through multilateral negotiations. This movement towards global free trade, however, has not stopped states from using trade tools to further their own foreign policy goals when they can. Thus we live in an environment where the political and the economic viewpoints of international trade compete for attention.

Eg. Regional trade agreements like NAFTA² and the EU frequently use economic tools to achieve political goals. One of the political goals of European economic integration is to strengthen the western Cold War alliance. One of the political goals of NAFTA was to stabilize and strengthen Mexico's democratic system.

Political Economy is a science which treats of the Nature, the Production, and the Distribution of Wealth. Political Economy," says M. Storch, "is the Science of the natural laws which determine the prosperity of nations, that is to say, their wealth and their civilization." Mr. M'Culloch have defined Political Economy to be " the Science of the laws which regulate the production, accumulation, distribution, and consumption of those articles or products that are necessarily useful to man.

² North American Free Trade Agreement

IPE is best defined as a problématique, a set of problems that bear some relationship to one another. The IPE problématique is the set of international and global problems that cannot usefully be understood or analyzed as just International politics or just International economics. These problems fall necessarily in the expanding domain of International Political Economy.

Its goal was to analyze the interaction of economics and politics in the international affairs of nation-states or, more narrowly, how economic factors influenced International relations. Although IPE research took many directions in this period, five sets of questions dominated the agenda: international trade, international finance, North-South relations, MNCs, and the problem of hegemony. A sixth concern -- globalization -- was soon added to the list.

✦ International Trade: Politics and Economics approach international trade from completely different points of view using completely different analytical frameworks. The borders of markets are dynamic, transparent, and porous; they rarely coincide exactly with the borders of states and a few markets today are even global in their reach. When trade within a market involves buyers and sellers in different nation-states, it becomes international trade and the object of political scrutiny.

The political analysis of this subject treats international trade as fundamentally different from domestic economic activity (while economic theory sees no important distinction between the two). The international exchange of goods, services, or resources with another country raises many political questions of national interest, especially questions concerning the economic and military security of the nation.

Although it is easy to oversimplify these security concerns (exports are desirable because they increase a nation's monetary reserves and create jobs whereas imports should be avoided because they create dependency, reduce national reserves, and threaten domestic business and labor interests) in practice the political analysis of international trade is far more complex. Exports create jobs, but their full impact on national security depends upon what is exported to whom and on what terms. An export of technology that has critical military or economic applications tends to weaken national security, not strengthen it. Nations have frequently imposed export controls for both economic and military reasons.

Imports also raise complex security issues. Although imports may reduce or threaten domestic employment, create the potential for external dependency, and reduce domestic monetary reserves, there is more to the IPE of trade policy than simple protectionism. Imports may be vital to domestic military and economic security, for example, so that national interest requires secure sources of specific imports. This is especially true regarding high technology military hardware. It may be impossible or impractical to avoid some foreign sourcing, so attention shifts from eliminating imports to establishing secure supply chains.

Willingness to permit imports from foreign nations can also be used as a foreign policy tool. During the Cold War, for example, the United States frequently used access to its domestic market as a bargaining chip in negotiations with other countries. Linking imports with political policies has continued since the Cold War, too, as illustrated by the US and European Union negotiations with China regarding entrance to the World Trade Organization.

Trade embargoes are another economic tool of foreign policy and a great deal of IPE research has focused upon the political economy of trade policies. The logic of an embargo is to shut off imports of many vital items and reduce export earning, thereby reducing domestic welfare and providing the state with an incentive to change its policies.

Eg. The multilateral economic embargo on South Africa linked that nation's policy of racial apartheid.

The U.S. trade embargo against Cuba

Saudi Arabia, Egypt and UAE trade embargo against Qatar

✘ International Finance: International Finance presents the second set of problems that have traditionally defined International Political Economy. The IPE of International Finance includes analysis of exchange rate policies, foreign exchange systems, international capital movements, particularly portfolio capital and debt flows, and the international and domestic institutions and political structures to which they relate. Three examples illustrate the types of issues that this problématique includes

Eg. 1. The architects of the Bretton Woods agreements designed an international monetary system built upon a dollar-gold standard. The values of international currencies

were fixed in terms of the US dollar, which was then defined as a fixed quantity of gold. The responsibility for managing the international monetary system fell on the United States for the most part since its dollar was the key reserve currency. US was confronted with an inevitable choice between its domestic needs and its international responsibilities. The problem is this: at some point, the US was likely to feel the need to put its domestic political concerns ahead of its responsibility to the international monetary system. The Bretton Woods monetary system did in fact finally fail on August 15, 1971 when the U.S. formally removed the fixed link between the dollar and gold.

One lesson to be learned from the collapse of the Bretton Woods monetary system is that economic arrangements create political obligations and are subject to political manipulation. The combination of political and economic arrangements must be "incentive compatible" if it is to succeed in the long run.

Eg. 2. The second example is the IPE of the euro, the single currency adopted by many members of the European Union. It is clear that the euro is both political and it is economic and that the two sides cannot be separated.

The principal goal in creating the single currency was political: the euro would bind Germany forever to its European Union partners and prevent its focus from shifting towards Central and Eastern European relations. In a sense, the economic ties of the euro were meant to replace the political ties of Cold War alliance. A secondary goal was economic: to create a region of relative currency stability to encourage regional economic growth in a world of increasing financial instability.

Eg.3. The third example concerns the IPE of international financial crises. The breakdown of the Bretton Woods, technological change, financial deregulation, the end Cold War divisions, and the emergence of new economic centers all contributed to or accelerated the transformation of finance from an international economic structure, subject to regulation by national governments, to a global structure beyond the regulatory authority of any nation-state, had created a global financial system. In theory the International Monetary Fund could serve this role, but in practice this institution's power is intentionally restricted to limit its ability to undermine state autonomy.

One result of this asymmetry between political and economic structures has been the sequence of international financial crises that includes the Mexican peso crisis of 1994-5, the East Asian financial crisis of 1997, and the Russia crisis of 1999 among others.

The argument is that the range of financial markets has expanded beyond the reach of the regulatory structures that support them. Global markets require global systems of governance to match.

One reason why it is so difficult to agree to a new monetary system is that political and economy systems are complex so that economic changes can have unexpected political consequences. Another reason is that international agreements require that states sometimes sacrifice their domestic needs to honor their international responsibilities. It is difficult to design a system that creates an environment where states consistently honor international agreements. Finally, the strengthening of international or global authority threatens domestic autonomy -- the ability of the state to take action in the national interest.

International finance is viewed by some as less political and more purely economic than international trade, but these three examples give evidence to the contrary. Political scholars may hesitate to engage in this analysis because of the necessity to master difficult theories and arcane terminology, but there is no riper area for IPE analysis. As financial globalization has progressed, the IPE of International Finance has risen in importance as an IPE problématique.

✘ Globalization: Currently the research agenda in IPE is being driven by a number of factors and forces that are often collectively labeled globalization.

The globalization problématique begins with the global expansion of production and finance and asks questions about the causes and effects of increasingly global market structures. These questions concern politics, business, culture, technology, the environment, global migration, gender relations, and tourism, to name only the most obvious areas.

At the heart of the globalization problématique is the question of the state. International Relations theory puts the state at the center, but many scholars argue that a combination of events has weakened the state, either absolutely or through the relative strengthening of other forces and players. The nation-state, it is argued, is increasingly too small to deal

effectively with global issues, and too large and removed to deal with local ones. The state exists in the "missing middle" of the emerging global/local geometry of human society.

Globalization is an example of Schumpeter's famous "creative destruction". It creates opportunities for new forms of economic and social relations, but in so doing it destroys what came before.

1.4. Early Approaches of IPE

1.4.1. Dependency Theory

Perhaps the earliest approach to IPE was dependency theory, developed largely by Latin American scholars writing in the 1960s. The many variants of dependency theory are unified by the idea that the economy and prospects for development in poor countries (the periphery) are conditioned by a global economy dominated by already developed states (the core). Today's poor countries are not just undeveloped, as had been the case for the core centuries earlier, but are underdeveloped by an international economy that is forever biased against them (Andre Gunder Frank 1966). It follows that underdeveloped countries cannot follow the same path as the already industrialized states, as posited by modernization theory, but that they must pursue new and more autonomous strategies of development.

Despite its early prominence, dependency theory waned by the 1980s for two reasons.

- Its proponents failed to develop a unified, logically consistent, and empirically robust theory of underdevelopment.
- The theory was essentially falsified by the rise of the so-called newly industrializing economies, who took off in the 1970s using an export-led growth strategy.

Nonetheless, dependency theory taps into issues of international inequality, uneven growth, and national control over international economic forces that remain central to contemporary debates about globalization.

1.4.2. Hegemonic³ Stability Theory (HST)

The hegemon is a rich and powerful state that undertakes to supply public goods to the international system. These public goods include stable money, security (such as freedom of the seas), and a system of free trade that can be shared by all. If the world system prospers, the hegemon necessarily prospers as well. In fact, this provision of public goods may be a strategy to secure or extend the hegemon's dominant position.

The theory of hegemonic stability holds that the world system is most prosperous when a hegemon exists to organize the international political and economic system and coordinate the provision of international public goods. Periods of Dutch (1620-72), British (1815-73), and U.S. hegemony (1945-71) are commonly cited as evidence of this link between hegemony and prosperity (although there is disagreement about specific dates). When hegemony breaks down, however, the international system falls into disorder and conflict, with the resulting decline in peace and prosperity. The theory of hegemonic stability puts great weight on the existence of the hegemon and the maintenance of effective hegemonic policies.

Based largely on the experiences of Great Britain in the mid-nineteenth and the United States in the mid-twentieth centuries, the key intuition behind this approach is that a single hegemonic state is necessary and sufficient for international economic openness to arise. For the world economy to be stabilized there has to be a stabilizer, one stabilizer.

It posits that large dominant states possess strong preferences for free and open international exchange and, in turn, coerce, induce, or persuade other states into opening their markets to foreign trade and investment (Gilpin 1975, 1977). Rather than focusing on collective action problems, hegemony theory posits that states have different preferences over international economic policy and outcomes are a result of strategic bargaining. Hegemony theorists argue that either states have more complex utility functions, including not just national wealth but power and stability.

³ Hegemony is a form of hierarchy necessary to enforce contracts and maintain international order so that international exchange and investment can occur.

As America's hegemony declined in the 1970s and 1980s, HST expected the international economy to become more fragile and, ultimately, to collapse into renewed protectionism and exclusive economic blocks (Gilpin 1987). The rising problems and tensions in the international economy, and America's own slide into new forms of protectionism, gave backing to this view.

By the early 1990s, the Soviet Union had collapsed, the European and Japanese economies had slipped into a decade of stagnation, and the United States was once again hegemonic—but HST was nearly forgotten. Central to this approach, however, was the recognition that not all countries are “created equal,” that some are more important to the openness of the world economy than others, and that large countries have particularly large effects on others.

This theory argues that hegemony is a self-limiting, self-defeating, and therefore temporary condition. The argument is that while the hegemonic state bears the burdens of organizing the international system and supplying public goods, free-rider states prosper, expand, and increase the burdens on the hegemon. At some point the hegemon finds itself over-committed and unable to bear the costs of the system it has created. Either the hegemon begins to put domestic interests over its international obligations or it becomes too weak to honor its widespread commitments. Either way hegemony collapses in on itself, the story goes, and chaos reigns until another hegemonic state arises to restore (temporary) order. Britain's decline in the 19th century (followed by World War I) is frequently cited as an example of hegemonic decline as is the collapse of the Bretton Woods system (viewed as the mechanism of US hegemony).

Hegemony is a state-centered concept that includes security as a critical element, but that draws upon the analysis of international trade and international finance to provide a richer and more complex explanation of the rise and fall of great powers.

1.4.3. Open Economy Politics

It dominates the study of IPE in the 1990s. OEP adopts the assumptions of neoclassical economics and international trade theory. It OEP provides a bridge between modern economics and political science.

In some OEP theories, individuals are primary but in most, firms, sectors, or factors of production are taken to be the relevant units. OEP begins with firms, sectors, or factors of

production as the units of analysis, derives their interests over economic policy from each unit's position within the international economy, conceives of institutions as mechanisms that aggregate interests (with more or less bias) and condition the bargaining of competing societal interests, and, finally, introduces when necessary bargaining at the international level between states with different societally produced interests.

Interests⁴

The fundamental building block of OEP is interest, or how an individual or group is affected by a particular policy. Actors that benefit from a policy are expected to expend resources in the political arena to obtain that policy (as shorthand, to lobby) up to the point where the marginal cost of that effort equals the marginal benefit. Conversely, actors that lose from a policy are expected to lobby against it. In short, politics is fundamentally about winners and losers from alternative policies.

OEP uses economic theory to deduce what types of individuals can be reasonably assumed to share identical interests. A key divide within the approach is between the Ricardo–Viner or specific factors theory of international trade, which assumes that, typically, capital and labor are fixed in particular occupations and, thus, will tend to have similar interests over trade policy, and the Heckscher–Ohlin theory of international trade, which assumes that all factors are mobile across occupations and, therefore, capital, land, and labor will possess opposing interests.

OEP studies distributional implications of different economic policies and, in turn, how a group is located relative to others in the international economy. Deducing interests from economic theory was a fundamental innovation for OEP, one that makes the approach unique in political economy.

Institutions

Institutions aggregate conflicting societal interests, with varying degrees of bias, and condition the bargaining between opposing groups. In weakly institutionalized political systems, like the international system or “failed states,” coercive strength is expected to determine political

⁴ Preferences over alternative policies

outcomes. In highly institutionalized settings, like most domestic political systems, established rules and procedures generally reflect group strength.

At any moment, institutions serve to define what political power means in a particular society, whether the competition over policy will be conducted via votes, via contributions and bribes, or via ideas and argument. In short, institutions determine the rules of the political game.

International Bargaining

With domestic interests aggregated through institutions into a national policy states then bargain when necessary to influence one another's behavior and to determine the joint outcome of their actions. This is the third and final step in the OEP approach.

International bargaining commonly arises when the policies of one state create externalities for others. In many situations, externalities arise from the collective choices of many small economic actors. In these so-called market failures, individually optimal choices lead to collectively sub optimal results.

Two assumptions here: small country" assumption of traditional international trade theory, which holds that any individual state's production or consumption is sufficiently small relative to world supply and demand that its actions cannot affect world prices. Under this assumption, the unilateral actions of states do not affect the welfare of others and, it follows, unilateral free trade is the first-best policy. Large countries, on the other hand, unilateral actions can affect world prices (for at least some commodities) and, as Kyle Bagwell and Robert Staiger (2002) demonstrate, negotiated movements toward freer trade can be superior.

Although important, externalities are not a necessary condition for international bargaining to arise. Even when they are not directly affected by the actions of others, states may promote international norms and may be willing to pay some price to gain adherents or alter the behavior of possible violators. Most theories of IPE continue to assume that bargaining occurs mostly as a result of some material externality.

Chapter Two

2. The Nature of Development Economics

2.1. Introduction

The study of economic development is one of the newest, most exciting, and most challenging branches of the broader disciplines of economics and political economy. Although one could claim that Adam Smith was the first “development economist” and that his *Wealth of Nations*, published in 1776, was the first treatise on economic development, the systematic study of the problems and processes of economic development in Africa, Asia, and Latin America has emerged only over the past few decades or so. Although development economics often draws on relevant principles and concepts from other branches of economics in either a standard or modified form, for the most part it is a field of study that is rapidly evolving its own distinctive analytical and methodological identity.

2.2. Evolution of Developmental Economics

Traditional economics is concerned primarily with the efficient, least-cost allocation of scarce productive resources and with the optimal growth of these resources over time so as to produce an ever-expanding range of goods and services. Traditional neoclassical economics deals with an advanced capitalist world of perfect markets; consumer sovereignty; automatic price adjustments; decisions made on the basis of marginal, private-profit, and utility calculations; and equilibrium outcomes in all product and resource markets. It assumes economic “rationality” and

a purely materialistic, individualistic, self-interested orientation toward economic decision making.

Political economy goes beyond traditional economics to study, among other things, the social and institutional processes through which certain groups of economic and political elites influence the allocation of scarce productive resources now and in the future, either for their own benefit exclusively or for that of the larger population as well. Political economy is therefore concerned with the relationship between politics and economics, with a special emphasis on the role of power in economic decision making.

Development economics has an even greater scope. In addition to being concerned with the efficient allocation of existing scarce (or idle) productive resources and with their sustained growth over time, it must also deal with the economic, social, political, and institutional mechanisms, both public and private, necessary to bring about rapid (at least by historical standards) and large-scale improvements in levels of living for the peoples of Africa, Asia, Latin America, and the formerly socialist transition economies. Unlike the more developed countries (MDCs), in the less developed countries, most commodity and resource markets are highly imperfect, consumers and producers have limited information, major structural changes are taking place in both the society and the economy, the potential for multiple equilibria rather than a single equilibrium is more common, and disequilibrium situations often prevail (prices do not equate supply and demand). In many cases, economic calculations are dominated by political and social priorities such as unifying the nation, replacing foreign advisers with local decision makers, resolving tribal or ethnic conflicts, or preserving religious and cultural traditions. At the individual level, family, clan, religious, or tribal considerations may take precedence over private, self-interested utility or profit-maximizing calculations.

Thus development economics, to a greater extent than traditional neoclassical economics or even political economy, must be concerned with the economic, cultural, and political requirements for effecting rapid structural and institutional transformations of entire societies in a manner that will most efficiently bring the fruits of economic progress to the broadest segments of their populations. It must focus on the mechanisms that keep families, regions, and even entire nations in poverty traps, in which past poverty causes future poverty, and on the most effective strategies for breaking out of these traps. Consequently, a larger government role and some degree of

coordinated economic decision making directed toward transforming the economy are usually viewed as essential components of development economics. Yet this must somehow be achieved despite the fact that both governments and markets typically function less well in the developing world. In recent years, activities of nongovernmental organizations, both national and international, have grown rapidly and are also receiving increasing attention. Because of the heterogeneity of the developing world and the complexity of the development process, development economics must be eclectic, attempting to combine relevant concepts and theories from traditional economic analysis with new models and broader multidisciplinary approaches derived from studying the historical and contemporary development experience of Africa, Asia, and Latin America. Development economics is a field on the crest of a breaking wave, with new theories and new data constantly emerging. These theories and statistics sometimes confirm and sometimes challenge traditional ways of viewing the world. The ultimate purpose of development economics, however, remains unchanged: to help us understand developing economies in order to help improve the material lives of the majority of the global population.

2.3. What Do We Mean by Development?

Because the term development may mean different things to different people, it is important that we have some working definition or core perspective on its meaning. Without such a perspective and some agreed measurement criteria, we would be unable to determine which country was actually developing and which was not.

2.3.1. Traditional Economic Measures

In strictly economic terms, development has traditionally meant achieving sustained rates of growth of income per capita to enable a nation to expand its output at a rate faster than the growth rate of its population. Levels and rates of growth of “real” per capita gross national income (GNI) (monetary growth of GNI per capita minus the rate of inflation) are then used to measure the overall economic well-being of a population—how much of real goods and services is available to the average citizen for consumption and investment.

Economic development in the past has also been typically seen in terms of the planned alteration of the structure of production and employment so that agriculture’s share of both declines and that of the manufacturing and service industries increases. Development strategies have therefore

usually focused on rapid industrialization, often at the expense of agriculture and rural development.

With few exceptions, such as in development policy circles in the 1970s, development was until recently nearly always seen as an economic phenomenon in which rapid gains in overall and per capita GNI growth would either “trickle down” to the masses in the form of jobs and other economic opportunities or create the necessary conditions for the wider distribution of the economic and social benefits of growth. Problems of poverty, discrimination, unemployment, and income distribution were of secondary importance to “getting the growth job done.” Indeed, the emphasis is often on increased output, measured by gross domestic product (GDP).

2.3.2. The New Economic View of Development

The experience of the 1950s and 1960s, when many developing nations did reach their economic growth targets but the levels of living of the masses of people remained for the most part unchanged, signaled that something was very wrong with this narrow definition of development. An increasing number of economists and policymakers clamored for more direct attacks on widespread absolute poverty, increasingly inequitable income distributions, and rising unemployment. In short, during the 1970s, economic development came to be redefined in terms of the reduction or elimination of poverty, inequality, and unemployment within the context of a growing economy. “Redistribution from growth” became a common slogan. Dudley Seers posed the basic question about the meaning of development succinctly when he asserted:

The questions to ask about a country's development are therefore: What has been happening to poverty? What has been happening to unemployment? What has been happening to inequality? If all three of these have declined from high levels, then beyond doubt this has been a period of development for the country concerned. If one or two of these central problems have been growing worse, especially if all three have, it would be strange to call the result “development” even if per capita income doubled.

This assertion was neither idle speculation nor the description of a hypothetical situation. A number of developing countries experienced relatively high rates of growth of per capita income

during the 1960s and 1970s but showed little or no improvement or even an actual decline in employment, equality, and the real incomes of the bottom 40% of their populations. By the earlier growth definition, these countries were developing; by the newer poverty, equality, and employment criteria, they were not. The situation in the 1980s and 1990s worsened further as GNI growth rates turned negative for many developing countries, and governments, facing mounting foreign-debt problems, were forced to cut back on their already limited social and economic programs. Nor can we count on high rates of growth in the developed world to trickle down to the poor in developing countries. Growth was rapid in much of the developing world in the 2000s, while many wondered if it was fueled by the bubbles in the West and could be derailed by the financial crisis and later aftershocks.

But the phenomenon of development or the existence of a chronic state of underdevelopment is not merely a question of economics or even one of quantitative measurement of incomes, employment, and inequality. Development must therefore be conceived of as a multidimensional process involving major changes in social structures, popular attitudes, and national institutions, as well as the acceleration of economic growth, the reduction of inequality, and the eradication of poverty. Development, in its essence, must represent the whole gamut of change by which an entire social system, tuned to the diverse basic needs and evolving aspirations of individuals and social groups within that system, moves away from a condition of life widely perceived as unsatisfactory toward a situation or condition of life regarded as materially and spiritually better. No one has identified the human goals of economic development as well as Amartya Sen, perhaps the leading thinker on the meaning of development.

2.4. Amartya Sen's "Capability" Approach

The view that income and wealth are not ends in themselves but instruments for other purposes goes back at least as far as Aristotle. Amartya Sen, the 1998 Nobel laureate in economics, argues that the "capability to function" is what really matters for status as a poor or non poor person. As Sen put it, "Economic growth cannot be sensibly treated as an end in itself. Development has to be more concerned with enhancing the lives we lead and the freedoms we enjoy."

In effect, Sen argues that poverty cannot be properly measured by income or even by utility as conventionally understood; what matters fundamentally is not the things a person has—or the

feelings these provide—but what a person is, or can be, and does, or can do. What matters for well-being is not just the characteristics of commodities consumed, as in the utility approach, but what use the consumer can and does make of commodities. For example, a book is of little value to an illiterate person (except perhaps as cooking fuel or as a status symbol). Or as Sen noted, a person with parasitic diseases will be less able to extract nourishment from a given quantity of food than someone without parasites.

To make any sense of the concept of human well-being in general, and poverty in particular, we need to think beyond the availability of commodities and consider their use: to address what Sen calls functionings, that is, what a person does (or can do) with the commodities of given characteristics that they come to possess or control. Freedom of choice, or control of one's own life, is itself a central aspect of most understandings of well-being. As Sen explains:

The concept of “functionings” ...reflects the various things a person may value doing or being. The valued functionings may vary from elementary ones, such as being adequately nourished and being free from avoidable disease, to very complex activities or personal states, such as being able to take part in the life of the community and having self-respect. Heterogeneity

Sen identifies five sources of disparity between (measured) real incomes and actual advantages: first, personal heterogeneities, such as those connected with disability, illness, age, or gender; second, environmental diversities, such as heating and clothing requirements in the cold, infectious diseases in the tropics, or the impact of pollution; third, variations in social climate, such as the prevalence of crime and violence, and “social capital”; fourth, distribution within the family: Economic statistics measure incomes received in a family because it is the basic unit of shared consumption, but family resources may be distributed unevenly, as when girls get less medical attention or education than boys do. Fifth, differences in relational perspectives, meaning that

the commodity requirements of established patterns of behavior may vary between communities, depending on conventions and customs. For example, being relatively poor in a rich community can prevent

a person from achieving some elementary “functionings” (such as taking part in the life of the community) even though her income, in absolute terms, may be much higher than the level of income at which members of poorer communities can function with great ease and success. For example, to be able to “appear in public without shame” may require higher standards of clothing and other visible consumption in a richer society than in a poorer one.

In a richer society, the ability to partake in community life would be extremely difficult without certain commodities, such as a telephone, a television, or an automobile; it is difficult to function socially in Singapore or South Korea without an e-mail address.

Thus looking at real income levels or even the levels of consumption of specific commodities cannot suffice as a measure of well-being. One may have a lot of commodities, but these are of little value if they are not what consumers desire. One may have income, but certain commodities essential for well-being, such as nutritious foods, may be unavailable. Even when providing an equal number of calories, the available staple foods in one country (cassava, bread, rice, cornmeal, potatoes, etc.) will differ in nutritional content from staple foods in other countries. Moreover, even some sub varieties of, for example, rice, are much more nutritious than others. Finally, even when comparing absolutely identical commodities, one has to frame their consumption in a personal and social context. Sen provides an excellent example:

Consider a commodity such as bread. It has many characteristics, of which yielding nutrition is one. This can—often with advantage—be split into different types of nutrition, related to calories, protein, etc. In addition to nutrition-giving characteristics, bread possesses other characteristics as well, e.g., helping get-togethers over food and drinks, meeting the demands of social conventions or festivities. . . . But in comparing the functionings of two different persons, we do not get enough information by looking merely at the amounts of bread (and similar goods) enjoyed by the two persons respectively. The conversion of commodity-characteristics into personal achievements of functionings depends on a variety of factors—personal and social. In the case of nutritional achievements it depends on

such factors as (1) metabolic rates, (2) body size, (3) age, (4) sex (and, if a woman, whether pregnant or lactating), (5) activity levels, (6) medical conditions (including the absence or presence of parasites), (7) access to medical services and the ability to use them, (8) nutritional knowledge and education, and (9) climactic conditions.

In part because such factors, even on so basic a matter as nutrition, can vary so widely among individuals, measuring individual well-being by levels of consumption of goods and services obtained confuses the role of commodities by regarding them as ends in themselves rather than as means to an end. In the case of nutrition, the end is health and what one can do with good health, as well as personal enjoyment and social functioning. Indeed, the capacity to maintain valued social relationships and to network leads to what James Foster and Christopher Handy have termed external capabilities, which are “abilities to function that are conferred by direct connection or relationship with another person.” But measuring well-being using the concept of utility, in any of its standard definitions, does not offer enough of an improvement over measuring consumption to capture the meaning of development.

As Sen stresses, a person’s own valuation of what kind of life would be worthwhile is not necessarily the same as what gives pleasure to that person. If we identify utility with happiness in a particular way, then very poor people can have very high utility. Sometimes even malnourished people either have a disposition that keeps them feeling rather blissful or have learned to appreciate greatly any small comforts they can find in life, such as a breeze on a very hot day, and to avoid disappointment by striving only for what seems attainable. (Indeed, it is only too human to tell yourself that you do not want the things you cannot have.) If there is really nothing to be done about a person’s deprivation, this attitude of subjective bliss would have undoubted advantages in a spiritual sense, but it does not change the objective reality of deprivation. In particular, such an attitude would not prevent the contented but homeless poor person from greatly valuing an opportunity to become freed of parasites or provided with basic shelter. The functioning of a person is an achievement; it is what the person succeeds in doing with the commodities and characteristics at his or her command...For example, bicycling has to be distinguished from possessing a bike. It has to be distinguished also from the happiness generated by [bicycling]....A functioning is thus different both from (1) having goods (and the

corresponding characteristics), to which it is posterior, and (2) having utility (in the form of happiness resulting from that functioning), to which it is, in an important way, prior.

To clarify this point, in his acclaimed 2009 book “The Idea of Justice” Sen suggests that subjective well-being is a kind of psychological state of being—a functioning—that could be pursued alongside other functionings such as health and dignity. In the next section we return to the meaning of happiness as a development outcome, in a sense that can be distinguished from conventional utility.

Sen then defines capabilities as “the freedom that a person has in terms of the choice of functionings, given his personal features (conversion of characteristics into functionings) and his command over commodities.” Sen’s perspective helps explain why development economists have placed so much emphasis on health and education and more recently on social inclusion and empowerment, and have referred to countries with high levels of income but poor health and education standards as cases of “growth without development.” Real income is essential, but to convert the characteristics of commodities into functionings, in most important cases, surely requires health and education as well as income. The role of health and education ranges from something so basic as the nutritional advantages and greater personal energy that are possible when one lives free of certain parasites to the expanded ability to appreciate the richness of human life that comes with a broad and deep education. People living in poverty are often deprived—at times deliberately—of capabilities to make substantive choices and to take valuable actions, and often the behavior of the poor can be understood in that light.

For Sen, human “well-being” means being well, in the basic sense of being healthy, well nourished, well clothed, literate, and long-lived and more broadly, being able to take part in the life of the community, being mobile, and having freedom of choice in what one can become and can do.

2.5. Three Core Values of Development

Is it possible, then, to define or broadly conceptualize what we mean when we talk about development as the sustained elevation of an entire society and social system toward a “better” or “more humane” life? What constitutes the good life is a question as old as philosophy, one that must be periodically reevaluated and answered afresh in the changing environment of world

society. The appropriate answer for developing nations today is not necessarily the same as it would have been in previous decades. But at least three basic components or core values serve as a conceptual basis and practical guideline for understanding the inner meaning of development. These core values— sustenance, self-esteem, and freedom—represent common goals sought by all individuals and societies. They relate to fundamental human needs that find their expression in almost all societies and cultures at all times. Let us therefore examine each in turn.

2.5.1. Sustenance: The Ability to Meet Basic Needs

All people have certain basic needs without which life would be impossible. These life-sustaining basic human needs include food, shelter, health, and protection. When any of these is absent or in critically short supply, a condition of “absolute underdevelopment” exists. A basic function of all economic activity, therefore, is to provide as many people as possible with the means of overcoming the helplessness and misery arising from a lack of food, shelter, health, and protection. To this extent, we may claim that economic development is a necessary condition for the improvement in the quality of life that is development. Without sustained and continuous economic progress at the individual as well as the societal level, the realization of the human potential would not be possible. One clearly has to “have enough in order to be more.” Rising per capita incomes, the elimination of absolute poverty, greater employment opportunities, and lessening income inequalities therefore constitute the necessary but not the sufficient conditions for development.

2.5.2. Self-Esteem: To Be a Person

A second universal component of the good life is self-esteem—a sense of worth and self-respect, of not being used as a tool by others for their own ends. All peoples and societies seek some basic form of self-esteem, although they may call it authenticity, identity, dignity, respect, honor, or recognition. The nature and form of this self-esteem may vary from society to society and from culture to culture. However, with the proliferation of the “modernizing values” of developed nations, many societies in developing countries that have had a profound sense of their own worth suffer from serious cultural confusion when they come in contact with economically and technologically advanced societies. This is because national prosperity has become an almost universal measure of worth. Due to the significance attached to material

values in developed nations, worthiness and esteem are nowadays increasingly conferred only on countries that possess economic wealth and technological power—those that have “developed.” As Denis Goulet put it, “Development is legitimized as a goal because it is an important, perhaps even an indispensable, way of gaining esteem.”

2.5.3. Freedom from Servitude: To Be Able to Choose

A third and final universal value that we suggest should constitute the meaning of development is the concept of human freedom. Freedom here is to be understood in the sense of emancipation from alienating material conditions of life and from social servitude to nature, other people, misery, oppressive institutions, and dogmatic beliefs, especially that poverty is predestination. Freedom involves an expanded range of choices for societies and their members together with a minimization of external constraints in the pursuit of some social goal we call development. Amartya Sen writes of “development as freedom.” W. Arthur Lewis stressed the relationship between economic growth and freedom from servitude when he concluded that “the advantage of economic growth is not that wealth increases happiness, but that it increases the range of human choice.” Wealth can enable people to gain greater control over nature and the physical environment (e.g., through the production of food, clothing, and shelter) than they would have if they remained poor. It also gives them the freedom to choose greater leisure, to have more goods and services, or to deny the importance of these material wants and choose to live a life of spiritual contemplation. The concept of human freedom also encompasses various components of political freedom, including personal security, the rule of law, freedom of expression, political participation, and equality of opportunity. Although attempts to rank countries with freedom indexes have proved highly controversial, studies do reveal that some countries that have achieved high economic growth rates or high incomes, such as China, Malaysia, Saudi Arabia, and Singapore, have not achieved as much on human freedom criteria.

2.6. The Three Objectives of Development

We may conclude that development is both a physical reality and a state of mind in which society has, through some combination of social, economic, and institutional processes, secured the means for obtaining a better life. Whatever the specific components of this better life, development in all societies must have at least the following three objectives:

1. To increase the availability and widen the distribution of basic life-sustaining goods such as food, shelter, health, and protection
2. To raise levels of living, including, in addition to higher incomes, the provision of more jobs, better education, and greater attention to cultural and human values, all of which will serve not only to enhance material wellbeing but also to generate greater individual and national self-esteem.
3. To expand the range of economic and social choices available to individuals and nations by freeing them from servitude and dependence not only in relation to other people and nation-states but also to the forces of ignorance and human misery

2.7. Chapter Summery & Conclusion

Development economics is a distinct yet very important extension of both traditional economics and political economy. While necessarily also concerned with efficient resource allocation and the steady growth of aggregate output over time, development economics focuses primarily on the economic, social, and institutional mechanisms needed to bring about rapid and large-scale improvements in standards of living for the masses of poor people in developing nations. Consequently, development economics must be concerned with the formulation of appropriate public policies designed to effect major economic, institutional, and social transformations of entire societies in a very short time. Otherwise, the gap between aspiration and reality will continue to widen with each passing year. It is for this reason that the public sector has assumed a much broader and more determining role in development economics than it has in traditional neoclassical economic analysis.

As a social science, economics is concerned with people and how best to provide them with the material means to help them realize their full human potential. But what constitutes the good life is a perennial question, and hence economics necessarily involves values and value judgments. Our very concern with promoting development represents an implicit value judgment about good (development) and evil (underdevelopment). But development may mean different things to different people. Therefore, the nature and character of development and the meaning we attach to it must be carefully spelled out.

The central economic problems of all societies include traditional questions such as what, where, how, how much, and for whom goods and services should be produced. But they should also include the fundamental question at the national level about who actually makes or influences economic decisions and for whose principal benefit these decisions are made. Finally, at the international level, it is necessary to consider the question of which nations and which powerful groups within nations exert the most influence with regard to the control, transmission, and use of technology, information, and finance. Moreover, for whom do they exercise this power?

Any realistic analysis of development problems necessitates the supplementation of strictly economic variables such as incomes, prices, and savings rates with equally relevant noneconomic institutional factors, including the nature of land tenure arrangements; the influence of social and class stratifications; the structure of credit, education, and health systems; the organization and motivation of government bureaucracies; the machinery of public administrations; the nature of popular attitudes toward work, leisure, and self-improvement; and the values, roles, and attitudes of political and economic elites. Economic development strategies that seek to raise agricultural output, create employment, and eradicate poverty have often failed in the past because economists and other policy advisers neglected to view the economy as an interdependent social system in which economic and noneconomic forces are continually interacting in ways that are at times self-reinforcing and at other times contradictory. As you will discover, underdevelopment reflects many individual market failures, but these failures often add up to more than the sum of their parts, combining to keep a country in a poverty trap. Government can play a key role in moving the economy to a better equilibrium, and in many countries, notably in East Asia, government has done so; but all too often government itself is part and parcel of the bad equilibrium.

Chapter Three

3. Basic Indicators and Measures of Development

3.1. Introduction

In this section, we examine basic indicators of three facets of development: real income per capita adjusted for purchasing power; health as measured by life expectancy, undernourishment, and child mortality; and educational attainments as measured by literacy and schooling.

3.2. Purchasing Power Parity

In accordance with the World Bank's income-based country classification scheme, gross national income (GNI) per capita, the most common measure of the overall level of economic activity, is often used as a summary index of the relative economic well-being of people in different nations. It is calculated as the total domestic and foreign value added claimed by a country's residents without making deductions for depreciation (or wearing out) of the domestic capital stock. Gross domestic product (GDP) measures the total value for final use of output produced by an economy, by both residents and nonresidents. Thus GNI comprises GDP plus the difference between the income residents receive from abroad for factor services (labor and capital) less payments made to nonresidents who contribute to the domestic economy. Where there is a large nonresident population playing a major role in the domestic economy (such as foreign corporations), these differences can be significant. In 2008, the total national income of all the nations of the world was valued at more than U.S. \$58 trillion, of which over \$42 trillion originated in the economically developed high-income regions and less than \$16 trillion was

generated in the less developed nations, despite their representing about five-sixths of the world's population. In 2008 Norway had 312 times the per capita income of Ethiopia and 84 times that of India.

Per capita GNI comparisons between developed and less developed countries are, however, exaggerated by the use of official foreign-exchange rates to convert national currency figures into U.S. dollars. This conversion does not measure the relative domestic purchasing power of different currencies. In an attempt to rectify this problem, researchers have tried to compare relative GNIs and GDPs by using purchasing power parity (PPP) instead of exchange rates as conversion factors. PPP is calculated using a common set of international prices for all goods and services. In a simple version, purchasing power parity is defined as the number of units of a foreign country's currency required to purchase the identical quantity of goods and services in the local developing country market as \$1 would buy in the United States. In practice, adjustments are made for differing relative prices across countries so that living standards may be measured more accurately. Generally, prices of non traded services are much lower in developing countries because wages are so much lower. Clearly, if domestic prices are lower, PPP measures of GNI per capita will be higher than estimates using foreign-exchange rates as the conversion factor. For example, China's 2008 GNI per capita was only 6% of that of the United States using the exchange-rate conversion but rises to 13% when estimated by the PPP method of conversion. Income gaps between rich and poor nations thus tend to be less when PPP is used.

3.3. Indicators of Health and Education

Besides average incomes, it is necessary to evaluate a nation's average health and educational attainments, which reflect core capabilities. Life expectancy is the average number of years newborn children would live if subjected to the mortality risks prevailing for their cohort at the time of their birth. Undernourishment means consuming too little food to maintain normal levels of activity; it is what is often called the problem of hunger. High fertility can be both a cause and a consequence of underdevelopment, so the birth rate is reported as another basic indicator. Literacy is the fraction of adult males and females reported or estimated to have basic abilities to read and write; functional literacy is generally lower than the reported numbers.

3.4. Holistic Measures of Living Levels and Capabilities

3.4.1. The Traditional Human Development Index

The most widely used measure of the comparative status of socioeconomic development is presented by the United Nations Development Program (UNDP) in its annual series of Human Development Reports. The centerpiece of these reports, which were initiated in 1990, is the construction and refinement of its informative Human Development Index (HDI). The HDI attempts to rank all countries on a scale of 0 (lowest human development) to 1 (highest human development) based on three goals or end products of development: longevity as measured by life expectancy at birth, knowledge as measured by a weighted average of adult literacy (two-thirds) and gross school enrollment ratio (one third), and standard of living as measured by real per capita gross domestic product adjusted for the differing purchasing power parity of each country's currency to reflect cost of living and for the assumption of diminishing marginal utility of income. Using these three measures of development and applying a formula to data for 177 countries, the HDI ranks countries into four groups: low human development (0.0 to 0.499), medium human development (0.50 to 0.799), high human development (0.80 to 0.90), and very high human development (0.90 to 1.0).

Calculation of the traditional HDI underwent a number of changes since its inception. (The new 2010 version of the HDI is introduced in the next section.) In particular, in the past a relatively complicated formula was used to convert PPP income into "adjusted" income (meaning income adjusted for diminishing marginal utility so that well-being increases with income but at a decreasing rate). More recently, adjusted income is found by simply taking the log of current income. Then, to find the income index, one subtracts the log of 100 from the log of current income, on the assumption that real per capita income can not possibly be less than \$100 PPP. The difference gives the amount by which the country has exceeded this "lower goalpost." To put this achievement in perspective, consider it in relation to the maximum that a developing country might reasonably aspire to over the coming generation. The UNDP takes this at \$40,000 PPP. So we then divide by the difference between the log of \$40,000 and the log of \$100 to find the country's relative income achievement. This gives each country an index number that ranges between 0 and 1. For example, for the case of Bangladesh, whose 2007 PPP GDP per capita was estimated by the UNDP to be \$1,241, the income index is calculated as follows:

$$\text{Income index} = \frac{[\log(1,241) - \log(100)]}{[\log(40,000) - \log(100)]} = 0.420 \quad (2.1)$$

The effect of diminishing marginal utility is clear. An income of \$1,241, which is just 3% of the maximum goalpost of \$40,000, is already enough to reach more than two-fifths of the maximum value that the index can take. Note that a few countries have already exceeded the \$40,000 PPP income target; in such cases, the UNDP assigned the maximum value of \$40,000 PPP income, and so the country gets the maximum income index of 1. To find the life expectancy (health proxy) index, the UNDP starts with a country's current life expectancy at birth and subtracts 25 years. The latter is the lower goalpost, the lowest that life expectancy could have been in any country over the previous generation. Then the UNDP divides the result by 85 years minus 25 years, or 60 years, which represents the range of life expectancies expected over the previous and next generations. That is, it is anticipated that 85 years is a maximum reasonable life expectancy for a country to try to achieve over the coming generation. For example, for the case of Bangladesh, whose population life expectancy in 2007 was 65.7 years, the life expectancy index is calculated as follows:

$$\text{Life expectancy index} = \frac{65.7 - 25}{85 - 25} = 0.678 \quad (2.2)$$

Notice that no diminishing marginal utility of years of life are assumed; the same holds for the education index. The education index is made up of two parts, with two-thirds weight on literacy and one-third weight on school enrollment. Because gross school enrollments can exceed 100% (because of older students going back to school), this index is also capped at 100%. For the case of Bangladesh, adult literacy is estimated (rather uncertainly) at 53.5%, so

$$\text{Adult literacy index} = \frac{53.5 - 0}{100 - 0} = 0.535 \quad (2.3)$$

For the gross enrollment index, for Bangladesh it is estimated that 52.1% of its primary, secondary, and tertiary age population are enrolled in school, so the country receives the following value:

$$\text{Gross enrollment index} = \frac{52.1 - 0}{100 - 0} = 0.521 \quad (2.4)$$

Then, to get the overall education index, the adult literacy index is multiplied by two-thirds and the gross enrollment index is multiplied by one-third. This choice reflects the view that literacy is the fundamental characteristic of an educated person. In the case of Bangladesh, this gives us

$$\begin{aligned}\text{Education index} &= \frac{2}{3}(\text{adult literacy index}) + \frac{1}{3}(\text{gross enrollment index}) \\ &= \frac{2}{3}(0.535) + \frac{1}{3}(0.521) = 0.530\end{aligned}\quad (2.5)$$

In the final index, each of the three components receives equal, or one-third, weight. Thus

$$\text{HDI} = \frac{1}{3}(\text{income index}) + \frac{1}{3}(\text{life expectancy index}) + \frac{1}{3}(\text{education index})\quad (2.6)$$

For the case of Bangladesh,

$$\text{HDI} = \frac{1}{3}(0.420) + \frac{1}{3}(0.678) + \frac{1}{3}(0.530) = 0.543\quad (2.7)$$

One major advantage of the HDI is that it does reveal that a country can do much better than might be expected at a low level of income and that substantial income gains can still accomplish relatively little in human development.

Further, the HDI points up that disparities in income are greater than disparities in other indicators of development, at least health and education. Moreover, the HDI reminds us that by development we clearly mean broad human development, not just higher income. Many countries, such as some of the higher-income oil producers, have been said to have experienced “growth without development.” Health and education are inputs into the national production function in their role as components of human capital, meaning productive investments embodied in persons. Improvements in health and education are also important development goals in their own right. We cannot easily argue that a nation of high-income individuals who are not well educated and suffer from significant health problems that lead to their living much shorter lives than others around the globe has achieved a higher level of development than a low-income country with high life expectancy and widespread literacy. A better indicator of development disparities and rankings might be found by including health and education variables

in a weighted welfare measure rather than by simply looking at income levels, and the HDI offers one very useful way to do this.

There are other criticisms and possible drawbacks of the HDI. One is that gross enrollment in many cases overstates the amount of schooling because in many countries a student who begins primary school is counted as enrolled without considering whether the student drops out at some stage. Equal (one third) weight is given to each of the three components, which clearly has some value judgment behind it, but it is difficult to determine what this is. Note that because the variables are measured in very different types of units, it is difficult even to say precisely what equal weights mean. Finally, there is no attention to the role of quality. For example, there is a big difference between an extra year of life as a healthy, well-functioning individual and an extra year with a sharply limited range of capabilities (such as being confined to bed). Moreover, the quality of schooling counts, not just the number of years of enrollment.

It should be stressed that the HDI has a strong tendency to rise with per capita income, as wealthier countries can invest more in health and education, and this added human capital raises productivity. But what is so striking is that despite this expected pattern, there is still such great variation between income and broader measures of well-being. For example, Senegal and Rwanda have essentially the same average HDI despite the fact that real income is 92% higher in Senegal. And Costa Rica has a higher HDI than Saudi Arabia, despite the fact that Saudi Arabia has more than double the real per capita income of Costa Rica. Many countries have an HDI significantly different from that predicted by their income. South Africa has an HDI of 0.683, but it ranks just 129th, 51 places lower than to be expected from its middle-income ranking. But similarly ranked São Tomé and Príncipe (number 131) ranks 17 places higher than expected from its income level.

Clearly, the United Nations Human Development Index has made a major contribution to improving our understanding of what constitutes development, which countries are succeeding (as reflected by rises in their HDI over time), and how different groups and regions within countries are faring. By combining social and economic data, the HDI allows nations to take a broader measure of their development performance, both relatively and absolutely.

Although there are some valid criticisms, the fact remains that the HDI and its new version considered in the next section, when used in conjunction with traditional economic measures of development, greatly increase our understanding of which countries are experiencing development and which are not. And by modifying a country's overall HDI to reflect income distribution, gender, regional, and ethnic differentials, as presented in recent Human Development Reports, we are now able to identify not only whether a country is developing but also whether various significant groups within that country are participating in that development.

3.5. The New Human Development Index

In November 2010, the UNDP introduced its New Human Development Index (NHDI), intended to address some of the criticisms of the HDI. The index is still based on standard of living, education, and health. But it has eight notable changes, each with strengths but also a few potential drawbacks.

3.5.1. What Is New in the New HDI

1. Gross national income (GNI) per capita replaces gross domestic product (GDP) per capita. This should be an unambiguous improvement: GNI reflects what citizens can do with income they receive, whereas that is not true of value added in goods and services produced in a country that go to someone outside it, and income earned abroad still benefits some of the nation's citizens. As trade and remittance flows have been expanding rapidly, and as aid has been better targeted to very low-income countries, this distinction has become increasingly important.
2. The education index has been completely revamped. Two new components have been added: the average actual educational attainment of the whole population and the expected attainment of today's children. Each of these changes to the index has implications. Use of actual attainment—average years of schooling—as an indicator is unambiguously an improvement. Estimates are regularly updated, and the statistic is easily compared quantitatively across countries. And even though it is at best a very rough guide to what is actually learned—on average, a year of schooling in Mali provides students with much less than a year of schooling in Norway—this is the best measure we have at present because more detailed data on quality that are credible and comparable are simply not available.

3. Expected educational attainment, the other new component, is somewhat more ambiguous: it is not an achievement but a UN forecast. History shows that much can go wrong to derail development plans. Nevertheless, there have also been many development upside surprises, such as rapid improvements in educational attainment in some countries; there is a risk that low expectations will prove discouraging. Note that life expectancy, which remains the indicator for health, is also a projection based on prevailing conditions.

4. The two previous components of the education index, literacy and enrollment, have been correspondingly dropped. In contrast to expected attainment, literacy is clearly an achievement, and even enrollment is at least a modest achievement. However, literacy has always been badly and too infrequently measured and is inevitably defined more modestly in a less developed country. And enrollment is no guarantee that a grade will be completed or for that matter that anything is learned or that students (or teachers) even attend.

5. The upper goalposts (maximum values) in each dimension have been increased to the observed maximum rather than given a predefined cutoff. In some ways, this returns the index to its original design, which was criticized for inadequately recognizing small gains by countries starting at very low levels.

6. The lower goalpost for income has been reduced.

7. Another minor difference is that rather than using the common logarithm (\log) to reflect diminishing marginal benefit of income, the NHDI now uses the natural log (\ln), as used in the fifth equation in Box 2.1. This reflects a more usual construction of indexes.

8. Possibly the most consequential change is that the NHDI is computed with a geometric mean, as we examine next.

The component indexes of the NHDI are computed by the same method as for the HDI, such as seen for the case of life expectancy in Equation 2.2 (and, for the case of China in the NHDI, as in the first equation in Box 2.1). We start by taking the difference between the country's actual achievement and the minimum goalpost value and then divide the result by the difference between the overall maximum goalpost and minimum goalpost values.

But in calculating the overall index, in place of the arithmetic mean, a geometric mean of the three indexes is used (a geometric mean is also used to build up the overall education index from its two components). Let’s look at why this change is important and how the calculations are done.

3.5.2. Computing the NHDI

The use of a geometric mean in the NHDI is very important. When using an arithmetic mean (adding up the component indexes and dividing by three) in the HDI, the effect is to assume perfect substitutability across income, health, and education. For example, a higher value of the education index could compensate, one for one, for a lower value of the health index. In contrast, use of a geometric mean ensures that poor performance in any dimension directly affects the overall index. Thus, allowing for imperfect substitutability is a beneficial change; but there is active debate about whether using the geometric mean is the most appropriate way to accomplish this. Thus as the UNDP notes, the new calculation “captures how well rounded a country’s performance is across the three dimensions.” Moreover, the UNDP argues, “that it is hard to compare these different dimensions of well-being and that we should not let changes in any of them go unnoticed.” So in the NHDI, instead of adding up the health, education, and income indexes and dividing by 3, the NHDI is calculated with the geometric mean:

$$NHDI = H^{1/3}E^{1/3}I^{1/3} \tag{2.8}$$

where H stands for the health index, E stands for the education index, and I stands for the income index. This is equivalent to taking the cube root of the product of these three indexes. The calculations of the NHDI are illustrated for the case of China in Box 2.1.

Example: China

Indicator	Value
Life expectancy at birth (years)	73.5
Mean years of schooling (years)	7.5
Expected years of schooling (years)	11.4
GNI per capita (PPP U.S. \$)	7,263

Note: Values are rounded.
Source: UNDP Human Development Report, 2010, pp. 216-217.

Life expectancy index = $\frac{73.5 - 20}{83.2 - 20} = 0.847$

Mean years of schooling index = $\frac{7.5 - 0}{13.2 - 0} = 0.568$

Expected years of schooling index = $\frac{11.4 - 0}{20.6 - 0} = 0.553$

Education index = $\frac{\sqrt{0.568 \times 0.553} - 0}{0.951 - 0} = 0.589$

Income index = $\frac{\ln(7,263) - \ln(163)}{\ln(108,211) - \ln(163)} = 0.584$

Human Development Index = $\sqrt[3]{0.847 \times 0.589 \times 0.584} = 0.663$

Chapter Four

4. Theories of Economic Growth and Development

4.1. Introduction

Every nation strives after development. Economic progress is an essential component, but it is not the only component. As noted in Chapter 1, development is not purely an economic phenomenon. In an ultimate sense, it must encompass more than the material and financial side of people's lives, to expand human freedoms. Development should therefore be perceived as a multidimensional process involving the reorganization and reorientation of entire economic and social systems. In addition to improvements in incomes and output, it typically involves radical changes in institutional, social, and administrative structures as well as in popular attitudes and even customs and beliefs. Finally, although development is usually defined in a national context, its more widespread realization may necessitate modification of the international economic and social system as well. In this chapter, we explore the historical and intellectual evolution in scholarly thinking about how and why development does or does not take place. We do this by examining four major and often competing development theories. You will see that each offers valuable insights and a useful perspective on the nature of the development process.

4.2. Classic Theories of Economic Growth and Development

The classic post–World War II literature on economic development has been dominated by four major and sometimes competing strands of thought: (1) the linear-stages-of-growth model, (2) theories and patterns of structural change, (3) the international-dependence revolution, and (4) the neoclassical, free-market counterrevolution. In recent years, an eclectic approach has emerged that draws on all of these classic theories.

Theorists of the 1950s and 1960s viewed the process of development as a series of successive stages of economic growth through which all countries must pass. It was primarily an economic theory of development in which the right quantity and mixture of saving, investment, and foreign aid were all that was necessary to enable developing nations to proceed along an economic growth path that had historically been followed by the more developed countries. Development thus became synonymous with rapid, aggregate economic growth.

This linear-stages approach was largely replaced in the 1970s by two competing schools of thought. The first, which focused on theories and patterns of structural change, used modern economic theory and statistical analysis in an attempt to portray the internal process of structural change that a “typical” developing country must undergo if it is to succeed in generating and sustaining rapid economic growth. The second, the international-dependence revolution, was more radical and more political. It viewed underdevelopment in terms of international and domestic power relationships, institutional and structural economic rigidities, and the resulting proliferation of dual economies and dual societies both within and among the nations of the world. Dependence theories tended to emphasize external and internal institutional and political constraints on economic development. Emphasis was placed on the need for major new policies to eradicate poverty, to provide more diversified employment opportunities, and to reduce income inequalities. These and other egalitarian objectives were to be achieved within the context of a growing economy, but economic growth per se was not given the exalted status accorded to it by the linear stages and structural-change models.

Throughout much of the 1980s and 1990s, a fourth approach prevailed. This neoclassical (sometimes called neoliberal) counterrevolution in economic thought emphasized the beneficial role of free markets, open economies, and the privatization of inefficient public enterprises. Failure to develop, according to this theory, is not due to exploitive external and internal forces as expounded by dependence theorists. Rather, it is primarily the result of too much government intervention and regulation of the economy. Today’s eclectic approach draws on all of these perspectives, and we will highlight the strengths and weaknesses of each.

4.3. Development as Growth and the Linear Stage Theories

When interest in the poor nations of the world really began to materialize following World War II, economists in the industrialized nations were caught off guard. They had no readily available conceptual apparatus with which to analyze the process of economic growth in largely agrarian societies that lacked modern economic structures. But they did have the recent experience of the Marshall Plan, under which massive amounts of U.S. financial and technical assistance enabled the war-torn countries of Europe to rebuild and modernize their economies in a matter of years. Moreover, was it not true that all modern industrial nations were once undeveloped agrarian societies? Surely their historical experience in transforming their economies from poor agricultural subsistence societies to modern industrial giants had important lessons for the “backward” countries of Asia, Africa, and Latin America. The logic and simplicity of these two strands of thought—the utility of massive injections of capital and the historical experience of the now developed countries—was too irresistible to be refuted by scholars, politicians, and administrators in rich countries, to whom people and ways of life in the developing world were often no more real than UN statistics or scattered chapters in anthropology books. Because of its emphasis on the central role of accelerated capital accumulation, this approach is often dubbed “capital fundamentalism.”

4.3.1. Rostow’s Stages of Growth

The most influential and outspoken advocate of the stages-of-growth model of development was the American economic historian Walt W. Rostow. According to Rostow, the transition from underdevelopment to development can be described in terms of a series of steps or stages through which all countries must proceed. As Rostow wrote in the opening chapter of *The Stages of Economic Growth*:

It is possible to identify all societies, in their economic dimensions, as lying within one of five categories: the traditional society, the preconditions for take-off into self-sustaining growth, the take-off, the drive to maturity, and the age of high mass consumption. . . . These stages are not merely descriptive. They are not merely a way of generalizing certain factual observations about the sequence of development of modern societies. They have an inner logic and continuity. . . . They constitute, in the end, both a theory about economic growth and a more general, if still highly partial, theory about modern history as a whole.

The advanced countries, it was argued, had all passed the stage of “takeoff into self-sustaining growth,” and the underdeveloped countries that were still in either the traditional society or the “preconditions” stage had only to follow a certain set of rules of development to take off in their turn into self-sustaining economic growth.

One of the principal strategies of development necessary for any takeoff was the mobilization of domestic and foreign saving in order to generate sufficient investment to accelerate economic growth. The economic mechanism by which more investment leads to more growth can be described in terms of the Harrod-Domar growth model, today often referred to as the AK model because it is based on a linear production function with output given by the capital stock K times a constant, often labeled A .

4.3.2. The Harrod-Domar Growth Model

Every economy must save a certain proportion of its national income, if only to replace worn-out or impaired capital goods (buildings, equipment, and materials). However, in order to grow, new investments representing net additions to the capital stock are necessary. If we assume that there is some direct economic relationship between the size of the total capital stock, K , and total GDP, Y —for example, if \$3 of capital is always necessary to produce an annual \$1 stream of GDP—it follows that any net additions to the capital stock in the form of new investment will bring about corresponding increases in the flow of national output, GDP. Suppose that this relationship, known in economics as the capital-output ratio, is roughly 3 to 1. If we define the capital-output ratio as k and assume further that the national net savings ratio, s , is a fixed proportion of national output (e.g., 6%) and that total new investment is determined by the level of total savings, we can construct the following simple model of economic growth:

1. Net saving (S) is some proportion, s , of national income (Y) such that we have the simple equation

$$S = sY \quad (3.1)$$

2. Net investment (I) is defined as the change in the capital stock, K , and can be represented by ΔK such that

$$I = \Delta K \quad (3.2)$$

But because the total capital stock, K , bears a direct relationship to total national income or output, Y , as expressed by the capital-output ratio, c , it follows that

$$\frac{K}{Y} = c$$

or

$$\frac{\Delta K}{\Delta Y} = c$$

or, finally,

$$\Delta K = c\Delta Y \quad (3.3)$$

3. Finally, because net national savings, S , must equal net investment, I , we can write this equality as

$$S = I \quad (3.4)$$

But from Equation 3.1 we know that $S = sY$, and from Equations 3.2 and 3.3 we know that

$$I = \Delta K = c\Delta Y$$

It therefore follows that we can write the “identity” of saving equaling investment shown by Equation 3.4 as

$$S = sY = c\Delta Y = \Delta K = I \quad (3.5)$$

or simply as

$$sY = c\Delta Y \quad (3.6)$$

Dividing both sides of Equation 3.6 first by Y and then by c , we obtain the following expression:

$$\frac{\Delta Y}{Y} = \frac{s}{c} \quad (3.7)$$

Note that the left-hand side of Equation 3.7, Y/Y , represents the rate of change or rate of growth of GDP.

Equation 3.7, which is a simplified version of the famous equation in the Harrod-Domar theory of economic growth, states simply that the rate of growth of GDP (Y/Y) is determined jointly by the net national savings ratio, s , and the national capital-output ratio, c . More specifically, it says that in the absence of government, the growth rate of national income will be directly or positively related to the savings ratio (i.e., the more an economy is able to save—and invest—out of a given GDP, the greater the growth of that GDP will be) and inversely or negatively related to the economy's capital-output ratio (i.e., the higher c is, the lower the rate of GDP growth will be).

The economic logic of Equations 3.7 is very simple. To grow, economies must save and invest a certain proportion of their GDP. The more they can save and invest, the faster they can grow. But the actual rate at which they can grow for any level of saving and investment—how much additional output can be had from an additional unit of investment—can be measured by the inverse of the capital-output ratio, c , because this inverse, $1/c$, is simply the output-capital or output-investment ratio. It follows that multiplying the rate of new investment, $s = I/Y$, by its productivity, $1/c$, will give the rate by which national income or GDP will increase.

In addition to investment, two other components of economic growth are labor force growth and technological progress. In the context of the Harrod-Domar model, labor force growth is not described explicitly. This is because labor is assumed to be abundant in a developing-country context and can be hired as needed in a given proportion to capital investments (this assumption is not always valid). In a general way, technological progress can be expressed in the Harrod-Domar context as a decrease in the required capital-output ratio, giving more growth for a given level of investment. This is obvious when we realize that in the longer run this ratio is not fixed but can change over time in response to the functioning of financial markets and the policy environment. But again, the focus was on the role of capital investment.

4.3.2.1. Necessary versus Sufficient Conditions: Some Criticisms of the Stages Model

Unfortunately, the mechanisms of development embodied in the theory of stages of growth did not always work. And the basic reason they didn't work was not because more saving and investment isn't a necessary condition for accelerated rates of economic growth but rather because it is not a sufficient condition. The Marshall Plan worked for Europe because the European countries receiving aid possessed the necessary structural, institutional, and attitudinal

conditions (e.g., well-integrated commodity and money markets, highly developed transport facilities, a well-trained and educated workforce, the motivation to succeed, an efficient government bureaucracy) to convert new capital effectively into higher levels of output.

The Rostow and Harrod Domar models implicitly assume the existence of these same attitudes and arrangements in underdeveloped nations. Yet in many cases they are lacking, as are complementary factors such as managerial competence, skilled labor, and the ability to plan and administer a wide assortment of development projects.

4.4. Structural Change Models

Structural-change theory focuses on the mechanism by which underdeveloped economies transform their domestic economic structures from a heavy emphasis on traditional subsistence agriculture to a more modern, more urbanized, and more industrially diverse manufacturing and service economy. It employs the tools of neoclassical price and resource allocation theory and modern econometrics to describe how this transformation process takes place.

Two well-known representative examples of the structural-change approach are the “two-sector surplus labor” theoretical model of W. Arthur Lewis and the “patterns of development” empirical analysis of Hollis B. Chenery and his coauthors.

4.4.1. The Lewis Theory of Development

Basic Model: One of the best-known early theoretical models of development that focused on the structural transformation of a primarily subsistence economy was that formulated by Nobel laureate W. Arthur Lewis in the mid-1950s and later modified, formalized, and extended by John Fei and Gustav Ranis. The Lewis two-sector model became the general theory of the development process in surplus-labor developing nations during most of the 1960s and early 1970s, and it is sometimes still applied, particularly to study the recent growth experience in China and labor markets in other developing countries.

In the Lewis model, the underdeveloped economy consists of two sectors: a traditional, overpopulated rural subsistence sector characterized by zero marginal labor productivity—a situation that permits Lewis to classify this as surplus labor in the sense that it can be withdrawn from the traditional agricultural sector without any loss of output—and a high-productivity

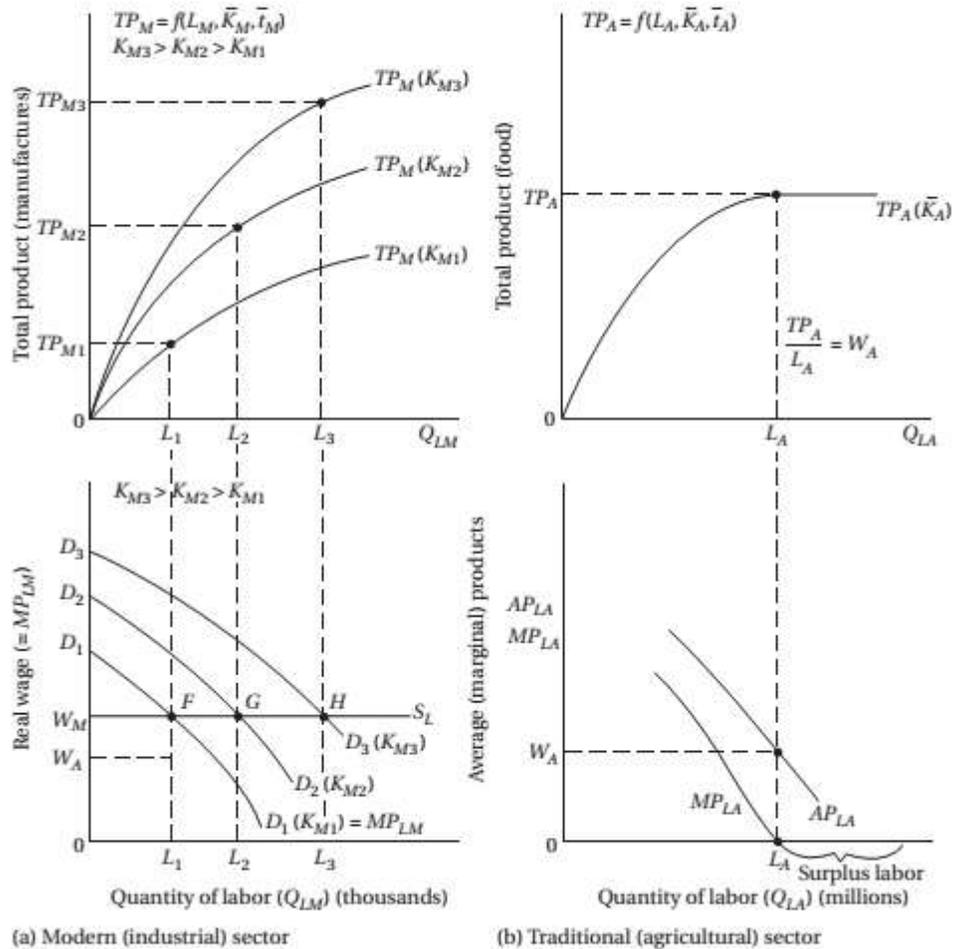
modern urban industrial sector into which labor from the subsistence sector is gradually transferred.

The primary focus of the model is on both the process of labor transfer and the growth of output and employment in the modern sector. (The modern sector could include modern agriculture, but we will call the sector “industrial” as a shorthand). Both labor transfer and modern-sector employment growth are brought about by output expansion in that sector. The speed with which this expansion occurs is determined by the rate of industrial investment and capital accumulation in the modern sector. Such investment is made possible by the excess of modern-sector profits over wages on the assumption that capitalists reinvest all their profits.

Finally, Lewis assumed that the level of wages in the urban industrial sector was constant, determined as a given premium over a fixed average subsistence level of wages in the traditional agricultural sector. At the constant urban wage, the supply curve of rural labor to the modern sector is considered to be perfectly elastic.

We can illustrate the Lewis model of modern-sector growth in a two-sector economy by using Figure 3.1. Consider first the traditional agricultural sector portrayed in the two right-side diagrams of Figure 3.1b. The upper diagram shows how subsistence food production varies with increases in labor inputs. It is a typical agricultural production function in which the total output or product (TPA) of food is determined by changes in the amount of the only variable input, labor (LA), given a fixed quantity of capital, A, and unchanging

FIGURE 3.1 The Lewis Model of Modern-Sector Growth in a Two-Sector Surplus-Labor Economy



traditional technology. In the lower-right diagram, we have the average and marginal product of labor curves, AP_{LA} and MP_{LA} , which are derived from the total product curve shown immediately above. The quantity of agricultural labor (Q_{LA}) available is the same on both horizontal axes and is expressed in millions of workers, as Lewis is describing an underdeveloped economy where much of the population lives and works in rural areas.

Lewis makes two assumptions about the traditional sector. First, there is surplus labor in the sense that MP_{LA} is zero, and second, all rural workers share equally in the output so that the rural real wage is determined by the average and not the marginal product of labor (as will be the case in the modern sector). Metaphorically, this may be thought of as passing around the family

rice bowl at dinnertime, from which each person takes an equal share (this need not be literally equal shares for the basic idea to hold). Assume that there are LA agricultural workers producing TPA food, which is shared equally as WA food per person (this is the average product, which is equal to TPA/LA). The marginal product of these LA workers is zero, as shown in the bottom diagram of Figure 3.1b; hence the surplus-labor assumption applies to all workers in excess of LA (note the horizontal TPA curve beyond LA workers in the upper-right diagram).

The upper-left diagram of Figure 3.1a portrays the total product (production function) curves for the modern industrial sector. Once again, output of, say, manufactured goods (TPM) is a function of a variable labor input, LM, for a given capital stock and technology. On the horizontal axes, the quantity of labor employed to produce an output of, say, TPM1, with capital stock KM1, is expressed in thousands of urban workers, L1. In the Lewis model, the modern-sector capital stock is allowed to increase from KM1 to KM2 to KM3 as a result of the reinvestment of profits by industrial capitalists. This will cause the total product curves in Figure 3.1a to shift upward from TPM(KM1) to TPM(KM2) to TPM(KM3). The process that will generate these capitalist profits for reinvestment and growth is illustrated in the lower-left diagram of Figure 3.1a. Here we have modern-sector marginal labor product curves derived from the TPM curves of the upper diagram. Under the assumption of perfectly competitive labor markets in the modern sector, these marginal product of labor curves are in fact the actual demand curves for labor. Here is how the system works.

WA in the lower diagrams of Figures 3.1a and 3.1b represents the average level of real subsistence income in the traditional rural sector. WM in Figure 3.1a is therefore the real wage in the modern capitalist sector. At this wage, the supply of rural labor is assumed to be unlimited or perfectly elastic, as shown by the horizontal labor supply curve WMSL. In other words, Lewis assumes that at urban wage WM above rural average income WA, modern-sector employers can hire as many surplus rural workers as they want without fear of rising wages. (Note again that the quantity of labor in the rural sector, Figure 3.1b, is expressed in millions whereas in the modern urban sector, Figure 3.1a, units of labor are expressed in thousands.) Given a fixed supply of capital KM1 in the initial stage of modern-sector growth, the demand curve for labor is determined by labor's declining marginal product and is shown by the negatively sloped curve D1(KM1) in the lower-left diagram. Because profit-maximizing modern-sector employers are

assumed to hire laborers to the point where their marginal physical product is equal to the real wage (i.e., the point F of intersection between the labor demand and supply curves), total modern sector employment will be equal to L_1 . Total modern-sector output, TPM_1 , would be given by the area bounded by points $0D_1FL_1$. The share of this total output paid to workers in the form of wages would be equal, therefore, to the area of the rectangle $0WMFL_1$. The balance of the output shown by the area WMD_1F would be the total profits that accrue to the capitalists. Because Lewis assumes that all of these profits are reinvested, the total capital stock in the modern sector will rise from KM_1 to KM_2 . This larger capital stock causes the total product curve of the modern sector to shift to $TPM(KM_2)$, which in turn induces a rise in the marginal product demand curve for labor. This outward shift in the labor demand curve is shown by line $D_2(KM_2)$ in the bottom half of Figure 3.1a. A new equilibrium modern-sector employment level will be established at point G with L_2 workers now employed. Total output rises to TPM_2 or $0D_2GL_2$ while total wages and profits increase to $0WMGL_2$ and WMD_2G , respectively. Once again, these larger (WMD_2G) profits are reinvested, increasing the total capital stock to KM_3 , shifting the total product and labor demand curves to $TPM(KM_3)$ and to $D_3(KM_3)$, respectively, and raising the level of modern-sector employment to L_3 .

This process of modern-sector self-sustaining growth and employment expansion is assumed to continue until all surplus rural labor is absorbed in the new industrial sector. Thereafter, additional workers can be withdrawn from the agricultural sector only at a higher cost of lost food production because the declining labor-to-land ratio means that the marginal product of rural labor is no longer zero. This is known as the “Lewis turning point.” Thus the labor supply curve becomes positively sloped as modern-sector wages and employment continue to grow. The structural transformation of the economy will have taken place, with the balance of economic activity shifting from traditional rural agriculture to modern urban industry.

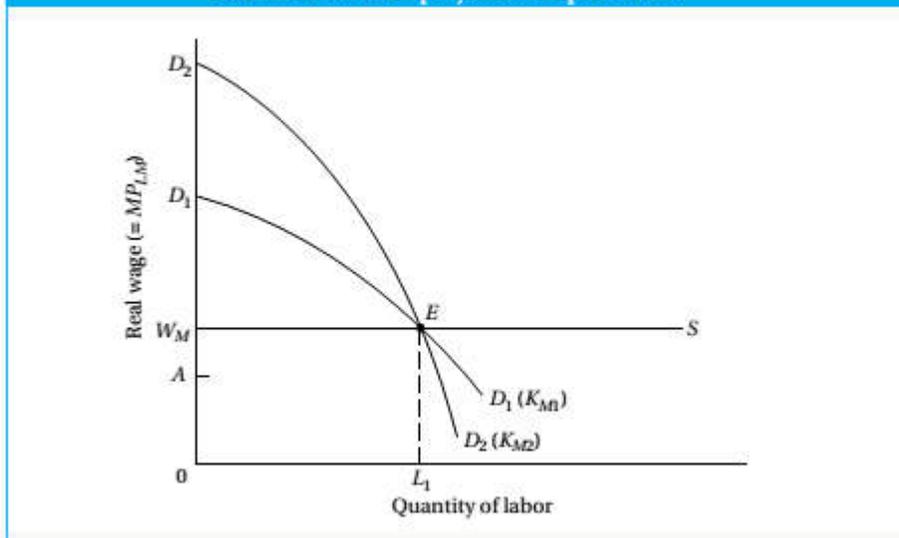
4.4.1.1. Criticisms of the Lewis Model

Although the Lewis two-sector development model is simple and roughly reflects the historical experience of economic growth in the West, four of its key assumptions do not fit the institutional and economic realities of most contemporary developing countries.

First, the model implicitly assumes that the rate of labor transfer and employment creation in the modern sector is proportional to the rate of modern sector capital accumulation. The faster the

rate of capital accumulation, the higher the growth rate of the modern sector and the faster the rate of new job creation. But what if capitalist profits are reinvested in more sophisticated laborsaving capital equipment rather than just duplicating the existing capital, as is implicitly assumed in the Lewis model? (We are, of course, here accepting the debatable assumption that capitalist profits are in fact reinvested in the local economy and not sent abroad as a form of “capital flight” to be added to the deposits of Western banks.) Figure 3.2 reproduces the lower, modern-sector diagram of Figure 3.1a, only this time the labor demand curves do not shift uniformly outward but in fact cross. Demand curve $D_2(KM2)$ has a greater negative slope than $D_2(KM1)$ to reflect the fact that additions to the capital stock embody laborsaving technical progress—that is, $KM2$ technology requires much less labor per unit of output than $KM1$ technology does.

FIGURE 3.2 The Lewis Model Modified by Laborsaving Capital Accumulation: Employment Implications



We see that even though total output has grown substantially (i.e., $0D_2EL_1$ is significantly greater than $0D_1EL_1$), total wages ($0W_MEL_1$) and employment (L_1) remain unchanged. All of the extra output accrues to capitalists in the form of profits. Figure 3.2 therefore provides an illustration of what some might call “anti developmental” economic growth—all the extra income and output growth are distributed to the few owners of capital, while income and employment levels for the masses of workers remain largely unchanged. Although total GDP

would rise, there would be little or no improvement in aggregate social welfare measured, say, in terms of more widely distributed gains in income and employment.

The second questionable assumption of the Lewis model is the notion that surplus labor exists in rural areas while there is full employment in the urban areas. Most contemporary research indicates that there is little surplus labor in rural locations. True, there are both seasonal and geographic exceptions to this rule (e.g., at least until recently in parts of China and the Asian subcontinent, some Caribbean islands, and isolated regions of Latin America where land ownership is very unequal), but by and large, development economists today agree that Lewis's assumption of rural surplus labor is generally not valid.

The third dubious assumption is the notion of a competitive modern sector labor market that guarantees the continued existence of constant real urban wages up to the point where the supply of rural surplus labor is exhausted. Prior to the 1980s, a striking feature of urban labor markets and wage determination in almost all developing countries was the tendency for these wages to rise substantially over time, both in absolute terms and relative to average rural incomes, even in the presence of rising levels of open modern-sector unemployment and low or zero marginal productivity in agriculture. Institutional factors such as union bargaining power, civil service wage scales, and multinational corporations' hiring practices tend to negate competitive forces in modern-sector labor markets in developing countries.

A final concern with the Lewis model is its assumption of diminishing returns in the modern industrial sector. Yet there is much evidence that increasing returns prevail in that sector, posing special problems for development policymaking.

We study the Lewis model because, as many development specialists still think about development in this way either explicitly or implicitly, it helps students participate in the debates. Moreover, the model is widely considered relevant to recent experiences in China, where labor has been steadily absorbed from farming to manufacturing and a few other countries with similar growth patterns. The Lewis turning point at which wages in manufacturing start to rise was widely identified with China's wage increases of 2010.

However, when we take into account the laborsaving bias of most modern technological transfer, the existence of substantial capital flight, the widespread nonexistence of rural surplus labor, the

growing prevalence of urban surplus labor, and the tendency for modern-sector wages to rise rapidly even where substantial open unemployment exists, we must acknowledge that the Lewis two-sector model—though valuable as an early conceptual portrayal of the development process of sectoral interaction and structural change and a description of some historical experiences including some recent ones such as China—requires considerable modification in assumptions and analysis to fit the reality of most contemporary developing nations.

4.4.2. Structural Change and Patterns of Development

Like the earlier Lewis model, the patterns-of-development analysis of structural change focuses on the sequential process through which the economic, industrial, and institutional structure of an underdeveloped economy is transformed over time to permit new industries to replace traditional agriculture as the engine of economic growth. However, in contrast to the Lewis model and the original stages view of development, increased savings and investment are perceived by patterns-of-development analysts as necessary but not sufficient conditions for economic growth.

In addition to the accumulation of capital, both physical and human, a set of interrelated changes in the economic structure of a country are required for the transition from a traditional economic system to a modern one. These structural changes involve virtually all economic functions, including the transformation of production and changes in the composition of consumer demand, international trade, and resource use as well as changes in socioeconomic factors such as urbanization and the growth and distribution of a country's population.

Empirical structural-change analysts emphasize both domestic and international constraints on development. The domestic ones include economic constraints such as a country's resource endowment and its physical and population size as well as institutional constraints such as government policies and objectives. International constraints on development include access to external capital, technology, and international trade. Differences in development level among developing countries are largely ascribed to these domestic and international constraints. However, it is the international constraints that make the transition of currently developing countries differ from that of now industrialized countries. To the extent that developing countries have access to the opportunities presented by the industrial countries as sources of capital, technology, and manufactured imports as well as markets for exports, they can make the transition at an even faster rate than that achieved by the industrial countries during the early

periods of their economic development. Thus, unlike the earlier stages model, the structural-change model recognizes the fact that developing countries are part of an integrated international system that can promote (as well as hinder) their development.

The best-known model of structural change is the one based largely on the empirical work of Harvard economist Hollis B. Chenery and his colleagues, who examined patterns of development for numerous developing countries during the postwar period. (This approach also built on research by Nobel laureate Simon Kuznets on modern economic growth of developed countries.) Their empirical studies, both cross-sectional (among countries at a given point in time) and time-series (over long periods of time), of countries at different levels of per capita income led to the identification of several characteristic features of the development process. These included the shift from agricultural to industrial production, the steady accumulation of physical and human capital, the change in consumer demands from emphasis on food and basic necessities to desires for diverse manufactured goods and services, the growth of cities and urban industries as people migrate from farms and small towns, and the decline in family size and overall population growth as children lose their economic value and parents substitute what is traditionally labeled child quality (education) for quantity, with population growth first increasing and then decreasing in the process of development. Proponents of this school often call for development specialists to “let the facts speak for themselves” rather than get bogged down in the arcane of theories such as the stages of growth. This is a valuable counterbalance to empty theorizing, but it also has its own limits.

4.4.3. Conclusions and Implications

The structural changes that we have described are the “average” patterns of development Chenery and colleagues observed among countries in time-series and cross-sectional analyses. The major hypothesis of the structural-change model is that development is an identifiable process of growth and change whose main features are similar in all countries. However, as mentioned earlier, the model does recognize that differences can arise among countries in the pace and pattern of development, depending on their particular set of circumstances. Factors influencing the development process include a country’s resource endowment and size, its government’s policies and objectives, the availability of external capital and technology, and the international trade environment.

One limitation to keep in mind is that by emphasizing patterns rather than theory, this approach runs the risk of leading practitioners to draw the wrong conclusions about causality—in effect, to “put the cart before the horse.” Observing developed-country patterns such as the decline of the share of the labor force in agriculture over time, many developing-country policymakers have been inclined to neglect that vital sector. But that is precisely the opposite conclusion to the one that should be drawn. Observing the important role of higher education in developed countries, policymakers may be inclined to emphasize the development of an advanced university system even before a majority of the population has gained basic literacy, a policy that has led to gross inequities even in countries at least nominally committed to egalitarian outcomes, such as Tanzania.

Empirical studies on the process of structural change lead to the conclusion that the pace and pattern of development can vary according to both domestic and international factors, many of which lie beyond the control of an individual developing nation. Yet despite this variation, structural-change economists argue that one can identify certain patterns occurring in almost all countries during the development process. And these patterns, they argue, may be affected by the choice of development policies pursued by governments in developing countries as well as the international trade and foreign-assistance policies of developed nations. Hence structural-change analysts are basically optimistic that the “correct” mix of economic policies will generate beneficial patterns of self-sustaining growth. The international-dependence school to which we now turn is, in contrast, much less sanguine and is in many cases downright pessimistic.

4.5. The International Dependence Revolution

During the 1970s, international-dependence models gained increasing support, especially among developing-country intellectuals, as a result of growing disenchantment with both the stages and structural-change models. While this theory to a large degree went out of favor during the 1980s and 1990s, versions of it have enjoyed a resurgence in the twenty-first century as some of its views have been adopted, albeit in modified form, by theorists and leaders of the anti globalization movement. Essentially, international-dependence models view developing countries as beset by institutional, political, and economic rigidities, both domestic and international, and caught up in a dependence and dominance relationship with rich countries.

Within this general approach are three major streams of thought: the neocolonial dependence model, the false-paradigm model, and the dualistic-development thesis.

4.5.1. The Neocolonial Dependence Model

The first major stream, which we call the neocolonial dependence model, is an indirect outgrowth of Marxist thinking. It attributes the existence and continuance of underdevelopment primarily to the historical evolution of a highly unequal international capitalist system of rich country–poor country relationships. Whether because rich nations are intentionally exploitative or unintentionally neglectful, the coexistence of rich and poor nations in an international system dominated by such unequal power relationships between the center (the developed countries) and the periphery (the developing countries) renders attempts by poor nations to be self-reliant and independent difficult and sometimes even impossible. Certain groups in the developing countries (including landlords, entrepreneurs, military rulers, merchants, salaried public officials, and trade union leaders) who enjoy high incomes, social status, and political power constitute a small elite ruling class whose principal interest, knowingly or not, is in the perpetuation of the international capitalist system of inequality and conformity in which they are rewarded. Directly and indirectly, they serve (are dominated by) and are rewarded by (are dependent on) international special interest power groups, including multinational corporations, national bilateral aid agencies, and multilateral assistance organizations like the World Bank or the International Monetary Fund (IMF), which are tied by allegiance or funding to the wealthy capitalist countries. The elites' activities and viewpoints often serve to inhibit any genuine reform efforts that might benefit the wider population and in some cases actually lead to even lower levels of living and to the perpetuation of underdevelopment. In short, the neo-Marxist, neocolonial view of underdevelopment attributes a large part of the developing world's continuing poverty to the existence and policies of the industrial capitalist countries of the northern hemisphere and their extensions in the form of small but powerful elite or comprador groups in the less developed countries. Underdevelopment is thus seen as an externally induced phenomenon, in contrast to the linear stages and structural-change theories' stress on internal constraints such as insufficient savings and investment or lack of education and skills. Revolutionary struggles or at least major restructuring of the world capitalist system is therefore required to free dependent developing nations from the direct and indirect economic control of their developed-world and domestic oppressors.

One of the most forceful statements of the international-dependence school of thought was made by Theotonio Dos Santos:

Underdevelopment, far from constituting a state of backwardness prior to capitalism, is rather a consequence and a particular form of capitalist development known as dependent capitalism. . . . Dependence is a conditioning situation in which the economies of one group of countries are conditioned by the development and expansion of others. A relationship of interdependence between two or more economies or between such economies and the world trading system becomes a dependent relationship when some countries can expand through self impulsion while others, being in a dependent position, can only expand as a reflection of the expansion of the dominant countries, which may have positive or negative effects on their immediate development. In either case, the basic situation of dependence causes these countries to be both backward and exploited. Dominant countries are endowed with technological, commercial, capital and sociopolitical predominance over dependent countries—the form of this predominance varying according to the particular historical moment—and can therefore exploit them, and extract part of the locally produced surplus. Dependence, then, is based upon an international division of labor which allows industrial development to take place in some countries while restricting it in others, whose growth is conditioned by and subjected to the power centers of the world.

A similar but obviously non-Marxist perspective was expounded by Pope John Paul II in his widely quoted 1988 encyclical letter (a formal, elaborate expression of papal teaching) *Sollicitudo rei socialis* (The Social Concerns of the Church), in which he declared:

One must denounce the existence of economic, financial, and social mechanisms which, although they are manipulated by people, often function almost automatically, thus accentuating the situation of wealth for some and poverty for the rest. These mechanisms, which are maneuvered directly or indirectly by the more developed countries, by their very functioning, favor the interests of the people manipulating them. But in the end they suffocate or condition the economies of the less developed countries.

4.5.2. The False-Paradigm Model

A second and less radical international-dependence approach to development, which we might call the false-paradigm model, attributes underdevelopment to These experts are said to offer complex but ultimately misleading models of development that often lead to inappropriate or incorrect policies. Because of institutional factors such as the central and remarkably resilient role of traditional social structures (tribe, caste, class, etc.), the highly unequal ownership of land and other property rights, the disproportionate control by local elites over domestic and international financial assets, and the very unequal access to credit, these policies, based as they often are on mainstream, neoclassical (or perhaps Lewis-type surplus-labor or Chenery-type structural-change) models, in many cases merely serve the vested interests of existing power groups, both domestic and international.

In addition, according to this argument, leading university intellectuals, trade unionists, high-level government economists, and other civil servants all get their training in developed-country institutions where they are unwittingly served an unhealthy dose of alien concepts and elegant but inapplicable theoretical models. Having little or no really useful knowledge to enable them to come to grips in an effective way with real development problems, they often tend to become unknowing or reluctant apologists for the existing system of elitist policies and institutional structures. In university economics courses, for example, this typically entails the perpetuation of the teaching of many “irrelevant” Western concepts and models, while in government policy discussions, too much emphasis is placed on attempts to measure capital-output ratios, increase savings and investment ratios, privatize and deregulate the economy, or maximize GDP growth rates. As a result, proponents argue that desirable institutional and structural reforms, many of which we have discussed, are neglected or given only cursory attention.

4.5.3. The Dualistic-Development Thesis

Implicit in structural-change theories and explicit in international-dependence theories is the notion of a world of dual societies, of rich nations and poor nations and, in the developing countries, pockets of wealth within broad areas of poverty. Dualism is a concept widely discussed in development economics. It represents the existence and persistence of substantial and even increasing divergences between rich and poor nations and rich and poor peoples on various levels. Specifically, although research continues, the traditional concept of dualism embraces four key arguments:

1. Different sets of conditions, of which some are “superior” and others “inferior,” can coexist in a given space. Examples of this element of dualism include Lewis’s notion of the coexistence of modern and traditional methods of production in urban and rural sectors; the coexistence of wealthy, highly educated elites with masses of illiterate poor people; and the dependence notion of the coexistence of powerful and wealthy industrialized nations with weak, impoverished peasant societies in the international economy.
2. This coexistence is chronic and not merely transitional. It is not due to a temporary phenomenon, in which case time could eliminate the discrepancy between superior and inferior elements. In other words, the international coexistence of wealth and poverty is not simply a historical phenomenon that will be rectified in time. Although both the stages-of-growth theory and the structural-change models implicitly make such an assumption, to proponents of the dualistic development thesis, the facts of growing international inequalities seem to refute it.
3. Not only do the degrees of superiority or inferiority fail to show any signs of diminishing, but they even have an inherent tendency to increase. For example, the productivity gap between workers in developed countries and their counterparts in most developing countries seems to widen with each passing year.
4. The interrelations between the superior and inferior elements are such that the existence of the superior elements does little or nothing to pull up the inferior element, let alone “trickle down” to it. In fact, it may actually serve to push it down—to “develop its underdevelopment.”

4.5.4. Conclusions and Implications

Whatever their ideological differences, the advocates of the neocolonial dependence, false-paradigm, and dualism models reject the exclusive emphasis on traditional neoclassical economic theories designed to accelerate the growth of GDP as the principal index of development. They question the validity of Lewis-type two-sector models of modernization and industrialization in light of their questionable assumptions and recent developing-world history. They further reject the claims made by Chenery and others that there are well-defined empirical patterns of development that should be pursued by most poor countries. Instead, dependence, false-paradigm, and dualism theorists place more emphasis on international power imbalances

and on needed fundamental economic, political, and institutional reforms, both domestic and worldwide. In extreme cases, they call for the outright expropriation of privately owned assets in the expectation that public asset ownership and control will be a more effective means to help eradicate absolute poverty, provide expanded employment opportunities, lessen income inequalities, and raise the levels of living (including health, education, and cultural enrichment) of the masses. Although a few radical neo-Marxists would even go so far as to say that economic growth and structural change do not matter, the majority of thoughtful observers recognize that the most effective way to deal with these diverse social problems is to accelerate the pace of economic growth through domestic and international reforms accompanied by a judicious mixture of both public and private economic activity.

Dependence theories have two major weaknesses. First, although they offer an appealing explanation of why many poor countries remain underdeveloped, they give no insight into how countries initiate and sustain development. Second and perhaps more important, the actual economic experience of developing countries that have pursued revolutionary campaigns of industrial nationalization and state-run production has been mostly negative. If we are to take dependence theory at face value, we would conclude that the best course for developing countries is to become entangled as little as possible with the developed countries and instead pursue a policy of autarky, or inwardly directed development, or at most trade only with other developing countries. But large countries that embarked on autarkic policies, such as China and, to a significant extent, India, experienced stagnant growth and ultimately decided to open their economies, China beginning this process after 1978 and India after 1990. At the opposite extreme, economies such as Taiwan and South Korea, and China more recently that have most emphasized exports to developed countries have grown strongly.

4.6. The Neo Classical Counter Revolution: Market Fundamentalism

4.6.1. Introduction

In the 1980s, the political ascendancy of conservative governments in the United States, Canada, Britain, and West Germany came with a neoclassical counterrevolution in economic theory and policy. In developed nations, this counterrevolution favored supply-side macroeconomic policies, rational expectations theories, and the privatization of public corporations. In developing countries, it called for freer markets and the dismantling of public ownership, statist

planning, and government regulation of economic activities. Neoclassicists obtained controlling votes on the boards of the world's two most powerful international financial agencies—the World Bank and the International Monetary Fund.

The central argument of the neoclassical counterrevolution is that underdevelopment results from poor resource allocation due to incorrect pricing policies and too much state intervention by overly active developing-nation governments. Rather, the leading writers of the counterrevolution school, including Lord Peter Bauer, Deepak Lal, Ian Little, Harry Johnson, Bela Balassa, Jagdish Bhagwati, and Anne Krueger, argued that it is this very state intervention in economic activity that slows the pace of economic growth. The neoliberals argue that by permitting competitive free markets to flourish, privatizing state-owned enterprises, promoting free trade and export expansion, welcoming investors from developed countries, and eliminating the plethora of government regulations and price distortions in factor, product, and financial markets, both economic efficiency and economic growth will be stimulated. Contrary to the claims of the dependence theorists, the neoclassical counterrevolutionaries argue that the developing world is underdeveloped not because of the predatory activities of the developed world and the international agencies that it controls but rather because of the heavy hand of the state and the corruption, inefficiency, and lack of economic incentives that permeate the economies of developing nations. What is needed, therefore, is not a reform of the international economic system, a restructuring of dualistic developing economies, an increase in foreign aid, attempts to control population growth, or a more effective development planning system. Rather, it is simply a matter of promoting free markets and laissez-faire economics within the context of permissive governments that allow the “magic of the marketplace” and the “invisible hand” of market prices to guide resource allocation and stimulate economic development. They point both to the success of economies like South Korea, Taiwan, and Singapore as “free market” examples (although, as we shall see later, these Asian Tigers are far from the laissez-faire neoconservative prototype) and to the failures of the public-interventionist economies of Africa and Latin America.

The neoclassical counterrevolution can be divided into three component approaches: the free-market approach, the public-choice (or “new political economy”) approach, and the “market-friendly” approach.

4.6.2. Free Market Approach

Free-market analysis argues that markets alone are efficient—product markets provide the best signals for investments in new activities; labor markets respond to these new industries in appropriate ways; producers know best what to produce and how to produce it efficiently; and product and factor prices reflect accurate scarcity values of goods and resources now and in the future. Competition is effective, if not perfect; technology is freely available and nearly costless to absorb; information is also perfect and nearly costless to obtain. Under these circumstances, any government intervention in the economy is by definition distortionary and counterproductive. Free-market development economists have tended to assume that developing-world markets are efficient and that whatever imperfections exist are of little consequence.

4.6.3. Public Choice theory/ New Political Economy Approach

Public-choice theory, also known as the new political economy approach, goes even further to argue that governments can do (virtually) nothing right. This is because public-choice theory assumes that politicians, bureaucrats, citizens, and states act solely from a self-interested perspective, using their power and the authority of government for their own selfish ends. Citizens use political influence to obtain special benefits (called “rents”) from government policies (e.g., import licenses or rationed foreign exchange) that restrict access to important resources. Politicians use government resources to consolidate and maintain positions of power and authority. Bureaucrats and public officials use their positions to extract bribes from rent-seeking citizens and to operate protected businesses on the side. Finally, states use their power to confiscate private property from individuals. The net result is not only a misallocation of resources but also a general reduction in individual freedoms. The conclusion, therefore, is that minimal government is the best government.

4.6.4. Market Friendly Approach

The market-friendly approach is a variant on the neoclassical counterrevolution associated principally with the 1990s writings of the World Bank and its economists, many of whom were more in the free-market and public-choice camps during the 1980s. This approach recognizes that there are many imperfections in developing-country product and factor markets and that governments do have a key role to play in facilitating the operation of markets through “nonselective” (market-friendly) interventions—for example, by investing in physical and social infrastructure, health care facilities, and educational institutions and by providing a suitable

climate for private enterprise. The market-friendly approach also differs from the free-market and public-choice schools of thought by accepting the notion that market failures are more widespread in developing countries in areas such as investment coordination and environmental outcomes. Moreover, phenomena such as missing and incomplete information, externalities in skill creation and learning, and economies of scale in production are also endemic to markets in developing countries.

Chapter Five

5. Developing Countries

5.1. Introduction

There are ten important features that developing countries tend to have in common, on average, in comparison with the developed world. However, these averages are very substantial differences in all of these dimensions among developing countries that are important to appreciate and take into account in development policy. These areas are the following:

1. Lower levels of living and productivity
2. Lower levels of human capital
3. Higher levels of inequality and absolute poverty
4. Higher population growth rates
5. Greater social fractionalization
6. Larger rural populations but rapid rural-to-urban migration
7. Lower levels of industrialization
8. Adverse geography
9. Underdeveloped financial and other markets
10. Lingering colonial impacts such as poor institutions and often external dependence.

The mix and severity of these challenges largely set the development constraints and policy priorities of a developing nation.

Defining Developing Countries

The most common way to define the developing world is by per capita income. Several international agencies, including the Organization for Economic Cooperation and Development (OECD) and the United Nations, offer classifications of countries by their economic status, but the best-known system is that of the International Bank for Reconstruction and Development (IBRD), more commonly known as the **World Bank**. In the World Bank's classification system, 210 economies with a population of at least 30,000 are ranked by their levels of gross national income (GNI) per capita. These economies are then classified as **low-income countries (LICs)**, lower middle-income countries (LMCs), upper-middle-income countries (UMCs), high income OECD countries, and other high-income countries. (Often, LMCs and UMCs are informally grouped as the **middle-income countries**.)

With a number of important exceptions, the developing countries are those with low-, lower-middle, or upper-middle incomes. The most common cutoff points for these categories are those used by the World Bank: Low-income countries are defined as having a per capita gross national income in 2008 of \$975 or less; lower-middle income countries have incomes between \$976 and \$3,855; upper-middle-income countries have incomes between \$3,856 and \$11,906; and high-income countries have incomes of \$11,907 or more.

Note that a number of the countries grouped as "other high-income economies" in are sometimes classified as developing countries, such as when this is the official position of their governments. Moreover, high-income countries that have one or two highly developed export sectors but in which significant parts of the population remain relatively uneducated or in poor health for the country's income level may be viewed as still developing. Examples may include oil exporters such as Saudi Arabia and the United Arab Emirates. Upper-income economies also include some tourism-dependent islands with lingering development problems. Even a few of the high-income OECD member countries, notably Portugal and Greece, have been viewed as developing countries at least until recently. Nevertheless, the characterization of the developing world as sub-Saharan Africa, North Africa and the Middle East, Asia except for Japan and, more recently South Korea, and perhaps two or three other high-income economies, Latin America and the Caribbean, and the "transition" countries of eastern Europe and Central Asia including the

former Soviet Union, remains a useful generalization. In contrast, the developed world constituting the core of the high-income OECD is comprised of the countries of western Europe, North America, Japan, Australia, and New Zealand.

Sometimes a special distinction is made among upper-middle-income or newly high-income economies, designating some that have achieved relatively advanced manufacturing sectors as **newly industrializing countries (NICs)**. Yet another way to classify the nations of the developing world is through their degree of international indebtedness; the World Bank has classified countries as severely indebted, moderately indebted, and less indebted. The United Nations Development Program (UNDP) classifies countries according to their level of human development, including health and education attainments as low, medium, high, and very high.

Another widely used classification is that of the **least developed countries**, a United Nations designation that as of 2010 included 49 countries, 33 of them in Africa, 15 in Asia, plus Haiti. For inclusion, a country has to meet each of three criteria: low income, low human capital, and high economic vulnerability. Other special UN classifications include landlocked developing countries (of which there are 30, half of them in Africa) and small island developing states (of which there are 38). Finally, the term *emerging markets* was introduced at the International Finance Corporation to suggest progress (avoiding the then-standard phrase *Third World* that investors seemed to associate with stagnation). While the term is appealing, we do not use it in this text for three reasons. First, “emerging market” is widely used in the financial press to suggest the presence of active stock and bond markets; although financial deepening is important, it is only one aspect of economic development. Second, referring to nations as “markets” may lead to an under emphasis on some non-market priorities in development. Third, usage varies and there is no established or generally accepted designation of which markets should be labeled emerging and which as yet to emerge.

The simple division of the world into developed and developing countries is sometimes useful for analytical purposes. Many development models apply across a wide range of developing country income levels. However, the wide income range of the latter serves as an early warning for us not to over generalize. Indeed, the economic differences between low-income countries in sub Saharan Africa and South Asia and upper-middle-income countries in East Asia and Latin America can be even more profound than those between high income OECD and upper-middle-income developing countries.

Chapter Six

6. Development Policy Planning

6.1. Question of Balance

National governments have played an important role in the successful development experiences of the countries in East Asia. In other parts of the world, including some countries in Africa, Latin America, the Caribbean, and the transition countries, government often appears to have been more of a hindrance than a help, stifling the market rather than facilitating its role in growth and development. This chapter examines the balance of and relationships between states and markets in the process of economic development.

Achieving the proper balance between private markets and public policy is a challenge. In early years of development following World War II and decolonization, a perception of the state as a benevolent supporter of development held sway, at least implicitly, but the record of corruption, poor governance, and state capture by vested interests in so many developing countries has made this view untenable. More recently, a negative view of government has predominated, but it too has been based more on theory than fact and has failed to explain the important and constructive role that the state has played in many successful development experiences, particularly in East Asia. Now a middle ground has emerged, recognizing both the strengths and the weaknesses of the public and private roles, providing a more empirically grounded analysis of what goes wrong

with governance in development and the conditions under which these flaws can be rectified, and incorporating an appreciation of the role of civil society. More subtle shadings between the sectors are also coming to be more appreciated. Not only do the private and public sectors work together constructively surprisingly often, but the lines between the sectors are not always sharp. Indeed, as pointed out by Elinor Ostrom, 2009 Nobel laureate in economics, we must appreciate that some phenomena “do not fit in a dichotomous world of ‘the market’ and ‘the state.’”

Development Planning Concept and Rational

6.2. The Planning Mystique

In the initial decades after the Second World War and decolonization, the pursuit of economic development was reflected in the almost universal acceptance of development planning as the surest and most direct route to economic progress. Until the 1980s, few people in the developing world would have questioned the advisability or desirability of formulating and implementing a national development plan. Planning had become a way of life in government ministries, and every five years or so, the latest development plan was paraded out with great fanfare.

National planning was widely believed to offer the essential and perhaps the only institutional and organizational mechanism for overcoming the major obstacles to development and for ensuring a sustained high rate of economic growth. To catch up with their former rulers, poor nations were persuaded that they required a comprehensive national plan. The planning record, unfortunately, did not live up to its advance billing. But a comprehensive development policy framework can play an important role in accelerating growth, reducing poverty, and reaching human development goals.

6.3. The Nature of Development Planning

Economic planning may be described as a deliberate governmental attempt to coordinate economic decision making over the long run and to influence, direct, and in some cases even control the level and growth of a nation’s principal economic variables (income, consumption, employment, investment, saving, exports, imports, etc.) to achieve a predetermined set of development objectives. An **economic plan** is simply a specific set of quantitative economic targets to be reached in a given period of time, with a stated strategy for achieving those targets. Economic plans may be comprehensive or partial. A **comprehensive plan** sets its targets to

cover all major aspects of the national economy. A **partial plan** covers only a part of the national economy—industry, agriculture, the public sector, the foreign sector, and so forth. Finally, the **planning process** itself can be described as an exercise in which a government first chooses social objectives, then sets various targets, and finally organizes a framework for implementing, coordinating, and monitoring a development plan.

Proponents of economic planning for developing countries argued that the uncontrolled market economy can, and often does, subject these nations to economic dualism, unstable markets, low investment in key sectors, and low levels of employment. In particular, they claimed that the market economy is not geared to the principal operational task of poor countries: mobilizing limited resources in a way that will bring about the structural change necessary to stimulate a sustained and balanced growth of the entire economy. Planning came to be accepted, therefore, as an essential and pivotal means of guiding and accelerating economic growth in almost all developing countries.

6.4. Planning in Mixed Developing Economies

Most development plans have been formulated and carried out within the framework of the mixed economies of the developing world. These economies are characterized by the existence of an institutional setting in which some of the productive resources are privately owned and operated and some are controlled by the public sector. The actual proportionate division of public and private ownership and control varies from country to country, and neither the private nor the public sector can really be considered in isolation from the other. However, mixed economies are often distinguished by a substantial amount of government ownership and control. The private sector in developing countries typically comprises four traditional forms of private ownership and a more recent emerging one:

1. The subsistence sector, consisting of small-scale private farms and handicraft shops selling a part of their production to local markets
2. Small-scale individual or family-owned commercial business and service activities in the formal and informal urban sectors
3. Medium-size commercial enterprises in agriculture, industry, trade, and transport owned and operated by local entrepreneurs

4. Large jointly owned or completely foreign-owned manufacturing enterprises, mining companies, and plantations, catering primarily to foreign markets but sometimes with substantial local sales (the capital for such enterprises usually comes from abroad, and a good proportion of the profits tends to be transferred overseas)
5. A growing number of relatively large, domestic-based firms, primarily locally managed and largely locally owned, often listed on national stock markets in countries such as Brazil, Russia, India, and China but much more common in middle-income than low-income countries and rare in the least developed countries

In the context of such an institutional setting, we can identify two principal components of development planning in mixed economies:

1. The government's deliberate use of domestic saving and foreign finance to carry out public investment projects and to mobilize and channel scarce resources into areas that can be expected to make the greatest contribution toward the realization of long-term economic objectives (e.g., the construction of railways, schools, hydroelectric projects, and other components of **economic infrastructure**, as well as the creation of import-substituting industries or projected future export sectors)
2. Governmental economic policy (e.g., taxation, industrial licensing, the setting of tariffs, and the manipulation of quotas, wages, interest rates, and prices) to stimulate, direct, and in some cases even control private economic activity so as to ensure a harmonious relationship between the desires of private business operators and the social objectives of the central government

Thus even when development planning is quite active, there is almost always a balance between the extremes of market inducement and central control, as is readily evident from our simplified characterization of planning in mixed market economies.

6.5. The Rationale for Development Planning

The early widespread acceptance of planning as a development tool rested on a number of fundamental economic and institutional arguments. Of these we can single out four as the most often put forward.

Market Failure Markets in developing economies are permeated by imperfections of structure and operation. Commodity and factor markets are often badly organized, and the existence of

distorted prices often means that producers and consumers are responding to economic signals and incentives that are a poor reflection of the real cost to society of these goods, services, and resources. It is therefore argued that governments have an important role to play in integrating markets and modifying prices. Moreover, the failure of the market to price factors of production correctly is further assumed to lead to gross disparities between social and private valuations of alternative investment projects. In the absence of governmental interference, therefore, the market is said to lead to a misallocation of present and future resources or, at least, to an allocation that may not be in the best long-run social interests. This **market failure** argument is perhaps the most often quoted reason for the expanded role of government in less developed countries.

Various kinds of market and government failures are examined in several of the earlier chapters, but a brief review is in order here. There are three general forms in which market failure can be observed: The market cannot function properly or no market exists; the market exists but implies an inefficient allocation of resources; the market produces undesirable results as measured by social objectives other than the allocation of resources. Market failures can occur in situations in which social costs or benefits differ from the private costs or benefits of firms or consumers; public goods, externalities, and market power are the best-known examples. With public goods, “free riders” who do not pay for the goods cannot be excluded except at high cost; it is economically inefficient to exclude nonpaying individuals from consuming these goods. With externalities, consumers or firms do not have to pay all the costs of their activities or are unable to receive all the benefits. Coordination failures occur when several agents would be better off if they could cooperate on actions if all or most agents participate but worse off taking the action if too few participate. Moreover, economic development is a process of structural change. The market may be efficient in allocating resources at the margin, allowing certain industries to emerge and others to fail, but may be ineffective in producing large discontinuous changes in the economic structure that may be crucial to the country’s long-term development. Market power occurs when firms can influence price by restricting quantity, a power most common under increasing returns to scale. Capital markets are particularly prone to failure due to their intrinsic connection to information generation and transmittal; information has public-good properties. A more equal distribution of income itself can be considered a public good when it is an agreed social objective. There may be concern for the well-being of future generations, who cannot

participate in today's economic or political markets. Merit goods, such as health, education, and basic welfare, can also be considered public goods or social entitlements guaranteed by government. But concerns about distribution and merit goods are often treated as separate rationales for policy because their levels are generally viewed as outside the realm of economic efficiency.

Unfortunately, we cannot jump to the conclusion that if economic theory says policy can fix market failures, it will do so in practice. Government failure may also occur in the many cases in which politicians, bureaucrats, and the individuals or groups who influence them give priority to their own private interests rather than the public interest. Analysis of incentives for government failure helps guide reforms such as constitution design and civil service rules. Developing countries tend to have both high market failure and government failure.

Resource Mobilization and Allocation This argument stresses that developing economies cannot afford to waste their very limited financial and skilled human resources on unproductive ventures. Investment projects must be chosen not solely on the basis of partial productivity analysis dictated by individual industrial capital-output ratios but also in the context of an overall development program that takes account of external economies, indirect repercussions, and long-term objectives. Skilled workers must be employed where their contribution will be most widely felt. Economic planning is assumed to help by recognizing the existence of particular constraints and by choosing and coordinating investment projects so as to channel these scarce factors into their most productive outlets. In contrast, it is argued, competitive markets will tend to generate less investment and to direct that investment into areas of low social priority (e.g., consumption goods for the rich).

Attitudinal or Psychological Impact It is often assumed that a detailed statement of national economic and social objectives in the form of a specific development plan can have an important attitudinal or psychological impact on a diverse and often fragmented population. It may succeed in rallying the people behind the government in a national campaign to eliminate poverty, ignorance, and disease or to boost national prowess. By mobilizing popular support and cutting across class, caste, racial, religious, or tribal factions with the plea to all citizens to work together toward building the nation, it is argued that an enlightened central government, through its economic plan, can best provide the needed incentives to overcome the inhibiting and often

divisive forces of sectionalism and traditionalism in a common quest for widespread material and social progress.

Foreign Aid The formulation of detailed development plans has often been a necessary condition for the receipt of bilateral and multilateral foreign aid. With a shopping list of projects, governments are better equipped to solicit foreign assistance and persuade donors that their money will be used as an essential ingredient in a well-conceived and internally consistent plan of action.