Economic Development Theories

PAD 6838/ 7865
Lecture 1
Economic Development Theories

- Evolution of Econ. Dev. Theories
  - Pre-classical (16th – late 18th century)
  - Classical Economics (~1776-1870s)
  - Neo-classical Economics (1870s-1930s)
  - Keynesian Economics (1930s-1970s)
  - Development Economics (1940s-1990s)
  - Neoliberalism (~1990s onwards)

- Timeline does not necessarily imply loss of significance of a particular theory
## Economic Development Theories

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<th>Perspectives</th>
<th>Meanings of development</th>
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Source: Pieterse (2010, p. 7)
## Economic Development Theories

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Source: Pieterse (2010, p. 10)
Economic Development Theories

Figure 1.1  What is ‘Development’?

Source: Sumner and Tribe (2008, p. 11)
Pre-Classical: Mercantilism

- **Context:** Feudal society, in the throes of Industrial Revolution (18th century onwards)
- **European origins,** achieving national power through economic growth
  - Colonization to gain control over resources
- **Based on trade** (*mercans* = trade in Latin)
  - Generally, trade monopolies (e.g. Dutch East India Co.) due to colonization [raw materials, cotton, opium, spices]
  - Trade based on shipping
  - Bullion (i.e. gold and silver) exchange
- **Economic prosperity** based on favorable balance of trade
  - Net exports [over imports]
  - Protectionism: Elite’s influence on protection of domestic economy through tariffs and other preferential laws (e.g. Corn laws protecting British landlords)
Classical economics-1

- Based on critique of Mercantilism
- General belief on economic development through free market (i.e. trade without barriers)
- Adam Smith’s *Wealth of Nations* (1776) marks the beginning
  - *Self-interest* as economic drive
  - Limited government intervention—free trade; self-regulating markets [contrast: mercantile protectionism]
  - Market prices limited by competition
  - *Invisible hand* of self-regulating markets transform self-interest into public virtue
  - *Division of labor* (i.e. specialization) enhances production [distinctively industrial orientation]
  - *Division of labor* limited by the extent of market
Malthus’s *Essay on Population* (1798)
- Human progress limited by human passion—population outgrows food production
  - While population increases in geometric progression (2, 4, 8, 16, ...), food increases in arithmetic progression (2, 4, 6, 8, 10, ...)

David Ricardo’s *Principles of Political Economy and Taxation* (1817)
- Economic development through Comparative Advantage: Countries gain when they trade products in which they have greatest comparative advantage
Neo-classical economics

- Beginning in 1871
  - William Stanley Jevons’s Theory of Political Economy;
  - Carl Menger’s Principles of Economics; Leon Walras’s Elements of Pure Economics
  - Alfred Marshall's Principles of Economics (1890)

- Free competitive markets as means of efficient allocation of resources

- Assumption: Rational and self-interested individuals maximizing their utility

- Significance of marginal utility
  - Marginal utility proportional to price (supply/demand)
  - Long run equilibrium

- Minimal state intervention
  - Laissez-faire
Keynesian Economics

- Critique of Classical economics; gained credence after the 1929 Depression

  - Markets not self-adjusting
  - Long-run equilibrium untenable [In the long run, we are all dead]
  - Economic uncertainty
  - Savings=investment matter for economic growth

- Macro-level behavior
  - Aggregate demand (country level) as driver of economic growth
  - Active fiscal policy to control markets (planned economies)
  - Economic growth can be accelerated by changing the saving rate
  - Government regulation of interest rates
Context: Post World War II, when most developing countries gained independence & in-country concerns dominate

Harrod Domar model (1946)
- Inspired by Keynesian economics
- GDP growth rate \( g \) [warranted rate of growth] depends directly on the national saving ratio \( s \) and inversely on the national capital/output ratio \( k \) (adjusted for depreciation \( d \)) \[ g = \frac{s}{k} - d \]
- Need for capital formation (i.e. investment) for economic growth
- National savings as a source for capital
- International aid as supplement (financing gap) for savings for economic growth
Trickle down economics
- No specific economist associated with this; yet, many governments have implicitly or explicitly subscribed to this
- Overall economic growth benefits the poor, since benefits will ultimately trickle down the economic ladder
- Tax benefits to businesses will benefit the poor since businesses will then expand, and absorb more labor (thus creating jobs)
- Critique: Overall economic growth does not imply that benefits are shared by all in the economy (there could be dualistic economy). Redistribution is not automatic
- Despite it being derided, it manages to survive in many circles.
- See the following for a good critique:

Dependency theory (Raul Prebisch)
- Contrary to classical and neo-classical position that trade is necessarily beneficial
- Countries in the center (Europe/ N America) gain over weaker peripheral countries in trade
- Benefits of industrial goods exchange are more than primary goods for exchange; while Center trades in the former, peripheral countries trade in the later.
- Import substitution policies to stimulate domestic industries
Rostow’s five stages of growth (1960)

- **Stage 1: Traditional society** (subsistence agriculture, barter economy, hierarchical structure, low social mobility)
- **Stage 2: Pre-conditioning** (agricultural modernization, transition to industrial economy; infrastructure growth; centralization)
- **Stage 3: Take off** (increase in industrialization, high investment, steady economic growth)
- **Stage 4: Drive to maturity** (economic and technical progress; diversification)
- **Stage 5: Maturity** (social prosperity; mass consumption, service sector dominance)
Development Economics - 4

- Basic needs approach (Paul Streeten, 1979)
  - Critique of macro level economic growth theories
  - Reduce mass deprivation; give everyone an opportunity to live a full life
  - Development is a function of meeting human being’s basic needs
  - Most country policies translated basic needs as food, shelter, and clothing

- Urban Bias (Michael Lipton, 1977)
  - Country bias in putting more investment in urban areas
  - Urban populations are more organized and politically powerful compared to rural people
  - Trade protectionist policies and low food prices adversely affect rural areas, since farmers do not benefit
  - Urban bias induces rural urban migration [better job opportunities, but also increased crowding and informal sector employment]
Neoliberalism

- **Context**: Reagan-Thatcherite era, fall of Berlin Wall, demise of socialist economies, globalization, ICT
- **Washington consensus (1980s)**
  - Economically influential bits of Washington (US government and the international financial institutions)
  - IMF & World Bank lending policies
    - Stabilization policies: pursue macroeconomic stability by controlling inflation and reducing fiscal deficits
    - Structural adjustment: open economies to the world through trade and currency liberalization; liberalize domestic economy through privatization and deregulation
  - Reduce government (New Public Management to emulate business practices); contractual relationships and outsourcing
- **New Institutional Economics (1990s)**
  - Policies, laws, rules, and regulations & their enforcement (i.e. institutions) hold incentives for productive activities
  - Effective legal system for securing property rights
  - Institutions could reduce or increase transaction costs
  - Organizational effectiveness according to their comparative advantage (public/ private/ non-profits)
Development Categories

- Categories:
  - Third World/ First World
  - Developing/ Less Developed (LDC) vs Developed
    - Also, Backward/ Underdeveloped Countries
  - World Bank measures [GNI per capita]
    - Low Income
    - Middle Income
      - Lower Middle
      - Upper Middle
    - High Income
  - Also: Heavily Indebted Poor Countries
### Box 1.3 Common Labels for Developing Countries and Critiques

- Developing countries: too counterfactual or optimistic a term for many countries
- Less developed countries: too patronizing a term – strongly suggesting inferiority
- Low income countries: too economically determinist
- The South: not geographically perfect but the term used by both the 1980 Brandt Commission and the 1990 South Commission
- Majority world: too general to say the countries account for 80% of the world’s population
- Post-colonial societies: too historically determinist – are countries that have had independence for, in some cases, several hundred years, still framed by that colonial experience?
- Non-OECD countries: those countries that are not members of the OECD, the body which essentially represents the economic interests of the industrialized countries

Source: Sumner and Tribe (2008, p. 17)
Millennium Development Goals

GOALS AND THEIR ACHIEVEMENT BY 2010

1. Eradicate extreme poverty and hunger
   - The global economic crisis has slowed progress, but the world is still on track to meet the poverty reduction target

2. Achieve universal primary education
   - Hope dims for universal education by 2015, even as many poor countries make tremendous strides

3. Promote gender equality and empower women
   - For girls in some regions, education remains elusive

4. Reduce child mortality
   - Child deaths are falling, but not quickly enough to reach the target

5. Improve maternal health
   - Reduce by three quarters, between 1990 and 2015, the maternal mortality ratio

6. Combat HIV/AIDS, malaria & other diseases
   - The spread of HIV appears to have stabilized in most regions, and more people are surviving longer

7. Ensure environmental sustainability
   - The rate of deforestation shows signs of decreasing, but is still alarmingly high

8. Develop a global partnership for development
   - Aid continues to rise despite the financial crisis, but Africa is short-changed