Classic Theories of Economic Growth and Development

Todaro & Smith, Ch. 3 of Economic Development, 11th Edition

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INTRODUCTION

EVERY NATION

STRIVES FOR DEVELOPMENT

But economic progress is not the only component

DEVELOPMENT > material & financial

Widespread realization = national context + international economic + social system

FOUR APPROACHES

Post World War II

1. Linear stages of growth
2. Theories and patterns of structural change
3. International-dependence revolution
4. Neo-classical, free market counterrevolution

POST WORLD WAR II

Context:

- Struggle to rebuild
- Postwar economic boom
- ⬆ Demand for consumer goods
- Flowing foreign aid to countries like PH
- PH context: Bell Trade Act (no import duties for US products)

I. LINEAR STAGES THEORY

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DEVELOPMENT AS GROWTH

Post-war interest on poor nations

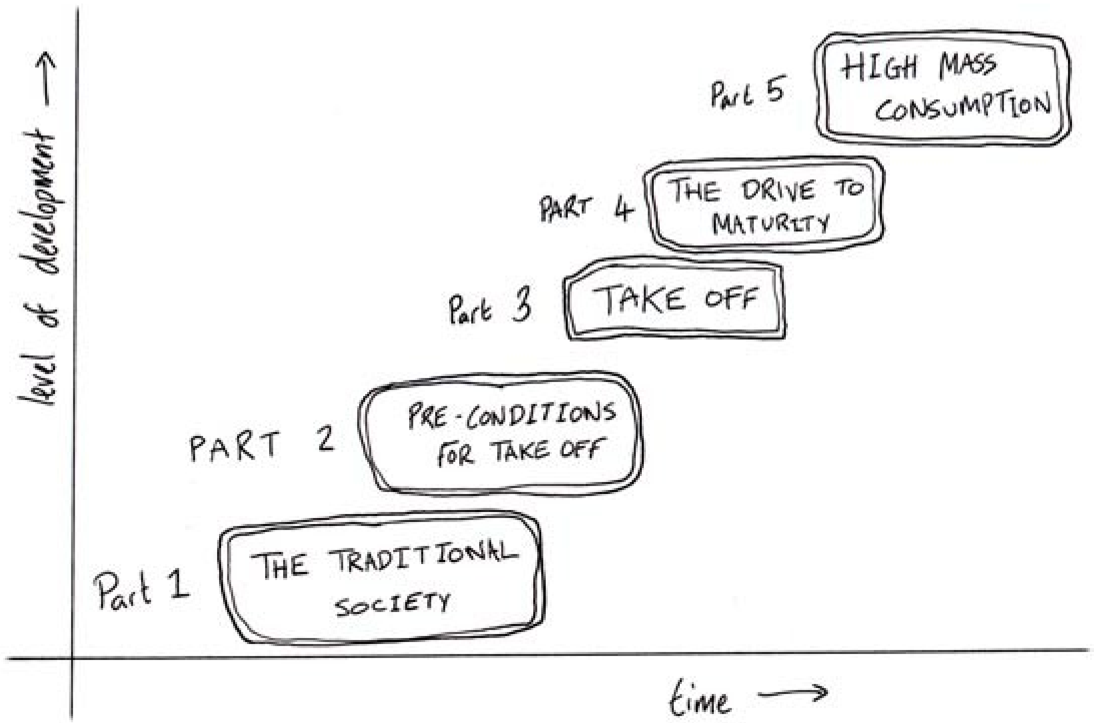
- Economists had no conceptual apparatus for largely agrarian countries w/o modern economic structures

Strands of thought

- Marshall Plan: US financial and technical assistance to war-torn European countries
- All modern industrial nations were once underdeveloped agrarian societies

I. LINEAR STAGES THEORY

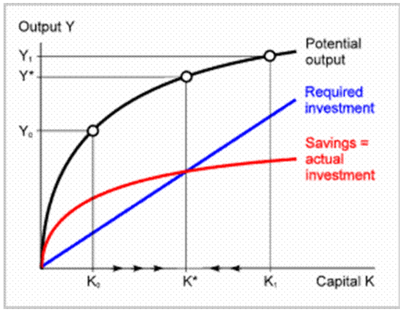
Rostow's Stages of Growth



* Developed countries already passed all stages. Underdeveloped in traditional and preconditions stage should just follow rules of dev't to self-sustaining economy

I. LINEAR STAGES THEORY

The Harrod-Domar Growth Model



- 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.

*** To grow, economies must save and invest**

*** Other components: labor force growth & technological progress**

- Sample: $$\frac{\Delta Y}{Y} = \frac{s}{c} = \frac{6\%}{3} = 2\% \qquad \frac{\Delta Y}{Y} = \frac{s}{c} = \frac{15\%}{3} = 5\%$$
- Countries able to save 15% to 20% would develop faster
- PROBLEM: relatively low level of new capital formation in most poor countries ANSWER: through either foreign aid or private foreign investment (justified Marshall plan for developing world)

I. LINEAR STAGES THEORY

PROBLEMS:

- Mechanisms of development embodied in the theory DOES NOT ALWAYS WORK
- WHY? More savings and investment are not sufficient
- Worked for Europe because of necessary structural, institutional, and attitudinal conditions

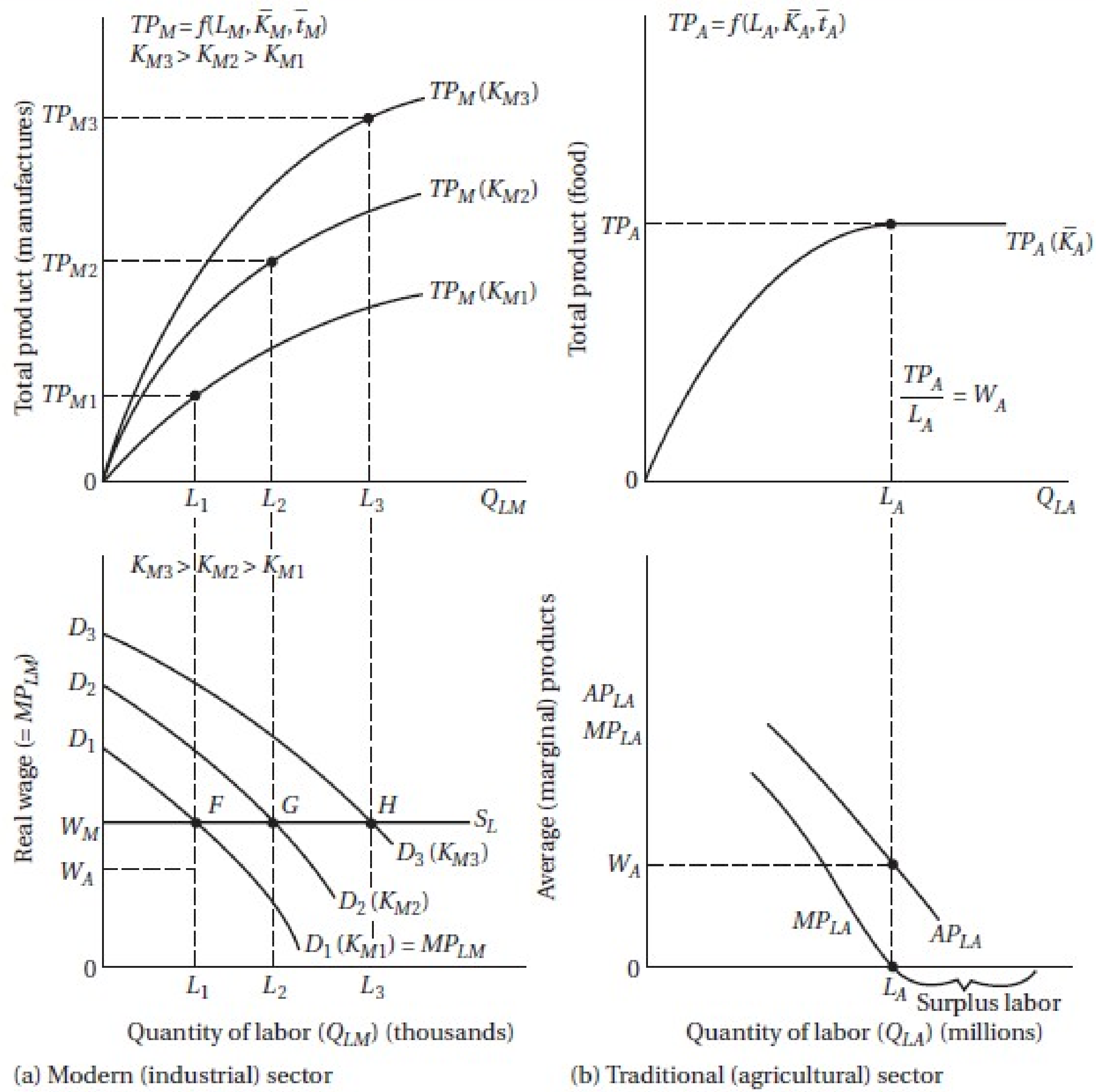
II. STRUCTURAL CHANGE MODELS

II. STRUCTURAL CHANGE

**2-SECTOR SURPLUS MODEL/
LEWIS THEORY OF DEVELOPMENT**

- Structural transformation of a subsistence economy
- Presence of 2 sectors: overpopulated rural sector w/ zero marginal labor productivity and a high-productivity industrial sector
- Transfer of labor from traditional to modern, growth of product output

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



II. STRUCTURAL CHANGE

LEWIS THEORY OF DEVELOPMENT

- Growth until surplus labor is absorbed by industrial sector
- **Lewis turning point:** declining labor-to-land ratio (marginal product of rural labor no longer 0) = labor supply curve positively sloped as modern-sector wage & employment grow

II. STRUCTURAL CHANGE

LEWIS THEORY OF DEVELOPMENT

CRITICISMS:

1. Assumes labor transfer & employment creation proportional to capital accumulation. But what if profits invested in labor-saving equipment?
2. Contemporary research show little surplus labor in rural areas (except in some countries like China)
3. Urban surplus labor
4. Wages increase amid unemployment

II. STRUCTURAL CHANGE

PATTERNS OF DEVELOPMENT ANALYSIS

- Economic, industrial and institutional structure of an economy transformed to permit new industries as engine of growth
- Capital accumulation + changes in economic structure needed
- **Constraints** (affect level of dev't): Internal - resources, population size, government policies; External – access to capital, technology, trade (countries as part of internatl system)
- Empirical work of Harvard economist **Holllis Chenery and his colleagues**, cross-sectional and time-series studies of countries at diff. levels of per capital income, identified characteristic features of the development process:

II. STRUCTURAL CHANGE

PATTERNS OF DEVELOPMENT ANALYSIS

- Shift from agri to industrial production
- Steady accumulation of physical and human capital
- Change in consumer demand from basic necessities to diverse manufactured goods
- Growth of cities and urban industries
- Decline in family size ad overall population

- Proponents of structural change model prefer “facts to speak for themselves” unlike theories such as stages of growth

II. STRUCTURAL CHANGE

CONCLUSIONS

- **Major hypothesis:** development is an identifiable process of growth and change with features similar in all countries.
- Problem: The model does not recognize differences, factors influencing development process.
- Limitations of emphasizing patterns over theory. May draw wrong conclusions about causality.
- Optimistic that “correct” mix of policies will generate beneficial patterns

III. INTERNATIONAL-DEPENDENCE REVOLUTION

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1970s – International-dependence models gained support because of disenchantment w/ stages and structural-change models

- **Resurgence in various forms in the 21st century**

Developing countries caught in a dependence and dominance relationship with rich countries because of institutional, political and economic rigidities = difficulty for poor nations to be self-reliant and independent

III. INTERNATIONAL-DEPENDENCE REVOLUTION

1. NEOCOLONIAL DEPENDENCE MODEL

- Indirect outgrowth of Marxist thinking
- Underdevelopment as result of historical evolution of highly unequal international capitalist system of rich country-poor country relationships
- Regardless if intentional, nations are under unequal power relations between the **center** and the **periphery**

III. INTERNATIONAL-DEPENDENCE REVOLUTION

1. NEOCOLONIAL DEPENDENCE MODEL

- Small elite ruling class (landlords, entreps, military rulers, merchants, public officials, etc.) interests (knowingly or not) to perpetuate the international capitalist system of inequality
- The elite serve or are rewarded by international special-interest power groups tied by allegiance or funding to wealthy capitalist countries
- Elites' viewpoints inhibit genuine reform efforts and may lead to even lower levels of living and perpetuation of underdvelopment
- External-induced against internal constraints

III. INTERNATIONAL-DEPENDENCE REVOLUTION

1. NEOCOLONIAL DEPENDENCE MODEL

- Revolutionary struggles or major restructuring of world capitalist system required to free dependent nations
- **Theotonio Dos Santos**: Dependence as conditioning situation ; Expand based on expansion of dominant countries; Dominant countries w/ technological, commercial, capital and sociopolitical predominance can exploit and extract local surplus; Dependence as based on the international division of labor – industrial development in some and restricted in others

III. INTERNATIONAL-DEPENDENCE REVOLUTION

1. NEOCOLONIAL DEPENDENCE MODEL

- **Pope John Paul II**: 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.

III. INTERNATIONAL-DEPENDENCE REVOLUTION

2. FALSE-PARADIGM MODEL

- less-radical
- **Underdevelopment as result of faulty and inappropriate advice by well-meaning, though uninformed or biased advisers from developed country agencies and orgs**
- Inappropriate policies merely serving vested interests of existing power groups (domestic and international)
- Intellectuals, economists, civil servants trained in alien and “irrelevant” Western concepts

III. INTERNATIONAL-DEPENDENCE REVOLUTION

3. DUALISTIC-DEVELOPMENT THESIS

Dualism – divergence between rich and poor nations, rich and poor peoples on various levels

III. INTERNATIONAL-DEPENDENCE REVOLUTION

4 KEY ARGUMENTS

- Different sets of conditions coexist: rich and poor, modern and traditional (Lewis model), elites and masses, powerful industrialized nations and impoverished peasant societies
- Chronic coexistence (not temporary) of wealth and poverty will not be rectified in time.
- Degrees of superiority or inferiority show no signs of diminishing and instead increases
- Superior element does little to pull up or “trickle down” to the inferior element, may even push it down

III. INTERNATIONAL-DEPENDENCE REVOLUTION

- IDR models, amid ideological differences, all reject the emphasis on traditional neoclassical economic theories
- Question validity of the Lewis-type models, reject Chenery observation of “well-defined empirical patterns” that should be followed by poor countries
- Emphasis on international power imbalances and need for economic, political and institutional reforms (internal & world)
- Expropriation of private assets w/ expectation that public asset ownership and control will help address poverty & unemployment

III. INTERNATIONAL-DEPENDENCE REVOLUTION

WEAKNESSES:

- Appealing explanation but no insight on how countries initiate and sustain development
- Actual economic experience of developing countries that pursued revolutionary campaigns of industrial nationalization and state-run production has been mostly negative

* Based on dependency theory, countries could pursue a policy of **autarky** or inwardly directed development & trade w/ other developing countries

IV. NEOCLASSICAL COUNTERREVOLUTION

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Neoclassical counterrrevolution

- Challenges statist models in favor of free markets, public choice & market-friendly approaches
- Developed nations: favored supply-side macroeconomic policies, rational expectations theories and privatization of public corporations
- Developing countries: freer markets and dismantling of public ownership, statist planning and government regulation

IV. NEOCLASSICAL COUNTERREVOLUTION

Context

- Emerged in the 1980s during political ascendancy of conservative governments of US, Canada, Britain and West Germany
- Neoclassicists on the board of powerful international agencies World Bank and International Monetary Fund as influence of International Labor Organization, United Nations Development Program and United Nations Conference on Trade and Development eroded

IV. NEOCLASSICAL COUNTERREVOLUTION

Argument

- Underdevelopment resulted from poor resource allocation because of incorrect pricing policies and state intervention (corruption, inefficiency, lack of incentives, etc.)
- State intervention slows economic growth
- Neoliberals: economic efficiency and growth will be stimulated by free markets, privatizing state enterprises, export expansion and eliminating government regulation and price distortions
- Allow “magic of the marketplace” and “invisible hand” to guide resource allocation and stimulate economic dev’t

IV. NEOCLASSICAL COUNTERREVOLUTION

3 component approaches

1. **Free-market approach** - markets alone are efficient; competition is effective, technology and information freely available and costless; gov't is counterproductive
2. **Public choice approach -** new political economy approach; governments do nothing right because of selfish interests; misallocation of resources
3. **Market-friendly approach –** imperfections in economy and need gov't for market-friendly interventions (social services and climate for private enterprise); acceptance of market failures

IV. NEOCLASSICAL COUNTERREVOLUTION

Traditional Neoclassical Growth Theory

Liberalization – opening up of markets, draw investment and increase rate of capital accumulation

Solow neoclassical growth model - economies to converge to same income level if same rates of savings, depreciation, labor force and productivity growth.

Source of output growth: labor quantity and quality, increase in capital and technology improvement

Openness – encourages access to foreign production ideas, technological progress

IV. NEOCLASSICAL COUNTERREVOLUTION

CONCLUSIONS

- Finger-pointing between dependence theorists (many from developing countries, seeing underdevelopment as externally induced phenomenon) and neoclassical revisionists (most from Western economies, blame gov't intervention and bad economic policies)
- Market price allocation may do a better job than state intervention but developing economies have very different structures:
    - Competitive free markets generally do not exist, information is limited, markets fragmented, etc.

IV. NEOCLASSICAL COUNTERREVOLUTION

CONCLUSIONS

- Invisible hand often lifts those already well-off, failing to offer opportunities for upward mobility of the majority
- Lessons from supply-and-demand analysis to arrive at "correct" prices
- "In an environment of widespread institutional rigidity and severe socioeconomic inequality, *both markets and governments* will typically fail."

RECONCILING DIFFERENCES

RECONCILING DIFFERENCES

- Each approach has strengths and weaknesses
- Controversies – ideological, theoretical or empirical – makes the study of economic development challenging
- Evolving patterns of insights and understandings
- CONSENSUS? Significance from each approach:
  - **Linear stages:** crucial role of savings and investment
  - **Two-sector model:** transfer of resources from low to high-productivity activities, linkages between traditional & modern
  - **Dependence theory:** importance of world economy and decisions of developed world affecting developing economies
  - **Neoclassical:** efficient production, proper price systems