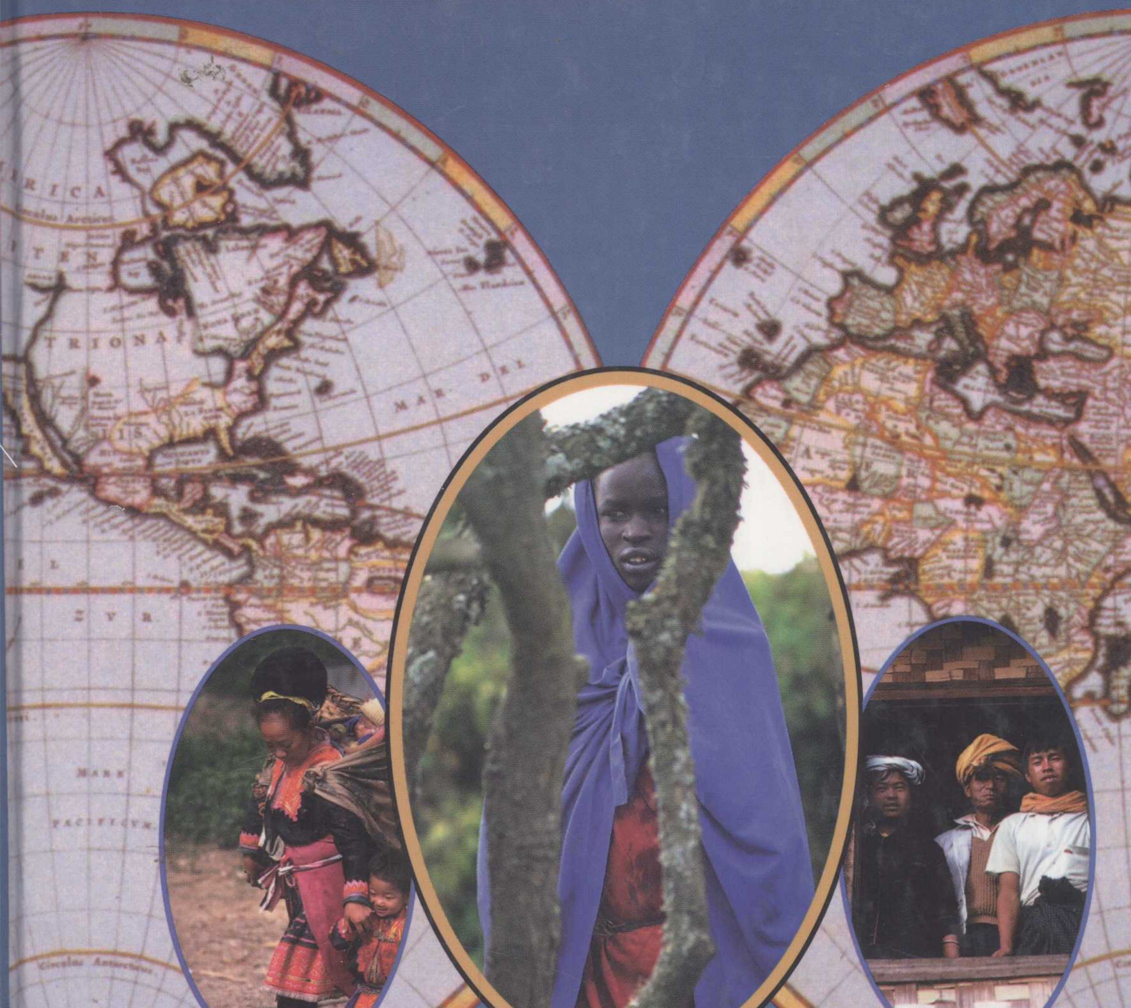
ECONOMIC DEVELOPMENT

THIRD EDITION



JAN S. HOGENDORN

Economic Development

THIRD EDITION

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Colby College

HarperCollins*CollegePublishers*

To Dianne

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Library of Congress Cataloging-in-Publication Data

Hogendorn, Jan S.
Economic development/Jan S. Hogendorn.—3rd ed.
p. cm.
Includes bibliographical references and index.
ISBN 0-673-99475-9
1. Economic development. I. Title.
HD75.H64 1995 95–22776
338.9—dc20 CIP

2 3 4 5 6 7 8 9 10-DOC-01 00 99 98 97

Preface

Everyone is aware of poverty, malnutrition, and other forms of human misery present in much of the world. The images caught on photos and films, especially of children, are compelling. Why does such misery occur? Is it inevitable? Can something be done to alleviate it or end it? Economic development is the field that deals with these momentous questions.

Our subject exhibits many contradictions. In recent years, some less developed countries (or LDCs) have been undergoing development at rates as rapid as the world has ever seen. At their current rates of growth, they will not be LDCs for much longer. In other countries, however, conditions have worsened seriously, with output having fallen by 20 percent or more over two or three decades, and with governments that have largely broken down. Some LDCs have recently chosen to let markets work and to avoid damaging government interventions in their economies, while others continue to employ counterproductive policies. A large increase in investment by the rich countries in the LDCs has taken place, but investors are fickle and a small minority of countries is receiving most of the money. High- and low-income countries have shown new willingness to reduce their trade barriers against one another, as seen in the Uruguay Round of trade negotiations. But concerns over competition for developed-country workers from low-wage labor in the LDCs promise to keep the issue of trade barriers alive. In many countries, health and education have improved, but high population growth threatens to undermine the gains. Especially where growth is most rapid, environmental concerns have surfaced, and some of these have global implications. Political instability in the LDCs seems more dangerous for world peace and prosperity than anything likely to arise in the developed countries. These questions are central to economic development.

The third edition of *Economic Development* addresses these issues while providing analysis of the basic theories of development. As in the past editions, a main distinguishing feature is the book's coverage of the international economic aspects of development. The discussion in Chapters 13 to 15 reflects my conviction that trade is now probably the single fastest path to development, but a path that could easily be closed off by the developed world. Developed-country trade barriers, often touched on only briefly in competing texts, receive a thorough treatment.

I have continued to try to produce a highly readable book, making the writing a literary effort as well as a pedagogical one. The material is intended to be understood by students who have taken only the first-year principles of an economics course. Although some boxed material is included for those economics majors who have taken intermediate theory, the body of the text does not require knowledge beyond an initial course. As in the past editions, the bibliographical referencing remains extensive, which should prove valuable to students and instructors alike. The endnotes at the conclusion of each chapter contain this referencing. By contrast the footnotes at the bottoms of the pages are intended to be read, and usually add human interest to the subject.

ORGANIZATION AND NEW FEATURES

The first chapter is an introduction to the field, emphasizing the disparate performance of the low-income countries and the need for the development of human capabilities as well as output growth. In this edition, the contrast between a human development approach and an approach emphasizing economic growth, and the importance of women in the development effort, have been expanded. Chapter 2 reflects my belief that the *measurement* of development (including national product and income, income distribution, and indicators of the "quality of life") should come early in the analysis. New in this chapter is an extended treatment of GDP corrected for purchasing power and the recent improvements to the UN's Human Development Index.

Chapter 3 is a survey of how countries develop. The initial lessons are drawn from the experiences of today's developed countries. The chapter then considers the very successful experience of the high-performing Asian economies—the earlier achievers, South Korea, Taiwan, Hong Kong, and Singapore, and three latecomers, Indonesia, Malaysia, and Thailand. The startling accomplishments of these countries are then contrasted to the equally startling deterioration in several countries elsewhere in an effort to identify general lessons. The chapter reflects the growing concern that development prospects can be devastated by "state failure" in the LDCs that do not allow market incentives to operate. In this edition, new emphasis is directed toward the problems of endemic corruption in many LDCs and the debate on the advantages of democracy over authoritarianism.

Chapters 4, 5, 6, and 7 are reorganized to cover the financing of economic development. Chapter 4 focuses on the role of capital investment in the LDCs and how domestic saving by households, businesses, and government promotes it. The account of the role of capital in development now reflects recent modifica-

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tions in the modeling of economic growth, and the treatment of financial repression and the effect of low or negative real rates of interest on growth has been revised. Chapter 5 is new, containing material on government macroeconomic policy that formerly was included in other chapters. It presents analysis, including diagramming, of the effect of budget deficits and money creation, together with much new information on the successes and failures of macro stabilization and reform. Chapter 6 covers inflows of private foreign capital. The recent substantial rise in portfolio investment receives thorough coverage, as does direct investment by multinationals and the present state of the debt crisis in bank lending that was so damaging to the LDCs in the 1980s. Chapter 7 concludes the treatment of development finance by examining the role of foreign aid and the international agencies including the World Bank and the International Monetary Fund. It judges the debate on the efficacy of all of these, and adds recent analysis of the conditionality attaching to the financial flows from these sources.

Chapter 8 is a conventional approach to factor proportions, technology, and dualism in industry. It includes many real-world examples of the LDCs' problems in these areas, and a rewritten section on developed-countries' technological property and the LDCs.

Chapter 9 on population has undergone a major revision. It utilizes recent data indicating that a fast population increase does indeed harm economic growth in the LDCs. The emphasis is on the reasons why population growth has been rapid in the LDCs, why it can be damaging, and the actions countries might take to reduce population pressures.

Chapter 10, on "human capital," considers the importance of education, health, and nutrition as factors in raising productivity and as "basic needs." A new beginning section links inadequate human capital to low wages in the LDCs. It is followed by an updated approach to education, health, and nutrition that addresses the accumulation of more and better human capital.

In Chapter 11, on rural development, the sections on the spread of the high-yield varieties of foodstuffs and the consequences of their adoption, on rural credit problems, and on agricultural extension services are updated. They remain more comprehensive than in texts of comparable scope. The length and depth of coverage in this chapter fully reflect my belief that stimulating the rural sector of developing countries should have high priority.

Chapter 12, on industrialization in the LDCs, is new. Previous editions focused on planning at this point, while this edition considers and compares government failure and market failure. Today, comprehensive planning is distinctly out of fashion for very good reasons. Thus the selling-off of state enterprises receives thorough treatment here. But project appraisal and the linkage of investments are still valuable ideas, so I try to provide a more comprehensible treatment of cost-benefit analysis and shadow pricing than other development texts can offer. Much of the labor for an expansion of the urban sector of the LDCs is coming from a huge rural-to-urban migration, a discussion of which now finds a home in this chapter. An appendix covers technical aspects of the capital–output ratio.

Chapters 13, 14, and 15 consider the international economic aspects of development. Topics examined in detail include autarky and import substitution versus export promotion, prospects for the terms of trade, depreciation of the exchange rate as a strategy, and customs unions. The important subject of developed-country trade barriers receives a thorough treatment. The Uruguay Round promises a helpful reduction in these barriers in coming years, but if unskilled and semiskilled jobs in the developed countries are lost to imports from the LDCs—or if the public perceives that to be the case—a new era of protectionist trade barriers could easily emerge.

Chapter 16 considers the consequences for the environment of economic development. The rather sudden realization that serious environmental problems may be caused by the long-run growth of heavily populated LDCs is a disturbing element in our subject, one that received little attention until recently. The chapter assesses the dangers to the world environment, discusses how trade barriers based on environmental concerns may become common, and calls for an international organization to assess and police these issues. The book concludes with Chapter 17, a resumé of the lessons learned in the preceding chapters.

I recommend that students using this text be encouraged to purchase the latest issue of the World Bank's *World Development Report*, available from Oxford University Press. This will provide convenient access to the latest available data. If additional readings are desired, Gerald M. Meier's *Leading Issues in Economic Development*, also from Oxford University Press and available in a 1995 edition, serves as an excellent supplement. I cite *Leading Issues* more often than any other single nonstatistical source, only fitting since Professor Meier taught economic development at Wesleyan University when I was an undergraduate there.

ACKNOWLEDGMENTS

Numerous reviewers helped with suggestions and comments. I did not always accept their advice, and they are thus not responsible for any remaining flaws. But I accepted it very often with many resulting improvements. At some point in the life of this book, the manuscript has been read or comments have been received from Eliezer B. Ayal of the University of Illinois, Chicago Circle; William J. Barber of Wesleyan University; Wilson Brown of the University of Winnipeg; Robert Christiansen at the World Bank; Kong Chu of the Georgia Institute of Technology; Eugene R. Dykema of Calvin College; Evangelos M. Falaris of the University of Delaware; Patrick J. Gormely of Kansas State University; Ann Helwege of Tufts University; Whitney Hicks of the University of Missouri; Olu Onafowora of Susquehanna University; Abdul Turay of Radford University; C. R. Winegarden of the University of Toledo; and Harish C. Gupta, William E. Kuhn, and Hendrik van den Berg at the University of Nebraska. Their collective advice led to many alterations and improvements in the finished product. Over the years, Peter Kilby at Wesleyan University has provided encouragement and helpful comments.

The student assistants at Colby College who worked on the third edition were Azeen Chamarbagwala and Susan Hale.

I have heard it said that being an author means wearing a bathrobe late into the morning, asking for many cups of tea, and calling out frequently for synonyms and hyphenation rules. My wife knows how all-too-true this is. Thanks for bearing with me.

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ABOUT THE AUTHOR

Jan S. Hogendorn is the Grossman Professor of Economics at Colby College. A graduate of Wesleyan University, he received his doctorate from the London School of Economics. He has been a visiting scholar at Oxford University and the University of Birmingham in England, Ahmadu Bello University in Nigeria, and Robert College (Bosporus University) in Turkey. His work has been supported by fellowships from the Danforth Foundation, the Guggenheim Foundation, the Mellon Foundation, and the Institute for European Studies, and he has been a Fulbright Scholar in England and Nigeria. Books by Professor Hogendorn have been published by Cambridge University Press, Oxford University Press, Academic Press, Addison-Wesley, and Prentice-Hall, as well as HarperCollins.

Contents

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Chapter 1

Studying Economic Development

Economic development is the study of how human economic circumstances change over time and how they can be made to change. Development has a special immediacy because it grapples with human misery, poverty and disease, as well as the attempts to correct them. The closeness to these problems and the awareness that much will be gained by their elimination brings enormous human interest to the subject. Likewise, a first visit to a low-income country brings quick understanding why such a country may view its struggle to develop as a war, or even a great crusade. The topic holds center stage as the world comes to recognize that poverty is becoming an increasing threat to well-being everywhere.

Economic development is a grand subject that spans continents and disciplines; the sheer scale and scope of its coverage make it the broadest subset of economics.[1] In a sense it is also the oldest branch of the discipline, for obviously all of the early economists were dealing with development topics, many of them similar to what development economists deal with today.[2]

The study of economic development can be distilled into an elementary insight. It is the study of choice made necessary because resources—land, labor, physical and human capital, technology, and entrepreneurial ability—are scarce. Consider the production possibilities curve (PPC) of first-year economics courses. In Figure 1.1, curve 1 shows the combinations of food on the vertical axis and machinery on the horizontal that can be produced with a given resource endowment. The curve shows the trade-off between food and machinery production: greater quantities of food require a sacrifice of machinery; and more machinery means less food.

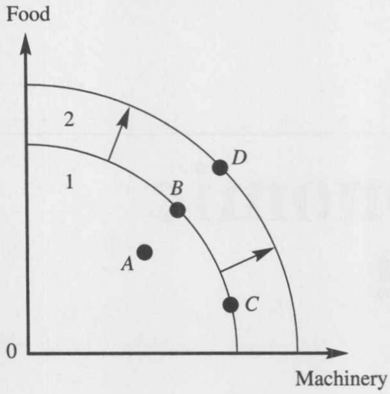

Figure 1.1 Development and the PPC. Economic development can be seen as a search for productive efficiency (attainment of a position on the PPC rather than inside it); allocative efficiency (a position on the PPC that provides an adequate balance in what is produced); and growth in the factors of production that leads to an outward movement of the PPC.

The basic concerns of economic development can be illustrated by means of a PPC diagram. These concerns are (1) The achievement of production efficiency, that is, utilizing available resources fully and at maximum efficiency so that the point of production is on the PPC, as at *B*, rather than below it, as at *A*. (2) Achievement of allocative efficiency, that is, ensuring that economic choices do not result in unwarranted over-emphasis on some forms of production and under-emphasis on others (for example, too much machinery and not enough food, as at *C*, where people go hungry not because production capacity is inadequate but because an inefficient production decision has been made. (3) Growth in the quantity and quality of productive resources, so that the PPC moves outward from curve 1 to curve 2, allowing actual production to rise, say to point *D*.

The first two considerations—productive and allocative efficiency—involve the study of economic pathologies that are potentially correctable, and we shall see that insights from the study of diseased economies can be penetrating.[3] Correction of these inefficiencies can often be accomplished rather rapidly if and when government policies are changed; they are mainly short-run problems. The third consideration, growth in the quantity and quality of resources, is a continuing process that takes a long time. It involves major questions such as what government policies can help to move the PPC outward and whether policies that succeed in some countries are transferable to others.

WHAT IS DIFFERENT ABOUT DEVELOPMENT ECONOMICS?

Much of the subject matter covered is familiar to every economist. Completely new tools for analysis have not usually been necessary, and the standard ones are drawn from every branch of the discipline. Though there used to be a school of thought that totally new models were needed to explain development adequately, today most of the standard conclusions of micro and macroeconomics are quite generally accepted even by many former skeptics.*

Yet some of the major approaches of development economics will seem unusual to a student brought up in the neoclassical tradition of supply and demand and equilibrium. These different approaches attempt to deal with a number of situations quite unlike those of conventional economics. The emphasis on sectoral and systemic transformation is probably the most important of these. Among the important examples of ongoing transformation are the shift in production from agricultural commodities and minerals ("primary products") to industrial output; the movement from small-scale to large-scale production and marketing; the effects of rapid population growth and the migration of enormous numbers of people from rural areas to cities; and the emergence of modern ways from old traditional socioeconomic patterns. Increasing modernity is seen when male dominion and low status of women are replaced by more equality between the genders, when extended families with relatives living together are succeeded by smaller nuclear families, or where closed and self-sufficient peasant villages are replaced by communities engaged in regional and international trade.

Usually these shifts are slow and, at any given moment, incomplete. Hence low-income economies often exhibit pervasive and persistent dualisms that, contrary to the neoclassical theories of markets and movements toward equilibrium, may not be rapidly self-correcting. Urban dualism is the existence of an informal, small-scale, labor-intensive, low-wage sector of highly competitive family and individual enterprises alongside a modern, capital-intensive, high-wage industrial sector. The modern sector may employ world-class technology, radically different from that in the informal sector, and often includes huge multinational firms as well as the large government firms (known as state operated enterprises, or SOEs) that frequently do not follow the conventional rules of profit maximization.

Rural dualism takes the form of small family farms, sometimes heavily engaged in the subsistence production of food and other products for the family's own use, alongside large plantations, state farms, and mining enterprises that use very different ratios of labor to capital and pay much higher wages. Markets can be highly fragmented with limited information and very high transactions costs. Sharecropping—where tenants share their income with landowners—may be prevalent, and frequently the major portion of credit to farmers is provided by these landowners. This low-wage agricultural sector, where production for subsistence is important, holds huge numbers of people, with inadequate opportunities for employing them elsewhere. Many migrate to the cities despite the strong possibility that they will end up employed only in the low-wage, informal sector.[4]

*A note for the already-knowledgeable: The flow of models has not been just one way. Some of the discoveries of development economics that have informed the work of other areas of the discipline include efficiency wages and pecuniary externalities, cost-benefit analysis, hysteresis, principal-agent models, and the crowding-in effect of public investment. See Bardhan, "Economics of Development and the Development of Economics," 129–142; and Alain de Janvry, Elisabeth Sadoulet, and Erik Thorbecke, "Introduction," *World Development* 21, no. 4 (April 1993): 565–575.

Often the dualism is compounded by a public policy of urban bias, with favoritism demonstrated toward the cities.

Another major difference in the economics of development concerns the role of government. Whereas the economies of the developed countries generally benefit from excellent if not perfect information about markets and low transactions costs in marketing, economic development must deal with situations where the information in markets is inadequate and transactions costs are high. Arguably, these economies are also less flexible, with economic change more difficult to bring about. Reasons for such inflexibility include institutions that do not work well, blockages, bottlenecks, rigidities, and lags that contribute to inelasticities in the supply of essential inputs, and imperfect markets. Enterprise may be deficient; responses slow or perverse. Lack of knowledge, inferior transport, poor communication, and an absence of a complete set of markets to ensure against risks of all kinds may hinder the path to equilibrium charted by supply and demand curves. One symptom of slow response by suppliers (that is, low elasticities of supply) might be that inflation is quick to occur and hard to control. Under such conditions, market pricing may work less efficiently.

To overcome these difficulties, it has long been understood that government has an important role. Indeed, at the dawn of development economics, governments were typically too small to carry out effective remedial policies. Later, many governments grew large, often too large, and many of their policies became counterproductive. Numerous prices were kept unchanged by government decisions. Included were foreign exchange rates, interest rates, prices charged by state enterprises, and prices paid for agricultural products. Some governments even tried to emulate the economic planning of the Soviet Union. These activities distorted the information carried by the price system and especially distorted the flow of investment. In many countries, they continue to do so.

Substantial evidence supports the view that a major reason countries are poor is because their policies are poor.[5] Their management inefficiencies in the public sector, often combined with political instability, are severe handicaps. The absence of sufficient administrative competence and organizational ability in government may actually be the greatest existing block to development. As a result, modern development economists face a major task concerning the role of governments. They must work to reinforce that role when it is helpful in mobilizing resources, allocating them efficiently, and raising productivity. But they must also work to downsize government activity when is not furthering these aims.[6] Knowing when to support government activity and when to criticize it is a talent that development economists must carefully cultivate.

DEVELOPMENT: AN INTERDISCIPLINARY SCIENCE

Development is an area of economics that must draw frequently on knowledge from other disciplines. This knowledge is not only useful but also critical for the work of the economist.[7] Law and order or the lack thereof, the degree of democracy and personal trust, behavior based on a desire for power as opposed to economic gain, the struggle of ethnic groups within a country, and the constraints of family and religion are all broadly important. But these institutional areas often are not defined or discussed very clearly by economists. Often insufficient work is done on how these factors influence the "economic" factors. Researchers may ignore these institutional areas or may acknowledge their existence and then, in effect, discount them by holding them constant, *ceteris paribus*. But these areas ought not to be overlooked by a development specialist: sociology, anthropology, political science, and history are all important to this field. This is no doubt one reason why an economist narrowly trained in the standard tools of the profession may feel uncomfortable with this subject and may in an understandable reaction accuse it of being "soft." Experienced development economists—not all of them, but many—cheerfully admit to this accusation and believe that wide application of the knowledge from other disciplines adds to the intellectual vitality of economic studies.

The development economist can profit also from some knowledge of personal psychology—how to deal with and understand people. If old policies are to be scrapped, new policies effectively implemented, or present policies appreciated and defended, then a convincing message must be conveyed to government administrators and politicians. These officials, with training and backgrounds different from economists, are often distrustful of academic models and, perhaps, of academics themselves. Also, these officials must consider political as well as economic realities. They know that a policy change, however much it contributes to efficiency, will have its losers, and the losers may possess political influence and economic power. Policies concerning taxes, subsidies, land, trade, foreign exchange, credit, and pricing of public goods have implications of penalty and reward for political enemies and supporters. Thus, the advice of the development economist, however sensible, may be rejected. A desire to promote national unity, heal ethnic divisions, or project an image of progress can also spur politicians toward economic programs that might appear less than fully rational to economists. Politicians might, therefore, give unexpected high priority to heavy industries such as steel, to a policy of import substitution to reduce national "dependence," to a "strong" foreign exchange rate, to modern tanks and planes for the military, to wide-bodied jets for the national airline and a superhighway to the airport, or to magnificent avenues and buildings in the capital city.[8]

In the face of all this, the economist who can present a model, expound it effectively, and explain the difficult points in an understandable and convincing way is an especially valuable person. There is abundant evidence that proper policy can promote development and that mistaken policy impedes it, which puts a grave responsibility on economists to communicate effectively. The field also calls for the perception that "first-best" solutions, representing the most sensible economic responses to problems, may for political reasons be less desirable than "second-best" solutions. The advisor who can work effectively within these constraints, recommending policies that can be adopted and that will work almost as well as the first best-policies, is a valuable person.[9] Yet it is also fair to say that it can be a great waste of time for an economist to try to convince politicians to change priorities if voters (or political supporters in countries that do not have elections) are not convinced first. A general lack of knowledge about economic policy can be a serious hindrance to the adoption of proper policy, and acquiring the education that could break this bottleneck would likely take a long time.

On Guard!

The student of this subject must be always on guard. The sheer vastness of development economics brings a pronounced tendency to generalize prematurely about what causes development.[10] Catchwords and nostrums of all kinds abound in the literature about less-developed countries. Beware the "hedgehog theories," to use the words of Isaiah Berlin—theories of single causation that reflect little complexity in a subject that is assuredly complicated. There is a danger in being tied to one approach. It is better to use the approaches that promise to yield the best results. The proponents of single-minded points of view are now perhaps somewhat less zealous and less partisan than they were only a short time ago. But a very useful trait for a development economist still is, as we shall see throughout this book, a healthy skepticism in the presence of "true believers" who profess to know exactly how development occurs and precisely what obstructs it. Perhaps even some humility is required—an appreciation of how little is sometimes known of the human and social constraints on progress.

To be sure, a development economist does not need to be a sociologist, anthropologist, political scientist, historian, practicing psychologist, skeptic, and humble student all at the same time. But openness to other disciplines helps to avoid the complaint of Friedrich von Hayek, who said that "nobody can be a great economist who is only an economist. . . . An economist who is only an economist is likely to be a nuisance if not a positive danger."

A TYPICAL LOW-INCOME COUNTRY?

The more than 150 countries that make up this research area have low incomes. Using gross national product (GNP) per capita as a measure, the 1994 *World Development Report* listed 42 "least-developed" low-income countries with per capita GNP of under $675, and 66 middle-income countries with per capita GNP between $675 and $8356.* By contrast, 19 high-income industrial countries have GNP per capita above $8356. Four economies, Israel, Hong Kong, Singapore, and the United Arab Emirates, have incomes large enough to qualify as high-income,

*GNP and income figures here and throughout are mostly the latest available at the time of writing, taken from tables 1, 1a, and 2 of the World Bank's *World Development Report 1994.* Current population figures are also in table 1. Most statistical data in the remainder of this book, when not otherwise footnoted, is either taken directly from the annex to the 1994 report, "World Development Indicators," or is calculated from it by the author. References to the *World Development Report* are hereafter cited as *WDR.*

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