

---

THE  
ECONOMIC THEORY  
OF  
GROWTH AND DEVELOPMENT

---

David Z. Rich

---

THE  
ECONOMIC THEORY  
OF  
GROWTH AND DEVELOPMENT

---

David Z. Rich

---

PRAEGER

Westport, Connecticut  
London

**Library of Congress Cataloging-in-Publication Data**

Rich, David Z.

The economic theory of growth and development / by David Z. Rich  
p cm

Includes bibliographical references and index.

ISBN 0-275-94687-8 (alk. paper)

1. Economic development I. Title

HD75.R53 1994

338.9—dc20 93-23474

British Library Cataloguing in Publication Data is available.

Copyright © 1994 by David Z. Rich

All rights reserved. No portion of this book may be reproduced, by any process or technique, without the express written consent of the publisher.

Library of Congress Catalog Card Number: 93-23474

ISBN 0-275-94687-8

First published in 1994

Praeger Publishers, 88 Post Road West, Westport, CT 06881

An imprint of Greenwood Publishing Group, Inc.

Printed in the United States of America



The paper used in this book complies with the Permanent Paper Standard issued by the National Information Standards Organization (Z39.48-1984).

10 9 8 7 6 5 4 3 2 1

## ACKNOWLEDGEMENTS

I would like to express my thanks and appreciation to my editor, Dr. James R. Ice, and especially to my project editor, Ms. Sasha Kintzler and my copy editor, Charles Eberline, for making this work presentable. Their editorial expertise has been of great value to me.

Also, my sincerest thanks and appreciation goes to Reuven Sheffer and his staff at Ein Nun Ein in Tel Aviv, Israel, for their expertise and dedication in the camera-ready preparation of this work. My special thanks to Eran Sheffer and to Ruthie Chazanovich for their dedication and hard work on my behalf.

These ideas have been developed since the publication of my first two books, *Contemporary Economics: A Unifying Approach* (Praeger, 1986), and *The Dynamics of Knowledge: A Contemporary View* (Greenwood Press, 1988). While I owe a debt to the thinkers from whom I learned, the ideas expressed in this work are my own and I bear the responsibility for their clarity and effectiveness.

# CONTENTS

Acknowledgements	IX
<b>Part I: The Problem Situation</b>	
1. The Contemporary Situation of Economic Development	3
2. The Problems of Economic Development	17
3. Business Cycles: Comments on Method	41
<b>Part II: The Theory of Economic Development</b>	
4. Stages of Economic Growth	57
5. The Business Cycle: Concepts and Tools	73
6. The Liquidity Function: Money, Prices, and Interest	103
7. The Business Cycle: Dynamic Equilibrium and Three Theories of Growth	135
8. The Business Cycle: Dynamic Disequilibrium and Growth	157
<b>Part III: The Contemporary Challenges to Economic Growth and Development</b>	
9. The Paradox of Industrialization	215
10. The International Utility Function	223
11. Economic Growth and Development: Political Considerations	239
12. Conclusion	247
Selected Bibliography	251
Index	255

*Part I*

---

THE PROBLEM SITUATION



## *Chapter I*

---

# THE CONTEMPORARY SITUATION OF ECONOMIC DEVELOPMENT

If we ask why a people has made a certain choice, the answer lies usually in history; but if we ask why it has had that particular history, we are back among the mysteries of the universe. Fortunately, not all the answers depend on history. It is possible for a nation to take a new turn if it is fortunate enough to have the right leadership at the right time. In the last analysis history is only the record of how individuals respond to the challenge of their times. All nations have opportunities which they may grasp if only they can summon the courage and the will.

W. Arthur Lewis,  
*Theory of Economic Growth*<sup>1</sup>

The events of our recent history — the overthrowing of dictatorships in Eastern Europe, the dissolution of the Soviet empire, the reunification of Germany, the finalization of the European Common Market, and the beginning of the first real peace talks involving the combatants in the troubled Middle East — are certainly of the greatest historical significance. They pose problems and opportunities unique to our historical era.

In previous historical eras situations of such importance usually required that great leaders come to the fore to provide viable solutions for their peoples. The Congress of Vienna of 1815, which brought about relative peace in Europe for a hundred years, resulted in the Industrial Revolution taking hold on the Continent and provided sufficient stability for industry to develop and for each country to establish its own working patterns in industry according to its national characteristics. Competition in trade regulated quality in production, and internal competition provided the basis for new products to be developed to capture both the domestic and foreign markets. This stability ended with the military posturing that resulted in World War I.



After World War I the League of Nations, formed to arbitrate disputes among nations, proved unable to hold world conflict in check, partly because its charter was not ratified by the United States due to that country's isolationist position brought about by its geographical remoteness from the centers of conflict, but mainly because the bellicose countries still held old scores that they wanted to settle. Disregard for the League of Nations led Germany and Japan to rearm with impunity. This rearmament also provided economic growth in their depressed economies. These dynamics set in motion World War II, and from the ashes of that war's destruction rose the United Nations and its economic organizations, established to prevent further world conflict and to police local conflicts.

There are two noteworthy historical exceptions in which the great leaders did not establish on their own viable solutions for their peoples. These are the American Revolution against the British and the French Revolution against the monarchy, both of which were primarily grass-roots movements guided by the chosen leadership.

The disfranchisement and oppression felt by the peoples of these lands resulted in great political leadership rising to the occasions. These revolutions set the patterns for the situation in our historical era, in which the revolutions in the Soviet empire and in East Germany and Eastern Europe were the responses of leaders who emerged to realize the desires and political aspirations of the people from where they came. Thus, while the historical revolutions of our era differ from the American and French revolutions, they were undertaken in their predecessors' spirit that a people oppressed will not merely speak, but will do so in a voice and with actions that must be heeded.

It is important to note that during the events of our era several myths have been exposed. One such myth is that in the Communist state there is no poverty because all able-bodied workers are employed and those people unable to work are supported adequately by the state. This was exposed by the long food lines and the deficiencies in supplies. The central marketing board replaced the capitalist market allocation, so that planning, logistics, and quality control were determined by planners' concepts and visions according to their understanding of their countries' needs and requirements. Monies that would have been used to provide efficient production infrastructure and the moving of goods and produce were directed to projects such as defense and regulated education. The poverty that was exposed is due not to the lack of employment, but to restrictions on labor mobility and the low real value of money earned because of the lack of goods and services and inefficient uses of time by people who waited in line for foodstuffs, only to find the shelves empty or severely limited in supplies.<sup>2</sup>

The myth of capitalism, that because it is contrary to communism, only pockets of poverty exist in the industrialized Western-oriented countries,

has been exposed by the increasing reliance on the welfare systems for unemployment subsidies, education, and medical services and the levying of higher taxes to finance these benefits.<sup>3</sup> Greater reliance on such welfare programs is an important indicator that more than pockets of poverty exist in these countries. As social costs are increased through the demand for these services, taxation reduces production because manufacturers have to increase their prices to offset the cost of the taxes. Increased social costs result in reduced consumption and a consequent reduction in employment, thereby increasing the reliance on the welfare system. This is the paradox of contemporary industrialization and will be discussed further in part II of this volume, pages 92 and following, and part III, Chapter 9. It must be stated here, however, that this paradox results from both domestic and international competition and is not affected by changes in product nuances or styles. Competition among producers and retailers results in product cycles with a recessive phase of increased costs and consequent decreased revenues. It is during this phase that employment is affected, as cost-decreasing techniques are often introduced to increase profits, but again discussion of the effect that this has on the economies and a solution to this paradox must wait until part II.

The third myth, that underdevelopment pertains to those newly formed Third World countries that are seeking political stability and a sound economic basis for production and growth, most certainly has been exposed. Granted that underdevelopment is a condition of these Third World countries, and that their problems often result from political and military conflicts in the seizure of power — the Sudan and Ethiopia are only two countries that are in this predicament — underdevelopment is now being shared by the Third World countries with those countries that were once considered industrialized and are now being confronted by the necessity of reorganizing their economies in order to enter into competition with the developed countries. Moreover, the countries of the former Soviet Union are proclaiming their political and economic independence; this can only be done if they base their economies on those of the developed marketing countries. While their economic infrastructures are far more sound than those of the Sudan and Ethiopia, they are still far removed from the industrial capabilities of the European Common Market countries, Japan, and the United States. These countries are Third World only in the sense that they are part of a developing world in which each economy is struggling for greater production in light of competition; they simply have not incorporated sufficient economic infrastructure due to the diversion of resources to the political and military struggles for the establishment of power. But with the dissolution of the Soviet Union, the forming of the European Economic Community, and the advance of the Asian countries into positions of economic strength, the external circumstances of these countries compel them to resolve their problems swiftly and efficiently

so that they can rise from the ashes of their destruction, remember their pasts as great historical struggles, and seek to realize the potential of their futures.

While the contemporary situation of economic development is pressing, the problems of economic development are certainly not unique to our era. The Industrial Revolution generated difficulties due to the migration of labor from the rural settlements to the cities, bringing about overcrowding, slums, disease, and a burden on the city officials in raising funds to cope with these difficulties while making the cities centers of intellectual and cultural activities. Moreover, as industries became more sophisticated, they relocated from city centers to unpopulated areas, bringing with them their labor forces and thereby establishing city infrastructures. The silicon chip industry that manufactures the integral parts of sophisticated computers is one example; the aircraft industry is another.

Indeed, the problems of economic development are probably as ancient as the organization of mankind into societies. Even in these societies the division of labor into farmers, hunters, and manufacturers of finished products was necessary to sustain the social organization. The military branch of these societies was formed for defense and for keeping the internal peace, and the legislative branch established the laws and norms of behavior in order to maintain the society in a functioning manner.<sup>4</sup> With increasing population expansion societies became more complex, and as a consequence the legislative, the military, and the overall governing branches to which both the military and legislative branches were expected to be subservient had to adopt policies and procedures to deal with these complexities in each society according to the temperaments of its people.

However, without commerce societies cannot survive, and if their military, legislative, and overall governing bodies lack the means for their support, they will be destroyed by the internal social pressures. St. Thomas Aquinas, in his book *On the Governance of Rulers* (written around 1260), related that when Alexander the Great of Macedonia was listening to Xenocrates, a brilliant architect, explain how a beautifully laid-out city could be built on a certain mountain, Alexander is said to have asked whether there were fields that could supply such a city with sufficient grain. Finding out that there were not, Alexander is said to have responded that a man who would build a city on such a site would be blameworthy; for just as a newborn infant cannot be fed or made to grow as it should except on its nurse's milk, so a city cannot have a large population, no matter how beautiful it is, without a large supply of foodstuffs. A ruler who built Xenocrates' beautiful city and provided foodstuffs sufficient to feed the population would have certainly built himself a monument for all of history to admire.

The notion of blameworthiness, important as it was in Alexander's time, is a part of the greater ethical concept of responsibility. The notion of

responsibility and the other ethical issues related to economics during the Industrial Revolution were relegated to a minor position in the discussion of economic theory and the problems of development. The political economists, from J.B. Say to J.S. Mill and Alfred Marshall, treated economics as a science, using logic and mathematics to reason through their arguments. Even T.R. Malthus, who was a Cambridge economist as well as a preacher, let his economic training overcome his human feelings when he wrote about poverty, starvation, and the difficulties of population growth with respect to food.<sup>5</sup> The exceptions to this were the works of Karl Marx, who in his *Capital* used the tools of economic reasoning as they had then been developed and merged them with a materialistic quasi-Hegelian dialectic to argue that the capitalist system would eventually evolve into a humane communist system in which poverty and starvation would be eliminated and the rational allocation of goods and services would be carried out. Another exception was the development of welfare economics, especially during the Great Depression when the capitalist system gave evidence of undergoing serious problems. The works of A.C. Pigou, a neoclassical economist who argued that the business cycle would eventually move upward, and J.M. Keynes's work *The General Theory of Employment Interest and Money* shed new light on the capitalist system and provided it with a greater humanity.<sup>6</sup> Ethical considerations of responsibility and the abolition of unemployment and poverty have since been incorporated to some extent into economic reasoning, even though economists as scientists must remain as scientifically objective as possible in the treatment of the various aspects of their discipline.

At the end of World War II, with the establishment of the United Nations, the International Monetary Fund, and the General Agreement on Tariffs and Trade, the problems of economic development came to the fore as matters of serious study for economists. Not only were there difficulties involved in the reconstruction of Europe, laid waste by war, and of Japan, ravaged and demoralized by the nuclear devastation of Hiroshima and Nagasaki, but as the economic situations of Latin and South America became known, and especially as countries sought to shed their colonial status and gain independence, economic development economists turned their attention to these regions. The European countries and to some extent Japan had undergone the dynamics of the Industrial Revolution and therefore had a work ethic appropriate to their cultures and histories. The political considerations of the Cold War had to be dealt with during reconstruction, and the victorious Soviet Union — itself undergoing reconstruction, but under the dictatorship of Josef Stalin — and the United States provided the means for development within the terms of their own political systems and geopolitical dynamics as they were evolving.

The concern of economists over developing and underdeveloped countries was justified also on the grounds that while Europe, Japan, and the

Soviet Union were undergoing reconstruction, the emerging and developing countries provided challenges because of their positions relative to the countries that were developed and physically unscathed by the war. The establishment of viable economic infrastructure and the formation of those factions competing for political control were of interest as these countries were observed in their processes for forming viable countries capable of competing in the world markets.

Moreover, there was a basis for this interest in the literature of economic theory, for these were the topics that concerned Adam Smith, J.B. Say, David Ricardo, and the other classical economists up to, and to some extent beyond, Karl Marx.<sup>7</sup> One postwar economic thinker, W.W. Rostow, wrote of undergraduate studies in the mid-1930s, when he decided to work professionally on applying modern economic theory to the problems of modern economic history and the broader problem of relating economics to social and political forces in the workings of whole societies.<sup>8</sup> That was the period of the Great Depression, and the problem of relating economics to the political and social forces of societies was considered by many macroeconomic thinkers. This was also a Marxist problem, as *Capital* was the watershed between classical economics, in which political and social forces were rendered subservient to the new science of economics, and the theories of social economics — especially Darwinian economic and social theory that followed Marx.

During the Great Depression attention was focused mainly on the industrialized economies, those that had undergone the Industrial Revolution. The argument then was that economic and social forces are inseparable, even though much of the neoclassical economic theory was focused on the firm and its dynamics. In his *General Theory* Keynes, in the spirit of Pigou and J.A. Schumpeter, reoriented the focus onto the macro economy and its relation to the state as the representation of society. For example, concerning expenditures, Keynes wrote:

Thus it is natural — at any rate on the average of the community — that current consumption should be expanded when employment increases, but by less than full increment of real income. Moreover, what is true of the average of individuals is likely to be also true of governments, especially in an age when a progressive increase of unemployment will usually force the State to provide relief out of borrowed funds.<sup>9</sup>

After World War II the question was then considered of relating the theory of economics of the firm, and of the macro economy and international trade to the problems of the developing and emerging countries. In light of this, Sir John Maud stated in the Stamp Memorial Lecture of 1963 that the rich industrialized countries produce and consume more than two-thirds

of the world's goods and earn four-fifths of the whole world's income. That the industrialized countries' output increases more rapidly than their population is a strong indicator of the tremendous gap between the rich and poor countries and results in an average rise in their populations' average incomes.

The gap between the rich and poor thus widens, the rich becoming richer at a much faster rate than that at which the poor become less poor. And it can plausibly be said that this gap would still continue to grow even if the under-developed countries succeeded in increasing the average income of their peoples ten times faster than the developed countries did.<sup>10</sup>

These underdeveloped countries were little touched by the dynamics of industrialization that the developed countries had undergone. Aid to the underdeveloped countries, targeted for the construction of infrastructure, for improving medical facilities and treatment, and for raising the levels of education with the goal of making these countries competitive, was of some help. Those leaders of underdeveloped countries who possessed wisdom and concern for their peoples applied foreign aid in ways that brought their countries into various stages of development. Other leaders preferred self-aggrandizement and used portions of the funds for their own purposes, relying in part on the initiative of their peoples to make their own way, and in part on directing the funds that remained into the targeted projects.

Aid was also used as a strategy in the Cold War as the Soviet Union and its allies sought to gain supporters in its ideological and sometimes military adventures. Conflicts between countries that diplomacy failed to resolve to the satisfaction of the antagonists often led to military action; these countries then turned to the great powers, which, in turn, had to choose sides and support their beneficiaries with military as well as diplomatic and financial aid.

The problems of development often resulted in rebellion on the grass-roots level of peoples against regimes supported by one or the other superpower. The rebellion against the Vietnam regime, for example, brought the French into military conflict with the northern region. The French armies suffered in battle and withdrew, leaving a political vacuum that was filled by the United States. The Vietnam War was fought by the United States and its allies against the popular uprising and the North Vietnamese armies, supported by China and the Soviet Union. The withdrawal of the U.S. and allied forces left still another vacuum that China tried unsuccessfully to fill, but the region sought aid in reconstruction and rearming from the Soviet Union. The rebellion against the Soviet-sponsored leadership in Afghanistan was exploited by the Western superpowers and brought about the withdrawal of Soviet forces from that country.

Both the Western and the Soviet superpowers learned great lessons from the Vietnam and Afghanistan adventures. One such lesson was that an unpopular war could be won only at terrible costs to life and property and that if such a commitment to this destruction is not made and implemented, then the war against popular uprisings has little chance of succeeding, and the resources involved can be better employed elsewhere. On the fields of battle it was learned that a World War II type of military operation can no longer be fought because the weapons of war have become so fierce that the consequences of deploying and using them are unacceptable, no matter who comes out ahead. Also learned was that military action taken by a superpower had to have well-defined objectives; the action had to be swift and decisive, with withdrawal undertaken as soon as possible after these objectives had been achieved.<sup>11</sup> Finally, military action could be undertaken against a U.N. member country if the majority of the other members considered that country's actions illegal and reprehensible, and that country was unmoved by the U.N. members' requests to alter its ways, as in the case of Iraq's invasion of Kuwait and the U.S.-led action to force Iraq to cease its invasion and withdraw to its own borders.

From the end of World War II to our present situation, then, the subject of economic development has been related to the emerging and developing countries of the non-Western areas. The question as to why these countries were not influenced by the Industrial Revolution must be approached from the point of view that in many instances they were not countries but colonial territories to be exploited, with internal investment made to ease this exploitation. For this reason these regions, when they gained independence as countries, had to rely on what was best understood by their leaders and citizens, their cultures as they had evolved under the yoke of colonialism. Also, these ancient cultures did not allow any great economic initiative on the part of the individual. Hence in many of the emerging and developing countries today the political systems are political or religious dictatorships or a combination of both, unreceptive to rational argument and thought and ignoring empirical demonstration. The combination of religious and political influences in these countries restricts individual enterprise, allowing, in the old spirit of colonialism, initiative only to the extent that the monies generated will maintain the system and its religious and political leadership.

The significance of an enduring question lies in the different ways in which its answers have been given and interpreted in different historical eras. Adam Smith's question of the origins and causes of the wealth of nations is such an enduring question, and its given answers differ for the Industrial Revolution for which Smith provided the theoretical basis and for our historical era of knowledge with its emerging and developing economies. In spite of the great changes that the Westernized countries have undergone, religion in the emerging and developing countries holds people

under the command of powers outside their control and comprehension, rendering many of their activities and thoughts subject to forces that they cannot understand. Their thoughts and consciences are oriented to spheres unfamiliar through experience. The entrepreneurial activity necessary for real economic growth and development stands in direct conflict to this orientation, for such activity requires the rational exertion of control over resources and their applications in market development. The entrepreneur qua entrepreneur is answerable only to his or her clients and himself or herself, as these are forces that he or she understands and with which he or she works.

Dictatorship hinders deviations from the accepted behavioral models that have evolved over time—deviations that are necessary for entrepreneurial activity. These behavioral models are always deeply rooted in the national conceptualizations of the people, as can be evidenced by the reactions in the former Soviet Union to the newly acquired freedoms and the complaints that the new liberalization offers no real benefits and that a dictatorship may certainly handle the socioeconomic problems decisively. Dictatorships are modern expressions of authoritarianism and rely on the imposition of dictatorial ideas and methods by enforcement, tolerating deviation to the extent of the dictator's attitudes and the degree of deviation in question. However, while authoritarianism is an evolved form of rule, usually accepted by the people as part of the national heritage, dictatorships are imposed by force, with social evolution having little or no role in their establishment. Dictatorships have no real root in past national history nor in ideas of the collective social psyche justifying their power. They are an alien type of rule, liable to be overthrown by the very forces that placed them in power when the conditions are right. Dictatorships rely on the personality cult necessary for establishing an authoritarian figure who might have come to political prominence through social evolution and might have been a different sort of ruler. The personality cult of dictatorships, however, is as unstable as human passion, and heroes of the state and the people, as dictators tend to portray themselves, can become public enemies once they are deposed.

This does not mean that the nations at the time of the Industrial Revolution were free from authoritarianism and dogmatism. The Catholic and Protestant churches had great influence over their followers, but that historical situation differs greatly from the historical era and the social time of the emerging and developing countries today. The Protestant Reformation and the reaction within the Catholic church to its own behavior during the Inquisition, as well as the scientific progress made during and after the Renaissance, led to the evolution of a work ethos that separated work from religion by leading the churches to deal with the needs of the spirit and the subsequent industrialization with the material satisfactions. Although there was most certainly controversy, after the Inquisition there



were never serious social conflicts between material and spiritual needs. The consequence was that industrialization and religion accommodated each other very well.

Authoritarianism and religion posed no serious problems for industrialization for two reasons. One reason was the impact on society made by industrialization due to the radical changes that were occurring in manufacturing (from *manus*, “hand,” and *facere*, “to make”). Industrialization began when science merged with the processes of production, resulting in productive technology. This merger brought about the replacement of tedious processes of hand work by the implementation of more efficient machinery. The freedom of production gained from this merger was enhanced by individual initiative for accumulating the means of output in industry and by the development of new markets through innovation in products and their applications. This emphasis on individualism was soon recognized as industrialization continued and authoritarianism as a dominant sociopolitical force shifted from that of the ruler to the authority of the parents in the family. The religious leaders in society consented to share their dominant positions with material forces, making possible a social justification for further inquiry into the sciences and endeavors in the fields of the arts and commerce.

The second reason why authoritarianism and industrialization had no serious problems with mutual accommodation is that industrialization was not the result of forces held in check that had gathered momentum and burst on society in the form of a social revolution or rebellion, but gradually occurred as the sciences were applied to production.<sup>12</sup> The fertile ground for industrialization was prepared by the changing attitudes toward the arts and sciences, so that when industrialization began and Adam Smith’s writing appeared, a new era of political and social development had begun that would not clash with religion and that was greeted with great interest as industries were formed that were operated with new production processes and that opened new markets.

Hence part of the difficulty the emerging and developing countries face in their striving for economic development lies in their not being fully incorporated into our contemporary historical era. This era will be discussed in detail in chapter 2, but it suffices to say here that these countries lack political stability because of this lack of incorporation that is necessary for establishing the inner dynamism required to unleash the forces of individualism on which industrialization effectively relies. These countries’ histories of tribalism and/or religious sects sharing common territory and often at war were altered somewhat during the period of colonialization, when the Christian-oriented countries sought to expand their trade and domination over their neighbors as they searched for raw materials in distant lands to improve their wealth and trading power.

The religious beliefs of these countries were certainly strange to the