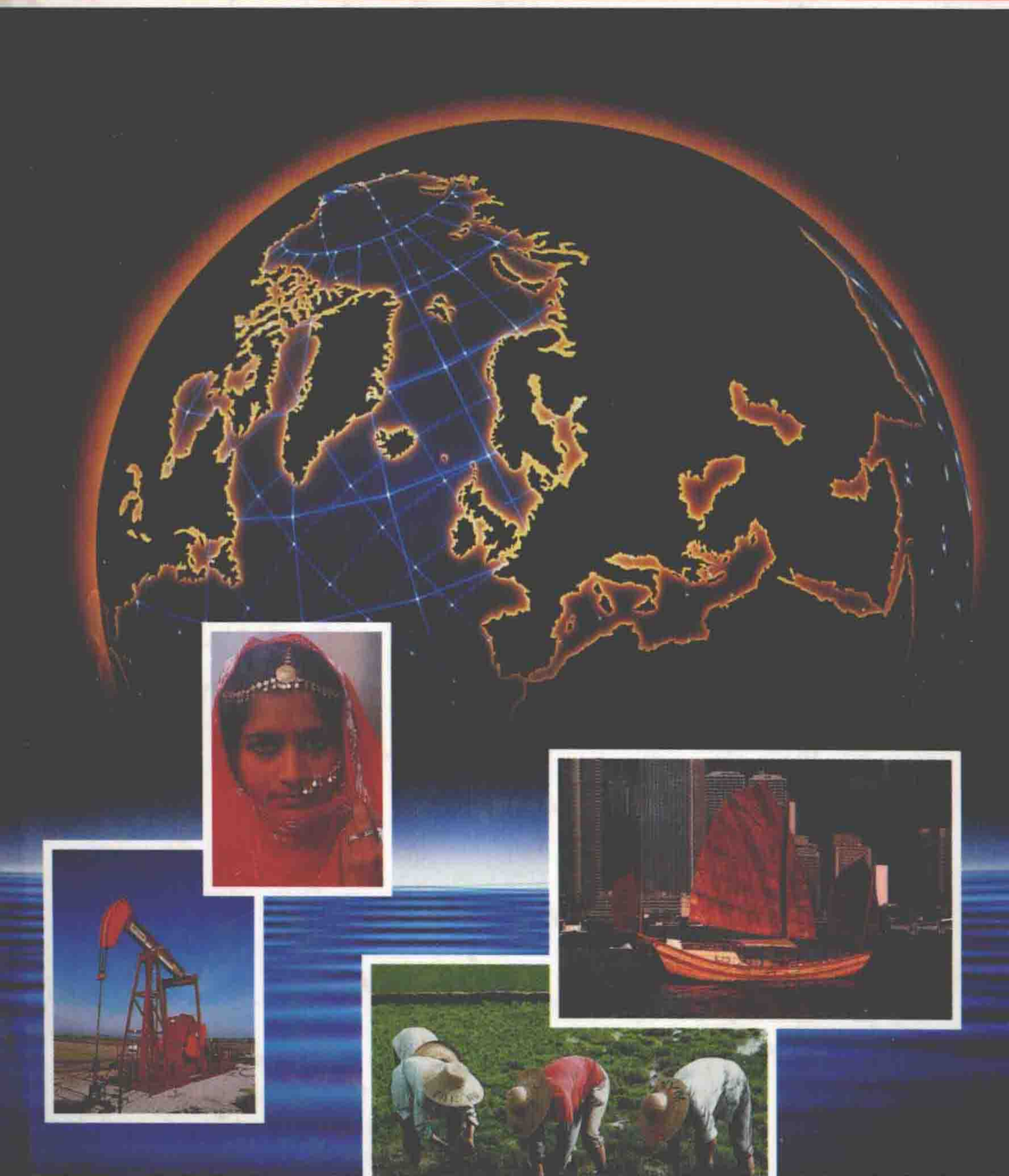
JAN S. HOGENDORN

Economic Development

Second Edition



ECONOMIC DEVELOPMENT

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To Dianne

Preface

With regularity, the newspapers or television news programs call our attention to the existence of poverty, malnutrition, and other forms of human misery in the world's poor countries. The images—especially of children—are compelling. Why does such misery occur? Is it inevitable? Can something be done to alleviate or end it? Economic development is the field that attempts to answer these momentous questions.

There has been substantial flux in the field of economic development in the past decade. In part, this has been forced by the success of some Pacific Rim countries, juxtaposed with worsening conditions in other parts of the world, particularly Africa. In part, the flux is due to the productivity slowdown and trade barriers of the developed countries, which has turned economists' attention away from stabilization issues and focused it on growth issues. These are momentous questions central to the field of economic development.

New Features

Economic Development, Second Edition, addresses these issues while providing a solid grounding in developmental concerns. It covers all of the basic theories of development. Its distinguishing feature is its coverage of the international economic aspects of development. This coverage in Chapters 12–15 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 only briefly in competing texts, receive a thorough treatment.

I have tried to write understandably for those students who have taken only the first-year principles of 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 anything beyond an initial course. Once more, the bibliographical referencing is extensive, which should prove valuable to students and teachers alike.

Organization

The book is structured as a survey of the standard subject matter with some departures from the traditional sequence of most texts. I believe 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, so this material appears in Chapter 2, immediately following the introduction.

Chapter 3 presents a short survey of how countries develop. Included are the lessons drawn from the experiences of today's developed countries during the periods of their greatest advances: Japan from 1880 to 1920, Russia and the Soviet Union from 1908 to 1940, and Germany from 1870 to 1900. The chapter also reviews the experience of two especially successful less-developed countries (LDCs)—South Korea and Taiwan—along with some notorious failures, in an effort to identify general lessons.

Chapters 4, 5, and 6 concern capital: saving, investment, the roles of the international agencies, foreign aid, multinational companies, and an analysis of the debt crisis. I have put these topics early in the text largely because, after a long period of downplaying capital as a major factor in development, a reappraisal has come. Also, the debt crisis has had a profound impact on the prospects for development. Additionally, students in recent years are much more concerned with studying banking, credit, and investment than was true in the past; early emphasis on these subjects builds on their existing interests. These chapters also address monetary and fiscal policies (including taxation, fiscal deficits, and inflation) in the LDCs because I found it logically preferable to integrate these subjects with the problems of capital formation and capital flows rather than to put them into a separate chapter. A detailed treatment is given to the distortions in capital markets, often introduced by government policies, that have received much recent attention in development literature.

Chapter 7 is a conventional approach to factor proportions, technology, and dualism in industry, and includes many real-world examples of the LDCs' problems in these areas.

Chapter 8, on population, emphasizes 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 9, on "human capital," considers the importance of education, health, and nutrition as factors in raising productivity and as "basic needs."

In Chapter 10, 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 more comprehensive than in texts of comparable scope. The length and depth of coverage in this chapter fully reflect the recent rise in importance of the rural sector in development economics.

Chapter 11, on planning and the market, compares the more questionable forms of comprehensive planning to "lighter" sectoral planning and reliance on market forces in the development process. I try to provide a more comprehensible treatment of cost-benefit analysis and shadow pricing than other development texts offer. Two appendices cover technical aspects of the capital-output ratio in planning and survey the long-standing "balanced growth" controversy.

Chapters 12, 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, export cartels, depreciation of the exchange rate as a strategy, and customs unions. The increasingly important subject of developed-country trade barriers receives a thorough treatment.

Finally, 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 and one that received only little attention until the late 1980s.

I strongly 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, the most recent edition of Gerald M. Meier's, *Leading Issues in Economic Development*, also from Oxford University Press, will serve as an excellent supplement.

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. The manuscript of either this or the first edition was read by Wilson Brown of Canada's University of Winnipeg, Robert Christiansen of the World Bank, Patrick J. Gormely of Kansas State University, Harish Gupta of University of Nebraska, Ann Helwege of Tufts University, Whitney Hicks of the University of Missouri, William E. Kuhn of the University of Nebraska, and Olu Onafowora of Susquehanna University. Their collective advice led to yet further alterations and improvements in the finished product. Peter Kilby at Wesleyan University provided helpful comments.

The student assistants who worked on the revised edition were Lesley Eydenberg, Katherine Rogers and Kristen Russo of Colby College, and Christiaan Hogendorn of Swarthmore College.

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. My family knows how all-too-true this is. Thanks for bearing with me.

Jan S. Hogendorn

Contents

Chapter 1

Introduction: Studying Economic Development

Development economics is the study of how human economic circumstances change over time and how they can be made to change. This is a grand subject that spans continents and disciplines; the sheer scale and scope of its coverage make it the broadest subset of economics.

The subject matter of development is not divorced from the main body of economics nor are there any great differences in analytical methods. Completely new tools for analysis usually have not been necessary, and the standard ones are drawn from every branch of the discipline.[1] A textbook that explores development must touch on labor economics and industrial organization, money, banking, and fiscal policy, international trade and finance, transport, welfare, and environmental economics, and education, population and agriculture. To a very large degree, the elementary insight that economics is the study of efficient choice among scarce resources, with a capacity to analyze the trade-offs (costs) of one policy versus another, is central to development studies, just as it is in so many other areas of the discipline. Many standard questions can be addressed with these orthodox tools, including (1) What factors lead to development? (2) Can proper economic policies such as price and tax reform help to achieve development? and (3) Are policy successes transferable among countries?

A DIFFERENT POINT OF VIEW?

Although much of the subject matter covered is familiar to every economist, some 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.

One such approach is to view economies in terms of pervasive and persistent dualisms that, contrary to the neoclassical theories of markets and movements toward equilibrium, may not be 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* (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. Sharecropping—where tenants share their income with landowners—is very 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.[2]

Whole countries must be looked at as an aspect of dualism when, for example, public policy is characterized by an urban bias of favoritism toward the cities or when the relative stagnation of one country is compared to the dynamism of its neighbors. Even entire continents are broadly different in their economic performance, as we shall see.

Development economics also provides a different viewpoint in its treatment of international trade. The great debate between the trade optimists and trade pessimists endures. To the optimists, trade is an engine of growth. To the pessimists, trade risks "backwash effects," with exports growing slowly if at all, with inelastic demands moving prices against poor countries, and with those prices (as well as quantities and earnings) being unstable, thus making development more difficult. These arguments have recently taken hard knocks, but there is enough realism in them, and repetition of them, to command attention. Worrisomely, protectionist policies in developed countries might radically change the rules of the game.

A further difference in development studies lies in the attention given to an apparent persistent tendency toward income inequality and the evaluation of frontal attack on the inequality by a strategy of direct action, bringing basic social services to people in what is often called a *basic needs approach*. Other differences are the attention given to the causes and effects of rapid population increase and the special concentration on how agriculture interacts with industry as a country grows.

A major field of study emphasized in development economics involves the perception that the system of market pricing may work less efficiently in conditions of poverty. There might be serious structural impediments to the smooth operation of a price system, including blockages, bottlenecks, rigidities, and lags, especially in supply. 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 insure 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 quicker to occur and harder to control.

Such structural arguments, all much debated, for many years have been used to justify government intervention in the economy through planning, the pros and cons of which are a staple of development theory and an element of much controversy as well. Often government itself may be part of the problem, with numerous prices kept unchanged by government decisions, including foreign exchange rates, interest rates, prices charged by state enterprises, and prices paid for agricultural products. This distorts the information carried by the price system and especially distorts the flow of investment. Substantial evidence supports the view that a major reason why countries are poor is because their policies are poor.[3] Their management inefficiencies in the public and private sector—but particularly in government—often combined with political instability, are severe handicaps. The absence of sufficient administrative competence and organizational ability in government may actually be the greatest block to development. The inefficiency may leave LDCs' actual GNP well below the potential level. Such countries face the daunting triple task of improving their abilities to mobilize their resources, allocate them efficiently, and raise productivity.

Perhaps the greatest difference between development and traditional economics is not the models but the mood. Development has a special immediacy because it grapples with human misery, poverty, disease, and the attempts to correct them. The closeness to these problems and the awareness of so much to be gained by their elimination brings enormous human interest to the subject; a first visit to a poor country brings quick understanding why such a country may view its struggle to develop as a war, or even a great crusade.

REQUIREMENT: A WIDE-RANGING MIND

Development is an area of economics in which knowledge from other disciplines must be drawn on frequently. This knowledge is not only useful but also critical for the work of the economist. 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. In much of the research, 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 cannot be ignored by a development specialist; sociology, anthropology, political science, and history are all important in 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, believing that wide application of the knowledge from other disciplines adds to the intellectual vitality of economic studies and is essential for progress in the field.

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 defended and appreciated, 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 "dependence," to defense of 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.[4]

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. It 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, may be even more valuable.[5] Yet it is also fair to say that it can be a great waste of time to try to convince politicians 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.

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 it is that causes development.[6] Capitalist catchwords and Communist nostrums of all kinds abound in the literature on 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 of being tied to one approach. It is better to use the approaches that promise to yield the best results. Although the proponents of single-minded points of view now appear somewhat less zealous and less partisan than only a short time ago, a very useful trait for a development economist still is, as we shall see throughout, 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. Actually, the mainstream idea that economic policy must be reformed meshes rather nicely with the Marxist contribution concerning historical perspective, the importance of power and interest groups, and the injustice of a stratified class system. In short, class and the market are *both* important.

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 it helps.

IS THERE A TYPICAL POOR COUNTRY?

The more than 100 countries that make up this research area have low incomes. Using gross national product as a measure, the 1990 *World Development Report* listed 42 "least-developed" low-income countries with per capita GNP of under $480, 70 middle-income countries between $480 and $6000, 11 countries with oil or manufactures exports boosting their GNP above $6000 but still regarded as less than developed, and 19 developed "industrial market economies."[7] (GNP data for most of these countries are shown on the end-papers.) The statistics for several Eastern European nonmarket economies, including the USSR, are not published by the World Bank. The pace of reform in these countries is such that they may soon come to be included in the study of development economics, rather than being considered as separate economic systems as is now the case.

Further broad similarities can be found among these poor countries. Almost always, the lower a country's level of income, the smaller the percent of its population employed in modern industry. There usually will be a large pool of underemployed labor, and often much open unemployment in the cities, that has proven very difficult to absorb. The vast farming and service sectors will be low in productivity. Exports usually consist of only primary products and labor-intensive manufactures, the proceeds from which pay for the imports of essential capital goods that cannot be produced at home. Whatever the goods produced, their production is often not as labor-intensive as might be pre-