DEVELOPMENT ECONOMICS

Richard Grabowski
&
Michael P. Shields

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Richard Grabowski
Southern Illinois University at Carbondale

Michael P. Shields
Central Michigan University

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Preface: Development Theory

The student of development economics is often surprised, sometimes pleasantly surprised, by the differences between development economics and other fields of study within economics. The material is often descriptive but the descriptions are bold and sweeping. Hence, the student seldom has to understand specific institutions. The material is theoretical but seldom formal. Hence, the student seldom has to master formal theoretical models. The material is empirical but seldom econometric. Hence the student does not need to master mathematical statistics. Finally, and most important, the material deals with the reasons for poverty on a scale few of the students have witnessed, much less experienced.

These differences may be, to some extent, both desirable and necessary because of inevitable differences in the subject matter. However, the student cannot help wishing that there was more continuity between the methods of development economics and the methods applied in other fields of economics. A consistent and formal treatment of various topics in development economics would go far in bridging the gap between development economics and economics in general. At a minimum, such a treatment would facilitate learning by employing consistent notation within a unified theoretical structure. Understanding of controversies would also be enhanced by interpreting opposing views within the same theoretical framework. The framework would be the mainstream of economic theory that is learned and applied in other courses. It is, of course, recognized that not all problems in development economics or, for that matter, in other areas of economics fit neatly into this framework. It is our belief, however, that real advances can be made by providing a unified theoretical approach to development economics. Insights from alternative views can then be discussed in terms of how they can be accommodated by the main approach.

Development theory can be organized in three different ways. Theories and theoretical innovations could be treated somewhat chronologically. Each

theory could be discussed in terms of when and why it appeared, how it is related to other theories, and how theoretical innovations refined or extended the theory. This organization may tend to stress disagreement and ignore interaction between theories. The second approach would be to organize theoretical discussions according to the applied topic toward which they are being directed. For example, one such topic could be the role of education in furthering economic growth and development. The implications of various theories on the relationship between education and the development process would then be discussed. These first two methods of organization are followed, often with some mixture of the two, in the theoretical discussions of most development textbooks. A third method is to organize development theory in terms of the field into which the theory fits. These fields would include choice theory, international economics, public economics, labor economics, and so forth. This is the approach taken in this book. This last approach is best suited to exploring the relationship between development theory and economic theory in general because it focuses directly on how economic theory can be used to understand economic development.

This book's primary audience includes advanced undergraduate students as well as graduate students. However, professional economists may also find this book worthwhile in terms of its approach and content. Some knowledge of calculus is assumed. However, efforts are made to emphasize the economic meaning of all analyses. The student should also have a good understanding of intermediate microeconomics along with some understanding of intermediate macroeconomics. A junior or senior level course in economic development is not necessary, but some background in development economics or other fields covered in the book could be helpful.

If the book is used as a graduate level course, the entire book can be covered in two semesters along with appropriate supplementary readings. However, it could also be used for a one semester course in development. The core sections on growth and development, a unifying theme, and the traditional sector would be covered first. Then the instructor could choose which of the remaining topics he or she wished to cover.

The book begins with a survey of theories of the process of growth and development in Chapter 1. This chapter introduces many models and concepts that are used in later chapters. Chapter 2 reviews the concept of rational choice, its uses and limitations, and introduces the theme underlying subsequent chapters. Chapters 3 through 7 apply concepts discussed in the first two chapters to fields of study within development economics. The theoretical concepts and models relevant to each of these fields are introduced. These models are modified to reflect the institutions and problems of less developed countries and to help organize the theoretical and empirical

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literature in the field of study in question. Finally, Chapter 8 considers the role of the state in development.

The book emphasizes theoretical concepts and models in development economics. Reference will be made to historical, institutional, and empirical features of less developed countries and how they have influenced and have been captured in the theory. It should be emphasized, however, that the book is intended to be primarily a book on development theory. Historical, institutional, and empirical material will be introduced to understand the development and the empirical implications of the theoretical models.

Because this will not be a comprehensive book on development, auxiliary readings will be desirable. Case studies, descriptions of various cultural characteristics, empirical investigations, and the history of different regions are best covered elsewhere. The book will provide a theoretical thread for these studies that, although present in the literature, have not been integrated into a unified treatment of development theory. In providing a unified treatment of development theory, we hope to make it easier for the reader to apply theory to development problems.

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1

Growth and Development: Some Views

Stagnation, both economic and demographic, seems to have been the condition facing humanity for almost all of its existence. Although population size as well as levels of living fluctuated, fundamental changes came slowly until the beginning of the industrial revolution. Individual nations rose and fell with little impact on the lot of humanity. For reasons that remain controversial, the economies of England and, later, other nations experienced sustained and, by previous historical standards, rapid economic growth. The economies of many countries, however, were left behind in this growth process or may have worsened as a result of growth in the expanding economies of the industrializing nations. Some key questions in development economics regard the nature of this apparent transformation from backward to modern economies. First, did this process involve qualitative, structural changes in the societies involved? If so, what was the nature of the mutual causality between these changes and the growth of the economy? Second, what elements of this growth process are subject to control by poor nations today? Third, can poor nations replicate the example of wealthy nations or has the world been so changed by the transformation of some formerly backward economies that the rest of humankind is doomed to dependence and poverty without major structural changes in the world trading system?

All three questions concerning the development process have in varying degrees motivated growth and development theories. In this chapter these theories will be classified into two categories. First, historical theories of how economic development has occurred and is occurring will be briefly reviewed. Second, formal theories of production and growth will be reviewed, focusing on questions of how countries can facilitate economic growth. There is, of course, some connection between historical and formal theories of growth. Formal theories may be in part representations of historical

theories. Historical theories in turn may be strongly influenced by formal theories.[1]

HISTORICAL THEORIES OF DEVELOPMENT

Historical theories are theories that explain current events or conditions in terms of a causal chain of historical events or conditions. The theory explains or predicts how these events or conditions evolve. Many historical theories of economic development simply postulate the existence of different phases or stages of a development process and hypothesize about the forces that cause a change in the phase or stage of development. Clearly delineated stage theories have been proposed by Karl Marx, Friedrich List, Karl Bücher, W. W. Rostow, and some members of the dependency school such as Andre Gunder Frank.[2] There are also elements of a stage theory in the writings of classical economists such as Adam Smith and current economists working within the classical tradition such as W. Arthur Lewis.[3] These historical theories will be considered roughly in the chronological order in which they were proposed. The order is not intended to necessarily represent scientific progress from early primitive theories to later more refined theories.

Historical Views of Classical Economists

The classical economists probably had no historical theory, per se. They were deeply involved in matters of economic policy, and their theorizing tended to be oriented toward the creation of a theory of value. They were, however, concerned with growth and tended to emphasize the extension of markets as a key element in this growth. Adam Smith saw economic prosperity as the result of increased specialization and trade. He saw limitations on free trade as restricting the scope of specialization and, hence, lessening economic prosperity. Smith attacked what he called mercantilism, which in Smith's view impeded the development of competitive markets and the resulting division of labor. David Ricardo stressed that agricultural protection, which raised agricultural rent and reduced the accumulation of capital, was a major impediment to growth. John Stuart Mill also emphasized free trade and production for the market as a source of prosperity. In particular, he saw tenant farms as lowering agricultural productivity and lessening the incentives for rural capital accumulation. To all these writers, development was enhanced and perhaps caused by the extension of isolated markets into a comprehensive market system. This view of the historical importance of markets was highly influential. Almost all contemporary and subsequent scholars concerned with historical explanations of development attempted to

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explain the rise of markets. Included among these scholars are persons with such diverse viewpoints as Karl Marx and W. W. Rostow.

Marxian Theories

Marx shared the view of the classical economists that the extension of markets was important for economic development. Markets became predominant in capitalism, which is only one of many historical stages. Marx saw not only history but science and nature as an interactive process of tensions that become more intense through time, eventually causing qualitative changes. Marx mentioned three phases through which history had moved and was moving. These stages are primitive communism, feudalism, and capitalism. Believing in progress, Marx believed that a fourth stage – communism – would soon emerge, and he welcomed its emergence. For the most part, he was concerned only with capitalism and the forces that it created which would eventually destroy capitalism. Marx explained these changes in economic order by developing a theory of historical change.

The traditional interpretation of Marx maintains that Marx believed that social, political, cultural, and spiritual aspects of life are conditioned by the mode of production. The mode of production is the sum of the material, productive forces of society. These productive forces include climate and geography as well as the existing technology. It is technology that Marxists view as the chief factor changing the material base of society. The technical nature of production conditions social relationships, and upon these social relationships is built the superstructure of political and legal institutions. These social relationships include the class structure of society and the control of the means of production and exchange.

As productive forces change, new social relationships will develop that are more appropriate to the altered production relationship. New social relationships and social classes will arise and come into conflict with the old. Eventually this conflict brings down the old society and initiates the new. Thus, history is a reflection of the ceaseless struggle between classes that occurs as a result of changes in the productive forces of society.

The rise of capitalism over the ashes of feudalism began with changes in productive forces, both technological and geographical, in that the discovery of the New World resulted in important changes in productive relationships that instituted a series of revolutions in the modes of production and exchange. The economic demands, which occurred because of the discovery of the New World, the development of new markets, and the expansion of trade, placed stress on the feudal economic order. A new commercial and manufacturing class arose in response to the new economic situation. Although this new class eventually transformed society, it initially met resistance from

the vested classes of the old order. The extension of markets led to struggles over the political machinery of the state. The new entrepreneurial class ultimately captured political control of the state, and its powers to transform society became complete.

Although Marx believed that capitalism would eventually fail, he had a high regard for the ability of capitalism in general and the capitalist class in particular to revolutionize the means of production. It is in the capitalist stage of history that production and new technology grew very rapidly. He also believed that the need of the capitalist class for a constantly expanding market would drive it to establish itself over the whole surface of the globe. As a result, the less developed nations would also see their economic structures revolutionized as the

> bourgeoisie, by rapid improvement of all instruments of production, by the immensely facilitated means of communication, draws all, even the most barbarian, nations into civilization. The cheap prices of its commodities are the heavy artillery with which it batters down all Chinese walls, with which it forces the barbarians' intensely obstinate hatred of foreigners to capitulate. It compels all nations, on pain of extinction, to adopt the bourgeois mode of production; it compels men to introduce what it calls civilization into their midst, i.e., to become bourgeois themselves. In other words, it creates a world after its own image.[4]

Marx tended to view history as evolutionary in the sense that historical forces lead to progress. Capitalism was a necessary stage in the historical evolution. During this stage, feudalism is destroyed and the production process revolutionized. Thus, there is a period of rapid economic growth and the development of class conflict between capitalist and worker.

A group of scholars within the Marxist tradition has developed a very different perspective. This group, sometimes called *neo-Marxist,* argues that the underdevelopment of Africa, Asia, and Latin America has been a product of the same forces that have led to development in Europe and North America. The integration of backward areas into the world capitalist system is viewed as a major source of underdevelopment. This can be characterized as the development of underdevelopment. One of the major proponents of this view is Paul Baran.[5] He argued that the spread of capitalism into less developed nations resulted in a political amalgam combining the worst features of both capitalism and feudalism that, in a number of ways, effectively blocks all possibilities of economic growth.

To understand Baran's work one must distinguish between a country's actual and potential economic surplus. A country's actual economic surplus

is identical with current savings or capital accumulation and is the difference between actual current output and actual current consumption. This is the main factor in promoting rapid economic growth. A country's potential economic surplus is the difference between the output that could be produced and essential consumption.

Within the context of the less developed nations, the actual surplus is much below the potential economic surplus and thus the actual rate of growth is much below the potential rate of growth. This low growth occurs because, when capitalism penetrated the less developed nations, feudalism and its dominant class was not destroyed, as Marx predicted. Instead, an alliance among the foreign capitalists, native capitalists, and feudal overlords is established. Within the context of this alliance much of the potential economic surplus is transferred out of the country by the dominant foreign capitalists. In addition, the native capitalist class and the feudal overlords use much of the potential surplus for luxurious consumption. As a result, the actual economic surplus is meager and the growth rates of these countries are relatively low.

Growth in these nations is further inhibited by other factors. Because wealth and income are concentrated in the hands of a few, the domestic market for industrial goods is not well developed. Hence, there is little incentive to invest and thereby to create productive enterprises supplying these types of goods. In addition, the capitalists have essentially a monopoly position in most of these nations. As a result, they are hesitant to invest in additional activities for fear of generating increased competition. Finally, the infrastructure for servicing a domestic market is also lacking. Indeed infrastructure development is often limited to the servicing of an enclave export section. Thus, few external economies are to be reaped by firms seeking to produce for the domestic market.

Baran is very skeptical concerning the possibilities of increasing the productivity of the agricultural sector. He believes that little additional land is available for agricultural purposes, and what land is available would require significant amounts of investment to cultivate. He doubts that this investment is economical. Thus, the development of industry is the key for Baran. Only through an increase in industrial productivity can agricultural machinery, fertilizer, electrical power, and so forth be made available to the agricultural producer. Only through an expansion of the demand for industrial labor can agricultural wages be increased and a stimulus provided for the modernization of the agricultural economy. Therefore, for Baran, mobilizing the potential economic surplus and using it to promote an unbalanced growth strategy emphasizing industry, is the key to development.

Why do the governments in these countries not take the necessary steps to surmount the obstacles to growth outlined by Baran? These governments,

he argued, are not capable of undertaking these steps because the political and social structure of the government in power prevents any resolution of the problem. The alliance of dominant classes controlling the future of most less developed countries cannot be expected to design and carry out measures contrary to their immediate vested interests.

For these countries to experience rapid economic growth, their political framework must be drastically altered. The alliance among landlords, domestic capitalists, and foreign capitalists must be broken. This transition is likely to be abrupt and painful.

Andre Gunder Frank has extended the work of Baran and other modern neo-Marxists. He agrees with Baran that the state of underdevelopment in many poor countries is the result of their contact with and exploitation by the capitalist, developed nations. However, he extends the analysis by concentrating on the role of the city. He believes that the cities incorporate the indigenous population into the economy and serve as an instrument of domination. He refers to this as a metropolis–satellite relationship, which extracts economic surplus from the rural satellite areas and transfers this surplus to the city (metropolis). The extraction of surplus occurs not only at the international level from the less developed, satellite nations to the capitalist, metropolitan nations, it also occurs within nations between metropolitan areas and rural areas. As a result, a whole chain of metropolis and satellites relate all parts of the system from the metropolitan center, in Europe and the United States, to the most distant less developed nation.

Samir Amin also emphasized the idea that the development process of the center retards growth in the periphery.[6] In his analysis, the center economies are characterized by an articulated pattern of accumulation. By this it is meant that productivity increases do not accrue completely to capital, because worker consumption would not grow and thus a market for increased production would lag. Neither do they completely accrue to labor because this would sharply reduce capitalist profit. Instead, productivity gains are split between capital and labor, permitting a dynamic equilibrium to occur among sectors and between production and consumption. However, the underlying tendency of central capitalism is toward underconsumption, and the resulting crisis depresses the rate of profit. State intervention can counteract this tendency through Keynesian-type aggregate demand policies. The social basis for this type of intervention is the presumed social contract between capital and labor. This contract allows the state to manage conflicting wage and profit demands relative to productivity gains. The monopolization of capital and the organization of labor have made this approach possible.

The preceding process represents the internal solution to the maintenance of dynamic equilibrium. An external solution also exists and becomes necessary if the social contract in the center is not sufficiently effective. This

solution has the periphery performing two basic functions. These functions are to provide a large market for the output of the center and to increase the rate of profit on the capital of the center.

During the age of competitive capitalism the role of the periphery as a market for the center was most important. During this time period, increases in productivity resulted, according to Amin, in reductions in price, not in increases in wage rates. Thus, underconsumption in the center forced capitalism to use the periphery to absorb the excess production. With the development of monopoly capital and the organization of labor, increases in productivity in the center led to rising wages. Monopolist profits could not be fully utilized in new investment in the center because this would tend to undermine their position in the market. As a result, capital would be exported to the periphery, where labor is relatively cheap. Higher profits could then be earned and repatriated to the center. Of course, this aggravates the center's problem of what to do with this surplus being extracted from the periphery. Internal aggregate demand policies within the center and additional capital exports would become necessary to maintain dynamic equilibrium. In the periphery, the inflow of capital would result in periods of rapid growth for particular sectors of the economy. However, the extraction of surplus via repatriation of profit and unequal trade (the terms of trade turning against the periphery) would create a situation in which long-run development is blocked.

These ideas, in which capitalism (the center) is seen as blocking the development of the periphery, have come under severe criticism from within the Left itself. These criticisms are of both a theoretical nature and empirical nature. Critics argue that a brief examination of the data concerning the development experiences of less developed nations is enough to dispel the notion that these regions have stagnated. For example, the real growth rate of gross domestic product was 79 percent higher in the periphery than in the center for the period 1969–1976. Gross fixed capital formation was 360 percent higher in the periphery than in the center for the same period. Even on a per capita basis, the growth rate was higher in the periphery relative to the center.

There are a number of theoretical criticisms of the development of underdevelopment idea. Only a few will concern us here. First, the development of underdevelopment emphasizes the external factor, surplus extraction by the center, as the prime factor in promoting backwardness. Critics of this view do not deny that the center benefits through the international transfer of the surplus. However, for critics such as Geoffrey Kay, underdevelopment results from an internal class structure that blocks the development of the production process.[7] As a result, the inflow of capital from the center blocks development not because it exploits the less developed countries, but

because "it did not exploit it enough." Second, the development of underdevelopment view sees capitalism as being incapable of developing the productive forces of the periphery. Again, critics such as Bill Warren claim that it is absurd to argue that foreign investment leads to stagnation.[8] Finally, the underdevelopment view tends to replace exploitation between social classes with exploitation between geographical areas. The workers of the center have allied themselves with the capitalists via a social contract. Therefore, an objective basis for international workers' solidarity would not exist. Critics, within the Left, vigorously disagree. They argue that the exploitation of labor is greatest within the center and that a basis for international workers' solidarity does exist.

Alain de Janvry attempts to incorporate several aspects of the criticisms just discussed into a modern Marxist perspective.[9] Most of his work is concerned with analyzing the political economy of development in Latin America. He argues that Latin America was transformed into a periphery of the center first through colonization, which integrated the region into the commercial market, and later through efforts by England to destroy the Spanish empire in order to establish free trade. These free trade policies encouraged the development of an economic system based upon the export of primary commodities and the import of manufactured consumption goods. Within this export enclave economy, much of the population earned its living in the traditional sector that had few if any economic links to the modern export sector. Unequal exchange to the benefit of the center is obtained through the maintenance of low agricultural wages through precapitalist relations of production. Under these relationships the workers were tied to the land and, consequently, were unable to take advantage of alternative market opportunities. This exploitation produces a deterioration of the external terms of trade to the benefit of the center.

Such deterioration of the terms of trade is the result of a process of unequal exchange, an idea first developed by Arghiri Emmanuel.[10] His argument is developed under the assumptions that capital is perfectly mobile and, thus, rates of profit are equalized between countries. In addition, labor is assumed not to be mobile. If wage rates are lower in the periphery relative to the center, the equalization of profit rates between countries will initially turn the terms of trade against the periphery.

With the rise of national entrepreneurial classes, import substitution strategies were followed in the early 1900s. This, according to de Janvry, induced the traditional landed elites to extend their sectoral control toward the newly rising industries and, also, induced a reverse movement whereby new industrialists sought access to land to gain power over the institutions of society. The industrialization that did occur was aimed at capturing the existing national market for manufactured goods, which was basically for luxury

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