Development Theories

What is Economic Development?

Economic Development occurs with the reduction and elimination of poverty, inequality and unemployment within a growing economy.

Gini coefficient This is a statistical measure of income distribution. A Gini coefficient of 0 means perfect equality.

Human Development Index (HDI) Measures a country's average achievements in three basic dimensions of human development: life expectancy, educational attainment and adjusted real income (PPP$ per person).

What do theories and models try to do?

Economic development theories and models seek to explain and predict how:
- Economies develop (or not) over time
- Barriers to growth can be identified and overcome
- Government can induce (start), sustain and accelerate growth with appropriate development polices

Theories are generalizations. While Less Developed Countries (LDCs) share similarities, every country's unique economic, social, cultural, and historical experience means the implications of a given theory vary widely from country to country.

There is no one agreed "model of development". Each theory gives an insight into one or two dimensions of the complex process of development. For example, the Rostow model helps us to think about the stages of development LDCs might take, while the Harrod-Domar model explains the importance of adequate savings in that process.

Balanced Growth Theory:

Balanced growth involves the simultaneous expansion of a large number of industries in all sectors and regions of the economy. Balanced growth (or the big push) theory argues that as a large number of industries develop simultaneously, each generates a market for one another.

If a large number of different manufacturing industries are created simultaneously then markets are created for additional output. For example, firms producing final goods can find domestic industries that can supply them with their inputs. The benefits of growth are spread over all sectors and, ideally, regions.

Balanced growth theory is an extension of Say's Law the demand for one product is generated by the production of others

It is argued that free markets are unable to deliver balanced growth because entrepreneurs:

- Do not expect a market for additional output – why risk resources when sales are uncertain?

- Require skilled workers but are not willing to hire and train unskilled staff who may then leave to work for rival firms – employers cannot 'internalize their positive externalities

- Do not anticipate the positive externalities generated by the investment of other firms engaged in expansion

- Are unable to raise finance for projects

If government can co-ordinate simultaneous investment in many industries one firm provides a market for another. This requires state planning and intervention to:

- Train labor
- Plan and organize the large-scale investment program.
- Mobilize the necessary finance
- Nationalize strategic industries and undertake infrastructure investments e.g. build roads
- Protect infant industries through tariff (tax on imports) and quota (limit on quantity of imports) policies

The strategy of balanced growth is beyond the resources of most poor countries; Balanced growth within a closed economy rather than specialization and trade contradicts comparative advantage

Government planning results in government failure i.e. government intervention in the market fails to bring about an efficient allocation of resources e.g. planning process creates a bureaucracy.

LDC development policies focusing on import substitution, agricultural self-sufficiency and state control of production yield poor growth.

Unbalanced Growth Theory:

Unbalanced growth theorists argue that sufficient resources cannot be mobilized by government to promote widespread, coordinated investments in all industries.

They share analysis with balanced growth theorists that free markets, alone, cannot generate development but differ in that government planning or market intervention is required just in strategic industries.

Those with the greatest number of backward and forward links are prioritized.

A country lacks resources to finance balanced growth. Resources are therefore concentrated on strategic industries with:

- Significant forward linkages i.e. firms creating essential inputs for other key firms in the economy

- Significant backward linkages i.e. key firms buy industrial inputs from a large number of domestic firms

- Import substitution. Developing domestic industries replaces imports and so improves the balance of payments.

Government identifies strategically important areas with significant backward and forward linkages to
- Nationalize (planned economy) or
- Subsidies (market economy).

E.g. State owned development banks finance priority investment projects chosen for their contribution to growth and development goals.

Rostow's Growth Model:

This is a linear theory of development. Economies can be divided into primary secondary and tertiary sectors. The history of developed countries suggests a common pattern of structural change:

Stage 1 - Traditional Society:

Characterized by subsistence economic activity i.e. output is consumed by producers rather than traded, but is consumed by those who produce it; trade by barter where goods are exchanged they are 'swapped'; Agriculture is the most important industry and production is labor intensive, using only limited quantities of capital.

Stage 2 - Transitional Stage:

The precondition for takeoff. Surpluses for trading emerge supported by an emerging transport infrastructure. Savings and investment grow. Entrepreneurs emerge.

Stage 3 - Take Off:

Industrialization increases, with workers switching form the land to manufacturing. Growth is concentrated in a few regions of the country and in one or two industries. New political and social institutions evolve to support industrialization.

Stage 4 - Drive to “Maturity”

Growth is now diverse supported by technological innovation.

Stage 5 - High Mass Consumption

Implications of Rostow's model

Development requires substantial investment in capital equipment; to foster growth in developing nations the right conditions for such investment would have to be created i.e. the economy needs to have reached stage 2.

For Rostow:

o Savings and capital formation (accumulation) are central to the process of growth hence development.

o The key to development is to mobilize savings to generate the investment to set in motion self generating economic growth.

o Development can stall at stage 3 for lack of savings – 15-20% of GDP required. If the domestic Savings rate is 5%, then international aid/loan must total 10-15% in order to plug the ‘savings gap’. Resultant investment means a move to stage 4 Drive to Maturity and self-generating economic growth

Limitations of Rostow's Model

Rostow's model is limited. The determinants of a country's stage of economic development are usually seen in broader terms i.e. dependent on:

o the quality and quantity of resources
o a country's technologies
o a countries institutional structures e.g. law of contract

Rostow explains the development experience of Western countries, well. However, Rostow does not explain the experience of countries with different cultures and traditions e.g. Sub Sahara countries which have experienced little economic development.

Dependency theory:

Dependency refers to over reliance on another nation. Dependency theory uses political and economic theory to explain how the process of international trade and domestic development makes some LDC's ever more economically dependent on developed countries ("DC's").

Dependency theory refers to relationships and links between developed and developing economies and regions.

Dependency theory sees underdevelopment as the result of unequal power relationships between rich developed capitalist countries and poor developing ones.

Powerful developed countries dominate dependent powerless LDC's via the capitalist system. In the Dependency model under development is externally induced (i.e. DC not LDC’s fault) system. Growth can only be achieved in a closed economy and pursue self-reliance through planning.

Dominant DC's have such a technological and industrial advantage that they can ensure the ‘rules of the game’ (as set out by World Bank and IMF) works in their own self-interest.

This partly explains the hostility shown towards the WTO in Seattle in 1999.

In this model under development is externally induced (i.e. DC not LDC’s fault) and only a break up of the world capitalist system and a redistribution of assets (e.g. elimination of world debt) will ‘free’ LDC's

Import Substitution Theory:

A development strategy whereby a government restricts or forbids the import of industrial material and subsidizes local material. For example, a country may not allow the import of refined oil and instead encourage development of local oil refineries. The ides behind this strategy is to make a less developed country less dependent on international assistance and foreign direct investment until such time as it is can absorb investment more easily and also trade its own products. This development strategy was followed in Latin America and some other regions for most of the mid and late 20th century. It has its theoretical foundations in Keynesian economics, though some analysts have claimed that each nation industrializing after the United Kingdom has followed some form of import substitution.

The import substitution approach substitutes externally produced goods and services, especially basic necessities such as energy, food, and water, with locally produced ones. By doing so, local communities can put their (hard-earned) money to work within their boundaries.

Export Promotion:

Opposite to the Import Substitution strategy, Export Promotion is a trade and economic policy aiming to speed-up the industrialization process of a country through exporting goods for which the nation has a comparative advantage. Export-led growth implies opening domestic markets to foreign competition in exchange for market access in other countries. Reduced tariff barriers, floating exchange rate (devaluation of national currency is often employed to facilitate exports), government support for exporting sectors and attracting FDI are all examples of policies adopted to promote EOI, and ultimately economic development.