Competing Theories of Economic Development

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In this section we are going to introduce you to four schools of economic thought that came into existence following World War II: (i) structuralism, (ii) the linear-stages-growth model, (iii) the neo-Marxist or dependency theory, and (iv) the neoclassical revival of the 1980s. These schools fall under the general rubric of "development economics," a branch of economic analysis that responded to the perceived inability of classical, neo-classical, and Marxist economics to address the economic reality that plagued the poor countries of the world.

By the 1950s, it was possible to divide the world into two groups of countries—the poor and the wealthy. The wealthy group was composed of most of the Western European countries, Canada and the United States. Inhabitants of these regions lived (and still live) in great affluence and consumed a large part of the world's resources. The other group- Latin America, Asia and Africa—was poor, underdeveloped, and contained almost 75 percent of the world's population. Economists and government policymakers, especially those in developing countries, began to look for reasons to explain this disparity and for ways to eliminate it.

This section will provide you with a general understanding of development economics, using the four schools of thought identified above. The first part will explain how development economics has taken a multidisciplinary approach to analyzing and addressing the economic problems of developing countries, particularly chronic poverty.

The second part will describe some of the main aspects regarding the structuralist school of development economics. Structuralists tried to explain how structural aspects of the domestic and international economy impeded the growth of developing countries. Their policy prescriptions called for major government intervention in the economy in order to promote industrialization. Many countries in Latin America and elsewhere adopted structuralist policies, also known as "import substitution" policies. While the early phase of such policies promoted growth, state-led development ultimately suffered serious inefficiencies, which led to market reforms in the 1980s and 1990s in Latin America and elsewhere. (In the 1970s, Asian economies abandoned import substitution in favor of export-led growth.)

The third part will address the linear model of development based upon the European experience. This school focused on the lack of domestic savings and investment. In order to promote growth, policymakers had to induce higher savings and investment rates in developing countries, a proposition that was easier said than done. The linear model of growth proved to be fundamentally flawed. Nevertheless, its optimism was infectious and still pervades the work of development institutions like the World Bank.

The fourth part of this section outlines neo-Marxist theories of development, which focused on exploitative relationships between advanced capitalist countries and the developing world. Although much of neo-Marxist theory has been discredited, it nevertheless constituted a useful rhetorical tool for developing countries seeking to establish economic sovereignty. Even today's Asian crisis has raised themes reminiscent of the neo-Marxist critique—i.e., certain advanced economies don't want the once-booming Asian economies to overtake them.

The final section addresses the neo-classical revival. With the onset of the debt crisis, the IMF and the World Bank pushed for market-based reforms in developing countries, with the intention of reducing the amount of state intervention in the economy. Deregulation and privatization became key goals for reformers. This framework is being adopted virtually worldwide today. Once again, the Asian crisis, discussed elsewhere in the E-book, provides the most recent example of market-based reform efforts.

As you read this section, ask whether these theories really matter. Are they merely useless elaborations that have no practical use? Or do they really influence the way institutions like the World Bank and the IMF operate? Have you heard government officials or important experts use language that reflects these theories? Which of these competing theories do you think makes the most sense?

A. *What Is Development Economics?*

Let's begin by exploring the meaning of development economics.

1. Development Economics is an Extension of Both Political and Traditional Economics.

Classical or neo-classical economics is concerned primarily with the efficient and cost effective allocation of scarce resources and with the optimal growth of those resources over time. They hold that countries develop economically via the market. In a market economy, economic benefits flow to participants, be they individuals or countries, from selfinterested and voluntary acts. This behavior is efficient and produces the greatest overall economic growth. So, if we were to ask such an economist why developing countries (or any country, for that matter) are experiencing economic growth problems, she would try to find government-created barriers that restrict the free market. To stimulate growth, those inefficient barriers have to be removed. This type of analysis and solution is universally applied—i.e., it does not radically change depending on the country being analyzed.

Marxist political economy provides a broader view of economic development. Like classical and neo-classical economists, political economists are concerned with the efficient and cost effective allocation of scarce resources. They, however, bring a new coefficient—politics—into the development equation. When addressing why some groups or countries are better off than others, political economists don't look solely at market forces for an explanation. They focus on the social and political mechanisms that economic groups have created in order to control the allocation of scarce resources.

Marxism tends to be universally applied as well. For example, to an orthodox Marxist, the class struggle is a by-product of capitalism. Capitalism inevitably creates a conflict between the working class and the owners of capital. Regardless of the country in question, the conflict will always reach the same result: the social inequities will reach an intolerable point and the working class will instigate a socialist revolution that will overthrow the capitalist regime.

Development economics goes beyond the scope of either classical/neo-classical economics or Marxist economics. It, too, is concerned with the efficient allocation of scarce resources. Its main concern, however, is sustained economic growth over time that improves the standard of living for the masses who live in poverty in developing countries. To that end, one of the main goals of development economics is the formulation of public policies designed to bring about rapid economic growth.

Like classical/neo-classical economists and Marxist economists, development economists see their role in society as model builders—they suggest models of economic growth for governments to follow. Development economists, however, do not believe that a single model can be universally applied, given the heterogeneity of developing countries. Thus, development economics has combined relevant concepts from traditional economic analysis with a broader multidisciplinary approach derived from studying the historical and contemporary development experience of the specific region or country in question. The tendency has been to first look at existing economic theories for inspiration or insight.

These existing theories are then modified or expanded upon so as to make them applicable to developing countries. The resulting theories have been used to explain the economic gap existing between developing and industrialized countries. The goal of development economics has been to pinpoint the cultural, political, economic and institutional mechanisms, both internal and external, impeding economic development in order to modify them in such a manner as to bring about economic progress.

B. The Structuralist School: State-Led Development Was Key

Although its influence has declined considerably, the structuralist school of development economics has had a lasting impact on debates regarding development, especially with respect to Latin America and other regions with similar problems.

1. Economic Development May Only be Achieved Through an Internal Expansion of the Local Economy.

The structuralists focus on the mechanism by which "underdeveloped" economies transform their domestic economies from a traditional subsistence agricultural base into a modern economy. A modern economy is defined as one in which most of the population is urban and the bulk of the country's output is in the form of manufactured products or services. Under this model, the ultimate question becomes how to expand the modern economy while contracting the indigenous traditional economy of the country or region. The object of development is the structural transformation of underdeveloped economies so as to permit a process of self-sustained economic growth. This may only be achieved by eliminating the underdeveloped country's reliance on foreign demand for its primary exports (raw materials) as the backbone fueling economic growth. Economic growth must be fueled through an expansion of the internal industrial sector.

The structuralist school emerged in Latin America in the 1940s. In the latter part of the nineteenth century and the beginning of the twentieth century Latin American countries were exporters of raw materials. Classical economics held that the region had a comparative advantage in raw materials, meaning they could produce raw materials more efficiently than other regions. As such they should concentrate on expanding such exports.

By the 1940s Latin American economists began to attack this notion. They argued that export-led growth of raw materials was no longer a feasible path to economic development. This was because the price of primary exports was declining while the price of manufactured products was increasing. In addition, the supply of manufactured goods was decreasing due to World War II. All of these factors created large disruptions in the economies of developing countries. Given the low price being paid for exports of primary products, developing countries were unable to make enough money to pay for all of the imports they needed, including high-priced manufactured products.

Many Latin American economists believed that the situation would not improve following the conclusion of the War. They cited two reasons in support of this conclusion. First, they noted that the advances in technology, which lowered the production costs of manufactured goods, were not resulting in lower-priced imports of such goods. Structuralists argued that the fruits of those advances were being retained by the industrialized nations in the form of increased profits for the manufacturer and higher wages for the workers. Given these "structural" impediments in the world economy, the structuralists argued that economic development had to be pursued through an expansion of the domestic industrial sector.

Second, structuralist economists warned that, given the United States' role as the world's new industrial leader, the demand for raw materials was going to diminish because the United States was rich in natural resources. Consequently, the United States would be willing to buy raw materials abroad only if it was cheaper than extracting them at home. But this scenario was unlikely because the post-war global economy differed substantially from the situation during the previous century. At that time, Great Britain, an island nation, was the pre-eminent economic power, but it had few natural resources. In order to feed its industries, Britain had to import raw materials. This gave providers of raw materials more bargaining power, power that developing countries would no longer have in the post-war world.

2. **Economic Development Meant Improving the Technological Levels of Lagging Sectors of the Economy.**

Structuralists also argued that focusing on overall economic growth numbers was a necessary but not sufficient step in pursuing economic development. An underdeveloped economy is defined as one in which the technological levels of one or more sectors of the economy fall below the technological level of the most advanced sector, especially if technology exists that will enable those sectors to be more productive. To the structuralists, development had to include the expansion of new technology and methods of production in order to eliminate the gap between the most advanced sectors of the economy and those that lagged.

Thus, the structuralists measured development by the number of economic sectors using the most advanced levels of technology. The goal was to have an economy in which the total output would be divided equally among all of the country's economic sectors. The existing scenario in which the bulk of the economy's output was derived from the primary product sectors was unacceptable. Economic development could only be achieved through the expansion of those sectors of the economy which up to that point had been neglected.

3. The Structure of Underdeveloped Economies Could be Explained by the Process Through which Developing Economies have Historically been Incorporated into the International Economy.

In addressing the cause of underdevelopment, structuralist economists focused on the evolution of economic relationships between developed countries and the rest of the world. Developing countries were brought into the international economy to serve two purposes: (i) to supply cheap raw material and (ii) to purchase finished manufactured goods from industrialized economies. This gave rise to "enclave" economies in developing countries that expanded the primary product export sector at the expense of the industrial sector.

The structural relationships in the international economies led to a dual economic structure in developing countries, where a modern economy (the export sector) coexisted with a backward and undeveloped one. The modern sector was maintained not through internal innovations and advancement but by purchasing new technology from the developed countries. As long as dualism persisted, autonomous economic development would be impossible; that is, growth would be dependent on the industrial countries. Structuralists argued that economic growth had to stem from internal demands.

4. The Structural Transformation of the Economy Could Only be Achieved Through Government Intervention.

The structuralists argued that the structural changes needed to bring about economic development could only be achieved by state intervention. For example, government-imposed tariffs on imports were designed to stimulate the internal market by protecting new industries within the country. A tariff was viewed as a way to even the playing field between a manufacturer in an industrialized country and one in a developing nation. The former tended to have better access to capital and technology as well as a more productive workforce. These factors enabled manufacturers in industrialized countries to produce a given product faster and cheaper than "infant industries" in developing countries.

A tariff is a tax that the government of the importing country places on imported products. The tax is designed to make the imported product more expensive than the domestic product, thereby making the latter more attractive to the consumer of the product because it is cheaper. In theory, the structuralists thought tariffs could be lowered or eliminated when the domestic industry had reached the level of development that enabled it to compete without the government-imposed protection.

Another important component of the structuralist approach was state-owned enterprises. The structuralists believed that, given the underdeveloped capital markets in developing countries, only the state could generate and manage the sizeable investments needed to industrialize. Other policies that were recommended were fiscal (taxes and government spending) and monetary (money supply and interest rates) in nature.

In sum, all of these policies, known collectively as "import-substitution," were geared at encouraging the country to industrialize. Thus, the structuralists accepted the notion that development was to be achieved through capitalism. But they were not convinced that the market alone could achieve the type of thriving capitalism that industrialized countries were enjoying. Governments of developing countries had to actively promote industrialization through government regulation of the economy.

5. The Structuralist Policies Enjoyed Limited Success.

While the structuralists made significant contributions to our knowledge of the process of development, their prescriptions were not successful in many cases. Countries that adopted the import-substitution model of development began to notice in the 1960s that government-led initiatives to industrialize could not effectively create the most important phase of industrialization relating to heavy machinery and plant installation. Moreover, the heavy involvement of the state in the market created inefficiencies that eventually caused major internal and external economic problems. And the drive to industrialize led, ironically, to increased dualism in developing countries as the gap between the rich and the poor widened.

C. The Linear-Stages-of-Growth Model: The Western European View of Economic Development

The industrialized nations did not pay much attention to the problems facing developing countries until the late 1940s and early 1950s. They approached the problems of the Third World only after they had finished rebuilding much of Western Europe.

Following World War II, most of the economies of Western Europe were devastated.

The Marshall Plan for economic reconstruction made possible an amazing and rapid revival of industrial Europe. Europe's success in rapid re-industrialization was to be very influential in how policymakers in industrialized countries approached the economic problems of developing countries.

The views discussed in this part all share the proposition that economic growth could only be achieved through industrialization. It was also accepted that the constraints impeding economic growth in developing countries were mostly internal. In particular, growth was restricted by local institutions and social attitudes, especially those that negatively affected the rate of savings and investment. This view contrasted with the structuralist view that developing countries' economic problems were due in large part to external factors.

The key to development was simple: implementation of a program providing for a massive injection of capital coupled with public sector intervention designed to accelerate the pace of economic development. This would compensate for the lack of internal savings and investment in developing countries. This process, after all, had worked very well in Western Europe via the Marshall Plan.

In this part, we look at Walt W. Rostow's stages-of-growth model of development. This is not to say that Rostow's model was the only one or the best. It was, however, the model that achieved dominance in this strand of development economics.

1. **Walt W. Rostow's Stages-of-Growth Model Viewed Economic Development as a Linear Process.**

Rostow argued that advanced countries had all passed through a series of stages. He designated the stages as follows: (1) the traditional society, (2) the preconditions to take-off, (3) the take-off, (4) the drive to maturity, and (5) the age of high mass-consumption.

In his view, the advanced countries had all passed the stage of take-off and had achieved self-sustaining growth. The developing economies were either in the "preconditions" or "traditional" stage. All that these societies had to do in order to take-off (to reach self-sustaining growth) was to follow a certain set of rules of development. Rostow defined take-off as a period when the degree of productive economic activity reaches a critical level and produces changes which lead to a massive and progressive structural transformation of the economy and society.

The take-off stage could only be reached if three criteria were satisfied. First, the country had to increase its investment rate, with investment amounting to no less than 10 percent of the national income. This requirement could be satisfied either through investment of the country's own savings or through foreign aid or foreign investment. Second, the country had to develop one or more substantial manufacturing sectors with a high rate of growth. Third, a political, social and institutional framework had to exist or be created to promote the expansion of the new modern sector.

Under this theory, economic growth was measured by a rising per capita income. Unlike the structuralists, Rostow was not concerned whether the production was evenly divided among all economic sectors. Thus, again unlike the structuralists, Rostow equated economic growth with economic development. To stimulate growth, the country had to increase savings and investment. Given the low savings rates in developing countries, the government was responsible under this theory for creating a class of people with a propensity to save. The government also had to ensure that people who saved more would obtain a greater share of the national income. Otherwise, national income would be consumed rather than invested.

It is easy to see why this model was so widely accepted. It justified massive transfers of capital and technology from the North (industrialized countries) to the South (developing countries). At the same time, it provided a rationale for the massive concentrations of wealth that existed in developing countries.

2. The Rostow Model was Based on Erroneous Assumptions that Failed to Take into Account Unique Structural Causes of Low Savings and Investment in Developing Countries.

Despite its appeal, the Rostow model proved to be seriously flawed. The linear-stages-of-growth model blamed developing countries' stagnation on internal factors, namely a lack of internal savings and investment. The model assumed that if these components were injected into developing countries through direct foreign investment or aid, economic growth would naturally follow. This assumption was based, in part, on the success of the Marshall Plan in Europe. Thus, the model assumed that but for the low savings and investment rates, developing countries and Europe were the same for purposes of development.

They were not. While post-World War II Europe lost its infrastructure and industrial base, social structures remained intact. It was a society rich in human resources—i.e., skilled labor and a competent managerial sector. It had a stable civil and criminal legal framework experienced in handling the many problems associated with capitalism. Developing countries' levels of human resources could not compare to those of Europe. Consequently, economic aid and foreign investment were not enough to industrialize the region. If sustained growth was to be achieved in developing countries, the society itself had to be restructured. The linear-stages-of-growth model focused only on the symptoms of an ailing economic society. It never bothered to determine what factors led to a society that saved very little and invested even less.

D. The Neo-Marxist Approach: Advanced Capitalist Countries Exploit Developing Countries

One of the most controversial schools of development economics in the 1960s and 1970s focused on neo-Marxist theory. Neo-Marxist economists accepted Marxist philosophy in principle but argued that it had to be modified if it was to be applicable to developing countries. They argued that Marx did not have sufficient information to develop a theory dealing with underdevelopment. Armed with observations that Marx could not possibly have made, neo-Marxists made important theoretical departures from orthodox Marxist doctrine. We will cover only two here.

1. Neo-Marxist Development Theory Focused on the Relationships Between Advanced Capitalist Countries and Developing Countries.

First, neo-Marxists broadened the scope of orthodox Marxist doctrine by looking at exploitation among nations. Marx's doctrine of surplus value stated that the worker was being robbed by the capitalist class. The worker received only a fraction of the value of the product which his labor produced. The difference was expropriated by the capitalists—the private owners of the factories and the machines. The neo-Marxists gave this theory an international dimension based on the behavior of nations. Hence they concluded that industrialized countries historically extracted surplus value from developing countries. Specifically, they argued that developed countries paid very low prices for the primary products imported from developing countries, transformed them into finished products and sold them back to developing countries at very high prices. This resulted in chronic poverty and misery in developing countries.

2. The Neo-Marxists Argued that Many Developing Countries Could Not Pass Through an Advanced Capitalist Stage Before Moving to Socialism.

Second, neo-Marxists took issue with the orthodox Marxist theory that a social revolution is possible only after a country has undergone a capitalist transformation. This orthodox position would mean that such a revolution could not occur in developing countries until industrialization flourished. Neo-Marxists argued, however, that passing through the industrialization stage was impossible for many developing countries, given the theorists' observations that developing countries were stuck in a state of underdevelopment and unequal exchange with advanced capitalist nations.

The path to industrialization was difficult and even impossible to follow because, as we've just noted, developing countries were brought into the capitalist international economy as producers of cheap raw materials. Thus, foreign capital flowed to and modernized only one sector of developing economies—the primary products sector. The by-product of this process was the destruction of indigenous industry, either directly or through neglect. Neo-Marxists argued that foreign capitalists had no interest in developing local industries. And the local capitalists were happy as long as they could extract surplus labor from the peasantry and wage laborers. The surplus capital was either invested abroad or consumed via the purchase of luxury goods from abroad of course.

All of these factors contributed to static economies in developing countries, which meant that capitalism could not be achieved. Consequently, neo-Marxists called upon the masses to engage in a socialist revolution without waiting for the arrival of industrialization. The revolution would place the surplus value in the hands of the workers, who would invest in socialist development.

3. Neo-Marxist Theory was Provocative but Flawed and Too Formalistic.

Neo-Marxist theory was an important and provocative contribution to development economics, primarily because it questioned many assumptions supporting development theory based on capitalism. Nevertheless, the theory was subject to a great deal of criticism, especially the neo-Marxist-based "dependency theory," which held that developing countries' development was dependent on, and thwarted by, advanced capitalist countries.

Classically trained economists argued that heeding neo-Marxist calls for self-sufficient development would lead to economic stagnation in developing countries. Pointing to empirical evidence, Marxist economists claimed the neo-Marxists incorrectly concluded that developing countries could not attain the capitalist mode that Marx deemed necessary for a socialist revolution. Others noted that neo-Marxist theory failed to explain patterns of specialization in developing countries. Still others believed neo-Marxist theory was too formalistic to be useful.

E. The Neoclassical Revival: Private Markets, Not Government Intervention, Are Critical for Development

Neoclassical theory experienced a resurgence in the 1980s. It is not coincidental that, during this same period, the governments of most of the industrialized nations were governed by conservative political parties.

Neoclassical economic theory dismissed neo-Marxist theory as flawed and unrealistic. It also rejected structuralists' claims that developing countries' problems were due to structural impediments in the international economy and that domestic structural flaws required significant state intervention in the economy.

To neoclassical economists, economic stagnation in developing countries was a by-product of poorly designed economic policies and excessive state interference in the economy. They argued that in order to stimulate the domestic economy and promote the creation of an efficient market, developing country governments had to eliminate market restrictions and limit government intervention. This was to be accomplished through the privatization of state-owned enterprises, promotion of free trade, reduction or elimination of restrictions on foreign investment, and a reduction or elimination of government regulations affecting the market. These reform measures collectively were called "the Washington Consensus." In sum, market forces, not government intervention in the economy, would bring about development in stagnating economies.

This framework became the basis for the massive economic changes that occurred in Latin America after the onset of the debt crisis in the early 1980s and for the equally profound transformation of socialist economies after the fall of the Soviet Union.