

Development Economics: An Introduction

1 Key Problems of Economic Development

2 Poverty and Inequality: Definition, Measurement, Implications

3 What is Development?

4 Actors in Development Cooperation

5 Development Theories; A Synopsis

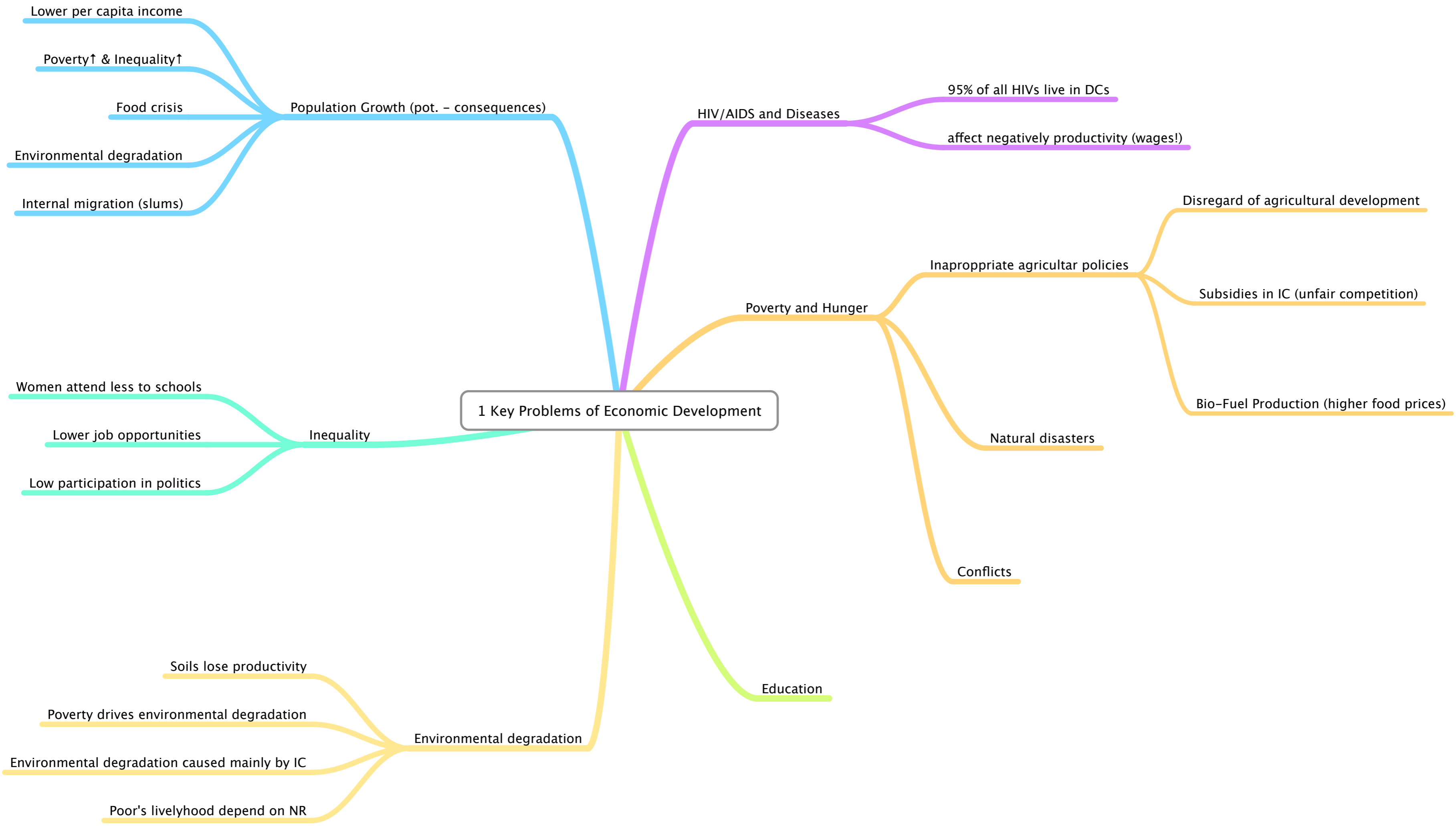
6 Population Growth

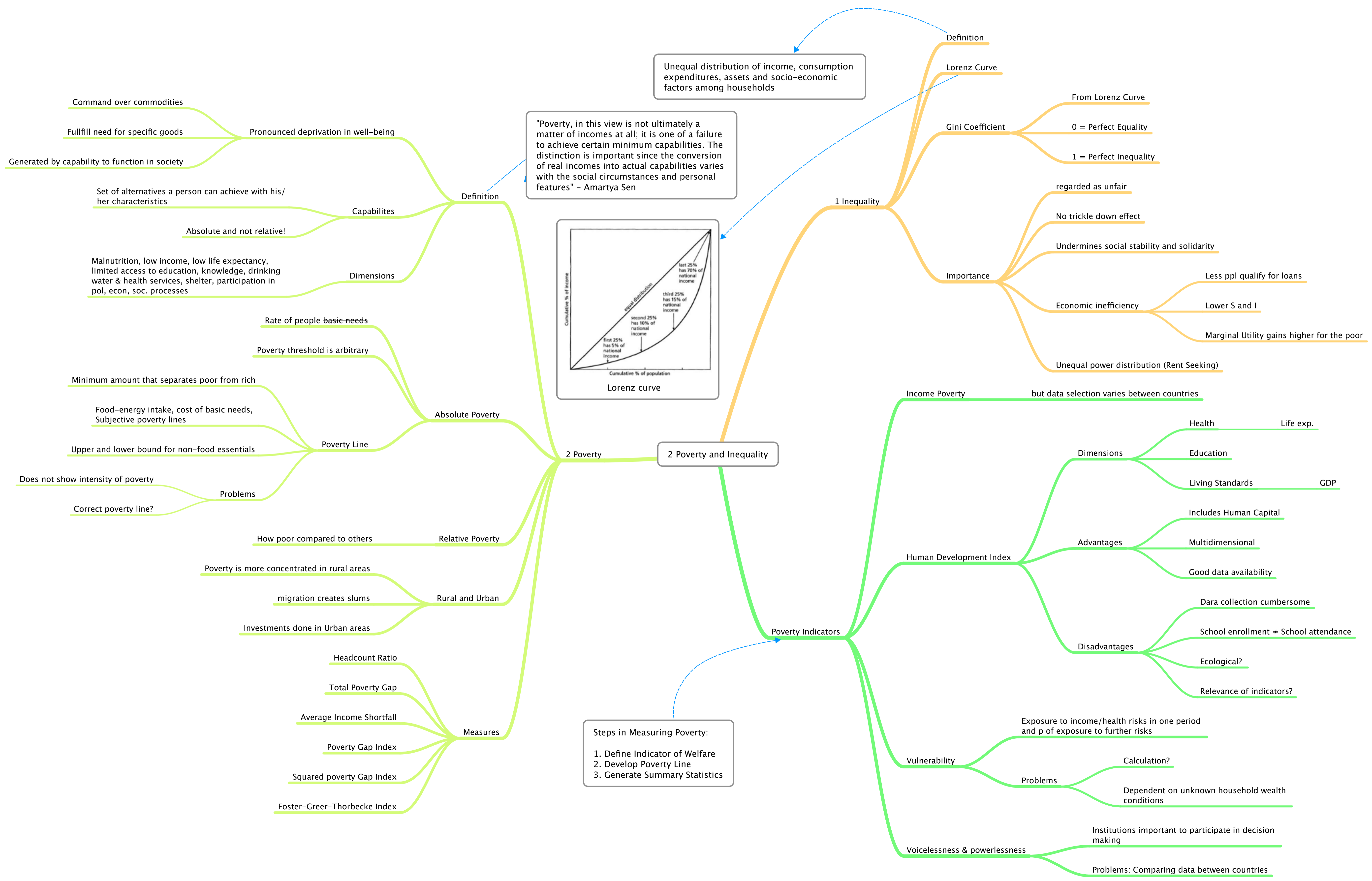
7 Environment and Development

8 Selected International Policy and Macroeconomic Issues

NeoClassic Theories on Economic Development

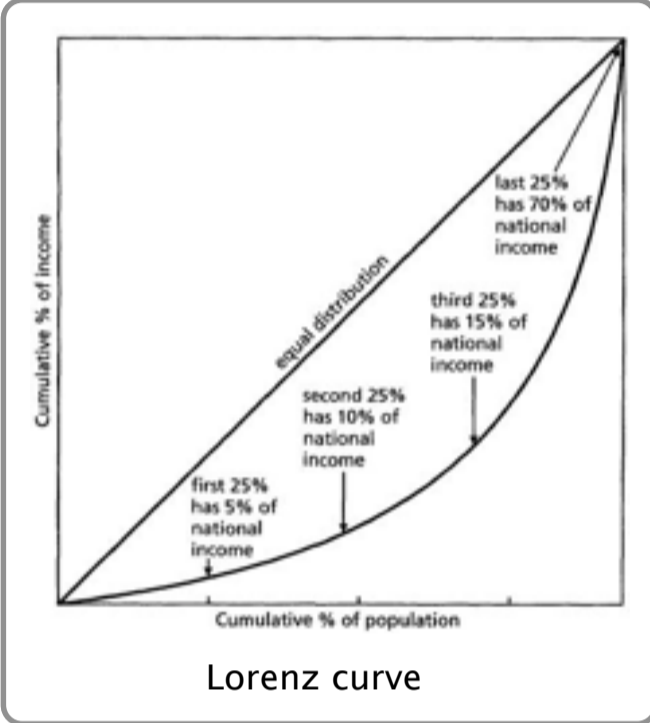
New Institutional Economics (NIE)





Unequal distribution of income, consumption expenditures, assets and socio-economic factors among households

"Poverty, in this view is not ultimately a matter of incomes at all; it is one of a failure to achieve certain minimum capabilities. The distinction is important since the conversion of real incomes into actual capabilities varies with the social circumstances and personal features" – Amartya Sen



2 Poverty and Inequality

1 Inequality

Definition

Lorenz Curve

Gini Coefficient

From Lorenz Curve

0 = Perfect Equality

1 = Perfect Inequality

Importance

regarded as unfair

No trickle down effect

Undermines social stability and solidarity

Economic inefficiency

Less ppl qualify for loans

Lower S and I

Marginal Utility gains higher for the poor

Unequal power distribution (Rent Seeking)

2 Poverty

2 Poverty and Inequality

Definition

Pronounced deprivation in well-being

Capabilities

Command over commodities

Fullfill need for specific goods

Generated by capability to function in society

Set of alternatives a person can achieve with his/her characteristics

Absolute and not relative!

Dimensions

Malnutrition, low income, low life expectancy, limited access to education, knowledge, drinking water & health services, shelter, participation in pol, econ, soc. processes

Absolute Poverty

Rate of people basic-needs

Poverty threshold is arbitrary

Minimum amount that separates poor from rich

Food-energy intake, cost of basic needs, Subjective poverty lines

Poverty Line

Upper and lower bound for non-food essentials

Problems

Does not show intensity of poverty

Correct poverty line?

Relative Poverty

How poor compared to others

Rural and Urban

Poverty is more concentrated in rural areas

migration creates slums

Investments done in Urban areas

Measures

Headcount Ratio

Total Poverty Gap

Average Income Shortfall

Poverty Gap Index

Squared poverty Gap Index

Foster-Greer-Thorbecke Index

Steps in Measuring Poverty:
1. Define Indicator of Welfare
2. Develop Poverty Line
3. Generate Summary Statistics

Poverty Indicators

Income Poverty

but data selection varies between countries

Dimensions

Health

Life exp.

Education

Living Standards

GDP

Advantages

Includes Human Capital

Multidimensional

Good data availability

Disadvantages

Dara collection cumbersome

School enrollment ≠ School attendance

Ecological?

Relevance of indicators?

Human Development Index

Vulnerability

Exposure to income/health risks in one period and p of exposure to further risks

Problems

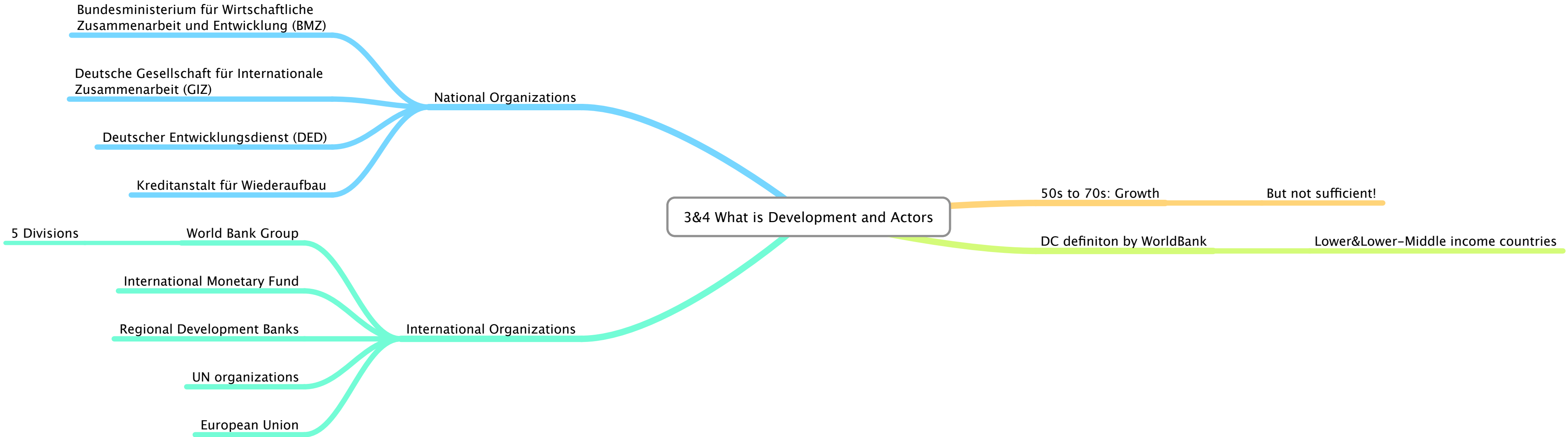
Calculation?

Dependent on unknown household wealth conditions

Voicelessness & powerlessness

Institutions important to participate in decision making

Problems: Comparing data between countries



5a Classification

Non-Economic

Climate/Geography

Sociology/Psychology

Modernization

Economic

Classical

Linear Stages

Dualism

Vicious Circle

Balanced/Unbalanced Growth

Demographic Theories

Foreign Trade Theoris

Neo Classical Growth Theories

New Institutional Economics

5: Non Economic Theories

Climate

Geography/climate explain development

Poorest countries are in the tropics

Montesquieu: Willingness to work increases as distance from equator increases

Key to understand changes in economic systems

Surplus for Winter

Manufacturing in Winter

Critique

Only one Explanatory factor

Today's climate not particularly harmful

Socio-Psychological

Social dispositions support economic and social development

Weber (1904): Calvinist ethic pushed development of capitalism

Traditional societies not fertile for entrepreneurship

Critique:

Little focus on economic development

Non-hierarchical African societies?

Theories of modernization

IC blueprint of Modern Society

DCs gell behind

Culture specific concepts?

Only western style valid?

Rostow's Stages of Growth

W. Rostow (1960): The Stages of Growth

- 1. Traditional society**
Agriculture, hierarchical society, low mobility
- 2. Pre-condition for take-off**
Increased saving, increased investment
- 3. Take-off**
Boom: 5-10% investment quota, key sectors with high growth rates, boosting entrepreneurship
- 4. Drive to maturity**
Modern technology, efficient use of resources, 10-20% investment quota, high level of growth, population growth, changing industrial organisation
- 5. High mass consumption**
Fully developed service sector, durable goods, also necessary: concentration of power

Rostow's

1 Linear Stages Theory

IC past "Take off" --> "Self sustaining Growth"

DCs in "Pre-condition to take off"

Investment & Savings

Rostow's Stages of Growth

Critique:

Little Explanatory Power

Deviations?

Poor empirical performance

Disregard of exogenous explanatory variables

5.3 Classical Theories I

2 Structural Change Models

2.1 Classical Dualism

Industry vs Agriculture

In Industry factors not completely substitutable

Modern Sector can't absorb new Labor Force without more capital

Critique:

Strong Simplification

Insufficient empirical proof

Links between sectors not considered

Industry not necessarily driving force for economic growth

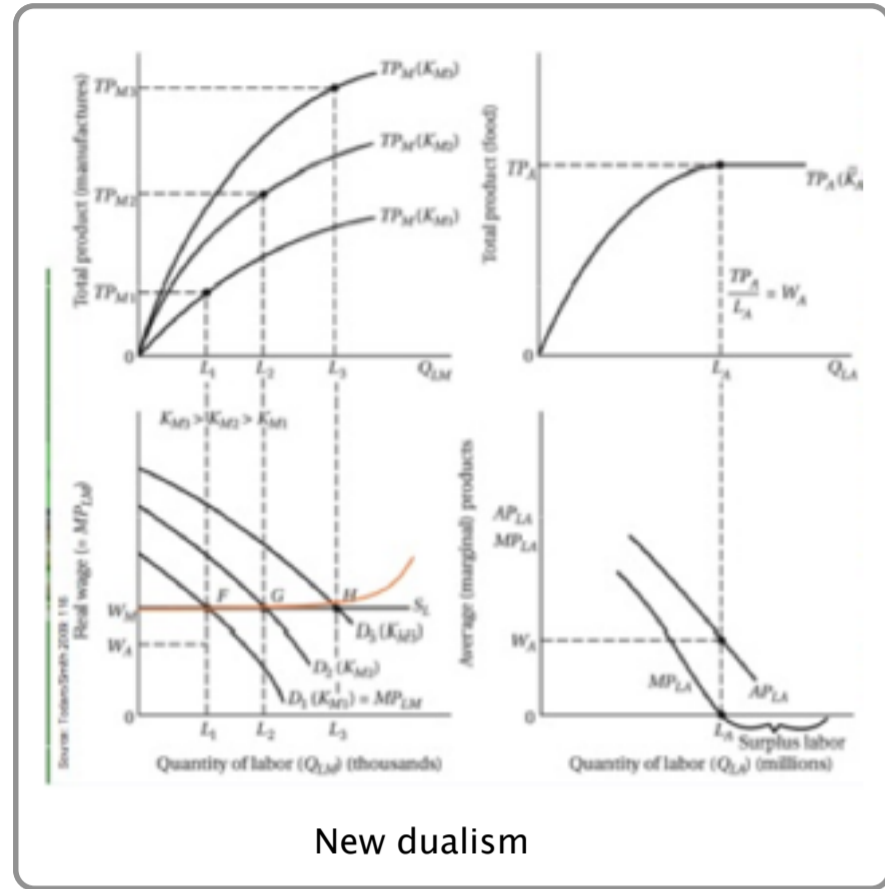
2.2 New Dualism

2.3 Balanced Growth

2.4 Unbalanced Growth

5.4 Classical Theories II

2 Structural Change Model



New dualism

2.1 Classical Dualism

2.2 New Dualism

- Subsistence econ --> Modern industrialised econ speed depends on investments
- Self sustainable growth until all surplus L is absorbed into Modern Sec.
- Profits -> Investments ↑ Increased Productivity Absorb more labor!

- Critique:
- Capital Flight
 - High unemployment in industry! (praxis)
 - Constant wages?
 - Profits are reinvested in labor saving tech Income is for owners!

2.3 Vicious Circle (Myrdal)

- High Savings -> High I Expansion!
- Low S -> Low I Underdevelopment!
- Call for active role of State

- Critique:
- Behavioral assumptions
 - No perfect substitution of factors
 - Natural law?
 - How to break circle?

Keynes

To overcome Vicious C: Balanced Growth

2.5 Balanced Growth

- Critique
- Too much confidence in State
 - Hayek (Information Problem)
 - Disregard of Price as regulating mechanism
 - State investment can hardly suffice for self-sustaining growth

2.6 Unbalanced Growth

- Disequilibria by active policy triggers entrepr. Profit motive Competition maximizes consumer welfare
- Critique:
 - Rational Entre. and Bureaucrats
 - Optimal magnitude of Disequilibrium?
 - May cause dualistic economies
 - little attention to division of labor

5.5 Classical Growth Theories: Foreign Trade Theories

Terms of Trade (ToT) – Prebisch–Singer

- ToT: Amount of imports a country can buy by an export
- Low Income elasticity for Primary commodities
- High Income Elasticity for manufactured commodities
- > Falling ToT
- > Transfer from DCs to ICs

Critique:

- Hypothesis does not hold!
- No consistent empirical pattern
- Australia & Canada export primary goods
- Laspeyres vs Paasche

Immiserizing Growth (Bhagwati)

- Growth -> $N \times \uparrow$ for imports from ICs
- Negative ToT crowds out positive growth effect
- Gains of growth transferred to IC
- Critique:
 - Extreme circumstances assumed
 - DCs may be Price takers
 - Brazil?

Import Substitution

- Substitute Imports with domestics
- Infant Industry argument
- Critique:
 - LATAM
 - Low Competition
 - Low quality -> die in International Market
 - Monopolies

Export Promotion

- Abolish Regulations of Foreign Trade
- Asian Tigers
- Countries with high export growth also have overall growth
- Causality?

5.6 Growth Theories

1 Harrod-Domar (Post-Keynesian)

growth if $I > \text{Depreciation}$

Easy Formula

+ Correlation btw. I and Growth

Influenced countries with Central Planning

Critique:

S and P.G assumed exogenous

I necessary but not sufficient!

No diminishing marginal returns

2 Solow (NeoClassical)

Most influential growth model

Diminishing marginal returns

Convergence

3 Endogenous Growth Theories

Technological Progress

Innovation/Human Capital as growth engine

5 Romer

Technological Spill over

Growth endogenous due to +externalities

Different growth rates of knowledge IC/DCs

4 Human Capital Model

Invest in Education!

Increasing marginal returns of HC

Critique of endogenous growth theories

Neoclassic assumption inappropriate for DCs

Structural change not modelled

Imperfect markets? Institutions?

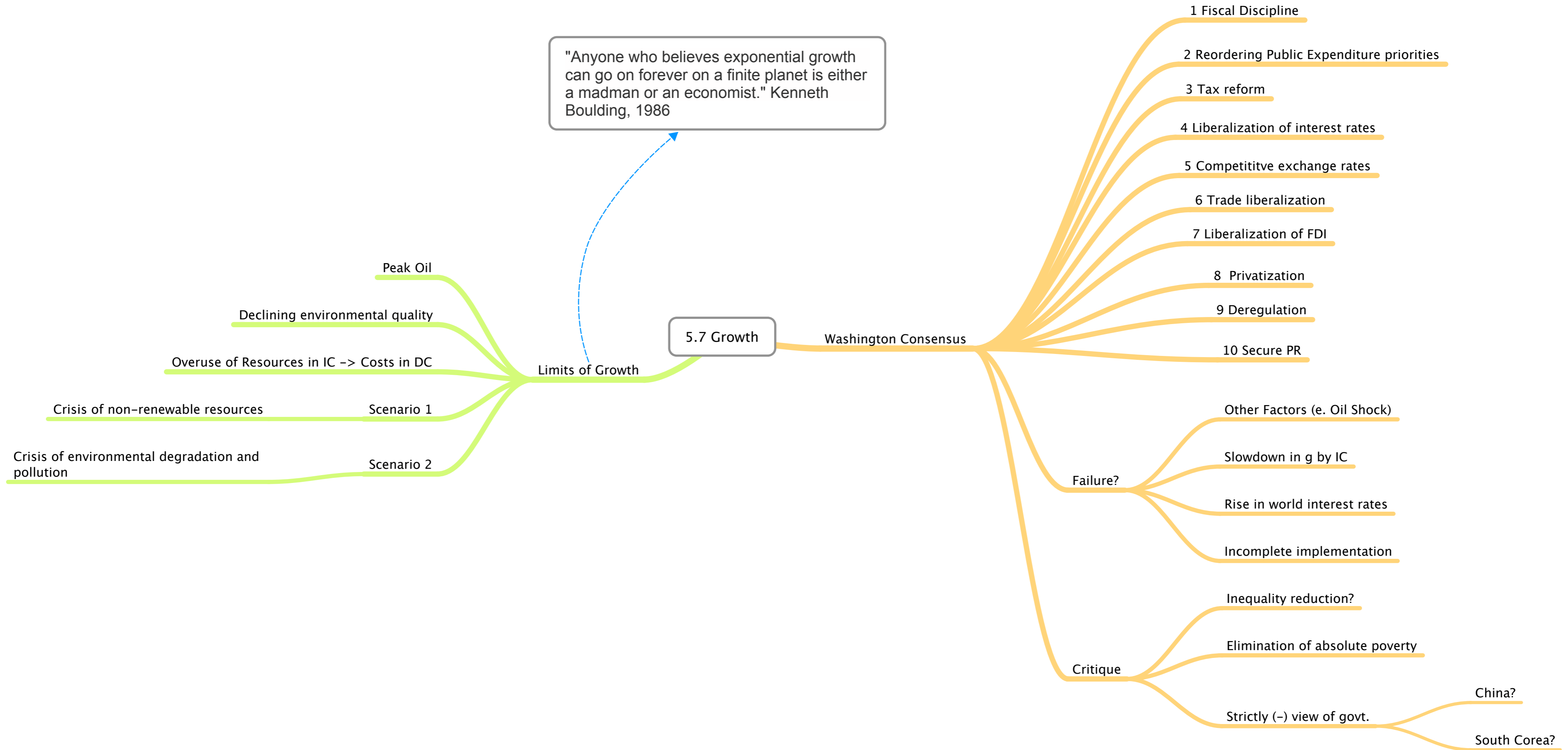
Limited support of empirical studies

Models of EconDev complementarities

Behavior by X -> Behavior by Y

No D without S, no S without D

Policy intervention to achieve best Equilibrium



6 New Institutional Economics (NIE)

"Institutions are humanly devised constraints that shape human interaction." North 1990

Rule of law: "reflects the degree to which citizens of a country are willing to accept the established institutions to make and implement laws and adjudicate disputes"

"The inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World." North

Property Rights

NIE & PR

- Bundle of Rights
- PR determined by Inst. (legal st. & norms)
- PR ensure that $Inv. \text{ today} = \pi \text{ tomorrow}$
- Clear defined PR help prevent conflict
- PR prevent externalities (Tragedy of Commons)
- no PR hinders I and spec.

ICRG Index

- Expropriation Risk and Rule of Law
- Repudiation of contract by govt
- Corruption in Govt and Bureauc. quality

PR and Econ. G

- PR Inst important for g
- PR influence size and efficiency of Inv.

Types

- Formal - Law
- Informal - Tradition

Functions

- Define choice set
- Reduce uncertainty
- Framework for invisible hand

Transaction Costs

- Costs of using the markets (Coase)
- Bounded rationality
 - Limited information processing capacity
 - Trade off - Returns of Spec. and TC↑
- DCs and TCs
 - Poor Transport / Underdeveloped Markets
 - Inefficient Public Administration
 - Poor education
- Contracts
 - Supervision Problems
 - Risks

Agency Problems

Inf. Asymmetries between P and A (due to TC)

- Ex ante: Adverse Selection
- Ex post: Moral Hazard
- Design incentives to reduce PA Problem!

Agency P in DCs

- P: Govt; A: Bureaucrats
- (Nat. Res): P: Pop. ; A: Govt

Powerful players take advantage of poor informed farmers

Lack of collateral -> Underdev. Financ. Markets

Institutional Design to overcome Ag.Pr

- Reputation & Trust
- Family Enterprises
- Self-Enforcing contracts (Ostrom)

Collective Action

Tragedy of the Commons

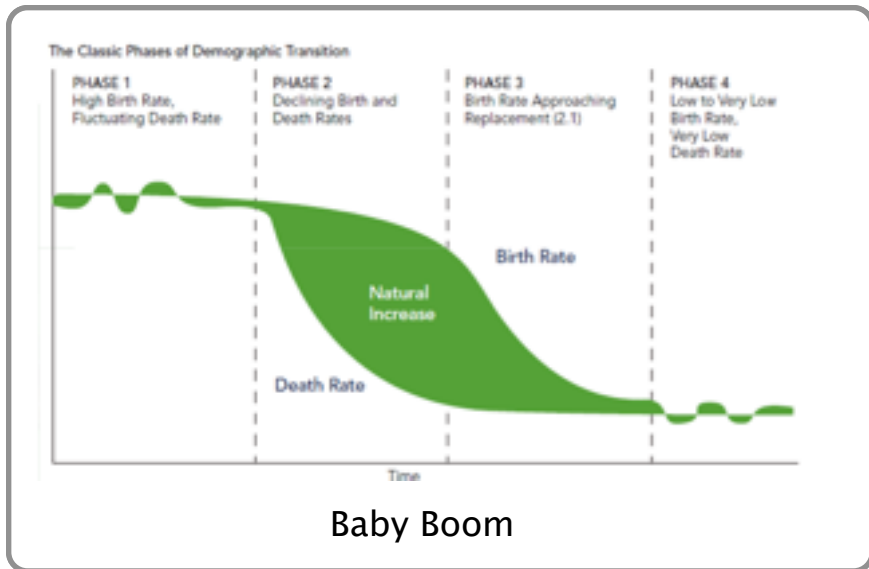
- Non-excludability -> Free riding
- to overcome it, INST to be considered

Types of property

- PR
- Common property (community)
- State property
- Open Access (Tragedy of commons)

Solution to Commons Problems

- State Regulation
 - Privatization
 - Collective Action
- Trust can lead to pareto efficient field of Prisoners Dilemma



Demographic Transition: Falling Death & Birth rate

7 Population Growth and Economic Development

Malthusianism (1798)

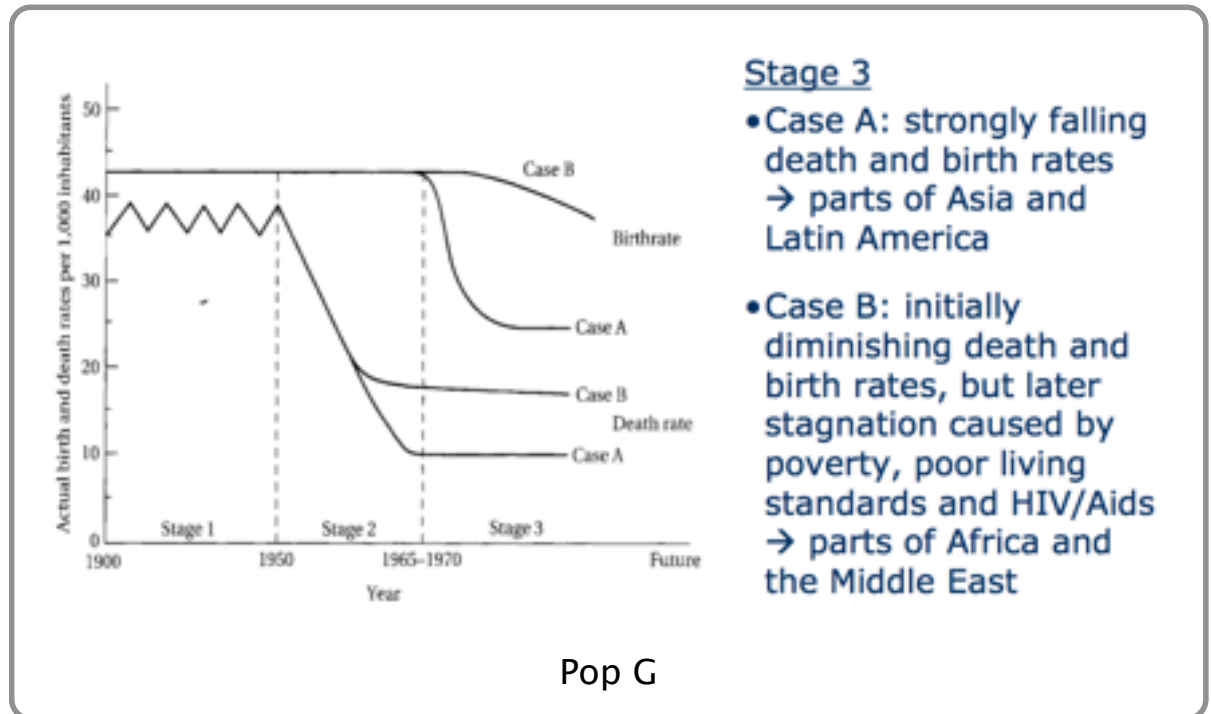
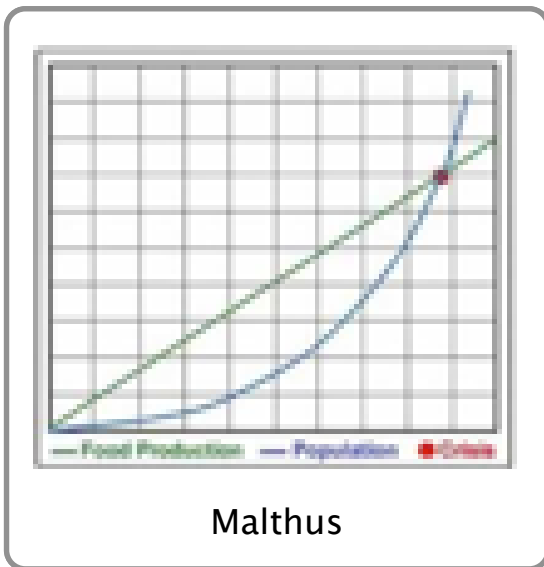
Population growth geometrical

Resource growth arithmetical

CRISIS!

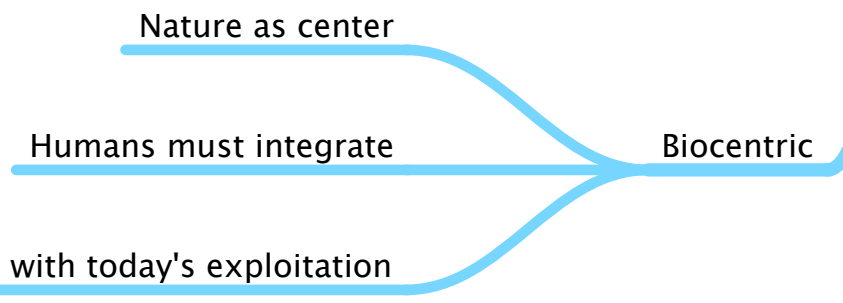
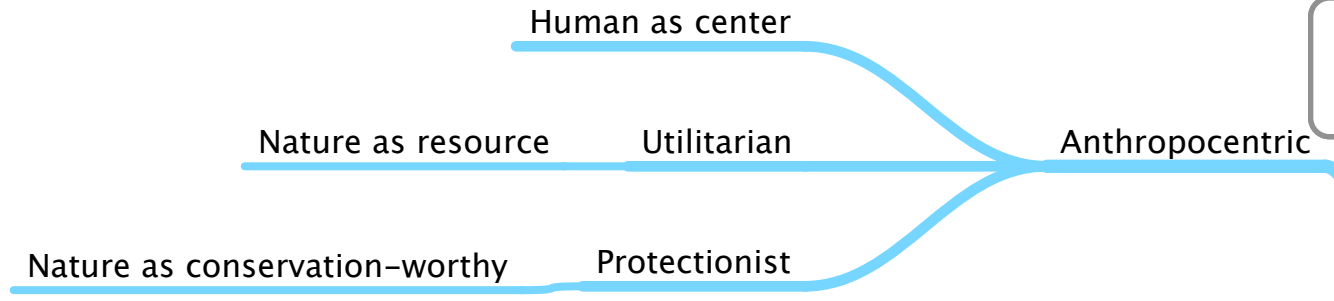
Proved wrong

New Tech



8 Environment and Development

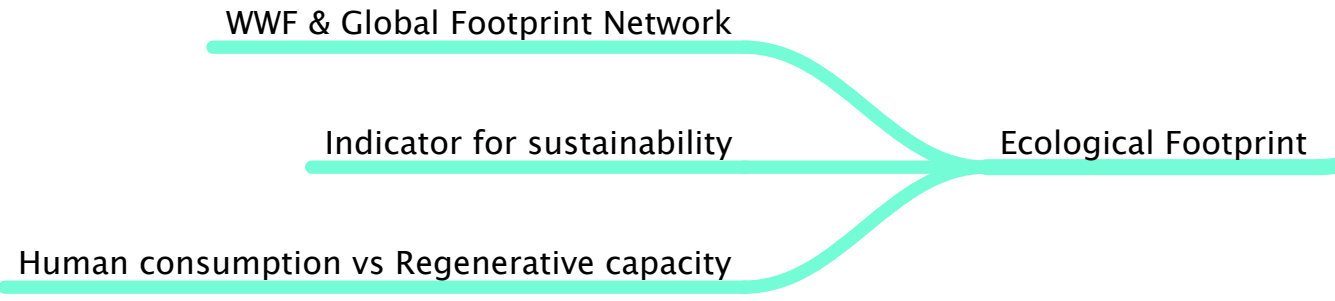
ICs most responsible for climate change. But Climate change hurts specially DCs



Conflicting views



Free riding, Tragedy of the Commons, Externalities



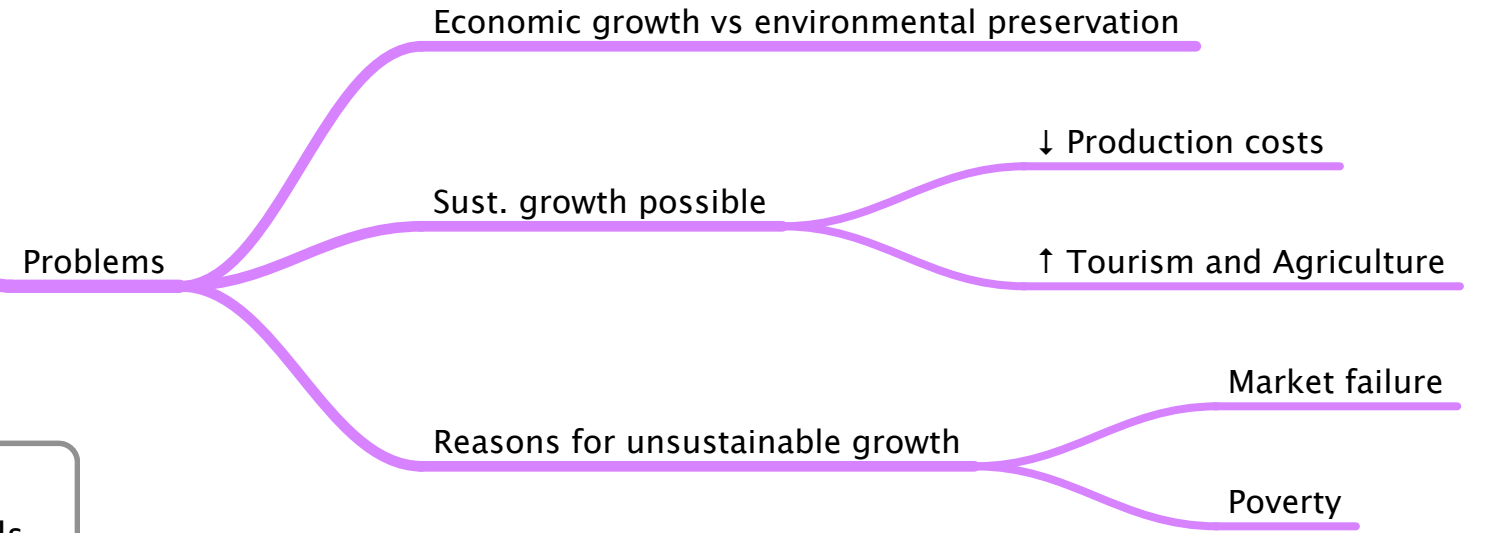
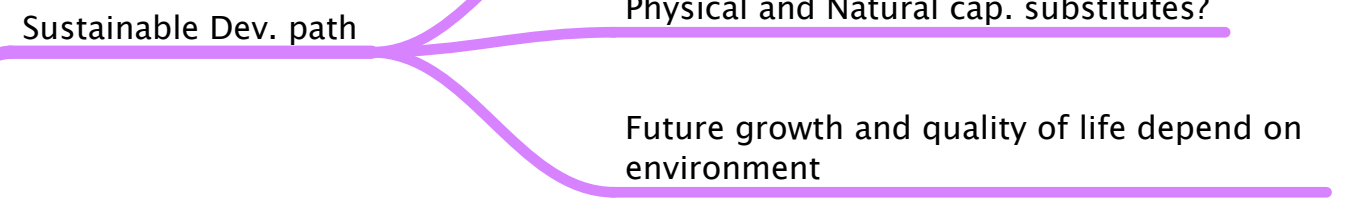
Static Efficiency

$\max \sum PR + CR$

"So long as all resources are privately owned and there are no market distortions, resources will be allocated efficiently." Todaro, Smith

"[...] meeting the needs of the present generation without compromising the needs of future generations" Todaro, Smith 2009

Sustainability



9 Trust and Economic Performance

"Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence." Arrow 1972

Trust: "Willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party." Mayer et al 1995

