

Comprehensive notes for DEC712S

CHARACTERISTICS OF DEVELOPING COUNTRIES

- **Low level of GNI per capita.** The Gross National Product (GNP) per capita or Gross National Income (GNI) per capita is often considered to be a good index of the economic welfare of the people in a country. Judging developing nations by this criterion one finds them in an extremely miserable position. The GNI per capita in these countries is very low. According to the estimates of the World Bank, in 2007 there were 43 low income economies where the GNI per capita was estimated at \$350 or even less. This low level of GNI per capita is sufficient to reflect the plight of common people in these countries. On world scale, income inequalities between the developed and developing countries are quite large. But what is more distressing is that the economic distance between the two groups of countries increases with every year that passes. In 2007, the average GNI per capita of the high income economies was estimated at \$37,566 while it was only \$578 in low income developing economies.
- **Larger income inequalities.** In developing countries apart from GNP per capita being considerably lower, income inequalities are also larger than in developed countries. Recent data published in the World Development Indicators lends credence to the view that income inequalities are far greater in developing countries than in developed countries. According to Simon Kuznets, inequalities are much larger in the developing countries. The comparison of income distribution in developed and developing countries is generally made of incomes prior to levying of direct taxes and the free benefits from the government also remain excluded. He rightly asserts “since the burden and progressivity of direct taxes are much greater in developed countries and since it is in the latter that substantial volumes of free economic assistance are extended to low income groups, a comparison in terms of income net of direct taxes and excluding government benefits would only accentuate the wider inequality of income distribution in the underdeveloped countries”
- **Widespread Poverty.** The extent of absolute poverty is an important dimension of the problem of income distribution in the developing countries. At relatively lower levels of GNP per capita large income inequalities as they exist in the developing countries of Asia, Africa and Latin America, have resulted in widespread poverty. The poverty problem could perhaps be overcome in these countries with a more equitable income distribution. China’s case lends credence to the view that in near future if developing countries wish to wipe out poverty they have no choice except to improve the income distribution so as to ensure a minimum standard of living in terms of calorie intake the nutrition levels, clothing, sanitation, health, education and so on. Poverty is, however, not easy to define, and whatever be the approach, there is bound to be an element of arbitrariness in it. Till recently, the World Bank used a poverty line of \$1 a day in 1993 PPP (Purchasing Power Parity) terms. This has now been revised to \$1.25 a day in 2005 PPP terms (which represents the mean of the poverty lines found in the poorest 15 countries ranked by per capita consumption)

- **Low levels of Productivity.** Labour productivity in developing countries is invariably low. It is both a cause and effect of low levels of living in these countries. Todaro and Smith assert that “low levels of living and low productivity are self-reinforcing social and economic phenomena in third World countries and as such are the principal manifestations of and contributors to their underdevelopment”. Labour productivity depends on a number of factors, particularly the availability of other inputs to be combined with labour, health and skill of workers, motivation for work and institutional flexibilities. The two inputs viz. capital and managerial skill raise the productivity of labour considerably when they are combined with it. But developing countries lack both of these inputs. Hence, it is quite natural to advocate that this deficiency should be overcome as early as possible by improving domestic supply of these inputs, and if need be, also by supplementing it from foreign sources.
- **Great dependence on agriculture with a backward industrial structure :** Harvey Leibenstein asserts that developing economies are basically agrarian in their character. In these countries agriculture and allied activities generally account for 30% to 80% of the labour force. This is true of most of the Asian and African countries. In Latin America, however there are a number of developing countries where proportion of labour force employed in agriculture has declined to 20% or even less of the total work force. As compared to overall labour productivity, labour productivity in the agricultural sector is lower in the developing countries than in the developed countries. Making his observations on this phenomenon. Simon Kuznets remarks “One major implication of the relatively low per worker production in agriculture in the underdeveloped countries is that a large proportion of the population is attached to a sector with low productivity operating under conditions of rural life and isolation that cannot be penetrated by modern economic methods”. The industrial sector in the developing countries is both small and backward while the extended industrial sector in these countries accounts for about a fifth of the total product in these countries, less than 10% is allocable to manufacturing proper.
- **High Proportion of consumption and expenditure and low risk saving rate:** on examining the major use structure of Gross National Product in the standard national accounts, Kuznets has observed that “the underdeveloped countries differ from developed countries in several respects: a large share for private consumption (73% – 75 % compared with 64%-66% for developed countries); a slightly lower share for government consumption (11 to 12 percent compared with 12 to 14 per cent); a distinctly lower share for gross domestic formation (15 to 16 percent , compared with 22 to 23 percent); and an even lower share of gross national capital formation (14 to 15 per cent, compared with 22 per cent)”. It is not surprising why the savings rate is lower in the developing countries. If the income level is low, the propensity to consume will be high, and as a consequence capital formation will be low. Ragnar Nurkse has contended that since the underdeveloped countries are caught in a vicious circle of poverty they do not have much capacity to save. Furthermore, on the demand side the market constraint operates as a distinctive and the potential savers indulge in wasteful consumption.

- **High rate of population growth and dependency burdens:** Population has been rising in most developing countries at rates varying between 2 and 3.5 percent per annum for the past few decades. This demographic trend is unprecedented in the history of mankind. Due to increased medical facilities there has been a sudden decline in the mortality rates in these countries. However, in most developing countries birth rate remain very high, in the range of 25 to 50 per thousands, while in developed countries, nowhere it exceeds 15 per thousand. Interestingly, china, Sri Lanka, and Thailand are the only lower middle income developing countries which have managed to bring down their birth rates to 10 to 15 per thousand. A high rate of population growth in the third world countries is both a cause and effect of their underdevelopment. A major implication of high birth rates in the developing countries is that it results in a greater dependency burden than that in developed countries.
- **High levels of unemployment and underemployment:** Unemployment in both rural and urban areas is widespread in the developing countries. The traditional agriculture characterised by outmoded techniques of production and low level of productivity lacks labour absorption capacity. Thus, with rapidly growing population in these countries, pressure of population on agricultural land has been increasing and with it the problem of disguised unemployment is becoming increasingly serious. Rural people are aware of this malady, and therefore quite often they migrate to cities in search of jobs where not many employment opportunities exist for them. This part of urban unemployment in the developing countries is a spill over of unemployment in the countryside. Another reason for unemployment in cities is inadequate growth of industries. In developing countries, markets for manufacturers are quite small due to widespread poverty. Faced with the problems of lack of adequate demand, industries grow at a snail pace and fail to provide jobs in sufficient number to absorb the growing population. Current rates of open unemployment in urban areas in most developing countries average from 10 to 15 per cent of the urban labour force. Unemployment among educated people aged 15 – 24 years is also considerable in the urban areas. According to Michael P. Todaro “when the unemployed are added to the openly unemployed and when “discouraged workers”- those who have given up looking for a job – are added in, almost 35% of the combined urban and rural labour forces in Third World nations is unutilised”
- **Technological Backwardness:** In developing countries, production techniques are inefficient over a wide range of industrial activity. This sorry state of affairs cannot be explained in terms of one or two factors. Lack of research and development (R&D), weak communication system between the research institutes and industries, abundance of labour and capital scarcity are some obvious reasons for the use of techniques which have otherwise become obsolete. Developing countries generally do not have large effective institutions working for discovering appropriate technology. Under the circumstances, an attempt is made to import technology from developed countries which often fails to adapt to local conditions. Moreover, whatever limited research is undertaken in industrial technology; its results fail to reach producers due to weak communication system. But those factors do not explain wholly the continuance of outmoded techniques. In most cases it's not the ignorance which prevents producers from adopting modern techniques. In many cases technological choice of producers is dictated by their poverty.
- **Dualism:** Economist talk of various types of dualism existing in developing economies. During the colonial and post-colonial period the concept of ‘**social Dualism**’ was quite popular with the western economist and they used it extensively to explain the problems of

underdeveloped economies. J.K Boeke in his study of the Indonesian economy argued that social dualism arises in a backward economy with the import of alien progressive system. In Indonesia, it had emerged with the import of capitalism, comes in conflict with indigenous system of another style. It however, cannot speed up the process of development. Boeke asserts that industrial or agricultural development in these countries has to be a 'slow processes', small scale and adapted to a dualistic system. Benjamin Higgins while rejecting Boeke's theory of social dualism contends that "dualism is more readily explained in economic and technological terms "He uses the concept of **technological dualism** to explain the labour employment problems. In his model of an underdeveloped economy there are two compartmentalised sectors, the traditional rural sector and the modern sector. The traditional rural sector has variable technical coefficients of production in contrast to modern sector's fixed technical coefficients of production. The implication of these is that the rapid growth of population results in unemployment of excess supply of labour or it must seek employment in the traditional sector where marginal productivity eventually falls to zero. According to Myint, the dualism in economic organisation and production method between the peasant sector and the mining manufacturing sector is paralleled by the **financial dualism**. In the colonial period in most underdeveloped countries domestic financial institutions co – existed with modern financial institutions oriented towards export production. After these underdeveloped countries got independence, they developed modern manufacturing industries oriented towards domestic market. This required development of modern financial institutions also giving rise to different kind of financial dualism.

- **Lower participation in foreign trade:** It is commonly believed that developing countries rely excessively on foreign trade, in the sense that their properties of exports and imports to domestic product are much higher than those of the developed countries. On careful scrutiny, this widespread belief is found to be wrong. Simon Kuznets after examining this question finds that the extent of participation of a country in foreign trade cannot be measured directly because the proportion of foreign trade to total output is affected by the size of a country. He, therefore, suggest that the effects of size should be measured and eliminated first. "Once this adjustment is made, it becomes clear that the extent of participation in foreign trade by underdeveloped countries is distinctly lower than that of developed countries. Thus, if the average foreign trade proportions expected on the basis of size were the same for the two groups of countries, viz., developed and developing, the average actual trade proportion for developing countries would be considerably lower than that for the developed countries. The inadequate development of transportation system and trade organisation and backwardness of production technology are some such factors that would make large exports and imports impossible.

- **Dependence:** The process of underdevelopment in the Asian, African and Latin American countries had begun with the integration of their economies with those of the West European capitalist economies. This relationship between the colonies and the metropolitan countries gave rise to an international division of labour which allowed industrial development to take place only in the latter. Though the economies of the colonies remained backward yet they were part of the world capitalist system. They were in fact made subservient to metropolitan interests and were forced to specialise in primary producing activities. The pattern and direction of trade in colonial period was also determined by the basic fact of the integration of colonies with the metropolitan countries. On the one hand colonies depend on the metropolitan countries for almost all the capital goods, industrial raw materials and most of the manufactured consumer goods, while on the other hand their exports constituted of one or two primary products.

The three co-values of development

1. **Sustenance:** The ability to meet basic needs. All people have certain basic needs without which life would be impossible. These life-sustaining basic human needs include food, health, and protection. When any of these is absent or in critically short supply, a condition of “absolute underdevelopment” exists.
2. **Self-Esteem:** A second universal component of the good life is self-esteem- a sense of worth and self-respect, of not being used as a tool by others for their own ends.
3. **Freedom from Servitude (bondage):** A third and final universal value that should constitute the meaning of development is the concept of human freedom. The concept of human freedom should also encompass various component of political freedom including, but not limited to, personal security, the rule of law, freedom of expression, political participation, and equity of opportunity

Crowding out effect

When government spending fails to increase overall aggregate demand because higher government spending causes an equivalent fall in private sector spending and investment. When the government has to borrow, it needs to borrow from the private sector. This could be private individuals, pension funds or investment trusts. It is argued that if the private sector buy government securities this will crowd out private sectors investment. This can be fully illustrated with the diagram below

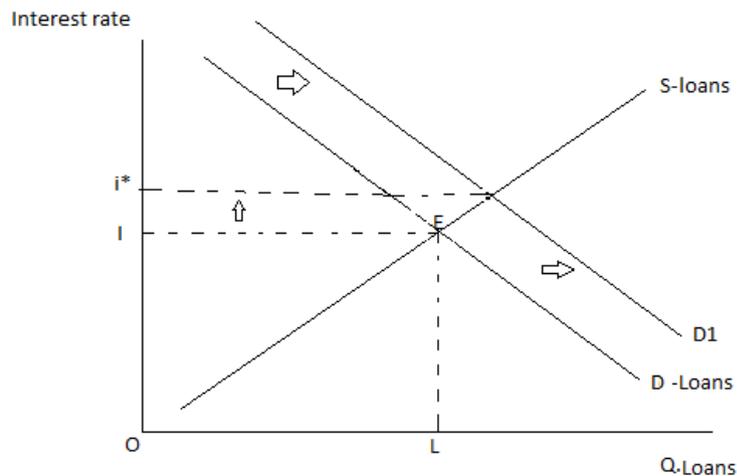


fig 1

When the government is experiencing budget deficit and as such decides to adopt expansionary policy using fiscal policy, it is required by the government to issue bonds. Given that the market price for demand and supply of loan is denoted by “E” an increase in government borrowing would lead to an increase in demand for loans, shifting to the right D1, thus leading to an increase in interest rate from ‘i’ to ‘i*’ thus leading to crowding out, as explained above. High interest rates caused by government borrowing attract foreign capital from foreign investors. Foreign investors purchase domestic bonds, which increases the demand for the domestic currency. The increased demand for domestic currency leads to the appreciation of the domestic currency. This reduces the exports and increases the imports of the domestic economy, further lowering AD, contrary to the objective of fiscal policy. Expansionary fiscal policy may lead to high inflation due to the increased aggregate demand. High inflation may also be due to the financing of a budget deficit through the printing of money. Other problems associated with expansionary fiscal policy include the time lag between the implementation of fiscal policy and detectable effects in the economy. In summary, classical economists argues due to the above reasons fiscal policy is not an effective economic tool.

Economic Characteristics of Poverty Groups

An understanding of the nature of the size distribution of income is central to any analysis of the poverty problem in low –income countries. Before we can formulate effective policies and programs to attack poverty at its source we need some specific knowledge of these poverty groups and their economic characteristics

Rural Poverty:- The most valid generalization about the poor are that they are disproportionately located in rural areas, that they are primarily engaged in agricultural and associated activities, that they are more likely to be women and children than adult males, and that they are often concentrated among minority ethnic groups and indigenous people. In Africa and Asia, about 80% of all target poverty groups are located in the rural areas, as are about 50% in Latin America. It is interesting to note, in light of the rural concentration of absolute poverty, that the largest share of most LDC government expenditures over the past several decades has been directed toward the urban area and especially toward the relatively affluent modern manufacturing and commercial sectors.

Women and Poverty: – Women make up a substantial majority of the world's poor. If we compared the lives of the inhabitants of the poorest communities throughout the developing world, we would discover that virtually everywhere, women and children experience the hardest deprivation. They are more likely to be poor and malnourished and less likely to receive medical services, clean water, sanitation and other benefits. The prevalence of female headed households and lower earning capacity of women, and their limited control over their spouses' income all contribute to this disturbing phenomenon. In addition women have less access to education, formal sector employment, and social security and government employment programs. These facts combine to ensure that poor women's financial resources are meagre and unstable relative to men's. Development policies that increases the productivity differentials between men and women are likely to worsen earnings disparities as well as further erode women economic status within the household. Since government programs to alleviate poverty frequently work almost exclusively with men, they tend to exacerbate these inequalities. In urban areas, training programs to increase earning potential and formal – sector employment are generally limited to men, while agricultural extension program promote male- dominated crops, frequently at the expense of women vegetable plots. Studies have shown that development effort can actually increase women's workload while at the same time reduce the share of households resources over which they exercise control. Consequently, women and their dependents remain the most economically vulnerable group in LDC.

Any process of growth that fails to improve the welfare of the people experiencing the greatest hardship, broadly recognised to be women and children, has failed to accomplish one of the principals' goals of development. In the long run, the low status of women is likely to translate into slower rates of economic growth.

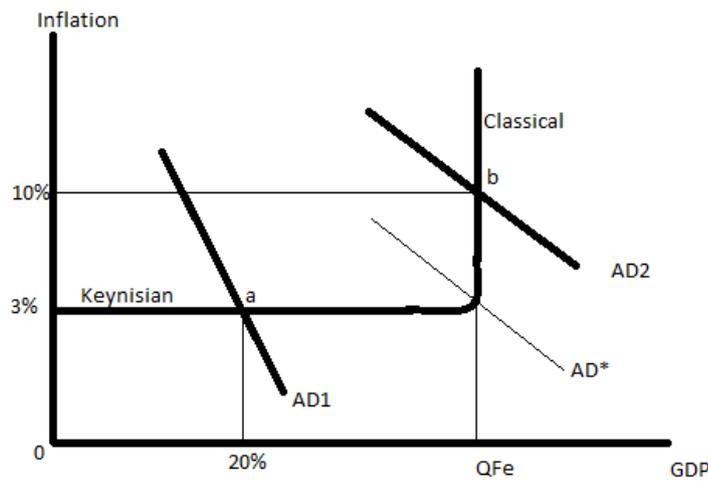
Ethnic Minorities and Poverty:- A final generalization about the incidence of poverty in the developing world is that it falls heavily on minority ethnic groups and indigenous populations. In recent years, domestic conflicts and even civil wars have arisen out of ethnic groups' perceptions that they are losing out in the competition for limited resources and job opportunities the poverty problem is even more serious for indigenous peoples, whose numbers exceed 300 million in over 5,000 different groups in more than 70 countries. In Latin America results have shown that most indigenous groups live in extreme poverty and that being indigenous greatly increases the chances that an individual will be malnourished, illiterate, in poor health and unemployed same research could also be applicable to Africa and Asia regions with high rates of poverty. It should be noted that the poor come from poor countries. Although this may seem like a trivial observation, it is actually a useful note of optimism. The negative relationship between poverty and per capita income suggest that if higher incomes can be achieved, poverty will be reduced, if only because of the great resources that countries will have available to tackle poverty problems. Unfortunately, a higher level of absolute poverty can also retard a country's growth prospects.

Macroeconomic Goals

The three important Macroeconomic goals are, stable prices, High sustainable growth and Low unemployment. These three goals can be achieved through Monetary and Fiscal policies. Monetary Policy is the process used a monetary authority (government or central bank) to control the supply, availability and the cost of money in the economy. Monetary policy can either be expansionary or contractionary Expansionary increases whilst contractionary monetary policy reduces the quantity of money in the economy. A substantial change in money supply would either increase or decrease interest rate which would either decrease or increase aggregate demand ($\Delta MS = \uparrow \downarrow i = \downarrow \uparrow AD$) which has an effect on the three macroeconomic goals. Fiscal policy is the use of government expenditure and revenue collection to influence the economy. The two main instruments of fiscal policy are Government expenditure and Taxation. Neutral stance of fiscal policy implies a balanced budget where $G=T$ (Government spending = Tax revenue). Government spending is fully funded by tax revenue and overall the budget outcome has a neutral effect on the level of economic activity. Expansionary fiscal policy involves a net increase in government spending ($G>T$) through rises in government spending, a fall in taxation revenue or a combination of the two. This will lead to a larger budget deficit or a small budget surplus than the government previous had Expansionary fiscal policy is usually associated with a budget deficit An increase in government expenditure would lead to an increase in money supply (Expansionary policy) which as a result would lead to increase in aggregate demand. Contractionary fiscal policy ($G<T$) occurs

when net government is reduced either through higher taxation revenue, reduced government spending or a combination of the two. This will lead to a lower budget deficit or larger surplus. Contractionary fiscal policy is usually associated with a surplus budget, and as such reduces aggregate demand. The diagram below analyses how the three macroeconomic goals can be controlled with the above mentioned policies.

Fig2



The classical economist assumes a state of full employment shown as Q_{Fe} , although the Keynesian school of thoughts didn't dispute the assumption they criticise the classicalist views on how to attain full employment in the long run citing the necessity of government intervention in the economy, which would shift demand curve to the right through fiscal policies (Increasing Government spending or decreasing tax); given unemployment rate at 20% and inflation rate at 3% the economy is approaching recession, as seen (fig.1) above the government can either choose to adopt fiscal or monetary policy or adopt both policies. Adopting fiscal policies would shift aggregate demand curve towards the right at AD^* , this could also be achieved using monetary policies, although the government suffers the consequences of inflation at 10% with a continuous expansionary policy, shifting aggregate demand to AD_2 from AD^* thus it is necessary for the governments to also adopt contractionary policies in order to balance the aggregate demand curve at AD^* maintaining inflation rate at 3% as well as achieving full employment.

MALTHUSIAN THEORY OF POPULATION

Thomas Robert Malthus wrote his essay on "Principle of Population" in 1798 and modified some of his conclusions in the next edition in 1803. He feared that England was heading for a disaster, and he considered it his solemn duty to warn his country-men of impending disaster. He deplored "the strange contrast between over-care in breeding animals and carelessness in breeding men." His theory is very simple. To use his own words: "By nature human food increases in a slow arithmetical ratio; man himself increases in a quick geometrical ratio unless want and vice stop him. The increase in numbers is necessarily limited by the means of subsistence. Population invariably increases when the means of subsistence increase, unless prevented by powerful and obvious checks."

Propositions of Malthus theory;

The first proposition is that the population of a country is limited by the means of subsistence. In other words, the size of population is determined by the availability of food. The greater the food production, the greater the size of the population which can be sustained. The check of deaths caused by want of food and poverty would limit the maximum possible population.

The second proposition states that the growth of population will out-run the increase in food production. Malthus thought that man's sexual urge to bear offspring knows no bounds. He seemed to think that there was no limit to the fertility of man. But the power of land to produce food is limited. Malthus thought that the law of diminishing returns operated in the field of agriculture and that the operation of this law prevented food production from increasing in proportion to labour and capital invested in land.

In fact, Malthus observed that population would tend to increase at a geometric rate (2, 4, 8, 16, 32, 64, etc.), but food supply would tend to increase at an arithmetic rate (2, 4, 6, 8, 10, 12). Thus, at the end of two hundred years "population would be to the means of subsistence as 259 to 9; in three centuries as 4,096 to 13, and in two thousand years the difference would be incalculable." Therefore, Malthus asserted that population would ultimately outstrip food supply.

According to the third proposition, as the food supply in a country increases, the people will produce more children and would have larger families. This would increase the demand for food and food per person will again diminish. Therefore, according to Malthus, the standard of living of the people cannot rise permanently. As regards the fourth proposition, Malthus pointed out that there were two possible checks which could limit the growth of population: (a) Preventive checks, and (b) Positive checks.

Preventive Checks:

Preventive checks exercise their influence on the growth of population by bringing down the birth rate. Preventive checks are those checks which are applied by man. Late marriage and self-restraint during married life are the examples of preventive checks applied by man to limit the family.

Positive Checks:

Positive checks exercise their influence on the growth of population by increasing the death rate. They are applied by nature. The positive checks to population are various and include every cause, whether arising from vice or misery, which in any degree contributes to shorten the natural duration of human life. The unwholesome occupations, hard labour, exposure to the seasons, extreme poverty, bad nursing of children, common diseases, wars, plagues and famines are some of the examples of positive checks. They all shorten human life and increase the death rate.

Malthus recommended the use of preventive checks if mankind was to escape from the impending misery. If preventive checks were not effectively used, positive checks like diseases, wars and famines would come into operation. As a result, the population would be reduced to the level which can be sustained by the available quantity of food supply.

Criticism of Malthusian Theory:

□ Gloomy forecast made by Malthus about the economic conditions of future generations of mankind has been falsified in the Western world. Population has not increased as rapidly as predicted by Malthus; on the other hand, production has increased tremendously because of the rapid advances in technology.

□ Malthus compared the population growth with the increase in food production alone. Malthus held that because land was available in limited quantity, food production

could not rise faster than population. But he should have considered all types of production in considering the question of optimum size of population. There is no food problem in Great Britain. Therefore, Malthus made a mistake in taking agricultural land and food production alone into account when discussing the population question.

□ Malthus held that the increase in the means of subsistence or food supplies would cause population to grow rapidly so that ultimately means of subsistence or food supply would be in level with population, and everyone would get only bare minimum subsistence. In other words, according to Malthus, living standards of the people cannot rise in the long run above the level of minimum subsistence. But, as already pointed out, living standards of the people in the Western world have risen greatly and stand much above the minimum subsistence level. There is no evidence of birth-rate rising with the increases in the standard of living. Instead, there is evidence that birth-rates fall as the economy grows.

□ Malthus gave no proof of his assertion that population increased exactly in geometric progression and food production increased exactly in arithmetic progression. It has been rightly pointed out that population and food supply did not change in accordance with these mathematical series. Growth of population and food supply cannot be expected to show the precision or accuracy of such series.

We must, however, add that though the gloomy conclusions of Malthus have not turned out to be true due to several factors which have made their appearance only in recent times, yet the

essentials of the theory have not been demolished. He said that unless preventive checks were exercised, positive checks would operate. So, Is Malthusian Theory valid today?

Okun`s Law

Economic study and thought has been around for centuries, and when it comes to studying the economy, growth and jobs are two primary factors that economists must consider. There is clearly a relationship between the two, and many economists have framed the discussion by trying to study the relationship between economic growth and unemployment levels. Economist Arthur Okun first started tackling the discussion in the 1960s, and his research on the subject has since become known as Okun's law. Below is a more detailed overview of Okun's Law, why it is important and how it stood the test of time since first being published

In its most basic form, Okun's law investigates the statistical relationship between a country's unemployment rate and the growth rate of its economy. According to research "the logic behind Okun's law is simple. Output depends on the amount of labor used in the production process, so there is a positive relationship between output and employment. Total employment equals the labor force minus the unemployed, so there is a negative relationship between output and unemployment (conditional on the labor force)." according to [the] currently accepted versions of Okun's law, to achieve a 1 percentage point decline in the unemployment rate in the course of a year, real GDP must grow approximately 2 percentage points faster than the rate of growth of potential GDP over that period. So, for illustration, if the potential rate of GDP growth is 2%, Okun's law says that GDP must grow at about a 4% rate for one year to achieve a 1 percentage point reduction in the rate of unemployment." It is most important to note that Okun's law is a statistical relationship that relies on a regression of unemployment and economic growth. As such, running the regression can result in differing coefficients that are used to solve for the change in unemployment, based on how the economy grew. It all depends on the time periods used and inputs, which are historical GDP and employment data. The law has indeed "evolved," or changed over time to fit the current economic climate and employment trends at the time. One version of Okun's law has stated very simply that when unemployment falls by 1%, GNP rises by 3%. Another version of Okun's Law focuses on a relationship between unemployment and GDP, whereby a percentage increase in unemployment causes a 2% fall in GDP. As with any law in economics, science or any discipline, it is important to determine if it holds under varying conditions and over time. In regard to Okun's law, there appear to be conditions where it holds quite well and others where it doesn't. For instance, a review of Okun's law by the Federal Reserve of Kansas City detailed that one of Okun's first

relationships looked at quarterly changes in unemployment compared to quarterly growth in real output and it seemed to hold up well. Despite the fact that there are in reality many moving parts to the relationship between unemployment and economic growth, there does appear to be empirical support for the law. The Kansas City Fed study concluded that "Okun's law is not a tight relationship," but that "Okun's law predicts that growth slowdowns typically coincide with rising unemployment." In regard to the fact it did not hold up that well during the financial crisis.

Overall, there is little debate that Okun's law represents one of the most straightforward and convenient methods to investigate the relationship between economic growth and employment. One of the key benefits of Okun's law is its simplicity, a benefit shared by portfolio management, and the ability to simply state that a 1% decrease in unemployment will occur when the economy grows about 2% faster than expected. Additionally, his law has been studied extensively since it was first published. Finally, there has been plenty of history over the past five decades, since Okun's first works were published, to put it to the test. In reality though, it appears that relying on Okun's law to make specific predictions about unemployment, given economic growth trends, doesn't hold up that well. For instance, since it has been studied it has been known to shift over time and be impacted by more unusual economic climates, including jobless recoveries and the more recent financial crisis. Because of the complexity of the inputs, different time periods that can be used and basic uncertainty that goes with running economic regressions, the law can become quite complex. It simply employs many different economic variables to try and analyze the relationship more precisely. Okun's law doesn't hold up as well under these more precise stipulations, but empirical evidence does still support its usefulness. Okun's law may not be entirely predictive, but it again helps frame the discussion of economic growth and how employment influences it and vice versa

Rostow`s theory of development

In 1960, the American Economic Historian, WW Rostow suggested that countries passed through five stages of economic development.

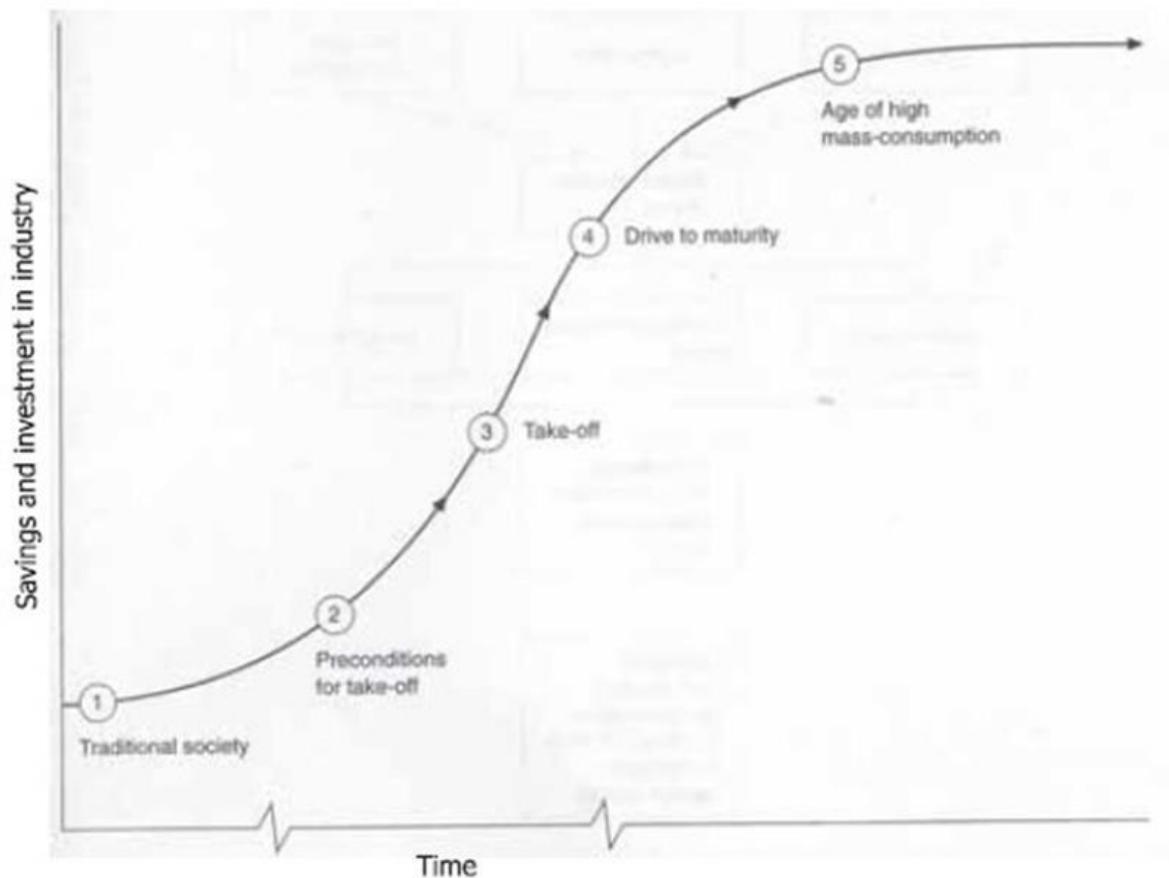


fig 3

Stage 1 Traditional Society

The economy is dominated by subsistence activity where output is consumed by producers rather than traded. Any trade is carried out by barter where goods are exchanged directly for other goods. Agriculture is the most important industry and production is labour intensive using only limited quantities of capital. Resource allocation is determined very much by traditional methods of production.

Stage 2 Transitional Stage (the preconditions for takeoff)

Increased specialisation generates surpluses for trading. There is an emergence of a transport infrastructure to support trade. As incomes, savings and investment grow entrepreneurs emerge. External trade also occurs concentrating on primary products.

Stage 3 Take Off

Industrialisation increases, with workers switching from the agricultural sector to the manufacturing sector. Growth is concentrated in a few regions of the country and in one or two manufacturing industries. The level of investment reaches over 10% of GNP.

The economic transitions are accompanied by the evolution of new political and social institutions that support the industrialisation. The growth is self-sustaining as investment leads to increasing incomes in turn generating more savings to finance further investment.

Stage 4 Drive to Maturity

The economy is diversifying into new areas. Technological innovation is providing a diverse range of investment opportunities. The economy is producing a wide range of goods and services and there is less reliance on imports.

Stage 5 High Mass Consumption

The economy is geared towards mass consumption. The consumer durable industries flourish. The service sector becomes increasingly dominant.

According to Rostow development requires substantial investment in capital. For the economies of LDCs to grow the right conditions for such investment would have to be created. If aid is given or foreign direct investment occurs at stage 3 the economy needs to have reached stage 2. If the stage 2 has been reached then injections of investment may lead to rapid growth.

Limitations

Many development economists argue that Rostow's model was developed with Western cultures in mind and not applicable to LDCs. In addition its generalised nature makes it somewhat limited. It does not set down the detailed nature of the pre-conditions for growth. In reality policy makers are unable to clearly identify stages as they merge together. Thus as a predictive model it is not very helpful. Perhaps its main use is to highlight the need for investment. Like many of the other models of economic developments it is essentially a growth model and does not address the issue of development in the wider context.

The Harrod-Domar Growth Model

Every economy must save a certain proportion of its national income, if only to replace worn-out or impaired capital goods (buildings, equipment and materials). However, in order to grow, new investments representing net additions to the capital stock are necessary. If we assume that there is some direct economic relationship between the size of the total capital stock, k , and total GDP, Y , for example if \$3 of capital is always necessary to produce a \$1 stream of GDP it follows that any net additions to the capital stock in the form of new investment will bring about corresponding increase in the flow of national output, GDP. Suppose that this relationship, known in economics as the capital –output ratio, is roughly 3 to 1. If we define the capital – output ratio as k and assume further that the national net savings ratio, s , is a fixed proportion of national output (e.g.,

6%) and that total new investment is determined by the level of total savings, we can construct the following simple model in economic growth:

Net savings (S) is some proportion, s , of National Income (Y) such that we have the simple equation

$$S=sY \quad (1.1)$$

Net investment (I) is defined as the change in the capital stock, K, and can be represented by ΔK such that

$$I=\Delta K \quad (1.2)$$

But because the total capital stock K bears a direct relationship to total national income or output, Y, as expressed by the capital- output ratio k , it follows that

$$K/Y=k$$

Or

$$\Delta K/\Delta Y=k$$

Finally,

$$\Delta K=k\Delta Y \quad (1.3)$$

Finally, because net national savings, S, must equal net investment, I, we can write this equality as

$$S=I \quad (1.4)$$

But from equation 1.1 we know that $S=sY$, and from equations 1.2 and 1.3 we know that

$$I=\Delta K=k\Delta Y$$

It therefore follows that we can write the identity of saving equalling investment shown by equation 1.4 as

$$S=sY=k\Delta Y=\Delta K=I \quad (1.5)$$

Or simply as

$$sY=k\Delta Y \quad (1.6)$$

Dividing both sides of Equation 1.6 first by Y and then by k, we obtain the following expression:

$$\Delta Y/Y=s/k \quad (1.7)$$

Note, that the left – hand side of equation 1.7, $\Delta Y/Y$, represents the rate of change or rate growth of GDP. Rate of growth is determined by the net national savings ratio, and the capital-output ratio.

From Harrod-Donmar growth model we learn that the most fundamental strategies of economic growth is simply to increase the proportion of national income saved (i.e., not consumed). If we can raise s in equation 1.7, we can increase $\Delta Y/Y$, the rate of growth. For example if we assume that the national capital output ratio in some less developed country is, say 3 and the aggregate net saving ratio is 6% of GDP, it follows from equation 1.7 that this country can grow at the rate of 2% per year because

$$\Delta Y/Y = s/k = 6\%/3 = 2\%$$

Now if the national net savings rate can somehow be increased from 6% to, say, 15% through some combination of increased tax, foreign aid, and general consumption sacrifices – GDP growth can be increased from 2% to 5%

Reasons behind its failure in less developed countries the basic reason they didn't work was not because more savings and investment isn't a necessary condition for accelerated rates of economic growth but rather because it's not a sufficient condition. The marshal plan worked for Europe because the European country receiving aid possessed the necessary structural, institutional and attitudinal conditions (e.g. well integrated commodity and money markets, highly developed transport facilities, a well-trained and educated work force, the motivation to succeed an efficient government bureaucracy) to convert new capital effectively into higher levels of output.

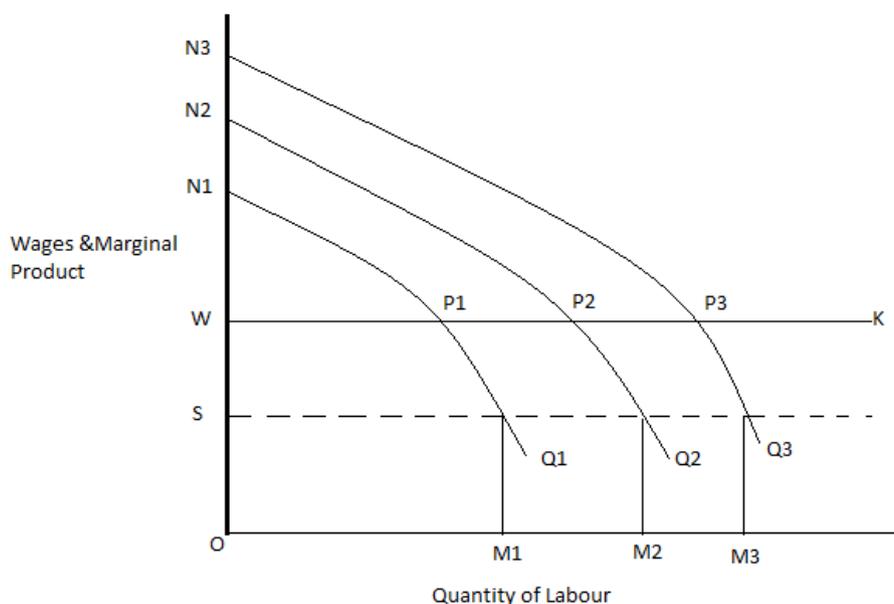
The Lewis Dual Sector

Lewis proposed his dual sector development model in 1954. It was based on the assumption that many LDCs had dual economies with both a traditional agricultural sector and a modern industrial sector. The traditional agricultural sector was assumed to be of a subsistence nature characterised by low productivity, low incomes, low savings and considerable underemployment. The industrial sector was assumed to be technologically advanced with high levels of investment operating in an urban environment.

Lewis suggested that the modern industrial sector would attract workers from the rural areas. Industrial firms, whether private or publicly owned could offer wages that would guarantee a higher quality of life than remaining in the rural areas could provide. Furthermore, as the level of labour productivity was so low in traditional agricultural areas people leaving the rural areas would have virtually no impact on output. Indeed, the amount of food available to the remaining villagers would increase as the same amount of food could be shared amongst fewer people. This might generate a surplus which could then be sold generating income.

Those people that moved away from the villages to the towns would earn increased incomes and this crucially according to Lewis generates more savings. The lack of development was due to a lack of savings and investment. The key to development was to increase savings and investment. Lewis saw the existence of the modern industrial sector as essential if this was to happen. Urban migration from the poor rural areas to the relatively richer industrial urban areas gave workers the opportunities to earn higher incomes and crucially save more providing funds for entrepreneurs to investment. A growing industrial sector requiring labour provided the incomes that could be spent and saved. This would in itself generate demand and also provide funds for investment.

fig.4



The situation is depicted in figure 3 above, where OS represents subsistence earnings, OW the real wage in the capitalist sector and WK the perfectly elastic supply of labour. Given a fixed amount of capital at the outset, the demand for labour is initially represented by the marginal productivity schedule of labour $N1Q1$. If we assume profit maximization, capital will be employed up to the point where the current wage equals the marginal productivity of labour. If OW is the current wage, the amount of labour employed in the capitalist sector is OM1. Beyond the point M1, workers earn whatever they can in the subsistence sector. The total product in this case is ON1P1M1 of which the share of wages is OWP1M1 and capitalist surplus or profits is N1WP1.

Criticism of the model

- Model assumes that all profits made by the entrepreneurs will be reinvested, this may not always be the case
- Reinvestment may take place in the form of fixed capital but it may be capital that is labour saving and thus demand for labour may in fact fall.
- The model also assumes that there is a surplus of labour in the agricultural sector that can easily move to the manufacturing sector.

Wage levels may not always be fixed. There may be upward pressure on wages for example through trade union activity and profits may therefore fall.

The Neoclassical Counterrevolution: Market Fundamentalism

In the 1980`s, the political ascendancy of conservative governments in the United states, Canada, Britain and West Germany came with a neoclassical counter revolution in economic theory and policy. In developed nations, this counterrevolution favoured supply side macroeconomic policies,

rational expectations theories and privatisation of public corporations. In developing countries, it called for freer markets and dismantling of public ownership, statist planning, and government regulation of economic activities. Neoclassical obtained controlling votes on the boards of the two most powerful international financial agencies – the World Bank and international Monetary Fund. In conjunction and with the simultaneous erosion of influence of organization such as international labour Organization (ILO), the United Nation Development Program (UNDP), and the United Nation Conference on Trade and Development (UNCTAD), which more fully represent the views of LDC delegates, it was inevitable that the neoconservative, free market challenge to the interventionist arguments of dependence theories would gather momentum. The central argument of the neoclassical counterrevolution is that underdevelopment results from poor resource allocation due to incorrect pricing policies and too much state intervention by overly active developing –nation governments. According to them what is needed is not a reform of the international economic system, a restructuring of dualistic developing economies, an increase in foreign aid, attempts to control population growth, or a more effective developing planning system. Rather it is simply a matter of promoting free market and laissez –faire economics within the context of permissive government that allows the magic of the market place and the invisible hand of market prices to guide resource allocation and stimulate economic development. They made emphasis to the Asian Tigers which embraces “free market” approach. The neoclassical counterrevolution can be categorise under three different approaches:

1. **The free Market approach:** it argues that markets alone are efficient- product markets provide the best signals for investments in new activities, labor markets respond to these new industries in appropriate ways; producers know best what to produce and how to produce it efficiently, and product and factor prices reflect accurate scarcity values of goods and resources now and in future. Competition is effective, if not perfect; technology is freely available and nearly costless to absorb information is also perfect and nearly costless to obtain. Under these circumstances, any government intervention in the economy is by definition distortionary and counterproductive. Free- market development economist have tended to assume that developing world markets are efficient and that whatever imperfections exist are of little consequence.

2. **Public – choice theory:** this is also known as new political economy approach, it goes even further to argue that government can do nothing right. This is because public-choice theory assumes that politicians, bureaucrats, citizens and state act solely from a self-interested perspective, using their power and authority of government for their own selfish ends. Citizens use political influence to obtain special benefits from governments policies, politicians use government resources to consolidate and maintain positions of power and authority. Bureaucrats and public officials use their positions to extract bribes from rent seeking citizens and to operate protected business on the side. The net result is not only a misallocation of resources but also a general reduction in individual freedoms. The conclusion, therefore, is that minimal government is the best government.

3. **Market –friendly approach:** this is a variant on the neoclassical counterrevolution associated principally with the 1990`s writings of the world bank and its economists, many of whom were more in the free market and public- choice camps during the 1980`s. this approach recognises that there are many imperfections in LDC, product and factor markets and that the governments do

have a key role to play in facilitating the operation of market through “non-selective” interventions for example by investing in physical and social infrastructure, health care facilities and educational institutions and by providing a suitable climate for private enterprise. The market friendly approach also differs from the free- market and public-choice schools of thought by accepting the notion that market failures are more widespread in developing countries in areas such as investment coordination and environmental outcomes.

John Rawl`s theory of justice

The term veil of ignorance was an idea by John Rawls in his book “Theory of Justice” in 1971 the idea relates to how a just society can be formed. As Rawls argues the justice and the maximizing of it becomes the basis for all social orders, he has to derive a philosophical justification for the notion of justice as fairness. In order to accomplish this, Rawls develops the "veil of ignorance." Essentially, it means that if an individual had no idea as to what and where they would fit in a social or political order, they would make decisions with the least benefitted individuals in mind. They would do this because this could be them. Few would create decisions that would benefit the upper echelon of a social order because in a veil of ignorance, there is a distinct possibility that an individual could wind up at the bottom rung of a social order. If a rational person had to select policy within the veil of ignorance, they would do so ensuring that that the lower levels of society would be represented in some manner for this could be them. The veil of ignorance is what Rawls uses formulate his two premises of justice in that individuals have the right to individual liberty and freedom in so far as it does not interfere with another and that social/ political orders have accountability to ensure that those who are marginalized are spoken for in this political order as justice being fairness, under the veil of ignorance, demands

Why is Inequality Bad

There are major answers to this question.

First: extreme income inequality leads to economic inefficiency. This is partly because at any given average income, the higher the inequality, the smaller the fraction of the population that qualifies for a loan or other credit. Indeed, one definition of relative poverty is the lack of collateral.

When low- income individuals (whether they are absolutely poor or not) cannot borrow money, they generally cannot adequately educate their children or start and expand a business. Moreover, with high inequality, the overall rate of saving in the economy tends to be lower, because the highest rate of marginal savings is usually found among the middle classes. Although the rich may save a larger dollar amount, they typically save a smaller fraction of their incomes, and they certainly save a smaller fraction of their marginal incomes. Landlords, business leaders, politicians, and other rich elites are known to spend much of their incomes on imported luxury

goods, gold, jewellery, expensive houses, and foreign travel or to seek safe havens abroad for their savings in what is known as capital flight. Such savings and investment do not add to the nations productive resources; in fact, they represent substantial drains on these resources. In short, the rich do not generally save and invest significantly larger proportions of their incomes (in the real economic sense of productive domestic saving and investment) than the middle class or even the poor.

Furthermore, inequality may lead to an inefficient allocation of assets. The second reason to be concerned with inequality above the poverty line is that extreme income disparities undermine social stability and solidarity. Worse, high inequality strengthens the political power of the rich and hence their economic bargaining power.

Usually this power will be used to encourage outcomes favourable to themselves. High inequality facilitates rent seeking, including actions such as excessive lobbying, large political donations, bribery and cronyism. When resources are allocated to such rent-seeking behaviours, they are diverted from productive purposes that could lead to faster growth.

Finally, extreme inequality is generally viewed as unfair. The philosopher John Rawls proposed a thought experiment to help clarify why this is so. Suppose that before you were born into this world, you had a chance to select the overall level of inequality among the earth's people but not your own identity. That is, you might be born as Bill Gates, but you

might be born as the most wretchedly poor person in rural Ethiopia with equal probability. Rawls calls this uncertainty the "veil of ignorance." The question is, facing this kind of risk; would you vote for an income distribution that was more equal or less equal than the one you see around you? If the degree of equality had no effect on the level of income or rate of growth, most people would vote for nearly perfect equality.