LECTURE 3

CLASSICAL THEORIES OF DEVELOPMENT

Literature on economic development is dominated by the following four strands of thought:

i) Linear-stages-of-growth model: 1950s and 1960s
ii) Theories and patterns of structural change: 1970s
iii) International-dependence revolution: 1970s
iv) Neo-classical, free-market counterrevolution: 1980s and 1990s

LINEAR-STAGES THEORY

These theories viewed the process of development as a series of successive stages of economic growth; mixture of saving, investment, and foreign aid was necessary for economic development and emphasized the role of accelerated capital accumulation in economic development. A representative strand of linear-stage growth is Bill Rostow’s five stages of development model.

ECONOMIC GROWTH STAGES OF ROWSTOW

According to Rowstow there 5 stages of economic development:

i. The traditional society
ii. The preconditions for take-off
iii. The take-off
iv. The drive maturity
v. The age of high mass consumption

The traditional society

The traditional society is characterized by;

Subsistence agriculture or hunting & gathering; almost wholly a "primary"
sector economy
Limited technology;
A static or 'rigid' society: lack of class or individual economic mobility, with stability prioritized and change seen negatively

The preconditions for take-off
At this stage the society is characterized by change in Social attitude, expectations, structure and value system. According to Rowswow there are radical changes that must take place in three non-industrial sectors:

i. Transport expands to enlarge market, to find out natural resources and for state to rule effectively.

ii. Agriculture undergoes a technological revolution and productivity increases to meet the need of the rising population.

iii. Imports expand financed by efficient production and market of natural resources for export.

iv. In his own words Rowstow says ‘the essence of the transition can be described legitimately as a rise in the rate of investment to a level which regularly substantially and perceptibly outstrips population growth’.

The take-off Stage
Three conditions characterize this stage:-

i. A rise in the rate of productive investment

ii. Development of one or more of substantial manufacturing sectors with a high rate of growth

iii. Existence of cultural framework that exploits expansion

At this stage increase in per capita output should go ahead of the growth of population to maintain a high level of per capita income in the economy. According to Rowstow three sectors of the economy have to develop at this stage:-

a) Primary growth sectors- possibilities of innovation or of exploiting
new or unexplored resources tend to be a higher growth rate that in the rest of the economy.

b) Supplementary growth sectors-due to development in primary growth sectors, rapid growth takes place with the development of railways, other supplementary growth sectors grow as well e.g. iron, coal and steel industry

c) Derived growth sector- production of food, houses and other sectors grow to meet the demand of growing population.

Larger saving must be made to raise effective demand for the manufactured products and to create external economies through the expansion of the leading sector. In this way, take-off is initiated by a sharp stimulus as the development of a leading sector or political revolution that brings an outgoing change in the production process.

**The Drive to Maturity**

According to Rowstow, drive to maturity is a period when a society has effectively applied a range of (then) modern technologies to the bulk of its resources. Old techniques give way to new ones and the rate of investment is higher than 10% of the national income. The economy is strong enough to cope with unexpected events.

When a country reaches the stage of technology maturity three changes are visible:-

a) Working forces have change in character- they are skilled, city dwellers with rising real wages and organize themselves to gain more economic and social security

b) Enterprisership changes- refined and polite managers in place of rugged and hardworking masters.
The age of high mass consumption

High mass production is expressed through migration of rural inhabitants as workers, greater use of automobiles, durable consumer goods and households. There are three forces that lead to welfare increase:-

i. The pursuit of national interest to increase power and influence beyond the national frontiers

ii. A more equitable distribution of national income through progressive taxation, increased social security and leisure to working class.

iii. Decisions to create new commercial centre and leading sectors like cheap automobiles, houses and innumerable electric operated household articles.

Criticism of Rowstow’s Theory

Economists have expressed doubts of Rowsto’s stages of growth.

i. Traditional society not essential for development

ii. Preconditions may not come before take-off. There is no reason to trust that an agricultural revolution and collection of social overhead capital in transport must come before take-off.

iii. Overlapping of stages- for example agricultural development could be observed in the take-off stage as well.

iv. Criticism of the take-off analysis of the take-off neglects the effect of historical heritage, time of entry into the process of modern economic growth, degree of backwardness and other relevant factors on the characteristics of the early phases of modern economic development in other countries.
STRUCTURAL CHANGE THEORIES

Structural-change theory focuses on the mechanism by which underdeveloped economies transform their domestic economic structures from traditional to an industrial economy. Adam Smith’s and Lewis model of development are representative strands in this model of development.

ADAM SMITH’S THEORY OF DEVELOPMENT

Adam Smith’s ideas on economic development are expounded on his publication of 1776 titled ‘An inquiry into the Nature and Causes of the Wealth of Nations’.

Salient Features

i. Natural Law: - every man is directed by the ‘invisible hand’ and everyone is free to act. He argued that in free trade without government intervention and competitive markets tend to maximise national wealth.

ii. Division of labor: - According to Adam Smith, division of labor tends to result in greatest improvement in the productive powers of labor. He argues that the increase in productivity would arise as a result of (a) efficiency of every worker (b) saving in time with more goods production (c) invention of more labor-saving machines.

iii. Process of capital accumulation: - According to Adam Smith, capital accumulation must precede the introduction of division of labor. He says ‘As the accumulation of stock must, in the nature of things, be previous to the division of labor, so labor can be more subdivided in proportion only as stock is previously more and more accumulated’. Economic development needs capital accumulation. According to Adam Smith capital is that portion which a person saves annually.
iv. Why Capitalists make Investments: - Capitalists invest to earn profits on their investments in future. According to Adam Smith profits tend to fall in economic development. In his own words ‘when the stock of many rich merchants are turned into the same trade, their mutual competition naturally tends to lower the profit, and when there is like increase of stock in all the different trades carried on in the same society, the same competition must produce the same effect on all of them’. In this way, competition among enterprisers for scarce labor tends to increase in wages and profits go down.

v. Interest: - with the increase in prosperity, progress and population the rate of interest fall and the supply of capital is increased. The fall in rate of interest tends to increase in capital accumulation and economic progress.

vi. Agents of growth: - According to Smith, producers and businessmen are agents of progress and economic growth. The market expands with free trade. Development in agriculture leads to increase in construction work and commerce. Further there is demand in commercial service and manufactured articles.

vii. Process of growth: - Smith starts from the assumption that a social group-say a nation' will experience a certain rate of economic growth that is accounted for by increase in number and by saving. This induces a widening of market which in turn increases division of labor and thus increases productivity… “In this theory the economy grows like a tree. This process is no doubt exposed to disturbances by external factors, that are not economic but in itself it proceeds steadily, continuously. Each situation grows out of the proceeding one in a uniquely determined way, and the individuals whose acts combine to produce each situation count individually for no more than the individual cells of a tree.
Limitations

i. Rigid division of society: - The Adam Smith theory of development is based on socio-economic environment prevailing in Europe. It assumes the existence of a rigid society between capitalists and laborers. The modern society has an important place for the middle class. In this sense, Adam Smith theory completely neglects the role of middle class and the role it plays in giving the necessary impetus to economic development.

ii. One-sided saving base: - Smith puts saving capitalists, landlords and moneylenders. This is thought to be one-sided base savings.

iii. Unrealistic Assumption of Perfect Competition: - Perfect competition is not found in any economy.

iv. Neglect of Enterpriser: - The enterpriser is the focal point of development. Smith neglects the role of the enterpriser.

v. Unrealistic assumption of stationery state: - Smith puts the end result of a capitalist economy in the stationery state. There is progress but is steady, uniform and regular. This characterization of the economy is now realistic because development takes place in fits and starts and is not uniform and steady.

Applicability of Smith’s Theory to Underdevelopment Nations

It has limited application in developing countries because the markets are small, there is little savings and income is low. Political, social and institutional assumptions do not apply as conditions do not allow them. The government has to play a big role in bringing about development.
UNLIMITED SUPPLY OF LABOR THEORY BY LEWIS

According to Lewis the theory of unlimited supply of labor is tenable for economic development. He believed that underdevelopment countries have unlimited supply of labor at subsistence wage. He believed in a two sector economy i.e. the subsistence agriculture and the capitalist sector. Capital accumulation takes place if the surplus labor is withdrawn from subsistence sector to capitalist sector.

Capitalist sector is that part of the economy which uses reproducible capital and pays capitalists for its use. It employs labor for earning profits. The subsistence sector is that part of economy which does not use reproducible capital. In the subsistence sector output per head is lower that in the capitalist sector.

According to Lewis supply of labor is fully elastic at subsistence wage in underdeveloped countries. In his view these countries are overpopulated compared to capital and natural resources. The marginal productivity of labor is negative, zero or negligible. As the labor supply is unlimited, new industries spring up or existing ones are expanded without limit at the current wage at subsistence level. But it is important to note that capitalist sector required skilled labor which they obtain by providing training facilities for unskilled labor.

Capitalist Surplus

In practice capitalist wages are more than 50% higher than subsistence wages are due to:-

I. A substantial increase in the output of the subsistence sector by raising real income might induce workers to ask for a higher capitalist wage before offering themselves for employment.

II. After the withdrawal of labor from the subsistence sector, if the total
product remains the same the average product and real income of those
left behind will rise and withdrawn workers might insist on a higher
wage in the capitalist sector.

III. The high cost of living may cause the employers to raise the real wage
or with government might insist a higher wage for workers unions with
support for their wage-bargaining efforts. Since the marginal productivity
in the capitalist sector is higher than the capitalist wage, capitalist surplus
is the consequence.

**Capital formation based on capitalist surplus**

Capitalist surplus is reinvested in new capitalist assets. There is capital
formation and more workers are employed from the subsistence sector. The
process goes on until capital-labor ratio rises and the supply of labor becomes
inelastic. In his own words Lewis says ‘the key to the process is the use which
is made of the capitalist surplus. In so far as it is reinvested in creating new
capital, the capitalist sector expands taking more people into capitalist
employment out of the subsistence sector, the surplus is then larger still, the
labor surplus disappears.’ Lewis does not make any distinction between growth
of technical and growth of productive capital and treats them as a ‘single
phenomenon’ with the results that technical progress tends to raise profits and
increase employment in the capitalist sector.

According to Lewis ‘the central problem in the theory of economic
development is to understand the process by which a community which was
previously saving and investing 5% of its national income or less converts itself
into an economy where voluntary saving is running at about 15% of national
income or more. This is the central problem because the central fact of
economic development is rapid capital accumulation.'
The dominant classes of land lords, traders, money lenders, priests, soldiers, princes spend more on consumption and not on production. So the state capitalist and indigenous private capitalists who create capital out of profits earned. The state capitalist can accumulate capital even faster than private capitalists. Capital formed but only through profits but also through bank credits. Underdeveloped countries have national resources more in idleness and due to shortage of capital. Credit creation has the same effect on capital formation leads to inflation in prices for the same period. Similarly, surplus labor if engaged and paid through credit money, price rises due to increase in income while consumer goods output remains constant. This is only temporary because as production of goods rise, prices ultimately go down.

**End of the growth process**

The Lewis theory shows that if unlimited supply of labor is available at a constant real wage and if any part of profit is reinvested in productive capacity, profits will grow continuously relative to the national income. However, the process cannot go on indefinitely, it has to stop at some point.

According to Lewis, end of growth occurs if:-

1. No surplus labor is left
2. The capitalist sector expands so rapidly that it reduces the population in the subsistence sector and the average productivity and labor rises in the subsistence sector as there are few persons to share the product and so the capitalist wage rises in the former sector
3. As a result of the expansion of the capitalist sector relative to the subsistence sector, the terms of trade turn against the capitalist sector with rising prices of raw materials and food, the capitalists have to pay higher wages to the workers
4. The subsistence sector adopts new techniques of production; real wages rise in the capitalist sector and so reduce the capitalist surplus
5. The workers in the capitalist sector imitate the capitalist way of living
and agitate for higher wages and if successful in raising their wages, the capitalist surplus and the rate of capital formation will be reduced.

**Criticism of Lewis theory**

I. Not all underdeveloped countries have an unlimited supply of labor. Actually many countries in Africa and South America are rather thinly populated

II. Limited enterprise/capitalist initiative. According to Lewis a capitalist class exists in underdeveloped countries. The process of development is dependent on the existence of such a class that is developing and harnessing the necessary skills and accumulating wealth. In many underdeveloped countries such a class is rather limited

III. In underdeveloped countries multiplier process does not operate. Lewis postulates that capital accumulation takes place when the capitalist class continue to reinvest profits. But if profits are reduced and the price of wage and goods rise, the process of capital formation will stop before surplus labor is used up

IV. Neglects total demand; according to Lewis, there is no possibility of capitalist sector selling its product to the subsistence sector. The growth process may stop much soon through unfavorable trade terms or subsistence sector adopting new techniques of production to meet the expanding raw material demand of the capitalist sector
V. Mobility of labor is not easy; although capitalist gives higher wages, the surplus from subsistence sector will not move to capitalist sector. The attachment to family does not allow them to leave relations. In addition, differences in language and custom, congestion, housing and high cost of living in the capitalist sector stands in the way of mobility of labor to this sector.

VI. Marginal productivity of labor is not zero if marginal productivity of labor in the overpopulated underdeveloped countries in zero or negligible, the subsistence wage would also tend to zero. As every worker gets a subsistence wage it is difficult to find out the exact number of surplus labourers who are ready to move to the capitalist sector.

Merits
Despite the demerits, Lewis theory explains a very clear cut process of development. The two sector theory has a good analytical value. The theory touches on some key real life problems such as credit, inflation, population growth, technological progress and international trade.

References