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THE STRUCTURE OF LESS DEVELOPED ECONOMIES

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Lecture 1

THE STRUCTURE OF LESS DEVELOPED ECONOMIES

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It is a commonplace that the economic structure of the LDC's differs substantially from that of the more advanced countries. But this is rather vague. It is useful to specify the main points of difference, and to consider how they affect the applicability of "Western" economic analysis to these economies.

Nor must we fall into the trap, which we have already warned against, of treating all LDC's as similar. There are major differences within the group, and we must ask how the LDC's can most usefully be classified for analysis.

It will be useful also to speculate about the initiation of growth, about the first steps which growth models assume to have been taken at some time in the past. In later chapters we shall also be assuming that growth is already underway. But how does it begin? We cannot afford to bypass this issue, even if we may not be able to get very far with it.

"These Economies Are Different"

The LDC's differ from the DC's in so many ways that it is difficult to know where to begin. We concentrate here on economic, rather than socio-political differences, and on statements which are true in some measure of all LDC's, rahter than on special characteristics of sub-categories within the group. We are interested not so much in quantitative aspects of performance--output mix, aggregate growth rates, capital formation rates, and so on--as in structural differences which bear on the kind of economic analysis required for explanatory and policy purposes. Sectoring of the economy. Suppose we wish to set up a model of a LDC, sufficiently disaggregated to recognize the major production sectors and the interrelations among them. What kind of sectoring is appropriate? Because of the lack of real economic integration in the LDC's, the typical fragmentation of their economies, we shall need to recognize more sectors than we would normally use in a developed country; and the specific characteristics of these sectors will of course be quite different.

1. Agriculture. This is almost always the largest sector in value of output, and much the largest in terms of employment. Its characteristics are crucial to the behavior of any model. Most effort in this sector is devoted to subsistence production; but there is also some production for sale in the domestic market, and export crops sometimes play an important role. The system of land tenure also needs to be specified. One cannot reason in the same way about latifundia, landlord-tenant systems, and peasant economies.

2. Retailing and services. These are traditional activities, conducted on a very small scale by a multitude of underemployed individuals. This is usually the second largest sector in terms of employment. It is important as a refuge for surplus labor; and conversely, when labor requirements are rising elsewhere, it is an important reservoir from which labor can be withdrawn with little loss of output.

3. Handicrafts. This is analagous in some ways to the previous category but it has more growth potential. As the market for manufactured goods widens, handicraft producers may expand by taking on apprentices and helpers; or work may be spread around the countryside by putting-out systems; or small shops may develop as suppliers of materials and components to larger manufacturers in the cities. In the early decades of growth, a substantial part of the rise in manufacturing output comes about in these ways. In addition to handicraft manufacturing, this sector includes small-scale construction and much of local and over-the road motor transport.

4. Large-scale industry. Scale is a matter of degree, and we do not necessarily mean very large in the first instance, But these are organized manufacturing plants, using wage labor and operating on commercial principles, and located in urban centers. This sector includes also railroading, electric power, and other public utilities, normally government-owned but analagous to private industry in many respects. Substantial building contractors, wholesale and export-import merchants, and bankers may be regarded also as falling within this "modern" sector.

5. General government. This sector provides defense, law and order, health, education, and other basic public services. It is typically a good deal smaller, as a percentage of national output, than in the more developed countries. But it requires financing, and the revenue-mix differs considerably from that found in the developed countries. This fiscal system is also a major regulator of private economic activity.

6. Exports. While this sector is often omitted in first-approximation models, it must be brought into the picture if any really useful results are to be attained. It is always important, and in the smaller LDC's it is usually dominant. As Seers has pointed out, export fluctuations in the LDC's play somewhat the role of investment fluctuations in the DC's generating economy-wide fluctuations in other components of national income. The type of export in question needs to be specified--it makes considerable difference whether one is talking about oil, copper, cocoa, or wheat. If the major exports are agricultural products, this sector ties back into the basic agricultural sector.

Essentially, then, an "LDC growth model" has to specify the main characteristics of each of these sectors, and the main flows of inputs, outputs, and finance among them. To be useful for dynamic reasoning, it must contain some mechanism which generates shifts in the relative importance of these sectors, without which aggregate output cannot expand continuously over time.

Market Structure

In the developed countries, it is not wildly implausible to assume well-organized markets, with well-informed and numerous buyers and sellers, with input and output prices consequently tending toward uniformity, and moving flexibly to provide socially correct signaling devices for private economic decisions. The absence of such a market mechanism is of the essence of under-development. Because of the limited size of markets, the geographic fragmentation of the economy, the concentration of politico-economic power and financial and other limitations on new enterprise, monopoly and monopsony are much commoner than in developed countries. Even where this is not true, markets are highly imperfect, and wide price differentials for similar products or input services are the general rule. While this is due largely to inherent characteristics of the economy, it is usually accentuated by public policy. Government regulation of wages, interest rates, exchange rates, and other prices add to the distortions which would be present in any event.

1. Labor. The agricultural workers in the countryside are largely outside the money economy. Their real incomes are typically much below those of urban wage-earners. There is consequently little problem of inducing labor to flow from country to city. Indeed, premature movement to the towns before job opportunities have developed, with high levels of urban unemployment and underemployment, is a serious problem in some countries.

In the urban areas, an abundance of untrained labor coexists with shortages of manual skills and an even greater shortage of technical, professional, and administrative skills. This is associated with an educational system which tapers rapidly toward the top, and which may also be biased toward "prestige subjects" of low economic usefulness. Admission to the higher educational levels depends heavily on economic and social status, and the notion of equal opportunity for talent is only a distant mirage.

It follows that wage and salary differentials are much wider than in the developed countries. A skilled craftsman, who in the developed countries might earn a third or a half more than a laborer, will in the LDC's earn several times as much. Even the lower white-collar salaries are above the top manual wages, and professional and administrative salaries are very much higher. (The high money cost of teachers, for example, is a major problem in educational expansion.) These wide differentials arise basically from supply bottlenecks, but they also reflect status differences which have become conventional and accepted over the years. They are an important element in the marked inequality of personal incomes which characterises the LDC's.

2. Capital. Here again there are sharp cleavages between the money-less economy, the domestic monetized economy, and the export-import sector, which often has its own sources of finance through local branches of foreign banks. Within the domestic monetized economy, finance is largely self- finance-accumulation of initial capital from family members plus reinvestment of earnings. This is one reason why businesses in the LDC's are typically family businesses. Another reason may be that the law does not provide adequate protection against business associates.

Financial institutions are very inadequately developed. There is normally a central bank, which has weak instruments of monetary control and serves mainly as financial agent for the government. There are a small number of commercial banks, concentrated in the main cities and lending mainly for trade rather than production. Government may operate industrial and agricultural lending institutions of limited scope. But the great network of savings banks, insurance companies, investment banks, mortgage lending institutions, securities dealers, and so on which exists in developed countries is here very rudimentary. This makes it difficult to mobilize savings and to transfer savings to expanding sectors of the economy. Hence the dependence on self-finance already noted.

Fragmentation of the capital market is reflected in a wide spread of interest rates. There is often a legal ceiling on the rates which the organized commercial banks may charge on business loans, a rate much below the profit rate earned by the borrowers, and much below what would prevail in an unregulated market. (In some of the Latin American countries, the bank rate is normally below the annual rate of inflation, so that it amounts to a negative rate of interest. The successful borrower is receiving a guaranteed bonus) The banks then ration credit within a limited circle of preferred and established customers. Other would-be borrowers must resort to the unorganized money market, where they pay substantially higher rates. This is one reason why it is difficult for new entrepreneurs to set up in competition with established industries. The highest interest rates in the economy are usually those charged by money-lenders in rural areas.

3. Land. Land tenure is a complex matter, to which we shall devote most of a chapter later on. Here we note merely that there may or may not be a market for land. Under latifundia and other large landholding systems, the land may descend in feudal fashion within a family, and there may be no way in which the small cultivator can acquire title. Even where land transfers are possible in principle a good market requires accurate surveys, assured titles, and a source of mortgage finance. One or more of these components are frequently missing. Land prices tend to reflect the prestige value of land ownership as well as the land's productive capacity; and they are also much affected by the tax system.

4. Foreign exchange. The price of the country's currency in terms of foreign currencies is often pegged at an artificially high level, and this has important effects on all international transactions. It creates a "scarcity" of foreign exchange, which then has to be rationed among a surplus of applicants. While this provides opportunity for systematic application of national priorities, it also provides opportunity for favoritism, bribery, and economic error. Foreign capital goods and consumer goods are made artificially cheap in terms of domestic prices; and the successful applicants for import permits receive windfall profits which serve no economic function. At the same time, exporters are taxed, and the export expansion which is desirable if not essential in early economic growth is discouraged.

It is clear even from this brief account that the economic systems of the LDC's are typically unfavorable to new enterprise. Access to the scarce inputs needed to set up in business (bank credit, import quotas, building permits, etc. etc.) depends on favorable decisions by government officials, bankers, perhaps even direct business rivals). Such a system favors the politico-economic insiders, the families which at some point got a head start in the economic race. The prescription to develop the economy via private enterprise is apt to mean (or at least to be interpreted as meaning) a further strengthening of these positions of economic power and privilege. It may nevertheless be a sensible prescription, but it is easy to see why its supporters are politically vulnerable.

Productivity Levels and Economic Slack

There is a natural tendency to reason that, if per capita output is low, this must be due to shortage of productive resources. There may be a sense in which this is true. But two other things are equally true and possible more pertinent. First, in a LDC there are usually more resources available than are actually being used in production. In this sense there is a good deal of "economic slack" waiting to be taken up. Second, the resources which are employed are so managed as to produce relatively little per worker. There is a productivity problem as well as an underutilization problem.

It is a truism that so-called "natùral" resources can be considerably augmented by discovery and development. Geological surveys--still very spotty in most LDC's-- can uncover oil and mineral resources. Land can be reclaimed, improved, and irrigated by human effort. Agricultural research can enable previously "uncultivable" areas to be taken under cultivation--witness the northward movement of the wheat frontier in North America as drought-resistant and fast-ripening strains were developed; or the extension of potential cattle grazing areas in some of the tropical countries by successful campaigns against tsetse fly, rinderpest, and other diseases.

Economists have engaged in rather elaborate semantics over the presence or absence of "disguised unemployment" in the LDC's; and we shall play this game ourselves in a later chapter. But simple observation suggests that many able-bodied men in these countries are not working a full day or week. There is substantial labor force slack. Economic historians studying early economic growth in Britain and Europe have noted the same phenomenon in those countries before accelerated growth began.

There is also unused saving capacity, both in the sense that many people are consuming above subsistence level, and in the sense that they are consuming more than they would choose to consume if greater savings opportunities were available. If savings could be put into secure institutions, at interest rates reflecting the scarcity of capital in the economy, a larger flow of savings would be forthcoming. This situation seems also to have prevailed in the DC's at the time their accelerated growth began; and this must help to explain the fact that capital shortage was never a serious problem during the growth process.

Turn now to the question of why the resources which are being used produce much less per worker than in the developed countries. Low productivity is sometimes associated specifically with traditional agriculture. In fact, low productivity is characteristic in some measure of every sector of the less developed economy; but the reasons for it differ from sector to sector.

In agriculture, low productivity is associated with traditional crops and production methods, which have often changed little for centuries. The peasant's lack of education and lack of contact with the world beyond his village conduces to a conservative, non-experimental habit of mind. And modern inputs of seed, fertilizer, and so on may be physically unavailable. In countries with serious population pressure, the unfavorable labor-land ratio contributes to low output per head. The number of man-hours applied to each acre of land is not governed by equating marginal product to a money wage. The number of people on the land being in a sense overhead, it makes sense to maximize output by applying extra hours so long as marginal product is positive. But working further down the marginal product schedule necessarily reduces average product per worker.

Even in countries which cannot be regarded as having surplus population, there is often a surplus of urban population. The wide income gap between city and country, plus the "bright lights" attraction of city life, leads to cityward migration in excess of any visible employment opportunities. What is to become of these people? Since public relief systems are scanty, and since relatives are naturally reluctant to support a newcomer in complete idleness, full-time unemployment is not very feasible. Surplus labor tends, therefore, to crowd into the trade-service sector. These occupations require little capital or training, and one does not have to be hired--one simply sets up shop on a street corner. But since the volume of service demanded does not expand proportionately to the workers available, output per worker is very low and may even be declining over time. In some early theories of economic growth--notable Colin Clark's three-sector schema--a growing proportion of workers in the "tertiary" sector was supposed to characterize a wealthy economy at an advanced stage of development. For the reason just noted, however, one often finds a relative increase of tertiary employment (though perhaps not of output) in poor and relatively stagnant economies.

A somewhat different explanation is required for excessive employment in occupations, such as government service and domestic service, where people are hired for a money wage. Here the normal tendency to equate wage and marginal product is modified by strong socialpressure to employ additional people on essentially charitable grounds. Hence the staff of six household servants where three would be ample, and the government offices crowded with clerks and messengers beyond any reasonable requirement.

The situation in manufacturing is more complicated. Man-hour output lower than that in Sweden or Germany is not presumptive evidence of inefficiency. One might expect a lower output-labor ratio, with a correspondingly higher output-capital ratio, as a rational adjustment of factor proportions to relative factor prices. But in fact total factor productivity is typically lower, and labor productivity much lower, than in corresponding branches of manufacturing in the developed countries. Several things probably countribute to this result: (1) Lower personal efficiency of the workers concerned, due partly to less adequate education and job training, partly to nutritional and health deficiencies. In tropical Africa the incidence of malaria, internal parasites, and endemic diseases is so high that one cannot expect the level of physical exertion found in Europe or America. This source of productivity difference is not ineradicable, but it may take quite a long time to eradicate.

2. More labor is normally employed relative to capital, as a rational adjustment to factor prices. Even where the main production operations are rigidly determined by technology, there is considerable flexibility in supplementary operations such as cleaning, maintenance, protective services, materials handling, storage, packing, and shipping. And in some industries, such as textiles, there is flexibility of man-machine ratios on the main production operations.

3. In addition to rational adjustment, however, excessive employment may be forced on the employer by the kind of social pressure noted above. Discharge or layoff of workers is often prohibited or severely penalized. So as labor requirements per unit of output fall as a result of technical progress, it may be impossible to shrink the labor force at a corresponding rate. An Indian steel executive once said in conversation that they estimated that the desirable employment level for their enterprise was about 20,000 men. Actual employment was 30,000 and, because of legal restrictions, could be reduced only as workers died, retired, or resigned.

4. Some sources of reduced productivity of labor and capital are beyond the control of local management. Limited size of market means shorter production runs and more frequent shifts of equipment from one product to another. The fact that spare machine parts, other supplies, and materials are often imported from places at several weeks' shipping distance means that larger inventories may be necessary, and even so production may sometimes be interrupted by shipping delays. Foreign exchange crises and unexpected cuts in import quotas may also lead to below-capacity operation for extended periods.

5. Poor management, however, is a distinct and important source of reduced production efficiency in the LDC's. Management tends to be "one-man management" under a family head who may be unwilling to delegate authority even to sons or other family members. Management positions tend to be achieved through family position rather than through a competitive struggle based on ability. A quasimonopolistic position in the product market may reduce pressure for cost reduction and innovation. Labor, though it may be expensive relative to general wage levels within the country, is cheap relative to the developed countries and to the productive potential of modern machinery. Anything which appears cheap is apt to be inefficiently utilized. And so methods of worker selection, training, supervision, and payment are often surprisingly primitive, not calculated to call forth a high level of effort.

The Applicability of "Western" Economics

Economists and students from the less developed countries often assert, with varying degrees of strength, that the economic theory taught in American graduate schools is not very relevant or useful in their own countries. It is usually not very clear what this statement means. It is important to sort out possible meanings because in some senses the statement is self-evidently true, while about other interpretations one may be quite skeptical.

One possible confusion should be removed at the outset. Use of western economic analysis is often identified with a particular policy stance. In particular, it is thought that using the standard microeconomic tools involves glorification of the market mechanism and an implied suspicion of government action. Both logically and historically this represents simply confusion. Logically, there is no reason why such basic concepts as utility, preference, production possibilities, or opportunity cost should be identified with any one institutional setting. True, as propositions get "fleshedout" with more detailed assumptions, as they become more concrete and realistic, their range of institutional relevance narrows. One would not expect to find oligopoly theory very useful in a centrally planned economy. But this indicates simply that caution is needed in using the central economic concepts to develop detailed propositions which will be relevant to a particular institutional setting. The same building blocks can beused to develop quite different bits of applied economics, as will be shown later in this section.

Historically, too, glorification of the market mechanism by economists in the developed countries, certainly reached and passed its peak some-time before 1930. Beginning in the 'thirties with imperfect competition and Keynesian macroeconomics, continuing in the 'forties and 'fifties with the new welfare economics, and more recently still with emphasis on uncertainty and other dynamic problems, the main thrust of economics has been to develop all the qualifications which must be attached to naive statements about the efficiency of competitive markets. What one typically finds today is Western economists chearfully teaching rigorous micro theory on one hand, and with equal cheer supporting a wide variety of government economic activities--and without feeling at all schizophrenic, as indeed they need not. Indeed, as has been familiar since Lange and Lener, the apparatus of microeconomics can be redirected to glorify, not a regime of private enterprise, but a market socialist regime (presumably heavily loaded with good economic technicians)

So we set aside the "planning <u>versus</u> the market" type of controversy as irrelevant for present purposes, though we shall have something to say about it at the end of the chapter.

A statement about the limited relevance of Western economics may mean at least four things, which are logically quite different: (1) it may mean that <u>quantitative coefficients</u> and relations which have been estimated for the developed countries will not hold, and will need to be re-estimated in the LDC's; (2) it may mean that <u>personal behavior</u> is in some sense "Less economic" in the LDC's, so that the conventional response to monetary incentives cannot be relied on; (3) it may mean that the priority of problems is different in the LDC's, with a consequent difference in the relative importance of specific branches of economics or specific analytical tools; (4) it may mean that, because of institutional differences,one has to put the building blocks together differently, to invent new pieces of applied economics for various policy purposes.

The first statement is self-evidently true. For the United States, we think we know a good deal about price and income elasticities of demand, input-output relations in production, returns to labor and capital, consumption and investment elasticities, the output and employment response to a given change in aggregate demand, the income elasticity of federal government revenues, and so on. This is in fact what we mean by asserting familiarity with the structure of the economy. Quite obviously, this knowledge is not directly transferable to an economy operating at a much lower income level,with quite different factor supplies and technology, and a quite different production organization. The parameters needed for policy purposes must be built up anew by painstaking research, as has been and is still being done in the developed countries. To "borrow" capital-output ratios or other coefficients from the developed countries is simply an error of judgment. One moral we can draw from our earlier discussion is that, because of the fragmentation of the less developed economy, there should be greater attention to particular products and sectors, and greater skepticism about the stability of aggregative coefficients, than would be needed in developed countries.

The first kind of statement, while true, is not damaging to the dogical structure of economics. The second kind of statement,if true, would be decidedly damaging. .Such statements come rather heavily from anthropologists, whose concept of economic rationality may not be very precise, and who in a sense have a vested interest in non-economic motivation. As regards wage-earners' motivation, they also come heavily from employers, whose view of their workers' mentality is probably even more myopic than that of employers in the developed countries (which is often myopic enough).

Tests of economic rationality must be framed with care. It is not sufficient to show that individuals' preference systems give somewhat different weight to non-income as against income considerations. In a particular country, for example, workers may give somewhat greater weight than U.S. workers would give to courteous treatmentby supervisors, or healthfulness of work conditions, or security of job tenure. Or medium-income families may, for one reason or another, save a smaller proportion of income than medium-income families in France or Canada--this may indeed be true all the way up the income scale. Or manufacturers may, for understandable reasons, show greater risk aversion and shorter time-horizons than their counterparts in developed countries. Such differences and readily accommodated within the framework of economic analysis.

Nor is the relevant question whether peasant producers, for example, behave as the economic observer concludes from simple deductive reasoning that they "ought" to behave, or as he thinks he would behave in their shoes. The peasant's subjective situation--the alternatives which appear open to him, and the various considerations relevant to choice--is usually different, and may indeed be very different, from the situation as viewed by the educated, middle-class, and perhaps foreign observer. It is useful and necessary to explore the subjective view of the economic actor; and here the techniques of the social anthropologist or social psychologist may be particularly helpful. But given the subjective situation, the question is, first, whether income is prominent among the criteria used in decisions; and second, whether the direction of reactions is "normal," i.e. whether higher incomes are preferred over lower incomes.

There is no solid evidence that economic actors in the less developed countries flunk this test; and there is a good deal of evidence to the contrary. As regards peasant producers, experienced observers have concluded that--given the traditional techniques which are all the know--peasants do apply labor d capital to land as far as it is reasonable to do so, i.e. until marginal rates of return have fallen to a very low level. Moreover, where peasants produce for market and where two or more crops are open to them, there is evidence of marked responsiveness to changes in relative product prices. If one crop becomes relatively more advantageous than before, the proportion of acreage devoted to this crop rises with only a short time-lag.The growing literature on this front will be reviewed in our chapter on agriculture in Part Two.

As regards labor, it is not usually denied that workers prefer higher-wage jobs to lower-wage ones. But it has sometimes been asserted that a limited view of consumption possibilities sets a low ceiling to the amount of income desired. Once this ceiling is reached, the amount of labor offered varies inversely with the hourly wage--the (short-run) labor supply curve bends backward. The writer was at some pains totest this hypothesis as regards new factory workers in Puerto Rico--a group which is untypical only as regards the strong demonstration effect of readily available American consumer goods. For this group, there was convincing evidence that income aspirations were quite elastic--workers wanted more money, know what they would do with it, and were willing to work longer hours to obtain it wherever factors schedules permitted. Elliot Berg and others have reported similar findings from studies of African workers.

The wide currency of this apparently mistaken hypothesis must be attributed, I think, to two sources. First, it has long been a standard argument offered by employers--particularly foreign employers of indigenous labor--as to why it would be unwise for them to pay higher wages. Nor is this defense of a cheap labor policy at all new. Two centuries ago early English industrialists were arguing that higher wages lead only to greater idleness--a conclusion which was challenged rather sharply by Adam Smith. Second, the argument is connected particularly with the peculiar circumstances of migratory labor in certain parts of Africa. Here the family does not accompany the worker to his place of wage employment, the wife does not become a consumer, and the normal pressures for a higher scale of household expenditure are inoperative. It is not surprising, then, that men work only long enough to acquire a few readily transportable consumer goods--bicycles, radios, etc.--or to accumulate the customary bride price in their area. Taking a world-wide view, however, this system of employment is (happily) very untypical, and will doubtless decline even in its home territory as economic development proceeds.

We probably do not need to argue that merchants, manufacturers, bankers, and other business men are likely to have a strong interest in financial returns. True, the owner-managers of family businesses, and even more the large landlord class, may be "satisficers" rather than maximizers, and this may reduce pressure for full use of resources and technical progress. But this is not an unfamiliar argument in developed countries.

Third, it is certainly true that the priority ranking of policy issues differs substantially as between developed and less developed countries. Among areas which have a higher relative ranking in the LDC's we may not particularly: agricultural organization and productivity; demography and population growth; small-scale manufacturing, construction, and trade; public finance-taxation; budgetary control, current economic services, infrastructure investment; and international trade and capital movements. Areas which are relatively less important than in developed countries include: organization, management, and competitive relations within large-scale industry; labor economics, collective bargaining, and related matters; banking and monetary policy, and possibly income distribution, both household and functional.

This means a corresponding re-ranking of the analytical tools of economics. Trade theory and taxation theory are highly important. The basic tools of microeconomics are highly useful, whether applied to agricultural output, small-scale industry, or evaluation of infrastructure projects in the public sector. Western macroeconomics is decidedly less useful; and so too are some of the more elaborate micro constructs--oligopoly, bilateral monopoly, monopsony, and the like.

Finally, even where familiar concepts are relevant to a policy problem, they usually need to be deployed differently because of differing institutional circumstances. Many LDC's, for example, have an <u>unemployment</u> problem, and so do many developed countries. In the developed countries, the post-Keynesian theory of aggregate demand is the main analytical tool, and monetary-fiscal measures to regulate demand are the main policy instruments. This apparatus is not appropriate to the LDC's, whose structural unemployment is associated with land and capital shortages. Expansion of aggregate demand, in the absence of these cooperant factors, would have little effect on employment or output and would influence mainly the price level and the balance of payments. There is no way in which unemployment can be reduced rapidly, though it may be whittled down gradually by measures aimed at altering the industry mix and factor proportions in the economy. Production theory and price theory, rather than macroeconomics, provides the appropriate tool box.

Again, most LDC's have a serious problem of <u>economic stability</u>; and in this respect they may seem superficially to resemble the developed countries. But, as Dudley Seers has shown, instability in the LDC's arises mainly from export fluctuations rather than from fluctuations in domestic investment. This changes both the analysis of fluctuations and the nature of stabilization measures.

The question of the applicability of Western economics to the LDC's turns out, then, to be quite a subtle one. It has to be approached in specific rather than general terms. Certainly one does not have to throw away all one's previous training in going from, say, Sweden to Uganda. One does have to look at the landscape with a new eye and to be wary about the transferability of "accepted" truths to this very different setting.

How Many Kinds of LDC?

We have emphasized repeatedly the great heterogeneity of the Latafroasian economies. Can they usefully be classified into sub-categories which will be more nearly heterogeneous? This raises the question of why one wants such a classification. Does one want to group countries which are in some sense structurally similar, for purposes of descriptive generalization? Or does one want to separate countries with varying degrees of growth potential? Or does one want to group countries by how far they have already travelled along the development road? The relevant criteria will differ with the purpose.

Suppose we have in mind the last of these purposes. We want to distinguish various degrees of development within the less developed world. (This implies that most economies do pass through a broadly similar development experience, that we can mark off stages on what is essentially the same road. At the moment this is no more than a working hypothesis, whose usefulness we propose to investigate.)

Let us get rid at the outset of the problem of size. A large proportion of the LDC's in terms of numbers are very small countries--island economies, or slivers of African territory laid out originally by the colonial powers, or Central American republics, containing no more than the population of one metropolitan area in the United States. These economies are very open, with exports often approaching half the national product, and this gives their development a primarily satellite character. We propose to concentrate here on substantial countries, with considerably lower export ratios, and whose growth is more largely self-contained.

Within this population, several bases of classification might be used. Let us review these, proceeding broadly from less useful to more useful classification systems.

1. GNP per capita

This is doubtless the commonest basis for ranking countries at present. Yet it is a treacherous, and on the whole quite a misleading, basis. Measurement difficulties alone can introduce substantial distortions. As regards the large category of subsistence output, both thoroughness of enumeration and basis of valuation vary substantially from country to country. Other GNP components are usually subject to considerably wider margins of error than in the developed countries. When the data are converted from local currency units into, say, U.S. dollars for comparative purposes, the outcome is affected by varying degrees of currency overvaluation (or, occasionally, undervaluation) in the less developed world.

The distribution of income is important as well as its size. Venezuela and Zambia stand high on the per capita income list because of large oil and copper exports. But this is surely a misleading guide to the average level of living of the population. Few would argue that Zambia is more developed than japan, which is what the raw figures imply. Nor does current level of per capitalincome correlate very well with rate of growth of income. Argentina and Chile are relatively high income countries which have progressed littile for decades. Meanwhile, some other countries with lower absolute income levels have been growing quite rapidly.

The basic reasons for rejecting per capita income as a significant basis of classification, however, lie deeper than this. Why do we regard Japan as a developed country, despite its relatively low per capita income? Partly, perhaps, because per capita income has been rising at a good rate for almost a century. But even more significant is Japanese economic organization, techno logy, and product mix. In these respects Japan of today seems very "modern", by which we perhaps mean no more than "like us). By the same token we do not consider Zambia a modern economy, despite the high output of the foreign-controlled mining sector, These examples suggest that the test of development is basically an organizational or institutional test, rather than an output test. A developed economy is one which, because of its structural characteristies, can be counted on to grow more or less continuously in the future. But economies whith these characterics are widely scattered on the income scale, all the way from Japan to the United States. The LDC's are also widely scattered, and their income range overlaps with that of the DC's.

2. Relative Factor Availities.

One might classify economies according to whether all available resources are being used and, if not, which factors are in excess supply. The frequent references in the literature to "labor-surplus economies" represent this approach. The numerous countries with open frontiers might be termed "land surplus economies". Some countries, such as Ghana and Nigeria, seem to have both unused labor time and unceltivated land, a surplus of "Land-cum-labor." Venezuela, Iran, and a few other oil rich countries might be considered "capital surplus economies" in the sense that more foreigh exchange is being generated than can be-or at least is being-used for domestic investment. The attractiveness of such a classification lies in its possible suggestiveness for a development strategy aimed at balanced use of all resource supplies.

But there are serios difficulties in this approach. By "labor surplus," economists often seem to mean merely a distinction between lightly populated and densely-populated countries. When one tries to be more precise than this, "labor surplus" becomes quite difficult to define and to measure. We have argued earlier that every economy has some labor force slack at the output of accelerated growth. How much slack is required ti throw a country into the labor-surplus category?

This is also a rather static basis of classification. Excess supply of one or more factors is compatible either with growth or stagnation. Moreover, the rate of change in excess supplies is significant. It matters considerably whwthwe an initial surplus of, say labor is shrinking over time or whether it is being increased by a high rate of population increase and a low rate of economic growth. Nor does the state of factor supplies correlate directly with the state of economic organisation which, as just suggested, is the most reliable indicator of economic modernization.

3. Diversification of Production

Seers has suggested an interesting classification based partly on the importance of industry relative to primary production, partly on diversification of output within each of these categories. His spectrum of economies runs as follows:

1. Large and diversified industrial economies, with an integrated national market and a relatively high degree of self-sufficiency. The U.S.A. and the U.S.S.R. are extreme cases of this sort. More typical cases are the U.K., France, Italy, West Germany, Japan.

2. Smaller and less well-balanced industrial economies, with greater export dependence, such as Canada and Sweden.

3. "Mixed economies" which have considerable manufacturing development, but in which primary exports are still of strategic importance. Australia, India, Pakistan, South Africa, Brazil, Mexico, and Argentina are illustrative cases.

4. Primary producers with a number of important export industries, such as Peru, Malaya, or Indonesia.

5. One-crop economies, where the country's economic life is heavily dependent on a single export crop. The Central American republics (bananas), Liberia (rubber), Cuba (sugar), Burma and Thailand (rice), Ghana (cocoa), and Ceylon (tea) illustrate this situation.

6. One-mineral economies, which are similarly dependent on minerals or petroleum, such as Bolivia (tin), Chile and Zambia (copper), Venezuela, Iran, and Iraq (petroleum). The extreme case of this sort is the "oil sheikhdom," where a complete GNP statement can be derived from the accounts of the foreign oil producer plus the accounts of the royal household.

As one goes down this spectrum, aggregative analysis of the $C + I + G = Y$ sort becomes progressively less relevant and useful. Exports become increasingly the level of the economy. For categories 5 and 6, an industry analysis of the major export product is crucial. Understanding of the economy requires a quite disaggregated approach, tailor made to the circumstances of each case.

This classification is designed to highlight the fact that, in most LDC's economic fluctuations stem from export performance, and that secular growth also usually has a strong export component. But its usefulness in other respects is not clear. There is an implication that a growing economy moves upward in this spectrum over the course of time. But the schema itself does not explain why or how this occurs, or whether it needs occur at all. Some of the smaller economies in the above listings can expect at most to reach category 3, or possibly 2.

4. Monetization and Market Development

A rather different approach, emphasized particularly by Hla Myint, runs in terms of the development of money transactions and a market mechanism. The process typically starts with the sale of export products for cash; but if this is all that happens, the economy remains underdeveloped. Only in so far as cash dealings, specialization in production, and trading relations spread gradually within the country can it be regarded as developing; and its degree of development is measured by how far it has moved toward full specialization, sale of all products and factor services for cash, and economic integration through markets.

Myint's approach is dynamic in that it contains a theory of why how a LDC moves in this direction. The process is different, he believes, in an economy whose exports come from peasant producers as against one in which exports come from mining or plantation companies. In the former case, the peasants initially just add some export output to their previous subsistence output, but do not specialize any more than before--indeed, they are clearly diversifying. The cash earned from exports is spent mainly on imported consumer goods, whose attractiveness induces the extra effort necessary to earn them. As a second stage, some producers may specialize increasingly in the export crop, buying their foodstuffs from other peasants who specialize in that direction. There is now an internal market in food, with dealers, markets, moneyflows, etc. A third stage is the growth of consumer goods manufacturing, which in part replaces former imports, and in part replaces the handicraft production which the peasants slough off in the process of growing specialization. There is now a rural-urban exchange of foodstuffs for manufactures, and also a labor market for factory workers.

In the mine-plantation case, on the other hand, the labor market comes first in the chain of development. The large, usually foreign owned, companies recruit wage labor, whose earnings provide a potential market for domestic food and consumer goods production. The penetrative power of the market economy via this route, however, is limited in several ways. First, the export enclave may be rather completely walled off from the domestic economy. The wage labor needed may be imported (cf. the recruitment of Indian labor for the tea plantations of Ceylon). The products on which wage-earners spend their incomes may also be largely imported. Second, these companies have usually followed a "cheap labor" policy, so that the contribution to domestic purchasing power is not large. Finally, where migrating labor is employed on a temporary basis, as in large parts of Africa, the wage system fails to become a central feature of the economy. In many cases, then, a domestic market economy has to be built up alongside and almost independent of the mining or plantation enterprises.

On this view, an economy is developed when farmers and all other producers in the economy have become business men, sensitive to monetary calculations, dependent on specialization and trade, knit together by a good network of physical communications, traders and other middlemen, and market institutions. Along with this goes a shift in the sector composition of output, the occupational composition of the labor force, and so on. But these changes are in a sense superficial or derivative. The basic fact is the movement from isolated, self-sufficient production to specialized, market-oriented production.

One difficulty with this approach is that it is hard to measure how far an economy has moved along the development road. It may be possible, however, to find useful indirect indicators or proxy measures. Total cash marketings as a percentage of total national output would be one indicator. Proportion of labor time of the rural population devoted to production of food and non-food items for their own use would be another. The ratio of wage and salary earners to self-employed persons would be suggestive. One would expect marked shifts in all these ratios as commercialization proceeds.

The approach also implies that development via private enterprise and private markets is in some sense the "natural" course of events, that an economy is unlikely to leap suddenly (or successfully) from a quite primitive structure to a fully socialized organization. This raises very broad issues, which will be considered briefly in the next section.

A broadly similar view of development has been expressed by Ranis,[1] who emphasizes the "connectedness" of major sectors of the economy. He distinguishes an agricultural sector, a rural-based industrial sector, an urban industrial sector, and a foreign sector. At the outset of development the second of these may be virtually absent and the third quite weak. Growth involves partly a filling-out of these missing sectors to proper relative proportions, but more especially a binding together of all sectors by commodity and financial flows. Ranis' approach is policy-oriented in that his central concern is what government can do to further greater connectedness and balanced expansion of all sectors. But his concepts could also be used in a positive way to lay out successive stages of movement from the primitive to the developed economy.

1. Gustav Ranis, "Planning for resources and planning for strategy change," Weltwirtschaftiliches Archiv, 1965, pp. 21-42.

The Initiation of Growth: Government and the Market

In later chapters we shall be examining possible growth paths for a less developed economy. These models, like those of Chapter Three, will normally assume that growth is already underway. But can we say anything useful about how the process gets started? This is not only historically interesting but obviously of great practical importance.

It will doubtless be said that this is a "non-economic problem." On a strict definition of economies, this is probably correct. But who else is likely to tackle the problem effectively? Should not economists venture occasionally beyond the strict borders of their discipline? May they not even have some comparative advantage in terms of familiarity with the economic results which are being aimed at?

The first step in growth must be a rise in per capita income from one source or another. One can introduce a burst of export demand as a deus ex machina; and this may well have been the commonest case in practice. If one relies on domestic sources, an increase in population by itself is not sufficient. Even with adequate land, this would lead only to development on the extensive margin, which would not necessarily raise per capita income. Growth of population accompanied by equivalent growth of capital, however, could make possible Smithian division of labor and economy-wide increasing returns. An even more promising possibility in modern times is importation of more advanced production techniques, raising total factor productivity and per capita income.

It is not difficult, then, to explain how per capita income could rise moderately for some time; and "pre-takeoff" economies do doubtless experience such temporary increases from time to time. But very often the "engine fails to catch," and income relapses to its previous level after a longer or shorter period. In other cases, however, the engine does catch and growth becomes cumulative. What makes the difference? Or, in policy terms, how does one construct an economic mechanism able to turn short-term gains into continuing progress?

We limit our speculations to "mixed economics" with a limited government sector. The question whether full socialization and central planning can transform an LDC more rapidly into a modern economy is one on which there is as yet very little evidence. At any event, it is a different kind of question.

Much effort has been wasted on ideological debate over "development via the market" versus "development via public enterprise and planning." This approach pictures the economy as a territorial battleground, with the frontier between private and public enterprise being pushed about by attack and counter-attack. In reality, most branches of the economy are non-controversial. No one doubts that government should produce education, health, and other "public goods," and should operate public utility enterprises whith marked indivisibilities and external economies. No one doubts that agriculture, retailing, handicrafts, and small business generally (which means 80 percent or more of productive activity) should be in private hands. Controversy over private versus public operation is limited largely to heavy manufacturing, which is not an important sector in the early stages of growth.

The most striking feature of the private sector is the very large number of small producers--not only in agriculture but also in trade, manufacturing, and services. If economy-wide growth is to occur, it must be largely through the spontaneous effort of these people. They must have both the opportunity and incentive to produce more, earn and save more, consume more. This in no way implies a laissez-faire role for government. The well-developed commodity and factor markets which exist in the advanced countries are in good measure the creation of government. In the LDC's the need for thoughtful shaping of economic institutions is even more evident. Government has in its hand the powerful levers of the tax system, which can be used to stimulate or to stifle individual effort. Trade policy, public investment policy, and locational policy are other unavoidable and potent instruments.

Effort to create a stimulative framework for private economic activity is in no way inconsistent with full exploitation of investment opportunities in the public sector. The two are complementary and need to be pushed in balanced fashion. But because large public investment projects are more obvious and easier to implement, there is perhaps some danger of their being overemphasized. As Gunnar Myrdal once maintained in my hearing, it is very simple to build a new steel mill where none has existed before. There are no vested interests to be disturbed. But attempt to alter the land tenure system and you bring down a political hornet's nest.

In most respects government economic activity, like private economic activity, is underdeveloped in the LDC's. In one respect, however, it is often overdeveloped. The obvious imperfection of markets leads, not to efforts to improve the market, but to decisions to supersede the market by direct controls over prices and quantities. It is thought that the economy can be moved in the desired directions by administrative control from the center. As one examines these policies ex post, the results do not seem clearly superior--in some cases they are demonstrably inferior--to what could have been obtained by allowing greater freedom of private decision. In the process, the scarce administrative resources of government are spread thin, and energy is diverted from higherpriority tasks which only government can perform. And private decision-making ability, which can be developed only through repeated experience, is stultified rather than increased.

The presently developed countries, to be sure, were also over-regulated at the outset. A noteworthy feature of early growth in these countries, however, was a progressive liberation of internal and external trade, production, and prices from direct government control. While one cannot infer causation, the coincidence is interesting. Then, during the twentieth century, government in the industrial countries, impressed by various inequities and other defects of an unregulated market mechanism, gradually built a new network of controls aimed at repairing these defects. The merit of some parts of this recent control legislation remains debatable. But the structure as a whole is demonstrably more sophisticated than that which existed, say in the England of 1750. Perhaps most importantly, the controls were applied to a business structure which by that time had sufficient internal vigor to survive and flourish.

Political leaders and civil servants in the LDC's, particularly in the recently-emancipated colonial countries, have grown up under the influence of civil servants from the mother countries, to whom government regulation of economic activity seems natural, right, and necessary. So without much forethought they have applied a sweeping array of controls to a private sector which is still inchoate and weak, which needs to be coaxed and teased into growth rather than ordered into it. They have adopted a strategy which, however feasible in the Britain of 1970, might well have stifled growth in the Britain of 1800, and can easily stifle growth in the Nigeria or Indonesia of today.

Ranis' conclusions[1] on this point seem well justified: "In this fashion planning for resources must be supplemented by planning for a strategy change which provides dispersed economic agents access to particular markets and permits indigenous entrepreneurship to challenge traditional output/quality mixes and production coefficients. In any realistic setting planners are clearly not free to sit on their hands and let events take their course. It is up to government to help clear markets, create economic and social overheads, provide technical assistance to cultivators, and assist the siphoning of the agricultural surplus directly by deploying its fiscal power, and indirectly by establishing financial intermediaries. But the typical underdeveloped economy government by itself, is not an efficient enough organizational device to move the system in any particular direction via a network of direct controls. Restraint must be exercised in deciding on its proper role..."

(1) op. ct.., p. 36