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## Development Economics and the issues of poverty and social inequalities<sup>\*</sup>

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### Abstract

Development economics emerged as a separate discipline of economic science in the 1950s but it wasn't until the 1960s and mid-1970s that it began to draw serious attention. Gradually, an extensive literature concerning economic development was built up. In the 1980s it turned out, however, that despite some successes, the economic growth in most of medium and less developed countries was not as high as expected. During the 1980s and 1990s, the so-called Washington Consensus dominated the theory and practice of economic development. This notion covered the whole range of activities that were to lead the developing countries to improved welfare and prosperity. It included strict fiscal and monetary policies, deregulation, foreign trade and capital flow liberalisation, elimination of government subsidies, moderate taxation, liberalisation of interest rates, maintaining low inflation, etc. Based on the developmental experience of over past ten years, a new paradigm of development is emerging, the elements of which can be described as follows:

- (1) the basic economic environment should encourage the long-term investment in
- (2) the economy should have a high sensitivity to market stimuli
- (3) human capital must complement physical capital
- (4) due to the fast flow and absorption of information in the rapidly changing world, the key role is played by institutions and mechanisms that jointly respond to stimuli

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- (5) wherever market failures occur, an intervention of the state should be market-friendly
- (6) social equality must be guaranteed if the economic development is to take place on a sustainable basis.

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## 1. The reasons for the emergence of development economics

For more than two hundred years, economists have been asking a fundamental question: why do some countries become rich and others remain poor? For centuries, scholars (and not only) have been trying to address the issue of how poorer countries can pursue the path to sustainable development, reduce poverty and achieve relative prosperity in the long run.

The fact that after the Second World War economists' interest in the development of backward areas increased notably was undoubtedly associated with the then initiated process of the collapse of the colonial system, as well as with the socialist transformations occurring at that time. **Development economics was created at the end of the 1940s, with the aim to tackle the problems of a deepening divide of the world between the rich and the poor.** Differences between countries were so great that it was not possible to explain the reasons for these inequalities in terms of the production factors of a country, the level of technological achievement or an implemented economic policy. For this reason, a broad movement for establishing a new discipline of economic science emerged and grew in strength.

Development economics was recognized as a separate discipline within the field of economics in the 1950s, but it wasn't until the 1960s and mid-1970s that greater interest in the subject matter could be observed. Theories of economic development may be organized pursuant to various criteria. They can be split into two main categories, both of which have their theoretical and philosophical roots primarily in the 18<sup>th</sup> and 19<sup>th</sup> century European thought. In both cases, it was assumed that progress and development are possible and desirable. Yet, the representatives of the first group were convinced that the interests of nations and social classes are common and harmonious (e.g. classicists, neo-classicists), whereas the members of the second group asserted that there is a clear conflict of interests (e.g. Marxists, dependency theorists, radicals).

Theories of development differ in their ideological origin, in the degree of commitment to the market and the mechanism of setting "the right prices" as well as in their approach to the global economy and impoverished countries.

In the 1980s, it turned out that despite some successes, the economic development of most countries in the world brought much less satisfaction to their societies than was generally expected. First, no marked progress was made in improving social welfare, which many development economists hoped for. According to UNICEF, in the period of 1980–2000, the income in the poorest Third World countries fell by 10–15%. And while in 1978 the share of the poorest Third World countries in the gross world product amounted to 5.5%, in 2000 it was only 4.0%. No neoclassical effect of the wealth “trickling down” to poorer countries has been observed. The ratio between the income of the richest and the poorest countries worsened rapidly—20:1 in 1960, 46:1 in 1980, and 73:1 in 2005.

## 2. The factors affecting economic development

Post-war experience shows that economic growth is a necessary but insufficient condition for economic development. Without a proper redistribution of income and wealth, it is impossible to reduce social inequalities. The economists dealing with development issues point to the growing evidence that social inequalities do not favour economic development (Desai & Potter, 2002). Development has to be perceived in terms of the improved well-being, civilisational standards and the recognition of human rights.

What is more, new problems have occurred, and they clearly came as a surprise to numerous development economics researchers. One of them was the accumulation of surplus and unused capital in rich Arab countries (including Qatar, Kuwait, and Saudi Arabia). It turned out that these countries were not able to use just 10–25% of available capital for their own development purposes. In the view of many economists, it was indeed one of these problems that development economics was not ready to solve.

In the early 1980s, Albert Otto Hirschman (1981), in a pessimistic tone, wrote that long-term hopes for the successful development of the Thirds World countries, so common in 50s and 60s, disappeared completely 20–30 years later. Another economist, Paul Streeten (1984), claimed that, “[...] we must confess that we do not know what causes development and therefore we lack a clear agenda for research”. In the mid-1980s, this general mood resulted in a marked revival of the debate between the advocates of the neoclassical approach to economic development (including: I. Little, A. Krueger, D. Lal and others)—referred to as the World Bank group (whose views are best captured in the Washington Consensus)—and the broadly understood and extremely diverse “rest” who represented various trends of development economics, such as structuralists, dependency theorists, neo-institutionalists, economists of the Brandt Commission, and many others. The lack of economic development was generally attributed to a wrong price system (neo-classicists), bad investment allocation or a bad choice of production techniques (Stewart, 1987).

A major difference between the World Bank group and “the rest” (development economics) lay in a dissimilar approach to the role of the state in the economy and a difference of emphasis, for example, in terms of prices. Nonetheless, it did not mean that the “the rest” rejected neoclassical instruments *en bloc*, but rather, having a good price system does not mean that the economic development process has been completed, though it is known that a wrong price system can halt the development altogether. According to “the rest”, there were no grounds for claiming that an undistorted price system could lead to a higher level of well-being than a system involving various forms of state intervention. “The rest” believed despite what neoliberals believe, nowhere in the world were development processes successfully initiated without the intervention of the state. Even in Asian countries which for the last forty years have been implementing an open and pro-export development strategy, various forms of strong protectionism were adopted in the initial period of their industrialization, while the state played an important and leading role in economic life.

A characteristic feature of the works in the field of development economics—in its initial period—was a deep conviction about the effectiveness of state interventionism, particularly in developing countries. The emphasis was put on non-price mechanisms, state control, interventionism and protectionism in foreign trade. To some extent, it was in line with the economic spirit of that era. The state was to be strong and to actively participate in economic life. It was mainly because these countries were undergoing the process of decolonization. At that time, there was a widespread belief that the economic freedom would be of no use in less developed countries, and the active role of the state is the only chance for accelerating the rate of economic growth and development. Moreover, it was thought that capitalism would not solve development issues and at the least a mixed economy is necessary. In many cases, countries managed to become politically independent, yet not achieving greater economic independence.

In the mid-1970s, the approach to the existing development paradigms changed both in developing and highly developed countries. Later, the process of transformations also took place in the then communist countries. Faced with the failure of protectionism, statism, and communism, development economics specialists began to speak more frequently for introducing free market mechanisms in the national economy and in foreign trade, as well as for reducing the role of the state. The example of economically successful countries (including Hong Kong, South Korea, Taiwan, and Singapore) provided sound arguments. Furthermore, the attitude of development economists toward governments changed substantially. It was initially believed that there is a need for a powerful and well-informed state, determined to safeguard the interest of its own society and striving to achieve prosperity. In the 1980s, the experts in development issues became more sceptical and even cynical while assessing the competence and motivations of governments. They were increasingly perceived as economic entities which act in the interests of politicians and bureaucrats, or strong advocacy groups. Rather than

a solution to developments dilemmas, governments became a problem of its own. The position of governments was gradually weakening as domestic and foreign public opinion was receiving information about common cases of corruption involving public officials, wasted public funds, poor allocation decisions, the inefficiency of state-owned enterprises, stealing from the foreign aid at various levels of power, incompetence, nepotism, etc. At the same time, representatives of development economics maintained that the characteristics of medium and poorly developed countries make it impossible to effectively use neoclassical instruments, such as Keynesian tools, which had been tested in highly industrialized countries.

Many important points were brought into the discussion on the causes of underdevelopment by a well-known English economist E.F. Schumacher, who already several decades before pointed out a fundamental flaw in the philosophy of growth and development of backward areas that resulted from ignoring the needs of these countries. In the dual economy, 15% of the population belong to the modern sector – concentrated in one or two large cities, while the remaining 85% of the population live in the countryside or in small towns. And it was in these large centres that development efforts were focused, which means that the development did not reach 85% of the population. It is hard to argue with Schumacher's view that a fight against the causes of poverty—i.e. a low level of education, poor organization and lack of discipline—should be given top priority. If these three elements are not coherent and effective, even the greatest wealth will not permit development. As Schumacher (1981) asserts, progress in these three respects can only be gradual and must involve the whole society.

### **3. The Washington Consensus**

Failed attempts at economic development in communist countries and most of developing countries allow a better understanding of why in the mid-1980s both economic theory and practice shifted to neoliberal solutions, and especially how a widespread conviction about the effectiveness of the so-called Washington Consensus (promoted by the World Bank and the International Monetary Fund) grew in strength. The period of the last 20 years (from historical perspective, it was not the first return to the liberal ideas) was and still is characterized by the belief and hope that on the whole, but especially in poorer countries, an unrestrained market serves development better than any form of protectionism and state interventionism. Meanwhile, two trends emerged in development economics—leftist and rightist. The former group of development economists adopted the so-called structuralist approach to macroeconomics, while the latter—neoclassical.

Over the past two decades, the Washington Consensus dominated the theory and policy of economic development. The term denoted a series of actions that were to bring greater prosperity to developing countries, among which were: strict fiscal and monetary policy, privatization, deregulation, liberalization (of foreign

trade and capital flows), elimination of government subsidies, moderate taxation, liberalisation of interest rates, maintaining low inflation, etc. It was assumed that a free market and a rejection of state intervention—with the support of the US—would solve the problems of developing countries.

A categorical point of view was presented by a well-known American economist Paul Krugman, who wrote that the views of the advocates of state economy “are based on a failure to understand even the simplest economic facts and concepts” (1996). At the beginning of the 1980s, Milton Friedman declared that increased economic freedom brings greater prosperity, which caused heated disagreements among economists, and they demanded that this thesis should be proven. As stated in the *Economist* (June 28, 2002), in 1990–2000 it was confirmed that there is a positive correlation between the degree of economic freedom countries and their rate of economic growth.

Without a doubt, there were periods in history when it was possible to achieve a reasonable approximation of views on goals and basic instruments of economic policy, just as a dozen or so years ago when the approach founded on the mainstream neoliberal monetarism dominated economic thought and practice. The successes of Asian countries pursuing an open and pro-export industrialization strategy (one should bear in mind that in the initial post-war period, the strategy of these countries was clearly of protectionism), with simultaneous failures of various types of closed and excessively statist economies, gradually brought about a profound re-evaluation in the theory of development economics as well as in the implemented economic policy.

At the end of the 1980s, in response to a prolonged structural crisis, for example in Latin America, a relatively coherent concept of economic policy reforms in these countries was formulated. It assumed such changes in the instruments of economic policy that would allow putting heavily indebted Latin American countries on the path of sustainable development. The main emphasis was placed on exports, far-reaching liberalization and an unhampered openness to external contacts. The new economic policy framework strongly stressed the need for the radical liberalization of trade and capital flows, the reduction of the excessive presence of the state in economic life as well as privatization. The key importance was attached to liberalization of foreign capital inflows, while at the same time lifting the barriers to convertibility and transfers of profits abroad. All the above was meant to facilitate sustainable development in the conditions of openness, providing that the economy operated based on a strict and transparent financial policy. Hence, “healthy” public finances, a stable exchange rate, and low inflation took on an immense significance.

#### 4. New development paradigms

After the lost decade of the 1980s in Latin America, an unsuccessful experiment with a centrally planned economy in Central and Eastern Europe as well as other “autarkic” strategies, the 1990s arrived with completely new paradigms of economic development. According to the representatives of the new (liberal) school of thought, to put developing countries on the path of sustainable economic development, it was necessary to meet the following conditions:

- (1) economic growth must be closely correlated with the openness of the national economy to the rest of the world,
- (2) the optimal allocation of resources is possible only under the conditions of the global market that is subject to competitive pressure,
- (3) the more socially acceptable the development is, the faster it occurs, i.e. it is necessary to follow democratic procedures.

The postulates of the new development paradigm stood in glaring contradiction to the old views: it was the global market that became the source of economic growth, whereas the nation-state—the source of inefficient, if not wrong, allocation of resources. In the case of developing countries, the change was fundamental as it involved a transition from the negative assessment of foreign exchange (particularly evident in, for example, the dependency school in the 1970s) to the adoption of a paradigm in line with which free trade and unrestricted flow of capital are the only chance to overcome the barrier of underdevelopment.

Supporters of liberalization and free trade represent the view that protectionism and state interventionism create a situation in which those who have factors of production or consumer goods at their disposal receive specific rent (and to obtain it, they are willing to give up on a part of their scarce resources). It is obvious that some individuals strive to increase their own wealth at the expense of the whole society.

In the mid-1990s, the fast-moving globalization not only confirmed the validity of the new “openness” paradigms, but it also offered a guarantee of their continuation and further development. In numerous countries, globalization was perceived as a phenomenon providing a historical opportunity to improve living conditions. It was commonly expected that developing countries would contribute actively to the accelerated development of the world economy. Already in the mid-1980s, about 1/8 of these countries achieved substantial economic and social progress. **Yet, stagnation, increasing income inequalities, and growing social discontent could be observed in the clear majority of the countries.** Progress varied across particular medium- and poorly-developed countries (considerable in Asia, small in Latin America and virtually non-existent in Africa).

Globalization and liberalization were accompanied by deepening **vertical and horizontal income inequalities**. Contrary to the expectations of the liberals, the neoclassical mechanisms of wealth “dripping” to lower classes did not work (while the income of the richest 20% increased). The expectations regarding the

benefits of globalization for the developing world were not realized (China, India and the European countries undergoing the transformation process are, to some extent, an exception). Meanwhile, the global economic system, which does not give poor countries a chance to permanently improve their living conditions, is losing its appeal, and without the support of the 80% of the world population inhabiting these countries, no global system can function in the long run. A growing number of economists is leaning towards the view that globalization encompasses only 20–25% of the world population, while the rest continues to be marginalized. Insufficient purchasing power of developing countries is the Achilles' heel of the global economy. Of 6 billion people, only 1.8 billion consumers can afford to buy goods and services on the world market (de Rivero, 2001).

Oswaldo de Rivero maintains that theorists, experts, and politicians have long believed that economic development is an innate ability of all countries. All it takes is to implement an adequate theory and economic policy, and poor countries will also start to create prosperity and become rich in the same manner as today's highly industrialized countries. The mythical character of development often creates highly unrealistic expectations among politicians of poor countries and make them demand actions that would quickly narrow the gap separating their countries from the highly developed world. It is reflected in the UN resolutions on "the right to development", frequently understood as the right of poor countries to achieve standards and models of consumption resembling those of industrialized countries. And it is a common knowledge that although such resolutions are important for politics and propaganda, they bear no relation to the real possibilities of putting promoted ideas into practice. On the contrary, if developing countries reached the level of consumption of today's industrialized world, it would bring an environmental disaster on a global scale (de Rivero, 2001, pp. 110–114).

The end of the 20<sup>th</sup> century revealed that the openness strategy has its limitations. The effectiveness of the Washington Consensus proved to be limited in the case of developing and post-communist countries. A buoyant market economy should be the main driving force of any development strategy; yet, its ultimate success depends on, among other things, an effective competition policy and an efficient legal and institutional system. Deregulation, liberalization, and privatization are meant to attain these goals, but their efficacy is limited if they are not accompanied by complementary reforms.

As stated by Joseph E. Stiglitz (1999), limiting ourselves to simply changing a state monopoly into a private monopoly will not lead to the creation of a more dynamic market economy. What is more, the neoclassical endeavours to channel efforts into setting "the right prices" are not enough to create a properly functioning market economy. One of the main shortcomings of the Washington Consensus is that it underestimates the importance of competition. In a like manner, another disadvantage was to disregard the need for creating an effective legal and institutional infrastructure.

For the market to function properly, there must be adequate institutional and legal infrastructure, the system must be transparent, and property rights guaranteed. The necessity of having efficient financial institutions cannot be overlooked either. The modern theory of macroeconomics draws attention to the links between financial markets and the real economy. It demonstrates that financial markets are of central importance to economic fluctuations and economic growth.

The success of development depends on reducing the gap not only in terms of physical capital but also in terms of knowledge. And while the knowledge about production processes is essential, the knowledge on the proper functioning of institutions or from the field of organization and management is significant as well.

Another problem lies in the so-called imperfections of information, which seriously hamper the functioning of markets. The traditional models that assume perfect information can make it difficult to understand how the land, labour, product and capital markets operate in developing countries. They fail to explain some of the crucial issues related to the institutional structure. It is particularly important in those countries where an access to information is severely restricted. Therefore, market reactions of economic entities in these countries can differ drastically from what, in the theory of economics, is assumed in standard models of the competitive market. In this situation, we should expect those market imperfections which are associated with the imperfections of information will continue to play an important role in developing countries, including post-communist countries, for a long time to come.

Based on the developmental experience of the last dozen or so years, a new paradigm of development is emerging, the elements of which can be described in the following way: a) the basic economic environment should encourage investment in the long term, b) the economy should have a high sensitivity to market stimuli, c) human capital has to complement physical capital, d) due to the fast flow and absorption of information in the rapidly changing world, the key role is played by institutions and mechanisms that jointly respond to stimuli, e) wherever market failures occur, an intervention of the state should be “market-friendly”, f) the increasing social inequalities are not conducive to prosperity (as evidenced in the vast majority of countries, there is a growing social dissatisfaction, crime, and the quality of life in these societies is deteriorating, etc.).

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