

# The Theory of Economic Development and Neo-liberalism

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# The Theory of Economic Development and Neo-liberalism<sup>1</sup>

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## I

From the point of view of the history of economic ideas, it is an interesting fact the rise of the Theory of Economic Development, in the fifties, as a branch of economic science, understood as the economic analysis for bettering the conditions of social life in the underdeveloped countries. Any branch of economic science is an extension or an application of the theoretical core – basically, the theory of general equilibrium or some versio of it – to a set of specific phenomena. Thus, there are monetary economics, international trade, labor economics and so on. However, economic development has the unique feature of being a branch which was built up rejecting the theoretical core of economic analysis. The purpose of this paper is to show how this feature has arose in the works of three authors who are recognized as the “founders” of this branch, namely, Paul Rosenstein-Rodan, A. Lewis and A. Hirschman. This will be done in the next three sections. In the last section, we will consider the fate of these works under the news views on development based on neo-liberal ideas.

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<sup>1</sup> This is a first draft of a possible paper. We had not time to edit the text, so we apologize for its grammatical errors.

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## II

Paul Rosenstein-Rodan studied economics in Vienna and received his doctoral degree in 1925. This is an important fact for understanding his subsequent work in economic development. As it is well known, Austrian economics is much more concerned with the process for an economic rupture to attain an equilibrium situation than with the conditions of equilibrium situation per se. It is in the first problem that the market system has to fulfill its role of coordinating the decisions of economic agents. In Rosenstein-Rodan's words:

“What matters is ‘the pursuit curve’. The pursuit curve shows the dynamic path toward equilibrium – not only the conditions at the point of equilibrium. (...) We are therefore concerned not only with the question of existence of equilibrium, but the possibilities of nonexistence of equilibrium.” (Rosenstein-Rodan, 1984, p. 208)

Then, in 1930, Rosenstein-Rodan moved to London. During the Second World War, he formed a group to study the economic conditions of poor areas of Europe. This group were organized at the Royal Institute for International Affairs, and work on those problems from 1942 to 1945. From that study, he derived a paper called “Problems of Industrialization of Eastern and South-Eastern Europe”, which was published in the *Economic Journal* in 1943. This paper was recognized later on as the seminal work for the emergence of economic development. Indeed, the article begins with a question that defines clearly what economic development is all about, and for that matter, regional development, namely, how is it possible to transform an stagnant region into a dynamic one?

Rosenstein-Rodan's answer was, first of all, to characterize what is stagnant economy of a region. He affirms that such area have a surplus labor, basically in their rural areas, and a lack of capital. The idea that an underdeveloped country has a surplus labor will permeate every work in economic development. At the same time, in the rich areas, we have the opposite situation: an abundance of capital with a lack of labor. Hence, the only

possible solution is to displace this excess of capital from rich areas to the poorer areas. The industrialization of these areas should be compatible to the international trade, that is, it would be a mistake for a country to produce what it already could purchase in the international market.

Now, it comes his basic economic argument. The process of industrialization as described above cannot be left for the market forces. More specifically, the theoretical apparatus of the theory of general equilibrium is inadequate for analyzing this process. This is so because what is at stake is a process of industrialization which necessarily involves the presence of externalities, either on the side of capital as on the side of labor. For example, it could be unprofitable for a single firm to invest in training its workers because they can move to another firm and the whole investment is lost. However, if all the firms form an institutional arrangement to training the labor force, then the externalities deriving from a specialization of workers will be internalized in the industrial sector. There is no need to remember here Rosenstein-Rodan's famous example of the installation of a firm producing shoes. This is an example of horizontal complementarity. There is also vertical complementary, that is, externalities which could be internalized by promoting investment for an entire productive chain, from producers to their suppliers until the last sector of the chain.

The theory of general equilibrium cannot handle that because it deals with a given economic situation. As it is well known, this theory has as its point of departure a given amount of productive resources which will be allocated for producing the amounts of goods, given the technology, in order to satisfy the given preferences of the economic agents. Now, a process of industrialization is, by its very nature, a process of transformation of the economic situation. This process involves what he called pecuniary external economies, indivisibilities<sup>4</sup>, particularly in the case of social overhead capital and Technological externalities like the one described above on training the work force. Hence, the market system cannot give the right signals for the autonomous decisions of the

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<sup>4</sup> The requirement of a minimum amount of resource to provide for the running of economic activity in a long scale is an old idea in economic science. Quesnay states that only with a minimum amount of resources, agriculture can produce an economic surplus. Smith, in Book II of his *Wealth of Nations*, also calls attention that only after a certain minimum amount can an individual act as a capitalist. Marx, in his analysis of the relative surplus-value, shows that this minimum amount grows with the changes in the economic organization of production for increasing labor productivity.

economic agents. Notice the important point that what for the theory of general equilibrium is a case of imperfection, for the process of industrialization is the normal situation. Again, in Rosenstein-Rodan's words:

“The market mechanism does not realize the ‘optimum’ either in one nation or between nations because it relies on such unrealistic assumptions as linear homogeneous production functions, no increasing returns or economies of scale or of agglomeration, and no phenomenon of minimum quantum of threshold. This obscures the nature of the development process and the risk involved. Nothing in theology or technology ordains that God created the world convex downwards.”  
(Rosenstein-Rodan, 1984, p. 209)

Since market forces cannot handle this process of industrialization, as conceived by a general equilibrium theory, then the solution is to organize an institution or an enterprise to coordinate this process. Its main role is to look for sources of capital outside the country and to direct and supervised its application. Rosenstein-Rodan suggests even a name for that institution, namely, the Eastern European Industrial Trust (EEIT).<sup>5</sup> The projects chosen by this enterprise should be coordinated in order to explore the externalities referred above. Also, these projects should be done in mass, otherwise those externalities will be lost. Hence:

“Industrialization of international depressed areas, once it is accomplished, may create an equilibrium, from which onwards normal private incentives may operate successfully. But it seems hopeless to rely on them before that point is reached.” (Rosenstein-Rodan, 1958, p. 252)

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<sup>5</sup> Rosenstein-Rodan (1958, p. 249).

### III

The work of A. Lewis is very different from the other two authors because he presents an entire analytical model for showing how an underdeveloped country could transform its economy from a static to a dynamic one. His model was published in 1954, so two years before Solow published his own model with the novelty of the concept of steady state equilibrium. Both models have some analytical similarities, but their conceptual content is very distinct. Perhaps, due to this difference, Solow's model is still taught as "the" model of economic growth, while that of Lewis is reserved for some few pages in textbooks on economic development.

In the beginning of the fifties, a set of questions about the problems of how an underdevelopment country should overcome their situation were under discussion. One of them, was how to finance their process of industrialization. For Lewis, the main problem was how to increase the private domestic saving. He reflected on how this had happened in the nineteenth century in Europe. For him, the answer was "from a rising share of profits in the national income."<sup>6</sup> But this answer led to another question, namely, how to increase the profit share? For him, neither Keynes' model nor the neoclassical economics provided a proper answer.<sup>7</sup> The main reason for his rejection of both models was that they could not provide any answer for explaining "a long-term rise in the savings propensity." Then, a possible answer came out in one morning in August 1952. In Lewis' words:

"(...) it suddenly occurred to me that all one needed to do was to drop the assumption – then usually (but not necessarily) made by neoclassical macroeconomists – that the supply of labor was fixed. Assume instead that it was infinitely elastic, add that productivity was increasing in the capitalist sector, and one got a rising profit share."  
(Lewis, 1984, p. 132)

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<sup>6</sup> Lewis (1984, p. 132)

<sup>7</sup> Lewis (1984, p. 132)

The sources of this infinitely supply of labor are the disguised unemployment in agriculture, technological unemployment – this idea came from Marx as Lewis recognized – underemployment in urban areas or the informal sector; “the movement of women from the household into the labor market;” and the most important of all, the increase of population.<sup>8</sup>

Therefore, from a feature of underdeveloped regions pointed out by Rosenstein-Rodan, the surplus labor was transformed into a crucial assumption in Lewis’ model. But what matters at this point is Lewis’ rejection of Keynesian and neoclassical economics in the presence of this assumption. Indeed, this rejection was spelled out in the very first pages of his seminal paper of 1954.<sup>9</sup>

In the case of Keynes, Lewis pointed out that, at the beginning, his theory seems to be appropriated to deal with this assumption since after all, Keynes’ work was concerned with the level of unemployment. As a matter of fact, it is precisely because Keynes is concerned with the unemployment that his theory could not couple with the case in hand, namely, a general underemployment of labor. That is, in an underdeveloped country even if its economy is at full employment, still there will be a mass of unemployment significant enough for characterizing its supply of labor as infinitely elastic. Moreover, as Lewis argued, in Keynes’ theory both labor and capital were in infinitely supply in the short-term. Once the Keynesian policies were put in action, the limit to increase production is given by a limited supply of labor. It is interesting to note that this idea was carried on by Harrod in his model of growth, defining the natural rate of growth, and then it was adopted by Solow.

Lewis went one by saying that once at the full employment, the neoclassical model “comes into its own again” since it was possible to maintain the assumption of a limited supply of labor and, for that matter, of capital. Indeed, as it was remarked in the section above, the theory of general equilibrium begins by assuming that there is a fixed supply of factors of production (the quantity of their services). These supplies will be allocated, given the technological constrain, for producing quantities of goods for satisfying the given preferences of economic agents. Now, the essence of this approach lies on the concept of *scarcity*. As a general feature of human life, scarcity gives the “economic” aspect of social

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<sup>8</sup> Lewis (1984, p. 133).

<sup>9</sup> Lewis (1958, p. 400-01).

life. Now, if the supply of labor is not fixed, in fact, it is infinitely elastic, then labor will not be a scarce factor, and hence, the entire neoclassical approach is useless for analyzing underdeveloped economies and the process of their development.

The way out of this impasse is given by the very assumption that makes unappropriated keynesian and neoclassical economies: to revert to the classical analysis of the process of capital accumulation. In Lewis' words:

“This essay is written in the classical tradition, making the classical assumption, and asking the classical question. The classics, from Smith to Marx, all assumed, or argued, that an unlimited supply of labor was available at subsistence wages. They then enquired how production grows through time. They found the answer in capital accumulation, which they explained in terms of their analysis of the distribution of income. Classical systems thus determined simultaneously income distribution and income growth, with the relative prices of commodities as a minor by-product.” Lewis (1958, p. 400)

This is a neat exposition of the theoretical structure of Political Economy. In fact, political economists assume that the wage rate is given and determined at the level which could maintain worker and his family. As Ricardo states this level could change with changes in the social condition of a society. Since the wage rate is determined by historical and social conditions – that is, it is a social “datum” – then a surplus product depends entirely on the productivity of labor.<sup>10</sup>

The concept of economic surplus is fundamental in Lewis' work. This surplus (profits) is the main source for capital accumulation. Moreover, Lewis does not separate capital accumulation from technical progress – an assumption taken for granted in every model of growth – therefore, in so far as capital is being accumulated the productivity of labor increases. This process goes on until the surplus labor is eliminated. At this point, the process of economic development is complete. The unproductive labor, in the sense of

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<sup>10</sup> For a simple exposition of this model, see Hicks (1965) and Pasinetti (1977).

classical economists, is all absorbed into the capitalist sector, and, hence, it becomes productive, that is, it produces an economic surplus.

A comparison of Lewis' model of capital accumulation with that of Solow gives an example of what we have been arguing in this paper. Solow's model of capital accumulation is built up from Keynesian and neoclassical theoretical principles. The work of Lewis rejects such principles and posits as its foundations the classical approach, utilizing concepts completely alien to the mainstream economics, in particular, that of economic surplus. Maybe, for this reason, Solow's model is still taken as the starting point of growth economics, while that of Lewis is taken as a historical curiosity or limited to discuss the role of agriculture in the process of economic development.

## IV

The work of Albert Hirschman is the most drastic example of the three authors here considered. This is due to his combination of knowledge of different realms of social science that he utilizes for building up his theory of economic development.<sup>11</sup> His thought on this question took shape in the late forties as a member of Federal Reserve Board, working as an economist in the project of postwar reconstruction of Western Europe, and then, from 1952 to 1956, at Bogotá, Colombia. In this last concrete experience, Hirschman noticed in their latin american fellows economists a negative attitude of them with respect to the problems of their society. He denominated this state of mind as the “failure complex”, translated for Portuguese as “fracassomania”. For Hirschman, where those economists saw problems, he saw the solution.

The work of Hirschman is most remembered due to his concept of “linkage”. But to focus on this concept could only be done by neglecting his entire approach to economic development. The base of his approach, and what gives the real content of his concept of “linkages”, is in the first chapter of his “The Strategy of Economic Development”, published in 1958. Indeed, the ideas developed in this initial chapter are barely mentioned in the literature. Therefore, it is from here that we will begin the exposition of Hirschman’s ideas on development.

First of all, it has to be noted that Hirschman inverts the terms of the equation utilized by economists concerned with economic development. Usually, those economists point out for the absence of some conditions for starting the process of development. A good example is given by the two authors considered above. Rosenstein-Rodan and Lewis point out for the lack of capital and from here they described how capital accumulation could be launched. In his turn, Hirschman states that underdeveloped countries have the conditions for developing, nothing is lacking. The problem is how to agglutinate these conditions for attaining development as a social objective. At this point, it comes the originality of Hirschman’s approach.

He remarks that a process of development involves the idea of change. However, there are two images, as he called them, about change in underdeveloped countries. The

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<sup>11</sup> See Bianchi (2004)

first is the “group-focused” or “cooperative” image. This is typically found in static societies, in which “individual members of such society usually have a definitive place and role assigned to them.” The increases in productivity by any individual should only happen “at the expenses of other members and of the cohesiveness of the group.” As a result individual attempts to change situation is ruled out. Development should be for everybody – maintaining their relative position in the social structure – and not for some group in particular. Hirschman then notes that a process of development involves, by its very nature, “that priorities are established and that certain activities and communities receive temporarily preferred treatment.” This is almost unacceptable in societies that have this kind of image of economic development. Thus, it is difficult to assert what are the priorities. An example is “the reluctance of many governments in underdeveloped countries to pick priorities and to maintain them in a consistent manner”.<sup>12</sup>

The second image of change is the “ego-focused” or “the “individualistic”. Here, “change may be conceived as possible for individual while it is not visualized at all for the group”.<sup>13</sup> Hirschman explains:

“The individual member of such societies who is brought face to face with the evidence of economic progress will reinterpret it to mean that he can improve his own lot. On the other hand, he will dismiss such possibility for society as a whole simply because, not identifying himself with society” (Hirschman, 1958, p. 14)

Now, initially it seems that such behavior is more adequate to economic progress. But a closer analysis shows us that this is not the case. First, because “success is conceived not as a result of the systematic application of effort and creative energy, combined perhaps with a ‘little bit of luck’, but as due either to sheer luck or to outwitting of others through careful scheming”.<sup>14</sup> From here, states Hirschman, the popularity of lotteries in Latin American countries.

But the most important obstacle in this type of society is that “it tends to obstruct a series of processes that are part of the entrepreneurial function”. An “ego-focused” society

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<sup>12</sup> Hirschman ((1958, p. 14).

<sup>13</sup> Hirschman ((1958, p. 14).

<sup>14</sup> Hirschman ((1958, p. 16).

seems to be more able for the activities of a schumpeterian innovating entrepreneur. However, even in this case some kind of cooperation is required for having a dynamic economy. As Hirschman states:

“In the United States, of course, the need for this ‘cooperative’ component of entrepreneurship has long been recognized and indeed cultivated, and ‘human engineering’ has come to occupy an increasingly prominent place in the training and thinking of corporation executives” (Hirschman, 1958, p. 17)

The final result of this analysis of these two types of images of change is that their decision-making process is inefficient, therefore, they do not take the amount of decisions and in a velocity required for making the necessary changes in the direction of economic progress. The situation is one in that everybody knows that some change has to occur, but nothing happens, or if it happens is in a slow and gradual steps. Now, it could be possible to think that the problem is the scarcity of the decision-making process then it would be possible to economize on this “scarce” factor. This would not do because any project of change requires some amount of this decision factor.

Bringing this analysis to the realm of economic, we know that an economic agent only changes his decisions if he is out of his state of equilibrium. Therefore, if the problem of development is due to a lack of the decision-making process then the solution is exactly to promote disequilibrium. This will work as a mechanism of pressure for individuals in society to make the necessary changes and, hence, to start a process of economic development. From Hirschman’s point of view, the idea of a balanced growth is unattainable because if a society has the capacity of conceiving and executing an entire plan which coordinates the projects of investment, then this society is developed.

Now, considering the process of investment, Hirschman calls attention for the insufficiency of the theory of economic growth, despite “the attempt to make our underdeveloped ‘economics of development’ benefit from the recent vigorous advances of the ‘economics of growth’”.<sup>15</sup> Any model of economic growth uses the equality of savings and investment as a condition of equilibrium, and such equality is taken for granted. But,

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<sup>15</sup> Hirschman (1958, p. 29).

from Hirschman's argument this can be so in a advanced society, one in which there is an entire set of institutions to make the savings disposable at one point to be applied at another. As a matter of fact, there are individuals in these societies whose job is precisely to look after economic opportunities and to search for resources to explore these opportunities. In other words, a developed society has already build up its decision-making process, it has already learning how to take such decisions and how to implement them. Therefore, economists in these countries can taken for granted the equality of savings and investment. However, this is not the case in an underdeveloped society since the process of taking decisions does not work with the same efficiency as it should do.

For Hirschman, this kind of "short-cut", namely, to utilize some theoretical piece derived in one society into another one can be a misleading act:

"The reason is that theories which, because of their high level of abstraction, look perfectly 'neutral' as between one kind of economic system and another, often are primarily relevant to the conditions under which they were conceived.(...) If they are useful theories, they will have focused on variables that in a particular setting are both strategic and subject to change by policy-makers. Therefore, the more useful they are in one setting , the less they are like to be so in a completely different one.(...) The attempt to apply the economics of growth to the economics of development may be a case in point." (Hirschman, 1958, p. 29)

Therefore, we need to look for concepts useful for understanding the reality of under developed countries. In the case of investment, this involves to recognize a third role of investment, besides those of increasing income through multiplier and of increasing productive capacity, due to the accelerator. This third role is that of inducing directly others investments. From this point of view, we have a different approach to the choice between projects of investment. In the traditional macro theory, the choice between two projects is guided by their rates of return, and it is chosen just one of them. But, from Hirschman's theory, the criteria should be which of them can cause more disequilibrium. If the choice is correct, the implementation of one will led to the other:

“In other words, our choice depends entirely on the pressure that the existence of [project] A exerts toward the coming into existence of [project] B as compared to the corresponding pressure that would emanate from B to A. Once the problem is formulated in this way it becomes quite clear that the comparative productivity of A and B which will both have to be undertaken is likely to be a rather minor factor in the decision assigning the priority” (Hirschman, 1958, p. 78)

It is in order to analyze what sequence is more apt to create the necessary pressure or disequilibrium that Hirschman introduces his concept of “linkages”. But, as we have seen, this occurs after a long theoretical journey in which he dismisses the rationality of economic agent, the macro theory of economic growth and finally, the strategy of balanced growth. All that from the perspective that we have to be very careful in the use of theories derived in one social environment to another. In that, Hirschman is hand in hand with Rosenstein-Rodan and Lewis.

## V

In the last century, the golden age of capitalism finished around the late sixties. The central economies began to suffer from a series of economic problems, one of them a completely new one: high rates of inflation with high rates of unemployment. In this context, the economic science – we mean by it, neo-classical theory – and also economic development went into a crisis. The mainstream theory of production and distribution was under a heavy attack after the publication of Piero Sraffa's book called "Production of Commodities by means of Commodities". The effectiveness of this criticism derives from pointing out to an internal logical inconsistency of those theories. In the seventies, another critique was made by Robert Lucas to the macro-econometric models. The final upshot was that the mainstream went back to its theoretical fundamentals, namely, those provided by the general equilibrium theory, based on the concept of the "representative agent". This kind of representation of an economic system fitted very well the new wave of neo-liberalism that began to take form in the eighties and nineties.

In its turn, economic development faces, on the one hand, the failure of the process of industrialization of underdeveloped countries to change their conditions of social life, and, on the other, under the neo-liberal agenda, ideas such as planning were completely ruled out since, after all, the market forces will do the job of mobilizing economic resources of these societies into a real process of development. Indeed, by the end of the eighties, a document called the Consensus of Washington, containing ten points of economic policies for developing economies, was transformed into a new strategy for development. Those points were based on the reforms that some Latin American countries were making since the seventies to adjust their economies to the new international order. The essence of this new strategy was to change the roles of the public and private sector. The former should take care of the stabilization of the economic system and devote its resources to social goals. The latter should invest their resources in accordance to the market opportunities.

An interesting aspect of the new agenda, articulated by John Williamson, is that it dismissed the theories of economic development:

A striking fact about the list of policies on which Washington does have a collective view is that they all stem from classical mainstream economic theory, at least if one is allowed to count Keynes as a classic

by now. None of the ideas spawned by the development literature- such as the big push, balanced or unbalanced growth, surplus labor, or even the two-gap model- plays any essential role in motivating the Washington consensus. (...) This raises the question as to whether Washington is correct in its implicit dismissal of the development literature as a diversion from the harsh realities of the dismal science”(Williamson, 1990, p.19-20)

This is really a good question. One thing is lost for sure. The idea of development as a process of change disappears from economic analysis and policies. All that matters is the stabilization of a given economic system, a problem whose theoretical treatment is akin to the mainstream economics.

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