

Participatory community economic analysis

DEVELOPMENT ECONOMICS.

- Development economics or the economics of development is the application of economic analysis to the understanding of the economies of developing countries in Africa, Asia, and Latin America.
- It is the sub discipline of economics that deals with the study of the processes that create or prevent economic development or that result in the improvement of incomes, human welfare, and structural transformation from a predominantly agricultural to a more advanced industrial economy.
- The subfield of development economics was born in the 1940s and 1950s but only became firmly entrenched following the awarding of the Nobel Prize to W. Arthur Lewis and Theodore W. Schultz in 1979. Lewis provided the impetus for and was a prime mover in creating the sub discipline of development economics.

As a subfield concerned with "how standards of living in the population are determined and how they change over time" (Stern), and how policy can or should be used to influence these processes, development economics cannot be considered independently of the historical, political, environmental, and sociocultural dimensions of the human experience. Hence development economics is a study of the multidimensional process involving acceleration of economic growth, the reduction of inequality, the eradication of poverty, as well as major changes in economic and social structures, popular attitudes, and national institutions.

Development economics covers a variety of issues, ranging from peasant agriculture to international finance, and touches on virtually every branch in economics: micro and macro, labor, industrial organization, public finance, resource economics, money and banking, economic growth, international trade, etc., as well as branches in history, sociology, and political science. It deals with the economic, social, political, and institutional framework in which economic development takes place.

1. The study of economic development has been driven by theories of economic development, which have developed along the lines of the classical ideas, the Marxist idea, or a combination of both.
2. Some approaches have focused on the internal causes of development or underdevelopment, while others have focused on external causes.
3. Economic growth increase in output and income has been used as a substitute for development and, in some cases, has been treated as synonymous with development.
4. Economic growth and economic development have been mostly studied by means of cross-country econometric analysis.

ECONOMIC PROBLEMS

1. Scarcity, choice and the basic economic problem
2. Opportunity costs, allocation of resources
3. Production possibility curve and productive efficiency

4. Positive and normative statements
5. Markets versus planning, free-market system, command economy
6. Economic models.

Scarcity, choice and the basic economic problem

- Inflation, unemployment, pollution, energy shortages and government deficits are some of the complex problems confronting an economy, which have an impact at the micro level also. These problems arise due to the fact that resources are limited while human wants are unlimited.
- This leads to dissatisfaction, causing human being to look for ways to fulfill their needs. Thus scarcity leads to the necessity of making choices. Problems of choice arise at all levels - at the level of the individual, at the level of producers, and at the level of the overall economy.
- Scarcity results when natural resources, human resources and capital resources are not available in sufficient quantity to satisfy all wants. So a producer has to decide what he wants to produce using a particular resource.
- For example, if he chooses to produce paper for textbooks from a stand of trees, then no other product can be produced from that particular stand of trees. Yet, there are many other products that could have been produced using the same natural resource, which are also desired by consumers.
- The opportunity cost of the decision thus becomes an important consideration; by making a choice, the next best alternative good cannot be produced.
- Consumers typically make their decisions based on two considerations- budget constraints and personal preferences. A budget constraint is the difficulty a person faces when he tries to satisfy his unlimited wants with a limited income.
- Thus, a purchase decision is based on income, price, and personal tastes and preferences. A consumer can have a choice of alternative products with a limited income if he can find a person with whom he can exchange goods or services.
- By means of such exchanges, he can increase his level of satisfaction. Such gains in satisfaction can be termed as 'gains from trade'.

Opportunity costs, allocation of resources

Opportunity cost can be defined as the cost of any decision measured in terms of the next best alternative, which has been sacrificed. To illustrate the concept better, let us assume that a person who has 100 at his disposal can spend it on either of the three options: having a dinner

at a restaurant, going for a music concert or for a movie. The person prefers going for a dinner rather than to the movie, and the movie over the music concert.

Hence, his opportunity cost is sacrificing the movie, the next best alternative once he

goes for a dinner. If we carry forward the same example at the firm level, a manager planning to hire a stenographer may have to give up the idea of having an additional clerk in the accounts department. This is applicable even at the national level where the country allocates higher defense expenditures in the budget at the cost of using the same money for infrastructural projects. In order to maximize the value of the firm, a manager must view costs from this perspective.

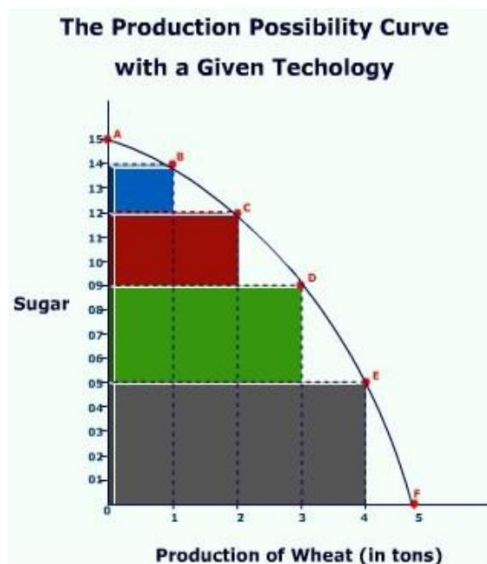
Production possibility curve and productive efficiency

Now let us analyze how individuals, producers and other economic agents use the limited resources to meet the unlimited needs. This to a large extent is possible with the help of the production possibility curve (PPC). The production possibility curve can be defined as a curve which shows the maximum combination of output that the economy can produce using all the available resources.

The production possibility curve helps us understand the problem of scarcity better, by showing what can be produced with given resources and technology. Technology is the knowledge of how to produce goods and services.

The following assumptions are made in constructing a PPC:

- The economic resources available for use in the year are fixed.
- These economic resources can be used to produce two broad classes of goods.
- Some inputs are better used in producing one of these classes of goods, rather than the other.



Positive and normative statements

Another debate about the nature of economics is whether it is a positive or a normative science. According to J. M. Keynes, “A positive science may be defined as a body of systematized knowledge concerning what is. A normative science or regulative science is a body

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of systematized knowledge relating to the criteria of what ought to be and concerned with the ideal as distinguished from the actual....The objective of a positive science is the establishment of uniformities; of a normative science, the determination of ideals.”

Positive economics explains economic phenomena according to their causes and effects. At the same time, it says nothing about the ends; it is not concerned with moral judgments. On the other hand, normative economics explains how things ought to be. According to Milton Friedman, positive economics deals with how an economic problem is solved.

Markets versus planning, free-market system, command economy

This economic system emphasizes the freedom of individuals as consumers and suppliers of resources, and allows market forces to determine the allocation of scarce resources through the price mechanism. Based on market demand and supply, consumers are free to buy goods and services of their choice and producers allocate their resources based on the demand. Decisions made by producers and consumers are influenced greatly by price.

- Price plays a major role in a market economy. The role of the government is negligible: consumers choose the goods they want and producers allocate their resources based on the market demand for different products.
- In such a system, efficiency is achieved through the profit motive. Producers make goods at the lowest cost of production, and consumers get higher value goods and services at lower prices.

Command Economy

In a command economy, all the economic decisions are taken by the government – what to produce, how to produce and for whom to produce. Thus, all decisions, from the allocation of resources to the distribution of end products, is taken care off by the government.

In this type of systems, efficiency can be achieved only when demands are accurately estimated and resources allocated accordingly. The USSR was an example of a command economy. The government had complete control over the economy, and consumers were just the price takers. The government set output targets for each district and factory and allocated the necessary resources.

Economic models

Economic models are a set of equations or relationships used to summarize the working of the national economy or of a business firm or some other economic unit. Models may be simple or complex and they are used to illustrate a theoretical principle or to forecast economic behavior.

- Economic models can be further classified into Micro Economics Models and Macro Economic Models.

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- Micro Economic Models: Models when they incorporate individual economic units such as households and firms, often grouped into individuals markets and industries and the relationship between them are called as micro models.
- Macro Economic Models: these models are used to explain and predict the working or performance of the economy as a whole, e.g changes in the level of NI, the level of employment and inflation.

Different approaches in solving the above issues/problems:

- Inputs (Factors of production) – 1) Land, 2) Labour and 3) Capital resources.
 - 1) Land – Natural resources
 - 2) Labour – human time spent in production
 - 3) Capital resources – machines, computers, hammers, trucks, automobiles etc.,

Formulation of Societies

- Market Economy or Free-market or laissez-faire economy makes decisions on an individual level with minimal government intervention.
- Planned Economy or Command Economy where all economic decisions are made by the government (Sloman, 2001).

SOCIETY'S CAPABILITIES

- Takes the initiative in combining the resources of land, labour, and capital
- Makes strategic business decisions
- Is an innovator
- Commercializes new products, new production techniques, and even new forms of business organization
- Takes risk to get profits

PRODUCTION POSSIBILITIES FRONTIER

- Society uses its scarce resources to produce goods and services
- The alternatives and choices it faces can best be understood through macro economic model
- We assume:
 1. Full employment
 2. Fixed Resources
 3. Fixed Technology
 4. Two goods

Important aspects

- Use of Resources
- Production Techniques
- Consumption
- Wants and demand

Putting the PPF to work

- Before development, the nation is poor. It must devote almost all its resources to food and enjoy few comforts
- PPF provides a rigorous definition of scarcity
- How societies choose among different patterns of output, how they pay for their choices, and how they benefit or lose
- PPF answers for what, how and whom.

The Production Possibilities Frontier

- Let's introduce the Production Possibilities Frontier
 - Better known as the PPF.
- The PPF is a basic workhorse in economics.
- Important for understanding some basic issues in economics.
- Great application is with international trade theory.
- Helps one understand and distinguish between comparative advantage and absolute advantage.
- An important historical figure in all this is David Ricardo.

David Ricardo

- Famous 19th century British economist.
- Some consider him the grandfather of international trade theory.
- Very influential in pioneering the theory of comparative advantage, *inter alia*.
- Very interesting, *very* bright guy.
- Had a lot of say about the "corn laws" in England.

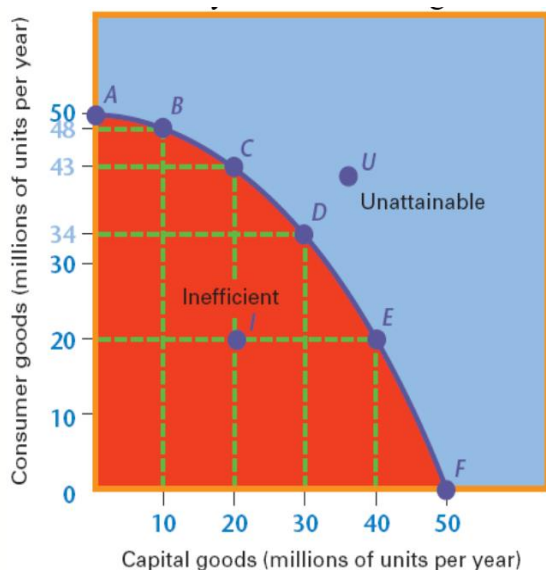
The Production Possibility Frontier - What Is It?

- The description of the best possible combinations of two goods to produce using all of the available resources.
- Shows the trade-off between more of one good in terms of the other.
- Assumes: input endowments given, technology given, time given and efficient production.
- Efficiency and Production Possibilities Frontier

PPF model

- Shows possible combinations of 2 types of goods that can be produced when available resources are used fully and efficiently
 - Figure
- **Inefficient and unattainable production**
 - Point I and U on the curve
- **Shape of the PPF**
 - Any movement along PPF involves giving up something

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- ▶ Production Possibilities Frontier – PPF Figure
- ▶ *A* through *F* are attainable
- ▶ *I* represents inefficient use of resources
- ▶ *U* represents unattainable combinations

- ▶ The resources in an economy are not all perfectly adaptable
- ▶ Law of increasing opportunity cost – each additional increment of one good requires the economy to give up larger increments of other good
- ▶ The PPF has a bowed-out shape due to the law of increasing opportunity cost

Shifts in the PPF

- ▶ Economic Growth – an expansion in the economy's ability to produce
- ▶ Changes in resource availability
 - ▶ Increase (more labor) – PPF shifts outward
 - ▶ Decrease (less resources) – PPF shifts inward
- ▶ Increases in stock of capital goods
- ▶ Technological change

OVERVIEW OF INTERNATIONAL TRADE THEORY

- **Free Trade** occurs when a government does not attempt to influence, through tariffs, quotas, or other means,
 - what citizens can **buy** from other countries or
 - **produce and sell** to other countries
- The **Benefits of Trade** allow countries to be richer by specializing in products they can produce most efficiently
- The history of trade and government involvement presents mixed evidence
 - There may be **some** ways that some governments can make things better by intervening
 - But government intervening in free trade is definitely **dangerous**

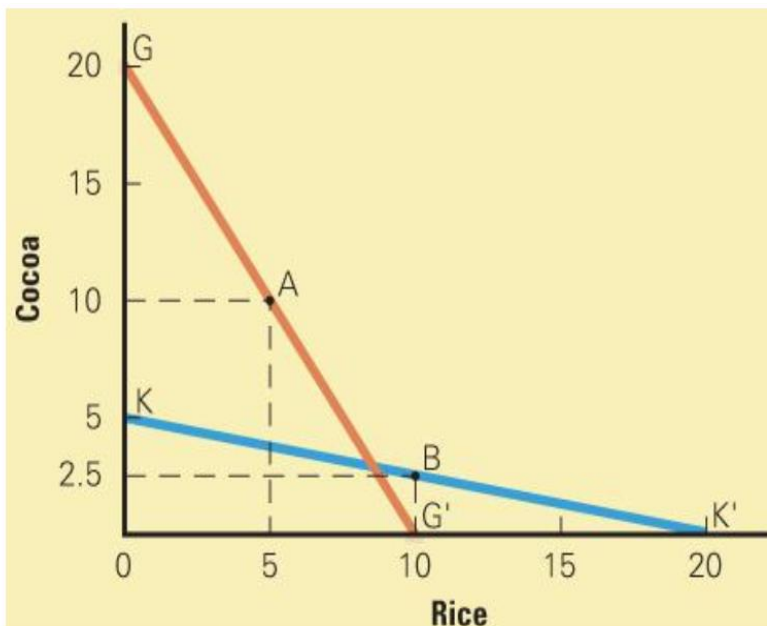
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THEORY OF ABSOLUTE ADVANTAGE

- Adam Smith argued (*Wealth of Nations*, 1776): Capability of one country to produce more of a product with the same amount of input than another country.
 - A country should produce **only goods where it is most efficient**, and trade (import) for those goods where it is not efficient
- Trade between countries is, therefore, beneficial
 - Example: Ghana/cocoa
- Export those goods and services for which a country is more productive than other countries
- Import those goods and services for which other countries are more productive than it is

Resources Required to Produce 1 Ton of Cocoa and Rice		
	Cocoa	Rice
Ghana	10	20
South Korea	40	10
Production and Consumption without Trade		
	Cocoa	Rice
Ghana	10.0	5.0
South Korea	2.5	10.0
Total production	12.5	15.0
Production with Specialization		
	Cocoa	Rice
Ghana	20.0	0.0
South Korea	0.0	20.0
Total production	20.0	20.0
Consumption After Ghana Trades 6 Tons of Cocoa for 6 Tons of South Korean Rice		
	Cocoa	Rice
Ghana	14.0	6.0
South Korea	6.0	14.0
Increase in Consumption as a Result of Specialization and Trade		
	Cocoa	Rice
Ghana	4.0	1.0
South Korea	3.5	4.0

TABLE 5.1
Absolute Advantage
and the Gains from
Trade



- There may also be long-term benefits

to free trade

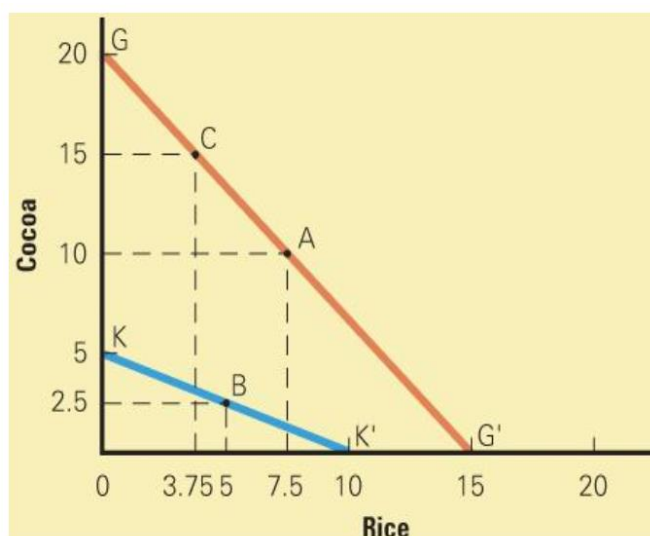
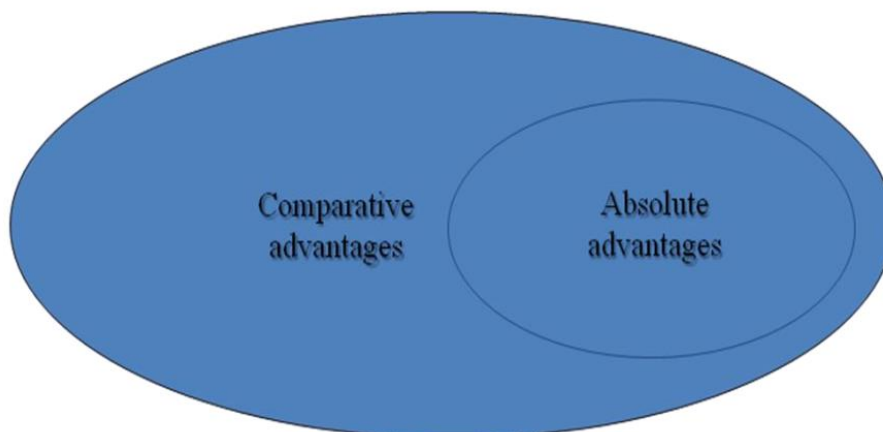
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- As people specialize and **seek higher incomes**, they may learn to do their specialties better

COMPARATIVE ADVANTAGE:

- Suppose one country is more efficient than another in **everything**?
- There are still global gains to be made if a country specializes in products it produces **relatively more efficiently than other products**
- David Ricardo (*Principles of Political Economy*, 1817):
 - Efficiency of resource utilization leads to more productivity
 - A country should import **even if country is more efficient in the product's production than country from which it is buying**
- Trade is a positive-sum game
- Produce and export those goods and services for which it is *relatively* more productive than other countries
- Import those goods and services for which other countries are *relatively* more productive than it is

Relations between Absolute Advantages Theory and Comparative Advantages Theory



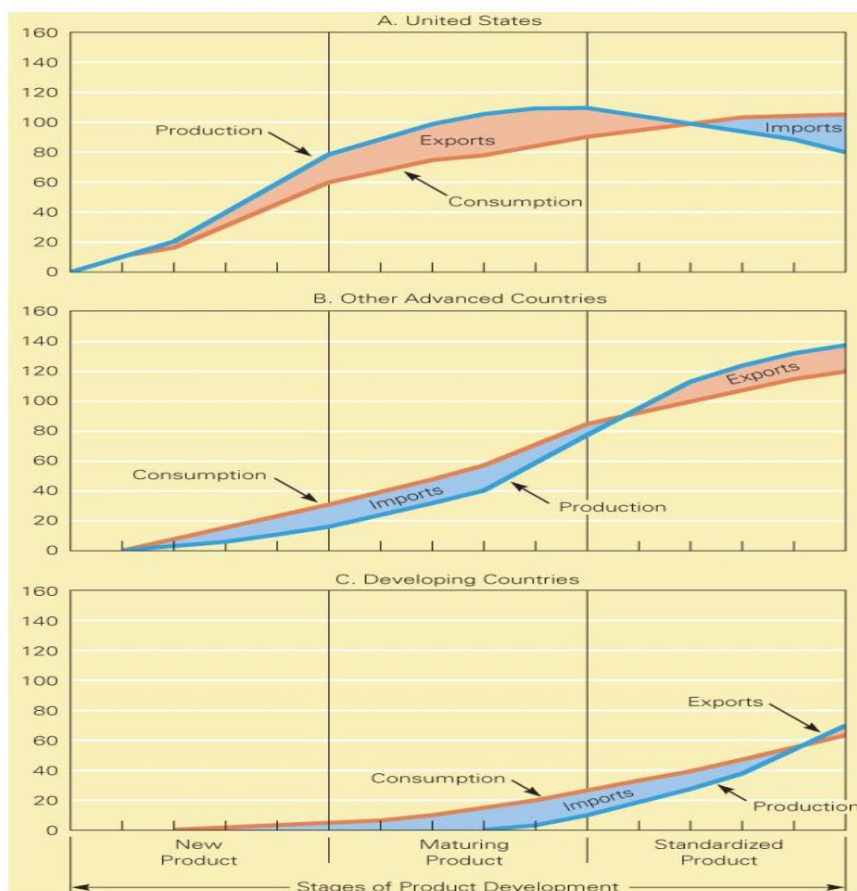
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- Your country **has comparative advantage** in the product or service where the ratio is $\frac{\text{Resources required in your country}}{\text{Resources required in the other country}}$ is lowest

PRODUCT LIFE-CYCLE THEORY - R. VERNON (1966)

- As products mature, location of both **sales** and optimal **production** changes
- Affects the direction and flow of imports and exports
- Globalization and integration of the economy has caused the changes in location to be different
- “Technological innovation is a key determinant of trade patterns in manufactured products.”
- During trade cycle, home country initially is an exporter, then loses its comparative advantage & eventually becomes importer.

Eg. In early 1960s Xerox machine was found initially consumed in US. Exported to Advanced countries of Europe. As demand began to grow in those countries, Xerox entered into joint ventures to produce in Japan (Fuji Xerox). Once, Xerox patents on photocopier expired, other foreign competitors entered into market (Canon in Japan, Olivetti in Italy).



Saying “Most of the new products found, produced, developed and introduced in US” is ethnocentric. It’s true that it played a dominant role in global economy.

ECONOMIC EFFICIENCY

Goal

- To be able to explain economic efficiency as it relates to a business.

Concepts

- Efficiency
- Capacity
- Marketplace
- Specialization

What is Economic Efficiency?

- Economic Efficiency is the wise use of available resources so that costs do not exceed benefits.

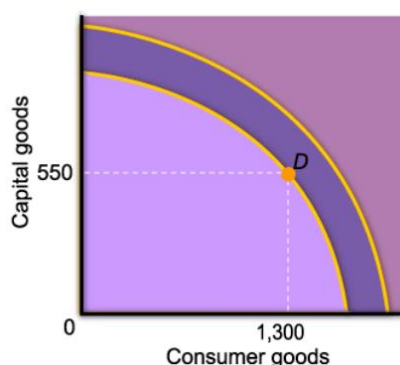
ECONOMIC GROWTH

Growth

Growth economics studies factors that explain economic growth – the increase in output per capita of a country over a long period of time. The same factors are used to explain differences in the level of output per capita between countries, in particular why some countries grow faster than others, and whether countries converge at the same rates of growth.

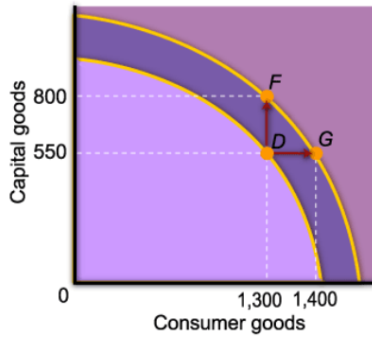
Much-studied factors include the rate of investment, population growth, and technological change. These are represented in theoretical and empirical forms (as in the neoclassical and endogenous growth models) and in growth accounting.

- **Economic growth** is an increase in the total output of the economy. It occurs when a society acquires new resources, or when it learns to produce more using existing resources.
- The main sources of economic growth are capital accumulation and technological advances.

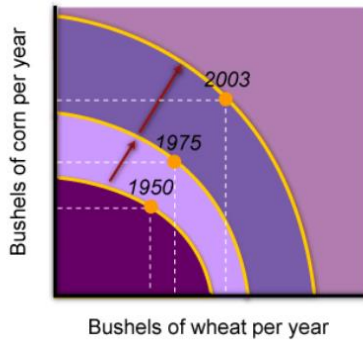


- Outward shifts of the curve represent **economic growth**.
- An outward shift means that it is possible to increase the production of one good without decreasing the production of the other.

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- From point D, the economy can choose any combination of output between F and G.



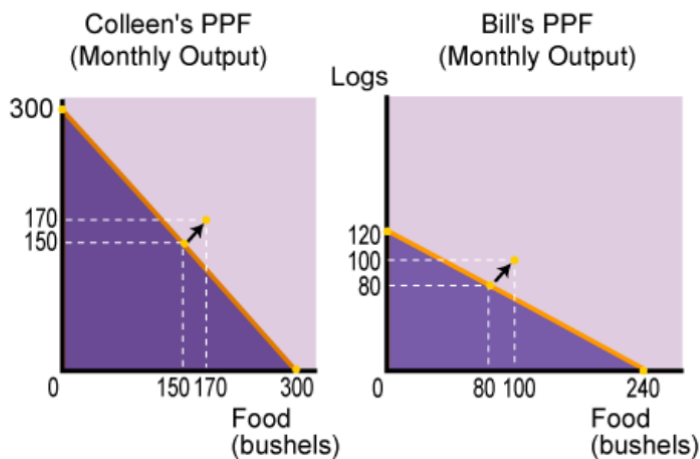
- Not every sector of the economy grows at the same rate.
- In this historic example, productivity increases were more dramatic for corn than for wheat over this time period.

Capital Goods and Growth in Poor and Rich Countries

- Rich countries devote more resources to capital production than poor countries.
- As more resources flow into capital production, the rate of economic growth in rich countries increases, and so does the gap between rich and poor countries.

Economic Growth and the Gains from Trade

- By specializing and engaging in trade, Colleen and Bill can move beyond their own production possibilities.



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