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The focus of the course will be the comparison of living standards of economies. The broad topics are: the measurement of living standards of a nation; the rate of growth (i.e., improvement) of living standards; the sources of or determinants of such growth, and the policies that can improve living standards of a nation faster.

1.1 Measures of Living Standards

Adam Smith suggested to take GNP, i.e., aggregate income of an economy as a measure of living standards. This has the obvious defect that it does not take into account how many people are sharing this aggregate income. For instance, the GNP of India and Sweden are comparable but India has a population almost eighty times larger than that in Sweden. As we all know that living standards in Sweden is much better than in India. A better measure is perhaps per capita income. While this measure takes care of the above problem, it suffers from other defects to qualify for a good measure of living standards. The one main one is that it is insensitive to income distribution. Consider for instance two nations each having per capita income $100 and a population of 100 persons. In one country, everybody has equal income, and in the other economy, 5 persons have $1000 each and 95 persons have $52.6 each. Which economy should be considered to have better standard of living? Obviously the first one. However, notice that per capita income does not discriminate this.

There are many other aspects such as life expectancy, literacy rate, freedom of speech or democracy, and political and economic stability that should also be included into a good measure of living standards. While per capita income is generally positively related to some of these variables such as life expectancy and literacy rate and thus to some extent represent these aspects, other aspects are not represented by it. There are some suggestions to adjust the per capita income to take into account some of these aspects, however, unadjusted per capita income is most widely used and we do the same.

Generally per capita income is measured in the local currency of the economy. How would you compare the per capita income Rs. 5400 in India with $ 15000 in the U.S.? We need a common unit. The general practice is to express per capita income of an economy in US dollars dividing it by the exchange rate (local currency/US$). This measure suffers from the *purchasing power parity (PPP)* problem of the nature that with $1000 you can buy much more and thus have a better standard of living in say Thailand than in the U.S. Exchange rate, for instance, does not take into account the relative prices of the non-tradables such as construction, hair-cuts etc. Again there are ways to adjust for the purchasing power parity, see in table 1 the PPP adjusted per capita income of various countries, and how they differ for countries. But general practice is to use the unadjusted one, and we follow the same practice. To compare the rate of improvement of living standards of various nations, it is appropriate to calculate the growth rate of per capita income in local currency but at constant prices (why constant prices?).

1.2 Comparison of living standards of a few selected countries

Table 1reports capita income in 1994 for a few selected countries. We find that there is significant difference in the standard of living of these countries. For instance,

In the third row of table 1 we report the growth rate of per capita income for each country. We again find a lot of variation.

Now compare the rate of growth of per capita income in the U.S. in different periods in the following table 2.

Here again we find a significant variation in the growth rate. The important questions that we will deal with in this course are:

- What is the significance of a small difference in the growth rate of per capita income?

Basic Indicators	**India**	**China**	**Thailand**	**Mexico**	**Korea**	**Singapore**	**U.S.**	**Japan**
P.C.income ($1994)	320	530	2,410	4,180	8,260	22,500	25,880	34,630
PPP Estimate of PC income	1,280	2,510	6,970	7,040	10,330	21,900	25,880	21,140
pc income gr.rate 1985-94	2.9	7.8	8.6	0.9	7.8	6.1	1.3	3.2
Pop. gr. rate1980-90	2.1	1.5	1.8	2.0	1.2	1.7	0.9	0.6
gr. rate of export 1980-90	5.9	11.5	14.0	6.6	12.0	10.0	5.2	4.8
gr. rate of export 1990-94	13.6	16.0	14.6	4.0	10.6	12.3	6.7	4.0
Savings to GDP ratio 1988	21.0		26.0	23.0	38.0	41.0	13.0	33.0

Table 1: Basic indicators of a few selected countries

Period	1889-1983	1953-1973	1973-1983
gr. rate. of per capita income	1.8	2.1	0.9

Table 2: Average annual growth of the US economy over a long period of time

- How long would it take for less developed countries to catch up with the current US standard of living? After how many years these less developed countries will surpass the living standard of the U.S. economy if the current growth rates are maintained?
- Could some of these less developed countries grow at this high rates for ever such that they become the real threat to the U.S. economy? (Convergence hypothesis).
- Why did some countries like Japan, Korea, and Hong Kong grew so fast while other countries like India, and U.S. grew very slow? Or in other words what are the sources of growth in these countries?
- What government policies can achieve higher growth rate in per capita income?

Remark 1 Growth theory is concerned with the long run growth of potential or full employment output, or the supply side of the economy say in the next ten or twenty years. So the policies we are interested in are those that affect this long-run growth rate of potential output. Macroeconomics is concerned with the stabilization of short-run fluctuations in actual output or the demand side of the economy.

We have discussed in the class a common structure of the less developed economies on various socio-economic dimensions and how they differ from the structure of developed economies. Development theory is meant not only to understand the process of growth in per capita income, which is the most important indicator of development, and it is meant also to study how the socio-economic-political structure of an underdeveloped economy could be transformed into socio-economic structures that are commonly observed in developed countries. Or in other words, development economics, also examines the mechanics of structural change, and its scope is broader than growth theory. There are other distinctions between economic growth theory and economic development theory, which we will not get into in this course.