CHAPTER II

LITERATURE REVIEW

A. Theoretical Framework

1. Theory of Regional Economic Development

a.) Economic Base Theory

Economic base theory states that the main determinants of economic growth in a region is directly related to demand for goods and services from outside a region (Arsyad, 1999:116).

This theory divides the activities of production/type of work within one region over the base sector and non-base sector. Base sector activity is an activity that has exogenous characteristic means not tied with internal condition of region's economy and at the same time can encourage growth of other types of work. While non-base activities are activities to meet the needs of community in that area itself. Therefore, its growth depends on the general condition of region's economy. That is, this sector is endogenous.

Its growth depends on the economic conditions of the region as a whole (Tarigan, 2010). Base activity has a role as a prime mover in the growth of a region. The greater from exports of one region to another will be more advanced in the region's growth, and vice versa. Any changes that occur in base sector will have a multiplier effect in the regional economy.

The base sector is the sector that becomes a backbone of the regional economy because it has a high competitive advantage. While the non-base sector is the other sectors that are less potential but serve as supporting the base sector or service industries. Economic base sector of a region can be analyzed by Location Quotient (LQ) technique, which is a comparison the big role of a sector/industry in a region toward the role of sector/industry nationally.

Based on limited amount of resources from local economy, important to make more advantageous for local community must be made by policy makers. Result from export base analysis can be interpreted, policy makers will be can best use “scarce resources (tax dollars and other sources of revenue) to produce the most benefits, so that constituents and taxpayers will be relatively well satisfied next they go to the polls” (Galambos and Schreiber). More various scenarios from literatur emphasized that will be occur as a result of incompatibe calculate from forecasting techniques; example, the assumption, in a region at small period has large amounts of local debt, period of turbulent economic with national trends which models characterized of operations research as a set of “complex techniques (which) are predictive by nature”. Policy makers must using models of research which can protect all of community in wrong economic regulation.

In history, economic base theory was changed in 1950s by some theories that more better explained in case of economic growth. And in 1970s, economic base theory was studied by student only at the undergraduate level, and has longest condemnations from its use in policy which usually in those impracticable journals of academic.

This does not mean there is not some truth from old economic base theory, or that some parts of it are not useful. Calculating multipliers and location quotients give some knowledge in regional economic calculation. In the mid-1980s, Paul Krugman used some of bits and pieces from economic base theory and combined them with other models to modernization how all of community think about regional growth and prosperity.

However, economic base theroty tells us nothing about how regions become more prosperous. In fact, the places with the strongest economic bases in Indiana are quite frequently the most dismal, dying, impoverished places. Efforts to squeeze out prosperity by attracting more of an economic base will continue to fail. But we've known that fact since at least the 1980's.

If your local government is busy trying to attract a new factory or build a new shell building or attract people who "make things", it is simply wasting public money better spent on things that matter. And by the way, those theories of growth from the 1950s onward tell us it is almost only people that matter in the economic prosperity of a region.

This theory are classified into two sectors, a basis sector and non-basis sector. Basis sector is the activity of export oriented economy out of bounds area concerned. Basis ector has a role of primer mover in the growth of a region. More larger an area will be more advanced export growth inarea. Any changes that occurr in basis sector will make double-base effect in the regional economy.

While non base sector is the sector that provide goods and services to people within borders of the respective economies. The broad scope of characteristic from production and marketingis local. The essence of this theory is that direction and growth of a region defined by region's exportswith role of activities or similar industries in regional economy (Emilia, 2006:24).

To analyze basis economic in a region used Location Quotient (LQ). LQ is used to determine how much the level of specialization sector basis or featured by comparing its role in the economy of the region with similar industrial activity or role in regional economy (Emilia, 2006: 24).

LQ using ratio of total value from GRDP in a region (regency/city) compared with a ratio of GRDP in the same sector in the reference area (provincial/national).

b.) Central Place Theory

Central place theory is a spatial theory in urban geography that tries to define the reasons behind the distribution size, format, and number of cities and regions around the world. It also defines to serve a framework by which those areas that can be studied both for historical reasons and for locational patterns of areas today.

This theory was first founded by Walter Christaller in 1933 after he began to know about the economic relationships between cities and their areas farther away. He mainly tested the theory in Southern Germany and conclude that people live together in cities to share all of ideas and goods and economic reasons lived.

Before Christaller testing his theory, he had to first explain about theory of central place. To struggle with his case of economic focus, he concludes that the central place exists primarily to serve more goods and services to its around areas population.

Central place theory considers that there is a hierarchy where each central place supported by a number of smaller places that provider resources (industrial and raw materials). That central place as a residential that provides services for area residents who support it. Central place theory shows how patterns of land from different industries to form an unified regional system of cities. This central place theory can be applied to the region's economic development, both in urban and rural areas. Example, the necessity of making a difference in function between neighbour regions (adjoining). Some regions can be service provider area, while other regions only as a residential area. An expert on regional economic development can help people to develop their functional role in the regional economic system.

c.) Cumulative Causation Theory

The condition of areas around the city are getting worse showing the basic concept from cumulative causation thesis. Market forces tend to lengthen the gap between these areas. Therefore we know there are so called developed regions and underdeveloped areas. Advanced areas accumulating a competitive advantage over other regions. This is what is referred to as backwash effect (Mrydal, 1957 in Arsyad, 1999).

Circular cumulative causation is a theory in development economics which was founded by the Nobel Prize winning economist Gunnar Myrdal in the 1950s. Myrdal's theory was one of the first to critique neoclassical theory from a development perspective; it highlights several issues with neoclassical theory and explains why it will not lead to the development and convergence of nations, as predicted, and instead, why it will lead to divergence and polarisation between developed and undeveloped nations.

According to this model, disparities in regional development will only be reduced through government programs. If only handed over to the market mechanism, regional inequality will continue to rise along with development (Sjafrizal, 2008:98).

d.) Attraction Model

Theory of industry attraction is economic development model most widely used by the public. The underlying economic theory is that a community can improve its market position to industrialists through the provision of subsidies and incentives (Arsyad, 2002:118).

1. Strategic of Regional Development

The purpose of economic development planning is to provide employment opportunities for societies. Furthermore, to achieve the economic stability of a region. Economic development will be successful if it is able to meet the needs of business, such as land, finance, and infrastructure.

In addition to successful economic development would be a blessing if the activities in it protected and free from ribawi practices. The next goal, to develop economic base and employment opportunities. This is as an anticipation toward possibility of sectoral economic fluctuations that will affect the employment opportunities of society.

Regional development strategy defines the objectives and instruments for the construction of overall potential from development, reduce inequalities in regional development and enhance potential of those parts of a country which are left behind in the direction of greater competitiveness. The main purposes of Regional Development Strategy are adjusting and supporting each other between local and regional levels in development needs with development priorities at the state level and providing support to less developed regions municipalities that is focused on identifying, enhancing, and optimal use of their development potential, through the elimination of causes that prevent their development.

In outline, regional economic development strategies can be grouped into four, namely: (1) Physical Development Strategy / Localities, (2) Business Development Strategy, (3) Human Resources Development Strategy, (4) Community Development Strategy. (Evi dan Hastarini, 2009:167).

2. Theory of Regional Economic Growth

a) Theory of Classical Growth

Adam Smith was the first to discuss economic growth systematically. Main point teachings of Smith is that the public is given widest possible freedom in determining economic activity is best to do. According to Smith's free market economic system will be representing an efficiency, bringing the economy to a state of full employment and ensure economic growth to achieve stationary position. While role of government is to provide security and provide legal certainty for economic actors. John Maynard Keynes correcting Smith’s approach has told that to ensure stable growth of government need to implement fiscal policy, monetary policy, and direct supervision.

The function of production will not provide us with some theory or explanation of growth. It is only an apropriate tool which helps us destruct economic growth into its components. However, there are many theories of growth that try to go a forward further. The oldest of these theories is so called classical growth theory which is primarily associated with Thomas Robert Malthus.

The classical growth theory , which was developed in the late 1700s, has little or no relevance today. In short, the classical growth theory may be described as folllows:

1. Due to technological development, the amount of capital increases and marginal product of labor increases too.
2. GDP per capita rises. With higher living standards, the population will increase.

3. As population increases, labor pructivity will fall (more individuals butt same amount of capital).
4. GDP per capita will fall again. When GDP per capita has fallen to a level just high enough to keep the population from starving, and the increase in population will be stop.

Destruction of capital, for example, through a war, works in the opposite way. The marginal product of labor falls, GDP per capita will falls and population decreases. This will lead to an increase in the marginal product of labor and GDP per capita return to the “survival rate”.

The main point from the model is the population groth will always eliminate positive effects of technological development and GDP per capita will always return to the survival level. This very “dismal” growth theory was prominent in the early 1800s, and economics to this day is sometimes called the “dismal science”.

b) Theory of Neo-Classical Growth

Theory of Neo-Classical Growth founded by Robert M. Solow (1970) from United States and TW. Swan (1956) from Australia. Based on this theory, growth rate is derived from three sources, namely the accumulation of capital, increasing labor supply and increased technology. Neo-classical theory as the successor of classical theory suggests that the condition is always directed to a perfect market. In a state of perfect market, economy can grow optimally. Advanced analysis of neo classical shows that the creation of a steady growth (steady growth), we need a level s (saving) that fits and all profits employers.

Neoclassical theory defines that the marginal product of capital will be greater in less developed nations, because of capital, by definition, will be more scares in these regions. Thus, in theory, capital should flow from developed countries to less developed countries (where the return on capital will be greater). Consequently, over time inequities in development (which can be measured crudely via real GDP per capita) between countries should be disappear as a capital flows from developed (high GDP per capita) countries to less developed (low GDP per capita) countries.

The inflows of capital to less developed regions increase the marginal productivity of labor, thus freeing up labor from the agricultural sector and allowing it to move into manufacturing. This in turn boosts the growth rates of less developed countries so that they exceed that of developed countries. The less developed countries will continue to grow at a faster rate up until the point where their GDP per capita convergence at a similar level to that of other developed nations.

Furthermore, neoclassical theory states that labor will migrate from less developed regions to more developed regions (where real wages are higher). In theory this should lead to a convergence in average real income (GDP per capita) across regions.

c) Adam Smith Theory

Adam Smith divides into five stages of economic growth sequential stages starting from hunt period, breed period, the period of cultivation, trade period, and phase of an industry. According to this theory, people will move from a traditional society modern capitalist community. In the process, economic growth will be increasingly encouraged by division system of labor among economic actors. Smith looked at workers as one of the inputs from production, the division of labor is a central point of discussion in this theory as an effort to increase productivity. In economic development, capital plays an important role.

Adam Smith is considered to be the father of economics. It is not so because he was first explorer in the field of economics, also not because he revolutionized economic planning by his first idea, but because he brief what he had received from his predecessors and handed it down as a guide to the coming generations.

Adam Smith contained all of his ideas in his “Wealth Nations”. The most important aspect of this book was a Theory of Economic Development. Physiocracy came into existence due to mercantilism. They believed in science of natural laws and emphasized significance of agriculture and contended that it is the only industry that can make country wealthy. Adam Smith’s “Wealth of Nations” was scientific not because it contained the absolute truth but beacause it came as a turning point, the beginning of all that came after, as it was the end of all that came before.

Accumulation of capital will determine fast or slow the economic growth that occurs in a country. The growth process will occur simultaneously and have a relationship independent from each other. The emergence of the increase in employment in a sector will increase attractiveness for capital formation, technological advances, increasing specialization and expand the market. This will encourage economic growth accelerated. The process of economic growth as a function of goal in the end should be subject to one of the constraints that limited economic resources (Kuncoro, 1997 dalam Akrom, 2010).

d) Whilt Whitman Rostow Theory

Based on Rostow in his book *The Stage of Economics Growth* (1965) economic growth process can be divided into five stages are: first, traditional communities at this stage where people use production methods are still primitive with hereditary habits. Second, prerequisite takeoff stage where transformation occurred in all sectors of life such as transformation of agricultural sector to urban sector. Third, stages of takeoff where there are drastic changes either in the form of political revolution, creation of a wide range of innovations and emergence of new markets. Fourth, stage towards maturity where the industry has been developing rapidly, the effective use of technology in all sectors of production, rising labor skills and social changes occur. Fifth, high consumption stage where everything is oriented to the problem of consumption not production (Zakaria, 2009:113-116).

Rostow (1960) developed a theory of stages of economic growth. Rostow argued that the economies of all countries could be placed within one of five different stages of economic growth. The stages include traditional society, preconditions to takeoff, takeoff, drive to maturity, and age of high mass consumption.

According to Rostow, the first stage of economic development consists of traditional society. Traditional societies focus on the most basic of economic activities such as farming and extractive industries like mining and harvesting of timber. The second stage of economic development is a transitional stage that establish the conditions necessary for further growth and development. This stage is referred to as preconditions to takeoff. Rostow's third stage is known as takeoff. A handful of key new industries start to emerge in the national economy that helps drive further economic growth. The fourth stage is known as the drive to maturity. This stage is about diversification and expansion. The economy in this stage of growth will be developing new and more sophisticated industries. Rostow's final stage is known as age of mass consumption. A relatively wealthy population enjoying a high standard of living marks this stage.

e) Harrod Domar Theory in Regional System

This theory funded by Roy F. Harrod (1948) in England dan Evsey D. Domar (1957) in USA. Different with Keynes that look economic activity with short period, this theory look from long period side based on some assumption:

1) Closed Economy

2) Save intention (MPS = s) constantly

3) Production process has constant coefficient

4) Growth rate of labor force is constant and equal to the rate of population growth.

Based on these assumptions, Harrod-Domar make an analysis and concluded that the long-term steady growth (the entire increase in production can be absorbed by the market) can only be achieved if fulfilled terms of a balance as follows:

$$g = k = n$$

Explain :

g = *Growth* (growth rate of output)

k = *Capital* (growth rate of capital)

n = growth rate of labor force

To ensure a balance between savings (S) and investment (I) there must be relation in balance each other, whereas a role to generate additional production is determined by v (capital output ratio) (Tarigan, 2007:49).

It is a growth model which states the rate of economic growth in an economy is dependent on the level of saving and capital output ratio. If there is a high level of saving in a country, it provides funds for firms to borrow and invest. Investment can increase the capital stock of an economy and generate economic growth through the increase in production of goods and services.

The capital output measures the productivity of investment that takes place. If capital output ratio decreases the economy will be more productive, so higher amounts of output is generated from fewer inputs. This again, leads to higher economic growth.

This model is mainly sed in development economics. It suggests that if developing countries want to achieve economic growth, government need to encourage saving, and support technological advancements to decrease the economies capital output ratio. The Harrod-Domar model provides a framework for economic development and has been an imortant influence to government policies, such as India's Five Year Plan (1951-1956).

f) Thomas Robert Malthus Theory

Malthus focused attention on the welfare of a country's development, namely economic growth can be achieved by improving well-being of a country. The welfare of a country depends partly on amount of output produced by labor and partly on a value of that products (Jhingan, 1993).

Malthus was interested in everything about populations. He accumulated figures on births, deaths, age of marriage and childbearing, and economic factors contributing to longevity. His main contribution was to highlight the relationship between food supply and population. Humans do not overpopulate to the point of starvation, he contended, only because people change their behavior in the face of economic incentives.

Noting that while food production tends to increase arithmetically, population teds to increase naturally at a (faster) geometric rate, Malthus argued that it is no surprise that people thus choose to reduce population growth. People can increase food production, Malthus thoughts, difficult methods such as reclaiming unused land or intensive farming; but they can check population growth more effectively. Malthus was fascinated not with the inevitability of human demise, but with why humans do not die off in the face of such overwhelming odds. As an economist, he studied responses to incentives.

3. Gross Regional Domestic Product (GRDP)

One of important macroeconomic indicators to determine economic conditions in an area over a certain time period, Gross Regional Domestic Product (GRDP). According to Central Bureau of Statistics (2011: 2), GRDP is total value added generated by all production units within a certain region or a total value of final goods and services produced by all economic units.

The GRDP calculation using two kinds of prices, GRDP at constant prices and GRDP at current prices. GRDP at constant prices is calculated by using a fixed price in a given year as base/reference. While GRDP at current prices calculated using the current year. GRDP based on the applicable illustrate the value-added goods and services.

There are three approaches used in calculation of the GRDP, are:

a. Production aproach, is total value of final goods and services produced by all production units / sectors in a region in a given period (usually one year).

b. Expenditure approach, sum of all components from final demand in a region, within a certain period. Final demand components include: household consumption expenditure, private consumption expenditure of non-profit institutions, government consumption expenditure, gross domestic fixed capital formation, changes in inventories/stock, and net exports.

c. Revenue approach, is sum of all the results of services received by factors of production used in production process in a region within a certain period. Components from the results of production factors are: wages and salaries, rent for land, capital interest and gains. All of these components before the deduction of income tax and other direct taxes.

However, revenue approach there is one component of service which is contrary to the rules of Islam, namely the service of capital loaned in the form of interest. if the investment foundation of service should be the result not of interest because an investment is not yet known advantages and disadvantages in the future.

4. Analysis of Shift Share

Analysis of Shift Shareis a very useful technique to analyze changes in the economic structure of the region compared to the national economy. Purpose of this analysis is to determine the performance or productivity of region's economy by comparing with larger area (region/national).

Shift share is similar to location quotient n that it highlights the uniqueness of a regional economy, but it does so in terms of job growth rather than total jobs in an industry. Industries with high regional competitiveness effects highlight the regions competitive advantage or disadvantages. Shift share does not indicate why this indutries are competitive, that is job of analysts who have knowledge of local conditions. Shift share merely shows the sectors in which a region is outcompeting or undercompeting the nation. Shift share is thus useful in identifying investment targets so that regional planners can help high performing regional indutries either continue to outperform national trends or else catch up with national trends so that regional economy is not left behind in those sectors.

This analysis provides data on the economy's performance in three areas that relate to each other, namely:

a. Regional economic growth is measured by analyzing the aggregate sectoral changes compared with changes in same sector in the economy is used as a reference.
b. Proportional shift measuring a change in the relative growth or decline in area compared to larger economy as a reference. Thus it can be seen whether the regional economy is concentrated in industries that are growing faster than the economy as a reference.
d. Differential shif tis used to determine how much the competitiveness of regional industries with the economy as a reference.

B. Previous Research

Research on a sector basis has been done by several researchers. The analysis is largely shift share analysis and LQ. In addition to using this analysis, some are using the analysis Klassen typology or LQ analysis combned with Klassen typology.

In journal of economic and development study, researched by Agus Tri Basuki and Utari Gayatri (2009) with title "*Penentu Sektor Unggulan Dalam Pembangunan Daerah : Studi Kasus Di Kabupaten Ogan Komering Ilir*". This research using approach of MRP analysis, Shift Share, LQ, Overlay and Klassen Typology. Result from this research can be conclude that potential economic in Ogan Komering Ilir Regency are agriculture sector and manufacturing industry as dominant sector. Beside of that, this sector shows increasing structure of economic growth. This is because the majority of population in Ogan Komering Ilir Regency still engaged in agriculture, so agriculture has a remarkable growth compared to other economic sectors. In addition, manufacturing industry is also an economic sector with remarkable growth. Example from this manufacturing industry is among kemplang and pempek industry widely grown in the province of South Sumatra and Ogan Komering Ilir Regency.

Mondal (2009) in *An Analysis of The Industrial Development Potential of Malaysia: A Shift-Share Approach*, this research shows that Malaysia has basis sector in a region of Klantan, Terenganu, Pahong and Johor Utara which from that four regions have unique mix industry compared to other region in Malaysia, and supported by abundant resources. In Semenanjung Malaysia, agriculture and fishery sector as dominant sector, beside of that tourism sector has an important role in Malaysian economy.

Table 2.1
Previous Research

No.	Researcher	Tool of Analysis	Title and Research Result
1	Wali I . Mondal (2009)	Shift Share	"*An Analysis of The Industrial Development Potential of Malaysia: A Shift-Share Approach*" Result from this research shows that Malaysia has basis sector in a region of Klantan, Terenganu, Pahong and Johor Utara which from that four regions have unique mix industry compared to other region in Malaysia, and supported by abundant resources. In Semenanjung Malaysia, agriculture and fishery sector as dominant sector, beside of that tourism sector has an important role in Malaysian economy.
2	Agus Tri Basuki and Utari Gayatri (2009)	- LQ - MRP (Rps, Rpr) - Overlay - Shift-Share - Klassen Typology - Overlay	"*Penentu Sektor Unggulan Dalam Pembangunan Daerah : Studi Kasus Di Kabupaten Ogan Komering Ilir*" Result from this research can be conclude that potential economic in Ogan Komering Ilir Regency are agriculture sector and manufacturing industry as dominant sector. Beside of that, this sector shows increasing structure of economic growth. This is because the majority of population in Ogan Komering Ilir Regency still engaged in agriculture, so agriculture has a remarkable growth compared to

			other economic sectors. In addition, manufacturing industry is also an economic sector with remarkable growth. Example from this manufacturing industry is among kemplang and pempek industry widely grown in the province of South Sumatra and Ogan Komering Ilir Regency.
3	Ahmad Mar'ruf (2009)	- LQ (DLQ) - Shift-Share - ICOR	"*Anatomi MakroEkonomi Regional: Studi Kasus Provinsi DIY"* Research result: The purpose of this study was to determine the growth rate, a description of the structure of regional economic and analyze the potential economic sectors as well as determine the level of investment and economic stability in Yogyakarta. This study concludes that the dynamics of economic growth of Yogyakarta in line with national growth. Then sectors that have the greatest contribution is the trade, hotels and restaurants. Typology Klassen shows that a sector with some potential to be developed is the agricultural sector, manufacturing and the services sector.

No.	Researcher	Tool of Analysis	***Title and Research Result***
4	JanaranjanaHeralth, Tesfa G. Gebremedhin dan Blessing M. Maumble (2010)	- Dynamic Shift-Share	*"A Dynamic Shift Share Analysis of economic Growth in West Virginia"* Research result: agriculture, mining and manufacturing is no longer the backbone of the economy of West Virginia. Three sectors show declining performance in the 38-year period. Services, finance insurance and real estate sectors are the most powerful contributing 91 percent of the job growth from 1970 to 2007. Apart from the two sectors, the wholesale and retail sector and construction showed positive growth. Identification of priority investments in this sector and the potential implementation of a comprehensive plan of regional development policies will certainly accelerate economic growth in West Virginia

5	Kartika Hendra Titisari (2012)	- Comparison of GRDP - Klassen Typology - LQ - MRP	*"Identifikasi Potensi Ekonomi Daerah Boyolali, Karanganyar, dan Sragen"* Research result: Analysis of internal potential (growth and contributions), which occupies a prime position and expand in Boyolali is the sector of electricity, gas and water utilities, financial institutions, building rental and corporate services as well as services. While in Karanganyar growing sector position is the sector of electricity, gas and water supply, transport and communications, building rental and corporate services, as well as services. For Sragen which occupy prime positions and growing in industry and the services sector. Klassen Typology results showed that the average income per capita in Karanganyar above the per capita income of the average in Central Java. While Boyolali and Sragen are below the average income per capita in Central Java.

Source: Relevant Undergraduate Thesis and Journal

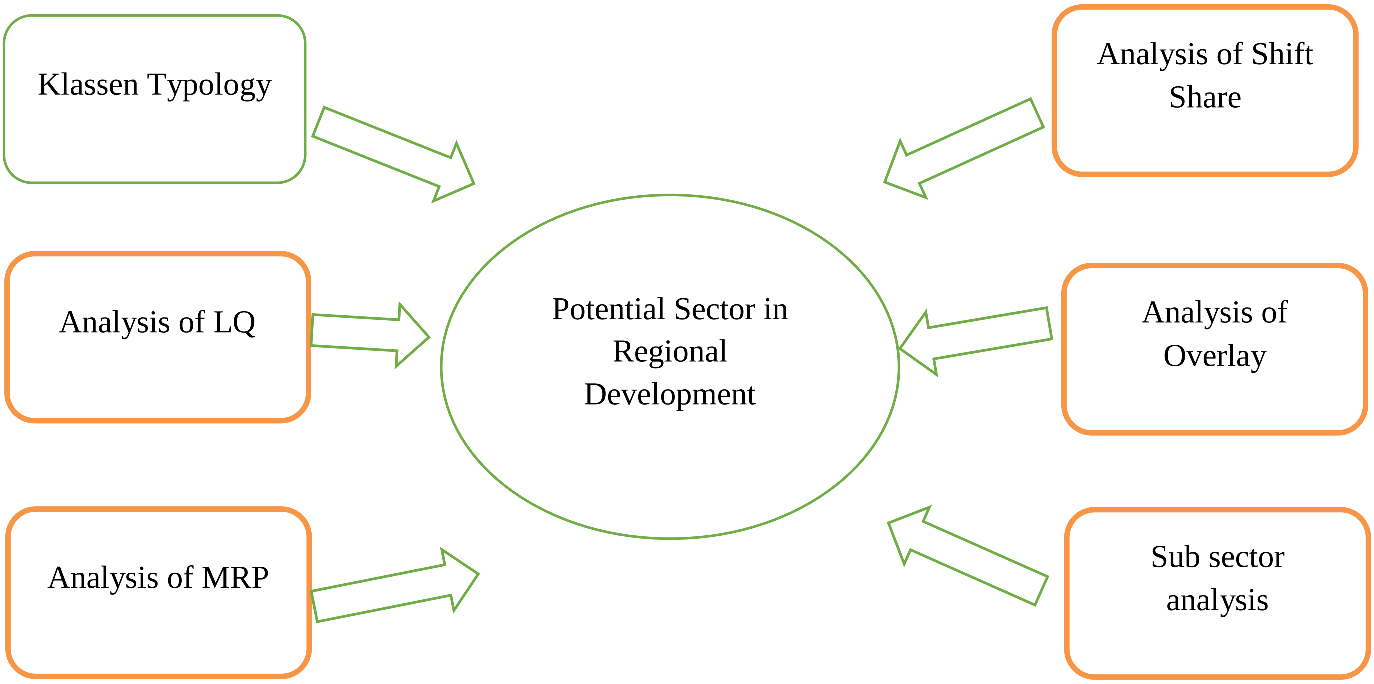
C. Research Framework

Each area has some potential economic sector. However, not all the existing economic potential identified correctly. Like basis sector with a competitive advantage, comparative and specialization unknown. This becomes a problem in the development of construction in an area. Likewise with the reference area as a development that people had not seen.

Referring to existing theory like theory of growth and economic development in a region, to identify an area that could be used as a reference development tools, while Klassen Typology analysis to determine the potential sectors in development of area can be used LQ analysis tool. Then potentially economic development region can use tool of MRP analysis and Overlay.

After all the analysis tools are used, it will get a result. The results will serve as a conclusion and policy making. With these policies there will be implications in form of regional development priorities. Thus seen from this study will have a role in determining local development priorities, especially in Pontianak regency.

Figure 1.1
Research Framework



Source: Developed by the author