

# The Economics of Developing Countries

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## Learning Objectives

- LO39W.1** Describe how the World Bank distinguishes between industrially advanced countries and developing countries.
- LO39W.2** List some of the obstacles to economic development.
- LO39W.3** Explain the vicious circle of poverty that afflicts low-income nations.
- LO39W.4** Discuss the role of government in promoting economic development within low-income nations.
- LO39W.5** Describe how industrial nations attempt to aid low-income countries.

It is difficult for those of us in the United States, where per capita GDP in 2012 was about \$51,749, to grasp the fact that about 2.5 billion people, or nearly half the world's population, live on \$2 or less a day. And about 1.3 billion live on less than \$1.25 a day. Hunger, squalor, and disease are the norm in many nations of the world.

In this bonus Web chapter we identify the developing countries, discuss their characteristics, and explore the obstacles that have impeded their growth. We also examine the appropriate roles of the private sector and government in economic development. Finally, we look at policies that might help developing countries increase their growth rates.

## The Rich and the Poor

**LO39W.1** Describe how the World Bank distinguished between industrially advanced countries and developing countries.

Just as there is considerable income inequality among families within a nation, so too is there great income inequality among the family of nations. According to the United Nations, the richest 20 percent of the world's population receive more than 80 percent of the world's income; the poorest 20 percent receive less than 2 percent. The poorest 60 percent receive less than 6 percent of the world's income.

### Classifications

The World Bank classifies countries into high-income, upper-middle-income, lower-middle-income, and low-income countries on the basis of national income per capita, as shown in Figure 39W.1. The *high-income nations*, shown in dark green, are known as the **industrially advanced countries (IACs)**; they include the United States, Japan, Canada, Australia, New Zealand, and most of the nations of western Europe. In general, these nations have well-developed market economies based on large stocks of capital goods, advanced production technologies, and well-educated workers. In 2010 this group of economies had a per capita income of \$38,745.

The remaining nations of the world are called **developing countries (DVCs)**. They have wide variations of income per capita and are mainly located in Africa, Asia, and Latin America. The DVCs are a highly diverse group that can be subdivided into three groups:

- The *upper-middle-income nations*, shown in light green in Figure 39W.1, include countries such as Brazil, Iran, Russia, South Africa, Mexico, China, and Thailand. The per capita output of these nations ranged all the way from \$3,976 to \$12,275 in 2010 and averaged \$5,884.
- The *lower-middle-income nations*, shown in yellow, had per capita incomes ranging from \$1,006 to \$3,975 in 2010 with an average per capita income of \$1,619. This category includes Armenia, India, Indonesia, Pakistan, Vietnam, and Zambia.
- The *low-income nations*, shown in orange, had a per capita income of \$1,005 or less in 2010 and averaged only \$528 of income per person. The sub-Saharan nations of Africa dominate this group. Low-income DVCs have relatively low levels of industrialization. In general, literacy rates are low, unemployment is high, population growth is rapid, and exports consist

largely of agricultural produce (such as cocoa, bananas, sugar, raw cotton) and raw materials (such as copper, iron ore, natural rubber). Capital equipment is minimal, production technologies are simple, and labor productivity is very low. About 15 percent of the world's population live in these low-income DVCs, all of which suffer widespread poverty.

### Comparisons

Several comparisons will bring the differences in world income into sharper focus:

- In 2010 U.S. GDP was \$14.6 trillion; the combined GDPs of the 144 DVCs in that year added up to \$20 trillion.
- The United States, with only 4.5 percent of the world's population in 2010, produced 23.1 percent of the world's output.
- Per capita GDP of the United States in 2010 was 127 times greater than per capita GDP in the Democratic Republic of the Congo, one of the world's poorest nations.
- The annual sales of the world's largest corporations exceed the national incomes of many of the DVCs. Walmart's annual world revenues of \$405 billion in 2010 were greater than the national incomes of all but 23 nations.

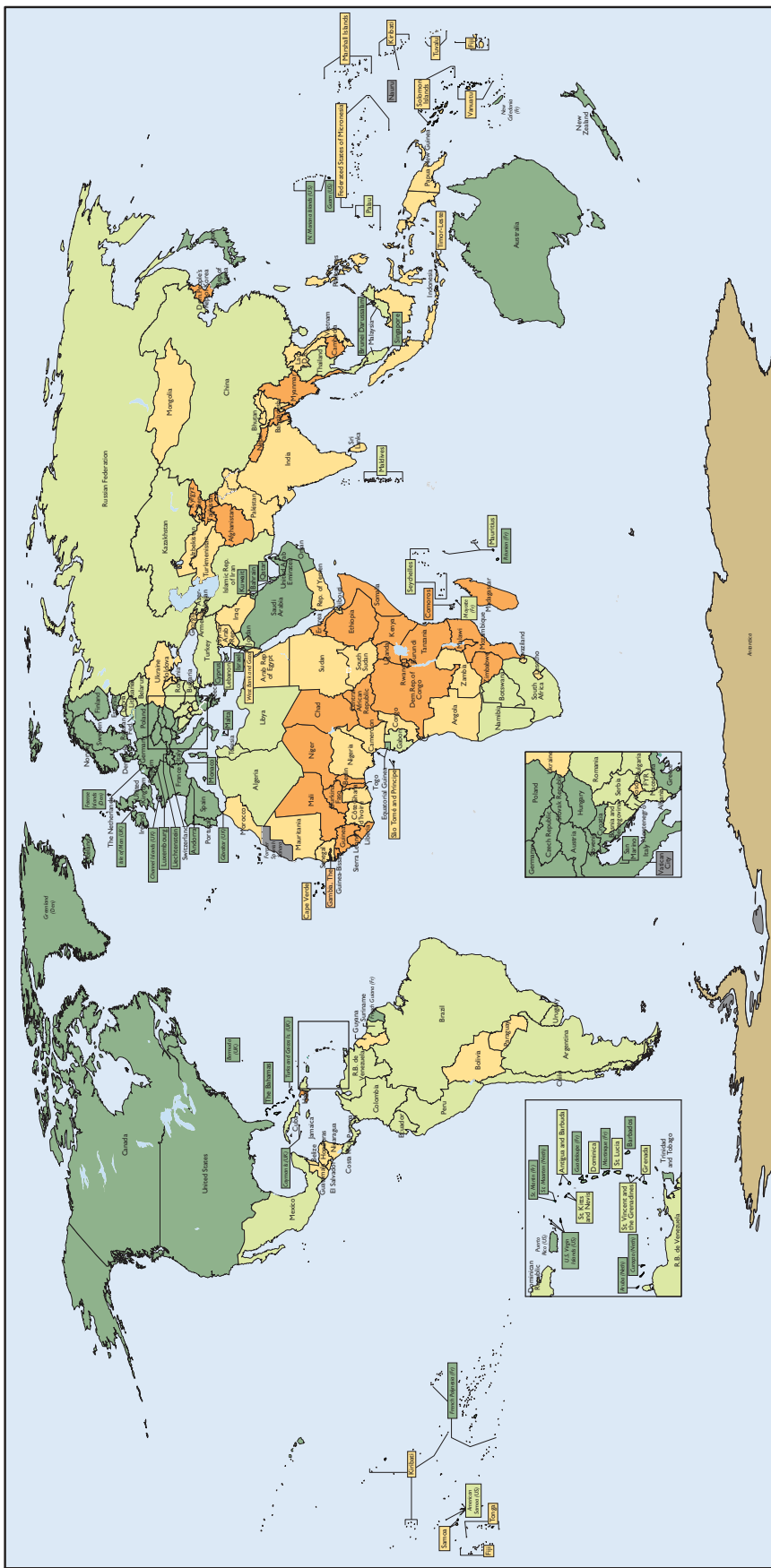
### Growth, Decline, and Income Gaps

Two other points relating to the nations shown in Figure 39W.1 should be noted. First, the various nations have demonstrated considerable differences in their ability to improve circumstances over time. On the one hand, DVCs such as Chile, China, India, Malaysia, and Thailand achieved high annual growth rates in their GDPs in recent decades. Consequently, their real output per capita increased several-fold. Several former DVCs, such as Singapore, Greece, and Hong Kong (now part of China), have achieved IAC status. In contrast, a number of DVCs in sub-Saharan Africa have recently been experiencing stagnant or even declining per capita GDPs.

Second, the absolute income gap between rich and poor nations has been widening. Suppose the per capita incomes of the advanced and developing countries were growing at about 2 percent per year. Because the income base in the advanced countries is initially much higher, the absolute income gap grows. If per capita income is \$400 a year in a DVC, a 2 percent growth rate means an \$8 increase in income. Where per capita income is \$20,000 per year in an IAC, the same 2 percent growth rate translates

**FIGURE 39W.1 Groups of economies.** The world's nations are grouped into industrially advanced countries (IACs) and developing countries (DVCs). The IACs (shown in dark green) are high-income countries. The DVCs are upper-middle-income, lower-middle-income, and low-income countries (shown respectively in light green, yellow, and orange).

■ Low (\$1,005 or less)  
 ■ Lower middle (\$1,006–\$3,975)  
 ■ Upper middle (\$3,976–\$12,275)  
 ■ High (\$12,276 or more)  
 ■ No data



Source: World Bank data, [www.worldbank.org](http://www.worldbank.org). National income per capita is converted to U.S. dollars using the World Bank's Atlas Method, which adjusts national amounts to U.S. dollars using 3-year exchange rate averages. See the World Bank's Web site for more details.

**TABLE 39W.1** Selected Socioeconomic Indicators of Development

Country	(1) Per Capita Income, 2010*	(2) Life Expectancy at Birth, 2010	(3) Under-5 Mortality Rate per 1,000, 2010	(4) Adult Illiteracy Rate, Percent, 2010	(5) Internet Users per 100, 2010	(6) Per Capita Energy Consumption, 2009**
United States	\$47,340	78	8	1	74.2	7,051
Japan	41,850	83	3	1	77.6	3,700
Brazil	9,390	73	19	11	40.7	1,243
China	4,270	73	18	8	34.4	1,695
India	1,270	65	63	39	7.5	560
Mauritania	1,030	58	111	42	3.0	180
Bangladesh	700	69	48	43	3.7	201
Mozambique	440	50	135	44	4.2	427
Ethiopia	390	59	106	57	0.7	402

\*Purchasing power parity basis (see World Bank Web site for definition and methodology).

\*\*Kilograms of oil equivalent.

Source: *World Development Indicators 2012 and World Development Report 2012*, [www.worldbank.org](http://www.worldbank.org). Used with permission of World Bank Publications, via Copyright Clearance Center, Inc.

into a \$400 increase in income. Thus the absolute income gap will have increased from \$19,600 (= \$20,000 – \$400) to \$19,992 (= \$20,400 – \$408). The DVCs must grow faster than the IACs for the gap to be narrowed.

A quick glance back at Figure 26.1 in our chapter on economic growth will confirm the “great divergence” in standards of living that has emerged between the United States, Western Europe, and Japan relative to Africa, Latin America, and Asia (excluding Japan).

## The Human Realities of Poverty

Development economist Michael Todaro points out that mere statistics conceal the human implications of the extreme poverty in the low-income DVCs:

Let us examine a typical “extended” family in rural Asia. The Asian household is likely to comprise ten or more people, including parents, five to seven children, two grandparents, and some aunts and uncles. They have a combined annual income, both in money and in “kind” (i.e., they consume a share of the food they grow), of \$250 to \$300. Together they live in a poorly constructed one-room house as tenant farmers on a large agricultural estate owned by an absentee landlord who lives in the nearby city. The father, mother, uncle, and the older children must work all day on the land. None of the adults can read or write; of the five school-age children, only one attends school regularly; and he cannot expect to proceed beyond three or four years of primary education. There is only one meal a day; it rarely changes and it is rarely sufficient to alleviate the children’s constant hunger pains. The house has no electricity, sanitation, or fresh water supply. There is much sickness, but qualified doctors and medical practitioners are far away in the cities attending to the needs of wealthier families. The work is hard, the sun is hot and aspirations for a better life are

constantly being snuffed out. In this part of the world the only relief from the daily struggle for physical survival lies in the spiritual traditions of the people.<sup>1</sup>

Table 39W.1 contrasts various socioeconomic indicators for selected DVCs with those for the United States and Japan. These data confirm the major points stressed in the quotation from Todaro.

## Obstacles to Economic Development

**LO39W.2** List some of the obstacles to economic development.

The paths to economic development are essentially the same for developing countries and industrially advanced economies:

- The DVCs must use their existing supplies of resources more efficiently. This means that they must eliminate unemployment and underemployment and also combine labor and capital resources in a way that will achieve lowest-cost production. They must also direct their scarce resources so that they will achieve allocative efficiency.
- The DVCs must expand their available supplies of resources. By achieving greater supplies of raw materials, capital equipment, and productive labor, and by advancing its technological knowledge, a DVC can push its production possibilities curve outward.

<sup>1</sup>Michael P. Todaro, *Economic Development in the Third World*, 7th ed. (New York: Addison Wesley Longman, 2000), p. 4.



All DVCs are aware of these two paths to economic development. Why, then, have some of them traveled those paths while others have lagged far behind? The difference lies in the physical, human, and socioeconomic environments of the various nations.

## Natural Resources

No simple generalization is possible as to the role of natural resources in the economic development of DVCs because the distribution of natural resources among them is so uneven. Some DVCs have valuable deposits of bauxite, tin, copper, tungsten, nitrates, and petroleum and have been able to use their natural resource endowments to achieve rapid growth. This is true, for instance, of Kuwait and several other members of the Organization of Petroleum Exporting Countries (OPEC). In other instances, natural resources are owned or controlled by the multinational corporations of industrially advanced countries, with the economic benefits from these resources largely diverted abroad. Furthermore, world markets for many of the farm products and raw materials that the DVCs export are subject to large price fluctuations that contribute to instability in their economies.

Other DVCs lack mineral deposits, have little arable land, and have few sources of power. Moreover, most of the poor countries are situated in Central and South America, Africa, the Indian subcontinent, and southeast Asia, where tropical climates prevail. The heat and humidity hinder productive labor; human, crop, and livestock diseases are widespread; and weed and insect infestations plague agriculture.

A weak resource base can be a serious obstacle to growth. Real capital can be accumulated and the quality of the labor force improved through education and training. But it is not as easy to augment the natural resource base. It may be unrealistic for many of the DVCs to envision an economic destiny comparable with that of, say, the United States or Canada. But we must be careful in generalizing: Japan, for example, has achieved a high standard of living despite limited natural resources. It simply imports the large quantities of natural resources that it needs to produce goods for consumption at home and export abroad.

## Human Resources

Three statements describe many of the poorest DVCs with respect to human resources:

- Populations are large.
- Unemployment and underemployment are widespread.
- Educational levels and labor productivity are low.

**TABLE 39W.2** Population Statistics, Selected Countries

(1) Country	(2) Population per Square Km, 2010*	(3) Annual Rate of Population Increase, 2000–2010
United States	34	0.9
Pakistan	225	1.8
Bangladesh	1,142	1.4
Venezuela	33	1.7
India	412	1.5
China	143	0.6
Kenya	71	2.6
Philippines	313	1.9
Yemen	46	3.1
<b>World</b>	<b>53</b>	<b>1.2</b>

\*1 square kilometer (km) = 0.386 square mile.

Source: *World Development Indicators 2012*, [www.worldbank.org](http://www.worldbank.org).

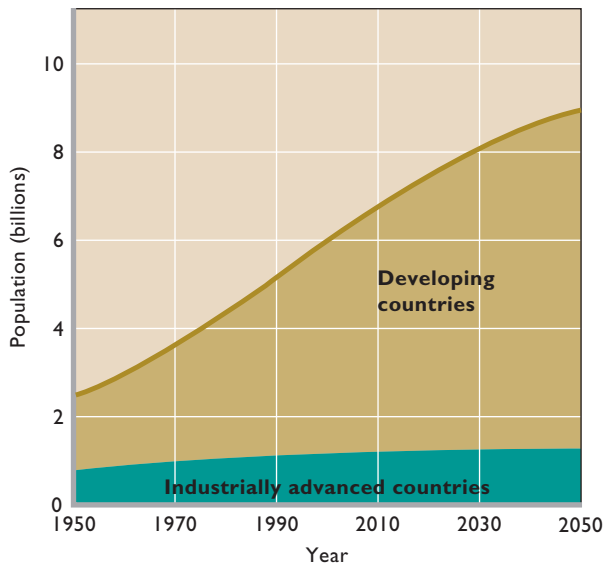
**Large Populations** As demonstrated by equation (1), a nation's standard of living or real income per capita depends on the size of its total output (or income) relative to its total population:

$$\text{Standard of living} = \frac{\text{Total output (or income)}}{\text{Population}} \quad (1)$$

Some of the DVCs with the most meager natural and capital resources not only have low total incomes but also large populations. These large populations often produce high population densities (population per square mile). In column 1 of Table 39W.2, note the high population densities of the selected DVCs relative to the lower densities of the United States and the world.

The high population densities of many DVCs have resulted from decades of higher rates of population growth than most IACs. Column 3 of Table 39W.2 shows the varying rates of population growth in selected countries over a recent period: 2000–2010. Although *fertility rates*—the number of children per woman's lifetime—are dramatically declining in many DVCs, the population growth rates of the DVCs remain considerably higher than for the IACs. Between 2000 and 2010, the annual population growth rate was 2.1 percent for the low-income DVCs and 1.2 percent for the middle-income DVCs. Those numbers compare to only a 0.7 percent rate of population growth for the IACs. Because a large percentage of the world's current population already lives in DVCs, their population growth remains significant. Over the next 15 years, 9 out of every 10 people added to the world population are projected to be born in developing nations.

**FIGURE 39W.2** Population growth in developing countries and advanced industrial countries, 1950–2050. The majority of the world's population lives in the developing nations, and those nations will account for most of the increase in population over the next 40 years.



Source: Population Reference Bureau, [www.prb.org](http://www.prb.org). The underlying data are from the United Nations Population Division, *World Population Prospects: The 2012 Revision*.

Figure 39W.2 dramatically illustrates the effect of population growth in the DVCs on past, present, and projected world population numbers. Population growth in the DVCs will continue to increase the world's population through midcentury, at which time world population is expected to begin to level off.

In some of the poorest DVCs, rapid population growth actually strains the levels of income growth so severely that per capita income remains stagnant or even falls toward subsistence levels. In the worst instances, death rates rise sharply as war, drought, and natural disasters cause severe malnutrition and disease.

Boosting the standard of living in countries that have subsistence- or near-subsistence levels of income is a daunting task. When a DVC is just starting to modernize its economy, initial increases in real income can for a time increase population and short-circuit the process. If population increases are sufficiently large, they simply spread the higher level of total income among more people such that the original gain in per capita income disappears.

Why might income gains in the poorest DVC increase population growth, at least for a while? First, such income growth often reduces the nation's death rate. The increase in income means better nutrition and that improves health and increases life expectancy. Also, the death rate falls as a result of the basic medical and sanitation programs that accompany greater economic development. Second, the

birthrate initially rises, particularly if medical and sanitation programs reduce infant mortality. For these reasons, the rapid population growth that results from income increases can convert an expanding standard of living into a stagnant or very slow-growing standard of living.

Population expansion can also impede economic development in four additional ways:

- **Reduced saving and investment** The expenses associated with raising large families often reduce the capacity of households to save, thereby restricting the economy's ability to accumulate capital.
- **Lower productivity** As population increases, added investment is required to maintain the amount of real capital per person. If investment fails to keep pace, then on average each worker will have fewer tools and less equipment, and that will reduce worker productivity (output per worker). Declining productivity implies stagnating or declining per capita incomes.
- **Overuse of land resources** Because most developing countries are heavily dependent on agriculture, rapid population growth may cause an overuse of land resources. The much-publicized African famines are partly the result of overgrazing and overplanting of land caused by the pressing need to feed a growing population. Population pressures also can encourage excessive cutting down of trees for use as fuel. This denuding of the landscape contributes to severe soil erosion from wind and water. Finally, in some cases population pressure leads to the use of crop waste and animal dung as needed fuel rather than as fertilizer to replenish the productivity of the soil. (We say more about the African famines in this chapter's Last Word.)
- **Contribution to urban problems** Rapid population growth in the cities of the DVCs, accompanied by unprecedented inflows of rural migrants, generates massive urban problems. Rapid population growth aggravates problems such as substandard housing, poor public services, congestion, pollution, and crime. Resolving or reducing these difficulties necessitates diverting resources from growth-oriented uses.

Most authorities see birth control as the most effective means for breaking out of the population dilemma. And breakthroughs in contraceptive technology in recent decades have made this solution increasingly relevant. As we have indicated, fertility rates have dropped significantly in the DVCs. But obstacles to population control are still present. Low literacy rates make it difficult to disseminate information about contraceptive devices. In peasant agriculture, large families are a major source of labor. Adults may regard having many children as a kind of informal social security

system: the more children, the greater the probability of the parents' having a relative to care for them in old age.

Finally, many nations that stand to gain the most through birth control are often the least willing, for religious reasons, to embrace contraception programs. For example, population growth in Latin America (which has a high proportion of Catholics) is among the most rapid in the world.

China, which has about one-fifth of the world's population, began its harsh "one-child" program in 1980. The government advocates late marriages and one child per family. Couples having more than one child are fined or lose various social benefits. Even though the rate of population growth has diminished under this program, China's population continues to expand. Between 2000 and 2010 it increased by 75.7 million people. India, the world's second most populous nation, had a 171-million person increase in population—a 16 percent rise—during the 2000–2010 period. With a total population of about 1.2 billion, India has 18 percent of the world's population but less than 2.5 percent of the world's landmass.

**Qualifications** We need to qualify our focus on population growth as a major cause of low per-capita incomes, however. As with the relationship between natural resources and living standards, the relationship between population sizes and living standards is less clear than one might expect. High population density certainly does not confine a nation to poverty. China and India have immense populations and are poor, but Japan, Singapore, and Hong Kong are densely populated and are wealthy. Moreover, the standard of living in many parts of China and India has rapidly increased in recent years.

Also, the population growth rate for the DVCs as a group has declined significantly in recent decades. Between 2000 and 2010, their annual population growth rate was about 1.3 percent; for 2010 through 2020, it is projected to fall to 1.1 percent (compared to 0.4 percent in the IACs). The world's population actually is projected to decline in the last part of this century.

Finally, not everyone agrees that reducing population growth is the best way to increase per capita GDP in the developing countries. Economists point to a **demographic transition** that occurs as economic growth takes off. In this transition, rising income transforms the population dynamics of a nation by reducing birthrates. In this view, high fertility rates and large populations are a consequence of low income, not the underlying cause. The task of a nation is to increase output and income. With success, declining birthrates will automatically follow.

This view recognizes both marginal benefits and marginal costs of having another child. In DVCs the marginal benefits are relatively large because the extra child becomes

an extra worker who can help support the family. Extra children can provide financial support and security for parents in their old age, so people in poor countries have high birthrates. But in wealthy IACs, the marginal cost of having another child is relatively high. Care of children may require that one of the parents incur the opportunity cost of sacrificing high earnings or that the parents purchase expensive child care. Also, children require extended and expensive education for the highly skilled jobs characteristic of the IAC economies. At the same time, the marginal benefits of having a child may also be lower in a wealthy IAC. In particular, most IACs are wealthy enough to afford extensive "social safety nets" (such as retirement and disability benefits) that protect adults from the insecurity associated with old age and the inability to work. People in the IACs therefore recognize that high birthrates are not in the family's short-term or long-term interest. Thus, many of them choose to have fewer children.

Note the differences in causation between the traditional view and the demographic transition view of population. The traditional view is that reduced birthrates must first be achieved and then higher per capita income can follow. Lower birthrates enable per capita income to rise. The demographic transition view is that higher output and income should first be achieved and then lower rates of population growth eventually will follow. Higher incomes reduce population growth.

Development economists typically suggest a dual approach to development that combines both views. The surest way for the poorest DVCs to break out of their poverty is to implement policies that expand output and income while establishing independent policies that give families greater access to birth control information and methods. In terms of equation (1) on page 39W-5, a set of policies that raises the numerator (total income) and holds constant or lowers the denominator (population) will provide the biggest lift to a developing nation's standard of living.

**Unemployment and Underemployment** A second human resource dimension of developing countries relates to employment. For many DVCs, employment-related data are either nonexistent or highly unreliable. But observation suggests that unemployment is high. There is also significant **underemployment**, which means that a large number of people are employed fewer hours per week than they want, work at jobs unrelated to their training, or spend much of the time on their jobs unproductively.

Many economists contend that unemployment may be as high as 15 to 20 percent in the rapidly growing urban areas of the DVCs. There has been substantial migration in most developing countries from rural to urban areas, motivated by the expectation of finding jobs with higher

wage rates than are available in agricultural and other rural employment. But this huge migration to the cities reduces a migrant's chance of obtaining a job. In many cases, migration to the cities has greatly exceeded the growth of urban job opportunities, resulting in very high urban unemployment rates. Thus, rapid rural-urban migration has given rise to urban unemployment rates that are two or three times as great as rural rates.

Underemployment is widespread and characteristic of most DVCs. In many of the poorer DVCs, rural agricultural labor is so abundant relative to capital and natural resources that a significant percentage of the labor contributes little or nothing to agricultural output. Similarly, many DVC workers are self-employed as proprietors of small shops, in handicrafts, or as street vendors. Unfortunately, however, many of them must endure long stretches of idle time at work due to a lack of demand. While they are not unemployed, they are clearly underemployed.

**Low Labor Productivity** The final human resource reality in developing nations is that labor productivity is low. As we will see, DVCs have found it difficult to invest in physical capital. As a result, their workers are poorly equipped with machinery and tools and therefore are relatively unproductive. Remember that rapid population growth tends to reduce the amount of physical capital available per worker, and that reduction erodes labor productivity and decreases real per capita incomes.

Moreover, most poor countries have not been able to invest adequately in their human capital (see Table 39W.1, columns 3 and 4); consequently, expenditures on health and education have been meager. Low levels of literacy, malnutrition, lack of proper medical care, and insufficient educational facilities all contribute to populations that are ill equipped for industrialization and economic expansion. Attitudes may also play a role: In countries where hard work is associated with slavery and inferiority, many people try to avoid it. Also, by denying educational and work opportunities to women, many of the poorest DVCs forgo vast amounts of productive human capital.

Particularly vital is the absence of a vigorous entrepreneurial class willing to bear risks, accumulate capital, and provide the organizational requisites essential to economic growth. Closely related is the lack of labor trained to handle the routine supervisory functions basic to any program of development. Ironically, the higher-education systems of some DVCs emphasize the humanities and offer relatively few courses in business, engineering, and the sciences. Some DVCs are characterized by an authoritarian view of human relations, sometimes fostered by repressive governments, that creates an environment hostile to thinking

independently, taking initiatives, and assuming economic risks. Authoritarianism discourages experimentation and change, which are the essence of entrepreneurship.

While migration from the DVCs has modestly offset rapid population growth, it has also deprived some DVCs of highly productive workers. Often the best-trained and most highly motivated workers, such as physicians, engineers, teachers, and nurses, leave the DVCs to better their circumstances in the IACs. This so-called **brain drain** contributes to the deterioration in the overall skill level and productivity of the labor force.

## Capital Accumulation

The accumulation of capital goods is an important focal point of economic development. All DVCs have a relative dearth of capital goods such as factories, machinery and equipment, and public utilities. Better-equipped labor forces would greatly enhance productivity and would help boost per capita output. There is a close relationship between output per worker (labor productivity) and real income per worker. A nation must produce more goods and services per worker as output to enjoy more goods and services per worker as income. One way of increasing labor productivity is to provide each worker with more tools and equipment.

Increasing the stock of capital goods is crucial because the possibility of augmenting the supply of arable land is slight. An alternative is to supply the available agricultural workforce with more and better capital equipment. And, once initiated, the process of capital accumulation may be cumulative. If capital accumulation increases output faster than the growth in population, a margin of saving may arise that permits further capital formation. In a sense, capital accumulation feeds on itself.

Let's first consider the possibility that developing nations will manage to accumulate capital domestically. Then we will consider the possibility that foreign funds will flow into developing nations to support capital expansion.

**Domestic Capital Formation** A developing nation, like any other nation, accumulates capital through saving and investing. A nation must save (refrain from consumption) to free some of its resources from the production of consumer goods. Investment spending must then absorb those released resources in the production of capital goods. But impediments to saving and investing are much greater in a low-income nation than they are in an advanced economy.

**Savings Potential** Consider first the savings side of the picture. The situation here is mixed and varies greatly between countries. Some of the very poor countries, such as



Burundi, Chad, Ghana, Guinea, Liberia, Madagascar, Mozambique, and Sierra Leone, have negative saving or save only 0 to 7 percent of their GDPs. The people are simply too poor to save a significant portion of their incomes. Interestingly, however, some middle-income countries save a larger percentage of their domestic outputs than do advanced industrial countries. In 2010 India and China saved 34 and 53 percent of their domestic outputs, respectively, compared to 24 percent for Japan, 23 percent for Germany, and 11 percent for the United States. The problem is that the domestic outputs of the DVCs are so low that even when saving rates are larger than those of advanced nations, the total volume of saving is not large.

**Capital Flight** Some of the developing countries have suffered **capital flight**, the transfer of private DVC savings to accounts held in the IACs. (In this usage, “capital” is simply “money,” “money capital,” or “financial capital.”) Many wealthy citizens of DVCs have used their savings to invest in the more economically advanced nations, enabling them to avoid the high investment risks at home, such as loss of savings or real capital from government expropriation, abrupt changes in taxation, potential hyperinflation, or high volatility of exchange rates. If a DVC’s political climate is unsettled, savers may shift their funds overseas to a “safe haven” in fear that a new government might confiscate their wealth. Rapid or skyrocketing inflation in a DVC would have similar detrimental effects. The transfer of savings overseas may also be a means of evading high domestic taxes on interest income or capital gains. Finally, money capital may flow to the IACs to achieve higher interest rates or a greater variety of investment opportunities.

Whatever the motivation, the amount of capital flight from some DVCs is significant and offsets much of the IACs’ lending and granting of other financial aid to the developing nations.

**Investment Obstacles** There are as many obstacles on the investment side of capital formation in DVCs as on the saving side. Those obstacles include a lack of investors and a lack of incentives to invest.

In some developing nations, the major obstacle to investment is the lack of entrepreneurs who are willing to assume the risks associated with investment. This is a special case of the human capital limitations of the labor force mentioned above.

But the incentive to invest may be weak even in the presence of substantial savings and a large number of willing entrepreneurs. Several factors may combine in a DVC to reduce investment incentives, including political instability, high rates of inflation, and lack of economies of scale.

Similarly, very low incomes in a DVC result in a lack of buying power and thus weak demand for all but agricultural goods. This factor is crucial because the chances of competing successfully with mature industries in the international market are slim. Then, too, lack of trained administrative personnel may be a factor in retarding investment.

Finally, the **infrastructure** (stock of public capital goods) in many DVCs is insufficient to enable private firms to achieve adequate returns on their investments. Poor roads and bridges, inadequate railways, little gas and electricity production, poor communications, unsatisfactory housing, and inadequate educational and public health facilities create an inhospitable environment for private investment. A substantial portion of any new private investment would have to be used to create the infrastructure needed by all firms. Rarely can firms provide an investment in infrastructure themselves and still earn a positive return on their overall investment.

For all these reasons, investment incentives in many DVCs are lacking. It is significant that four-fifths of the overseas investments of multinational firms go to the IACs and only one-fifth to the DVCs. If the multinationals are reluctant to invest in the DVCs, we can hardly blame local entrepreneurs for being reluctant too.

How then can developing nations build up the infrastructure needed to attract investment? The higher-income DVCs may be able to accomplish this through taxation and public spending. But in the poorest DVCs there is little income to tax. Nevertheless, with leadership and a willingness to cooperate, a poor DVC can accumulate capital by transferring surplus agricultural labor to the improvement of the infrastructure. If each agricultural village allocated its surplus labor to the construction of irrigation canals, wells, schools, sanitary facilities, and roads, significant amounts of capital might be accumulated at no significant sacrifice of consumer goods production. Such investment bypasses the problems inherent in the financial aspects of the capital accumulation process. It does not require that consumers save portions of their money income, nor does it presume the presence of an entrepreneurial class eager to invest. When leadership and cooperative spirit are present, this “in-kind” investment is a promising avenue for accumulation of basic capital goods.

## Technological Advance

Technological advance and capital formation are frequently part of the same process. Yet there are advantages in discussing technological advance separately.

Given the rudimentary state of technology in the DVCs, they are far from the frontiers of technological advance. But the IACs have accumulated an enormous body

of technological knowledge that the developing countries might adopt and apply without expensive research. Crop rotation and contour plowing require no additional capital equipment and would contribute significantly to productivity. By raising grain storage bins a few inches above ground, a large amount of grain spoilage could be avoided. Although such changes may sound trivial to people of advanced nations, the resulting gains in productivity might mean the difference between subsistence and starvation in some poverty-ridden nations.

The application of either existing or new technological knowledge often requires the use of new and different capital goods. But, within limits, a nation can obtain at least part of that capital without an increase in the rate of capital formation. If a DVC channels the annual flow of replacement investment from technologically inferior to technologically superior capital equipment, it can increase productivity even with a constant level of investment spending. Actually, it can achieve some advances through **capital-saving technology** rather than **capital-using technology**. A new fertilizer, better adapted to a nation's topography and climate, might be cheaper than the fertilizer currently being used. A seemingly high-priced metal plow that will last 10 years may be cheaper in the long run than an inexpensive but technologically inferior wooden plow that has to be replaced every year.

To what extent have DVCs adopted and effectively used available IAC technological knowledge? The picture is mixed. There is no doubt that such technological borrowing has been instrumental in the rapid growth of such Pacific Rim countries as Japan, South Korea, Taiwan, and Singapore. Similarly, the OPEC nations have benefited significantly from IAC knowledge of oil exploration, production, and refining. Recently Russia, the nations of eastern Europe, and China have adopted Western technology to hasten their conversion to market-based economies.

Still, the transfer of advanced technologies to the poorest DVCs is not an easy matter. In IACs technological advances usually depend on the availability of highly skilled labor and abundant capital. Such advances tend to be capital-using or, to put it another way, labor-saving. Developing economies require technologies appropriate to quite different resource endowments: abundant unskilled labor and very limited quantities of capital goods. Although labor-using and capital-saving technologies are appropriate to DVCs, much of the highly advanced technology of advanced nations is inappropriate to them. They must develop their own appropriate technologies. Moreover, many DVCs have "traditional economies" and are not highly receptive to change. That is particularly true of peasant agriculture, which dominates the economies of most of the poorer DVCs. Since technological change that fails may

well mean hunger and malnutrition, there is a strong tendency to retain traditional production techniques.

## Sociocultural and Institutional Factors

Economic considerations alone do not explain why an economy does or does not grow. Substantial sociocultural and institutional readjustments are usually an integral part of the growth process. Economic development means not only changes in a nation's physical environment (new transportation and communications facilities, new schools, new housing, new plants and equipment) but also changes in the way people think, behave, and associate with one another. Emancipation from custom and tradition is frequently a prerequisite of economic development. A critical but intangible ingredient in that development is the **will to develop**. Economic growth may hinge on what individuals within DVCs want for themselves and their children. Do they want more material abundance? If so, are they willing to make the necessary changes in their institutions and old ways of doing things?

**Sociocultural Obstacles** Sociocultural impediments to growth are numerous and varied. Some of the very-low-income countries have failed to achieve the preconditions for a national economic entity. Tribal and ethnic allegiances take precedence over national allegiance. Each tribe confines its economic activity to the tribal unit, eliminating any possibility for production-increasing specialization and trade. The desperate economic circumstances in Somalia, Sudan, Liberia, Zaire, Rwanda, and Afghanistan are due in no small measure to military and political conflicts among rival groups.

In countries with a formal or informal caste system, labor is allocated to occupations on the basis of status or tradition rather than on the basis of skill or merit. The result is a misallocation of human resources.

Religious beliefs and observances may seriously restrict the length of the workday and divert to ceremonial uses resources that might have been used for investment. Some religious and philosophical beliefs are dominated by the fatalistic view that the universe is capricious, the idea that there is little or no correlation between an individual's activities and endeavors and the outcomes or experiences that person encounters. The **capricious universe view** leads to a fatalistic attitude. If "providence" rather than hard work, saving, and investing is the cause of one's lot in life, why save, work hard, and invest? Why engage in family planning? Why innovate?

Other attitudes and cultural factors may impede economic activity and growth: emphasis on the performance of duties rather than on individual initiative; focus on the group rather than on individual achievement; and the

belief in reincarnation, which reduces the importance of one's current life.

**Institutional Obstacles** Political corruption and bribery are common in many DVCs. School systems and public service agencies are often ineptly administered, and their functioning is frequently impaired by petty politics. Tax systems are frequently arbitrary, unjust, cumbersome, and detrimental to incentives to work and invest. Political decisions are often motivated by a desire to enhance the nation's international prestige rather than to foster development.

Because of the predominance of farming in DVCs, the problem of achieving an optimal institutional environment in agriculture is a vital consideration in any growth program. Specifically, the institutional problem of **land reform** demands attention in many DVCs. But the reform that is needed may vary tremendously from nation to nation. In some DVCs the problem is excessive concentration of land ownership in the hands of a few wealthy families. This situation is demoralizing for tenants, weakens their incentive to produce, and typically does not promote capital improvements. At the other extreme is the situation in which each family owns and farms a piece of land far too small for the use of modern agricultural technology. An important complication to the problem of land reform is that political considerations sometimes push reform in the direction of farms that are too small to achieve economies of scale. For many nations, land reform is the most acute institutional problem to be resolved in initiating economic development.

Examples: Land reform in South Korea weakened the political control of the landed aristocracy and opened the way for the emergence of strong commercial and industrial middle classes, all to the benefit of the country's economic

development. In contrast, the prolonged dominance of the landed aristocracy in the Philippines may have stifled economic development in that nation.

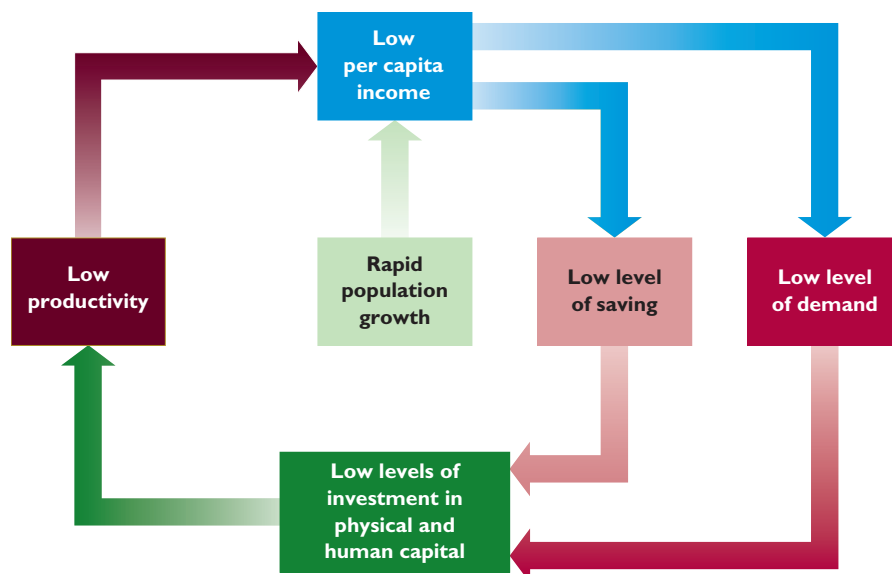
### QUICK REVIEW 39W.1

- About 12 percent of the world's population lives in the low-income DVCs, which typically are characterized by scarce natural resources, inhospitable climates, large populations, high unemployment and underemployment, low education levels, and low labor productivity.
- For DVCs just beginning to modernize, high birthrates caused by improved medical care and sanitation can increase population faster than income growth, leading to lower living standards; but as development continues, the opportunity costs of having children rise and population growth typically slows.
- Low saving rates, capital flight, weak infrastructures, and lack of investors impair capital accumulation in many DVCs.
- Sociocultural and institutional factors are often serious impediments to economic growth in DVCs.

## The Vicious Circle

**LO39W.3** Explain the vicious circle of poverty that afflicts low-income nations.

Many of the characteristics of the poorest of the DVCs just described are both causes and consequences of their poverty. These countries are caught in a **vicious circle of poverty**. They stay poor because they are poor! Consider Figure 39W.3. Common to most DVCs is low per capita



**FIGURE 39W.3** The vicious circle of poverty. Low per capita incomes make it difficult for poor nations to save and invest, a condition that perpetuates low productivity and low incomes. Furthermore, rapid population growth may quickly absorb increases in per capita real income and thereby destroy the possibility of breaking out of the poverty circle.

income. A family that is poor has little ability or incentive to save. Furthermore, low incomes mean low levels of product demand. Thus, there are few available resources, on the one hand, and no strong incentives, on the other hand, for investment in physical or human capital. Consequently, labor productivity is low. And since output per person is real income per person, it follows that per capita income is low.

Many economists think that the key to breaking out of this vicious circle is to increase the rate of capital accumulation, to achieve a level of investment of, say, 10 percent of the national income. But Figure 39W.3 reminds us that rapid population growth may partially or entirely undo the potentially beneficial effects of a higher rate of capital accumulation. Suppose that initially a DVC is realizing no growth in its real GDP but somehow manages to increase saving and investment to 10 percent of its GDP. As a result, real GDP begins to grow at, say, 2.5 percent per year. With a stable population, real GDP per capita will also grow at 2.5 percent per year. If that growth persists, the standard of living will double in about 28 years. But what if population also grows at the rate of 2.5 percent per year, as it does in parts of the Middle East, northern Africa, and sub-Saharan Africa? Then real income per person will remain unchanged and the vicious circle will persist.

But if population can be kept constant or limited to some growth rate significantly below 2.5 percent, real income per person will rise. Then the possibility arises of further enlargement of the flows of saving and investment, continuing advances in productivity, and the continued growth of per capita real income. If a process of self-sustaining expansion of income, saving, investment, and productivity can be achieved, the self-perpetuating vicious circle of poverty can be transformed into a self-regenerating, beneficent circle of economic progress. The challenge is to make effective policies and strategies that will accomplish that transition.

### ORIGIN OF THE IDEA

**O39W.1**  
Economic  
development



per capita real income. If a process of self-sustaining expansion of income, saving, investment, and productivity can be achieved, the self-perpetuating vicious circle of poverty can be transformed into a self-

regenerating, beneficent circle of economic progress. The challenge is to make effective policies and strategies that will accomplish that transition.

## The Role of Government

**LO39W.4** Discuss the role of government in promoting economic development within low-income nations.

Economists see a positive role for government in fostering DVC growth, but they generally agree that government efforts must support private efforts, not substitute for them. That is not always the case in practice.

## A Positive Role

Economists suggest that developing nations have several avenues for fostering economic growth and improving their standards of living.

**Establishing the Rule of Law** Some of the poorest countries of the world are plagued by banditry and intertribal warfare that divert attention and resources from the task of development. A strong, stable national government is needed to establish domestic law and order and to achieve peace and unity. Research demonstrates that political instability (as measured by the number of revolutions and coups per decade) and slow economic growth go hand in hand.

Clearly defined and strictly enforced property rights bolster economic growth by ensuring that individuals receive and retain the fruits of their labor. Because legal protections reduce investment risk, the rule of law encourages direct investments by firms in the IACs. Government itself must live by the law. The presence of corruption in the government sanctions criminality throughout the economic system. Such criminality discourages the growth of output because it lowers the returns available to honest workers and honest businesspeople.

**Building Infrastructure** Many obstacles to economic growth are related to an inadequate infrastructure. Sanitation and basic medical programs, education, irrigation and soil conservation projects, and construction of transportation links and communication facilities are all essentially nonmarketable goods and services that yield widespread spillover benefits. Government is the only institution that is in a position to provide public infrastructure. But it need not do all the work through government entities. It can contract out much of the work to private enterprises.

With respect to both private and public infrastructure, DVCs have an unexpected advantage over more developed countries because they can act as *follower countries* when it comes to technology. As explained in Chapter 26 on economic growth, DVCs can simply adopt technologies that were developed at high cost in the more technologically advanced *leader countries* without having to pay any of the development costs of those technologies. DVCs can often jump directly to the most modern and highly productive infrastructure without going through the long process of development and replacement that was required in the IACs. As a good example, many DVCs have developed Internet-capable wireless phone networks instead of using their scarce resources to build and expand landline systems.

**Embracing Globalization** Other things equal, open economies that participate in international trade grow



faster than closed economies. Also, DVCs that welcome foreign direct investment enjoy greater growth rates than DVCs that view such investment suspiciously or even as exploitation and therefore put severe obstacles in its way.

Realistic exchange-rate policies by government also help. Exchange rates that are fixed at unrealistic levels invite balance-of-payments problems and speculative trading in currencies. Often, such trading forces a nation into an abrupt devaluation of its currency, sending shock waves throughout its economy. More flexible exchange rates enable more gradual adjustments and thus less susceptibility to major currency shocks and the domestic disruption they cause.

**Building Human Capital** Government programs that encourage literacy, education, and labor market skills enhance economic growth by building human capital. In particular, policies that close the education gap between women and men spur economic growth in developing countries. Promoting the education of women pays off in terms of reduced fertility, greater productivity, and greater emphasis on educating children.

And government is in a position to nurture the will to develop, to change a philosophy of “Heaven and faith will determine the course of events” to one of “God helps those who help themselves.” That change encourages personal educational attainment and enhanced human capital.

**Promoting Entrepreneurship** The lack of a sizable and vigorous entrepreneurial class, ready and willing to accumulate capital and initiate production, indicates that in some DVCs private enterprise is not capable of spearheading the growth process. Government may have to take the lead, at least at first. But many DVCs would benefit by converting some of their state enterprises into private firms. State enterprises often are inefficient, more concerned with providing maximum employment than with introducing modern technology and delivering goods and services at minimum per-unit cost. Moreover, state enterprises are poor “incubators” for developing profit-focused, entrepreneurial persons who leave the firm to set up their own businesses.

**Developing Credit Systems** The banking systems in some of the poorest DVCs are nearly nonexistent and that makes it difficult for domestic savers and international lenders to lend money to DVC borrowers, who in turn wish to create capital goods. An effective first step in developing credit systems is through **microfinance**, in which groups of people pool their money and make small loans to budding entrepreneurs and owners of small businesses. People from the IACs can do the same, helping nurture the spirit of enterprise and foster the benefits that it brings. The benefits of microlending accrue not only to

the entrepreneurs in the DVCs but to the country as a whole because the lending creates jobs, expands output, and raises the standard of living.

At the national level, DVC governments must guard against excessive money creation and the high inflation that it brings. High rates of inflation simply are not conducive to economic investment and growth because inflation lowers the real returns generated by investments. DVCs can help keep inflation in check by establishing independent central banks to maintain proper control over their money supplies. Studies indicate that DVCs that control inflation enjoy higher growth rates than those that do not.

**Controlling Population Growth** Government can provide information about birth control options. We have seen that slower population growth can convert increases in real output and income to increases in real *per capita* output and income. Families with fewer children consume less and save more; they also free up time for women for education and participation in the labor market. As women participate in the labor market, they tend to reduce their fertility rate, which further helps to control population growth.

**Making Peace with Neighbors** Countries at war or in fear of war with neighboring nations divert scarce resources to armaments, rather than to private capital or public infrastructure. Sustained peace among neighboring nations eventually leads to economic cooperation and integration, broadened markets, and stronger economic growth.

## Public Sector Problems

Although the public sector can positively influence economic development, serious problems can and do arise with government-directed initiatives. If entrepreneurial talent is lacking in the private sector, are quality leaders likely to surface in the ranks of government? Is there not a real danger that government bureaucracy will impede, not stimulate, social and economic change? And what of the tendency of some political leaders to favor spectacular “showpiece” projects at the expense of less showy but more productive programs? Might not political objectives take precedence over the economic goals of a governmentally directed development program?

Development experts are less enthusiastic about the role of government in the growth process than they were 30 years ago. Unfortunately, government misadministration and **corruption** are common in many DVCs, and government officials sometimes line their own pockets with foreign-aid funds. Moreover, political leaders often confer monopoly privileges on relatives, friends, and political supporters and grant exclusive rights to relatives or friends to

produce, import, or export certain products. Such monopoly privileges lead to higher domestic prices and diminish the DVC's ability to compete in world markets.

Similarly, managers of state-owned enterprises are often appointed on the basis of cronyism rather than competence. Many DVC governments, particularly in Africa, have created "marketing boards" as the sole purchaser of agricultural products from local farmers. The boards buy farm products at artificially low prices and sell them at higher world prices; the "profit" ends up in the pockets of government officials. In recent years the perception of government has shifted from that of catalyst and promoter of growth to that of a potential impediment to development. According to a recent ranking of 176 nations based on perceived corruption, the 40 nations at the bottom of the list (most corrupt) were DVCs. Global Perspective 39W.1

shows the corruption scores for 16 selected nations, including the two least corrupt (Denmark and Singapore) and the two most corrupt (Afghanistan and Somalia).

## The Role of Advanced Nations

**LO39W.5** Describe how industrial nations attempt to aid low-income countries.

How can the IACs help developing countries in their pursuit of economic growth? To what degree have IACs provided assistance?

### Expanding Trade

Some authorities maintain that the simplest and most effective way for the United States and other industrially advanced nations to aid developing nations is to lower international trade barriers. Such action would enable DVCs to elevate their national incomes through increased trade. Trade barriers instituted by the IACs are often highest for labor-intensive manufactured goods, such as textiles, clothing, footwear, and processed agricultural products. These are precisely the sorts of products for which the DVCs have a comparative advantage. Also, many IACs' tariffs rise as the degree of product processing increases; for example, tariffs on chocolates are higher than those on cocoa. This practice discourages the DVCs from developing processing industries of their own.

Additionally, large agricultural subsidies in the IACs encourage excessive production of food and fiber in the IACs. The overproduction flows into world markets, where it depresses agricultural prices. DVCs, which typically do not subsidize farmers, therefore face artificially low prices for their farm exports. The IACs could greatly help DVCs by reducing farm subsidies along with tariffs.

But lowering trade barriers is certainly not a panacea. Some poor nations need only large foreign markets for their raw materials to achieve growth. But the problem for many poor nations is not to obtain markets in which to sell existing products or relatively abundant raw materials but to get the capital and technical assistance they need to produce products for domestic consumption.

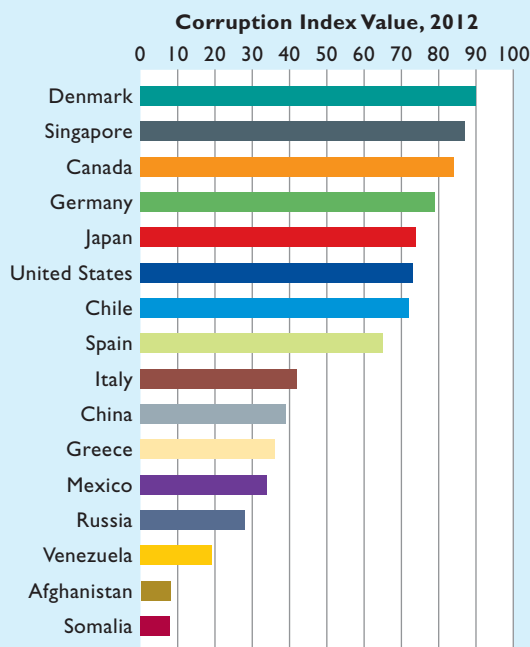
Also, close trade ties with advanced nations entail certain disadvantages. Dependence by the DVCs on exports to the IACs leaves the DVCs highly vulnerable to recessions in the IACs. As firms cut back production in the IACs, the demand for DVC resources declines; and as income in the IACs declines, the demand for DVC-produced goods declines. By reducing the demand for DVC exports, recessions in the IACs can severely reduce the prices of raw materials exported by the DVCs. For example, during the recession of 2007–2009, the world price of zinc fell



### GLOBAL PERSPECTIVE 39W.1

#### The Corruption Perceptions Index, Selected Nations, 2012\*

The corruption perceptions index measures the degree of corruption existing among public officials and politicians as seen by business people, risk analysts, and the general public. An index value of 100 is highly clean and 0 is highly corrupt.



\*Index values are subject to change on the basis of election outcomes, military coups, and so on.

Source: World Bank, *World Development Indicators 2012* and *World Development Report 2012*.

from \$2.02 per pound to \$0.49 per pound, and the world price of copper fell from \$4.05 per pound to \$1.40 per pound. These declines in prices severely reduce the export earnings of the DVCs. Because mineral exports are a significant source of DVC income, stability and growth in IACs are important to improved standards of living in the developing nations.

### Admitting Temporary Workers

Some economists recommend that the IACs help the DVCs by accepting more seasonal or other temporary workers from the DVCs. Temporary migration provides an outlet for surplus DVC labor. Moreover, migrant remittances to families in the home country serve as a sorely needed source of income. The problem, of course, is that some temporary workers illegally blend into the fabric of the IACs and do not leave when their visas or work permits expire. That may not be in the long-run best interest of the IACs.

### Discouraging Arms Sales

Finally, the IACs can help the DVCs as a group by discouraging the sale of military equipment to the DVCs. Such purchases by the DVCs divert public expenditures from infrastructure and education and heighten tensions in DVCs that have long-standing disputes with neighbors.

### Foreign Aid: Public Loans and Grants

*Official development assistance* (ODA), or simply “foreign aid,” is another route through which IACs can help DVCs. This aid can play a crucial role in breaking an emerging country’s circle of poverty by supplementing its saving and investment. As previously noted, many DVCs lack the infrastructure needed to attract either domestic or foreign private capital. The infusion of foreign aid that strengthens infrastructure could enhance the flow of private capital to the DVCs.

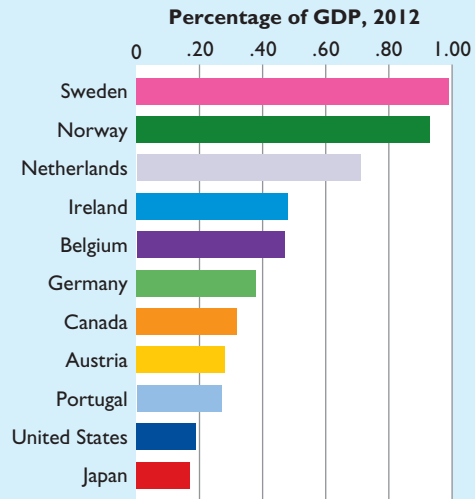
**Direct Aid** The United States and other IACs have assisted DVCs directly through a variety of programs designed to stimulate economic development. Over the past 10 years, U.S. loans and grants to the DVCs totaled \$15 billion to \$28 billion per year. The U.S. Agency for International Development (USAID) administers most of this aid. Some of it, however, consists of grants of surplus food under the Food for Peace program. Other advanced nations also have substantial foreign aid programs. In 2012 foreign aid from the IACs to the developing nations totaled \$126 billion. This amounted to about one-fourth of 1 percent of the collective GDP of the IACs that year



## GLOBAL PERSPECTIVE 39W.2

### Development Assistance as a Percentage of GDP, Selected Nations

In terms of absolute amounts, the United States was the leading provider of development assistance in 2012. It provided \$30.5 billion to developing nations. But many other industrialized nations contribute a larger percentage of their GDPs to foreign aid than does the United States.



Source: Based on data from OECD (2012); Development aid at its highest level ever in 2012 [Press release]. Table 1: Net Official Development Assistance from DAC and Other Donors in 2012: Preliminary data for 2012 (April 3, 2013), [www.oecd.org/dac](http://www.oecd.org/dac).

(see Global Perspective 39W.2 for percentages for selected nations).

A large portion of foreign aid is distributed on the basis of political and military rather than strictly economic considerations. Afghanistan, Egypt, Iraq, Israel, Pakistan, and Turkey, for example, are major recipients of U.S. aid. Asian, Latin American, and African nations with lower standards of living receive less.

Only one-fourth of foreign aid goes to the 10 countries in which 70 percent of the world’s poorest people live. The most affluent 40 percent of the DVC population receives over twice as much aid as the poorest 40 percent. Many economists argue that the IACs should shift foreign aid away from the middle-income DVCs and toward the poorest DVCs.

Some of the world’s poorest nations *do* receive large amounts of foreign aid relative to their meager GDPs. For example, in 2011 foreign aid relative to GDP was 54 percent in Liberia, 37 percent in Afghanistan, 23 percent in Haiti, 20 percent in Rwanda, 17 percent in Mozambique, and 15 percent in Sierra Leone.

# LAST WORD

## Famine in Africa

**The Roots of Africa's Persistent Famines Lie in Both Natural and Human Causes.**

A number of sub-Saharan African nations are periodically threatened by famine. For example, in the early 1990s about 300,000 children under the age of five died from famine in Somalia. In 2003 famine threatened the lives of an estimated 10 million people in several southern Africa nations (Lesotho, Malawi, Mozambique, Swaziland, Zambia, and Zimbabwe). Although most African countries were self-sufficient in food at the time they became independent nations, they are now heavily dependent on imported foodstuffs for survival.

The immediate cause of famine often is drought. For example, in Kenya drought and crop failures in 1999 and 2000 killed much of the nation's livestock, leaving an estimated 3.5 million people at risk of starvation. But as first pointed out by economist Amartya Sen, the ultimate causes of sub-Saharan Africa's inability to feed itself are rooted in a complex interplay of natural and human conditions. Lack of rainfall, chronic civil strife, rapid population growth, widespread soil erosion, and counterproductive public policies all contribute to Africa's famines.

**Civil Strife** Regional rebellions, prolonged civil wars, and wars between nations have devastated several African nations. Ethiopia, Sudan, and Rwanda, for example, have been plagued by decades of civil strife. As another example, Ethiopia has recently been at war with its neighbor Eritrea. Not only do these conflicts divert precious resources from civilian uses, but they seriously



complicate the ability of wealthy nations to provide famine and developmental aid. Governments frequently divert donated food to the army and deny it to starving civilians. In Somalia, factional feuding destroyed most of the existing schools, factories, and government ministries and reduced the country to anarchy. Armed gangs stole water pumps, tractors, and livestock from farms and looted ports of donated foodstuffs.

**Population Growth** Although substantially slowing from previous growth rates, the population of sub-Saharan Africa is

Also, these and many other low-income developing nations receive large amounts of support from private donors in the IACs. In fact, in recent years the private giving to the DVCs by private U.S. universities, foundations (such as the Gates Foundation), voluntary organizations, and religious organizations has exceeded the foreign aid provided by the U.S. government.

The large accumulated debts of some of the poorest DVCs have become a severe roadblock to their growth. Therefore, some of the recent direct assistance by the IACs to the DVCs has taken the form of forgiving parts of the past IAC-government loans to low-income DVCs. In 2005 the G8 nations canceled \$55 billion of debt owed by developing countries to the World Bank, the International Monetary Fund, and the African Development Bank. Of course, debt forgiveness creates a *moral hazard problem*. If current debt forgiveness creates an expectation of later debt

forgiveness, a country has little incentive against running up a new debt. Therefore, future loans by the IACs must be extended cautiously to the low-income developing nations that receive current debt forgiveness.

**The World Bank Group** The United States and other IACs also support the DVCs by participating in the **World Bank**, whose major objective is helping DVCs achieve economic growth. [The World Bank was established in 1945, along with the International Monetary Fund (IMF).] Supported by about 185 member nations, the World Bank not only lends out of its capital funds but also sells bonds and lends the proceeds and guarantees and insures private loans:

- The World Bank is a “last-resort” lending agency; its loans are limited to economic projects for which private funds are not readily available.



still growing very rapidly. Population is projected to grow by 2.4 percent annually from 2010 to 2020, compared to 0.4 percent in the industrially advanced economies. When crops are abundant, the sub-Saharan nations are able to feed their growing population. But when war or drought hits, hunger and malnutrition quickly follow.

**Ecological Degradation** Population growth has also contributed to the ecological degradation of Africa. With population pressures and the increasing need for food, marginal land has been deforested and put into crop production. In many cases trees that have served as a barrier to the encroachment of the desert have been cut down for fuel, allowing the fragile topsoil to be blown away by desert winds. The scarcity of wood that has accompanied deforestation in some cases has resulted in the use of animal dung for fuel, thereby denying its traditional use as fertilizer.

Furthermore, traditional fallow periods have been shortened, resulting in overplanting and overgrazing and a wearing out of the soil. Deforestation and land overuse have reduced the capacity of the land to absorb moisture, diminishing its productivity and its ability to resist drought. All this is complicated by the fact that there are few facilities for crop storage, making it difficult, even when crops are good, to accumulate a surplus for future lean years. A large percentage of domestic farm output in some parts of Africa is lost to rats, insects, and spoilage.

**Public Policies** Ill-advised public policies have contributed to Africa's famines.

First, many African governments generally have neglected investment in agriculture in favor of industrial development and military strength. It is estimated that African governments on

the average spend four times as much on armaments as they do on agriculture.

Second, many African governments have adopted a policy of setting the prices of agricultural commodities at low levels to provide cheap food for growing urban populations. That policy has diminished the incentives of farmers to increase production. While foreign aid has helped ease the effects of Africa's food-population problems, most experts reject aid as a long-term solution. Experience suggests that aid in the form of food can provide only temporary relief and may undermine the achievement of long-run local self-sufficiency in food production. Foreign food aid, it is contended, treats symptoms, not causes.

Most dramatically, Zimbabwe's seizure of thousands of white-owned commercial farms for redistribution to black settlers collapsed the food supply. Along with severe drought, the policy threatened half the Zimbabwe population with severe malnutrition in 2003.

**External Debt** All this is made more complex by the fact that the sub-Saharan nations are burdened with large external debts. The World Bank reports that the aggregate external debt of these nations was \$84 billion in 1980 and grew to \$295 billion in 2012. As a condition of further aid, these nations have had to invoke austerity programs that have contributed to declines in their per capita incomes. One tragic consequence is that many of these nations have cut back on social service programs such as health care for children. For that reason, in 2000 the major industrial nations and the World Bank initiated a program to forgive \$50 billion of total debt owed by some of these nations, on the condition that they end warfare and use the savings in interest and principal to ease the plight of their populations.

- Many World Bank loans have been for basic development projects—dams, irrigation projects, health and sanitation programs, communications, and transportation facilities. Consequently, the Bank has helped finance the infrastructure needed to encourage the flow of private capital.
- The Bank has provided technical assistance to the DVCs by helping them determine what avenues of growth seem appropriate for their economic development.

Affiliates of the World Bank function in areas where the World Bank has proved weak. The *International Finance Corporation (IFC)*, for example, invests in private enterprises in the DVCs. The *International Development Association (IDA)* makes "soft loans" (which may not be self-liquidating) to the poorest DVCs on more liberal terms than does the World Bank.

**Foreign Harm?** Although official development assistance directly from the IACs and indirectly through the World Bank has generally helped the DVCs expand their economies, the foreign-aid approach to helping DVCs has met with several criticisms.

**Dependency and Incentives** A basic criticism is that foreign aid may promote dependency rather than self-sustaining growth. Critics argue that injections of funds from the IACs encourage the DVCs to ignore the painful economic decisions, the institutional and cultural reforms, and the changes in attitudes toward thrift, industry, hard work, and self-reliance that are needed for economic growth. They say that, after some five decades of foreign aid, the DVCs' demand for foreign aid has increased rather than decreased. These aid programs should have withered away if they had been successful in promoting sustainable growth.

**Bureaucracy and Centralized Government** IAC aid is given to the governments of the DVCs, not to their residents or businesses. The consequence is that the aid typically generates massive, ineffective government bureaucracies and centralizes government power over the economy. The stagnation and collapse of the Soviet Union and communist countries of eastern Europe is evidence that highly bureaucratized economies are not very conducive to economic growth and development. Furthermore, not only does the bureaucratization of the DVCs divert valuable human resources from the private to the public sector, but it often shifts the nation's focus from producing more output to bickering over how unearned "income" should be distributed.

**Corruption and Misuse** Critics also allege that foreign aid is being used ineffectively. As we noted previously, corruption is a major problem in many DVCs, and some estimates suggest that from 10 to 20 percent of the aid is diverted to government officials. Also, IAC-based aid consultants and multinational corporations are major beneficiaries of aid programs. Some economists contend that as much as one-fourth of each year's aid is spent on expert consultants. Furthermore, because IAC corporations manage many of the aid projects, they are major beneficiaries of, and lobbyists for, foreign aid.

**Current Level of Foreign Aid** After declining in the late 1990s, foreign aid increased between 2000 and 2008. This increase resulted from a renewed international emphasis on reducing global poverty and also from expanded efforts by the IACs to enlist the cooperation of DVCs in fighting terrorism. In 2010 foreign direct aid by IAC governments to developing countries was \$103 billion.

## Flows of Private Capital

The IACs also send substantial amounts of private capital to the DVCs. Among the private investors are corporations, commercial banks, and, more recently, financial investment companies. General Motors or Ford might finance the construction of plants in Mexico or Brazil to assemble autos or produce auto parts. JPMorgan Chase or Bank of America might make loans to private firms operating in Argentina or China or to the governments of Thailand and Malaysia. And individuals living in IACs might purchase shares in "emerging markets" mutual funds run by investment companies like Fidelity. Those funds make financial investments in

the stock of promising firms in DVCs such as Hungary and Chile.

The total flow of private capital to DVCs was \$557 billion in 2010, but the makeup of this flow differed from the flow in earlier decades. The main private investors and lenders are now private IAC firms and individuals, not commercial banks. Also, more of the flow is in the form of **foreign direct investment** in DVCs, rather than loans to DVC governments. Such direct investment includes the building of new factories in DVCs by multinational firms and the purchase of DVC firms (or parts of them). Whereas DVCs once viewed foreign direct investment as "exploitation," many of them now seek out foreign direct investment as a way to expand their capital stock and improve their citizens' job opportunities and wages. Those wages are often very low by IAC standards but high by DVC standards. Another benefit of direct investment in DVCs is that management skills and technological knowledge often accompany the capital.

Unfortunately for the low-income DVCs, the strong flow of private capital to the DVCs has been very selective. The vast majority of IAC investment and lending has been directed toward China, India, Mexico, and other middle-income DVCs, with only small amounts flowing toward such extremely impoverished DVCs as those in Africa.

In fact, as we have indicated, many of the lowest-income countries face staggering debt burdens from previous government and private loans. Payment of interest and principal on this external debt is diverting expenditures away from maintenance of infrastructure, new infrastructure, education, and private investment.

Further, the flows of private capital to both the middle-income and low-income DVCs plummeted during the worldwide recession of 2007–2009. It may be several years before foreign direct investment regains its momentum.

### QUICK REVIEW 39W.2

- The IACs can assist the DVCs through expanded trade, foreign aid, and flows of private capital.
- Many of the poorest DVCs have large external debts that pose an additional obstacle to economic growth.
- The worldwide recession of 2007–2009 greatly reduced direct investment by the IACs in the DVC economies.

# SUMMARY

## **LO39W.1 Describe how the World Bank distinguishes between industrially advanced countries and developing countries.**

The majority of the world's nations are developing countries (low- and middle-income nations). While some DVCs have been realizing rapid growth rates in recent years, others have experienced little or no growth.

## **LO39W.2 List some of the obstacles to economic development.**

Scarcities of natural resources make it more challenging—but certainly not impossible—for a nation to develop.

The large and rapidly growing populations in many DVCs contribute to low per capita incomes. Increases in per capita incomes frequently induce greater population growth, often reducing per capita incomes to near-subsistence levels. The demographic transition view, however, suggests that rising living standards must precede declining birthrates.

Most DVCs suffer from unemployment and underemployment. Labor productivity is low because of insufficient investment in physical and human capital.

In many DVCs, formidable obstacles impede both saving and investment. In some of the poorest DVCs, the savings potential is very low, and many savers transfer their funds to the IACs rather than invest them domestically. The lack of a vigorous entrepreneurial class and the weakness of investment incentives also impede capital accumulation.

Appropriate social and institutional changes and, in particular, the presence of the will to develop are essential ingredients in economic development.

## **LO39W.3 Explain the vicious circle of poverty that afflicts low-income nations.**

The vicious circle of poverty brings together many of the obstacles to growth, supporting the view that poor countries stay poor because of their poverty. Low incomes inhibit saving and the accumulation of physical and human capital, making it difficult to increase productivity and incomes. Overly rapid population

growth, however, may offset promising attempts to break the vicious circle.

## **LO39W.4 Discuss the role of government in promoting economic development within low-income nations.**

The nature of the obstacles to growth—the absence of an entrepreneurial class, the dearth of infrastructure, the saving-investment dilemma, and the presence of social-institutional obstacles to growth—suggests that government should play a major role in initiating growth. Economists suggest that DVCs could make further development progress through such policies as establishing the rule of law, building infrastructure, opening their economies to international trade, setting realistic exchange rates, encouraging foreign direct investment, building human capital, encouraging entrepreneurship, controlling population growth, and making peace with neighbors. However, the corruption and maladministration that are common to the public sectors of many DVCs suggest that government may not be very effective in instigating growth.

## **LO39W.5 Describe how industrial nations attempt to aid low-income countries.**

Advanced nations can encourage development in the DVCs by reducing IAC trade barriers and by directing foreign aid (official development assistance) to the neediest nations, providing debt forgiveness to the poorest DVCs, allowing temporary low-skilled immigration from the DVCs, and discouraging arms sales to the DVCs. Critics of foreign aid, however, say that it (a) creates DVC dependency, (b) contributes to the growth of bureaucracies and centralized economic control, and (c) is rendered ineffective by corruption and mismanagement.

In recent years the IACs have reduced foreign aid to the DVCs but have increased direct investment and other private capital flows to the DVCs. Little of the foreign direct investment, however, has gone to the poorest DVCs. Also, foreign direct investment plummeted during the worldwide recession of 2007–2009.

# TERMS AND CONCEPTS

industrially advanced countries (IACs)  
developing countries (DVCs)  
demographic transition  
underemployment  
brain drain  
capital flight

infrastructure  
capital-saving technology  
capital-using technology  
will to develop  
capricious universe view  
land reform

vicious circle of poverty  
microfinance  
corruption  
World Bank  
foreign direct investment

## DISCUSSION QUESTIONS

1. What are the four categories used by the World Bank to classify nations on the basis of national income per capita? Identify any two nations of your choice for each of the four categories. **LO39W.1**
2. Explain how the absolute per capita income gap between rich and poor nations might increase, even though per capita income (or output) is growing faster in DVCs than in IACs. **LO39W.1**
3. Explain how each of the following can be obstacles to the growth of income per capita in the DVCs: lack of natural resources, large populations, low labor productivity, poor infrastructure, and capital flight. **LO39W.2**
4. What is the demographic transition? Contrast the demographic transition view of population growth with the traditional view that slower population growth is a prerequisite for rising living standards in the DVCs. **LO39W.2**
5. As it relates to the vicious cycle of poverty, what is meant by the saying “Some DVCs stay poor because they are poor”? Change the box labels as necessary in Figure 39W.3 to explain rapid economic growth in countries such as South Korea and Chile. What factors other than those contained in the figure might contribute to that growth? **LO39W.3**
6. Because real capital is supposed to earn a higher return where it is scarce, how do you explain the fact that most international investment flows to the IACs (where capital is relatively abundant) rather than to the DVCs (where capital is very scarce)? **LO39W.3**
7. List and discuss five policies that DVC governments might undertake to promote economic development and expansion of income per capita in their countries? **LO39W.4**
8. Do you think that the nature of the problems the DVCs face requires a government-directed or a private-sector directed development process? Explain your reasoning. **LO39W.4**
9. Why do you think there is so much government corruption in some developing countries? **LO39W.4**
10. What types of products do the DVCs typically export? How do those exports relate to the law of comparative advantage? How do tariffs by IACs reduce the standard of living of DVCs? **LO39W.5**
11. Do you favor debt forgiveness to all DVCs, just the poorest ones, or none at all? What incentive problem might debt relief create? Would you be willing to pay \$20 a year more in personal income taxes for debt forgiveness? How about \$200? How about \$2,000? **LO39W.5**
12. Do you think that IACs such as the United States should open their doors wider to the immigration of low-skilled DVC workers as a way to help DVCs develop? Do you think that it is appropriate for students from DVC nations to stay in IAC nations to work and build careers? **LO39W.5**
13. **LAST WORD** Explain how civil wars, population growth, and public policy decisions have contributed to periodic famines in Africa.

## REVIEW QUESTIONS

1. True or False: The term *developing country* (DVC) is applied to rich nations like the United States and Germany because their economies are always growing quickly by developing new technologies. **LO39W.1**
2. True or False: A DVC that has little in the way of natural resources is destined to remain poor. **LO39W.2**
3. Suppose a country’s total output is growing 10 percent per year, but its population is growing 11 percent per year. What will happen to living standards? **LO39W.2**
  - a. Rise.
  - b. Fall.
  - c. Remain the same.
4. A DVC’s population is growing 2 percent per year and output is growing 3 percent per year. If the government wants to improve living standards over coming decades, which of the following would probably be the best savings rate for the economy? **LO39W.2**
  - a. 0 percent.
  - b. 2 percent.
  - c. 5 percent.
  - d. 10 percent.
5. Compare a hypothetical DVC with a hypothetical IAC. In the DVC, average per capita income is \$500 per year. In the IAC, average per capita income is \$40,000 per year. If both countries have a savings rate of 10 percent per year, the amount of savings per capita in the DVC will be \_\_\_\_\_ per person per year, while in the IAC it will be \_\_\_\_\_ per person per year. **LO39W.3**
  - a. \$50; \$4,000.
  - b. \$5; \$400.
  - c. \$450; \$36,000.
  - d. None of the above.
6. Which of the following policies would economists consider to be actions that a DVC government might take that would *improve* growth prospects? **LO39W.4**  
*Choose one or more answers from the choices shown.*
  - a. Helping to extend the banking system to the rural poor.
  - b. Passing high tariffs against foreign products.
  - c. Constructing better ports, roads, and Internet networks.
  - d. Charging high fees for public elementary schools.
7. True or False: Economists are unanimous that foreign aid greatly helps DVCs. **LO39W.5**
8. True or False: Some economists argue that the single best thing that IACs could do for DVCs in terms of economic growth would be to eliminate trade barriers between IACs and DVCs. **LO39W.5**



**PROBLEMS**

1. Assume a DVC and an IAC currently have real per capita outputs of \$500 and \$5,000, respectively. If both nations have a 3 percent increase in their real per capita outputs, by how much will the per capita output gap change? **LO39W.1**
2. Assume that a very tiny and very poor DVC has income per capita of \$300 and total national income of \$3 million. How large is its population? If its population grows by 2 percent in some year while its total income grows by 3 percent, what will be its new income per capita rounded to full dollars? If the population had not grown during the year, what would have been its income per capita? **LO39W.2**

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