27 DOMESTIC AND INTERNATIONAL FACTORS AND ECONOMIC DEVELOPMENT

27.1 Domestic factors and economic development

Learning outcomes

- With reference to a specific developing economy, and using appropriate diagrams where relevant, examine how the following factors contribute to economic development:
  - **a** education and health
  - **b** the use of appropriate technology for industry and agriculture
  - **c** banking, credit and micro-credit
  - **d** the empowerment of women
  - **e** income distribution.

The line between economic growth and economic development is not always clear. Many of the factors that may promote economic growth in a nation also contribute to economic development. Growth itself, defined as an increase in the average income of a nation, contributes to development in that when people's incomes rise, their ability to consume education, afford healthcare and thereby improve the quality and length of their lives improves.

School children in Nepal.

In the same way that higher incomes can improve people's well-being, improvements in education, health and social harmony can contribute to economic growth. In summary, without growth, there can be no development; but without development, economic growth is far less likely. The two objectives are not mutually exclusive, so the pursuit of both should be the utmost priority of economic policy.

In their pursuit of macroeconomic objectives aimed at increasing national income and output (economic growth), governments may also achieve improvements in households' well-being by promoting policies that improve health and education. Both these measures increase productivity of the nation's workforce in the long run and help achieve the objectives of full employment, price stability and growth.

Economic development

Economic development requires a solid foundation of institutions provided by or closely regulated by the government, even in an economy in which economic growth is already happening. The most important source of economic development is almost certainly the quality and the quantity of resources available domestically in a nation. Resources, in this sense, comprise the human, technological and natural capital possessed by a nation. By improving these domestic factors, a country can promote economic development, improve the well-being of its people and simultaneously promote economic growth.

The domestic factors that contribute to economic development include the promotion of education and health among a nation's people, the acquisition and improvement of technology used in industry and agriculture, access to a stable banking system able to provide credit to businesses and entrepreneurs, a societal acceptance of the importance of women in achieving economic objectives, and a functioning tax system which allows the government to provide public goods that would not otherwise be provided by the free market.

Each of these domestic factors is explored below, with evidence from developing countries to provide you with a framework for the analysis of the importance of each factor.

Domestic obstacles to economic development

A poverty trap is a self-perpetuating mechanism that contributes to the persistence of poverty in a nation.

Before examining domestic and international sources of economic development, we must consider some of the obstacles poor countries face in achieving meaningful improvements in the standard of living of their people. Obstacles to development, like sources of development, can be both internal (domestic) and external (international).

Poverty traps

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A poverty trap is any self-reinforcing mechanism that contributes to the persistence of poverty in nation. If a country finds itself in a poverty trap over a long period of time, it is unlikely to escape unless meaningful steps are taken either domestically or initiated by an outside force to allow the country to escape the trap.

Poverty traps usually have at their core a fundamental obstacle that perpetuates itself and thereby keeps the country poor. Some examples of poverty traps include the natural resource trap, the geography trap, the poor education/poor governance trap, and the conflict trap.

Natural resource trap

A poor country with few natural resources may find itself in a poverty trap for two reasons. First, without mineral, energy, forest, or marine resources it cannot sustain its domestic need for such resources. Secondly, it cannot export resources to earn much-needed foreign exchange.

Without a developed secondary, manufacturing sector, many poor countries (such as Congo and other mineral-rich countries in Africa) depend greatly on the export of raw materials to Europe and East Asia. A country without a secondary sector and a poor supply of natural resources, however, could find itself in a particularly difficult situation in which the foreign capital required to invest in its secondary sector is inaccessible due to the lack of exchangeable commodities from within the country.

The natural resource trap is visualized in Figure 27.1.

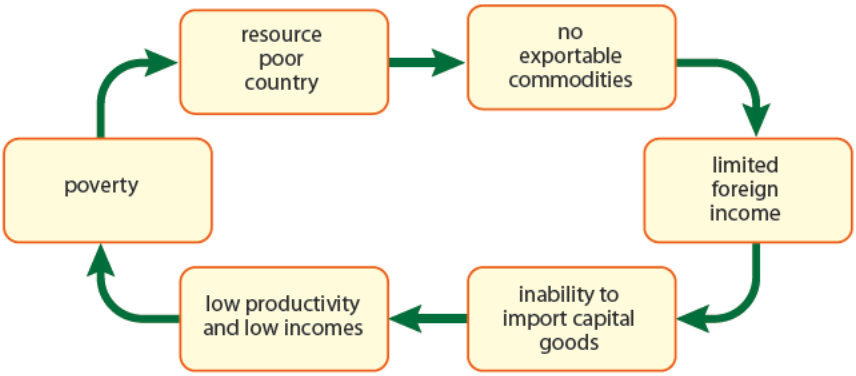


Figure 27.1 The natural resource trap.

Poverty persists because of the lack of access to capital goods from abroad. Since the country has few valuable natural resources to exchange with the rest of the world, it has only limited access to the foreign exchange it would need to acquire the capital goods needed to develop a secondary sector. Without capital, worker productivity and incomes remain low, and the people remain impoverished.

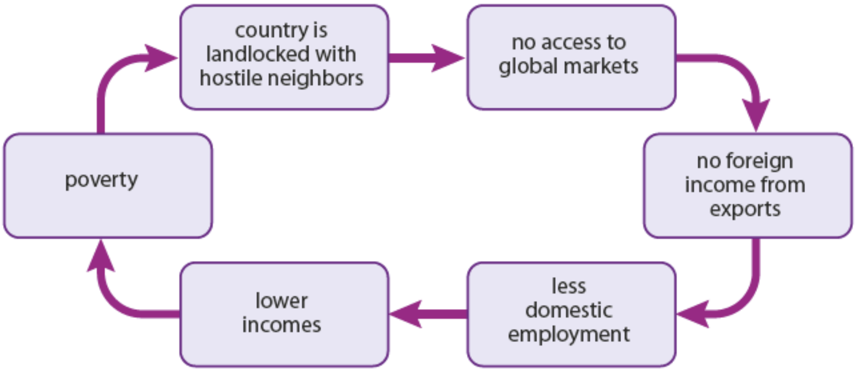
Paul Collier, an economics professor at Oxford, proposes another kind of natural resource trap, in which a poor country is kept poor because of its abundance of natural resources. His seemingly contradictory theory is explained by the fact that if all a poor country has to offer the global market is one valuable natural commodity (such as diamonds from Sierra Leone or Liberia), this breeds domestic conflict over the control of the one natural resource. Political and social upheaval may result from the struggle for control of the exportable commodity, creating conditions completely antithetical to those necessary for economic development.

Geography trap

Collier also suggests that a major source of persistent poverty for some nations is their geographical location. If a nation is land-locked and surrounded by poor countries, that country is extremely likely to be poor itself. Being landlocked alone does not mean a country is poor. There are several landlocked countries in Europe that are among the richest in the world, such as Luxembourg, Switzerland, Austria and Liechtenstein. But all these countries are fortunate to have rich neighbours with whom they have good economic relations.

A look at the map of Africa, Asia or South America identifies many landlocked countries that are among the poorest in the world, including Bolivia, Paraguay, Niger, Zambia, Nepal and Afghanistan. Each of these countries is landlocked and surrounded by other poor countries, a situation that makes it incredibly difficult for the landlocked country to begin a journey on the path of economic development. Figure 27.2 (overleaf) illustrates the geography trap.

Figure 27.2
The geography trap.

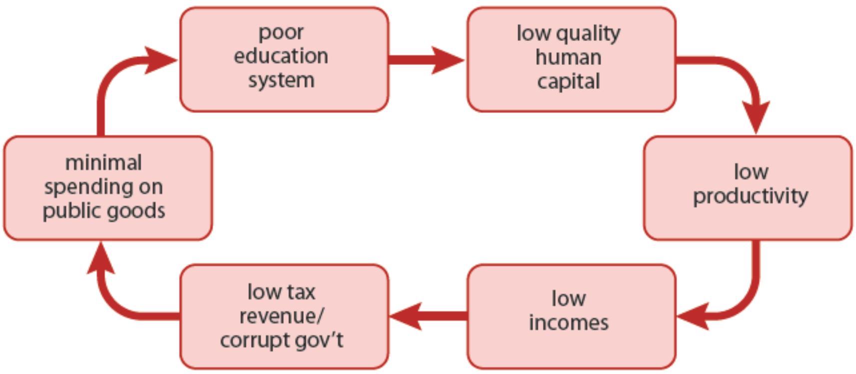


The key to the geography trap is the lack of access to sea ports even in neighbouring countries. Without access to sea ports, it does not matter how politically stable and economically attractive a country is to foreign producers and consumers. If there are no means to safely and reliably export their output to the rest of the world, such a country would not even be on the radar of international investors looking for places to produce goods for the global market. Without reliable demand from other countries, it would be nearly impossible for a poor country to increase its national income and the standards of living of its people.

Education / poor governance trap

One of the most important functions of government is to collect taxes and provide public goods to the nation's people, including education, healthcare and infrastructure. In a poor country with a corrupt government, an ineffective tax system and a poor education system, economic development is nearly impossible to achieve. And under-provision of education perpetuates the bad governance and poverty, as can be seen in Figure 27.3.

Figure 27.3
The education/poor governance trap.



Poor countries are poor because their leaders keep them poor. To what extent is this statement true? Is a good leader all that is needed to achieve economic development in a poor country?

A poorly educated workforce makes a country less attractive for foreign direct investment, limiting the amount of capital available to workers. Low skill levels and limited capital make the nation's workforce unproductive, meaning lower incomes, less tax revenue, and less ability for the probably corrupt government to provide the very public goods needed to get the country on the road to economic development.

The education and poor governance trap persists until a responsible government comes to power, is able to reduce corruption and waste, and ensure that any tax revenues generated by the economy are allocated responsibly towards improving education and thus the human capital of the nation's workforce.

Conflict trap

The worst poverty trap for a country to find itself in is a conflict trap. Unfortunately, any of the three poverty traps described above can easily evolve into conflict, and if a country finds itself in all three situations (landlocked with poor natural resources and a corrupt government) the likelihood of conflict arising is extremely high. Civil unrest perpetuates poverty for many reasons, but Figure 27.4 shows the basic problem with conflict in a developing nation.

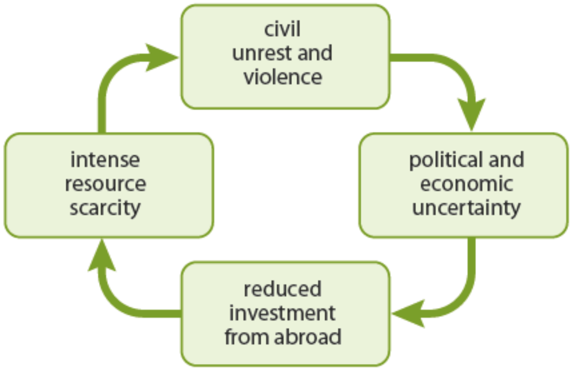


Figure 27.4
The conflict trap.

Much of the conflict in the poor world is over the resources that are needed to generate income that could then be put to work improving people's lives. But the existence of conflict ultimately intensifies the scarcity of resources and creates an environment of political and economic uncertainty that makes the country unattractive to foreign investors who might otherwise invest in the nation's economy. In this way, conflict born from scarcity actually intensifies scarcity and thereby fuels more conflict. A country in which many resources are going towards waging an internal war is most certainly going to remain poor until stability is achieved and an atmosphere deemed safe for international investors is restored.

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EXERCISES

1 The poverty traps described above are only some of the possible traps a poor country may find itself in. Identify three other possible traps that may cause poverty to persist in a poor country.

2 **a** Use the link in the hotlinks box above to discover some African news stories. Identify three headlines that you think might be about stories relating to economic development. Read the three articles you have discovered and determine whether or not they relate to one of the obstacles to development discussed above.

b Discuss with your class the headlines you found and determine whether they could be used to formulate an alternative poverty trap to those described above.

Institutional and political obstacles to economic development

Other domestic obstacles to economic development are rooted in the failure of institutions to lay the groundwork for meaningful improvements in people's lives.

Ineffective taxation structure

With an unclear or ineffective tax structure, a nation is unattractive to foreign investors who might otherwise invest in the country. Uncertainty about how taxes are collected deters investment and reduces the amount of foreign capital in the country. In addition, rich domestic households may choose to save their incomes and wealth abroad in a country whose tax structure is more stable and predictable. An ineffective tax structure may allow domestic firms and households to hide their income from the government, depriving the country of much-needed funds for investment in public goods.

Lack of property rights

If foreign investors cannot be sure that their property rights will be respected by the domestic government, they are unlikely to invest their capital into a poor country. The guaranteed protection of property rights makes a country more attractive to foreign investors and increases the amount of capital and thus the productivity and income of the nation's workforce. Domestically, a lack of property rights deters investors at even the lowest levels. Poor farmers neglect their fields; shop owners have no reason to invest in their businesses.

Political instability

An unstable political structure could lead a country into conflict and push a developing country into a cycle of conflict and uncertainty, perpetuating poverty.

Inequality in the distribution of income

An unequal distribution of income, demonstrated by a nation's Gini coefficient, is common in poor countries. While the vast majority of the population remains poor, what little income is generated by the economy is often enjoyed by a tiny elite. Unequal income distribution may be a result of an ineffective tax system, without which an equitable distribution of income is impossible. And without a system of transfer payments, the ability of the poor to escape poverty by improving their human capital is limited, keeping the majority of the country's population in poverty.

Lack of infrastructure

Infrastructure includes roads, highways, airports, rail track, sea ports and communications infrastructure such as cellular towers, phone lines and internet. Without these much-needed capital goods, a country is less attractive to foreign investors and subsequently the supply of productivity-enhancing foreign capital is limited. Infrastructure improves the efficiency with which a nation's economy functions; improved efficiency leads to lower costs and higher incomes. Lack of infrastructure is a major obstacle to economic development.

Lack of access to credit

Many developing countries lack an effective banking system able to offer secure deposits to savers and access to credit to borrowers. Without a functioning domestic financial system, households with money to save will likely save it abroad, a phenomenon known as capital flight. Without a supply of loanable funds domestically, it becomes nearly impossible for small businesses to access credit to finance productivity-enhancing investments. Consumers also find it impossible to borrow money to invest in real estate or consumer durable goods, both of which make up significant proportions of more developed countries' economies' total demand.

Social and cultural obstacles to economic development

The challenges to be overcome by a poor country in achieving development are many. From its geography to the composition of its exports, to corruption and conflict, the formula that must be satisfied for development to occur is exceedingly complex. But even if all the above obstacles are overcome, there remain several social and cultural issues that must be addressed for a nation to achieve meaningful economic development.

Religion

Religious differences within a nation can create an obstacle to economic development. This is particularly the case if members of the different religions are in conflict with one another. Israel's West Bank is a good example of a region in which two religious groups (Muslims and Jews) have yet to overcome their religious differences and begin working towards meaningful development. Other examples include Sri Lanka, where only recently has a 25-year conflict between Hindus and Buddhists ended; Southern Thailand, where tensions between Muslims and Buddhists have slowed progress towards economic development; and the Philippines, where Muslim rebel groups have staged attacks on the predominantly Christian population for over two decades. In each of these countries, many of the ingredients needed to promote development are in place, but the ongoing conflicts between religious groups create an environment in which economic uncertainty prevails and therefore actual development is limited.

Aid workers complain that religious objections to medical practices and treatments can get in the way of progress. For example, the Catholic Church forbids its followers to use condoms, even in parts of Africa where AIDS is most destructive. Secondly, recent efforts to eradicate polio have been set back in several Islamic countries (e.g. Pakistan and Nigeria) where religious leaders denounced the vaccines as 'impure' and 'an American plot', and urged followers to avoid them.

Tradition

In some cultures, the objectives of economic growth and development are questioned by the more traditional members of society; progress towards development in a modern sense of the word is undermined by those who wish to promote a more traditional society. The Taliban in Afghanistan wishes to turn the country into a religious theocracy ruled by Islamic Sharia law. In other countries, the perceived Westernization that economic development entails could form the basis for movements that promote a traditional societal structure in opposition to the ethics of economic growth and development.

Domestic factors that contribute to economic development

Understanding the obstacles developing countries face in achieving improvements in their people's welfare allows economists to focus on the strategies needed to overcome these obstacles. Some of the domestic factors that may promote development are discussed below.

Education

An educated population is able to contribute more to the economic output of a developing country more than if the population has less access to education. There is a strong correlation between education and income; as access to education increases, productivity of workers rises allowing them to contribute to the nation's output and increase their own income in the process.

Figure 27.5
There is a direct correlation between improved education and income in Nepal.

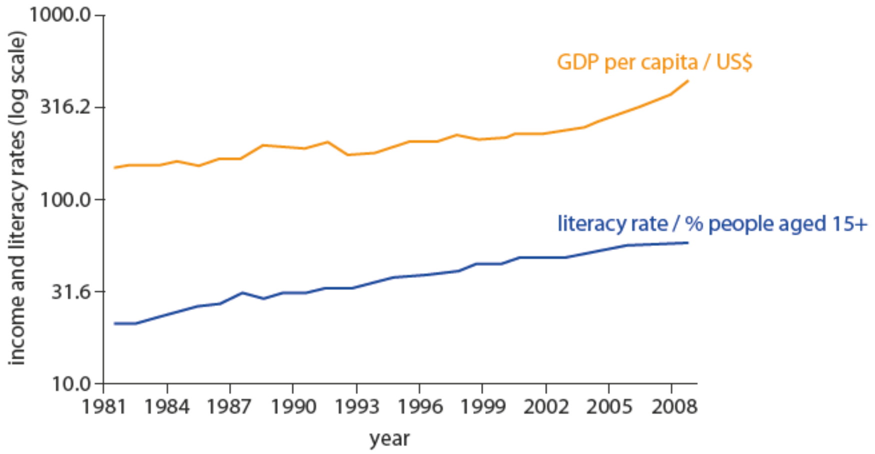

Figure 27.5 shows how the rising literacy rate in Nepal, a developing country, has coincided with growing *per capita* income since 1981, when only around 20% of the adult population could read and write and the *per capita* GDP was just $148. By 2008, literacy rates had tripled to 58% and tiny *per capita* income had grown to $440. Clearly, Nepal is still a very poor country, in which 80% of the population lives below the poverty line, but

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continued improvements in literacy will improve the population's ability to contribute to the nation economically and politically.

Health

Improved health and a longer life are not only the result of economic development; they also contribute to development in areas such as income and education. When factors such as life expectancy and infant mortality improve, the people of a nation can shift their focus towards becoming more productive members of the economy and improving their incomes and quality of life.

Figure 27.6 looks at Nepal between 1960 and 2008. As infant mortality plummeted from nearly 250 deaths per 1000 live births in 1960 to around 40 in 2008, and life expectancy increased from 40 years to 64 years, the *per capita* income in the nation increased around ten-fold. Fewer deaths in childbirth and a longer life point to improved health of the Nepalese people, while larger GDP *per capita* represents an improvement in the variety and quantity of goods and services to the average Nepali household. It should be pointed out that Nepal is still a very poor country. It is ranked 138th out of 169 by the United Nations Development Project's Human Development Index. However, Nepal's people today are far better off than they were 50 years ago.

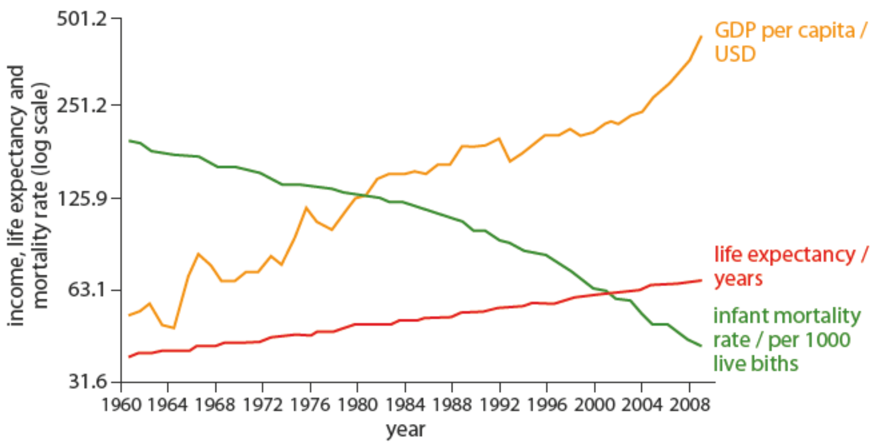


Figure 27.6 The correlation between improved health and income.

To learn more about health, visit www.pearsonhotlinks.com, enter the title or ISBN of this book and select weblink 27.4.

Banking, credit and micro-credit

Micro-credit is a much talked about and widely used development strategy that provides financial credit or technology loans to entrepreneurs in poor communities to create small businesses – ideally businesses with a socially beneficial purpose. Loans (credit) may be issued by community banks or by international micro-finance institutions. Community banks act like local banks in the developed world, collecting deposits from local savers and using them to make loans to local borrowers.

International micro-credit organizations match lenders in the developed world with borrowers in the developing world. There are even online organizations that allow individual lenders to peruse loan requests from individual entrepreneurs in developing nations, most of whom are women, and make loans directly to the borrower of their choice. Such a programme differs from regular commercial credit, which is either unavailable or very expensive. The benefit for poor country entrepreneurs is that without the existence of micro-credit institutions, they would have little access to credit, severely limiting the extent to which the human capital of poor countries can be put to work promoting economic growth and development.

Entrepreneurs with access to financial capital, either through a community bank or an international micro-credit institution are able to put their business skills to work employing others in providing goods and services that are in demand in their local communities. Often, the loans entrepreneurs receive are very small, as little as $100 or $200, which may be all that is needed to acquire some simple capital equipment such as a sewing machine or a vendor stand from which the entrepreneur can begin producing output demanded by her community. The more successful borrowers eventually gain access to larger amounts of credit, allowing them to expand their businesses, employ more workers and add more value to the developing nation's output.

Micro-lending is not always in the form of financial capital. Some development projects aim to put physical capital directly into the hands of poor entrepreneurs. In Kenya, for instance, an NGO known as WISER aims to match young entrepreneurs with the tools they need to start their own businesses using donated technology such as copy machines, laptop computers with cellular internet connections, foot pumps for water, and digital LCD projectors. The technology is sold on credit to entrepreneurs who are required to pay back the value of the capital through their business revenues.

The capital, once in the hands of local entrepreneurs, is immediately put to use providing services to the community. Here are some examples.

- The copy machine was installed and powered by a generator. It was the first such machine ever installed in the community. Local businesses, students, job seekers and others could, for a few cents, photocopy their documents locally, avoiding the two-hour drive previously required for such a service.
- The laptops were installed in an internet café and made available to local students and businesses. Farmers and fishermen could check product prices in the cities hours away, increasing efficiency and bargaining positions when middle men came to town to buy their produce. Job openings in the city newspapers' classifieds could be printed and posted for the local community to see, improving information symmetry between the poor countryside and the cities where job opportunities existed. The cost of access to these services was cheap, yet the entrepreneurs who were granted the laptop loan were able to pay back the cost of the technology in no time at all, and the community as a whole benefited from their existence.
- The LCD projector was the first of its kind ever seen in the community. The entrepreneur who received the projector hooked it up to a satellite dish in order to capture and project English Premier League football matches onto the wall of a large room in a local building. The business was to sell tickets to local football fans who were more than happy to pay to watch English football matches in full colour on a wall-sized screen. Before the projector arrived in the community, football fans had huddled around tiny black-and-white televisions with poor reception to watch football matches. The football-theatre business was the most successful of all, and paid back its loan fastest.

What do you think of the choice of an LCD projector for investment lending money? Do you think entertainment spending is any better or worse than other investment? On what basis did you answer initially, reason or emotion?

Community banking, micro-credit and micro-lending all promote the entrepreneurial talents of the people in less developed countries (LDCs), and for that reason promise great potential for long-run economic development. Whereas many of the obstacles to development and strategies for overcoming them outlined in this chapter require a top-down approach, micro-finance and micro-credit are purely grassroots in nature, empowering individuals within the poorest communities in the developing world to create their own opportunities while meeting the demands of their community and creating income and employment for others in the process.

'Women,' Mao Zedong said, 'are half the sky' and the neglect of women's potential is a waste of half the planet's human capital. This is one reason why the UN created a Gender Equity Index to rank country achievement in this critical aspect of development.

The empowerment of women

The role of women in society could play a crucial role in determining whether a developing country is able to achieve meaningful improvements in the standards of living of its people. Female education in particular should be a goal of poor countries wishing to promote development. Better-educated women mean improved chances at development for many reasons, including the two discussed below.

Reduced fertility rates

The more educated women become, the fewer children they are likely to have. This is important for several reasons; notably it reduces the burden on working members of society when there are fewer mouths to feed in the home. Lower fertility rates also mean the children women do have are likely to be better nourished and provided with more education themselves, which in the long run will improve the productivity of a nation's workforce. Slower population growth promises to increase the *per capita* income of a nation over time, improving the standards of living of the people.

Does the protection of human rights automatically lead to increased development? Are freedom, liberty and property rights enough to improve the lives of people in a poor country?

Women in the work force

When a developing country views women as an economic asset in themselves, the productive capacity of the nation is instantly increased. Women tend to be equally as productive as men in poor countries, contributing to economic activity and creating jobs and income through small enterprises and as members of the larger workforce. Better-educated women are, of course, more productive and able to earn incomes that can be used to provide health, education and a better life for their children, promoting future economic growth and development in the process.

27.2 International obstacles to economic development

Learning outcomes

- With reference to specific examples, explain how the following factors are barriers to development for economically less developed countries:
  - **a** over-specialization on a narrow range of products
  - **b** price volatility of primary product prices
  - **c** inability to access international markets.
- (HL only) With reference to specific examples, explain how the following factor is a barrier to development for economically less developed countries:
  - **a** long-term changes in the terms of trade.

Besides the internal obstacles to development detailed above, there are several external obstacles to a country achieving improvements in the income, health and education of its citizens.

Narrow range of exports

LDCs in which education and health are lacking and the value of human capital (i.e. the economic potential of the people of the nation) is therefore limited, often depend on a narrow range of exports for a major component of their total economic activity. A poor country with a currency that is non-convertible on foreign exchange markets must export to the rest of the world to gain hard currency that can then be used to acquire much-needed imported necessities for its people.

In addition, most LDCs are capital poor, meaning they have a workforce deprived of the technology and tools needed to increase productivity and incomes. In order to acquire capital goods, many of which are produced in more developed countries, poor countries must earn foreign currency through the sale of their exports to the rest of the world.

Being able to produce and offer a diversity of goods and services to foreign consumers is a valuable attribute for a developing country. Unfortunately, many poor countries have a very narrow range of exports, often primary or low-tech manufactured goods such as textiles. A narrow range of exports poses an obstacle to economic development for many reasons – two are discussed below.

Over-dependence on primary products

When a country specializes in the production of a single primary commodity, whether a food crop (e.g. coffee or cocoa) or an energy resource (e.g. oil or gas) or a mineral resource (e.g. copper or diamonds), the ability of that country to achieve meaningful improvements in its people's standards of living is limited by the extent to which it can earn steady income from its exports of its one commodity. The problem with primary commodities is that their prices tend to fluctuate greatly on the global commodity markets. Most poor countries specializing in a particular commodity have very little price-making power in the global market.

Being price-takers, a decrease in global demand and a fall in price of the commodity can have devastating effects on the country's net exports and overall level of aggregate demand and economic output. The highly inelastic supply of most agricultural and mineral resources means that even a slight fall in global demand can cause the price of the good to fall dramatically, reducing a poor country's income levels and its ability to purchase the imported consumer goods its people depend on.

Figure 27.7 shows how a decrease in demand for coffee grown in Country B from one year to the next can lead to a massive decrease in Country B's export revenues. Because the coffee farmers of Country B are highly unresponsive to a fall in demand for coffee in the short run, they must accept a lower price for their output in order to sell it. The alternative of taking their supply off the market by storing it is expensive and unrealistic for most farmers.

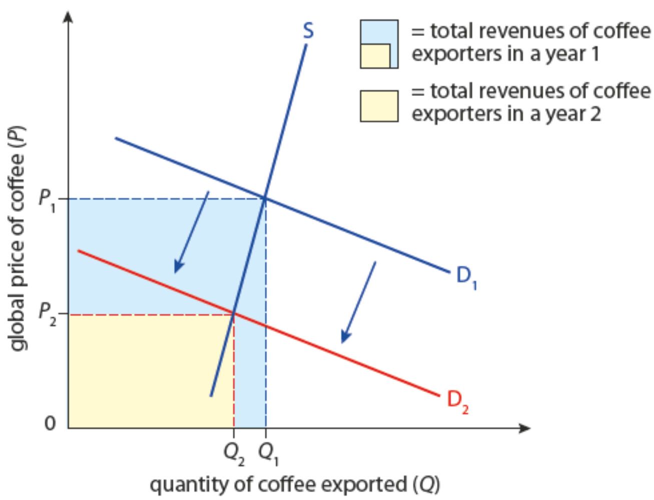


Figure 27.7 Over-dependence on a primary commodity poses an obstacle to growth and development.

If Country B depends heavily on the export of this one commodity, even a slight decrease in the world demand for coffee can devastate the country's economy and drastically reduce the standard of living of its people.

Consequences of adverse terms of trade (HL only)

A nation's terms of trade measures the value of its exports relative to the value of its imports. If a nation is heavily dependent on a particular primary or secondary commodity for a major component of its total exports and income, and the value of that export declines relative to the value of imports, the people of that nation will find their standard of living declining over time. Chapter 25 has a detailed explanation of how this occurs.

Once again the importance to a developing country of diversifying the composition of its output is emphasized. Along with becoming over-dependent on a primary commodity, a nation in which income and employment depend heavily on any particular type of good or service is likely to be harmed when global demand for its exports shrink, reducing revenues from exports and worsening the nation's terms of trade.

27.3 International factors that contribute to economic development

Learning outcomes

- With reference to specific examples, evaluate each of the following as a means of achieving economic growth and economic development:
  - **a** import substitution
  - **b** export promotion
  - **c** trade liberalization
  - **d** role of WTO
  - **e** bilateral and regional preferential trade agreements
  - **f** diversification.

To overcome the external obstacles to economic development, the government of a poor country may pursue several strategies to achieve economic growth and development. The effectiveness of the various external strategies for development is evaluated below.

Protectionism in international trade

Import substitution policies

Import substitution policies are protectionist policies meant to reduce domestic consumers' dependence on imported goods, for which they substitute domestic goods and services, thus promoting the development of domestic industries.

If a developing country's government chooses to enact protectionist policies, it could harm the economy's potential to achieve meaningful steps towards development. Protectionism is seen in a strategy for economic growth known as import substitution. Here, a country attempts to reduce domestic consumers' dependence on imported goods by setting strict tariffs and quotas on the import of certain goods and then promoting the development of domestic industries.

At first glance, it looks as though an import substitution policy could promote development. However, it can lead to retaliatory tariffs from countries whose imports are restricted in the developing nation. Thus the impact of protectionism at home may be reduced demand abroad for the developing nation's goods, a situation that reduces the level of domestic income and output and limits households' access to the goods, services and foreign capital that would improve their standards of living.

Export promotion policies

Export promotion policies are an alternative set of policies for promoting economic growth and development. They aim to increase the overseas market for domestic producers by employing subsidies, tariffs, and exchange rate controls that allow domestic producers of international commodities to gain the upper hand in foreign markets. Such a policy can be highly effective if done right, but once again the threat is that the resources allocated to producing goods for the foreign market might have been more efficiently allocated by the free market towards producing goods and services to meet the needs and wants of domestic consumers.

Export promotion policies are protectionist measures aimed at increasing the competitiveness of domestic producers in foreign markets. Subsidies for domestic producers of exportable goods and intentional devaluation of the nation's currency give domestic producers an advantage in international markets and promote export-oriented growth.

Export promotion has been employed by LDCs, particularly those of East and Southeast Asia, for decades with varying degrees of success. Malaysia, Thailand and the Philippines have all aimed to grow their export sectors through currency devaluation and targeted subsidies for domestic industries. All three countries have achieved strong economic growth over two decades, albeit economic development has at times been slow to follow and all three countries still face many social, institutional, cultural and political challenges before they join the ranks of the high-income countries of Europe, North America and East Asia.

Trade liberalization

An alternative to using protectionism to promote growth and development is for an LDC to embrace trade liberalization. The risks associated with a developing country opening its market to free trade are of course substantial. There is no guarantee that one country's opening itself to trade will be reciprocated by its trading partners.

For example, African Country K may choose to remove tariffs on imported grain from Europe in the hope that European nations will remove protectionist duties on Country K's exports, thereby liberalizing trade of goods to and from Country K. However, without some tariffs on European grain, heavily subsidized, capital-intensive food products from Europe will flood Country K's market at prices too low for its farmers to compete with.

While the intention of trade liberalization was to make imports cheaper for Country K's residents and to make Country K's products more attractive to foreign consumers, the result may be a reduction in the welfare of the primarily rural population of Country K who find it increasingly difficult to compete with subsidized food from Europe.

Role of World Trade Organization

The WTO (Chapter 20) has tried to alleviate poverty in LDCs by addressing the constraints to global trade that put poor countries at a disadvantage in the global economic system. Some of the challenges the WTO has attempted to address and will continue to address in future rounds of trade negotiations include the following.

- Encouraging LDCs to refocus their development agendas away from high tariff barriers and towards strategies relying on trade liberalization and integration into the global trading system.
- Getting developed countries to take into account the needs of developing countries when considering their own trade policies.

- Promoting access to new markets for manufactured goods and primary commodities from developing countries.
- Working towards meaningful cuts in protectionist agricultural subsidies in developed countries.
- Making sure that future bilateral or multilateral trade agreements do not undermine the industrialization prospects of developing countries.
- Providing duty-free and quota-free access to imports from LDCs in the developed world.
- Promoting increased movement of labour, both high skilled and low skilled, among LDCs and between LDCs and the developed economies.

The WTO's role in poverty alleviation is to bring countries together to develop a fair trade framework that promotes meaningful development in poor countries.

Bilateral and regional trading blocs

In the absence of progress at the multilateral or WTO level, a better option for a developing nation than removing all barriers to trade with other nations may be to start locally in trade liberalization by joining regional trading blocs or entering into preferential trade agreements with neighbouring countries.

The East African Community (EAC) is a common market agreement that includes Kenya, Burundi, Uganda, Tanzania and Rwanda. The aim of the EAC is to enable free movement of labour, services and capital to significantly boost trade and investments and make the region more productive and prosperous.

By embracing free trade first with its neighbours, and from there entering into additional preferential and free trade agreements with geographically more distant trading partners, developing countries may begin to enjoy the benefits of trade liberalization without being subjected to the unfair disadvantages that would result from the failure of more developed countries to reciprocate the removal of protectionist policies such as agricultural subsidies and import tariffs.

Diversification of national output

Perhaps the best strategy for a developing country to overcome the external obstacles to economic growth and development is to diversify the composition of its output. A poor country that is overly dependent on one or a few primary commodities, or even low-skilled manufactured goods, faces great obstacles in growing its economy in a manner that ensures higher incomes, better health and improved education among its people.

Investing in human capital may be the best way a government can achieve the diversification of its national output. Better-educated workers attract foreign investment from multinational corporations eager to tap the relatively low-wage, but well-educated workforce available. The inflow of foreign investment allows the LDC to acquire much-needed foreign capital and productivity-enhancing technology that can be employed in the production of manufactured goods, thus providing the nation's households with higher incomes. Higher incomes increase the level of savings in the nation, providing loanable funds to entrepreneurs and businesses at home, and further contributing to the nation's growth and development.

To access Worksheet 27.1 on Haiti, please visit www.pearsonbacconline.com and follow the onscreen instructions.

The key for a developing nation's government is to identify the poverty trap in which it is ensnared, and then pursue policies that enable it to escape that trap and begin the journey towards growth and development. This may be harder than it sounds, but some of the strategies described here will help a nation improve the standard of living of its people.

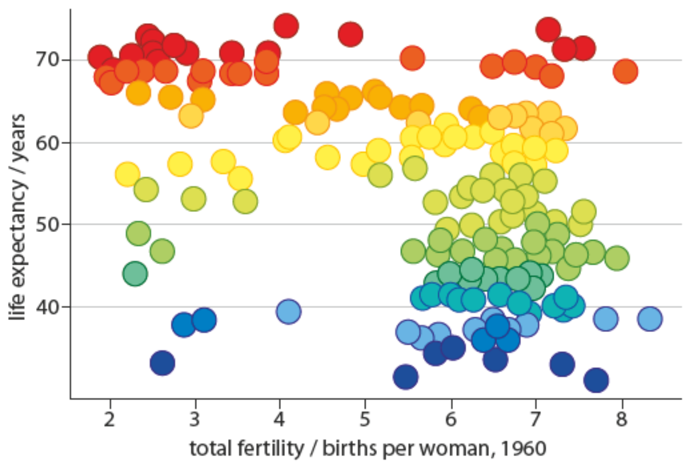
Overcoming the obstacles to economic development: the big picture approach

None of the challenges described above can be completely overcome in the short term. Many LDCs in the world today will still be poor a century from now; poverty will always exist in some form regardless of the gains from increased trade, growth and development.

There is great hope, however, that life will continue to improve for the great majority of the world's poorest people over the next 50 years, as it has in the last 50 years. Since 1960, the gap between the developed and developing world has become much less evident than it has been throughout most of history. Using available data from the World Bank, the Swedish statistician Hans Rosling has demonstrated the sweeping changes that have taken place. A quick review of Rosling's development data shows that despite what many in the developed world think, the poorest people today are actually much better off than they were just a couple of generations ago.

Human health

In 1960, for example, there was a clear gap between the countries with long life expectancy and low fertility rates and those with short life expectancy and high fertility rates. In 1956, just about all of sub-Saharan Africa, South Asia, Southeast Asia and Latin America experienced short lives and large families. Figure 27.8 shows the relationship worldwide between total fertility (expressed as average number of births per woman) and life expectancy (years) in 1960.



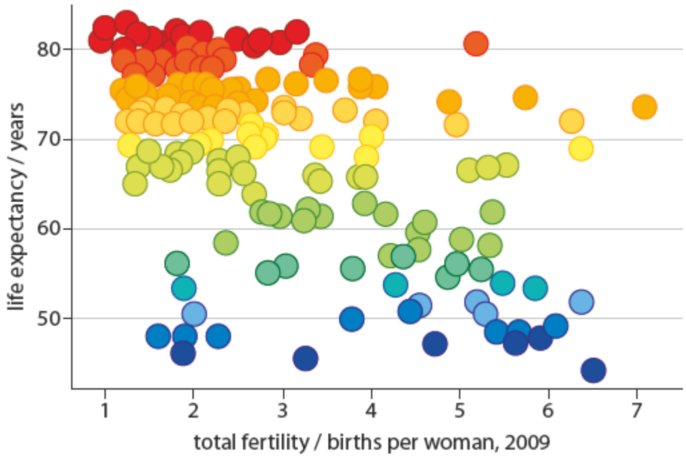
The World Bank

Figure 27.8
Total fertility and life expectancy in 1960: dots represent countries. Notice the gap between the countries with large families and short life and those with small families and long life.

Each coloured dot represents a country. The red countries (upper left) include the more developed countries (MDCs) of Western Europe and North America, where long life and small families were the norm 50 years ago. The blue countries (lower right) include those in the developing world 50 years ago, with larger families (more than five births per woman) and shorter lives (typically, less than 50 years). Fifty years ago, the gap between MDCs and LDCs was quite clear. The bunch in the upper left were the rich nations, the group in the lower right were the poor nations.

If not much had changed in the last 50 years, then we would expect there to be a similar relationship still visible today, with the poorest countries living short lives with large families. However, when we look at the data for the same two indicators of human welfare in 2009, we see that the world has changed dramatically (Figure 27.9, overleaf).

Figure 27.9
Total fertility and life expectancy in 2009: dots represent countries. Notice that many countries that had large families and short lives have now moved to the upper left.



The World Bank

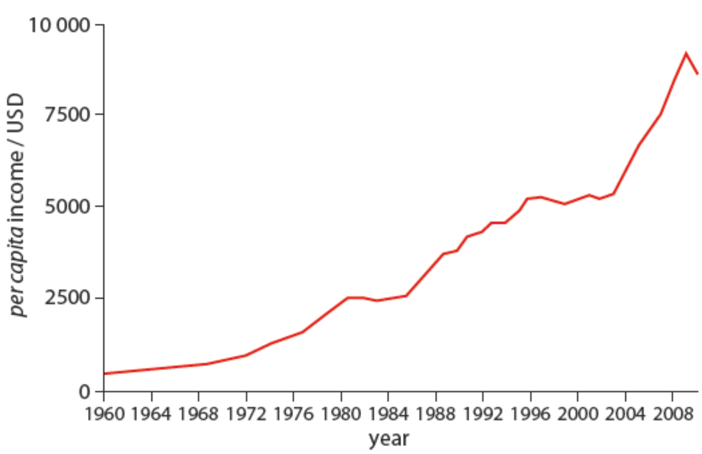
Today, there are far more red countries than there were 50 years ago. The majority of the nations that were then characterized by large families and short lives have managed to bring down fertility rates and simultaneously increase life expectancy. There is no longer a clear gap between the rich world and the poor world. Many of the countries in the upper left of the chart for 2009 are ones that in 1960 would have been in extreme poverty characterized by high fertility rates, high infant mortality rates, rampant disease and short life expectancy.

We can conclude from the analysis of simple, available data that over the last half century, some economic development has indeed come to the world's poorest countries. But there is more to be done. The people of countries represented by blue dots in Figure 27.9 still live in absolute poverty, many surviving on less than $2 per day. The bottom billion of people live lives still characterized by disease, poverty and suffering; they have enjoyed none of the benefits from economic globalization, growth and development. To continue to improve the lives of the world's poorest, governments and international development organizations must continue to employ the same strategies that have brought billions out of despair over the last 50 years.

Income

Figure 27.10
World *per capita* GDP has increased over 20-fold in 50 years.

The gap between the *per capita* incomes in the world's richest nations today and that in the developing world is still large, but much smaller than it was 50 years ago. Along with longer lives and smaller families, many of the world's poorest countries have experienced significant increases in *per capita* income during an era of globalization and market liberalization. The global *per capita* income has grown from just $446 50 years ago to nearly $9000 today (Figure 27.10). While this figure tells us nothing about the distribution of world income, it is a clear indication that, on average, people in 2010 are nearly 20 times richer than their grandparents were just 50 years ago.



The World Bank

Global income growth has come about because of many factors, and often in spite of bad governance, geographical or natural resource traps. The sheer demand from the international marketplace for raw materials, minerals, and goods manufactured using low-skilled labour has meant that foreign investment from the more developed economies to the less developed economies has increased incomes, output and the productive capacity of poor countries more than any domestic government policy could have.

Gains from trade

Of course, the degree to which an LDC benefits from globalization depends on the effectiveness of its government in managing trade flows, capital and financial investments from abroad and protecting the well-being of their workforce in a competitive global marketplace that is more than willing to exploit low-wage workers to benefit multi-national corporate interests. In addition, the revenues that flow to governments from the investments of foreign firms must continue to be invested in the human and physical capital of the developing nation if integration into the global economy is to bring development to the nation's people.

Many developing countries have looked to the success stories of East Asia for inspiration in their own journeys towards economic development. In China alone, more than 300 million people have been lifted out of poverty as three decades of rapid economic growth have increased the *per capita* income of the Chinese household seven-fold. But such economic miracles driven by ever-growing demand for cheap manufactured goods in the West is not likely to be realized by smaller developing nations without the access to international markets and the abundant workforce enjoyed by China.

A path to prosperity

A path towards development for the poorest countries today, namely those in sub-Saharan Africa, South and Central Asia and parts of Latin America, will require great attention by governments to the basic needs of their nation's people. Without sound investments in health, education, and financial and physical infrastructure, along with a reliable legal and political framework that reassures foreign investors of the nation's stability, economic development will continue to elude the poorest nations today.

The poverty traps outlined earlier are all able to be overcome if one of the components of the cycle can be broken. But without strong, stable and right-minded political leadership, poverty will endure in the LDCs of today.

For each of the domestic and international factors discussed in this chapter, what would you consider to be sufficient evidence that it plays a role in enhancing or inhibiting economic development?

27.4 Development section research project

In preparation for the IB examinations, it is important that you achieve a strong understanding of the domestic and international obstacles to and factors contributing to the economic development of a specific country. This project will help you become an expert on a particular country, which in turn will help you be better prepared for examination papers 2 and 3, which include questions on economic development.

World Bank Development Project Proposal

Introduction

The following research assignment will help you learn more about the obstacles facing countries and the strategies they can employ to achieving economic development. You will have approximately four class periods dedicated to in-class research and preparation. In addition, to produce a high-quality proposal, you will need to spend some time outside the class on this assignment.

Overview

You will assume the role of the Chief Development Officer (CDO) in charge of implementing an economic development project in a less developed country (LDC) of your choice. As the CDO, it is your duty to submit development project proposals to international lending agencies such as the World Bank and the African Development Bank. However, not all proposals from all countries can be granted, so before submitting a proposal, you must prepare a detailed report for the lending agency.

Objective

To win a concessionary loan from the World Bank to put towards a specific development project in the LDC you represent. Funds are extremely limited, so whether or not you receive aid and, if you do, how much aid you receive will be determined by a panel of judges consisting of your classmates.

You must prepare a detailed report, which should include the following sections.

- Part 1 Development data: an overview of your country's current level of economic development.
- Part 2 Obstacles to development: information on some of the obstacles to economic development faced by your country.
- Part 3 Resources and potential: an identification of existing resources within your country.
- Part 4 The proposal: a proposal for a specific development project that will improve human welfare in your country.

You will then make an appeal to lenders at the World Bank, requesting financing for your project. A panel of judges (your classmates) will decide whether to approve requests and bring them to the chief economist of the bank (your teacher). The best proposals (accurate, appropriate, achievable) will receive the limited financing available – the best marks. Less realistic proposals will receive fewer funds than they request or none at all.

The report may take any form you wish. It could be a written report to be delivered orally, it could be a slide presentation, or it could be a video. You could even choose to create a website or blog containing the details of your report. Any appropriate media can be used to prepare and present the report.

Resources online

The following hotlink boxes will take you to useful websites.

To learn more about World Bank Countries and Regions, visit www.pearsonhotlinks.com, enter the title or ISBN of this book and select weblink 27.5.

To learn more about the CIA's World Factbook, visit www.pearsonhotlinks.com, enter the title or ISBN of this book and select weblink 27.6.

To learn more about African Development Outlook, visit www.pearsonhotlinks.com, enter the title or ISBN of this book and select weblink 27.7.

To learn more about the African Development Bank, visit www.pearsonhotlinks.com, enter the title or ISBN of this book and select weblink 27.8.

To learn more about UNDP Human Development Reports, visit www.pearsonhotlinks.com, enter the title or ISBN of this book and select weblink 27.9.

Part 1 – Development data

From the website UNDP choose one of the countries listed under 'Low Human Development' to focus on in your research. This is the country for which you will act as the CDO.

1.1 Social and economic data

Using the websites above, research and include in your presentation the following data for your country. Along with each item, you must provide a brief explanation of its importance to your nation's economic development.

Social indicators of development:

- Human Development Index (HDI) ranking and value
- population growth rate
- school life expectancy
- life expectancy at birth
- total fertility rate
- education expenditures.

Economic indicators of development:

- GDP *per capita*
- GDP – composition by sector
- unemployment rate
- public debt
- stock of direct foreign investment – at home
- labour force – by occupation.

1.2 Dependency ratio

A nation's dependency ratio is the percentage of its population under the age of 15 and over the age of 64 (i.e. those not of working age) divided by the percentage of the population between 15 and 64 (i.e. those of working age).

A nation's dependency ratio tells you something about the ability of members of the nation's workforce to provide necessities for themselves and their dependants. Typically, LDCs have a higher dependency ratio than more developed countries (MDCs). The lower a nation's dependency ratio, the greater the ability of its workers to accumulate savings. Savings lead to investment, accumulation of capital, greater productivity, higher income and more economic development.

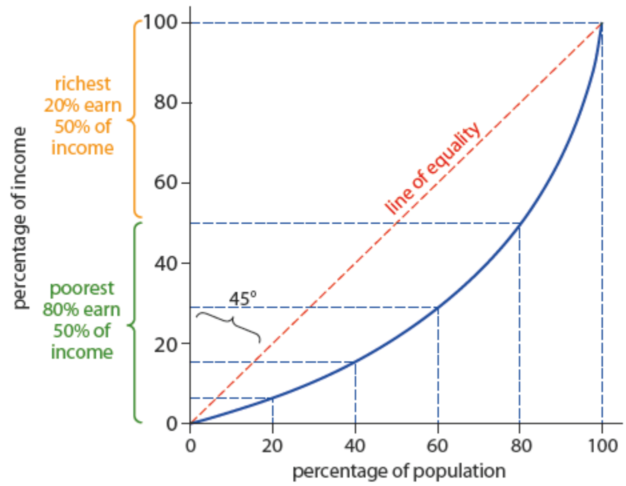
To calculate your nation's dependency ratio, you must find demographic information on its population. You may need to do additional research beyond the websites listed above to find this data.

Once you have calculated your country's dependency ratio, briefly describe the importance of this measure to your country's ability to achieve meaningful economic development.

1.3 Income distribution

The Lorenz curve (Chapter 16) is a graphical representation of a country's income distribution. It plots the percentage of a nation's total income (GDP) against its total population. The line of absolute equality is the 45-degree line, which indicates a nation where each quintile (each 20% of the population) earns exactly the same income as each other quintile. No country is absolutely equal, so the line of equality is only used for comparison. As an example, Figure 27.11 (overleaf) shows the Lorenz curve for Cambodia.

Figure 27.11
Lorenz curve for Cambodia.



The Gini coefficient is the ratio of the area below the line of equality and above the Lorenz curve to the total area of the triangle below the line of equality. A country with perfect income equality would have a Gini coefficient of zero. A country in which the top 1% of the population controlled all of the nation's income would have a Gini coefficient of nearly 1.

Example: Country A's income is distributed across its population as follows:

- 1st 20% – 5.9%
- 2nd 20% – 12%
- 3rd 20% – 17.2%
- 4th 20% – 23.6%
- 5th 20% – 41.3%
- Gini coefficient = 0.352.

Illustrating your country's Lorenz curve may require research beyond the websites suggested above. Try to find data on the share of national income earned by the richest and poorest households in your country. You may not find the percentages earned by each quintile, but you may find that richest 10% of the population earn, say, 70% of income while the lowest 10% earn only 3% of the income. This data can be applied to a Lorenz curve. Using the best data you can find, draw your country's Lorenz curve and include it in your report along with an explanation of the importance of income distribution as an indicator of economic development.

1.4 Development data analysis

To emphasize the importance of data in determining your country's development status and needs, answer each of the following questions at the end of Part 1 of your report.

To what extent does your country exhibit:

- low standard of living?
- low incomes?
- inequality?
- poor health?
- inadequate education?
- low levels of productivity?
- high rates of population growth and dependency burdens?
- high levels of unemployment?
- dependence on agricultural production and primary product exports?
- imperfect markets?
- dependency on foreign developed countries for trade, access to technology, foreign investment and aid?

Part 2 Obstacles to economic development

This section of your report focuses on the obstacles to further economic development faced by your nation. Answer the following question using your findings in Part 1 as support.

- What are the major domestic and international obstacles preventing your country from achieving economic development?

You can choose to create and present visual representations of poverty traps to show the major obstacles to development in your country. Poverty traps include:

- conflict trap
- natural resource trap
- geography trap
- education/poor governance trap.

Other domestic obstacles to development you may discover your country faces include institutional and political obstacles, ineffective taxation structure, lack of property rights, political instability, corruption, unequal distribution of income and lack of infrastructure.

International trade obstacles to development you may focus on include overdependence on primary products, adverse terms of trade, narrow range of exports, or protectionism in international trade.

You may also discuss the various social and cultural obstacles to development faced by your country, including religion, culture, tradition, or gender issues.

Part 3 Resources and potential

This section of your report describes the internal and external advantages your country possesses that will enhance its chances for development. What geographical, social, institutional/political, economic, technological, or other advantages does your country already possess that make it a viable candidate for external aid?

Your goal is to convince the panel from the World Bank that your country is a worthy aid recipient and will put resources to use responsibly towards socially and economically beneficial ends. Why should *your* country receive scarce foreign aid?

Part 4 Formal proposal

The final section of your report proposes a specific project to promote economic development and improve the standards of living of your nation's people. Your proposal must include each of the following components.

- **Project type**. What exactly are you requesting financing for? Possible project types include infrastructure investments, fair-trade organizations, micro-credit schemes, health or education initiatives, environmental and social projects.
- **Project goals**. Include specific details about who will be involved from your country and from the international community, what resources are needed to make your project possible, when and where exactly your project will take place, and how the project will promote human development in your country.
- **Examples of similar projects**. To convince your lenders that your project is realistic, you must include at least one example of a similar project that has been successfully implemented somewhere in the world. This will require some additional research into examples of development projects.
- **Financial analysis of the project**. Your proposal must include a financial breakdown of your project. Detailed cost estimates, expected rates of return, a repayment schedule detailing how and when the development loan will be repaid must all be estimated and

included in your proposal. Remember, the World Bank does not make donations to developing countries, it makes loans. And all loans are expected to be repaid. Therefore, only those projects that have a realistic chance of success will be granted financing.

Timeline for completion

The research and preparation of this report will take several class periods plus quite a bit of time outside of class. The timeline below is only a suggestion. Your teacher will decide on his or her own timeline as is appropriate with your school calendar.

- **Week 1.** Choose the medium you will use for your report and the country you will represent. Complete research for Part 1.
- **Week 2.** Continue research on Parts 2 and 3.
- **Week 3.** Research is now complete. Create your formal proposal with required detail. One day should be dedicated for peer-editing of reports. You should peer-edit two other students' reports and have yours reviewed by two classmates.
- **Week 4.** Completed reports presented in first class of the week. You present your report to the World Bank panel (classmates).

Distribution of funds

After each presentation, the panel members (students) complete a brief evaluation, which is submitted to the World Bank's chief economist (teacher) for review. Final distribution of funds (and grades) is determined by the chief economist. The countries whose reports best fulfil the above criteria will receive the most funds and the highest grades. Reports failing to adequately fulfil the above criteria will receive less funding (and a lower grade).

To access Quiz 27, an interactive, multiple-choice quiz on this chapter, please visit www.pearsonbacconline.com and follow the onscreen instructions.

PRACTICE QUESTIONS

1 **Karnataka tourism set to gain from admissions fever**

i Being admitted to professional courses in medical, dental and engineering institutions in India is the biggest ambition of most of the academically brilliant students and their parents. Given the limited number of places available in Indian Institutes of Technology (IIT), there is a huge demand for admission to professional colleges – as in the State of Karnataka where thousands apply every year, not only from within the state, but also from other parts of India and even from abroad.

ii Despite a fee of R30 000, there is **excess demand** for places. This year, a record number of 127 343 students have applied to Karnataka's colleges. Of these, as many as 59 299, or roughly 46.7%, are from outside the state. These candidates are competing with each other for the 26 000 places in the state's professional colleges – medical, dental and engineering.

iii With such large numbers of non-Karnataka students, possibly accompanied by at least one parent or adult to guide them, it is natural that there will be enormous business opportunities for the hotels, lodgings and travel operators. The state-owned Karnataka Tourism Development Corporation (KTDC) has taken the initiative to offer an elaborate and attractive package.

iv A spokesperson for the KTDC said, 'We believe there are many **social benefits** arising from the demand for places at IIT and it is our intention to take advantage of them'.

adapted from *The Economic Times*, India, 6 May 2001

a Define the following terms indicated in bold in the text:

i excess demand (paragraph ii) (2 marks) AO1

ii social benefits (paragraph iv). (2 marks) AO1 b With the aid of a diagram, explain how the social benefits resulting from the provision of education promote economic development in India. (4 marks) [AO2], [AO4]

c Identify and explain two possible government responses to the shortage of spots at the Indian Institute of Technology (4 marks) [AO2]

d To what extent is education an essential requirement for reducing poverty in LDCs such as India? (8 marks) [AO3]

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2 **Bitter coffee**

Item 1 The price slump has created some winners. Trans-national companies and global coffee cafes (such as Starbucks) are making record profits as the price of their main raw material slumps. Over the past three years the export price of coffee as a proportion of the retail price has fallen.

adapted from Celine Charveriat, *Bitter Coffee – How the poor are paying for the slump in coffee prices*, Oxfam, 2001

Item 2 What has happened to the price of coffee is a disaster. Years back, when coffee prices were good, we could afford to send our children to school. Now we are taking our children out of school because we cannot afford the fees. How can we send our children when we cannot afford to feed them well?

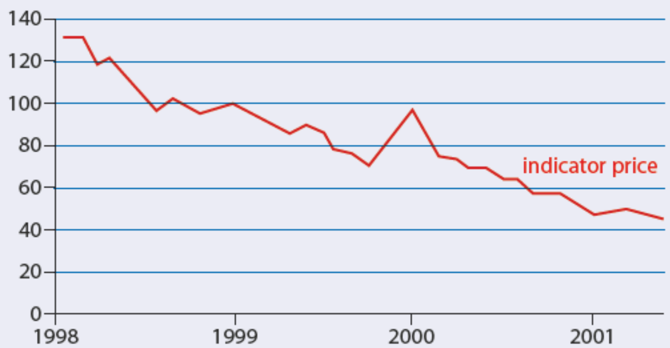
a coffee grower in Tanzania, in *Bitter Coffee*, Oxfam, 2001

Item 3 Developed countries often have no tariffs on coffee beans, but impose tariffs on processed coffee products to keep out these higher value products that return more income to job-starved poor countries.

adapted from *The Guardian*, 5 August 2002

Item 4

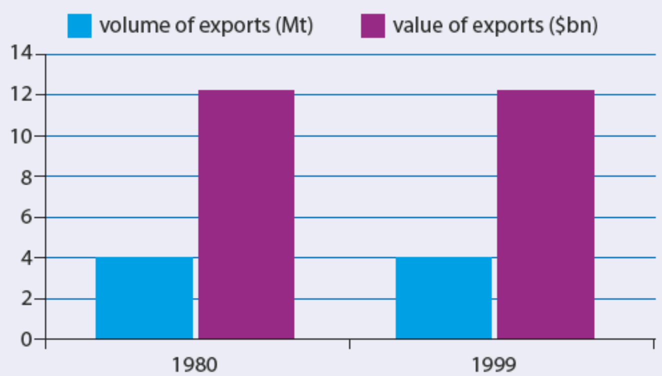
International coffee prices (US cents per unit weight of coffee, 1998–2001)



adapted from *Bitter Coffee*, Oxfam, 2001

Item 5

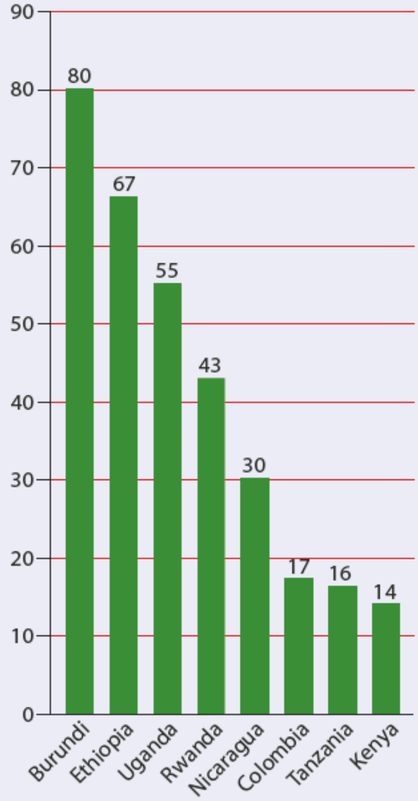
Dependence on coffee exports, selected countries (% of total exports, 1998)



adapted from *Bitter Coffee*, Oxfam, 2001

Item 6

Coffee exports from developing countries (volume and value, 1980 and 1999)



adapted from *Bitter Coffee*, Oxfam, 2001

a Explain the effects of the fall in coffee prices on:

i a coffee grower (2 marks) [AO1]

ii global coffee cafes. (2 marks) [AO1]

b Using a supply and demand diagram, explain the change in the volume and value of coffee exports between 1980 and 1999 (Item 6). (4 marks) [AO1], [AO2]

c Using an appropriate diagram, explain how the coffee-processing market is blocked to coffee-producing countries because of the high tariffs the processing countries put on these goods. (4 marks) [AO2], [AO4]

d Use evidence from the text and your knowledge of economics to discuss the importance for a developing country of diversifying the composition of its output in promoting stable economic growth and development. (8 marks) [AO3]

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