CHAPTER 1
INTRODUCING ECONOMIC DEVELOPMENT: A GLOBAL PERSPECTIVE

The Nature of Development Economics
Greater scope than traditional neoclassical economics and political economy.

Figure 1.1 World Income Distribution

Economies as Social Systems: The Need to Go Beyond Simple Economics
Social Systems: Interdependent relationships between economic and noneconomic factors

Success or failure of development policy
- Importance of taking account of institutional and structural variables along with more traditional economic variables

Traditional Economic Measures
- Gross National Income (GNI)

- Income per capita
- Utility of that income?

The New Economic View of Development
- Leads to improvement in wellbeing, more broadly understood

Amartya Sen’s “Capability” Approach
- Functionings as an achievement
- Capabilities as freedoms enjoyed in terms of functionings
- Development and happiness
- Well being in terms of being well and having freedoms of choice
- “Beings and Doings”.

Some Key “Capabilities”
Some Important “Beings” and “Doings” in Capability to Function:
- Being able to live long
- Being well-nourished
- Being healthy
- Being literate
- Being well-clothed
- Being mobile
- Being able to take part in the life of the community
- Being happy – as a state of being - may be valued as a functioning

Three Core Values of Development
1. Sustenance: The Ability to Meet Basic Needs
2. Self-Esteem: To Be a Person
3. Freedom from Servitude: To Be Able to Choose

Figure 1.2 Income and Happiness: Comparing Countries

The Central Role of Women
To make the biggest impact on development, societies must empower and invest in women

The Three Objectives of Development
- Increase availability of life-sustaining goods
- Raise levels of living
- Expand range of economic and social choices

Millennium Development goals (MDGs)
Eight goals adopted by the United Nations in 2000
1. Eradicate extreme poverty and hunger
2. Achieve universal primary education
3. Promote gender equality and empower women
4. Reduce child mortality
5. Improve maternal health
6. Combat HIV/AIDS, malaria, and other diseases
7. Ensure environmental sustainability
8. Develop a global partnership for development
Table 1.1 Millennium Development Goals and Targets for 2015

<table>
<thead>
<tr>
<th>Goals</th>
<th>Targets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Achieve universal primary education</td>
<td>• Reduce by half the proportion of people unable to read and write by 2015.</td>
</tr>
<tr>
<td></td>
<td>• Reduce by half the proportion of people unable to reach primary school by 2015.</td>
</tr>
<tr>
<td>2. Achieve universal primary education</td>
<td>• Reduce by half the proportion of people unable to reach primary school by 2015.</td>
</tr>
<tr>
<td></td>
<td>• Reduce by two-thirds the proportion of states with primary school dropout rates above 25%.</td>
</tr>
<tr>
<td>3. Promote gender equality and empower women</td>
<td>• Provide access to reproductive health services for all.</td>
</tr>
<tr>
<td></td>
<td>• Reduce by three-quarters the proportion of women giving birth with the assistance of a skilled health personnel by 2015.</td>
</tr>
<tr>
<td>4. Reduce child mortality</td>
<td>• Reduce by two-thirds the proportion of children dying before reaching 5 years of age by 2015.</td>
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<tr>
<td></td>
<td>• Achieve significant improvement in child survival rates by 2020.</td>
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<tr>
<td>5. Improve maternal health</td>
<td>• Reduce by three-quarters the proportion of maternal mortality rate by 2015.</td>
</tr>
<tr>
<td></td>
<td>• Reduce by three-quarters the proportion of maternal mortality rate by 2020.</td>
</tr>
<tr>
<td></td>
<td>• Reduce by two-thirds the proportion of people living with HIV/AIDS by 2020.</td>
</tr>
<tr>
<td>7. Ensure environmental sustainability</td>
<td>• Introduce basic environmental sanitation for all.</td>
</tr>
<tr>
<td></td>
<td>• Achieve significant improvement in environmental sanitation by 2020.</td>
</tr>
<tr>
<td>8. Develop a global partnership for development</td>
<td>• Develop a global partnership for development, including a commitment to debt relief, new and additional financial resources, and official development assistance (ODA) to countries in need.</td>
</tr>
</tbody>
</table>

Common characteristics of developing countries
These features in common are on average and with great diversity, in comparison with developed countries:

- Lower levels of living and productivity
- Lower levels of human capital
- Higher levels of inequality and absolute poverty
- Higher population growth rates
- Greater social fractionalization
- Larger rural population - rapid migration to cities
- Lower levels of industrialization and manufactured exports
- Adverse geography
- Underdeveloped financial and other markets
- Colonial Legacies - poor institutions etc.

Defining the Developing World
World Bank Scheme—ranks countries on GNP/capita
- LIC, LMC, UMC, OECD (see Table 2.1 and Figure 2.1)
Table 2.1 Classification of Economies by Region and Income, 2010 (continued)

<table>
<thead>
<tr>
<th>Country</th>
<th>Code</th>
<th>Region</th>
<th>High-Income OECD Countries</th>
<th>Upper-Middle Income OECD Countries</th>
<th>Lower-Middle Income OECD Countries</th>
<th>Low-Income Countries</th>
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Table 2.2 A Comparison of Per Capita GNI, 2008

<table>
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<tr>
<th>Country</th>
<th>Exchange Rate</th>
<th>Purchasing Power Parity</th>
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<tr>
<td>Argentina</td>
<td>7.190</td>
<td>1,390</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>5.200</td>
<td>1,440</td>
</tr>
<tr>
<td>Brazil</td>
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<td>1,460</td>
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<td>Benin</td>
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<tr>
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<td>1,710</td>
</tr>
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<td>Costa Rica</td>
<td>0.660</td>
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<td>Cote d’Ivoire</td>
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<td>Ecuador</td>
<td>6.080</td>
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<td>Egypt</td>
<td>1.040</td>
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<td>France</td>
<td>1.080</td>
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<tr>
<td>Germany</td>
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<td>3,000</td>
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<tr>
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<td>Hungary</td>
<td>1.080</td>
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<tr>
<td>India</td>
<td>0.480</td>
<td>4,300</td>
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<td>Indonesia</td>
<td>1.080</td>
<td>2,620</td>
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<tr>
<td>Israel</td>
<td>1.080</td>
<td>2,620</td>
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<td>Italy</td>
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<td>South Korea</td>
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<td>Morocco</td>
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<td>Qatar</td>
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<td>2,620</td>
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<td>Singapore</td>
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<td>2,620</td>
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<tr>
<td>South Africa</td>
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<td>2,620</td>
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<tr>
<td>Spain</td>
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<td>2,620</td>
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<td>Sri Lanka</td>
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<td>Thailand</td>
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<td>United Arab Emirates</td>
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<tr>
<td>United Kingdom</td>
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<tr>
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<tr>
<td>Vanuatu</td>
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<td>2,620</td>
</tr>
<tr>
<td>Venezuela</td>
<td>1.080</td>
<td>2,620</td>
</tr>
<tr>
<td>Zambia</td>
<td>1.080</td>
<td>2,620</td>
</tr>
</tbody>
</table>
Table 2.4 2009 Human Development Index for 24 Selected Countries (2007 Data)

<table>
<thead>
<tr>
<th>Country</th>
<th>Relative Rank</th>
<th>HDI Rank</th>
<th>GPD Per Capita (PPP, U.S.$)</th>
<th>Life Expectancy at Birth (years)</th>
<th>Mean Years of Schooling (years)</th>
<th>Expected Years of Schooling (years)</th>
<th>GNI Per Capita (PPP, 2005)</th>
<th>GNI Per Capita Rank</th>
<th>Non-income Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>N. Korea</td>
<td>82</td>
<td>18</td>
<td>1,340</td>
<td>68</td>
<td>3.6</td>
<td>8.4</td>
<td>11,000</td>
<td>13</td>
<td>685</td>
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<td>Iraq</td>
<td>94</td>
<td>91</td>
<td>580</td>
<td>65</td>
<td>4.3</td>
<td>8.4</td>
<td>11,000</td>
<td>13</td>
<td>685</td>
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<tr>
<td>Egypt</td>
<td>155</td>
<td>106</td>
<td>2,075</td>
<td>70</td>
<td>6.7</td>
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<td>685</td>
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<tr>
<td>China</td>
<td>167</td>
<td>109</td>
<td>4,190</td>
<td>70</td>
<td>6.7</td>
<td>9.4</td>
<td>11,000</td>
<td>13</td>
<td>685</td>
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</tbody>
</table>

Table 2.6 The 2010 New Human Development Index (NLDI), 2008 Data

<table>
<thead>
<tr>
<th>Characteristics of the Developing World: Diversity within Commonality</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Lower levels of living and productivity</td>
</tr>
<tr>
<td>2. Lower levels of human capital (health, education, skills)</td>
</tr>
<tr>
<td>3. Higher Levels of Inequality and Absolute Poverty</td>
</tr>
<tr>
<td>– Absolute Poverty</td>
</tr>
<tr>
<td>4. Higher Population Growth Rates, Crude Birth rates</td>
</tr>
</tbody>
</table>

Figure 2.4 Shares of Global Income, 2008

Table 2.7 The 12 Most and Least Populated Countries and Their Per Capita Income, 2008

<table>
<thead>
<tr>
<th>Most Populous</th>
<th>Population (millions)</th>
<th>GNI Per Capita (U.S.$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. China</td>
<td>1,323</td>
<td>2,900</td>
</tr>
<tr>
<td>2. India</td>
<td>1,100</td>
<td>1,400</td>
</tr>
<tr>
<td>3. United States</td>
<td>316</td>
<td>47,000</td>
</tr>
<tr>
<td>4. Indonesia</td>
<td>227</td>
<td>4,800</td>
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<tr>
<td>5. Brazil</td>
<td>192</td>
<td>7,000</td>
</tr>
<tr>
<td>6. Pakistan</td>
<td>169</td>
<td>9,000</td>
</tr>
<tr>
<td>7. Bangladesh</td>
<td>164</td>
<td>9,500</td>
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<tr>
<td>8. Nigeria</td>
<td>158</td>
<td>11,100</td>
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<td>9. Russian Federation</td>
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<td>10. Japan</td>
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<td>11. Germany</td>
<td>100</td>
<td>29,900</td>
</tr>
<tr>
<td>12. Philippines</td>
<td>93</td>
<td>1,900</td>
</tr>
</tbody>
</table>

Holistic Measures of Living Levels and Capabilities

- The New Human Development Index
- Introduced by UNDP in November 2010

What is new in the New HDI?

1. Calculating with a geometric mean
   Probably most consequential: The index is now computed with a geometric mean, instead of an arithmetic mean. A geometric mean is also used to build up the overall education index from its two components. The traditional HDI added the three components and divided by 3. New HDI takes the cube root of the product of the three component indexes. The traditional HDI calculation assumed one component traded off against another as perfect substitutes, a strong assumption. The reformulation now allows for imperfect substitutability.

2. Other key changes:
   - Gross national income per capita replaces gross domestic product per capita.
   - Revised education components: now using the average actual educational attainment of the whole population, and the expected attainment of today’s children. The maximum values in each dimension have been increased to the observed maximum rather than given a predefined cutoff. The lower goalpost for income has been reduced due to new evidence on lower possible income levels.
Characteristics of the Developing World: Diversity within Commonality

5. Greater Social Fractionalization
6. Larger Rural Populations but Rapid Rural-to-Urban Migration
7. Lower Levels of Industrialization and Manufactured Exports
8. Adverse Geography, Resource endowments

9. Underdeveloped Financial and Other markets
   - Imperfect markets
   - Incomplete information

10. Colonial Legacy and External Dependence
    - Institutions
    - Private property
    - Personal taxation
    - Taxes in cash rather than in kind

How Low-Income Countries Today Differ from Developed Countries in Their Earlier Stages

Eight differences
1. Physical and human resource endowments
2. Per capita incomes and levels of GDP in relation to the rest of the world
3. Climate
4. Population size, distribution, and growth
5. Historic role of international migration
6. International trade benefits
7. Basic scientific/technological research and development capabilities
8. Efficacy of domestic institutions

Are Living Standards of Developing and Developed Nations Converging?
Evidence of unconditional convergence is hard to find. But there is increasing evidence of “per capita income convergence,” weighting changes in per capita income by population size.
Figure 2.8 Relative Country Convergence: World, Developing Countries, and OECD

(a) Per capita growth 1980–2007 for 157 countries

(b) Per capita growth 1980–2007 for 96 developing countries

(c) Per capita growth 1950–2007 for 22 OECD countries

Figure 2.9 Growth Convergence versus Absolute Income Convergence

Long-Run Causes of Comparative Development
Schematic Representation
- Geography
- Institutional quality: colonial and post-colonial
- Colonial legacy: pre-colonial comparative advantage
- Evolution and timing of European development
- Inequality: human capital
- Type of colonial regime

Figure 2.11 Schematic Representation of Leading Theories of Comparative Development

Nature and Role of Economic Institutions
CHAPTER 3
CLASSIC THEORIES OF ECONOMIC GROWTH AND DEVELOPMENT

Classic Theories of Economic Development: Four Approaches
1. Linear stages of growth model
2. Theories and Patterns of structural change
3. International-dependence revolution
4. Neoclassical, free market counterrevolution

Development as Growth and Linear-Stages Theories
1. A Classic Statement: Rostow’s Stages of Growth
2. Harrod-Domar Growth Model (sometimes referred to as the AK model)

The Harrod-Domar Model
\[ S = sY \]  
\[ I = \Delta K \]  
\[ \Delta K = c \Delta Y \]  
\[ S = I \]  
\[ S = sY = c \Delta Y = \Delta K = I \]  
\[ \frac{\Delta Y}{Y} = \frac{s}{c} \]  

Criticisms of the Stages Model
Necessary versus sufficient conditions

Structural-Change Models
The Lewis two-sector model

Empirical Patterns of Development - Examples
Switch from agriculture to industry (and services), rural-urban migration and urbanization. Steady accumulation of physical and human capital. Population growth first increasing and then decreasing with decline in

The International-Dependence Revolution
The neocolonial dependence model
– Legacy of colonialism, Unequal power, Core-periphery
The false-paradigm model
– Pitfalls of using “expert” foreign advisors who misapply developed-country models
The dualistic-development thesis
– Superior and inferior elements can coexist; Prebisch-Singer Hypothesis

Criticisms and limitations
– Does little to show how to achieve development in a positive sense; accumulating counterexamples

The Neoclassical Counterrevolution: Market Fundamentalism
Challenging the Statist Model: Free Markets, Public Choice, and Market-Friendly Approaches
– Free market approach
– Public choice approach
– Market-friendly approach

Main Arguments
– Denies efficiency of intervention
– Points up state owned enterprise failures
– Stresses government failures
– Traditional neoclassical growth theory - with diminishing returns, cannot sustain growth by capital accumulation alone

Classic Theories of Development: Reconciling the Differences
Governments do fail, but so do markets; a balance is needed. Must attend to institutional and political realities in developing world. Development economics has no universally accepted paradigm. Insights and understandings are continually evolving. Each theory has some strengths and some weaknesses

Components of Economic Growth
– Capital Accumulation, investments in physical and human capital, increase capital stock
– Growth in population and labor force
– Technological progress, Neutral, labor/capital-saving, labor/capital augmenting

Empirical Patterns of Development - Examples
Switch from agriculture to industry (and services), rural-urban migration and urbanization. Steady accumulation of physical and human capital. Population growth first increasing and then decreasing with decline in

Rate of labor transfer and employment creation may not be proportional to rate of modern-sector capital accumulation. Surplus labor in rural areas and full employment in urban? Institutional factors? Assumption of diminishing returns in modern industrial sector

Figure 3.2 The Lewis Model Modified by Laborsaving Capital Accumulation: Employment Implications

Figure 3.1 The Lewis Model of Modern-Sector Growth in a Two-Sector Surplus-Labor Economy

Criticism of the Lewis Model
– Rate of labor transfer and employment creation may not be proportional to rate of modern-sector capital accumulation. Surplus labor in rural areas and full employment in urban?
– Institutional factors?

Figure A3.1.1 Effect of Increases in Physical and Human Resources on the Production Possibility Frontier

Figure A3.1.2 Effect of Growth of Capital Stock and Land on the Production Possibility Frontier
Appendix 3.2: The Solow Neoclassical Growth Model

\[
Y(t) = Y(t)^{\alpha}(A(t)L(t))^{1-\alpha}
\]

\[
y = Y - (\gamma K, \gamma L)
\]

\[
Y/L = f''(L/L,A) \times (y - f(k))
\]

\[
y = AK^{\alpha}
\]

\[
\Delta k = f(k) - (\delta + \eta)k
\]

\[
s'f'(k) = (\delta + \eta)k
\]

\[
\Delta f' = f(k) - (\delta + \eta)k
\]

\[
s'(k^*) = (\delta + \eta)k^*
\]

Figure A3.2.1 Equilibrium in the Solow Growth Model

Figure A3.2.2 The Long-Run Effect of Changing the Saving Rate in the Solow Model

Appendix 3.3: Endogenous Growth Theory

- Motivation for the new growth theory
- The Romer model

\[
Y = AK^{\alpha} L^{1-\alpha}
\]

\[
y = AK^{\alpha + \beta} L^{1-\alpha}
\]

\[
g - n = \frac{\beta N}{1 - \alpha - \beta}
\]

CHAPTER 4

CONTEMPORARY MODELS OF DEVELOPMENT AND UNDERDEVELOPMENT

Underdevelopment as a Coordination Failure

A newer school of thought on problems of economic development. Coordination failures occur when agents’ inability to coordinate their actions leads to an outcome that makes all agents worse off. This can occur when actions are complementary, i.e., Actions taken by one agent reinforces incentives for others to take similar actions

Multiple Equilibria: A Diagrammatic Approach

Other, these models can be diagrammed by graphing an S-shaped function and the 45º line

Equilibria are

- Stable: function crosses the 45º line from above
- Unstable: function crosses the 45º line from below

Figure 4.1 Multiple Equilibria

Starting Economic Development: The Big Push

Sometimes market failures lead to a need for public policy intervention.

The Big Push: A Graphical Model, 6 assumptions

- One factor of production
- Two sectors
- Same production function for each sector
- Consumers spend an equal amount on each good
Closed economy
Perfect competition with traditional firms operating, limit pricing monopolist with a modern firm operating

Conditions for Multiple Equilibria. A big push may also be necessary when there are:
- Intertemporal effects
- Urbanization effects
- Infrastructure effects
- Training effects

Figure 4.2 The Big Push

Why the Problem Cannot be Solved by a Super-Entrepreneur
Super Entrepreneur?
- Capital market failures
- Cost of monitoring managers - Asymmetric Information
- Communication failures
- Limits to knowledge
- Lack of any empirical evidence that would suggest this is possible

In a Nutshell: Big Push Mechanisms
- Raising total demand
- Reducing fixed costs of later entrants
- Redistributing demand to later periods when other industrializing firms sell
- Shifting demand toward manufacturing goods (usually produced in urban areas)
- Help defray costs of essential infrastructure (a similar mechanism can hold when there are costs of training, and other shared intermediate inputs)

Further Problems of Multiple Equilibria
- Inefficient Advantages of Incumbency
- Behavior and Norms
- Linkages
- Inequality, Multiple Equilibria, and Growth

Michael Kremer’s O-Ring Theory of Economic Development
The O-Ring Model
- Production is modeled with strong complementarities among inputs
- Positive assortative matching in production

Implications of strong complementarities for economic development and the distribution of income across countries

Economic Development as Self-Discovery
Hausmann and Rodrik: A Problem of Information. Not enough to say developing countries should produce “labor intensive products,” because there are thousands of them. Industrial policy may help to identify true direct and indirect domestic costs of potential products to specialize in, by:
- Encouraging exploration in first stage. Encouraging movement out of inefficient sectors and into more efficient sectors in the second stage

Three building blocks of the theory; and case examples of their reasonableness in practice. Uncertainty about products can produce efficiently (evidence: India’s success in information technology was unexpected; reasons for Bangladesh’s efficiency in hats vs Pakistan’s in bed sheets is not clear). Need for local adaptation (evidence: seen in cases such as ship building in South Korea). Imitation can be rapid (e.g. the spread of cut flower exporting in Colombia)

The Hausmann-Rodrik-Velasco Growth Diagnostics Framework
Focus on a country’s most binding constraints on economic growth. No “one size fits all” in development policy. Requires careful research to determine the most likely binding constraint.
Figure 5.2 The Greater the Curvature of the Lorenz Line, the Greater the Relative Degree of Inequality

Figure 5.3 Estimating the Gini Coefficient

Figure 5.4 Four Possible Lorenz Curves

Figure 5.5 Functional Income Distribution in a Market Economy: An Illustration

Measuring Inequality and Poverty
Measuring Absolute Poverty

Headcount Index: $H/N$

Where $H$ is the number of persons who are poor and $N$ is the total number of people in the economy. Total poverty gap:

$$TPG = \sum_{i=1}^{H} (Y_p - Y_i)$$

Where $Y_p$ is the absolute poverty line; and $Y_i$ the income of the $i$th poor person

Figure 5.6 Measuring the Total Poverty Gap

Measuring Inequality and Poverty
Measuring Absolute Poverty

Average poverty gap (APG):

$$APG = \frac{TPG}{N}$$

Where $N$ is number of persons in the economy

Note: normalized poverty gap, $NPG = APG/Y_p$

Average income shortfall (AIS):

$$AIS = \frac{TPG}{H}$$

Where $H$ is number of poor persons

Note: Normalized income shortfall, $NIS = $
\[ P_\alpha = \frac{1}{N} \sum_{i=1}^{H} \left( \frac{Y_p - Y_i}{Y_p} \right)^\alpha \]

N is the number of persons, H is the number of poor persons, and \( \alpha \geq 0 \) is a parameter. When \( \alpha = 0 \), we get the headcount index measure. When \( \alpha = 2 \), we get the “P2” measure.

The Multidimensional Poverty Index (MPI)

Identification of poverty status through a dual cutoff: First, cutoff levels within each dimension (analogous to falling below a poverty line for example $1.25 per day for income poverty). Second, cutoff in the number of dimensions in which a person must be deprived (below a line) to be deemed multidimensionally poor. MPI focuses on deprivations in health, education, and standard of living; and each receives equal (that is one-third of the overall total) weight.

MPI Indicators

Health - two indicators with equal weight - whether any child has died in the family, and whether any adult or child in the family is malnourished – weighted equally (each counts as one-sixth toward the maximum deprivation in the MPI).

Education - two indicators with equal weight - whether no household member completed 5 years of schooling, and whether any school-aged child is out of school for grades 1 through 8 (each counts one-sixth toward the MPI).

Standard of Living, equal weight on 6 deprivations (each counts as \( 1/18 \) toward the maximum): lack of electricity; insufficiently safe drinking water; inadequate sanitation; inadequate flooring; unimproved cooking fuel; lack of more than one of 5 assets – telephone, radio, TV, bicycle, and motorbike.

Interaction of the deprivations?

Building the index from household measures up to the aggregate measure (rather than using already-aggregated statistics), MPI approach takes account of multiplied or interactive harm (complementarity) done when multiple deprivations are experienced by the same individual or family. The MPI approach assumes an individual’s lack of capability in one area can only to a degree be made up by other capabilities – capabilities are treated as substitutes up to a point but then as complements.

Computing the MPI

The MPI for the country (or region or group) is then computed. A convenient way to express the resulting value is \( H^* A \), i.e., The product of the headcount ratio \( H \) (the percent of people living in multidimensional poverty), and the average intensity of deprivation \( A \) (the percent of weighted indicators for which poor households are deprived on average). The adjusted headcount ratio \( H A \) satisfies some desirable properties. Important example – Dimensional monotonicity: If a person already identified as poor becomes deprived in another indicator she is measured as even poorer - not the case using a simple headcount ratio.

Table 5.2 MPI Rankings and Poverty Headcounts for Selected Countries

The results showed that knowing income poverty is not enough if our concern is with multidimensional poverty. Multidimensionally, Bangladesh is substantially less poor – at Pakistan substantially poorer - than would be predicted by income poverty. Ethiopia is far more multidimensionally poor, and Tanzania much less so, than predicted by income poverty. Most Latin American countries e.g. Brazil rank worse on multidimensional poverty than on income poverty; but Colombia’s income and MPI poverty ranks are about same.

Poverty, Inequality, and Social Welfare

Kuznets’ Inverted-U Hypothesis

Poverty, Inequality, and Social Welfare

What’s So Bad about Extreme Inequality? Dualistic Development and Shifting Lorenz Curves: Some Stylized Typologies

- Traditional sector enrichment (see Figure 5.7)
- Modern sector enrichment (see Figure 5.8)
- Modern sector enlargement (see Figure 5.9)
5.3 Absolute Poverty: Extent and Magnitude

Progress on Extreme Poverty
- Clear progress on $1.25-a-day headcount
- Less clear progress on $2.00-per-day headcount (see Figure 5.14)
- Incidence of extreme poverty is uneven

Relationship between Growth and Poverty
- Association between growth and poverty reduction
- When it is inclusive, growth reduces poverty
- Lower extreme poverty may also lead to higher growth

Table 5.4 Income and Inequality in Selected Countries

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ethiopia</td>
<td>280</td>
<td>28.6</td>
<td>2005</td>
</tr>
<tr>
<td>Mozambique</td>
<td>880</td>
<td>47.0</td>
<td>2005</td>
</tr>
<tr>
<td>Nepal</td>
<td>400</td>
<td>47.3</td>
<td>2005</td>
</tr>
<tr>
<td>Cambodia</td>
<td>440</td>
<td>40.7</td>
<td>2007</td>
</tr>
<tr>
<td>Zambia</td>
<td>980</td>
<td>50.7</td>
<td>2005</td>
</tr>
</tbody>
</table>
| Lower Middle Income
  - India | 1,980                           | 26.0            | 2005                             |
  - Cameroon | 1,100                           | 46.6            | 2011                             |
  - Botswana | 3,000                           | 37.2            | 2007                             |
  - Egypt | 1,800                           | 35.4            | 2005                             |
  - Indonesia | 1,880                         | 37.6            | 2007                             |
| Upper Middle Income
  - North Africa | 4,210                        | 74.3            | 1995                             |
  - Bulgaria | 5,400                           | 20.2            | 2005                             |
  - South Africa | 5,900                          | 57.8            | 2009                             |
  - Argentina | 7,100                           | 48.8            | 2008                             |
  - Brazil | 7,300                           | 55.0            | 2007                             |
  - Mexico | 9,900                           | 51.6            | 2005                             |
| Upper Income
  - Hungary | 12,810                          | 30.0            | 2005                             |
  - Spain | 32,000                          | 14.7            | 2000                             |
  - Germany | 42,710                          | 28.3            | 2000                             |
  - United States | 47,900                        | 40.8            | 2000                             |
  - Norway | 82,340                          | 25.8            | 2000                             |

Figure 5.11 Kuznets Curve with Latin American Countries Identified

Figure 5.12 Plot of Inequality Data for Selected Countries

Figure 5.13 Long-Term Economic Growth and Income Inequality

Figure 5.14 Global and Regional Poverty Trends
Economic Characteristics of High-Poverty Groups
- Rural poverty
- Women and poverty
- Ethnic minorities, indigenous populations, and poverty

Policy Options on Income Inequality and Poverty: Some Basic Considerations
Areas of Intervention
- Altering the functional distribution
- Mitigating the size distribution
- Moderating (reducing) the size distribution at upper levels
- Moderating (increasing) the size distribution at lower levels

Policy options
- Changing relative factor prices
- Progressive redistribution of asset ownership
- Progressive taxation
- Transfer payments and public provision of goods and services

Summary and Conclusions: The Need for a Package of Policies
1. Policies to correct factor price distortions
2. Policies to change the distribution of assets, power, and access to education and associated employment opportunities
3. Policies of progressive taxation and directed transfer payments
4. Policies designed to build capabilities and human and social capital of the poor

Appropriate Technology and Employment Generation: The Price Incentive Model
- Choice of techniques
- Factor Price distortions and appropriate technology
- Possibilities of Labor-Capital substitution

Figure A5.1.1 Choice of Techniques: The Price Incentive Model

The Ahluwalia-Chenery Welfare Index
Constructing poverty-weighted index of social welfare

CHAPTER 6
POPULATION GROWTH AND ECONOMIC DEVELOPMENT: CAUSES, CONSEQUENCES, AND CONTROVERSIES

The Basic Issue: Population Growth and Quality of Life
Six major issues:
1. Will developing countries be able to improve levels of living given anticipated population growth?
2. How will developing countries deal with the vast increases in their labor forces?
3. How will higher population growth rates affect poverty?
4. Will developing countries be able to extend the coverage and improve the quality of health care and education in the face of rapid population growth?
5. Is there a relationship between poverty and family size?
6. How does affluence in the developed world affect the ability of developing countries to provide for their people?

Figure 6.1 World Population Growth, 1750-2050

Figure 6.2 World Population Distribution by Region, 2010 and 2050

Muhammad Firman (University of Indonesia - Accounting)
Population Growth: Past, Present, and Future

- Structure of the world’s population
  - Geographic region
  - Fertility and Mortality Trends
  - Rate of population increase
  - Birth rates, death rates, Total fertility rates
  - Age Structure and dependency burdens

Table 6.3 Fertility Rate for Selected Countries, 1970 and 2009

<table>
<thead>
<tr>
<th>Country</th>
<th>Total Fertility Rate 1970</th>
<th>Total Fertility Rate 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>7.0</td>
<td>2.3</td>
</tr>
<tr>
<td>Colombia</td>
<td>5.3</td>
<td>2.5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>5.3</td>
<td>2.4</td>
</tr>
<tr>
<td>Jamaica</td>
<td>5.3</td>
<td>2.4</td>
</tr>
<tr>
<td>Mexico</td>
<td>4.9</td>
<td>2.3</td>
</tr>
<tr>
<td>Thailand</td>
<td>5.5</td>
<td>1.8</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>7.7</td>
<td>3.6</td>
</tr>
</tbody>
</table>

The Hidden Momentum of Population Growth
- High birth rates cannot be altered overnight
- Age structure of developing country populations

Figure 6.4 Population Pyramids: All Developed and Developing Countries and Case of Ethiopia

The Demographic Transition
Stage I: High birthrates and death rates
Stage II: Continued high birthrates, declining death rates
Stage III: Falling birthrates and death rates, eventually stabilizing

Figure 6.5 The Demographic Transition in Western Europe

Figure 6.6 The Demographic Transition in Developing Countries

The Causes of High Fertility in Developing Countries: The Malthusian and Household Models

The Malthusian Population Trap
- The idea that rising population and diminishing returns to fixed factors result in a low levels of living (population trap)

Figure 6.7 The Malthusian Population Trap

Criticisms of the Malthusian Model
- Impact of technological progress
- Currently no positive correlation between population growth and levels of per capita income in the data
- Microeconomics of family size; individual and not aggregate variables

Figure 6.8 How Technological and Social Progress Allows Nations to Avoid the Population Trap

The Microeconomic Household Theory of Fertility: The Demand for Children in Developing Countries
- First two or three as “consumer goods”
- Additional children as “investment goods”:
  - Work on family farm, microenterprise
  - Old age security motivation

Figure 6.9 Microeconomic Theory of Fertility: An Illustration
Some empirical evidence: Implications. Fertility lower if
- Raise women’s education, role, and status
- More female nonagricultural wage employment
- Rise in family income levels
- Reduction in infant mortality
- Development of old-age and social security
- Expanded schooling opportunities

The Consequences of High Fertility: Some Conflicting Perspectives
Population growth: “It’s Not a Real Problem”: The real problem is not population growth but the following,
1. Underdevelopment
2. World resource depletion and environmental destruction
3. Population Distribution
4. Subordination of women

Overpopulation is a Deliberately Contrived False Issue. Population Growth is a Desirable Phenomenon.
“Population Growth Is a Real Problem”
- Extremist arguments
- Theoretical arguments
- Empirical arguments
  1. Lower economic growth
  2. Poverty
  3. Adverse impact on education
  4. Adverse impact on health
  5. Food issues
  6. Impact on the environment
  7. Frictions over international migration

Goals and Objectives: Toward a Consensus
Despite the conflicting opinions, there is some common ground on the following:
- Population is not the primary cause of lower living levels, but may be one factor
- Population growth is more a consequence than a cause of underdevelopment
- It’s not numbers but quality of life
- Market failures: potential negative social externalities
- Voluntary decreases in fertility is generally desirable for most developing countries with still-expanding populations

Some Policy Approaches
- Attend to underlying socioeconomic conditions that impact development
- Family planning programs should provide education and technological means to regulate fertility
- Developed countries have responsibilities too

What Developing Countries Can Do
- Persuasion through education
- Family planning programs
- Address incentives and disincentives for having children through the principal variables influencing the demand for children
- Coercion is not a good option
- Raise the socioeconomic status of women
- Increase employment opportunities for women (increases opportunity cost of having more children, as in microeconomic household theory)
- Address resources use inequities
- More open migration policies

How Developed Countries Can Help Developing Countries with Their Population Programs
- Research into technology of fertility control
- Financial assistance for family planning programs

CHAPTER 7
URBANIZATION AND RURAL URBAN MIGRATION: THEORY AND POLICY

The Migration and Urbanization Dilemma
As a pattern of development, the more developed the economy, the more urbanized. But many argue developing countries are often excessively urbanized or too rapidly urbanizing. This combination suggests the migration and urbanization dilemma. Urbanization: Trends and Projections

Figure 7.1 Urban Population and Per Capita Income across Selected Countries

Figure 7.2 Urbanization across Time and Income Levels

Figure 7.3 Proportion of Urban Population by Region, 1950-2050

Figure 7.4 Megacities: Cities with Ten Million or More Inhabitants
Industrial Districts and Clustering

Quality of clusters, or Industrial Districts, is a key to sectoral efficiency. Unfortunately, a majority of developing countries have made only limited progress. China: a country that has made huge strides in generating industrial districts over the last decade (Findings Box 7.1).

Urbanization Costs, and Efficient Urban Scale

But, cities also entail "congestion costs". Economically efficient urban scale (from point of view of productive efficiency) found were average costs for industries are lowest. Generally, differing efficient scales for different industrial specializations imply different city sizes. More extensive (expensive) capital infrastructure required in urban areas. Smaller cities may be expected in labor-intensive developing countries.

The Urban Giantism Problem

There may be general urban bias. Cities are capital intensive so may expect large cities commonly located in developed countries. But urbanization in developing countries has taken place at unexpectedly rapid pace. Huge informal sectors in shantytowns, favelas. Large fraction of workers outside formal sector. Much urban growth is in mid-size cities, but urban bias remains a serious issue in many developing countries.

Causes of Urban Giantism:
- Import substitution industrialization: less trade, incentive to concentrate in a single city largely to avoid transportation costs
- "Bread and circuses" to prevent unrest (evidence: stable democracies vs unstable dictatorships)
- Hub and spoke transportation system (rather than web) makes transport costs high for small cities
- Compounding effect of locating the national capital in the largest city

Table 7.1 Population of the Largest and Second-Largest Cities in Selected Countries (millions)

<table>
<thead>
<tr>
<th>Country</th>
<th>Largest-City Population</th>
<th>Second-Largest-City Population</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>Toronto, 5.403M</td>
<td>Montreal, 3.963</td>
<td>1.40</td>
</tr>
<tr>
<td>United States</td>
<td>New York, 18.727M</td>
<td>Los Angeles, 12.303M</td>
<td>1.52</td>
</tr>
<tr>
<td>Argentina</td>
<td>Buenos Aires, 12.551M</td>
<td>Cordoba, 1.423</td>
<td>8.79</td>
</tr>
<tr>
<td>Brazil</td>
<td>Sao Paulo, 18.817M</td>
<td>Rio de Janeiro, 11.168M</td>
<td>1.64</td>
</tr>
<tr>
<td>Chile</td>
<td>Santiago, 3.865M</td>
<td>Valparaiso, 0.837</td>
<td>4.61</td>
</tr>
<tr>
<td>Mexico</td>
<td>Mexico City, 18.735M</td>
<td>Guadalajara, 4.067</td>
<td>4.62</td>
</tr>
<tr>
<td>Peru</td>
<td>Lima, 8.081M</td>
<td>Arequipa, 0.732</td>
<td>11.94</td>
</tr>
</tbody>
</table>

The Urban Informal Sector

Why promote the urban informal sector?
- Generates surplus despite hostile environment
- Creating jobs due to low capital intensity
- Access to (informal) training, and apprenticeships
- Creates demand for less- or un-skilled workers
- Uses appropriate technologies, local resources
- Recycling of waste materials
- More benefits to poor, especially women who are concentrated in the informal sector

Table 7.2 Importance of Informal Employment in Selected Cities

<table>
<thead>
<tr>
<th>Category</th>
<th>Stability</th>
<th>Unstable</th>
<th>Stable</th>
<th>Unstable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Democracy</td>
<td>23%</td>
<td>33%</td>
<td>30%</td>
<td>37%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Figure 7.5 Estimated and Projected Urban and Rural Population of the More and Less Developed Regions, 1950-2050

Figure 7.6 Annual Growth of Urban and Slum Populations, 1990-2001

The Role of Cities

Agglomeration economies: Urbanization (general) economies, localization (industry or sector) economies. Saving on firm-to-firm, firm-to-consumer transportation. Firms locating near workers with skills they need. Workers locating near firms that need their skills. Firms benefit from (perhaps specialized) infrastructure. Firms benefit from knowledge spillovers in their and related industries. (Also: consumers may benefit from urban amenities.)

Figure 7.7 Politics and Urban Concentration

Figure 7.8 Importance of Informal Employment in Selected Cities
Migration and Development
Rural-to-urban migration was viewed positively until recently. The current view is that this migration is greater than the urban areas’ abilities to
- Create jobs
- Provide social services

Toward an Economic Theory of Rural-Urban Migration
A Verbal Description of the Todaro Model
- Migration is a rational decision
- The decision depends on expected rather than actual wage differentials
- The probability of obtaining a city job is inversely related to the urban unemployment rate
- High rates of migration are outcomes of rural urban imbalances

A Diagrammatic Presentation

Figure 7.11 Schematic Framework for Analyzing the Rural-to-Urban Migration Decision

Figure 7.12 The Harris-Todaro Migration Model

Toward an Economic Theory of Rural-Urban Migration

$$W_A = \frac{I_M}{L_{US}} (\bar{W}_M)$$

Where
- $W_A$ is agricultural income;
- $I_M$ is employment in manufacturing;
- $L_{US}$ is total urban labor pool;
- $W_M$ is the urban minimum wage

Five Policy Implications
1. Reduction of urban bias
2. Imbalances in expected income opportunities is crucial
3. Indiscriminate educational expansion fosters increased migration and unemployment
4. Wage subsidies and scarcity factor pricing can be counterproductive
5. Programs of integrated rural development should be encouraged

Summary and Conclusions: A Comprehensive Migration and Employment Strategy
1. Create a urban-rural balance
2. Expand small-scale, labor intensive industries
3. Eliminate factor price distortions
4. Choose appropriate labor-intensive technologies of production
5. Modify the linkage between education and employment
6. Reduce population growth
7. Decentralize authority to cities and neighborhoods

Figure 7.10 Components of Migration in Selected Countries
CHAPTER 8
HUMAN CAPITAL: EDUCATION AND HEALTH IN ECONOMIC DEVELOPMENT

The Central Roles of Education and Health
Health and education are important objectives of development, as reflected in Amartya Sen’s capability approach, and in the core values of economic development. Health and education are also important components of growth and development – inputs in the aggregate production function.

Education and Health as Joint Investments for Development
These are investments in the same individual. Greater health capital may improve the returns to investments in education:
- Health is a factor in school attendance
- Healthier students learn more effectively
- A longer life raises the rate of return to education
- Healthier people have lower depreciation of education capital

Greater education capital may improve the returns to investments in health:
- Public health programs need knowledge learned in school
- Basic hygiene and sanitation may be taught in school
- Education needed in training of health personnel

Improving Health and Education: Why Increasing Incomes Is Not Sufficient
Increases in income often do not lead to substantial increases in investment in children’s education and health. But better educated mothers tend to have healthier children at any income level. Significant market failures in education and health require policy action.

Investing in Education and Health: The Human Capital Approach
Initial investments in health or education lead to a stream of higher future income. The present discounted value of this stream of future income is compared to the costs of the investment. Private returns to education are high, and may be higher than social returns, especially at higher educational levels.

Table 8.1 Sample Rates of Return to Investment in Education by Level of Education, Country, Type, and Region

<table>
<thead>
<tr>
<th>Country and Region</th>
<th>Social Rate of Return (%)</th>
<th>Private Rate of Return (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developing</td>
<td>Primary</td>
<td>Secondary</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>24</td>
<td>18</td>
</tr>
<tr>
<td>Asia</td>
<td>26</td>
<td>13</td>
</tr>
<tr>
<td>Latin America</td>
<td>18</td>
<td>13</td>
</tr>
<tr>
<td>Developing</td>
<td>Primary</td>
<td>Secondary</td>
</tr>
<tr>
<td></td>
<td>14</td>
<td>10</td>
</tr>
</tbody>
</table>

Child Labor
Child labor is a widespread phenomenon. The problem may be modeled using the “multiple equilibria” approach. Government intervention may be called for to move to a “better” equilibrium. Sometimes this shift can be self-enforcing, so active intervention is only needed at first.

Assumptions of the Child Labor Multiple Equilibria Model
- Luxury Axiom: A household with sufficiently high income would not send its children to work.
- Substitution Axiom: Adult and child labor are substitutes (perfect substitutes in this model), in which the quantity of output by a child is a given fraction of that of an adult:
  \[ QC = yQA, 0 < y < 1. \]

The Gender Gap: Discrimination in Education and Health
Young females receive less education than young males in nearly every low and lower-middle income developing country.

Closing the educational gender gap is important because:
- The social rate of return on women’s education is higher than that of men in developing countries
- Education for women increases productivity, lowers fertility
- Educated mothers have a multiplier impact on future generations
- Education can break the vicious cycle of poverty and inadequate schooling for women
- Good news: Millennium Development Goals on parity being approached, progress in every developing region

Figure 8.1 Age-Earnings Profiles by Level of Education: Venezuela

Figure 8.2 Financial Trade-Offs in the Decision to Continue in School

Figure 8.3 Child Labor as a Bad Equilibrium

Other approaches to child labor policy
1. Get more children into school (as in Millennium Development Goals), e.g. new village schools; and enrollment incentives for parents such as in Progresa/ Oportunidades
2. Consider child labor an expression of poverty, so emphasize ending poverty generally (a traditional World Bank approach, now modified)
3. If child labor is inevitable in the short run, regulate it to prevent abuse and provide support services for working children (UNICEF approach)
4. Ban child labor; or if impossible, ban child labor in its most abusive forms (ILO strategy; “Worst Forms of Child Labor Convention”)
5. Activist approach: trade sanctions. Concerns: could backfire when children shift to informal sector; and if modern sector growth slows

The Gender Gap: Discrimination in Education and Health

Muhammad Firman (University of Indonesia - Accounting)
Figure 8.4 Youth Literacy Rate, 2008

Consequences of gender bias in health and education
- Economic incentives and their cultural setting
- "Missing Women" mystery in Asia

Increase in family income does not always lead to better health and education.

Figure 8.5 Female-Male Ratios in Total Population in Selected Communities

Educational Systems and Development
The Political Economy of Educational Supply and Demand: The Relationship between Employment Opportunities and Educational Demands. Social versus Private Benefits and Costs

Figure 8.6 Private versus Social Benefits and Costs of Education: An Illustration

Figure 8.7 Lorenz Curves for Education in India and South Korea

Figure 8.8 Gini Coefficients for Education in 85 Countries

Educational supply and demand: the relationship between employment opportunities and educational demands:
- Social versus private benefits and costs
- Distribution of education
- Education, inequality, and poverty
- Education, internal migration, and the brain drain

Health Measurement and Distribution
World Health Organization (WHO): The key United Nations agency concerned with global health matters.

Figure 8.9 Life Expectancy in Various World Regions

Figure 8.10 Under-5 Mortality Rates in Various World Regions

Figure 8.11 Deaths of Children under Age 5
Figure 8.12A Children’s Likelihood to Die in Selected Countries

Figure 8.12B Proportion of Under-Five Children Who Are Underweight, by Household Wealth, around 2008

Disease Burden
1. HIV/AIDS
2. Malaria
3. Parasitic Worms and Other “Neglected Tropical Diseases”

Figure 8.13 Proportion of Children under 5 Who Are Underweight, 1990 and 2005

Table 8.2 Regional HIV and AIDS Statistics, 2009

Table 8.3 The Major Neglected Tropical Diseases, Ranked by Prevalence

Health, Productivity, and Policy
Productivity: Is there a connection?
Health Systems Policy: Great variability in the performance of health systems at each income level

Figure 8.14 Wages, Education, and Height of Males in Brazil and the United States

Figure 8.15 GNI Per Capita and Life Expectancy at Birth, 2002
The Imperative of Agricultural Progress and Rural Development

The heavy emphasis in the past on rapid industrialization may have been misplaced. Agricultural development is now seen as an important part of any development strategy. Three complementary elements of an agriculture and employment-based strategy:
- Accelerated output growth
- Rising domestic demand for agricultural output
- Non-agricultural rural labor intensive rural development activities that are supported by the farming community

Agricultural Growth: Past Progress and Current Challenges

Although agriculture employs the majority of the developing country labor force, it accounts for a much lower share of total output. Agricultural production is rising but unevenly.

Figure 9.1 As Countries Develop, the Shares of GDP and Labor in Agriculture Tend to Decline, but with Many Idiosyncrasies

Malnutrition and famine inspire calls for a new green revolution focused on Africa. Food price spike of 2007-2008 partly due to short term factors but long term factors may herald return to persistently higher food prices in the years ahead. New upward spike of prices by early 2011. The presence of market failures and poverty alleviation goals - create need for constructive government role in agriculture

Roles for Government in Agricultural Development
1. Environmental externalities
2. Agricultural research and extension services
3. Economies of scale in marketing
4. Informational asymmetries in product quality
5. Providing institutions and infrastructure
6. Ensure shared growth in agriculture sector
7. Addressing poverty traps

The Structure of Agrarian Systems in the Developing World

Three systems of agriculture:
- Agriculture based countries, often subsistence, but agriculture makes up large part of growth. Transforming countries, most of world’s rural people, large % of poverty incidence found there, low contribution of agriculture to growth. Urbanized countries, half or more even of the poor found in urban areas. The trend is from agriculture-based, to transforming, to urbanized economies as illustrated with the cases of India, China, Indonesia, and Brazil in Fig. 9.3

Table 9.1 Land Productivity in Developed and Developing Countries

Peasant Agriculture in Latin America, Asia, and Africa
- Latin America and Asia: similarities and differences
- The Latifundio–Minifundio dualistic pattern in Latin America
- The fragmented and heavily congested dwarf land holdings in Asia
- Africa: extensive cultivation patterns

Table 9.2 Distribution of Farms and Farmland by Operational Farm Size and Land Tenure Status In Selected Developing Countries in Asia and Latin America

Table 9.3 Changes in Farm Size and Land Distribution
Transforming Economies: Problems of Fragmentation and Subdivision of Peasant Land in Asia

Impact of colonial rule in strengthening land tenure systems of private property rights and the consequent rise of moneylenders. Contemporary landlordism in India and Pakistan involves absentee landlordism and persistence of sharecroppers and tenant farmers. Rapid population growth resulted in more fragmentation and peasant impoverishment.

Agrarian Patterns in Latin America: Progress and Remaining Poverty Challenges

Apart from latifundios (large holdings) and minifundios (small farms) much production occurs on family farms and medium sized farms. Latifundios (traditional ones, especially) are relatively inefficient; landlords/owners are sometimes less focused on the business of farming; and large farms typically entail higher transaction costs. Overall the agricultural sector seems to be doing well in many Latin American countries. Two prominent examples: Chile (diversification), and Brazil (biofuels). Extreme rural inequalities still persist.

Subsistence Agriculture and Extensive Cultivation in Africa

- Low productivity due to lack of technology
- Shifting Cultivation
- High dependence on unimproved seeds sown on unfertilized, rain-fed fields
- Relatively high fraction of underutilized land
- High concern about climate change impact
- Need for an African new green revolution, there are hopeful signs that it is getting underway

The Important Role of Women

Women provide 60% to 80% of agricultural labor in Africa and Asia, and 40% in Latin America. Women work longer hours than men. Government assistance programs tend to reach men, not women.

Figure 9.4 Expansion of Modern Inputs in the World’s Developing Regions

The Microeconomics of Farmer Behavior and Agricultural Development

Subsistence farming: risk aversion, uncertainty, and survival

Traditional neoclassical model of profit maximization with certainty is not adequate. Price, weather, and other uncertainty, along with limited access to credit and insurance (and even savings vehicles), largely explains the extent of risk-averse behaviors observed. Risk-averse subsistence farmers (often not irrationally) can prefer technologies that combine low mean-perhectare with low variance to alternative high yielding but higher risk technologies. Efforts to minimize risk and remove commercial and institutional obstacles to small farmer innovation are necessary.
Environment and Development: The Basic Issues

Environmental issues affect, and are affected by, economic development. Classic market failures lead to too much environmental degradation. Poverty and lack of education may also lead to non-sustainable use of environmental resources. Global warming and attendant climate change is a growing concern in developing countries. Sustainable development and environmental accounting

Sustainable development has been defined as “meeting the needs of present generation without compromising the wellbeing of future generations”. So, running down the capital stock is not consistent with the idea of sustainability. Environmental and other forms of capital are substitutes only to a degree; eventually they likely act as complements. In developing countries, environmental capital is generally a larger fraction of total capital. To know whether environmental capital is increasing or decreasing, we need environmental accounting

Sustainable net national product is:

\[ \text{NNI} = \text{GNI} - D_m - D_n \]

Where
- \( \text{NNI} \) is sustainable national income
- \( \text{GNI} \) is Gross national income
- \( D_m \) is the depreciation of manufactured capital assets
- \( D_n \) is the depreciation of environmental capital

More expansively, sustainable net national product is:

\[ \text{NNI}^{**} = \text{GNI} - D_m - D_n - R - A \]

Where
- \( \text{NNI}^{**} \) is the revised NNI calculation
- \( \text{GNI}, D_m, \text{and} D_n \) are defined as before
- \( R \) is expenditure needed to restore environmental capital
- \( A \) is expenditure required to avert destruction of environmental capital

(Note: \( R \) and \( A \) are components of GNI but not \( \text{NNI}^{**} \))

The poor as both agents and victims of environmental degradation

Victims:
- The poor live in environmentally degraded lands which are less expensive because the rich avoid them
- People living in poverty have less political clout to reduce pollution where they live
- Living in less productive polluted lands gives the poor less opportunity to work their way out of poverty

Agents:
- The high fertility rate of people living in poverty
- Short time horizon of the poor (by necessity)
- Land tenure insecurity
- Incentives for forest resettlement

Environment and Development: The Basic Issues
1. Sustainable development and environmental accounting
2. Population, resources, and the environment
3. Poverty and the environment
4. Growth versus the environment
5. Rural development and the environment
6. Urban development and the environment
7. The global environment and economy
8. Nature and pace of Greenhouse Gas-Induced Climate change
9. Natural Resource-Based Livelihoods as a pathway out of poverty: Promise and Limitations

Natural Resource Based Livelihoods: Pathways Out of Poverty?

In low income countries, high dependence on natural resources: agriculture, animal husbandry, fishing, forestry, hunting, foraging. But access to the benefits of resources often very inequitable. Poor losing control of natural resource commons areas. Many poor lose farmland, forests, cattle, boats and equipment. Common village lands may be “spontaneously” privatized. Governments overlook, logging, fishing, and mining, without regard to local people or traditional rights. Governments designate lands “protected,” banning livelihoods, while corruption remains; no incentive to take part in protection. A solution: “pro-poor governance” – empowerment of the poor

The Scope of Domestic-Origin Environmental Degradation: An Overview

Environmental problems have consequences both for health and productivity
- Loss of agricultural productivity
- Prevalence of unsanitary conditions created by lack of clean water and sanitation
- Dependence on biomass fuels and pollution
- Airborne pollutants

Rural Development and the Environment: A Tale of Two Villages

Representative African village
- Desertification
- Low opportunity cost of women’s time encourages waste

Representative South American village
- Soil erosion
- Deforestation

Global Warming and Climate Change: Scope, Migration, and Adaptation


Some impacts of climate change in Developing Countries identified by IPCC
- Prolonged droughts, expanded desertification
- Increased severity of storms with heavy flooding and erosion
- Longer and more severe heat waves
- Reduced summer river flow and water shortages
- Decreased grain yields
- Climate-induced spreading ranges of pests and disease
- Lost and contaminated groundwater
- Deteriorated freshwater lakes, coastal fisheries, mangroves, coral reefs
- Coastal flooding
- Loss of essential species such as pollinators and soil organisms, forest and crop fires

Global Warming and Climate Change: Scope, Migration, and Adaptation

Problem primarily but not exclusively caused by developed countries
- Rapid industrial growth especially in Asia
- Deforestation in developing countries

Strategies for mitigation
- Taxes on carbon
- Caps on greenhouse gases (with “carbon markets”)
- Subsidies to encourage technological progress

Types of adaptation
- Planned (or “policy”) adaptation
- Autonomous adaptation (some types are reviewed in Box 10.1)

Economic Models of Environmental Issues
1. Privately owned resources
2. Inefficiencies result from imperfections in property rights

Perfect property rights are characterized by
- Universality
- Exclusivity or Excludability
- Transferability
- Enforceability

Figure 10.1 Static Efficiency in Resource Allocation

Allocational efficiency
Equate PV of marginal net benefits of last unit consumed in each period. That is, for allocational efficiency, consumer must be indifferent between

Muhammad Firman (University of Indonesia - Accounting)
Consuming last unit in this period or in another period

Figure 10.2 Optimal Resource Allocation over Time

**Common property resources**
- Inefficiencies may arise because resource is not privately owned
- Traditional models do not concern themselves with equity and income distribution
- Family farmers can benefit from extended tenancy or ownership
- Who should buy publicly owned land

Figure 10.3 Common Property Resources and Misallocation

**Understanding the tragedy of the Commons**
Users fail to take account of an externality: that as each uses more of the common resource the average return is lowered for other users. Traditional societies have sometimes responded effectively with social enforcement mechanisms.

**Elinor Ostrom’s Common Property Design Principles Derived from Empirical Studies**
- Clearly Defined Boundaries of the resource system
- Proportional equivalence between benefits and costs for users
- Collective-choice arrangements including those affected
- Monitoring, with those who audit accountable to users
- Graduated Sanctions
- Conflict-resolution mechanisms
- Recognition of rights to organize
- Nested enterprises when resources are parts of larger systems

Public goods and bads: regional environmental degradation and the freerider problem
- Internalization of externalities is not easy
- Free rider problems

Limitations of the public goods framework
- Pricing mechanism

Figure 10.4 Public Goods, Private Goods, and the Free-Rider Problem

**Urban Development and the Environment**
Environmental Problems of Urban Slums
- Health threatening pollutants
- Unsanitary environmental conditions
- Serious impact on poor

Industrialization and urban air pollution
- Environmental Kuznets curve
- Pollution tax
- Absorptive capacity of the environment
- Severity of industrial pollution- impact on health

Figure 10.5 Pollution Externalities: Private versus Social Costs and the Role of Taxation

Problems of congestion, Clean water, and Sanitation
- High health and economic costs associated
- Drag on development
- Impact on poor
- Private wells have led to land subsidence and flooding
- Impact on export earnings

The Local and Global Costs of Rain Forest Destruction
Rainforest loss contributes to global warming. Loss of biodiversity. Loss of livelihoods for people living in poverty who depend upon them. Much waste in the process of forest clearing. Thus, rainforest preservation (and restoration) is a global public good - a restorative mechanism for the environment. Sustainable management of rain forests is a priority. Provide funds, debt relief to help enhance biodiversity. In addition, support for forest preservation as climate change mitigation

Policy Options in Developing and Developed Countries

What Developing Countries can do
1. Proper resource pricing
2. Community involvement
3. Clearer property rights and resource ownership
4. Improved economic alternatives for the poor
5. Improved economic status of women
6. Investments that yield returns regardless of the shape of climate change, such as a better road network
7. Industrial emissions abatement policies
8. Proactive stance toward adapting to climate change

How developed countries can help developing countries
1. Lower developing country costs for environmental preservation
2. Trade policies: reduce barriers, subsidies
3. Debt relief and debt for nature swaps
4. Development assistance

What developed countries can do for the global environment
1. Emissions controls, including greenhouse gases
2. Research and Development on green technology and pollution control
3. Transfer of technology to developing countries
4. Restrictions on unsustainable production

A Question of Balance

Roles and Limitations of State, Market, and the Citizen Sector/NGOs in Achieving Economic Development and Poverty Reduction

Development Planning: Concepts and Rationale

The Planning Mystique

In the past, few doubted the importance and usefulness of national economic plans. Recently, however, disillusionment has set in – But a comprehensive development policy framework can play an important role in accelerating growth and reducing poverty

Development Planning: Concepts and Rationale

The nature of development planning resource mobilization for public investment. Economic policy to control private economic activity according to social objectives formulated by government. Planning in mixed developing economies. Private sector in mixed economies comprises:

- The subsistence sector
- Small scale businesses
- Medium size enterprises
- Larger domestic firms
- Large joint or foreign owned enterprises

The Rationale for Development Planning

- Market failure
- Resource mobilization and allocation
- Attitudinal or psychological impact
- Requirement to receive foreign aid

Three General Forms of Market Failure

The market cannot function properly or no market exists. The market exists but implies inefficient resource allocation. More expansively: the market produces undesirable results as measured by social objectives other than the allocation of resources. Often items such as more equal income distribution, and “merit goods” such as health, are treated as separate rationales for policy, outside of economic efficiency

Market Failure

Market failures can occur when social costs or benefits differ from private costs or benefits of firms or consumers. Market power (monopolistic, monopolonopistic)

- Public goods: free riders cannot be excluded except possibly at high cost
- Externalities: agents do not have to pay all costs of their activities, or are unable to receive all the benefits

Prisoners’ Dilemmas occur when agents better off if others cooperate but individual agents better off “defecting”. Coordination failures can occur when coordination is costly; e.g. with Big Push problems (Chapter 4). Capital markets are particularly prone to failure

Market and Government Failure: Broader Arguments

Government failure: in many cases, politicians and bureaucrats can be considered utility maximizers, not public interest maximizers. So can’t jump to conclusion that if economic theory says policy can fix market failures that it will do so in practice. Analysis of incentives for government failure guides reform, e.g. civil service reform, constitution design. Developing countries tend to have both high market failure and high government failures

The Development Planning Process: Some Basic Models

Characteristics of the planning process

Planning in stages: basic models
- Aggregate growth models
- Multisector-input-output, social accounting, and CGE models

Three stages of planning
- Aggregate
- Sectoral
- Project

Aggregate Growth Models: Projecting Macro Variables

\[ K(t) = cY(t) \]  

Where

- \( K(t) \) is capital stock at time t
- \( Y(t) \) is output at time t
- \( c \) is the average and marginal capital-output ratio

\[ I(t) = K(t+1) - K(t) + cK(t) = sY - S(t) \]  

Where

- \( I(t) \) is gross investment at time t
- \( s \) is the savings rate
- \( S \) is national savings
- \( \delta \) is the depreciation rate

If \( g \) is the targeted rate of output growth, then

\[ g = \frac{Y(t+1) - Y(t)}{Y(t)} \]

\[ \frac{\Delta K}{K} = \frac{\Delta Y}{Y} = \frac{\Delta Y}{Y} \]

\[ g = \frac{sY - \delta K}{K} = \frac{s}{c} - \delta \]

\[ W + \pi = Y \]

Where \( W \) and \( \pi \) are wage and profit incomes

\[ s_Y \pi + s_{W} W = I \]

Where \( s_Y \) and \( s_W \) are the marginal propensities to save from wage income and profit

\[ c'(g + \delta) = (s_y - s_w)(\pi) + s_F \]

The Development Planning Process: Some Basic Models

1. Multisector Models and Sectoral Projections
2. Interindustry or input-output models

Can be extended in 2 ways
- SAM models where data from national accounts, BOP, and flow-of-funds databases is supplemented with household survey data.
- CGE models where utility and production functions are estimated and impacts of policies are simulated.

Project Appraisal and Social Cost-Benefit Analysis

Basic concepts and methodology
- Specify objective function
- Compute social measures (shadow prices)
- Establish decision criterion

Muhammad Firman (University of Indonesia - Accounting)
Computing shadow prices and social discount rates
– Calculating the social rate of discount or social time preference

\[ NPV = \sum_{t=0}^{T} \frac{B_t - C_t}{(1+r)^t} \]  \hspace{1cm} (11.10)

Where

\( B_t \) is the expected benefit at time \( t \)
\( C_t \) is the expected cost at time \( t \)
\( r \) is the social rate of discount used

Choosing projects: some decision criteria
– NPV rule
– Compare the internal rate of return with an interest rate

Conclusions: planning models and plan consistency

Government Failure and Preferences for Markets over Planning
– The 1980s policy shift toward free markets
– Problems of Plan Implementation and Plan Failure
– Theory versus practice
– Deficiencies in the plans and their implementation
– Insufficient and or unreliable data
– Unanticipated economic disturbances, external and internal
– Institutional weaknesses
– Lack of political will
– Conflict, post-conflict, and fragile states

Potential problems of government intervention in developing countries
– Individuals know more about their preferences, circumstances
– Government may increase risks by pointing all in same direction
– Government may be more rigid and inflexible in decision making
– Governments lack capabilities to administer detailed plans
– Bureaucratic obstacles may block private sector initiative
– Hard to replicate market incentive system within governments
– Different parts of government may be poorly coordinated
– Black markets place constraints on government
– Controls create incentives for rent seeking
– Planning may be manipulated by narrow, privileged groups

The Market Economy
Well functioning market economy requires
– Clear property rights
– Laws and courts
– Freedom to establish business
– Stable currency
– Public supervision of natural monopolies
– Provision of adequate information
– Autonomous tastes
– Public management of externalities
– Stable monetary and fiscal policy instruments
– Safety nets
– Encouragement of innovation

The "Washington Consensus" on the Role of the State in Development and its Limitations. The consensus reflected a free market approach to development espoused by the IMF, the World Bank, and key U.S. government agencies.

The Washington Consensus on the Role of the State in Development and Its Subsequent Evolution
Towards a new consensus
– New emphasis on government’s responsibility toward poverty alleviation and inclusive growth
– Provision of fundamental public goods
– Importance of health and education
– A recognition that markets can fail
– Governments can help secure conditions for an effective market based economy

Development Political Economy: Theories of Policy Formulation and Reform
– Understanding voting patterns on policy reform
– Institutions and path dependency
– Democracy versus autocracy: which facilitates faster growth?
– Role of NGOs in development and the broader citizen sector

Development Roles of NGOs and the Broader Citizen Sector
Potentially important roles in:
– Common property resource management
– Local public goods
– Economic and productive ideas

Possibly other activities that are either:
– Excludable but not rival
– Rival but not excludable
– Partly excludable and partly rival

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Figure 11.1 Global Trends in Governance, 1946-2008

Development Roles of NGOs and the Broader Citizen Sector
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– Democracy versus autocracy: which facilitates faster growth?
– Role of NGOs in development and the broader citizen sector

Figure 11.2 Typology of Goods

Figure 11.3 Corruption as a Regressive Tax: The Case of Ecuador
Globalization: An Introduction
Core economic meaning— the increased openness of economies to international trade, financial flows, and foreign direct investment. Concerns with globalization center around the unevenness of the process, and risks

International Trade: Some Key Issues
Many developing countries rely heavily on exports of primary products with attendant risks and uncertainty. Many developing countries also rely heavily on imports (typically of machinery, capital goods, intermediate producer goods, and consumer products). Many developing countries have chronic deficits on current and capital accounts which depletes their reserves, causes currency instability, and may slow economic growth. Recently many developing countries sought to promote exports and accumulate large foreign exchange reserves to cushion against crises—spurring new policy debates

Five Basic Questions about Trade and Development
1. How does international trade affect economic growth?
2. How does trade alter the distribution of income?
3. How can trade promote development?
4. Can developing countries determine how much they trade?
5. Is an outward-looking or an inward-looking trade policy best?

The Importance of Exports to Different Developing Nations. Importance of exports to developing nations. Exports of developing countries are generally less diversified than those of developed countries. Merchandise exports as a share of GDP are often higher for developing countries

Demand Elasticities and Export Earning Instability
Other low price elasticity of demand for agricultural commodities but supply shocks. Other low price elasticity of supply for basic commodities but demand shocks. Result can be export earnings instability; risks to income. Also, low income elasticity of demand for primary products:

The Terms of Trade and the Prebisch-Singer Hypothesis
Total export earnings depend upon:
– Total volume of exports sold, and,
– Price paid for exports

Prebisch and Singer argued commodity export prices fall over time, so developing countries lose revenue unless they can continually increase export volumes. They concluded that developing countries need to avoid dependence on primary exports. Some evidence relative prices within manufactures are also diverging with falling prices for low-skill products

The Traditional Theory of International Trade
Comparative advantage, specialization. Relative factor endowments and international specialization: the Neoclassical model—Ricardo and Mill (static model)—Heckscher and Ohlin (factor endowment theory)

Different products require productive factors in different ratios. Countries have different endowments of factors of production

Table 12.1 Merchandise Exports in Perspective: Selected Countries, 2008

<table>
<thead>
<tr>
<th>Country Name</th>
<th>Merchandise Exports (current $ millions of U.S. $)</th>
<th>GDP (current $ millions of U.S. $)</th>
<th>Merchandise Exports as a Share of GDP (%)</th>
<th>Manufactures Exports (% of merchandise exports)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developing countries</td>
<td>Malaysia: 190,348</td>
<td>221,773</td>
<td>90</td>
<td>54</td>
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<td></td>
<td>Kenya: 80,100</td>
<td>113,114</td>
<td>90</td>
<td>54</td>
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<td></td>
<td>China: 1,204,010</td>
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<td></td>
<td>Mexico: 93,427</td>
<td>314,159</td>
<td>90</td>
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<td></td>
<td>Philippines: 45,115</td>
<td>160,309</td>
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<td></td>
<td>Indonesia: 193,381</td>
<td>316,229</td>
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<td></td>
<td>Japan: 210,180</td>
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<td>United Kingdom: 81,994</td>
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<td>97</td>
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<td></td>
<td>Germany: 4,572</td>
<td>55,555</td>
<td>86</td>
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<td>Italy: 2,340</td>
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<td>86</td>
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<td>India: 179,023</td>
<td>1,572,877</td>
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<td></td>
<td>Brazil: 285,016</td>
<td>1,670,363</td>
<td>85</td>
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<tr>
<td></td>
<td>Belgium: 452,813</td>
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<tr>
<td></td>
<td>Portugal: 762,117</td>
<td>1,590,610</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td></td>
<td>Australia: 1,391,132</td>
<td>14,901,151</td>
<td>9</td>
<td>24</td>
</tr>
</tbody>
</table>

Figure 12.1 Trade with Variable Factor Proportions and Different Factor Endowments
(a) Less Developed World (without trade, production and consumption occur at \( A \) with trade, production is at \( B \), consumption is at \( C \) exports = \( BD \); imports = \( DC \))
(b) Rest of World (without trade, production and consumption occur at \( A \) with trade, production is at \( A' \), consumption is at \( C' \) exports = \( B'D' \); imports = \( D'C' \))

Main conclusion of the neoclassical model is that all countries gain from trade. World output increases with trade. Countries will tend to specialize in products that use their abundant resources intensively. International wage rates and capital costs will gradually tend toward equalization.
Returns to owners of abundant resources will rise relatively. Trade will stimulate economic growth

Trade theory and Development: The Traditional Arguments
- Trade stimulates economic growth
- Trade promotes international and domestic equality
- Trade promotes and rewards sectors of comparative advantage
- International prices and costs of production determine trading volumes
- Outward-looking international policy is superior to isolation

Critique of Traditional Free-Trade Theory, in the Context of Developing-Country Experience
The following assumptions of the basic Neoclassical model have been scrutinized:
- Fixed resources, full employment, international factor immobility. And fixed, freely available technology and consumer sovereignty vs product cycle, ongoing development of synthetic substitutes for developing countries exports, and opportunities for dynamic gains in leading sectors. Internal factor mobility vs different types of structural rigidities; and perfect competition vs pervasive market power. Governmental non-interference in trade vs active trade policies. Balanced trade and international price adjustments vs instability. Trade gains accruing to nationals vs export enclaves with foreign ownership; distinction between GDP and GNI becomes important

Fixed Resources, Full Employment, and the International Immobility of Capital and Skilled Labor. Challenged by North-South trade models Porter’s “Competitive Advantage” theory: Traditional trade theory applies only to basic factors (unskilled labor, physical resources), But creation of advanced factors (knowledge resources, specialized infrastructure) is the first priority. Central task to “escape from the straightjacket of factor driven national advantage”

The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience
1. Alternative Theories
2. Vent for Surplus Theory

Figure 12.2 The Vent-for-Surplus Theory of Trade

Fixed, Freely Available Technology and Consumer Sovereignty
- Challenged by the Product Cycle theory
- Development of synthetic substitutes for developing country exports

International Factor Mobility, Perfect Competition, and Uncertainty:
- Increasing Returns, Imperfect Competition, and Issues in Specialization
  - Structural realities in developing countries
  - Increasing returns and exercise of monopolistic control over world markets
  - Risk and uncertainty inherent in international trading arrangements

The Absence of National Governments in Trading Relations
- Definite role for State
- Industrial policy is crafted by governments
- Commercial policies instruments (tariffs, quotas) are state constructs
- International policies can result in uneven distribution of gains from trade

Balanced Trade and International Price Adjustments
- Unrealistic (example: impact of oil price hikes of the 1970s)
- Trade gains accruing to nationals
- Enclave economies are promoted by trade
- Difference between GDP and GNI becomes important

Some Conclusions on Trade Theory and Economic Development Strategy
- Trade can lead to rapid economic growth under some circumstances
- Trade seems to reinforce existing income inequalities
- Trade can benefit developing countries if they can extract trade concessions from developed countries
- Developing countries generally must trade
- Regional cooperation may help developing countries

Traditional Trade Strategies for Development: Export Promotion versus Import Substitution
- Export promotion: looking outward and seeing trade barriers, Primary-commodity export expansion, limited demand
  - Low income elasticities
  - Low population growth rates in developing economies
  - Decline in prices implies low revenue (some periods of price spikes,
  - including recent years, but very long-run trend has been
downward)
  - Lack of success with international commodity agreements
  - Development of synthetic substitutes
  - Agricultural subsidies
  - Primary-commodity export expansion, supply rigidities

Expanding Exports of manufactured goods: Greater successes, particularly China; unevenly distributed across the developing world

Import substitution: looking inward but still paying outward
- Tariffs, infant industries, and the theory of protection

Figure 12.3 Import Substitution and the Theory of Protection

The import substitution (IS) industrialization strategy and results
- Protected industries get inefficient and costly
- Foreign firms often benefit more
- Subsidization of imports of capital goods tilts pattern of industrialization and contributes to balance of payments (BOP) problems
- Overvalued exchange rates hurt exports
- Does not stimulate self-reliant integrated industrialization

Tariff Structure and Effective Protection
- Nominal rate of protection
- Effective rate of protection

The nominal tariff rate, \( t \), is

\[
t = \frac{P' - P}{P} \quad (12.1)
\]

Where
- \( P \) is the tariff-inclusive price
- \( P' \) is the free trade price

Tariff Structures and Effective Protection
The effective tariff is

\[
\rho = \frac{\nu' - \nu}{\nu} \quad (12.2)
\]

Where
- \( \nu \) is the value added per unit of output, inclusive of the tariff
- \( \nu' \) is the value added per unit of output under free trade
Economic Integration: Theory and Practice
- The growth of trade among developing countries.
- Integration encourages rational division of labor among a group of countries and increases market size
- Provides opportunities for a coordinated industrial strategy to exploit economies of scale
- Trade creation
- Trade diversion

Regional trading blocs and the globalization of trade
- NAFTA
- MERCOSUR
- SADC
- ASEAN
- Local conditions matter
- Still not fully answered: Do blocs promote growth or retard the progress of globalization

Trade Policies of Developed Countries: The Need for Reform and Resistance to New Protectionist Pressures
Rich-nation economic and commercial policies matter for developing countries
- Tariff and non-tariff barriers to developing country exports
- Adjustment assistance for displaced workers
- General impact of economic policy

World Trade Organization, Despite 8 liberalization rounds over 50 years, trade barriers remain in place in agriculture; and, through various mechanisms, to a degree in other sectors. Doha Development Round begun 2001 tilted the nominal focus to needs of developing world; but talks remained stalled through the end of 2010, a self-imposed deadline

Figure 12.5 Effective Tariff Faced by Income Groups, 1997-1998

Chapter 13
Balance of Payments, Debt, Financial Crises, and Stabilization Process

International Finance and Investment: Key Issues
How major debt crises emerged during the 1980s

He Balance of Payments Account
General considerations:
1. Balance of Payments (BOP)
2. Current Account
3. Surplus and Deficit
4. Capital Account

Table 13.1 A Schematic Balance of Payments Account

<table>
<thead>
<tr>
<th>Description</th>
<th>Symbol</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports of goods and services</td>
<td>A</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>B</td>
</tr>
<tr>
<td>Exports of services</td>
<td>C</td>
</tr>
<tr>
<td>Imports of services</td>
<td>D</td>
</tr>
<tr>
<td>Net transfers and transfers</td>
<td>E</td>
</tr>
<tr>
<td>Total current account balance</td>
<td>(A + B - C - D + E)</td>
</tr>
<tr>
<td>Direct private investment</td>
<td>F</td>
</tr>
<tr>
<td>Foreign loans (public and private), and grants</td>
<td>G</td>
</tr>
<tr>
<td>Increase in foreign assets of the domestic banking system</td>
<td>H</td>
</tr>
<tr>
<td>Resident capital inflow</td>
<td>I</td>
</tr>
<tr>
<td>Total capital account balance</td>
<td>(B + H) - (I + J)</td>
</tr>
<tr>
<td>Inflow for changes in cash reserve account</td>
<td>K</td>
</tr>
<tr>
<td>Errors and omissions (L - F - K)</td>
<td></td>
</tr>
</tbody>
</table>

Cash Account or International Reserve Account

South-South Trade and Economic Integration

Muhammad Firman (University of Indonesia - Accounting)
Three forms:
1. Hard currency
2. Gold
3. Deposits with IMF

Table 13.2 Credits and Debits in the Balance of Payments Account

<table>
<thead>
<tr>
<th>Positive Effects (Credits)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Any sale of goods or services abroad (export)</td>
</tr>
<tr>
<td>2. Any earnings on an investment in a foreign country</td>
</tr>
<tr>
<td>3. Any receipt of foreign remittances</td>
</tr>
<tr>
<td>4. Any gift or aid from a foreign country</td>
</tr>
<tr>
<td>5. Any foreign sale of stocks or bonds</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Negative Effects (Debits)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Any purchase of goods and services abroad (import)</td>
</tr>
<tr>
<td>2. Any investment in a foreign country</td>
</tr>
<tr>
<td>3. Any payment to a foreign country</td>
</tr>
<tr>
<td>4. Any gift or aid given abroad</td>
</tr>
<tr>
<td>5. Any purchase of stocks or bonds from abroad</td>
</tr>
</tbody>
</table>

A hypothetical illustration: deficits and debts
- Current Account
- Capital Account

Table 13.3 A Hypothetical Balance of Payments Table for a Developing Nation

Table 13.4 Before and After the 1980s Debt Crisis: Current Account Balances and Capital Account Net financial Transfers of Developing Countries, 1978-1990 (billions of dollars)

Table 13.5 Developing Country Payments Balances on Current Account, 1980–2009 (billions of dollars)

Accumulation of Debt and Emergence of the Debt Crisis
Background and analysis
- External debt
- Debt service
- Basic transfer

Origins of the 1980s Debt Crisis
- OPEC oil price increase
- Increased borrowing
- Excess of imports
- Lagging exports

The Issue of Payment Deficits
Some initial policy issues
- International reserves

Restrictive fiscal and monetary policies:
1. Structural adjustment
2. Stabilization policies

Special drawing rights (SDRs)

Trends in the Balance of Payments

Figure 13.1 The Mechanics of Petrodollar Recycling
Origins of the Debt Crisis
– Debt-service obligations
– Debt-service payments
– Debt-service difficulty
– Oil shocks

Developing countries’ two options:
1. Curtail imports and restrictive fiscal and monetary measures
2. More external borrowing

Attempts at Alleviation: Macroeconomic Instability, Classic IMF Stabilization Policies, and Their Critics
The IMF stabilization program
– Macroeconomic instability
– Stabilization policies

Four basic components of IMF stabilization program:
1. Liberalization of foreign exchange and imports control
2. Devaluation of the official exchange rate
3. Stringent domestic anti-inflation program
4. Opening up of the economy to international commerce

Such policies can be politically unpopular because they hurt the lower- and middle-income groups. Less radical observers view the IMF as neither a developmental nor an antidevelopmental institution.

Tactics for debt relief:
1. Debtors’ cartel
2. Restructuring
3. Brady Plan
4. Debt for equity swaps
5. Debt for nature swaps
6. Debt repudiation

“Odious Debt” and Its Prevention
What is odious debt?
Sovereign debt used by an undemocratic government in a manner contrary to the interests of its people should be deemed invalid

Resolution of 1980s-1990s Debt Crises and Continued Vulnerabilities
– Highly indebted poor countries (HIPC’s)
– Some progress but vulnerabilities remain

The International Flow of Financial Resources
Three sources:
– Private direct and portfolio investment
– Remittances of earnings by international migrants
– Public and private development assistance

Private Foreign Direct Investment and the Multinational Corporation
Multinational Corporation (MNC)
– Recent growth of foreign direct investment (FDI)

The Role and Growth of Remittances

The Global Financial Crisis and the Developing Countries
Causes of the crisis and challenges to lasting recovery. Economic impacts on developing countries
1. Economic growth
2. Exports
3. Foreign investment inflows
4. Developing-country stock markets
5. Aid
6. Distribution of influence among developing countries
7. Worker remittances
8. Poverty
9. Health and education
10. General policy framework

Differing impacts across developing regions
– China and the exchange rates controversy
– East Asia and Southeast Asia except China
– India
– Latin America
– Africa

CHAPTER 14
FOREIGN FINANCE, INVESTMENT, AND AID: CONTROVERSIES AND OPPORTUNITIES

Private Foreign Direct Investment and the Multinational Corporation

Private Portfolio Investment: Benefits and Risks?
What is portfolio investment?
Emerging-country stock markets

The Role and Growth of Remittances
1. Wage differences
2. "Brain Drain"
3. Uneven flow of remittances

Figure 14.3 Sources of External Financing for Developing Countries, 1990–2008

---

Table 14.1 Major Remittance-Receiving Developing Countries, by Level and GDP Share, 2008

<table>
<thead>
<tr>
<th>Rank</th>
<th>Remittances (millions of U.S. dollars)</th>
<th>Annual Change (%)</th>
<th>Share of Remittances in GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>India</td>
<td>45,000</td>
<td>27.8</td>
</tr>
<tr>
<td>2.</td>
<td>China</td>
<td>34,400</td>
<td>5.0</td>
</tr>
<tr>
<td>3.</td>
<td>Mexico</td>
<td>26,212</td>
<td>3.4</td>
</tr>
<tr>
<td>4.</td>
<td>Philippines</td>
<td>18,325</td>
<td>12.1</td>
</tr>
<tr>
<td>5.</td>
<td>Nigeria</td>
<td>9,970</td>
<td>8.2</td>
</tr>
<tr>
<td>6.</td>
<td>Egypt</td>
<td>6,977</td>
<td>23.8</td>
</tr>
<tr>
<td>7.</td>
<td>Bangladesh</td>
<td>8,970</td>
<td>39.8</td>
</tr>
<tr>
<td>8.</td>
<td>Pakistan</td>
<td>7,035</td>
<td>17.1</td>
</tr>
<tr>
<td>9.</td>
<td>Mexico</td>
<td>6,730</td>
<td>0.0</td>
</tr>
<tr>
<td>10.</td>
<td>Indonesia</td>
<td>6,500</td>
<td>5.3</td>
</tr>
<tr>
<td>11.</td>
<td>Lebanon</td>
<td>6,000</td>
<td>4.0</td>
</tr>
<tr>
<td>12.</td>
<td>Vietnam</td>
<td>5,500</td>
<td>0.0</td>
</tr>
<tr>
<td>13.</td>
<td>Ukraine</td>
<td>5,000</td>
<td>11.0</td>
</tr>
<tr>
<td>14.</td>
<td>Colombia</td>
<td>4,523</td>
<td>0.0</td>
</tr>
<tr>
<td>15.</td>
<td>Russian Federation</td>
<td>4,523</td>
<td>0.0</td>
</tr>
<tr>
<td>16.</td>
<td>Egypt</td>
<td>4,510</td>
<td>9.0</td>
</tr>
</tbody>
</table>

---

Table 14.2 Official Development Assistance Net Disbursements from Major Donor Countries, 1985, 2002, and 2008

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Official Development Assistance (ODA)</strong> Net Disbursements (U.S. dollars)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>ODA per Capita (U.S. $)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>ODA as a Share of GNI (%)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>73</td>
<td>3,237</td>
<td>1.0</td>
<td></td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>46</td>
<td>1,077</td>
<td>0.9</td>
<td></td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>16</td>
<td>6,548</td>
<td>0.2</td>
<td></td>
</tr>
<tr>
<td>East Asia and the Pacific</td>
<td>5</td>
<td>2,664</td>
<td>0.2</td>
<td></td>
</tr>
<tr>
<td>South Asia</td>
<td>8</td>
<td>963</td>
<td>0.5</td>
<td></td>
</tr>
<tr>
<td>Europe and Central Asia</td>
<td>19</td>
<td>4,290</td>
<td>0.2</td>
<td></td>
</tr>
</tbody>
</table>

Foreign Aid: The Development Assistance Debate

Conceptual and measurement problems.
Amounts and allocations: public aid, Official development assistance (ODA).

---

Table 14.3 Official Development Assistance (ODA) by Region, 2008

<table>
<thead>
<tr>
<th>Region</th>
<th>ODA per Capita (U.S. $)</th>
<th>ODA as a Share of GNI (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Middle East and North Africa</td>
<td>3,237</td>
<td>1.0</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>1,077</td>
<td>0.9</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>6,548</td>
<td>0.2</td>
</tr>
<tr>
<td>East Asia and the Pacific</td>
<td>2,664</td>
<td>0.2</td>
</tr>
<tr>
<td>South Asia</td>
<td>963</td>
<td>0.5</td>
</tr>
<tr>
<td>Europe and Central Asia</td>
<td>4,290</td>
<td>0.2</td>
</tr>
</tbody>
</table>

---

The two-gap model: savings constraint

\[ I < F + sY \]  \hspace{1cm} (14.1)  

Where

- \( I \) is domestic investment
- \( F \) is the amount of capital inflows
- \( s \) is the savings rate
- \( Y \) is national income

The two-gap model: foreign-exchange constraint

Where

- \( I \) is domestic investment
- \( F \) is the amount of capital inflows
- \( E \) is the level of exports
- \( Y \) is national income
- \( m1 \) is the marginal import share
- \( m2 \) is the marginal propensity to import

Why recipient countries accept aid. The role of nongovernmental organizations in aid (NGOs). The effects of aid

Conflict and Development

The scope of violent conflict and conflict risks. The consequences of armed conflict

- Health
- Destruction of wealth
- Worsening hunger and poverty
- Loss of education
- A torn social fabric

Figure 14.4 Global Trends in Armed Conflict, 1946-2008

The causes of armed conflict and risk factors for conflict

- Horizontal inequalities
CHAPTER 15
FINANCE AND FISCAL POLICY FOR DEVELOPMENT

The Role of the Financial System in Economic Development

Six major functions of the financial system
1. Providing payment services
2. Matching savers and investors
3. Generating/distributing information
4. Allocating credit efficiently
5. Pricing, pooling, and trading risks
6. Increasing asset liquidity

Differences between developed and developing-country financial systems

The Role of Central Banks and Alternative Arrangements

Functions of a full-fledged central bank
- Issuer of currency and manager of foreign reserves
- Banker to the government
- Banker to domestic commercial banks
- Regulator of domestic financial institutions
- Operator of monetary and credit policy

Table 15.1 Central Banking Institutions

<table>
<thead>
<tr>
<th>Institution</th>
<th>Issuer of Currency</th>
<th>Banker to Government</th>
<th>Banker to Commercial Banks</th>
<th>Regulator of Financial Institutions</th>
<th>Operator of Monetary Policy</th>
<th>Operator of Financial Development</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full-fledged central bank</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Supranational central bank</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Currency board</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

Currency boards
Form of central bank that issues domestic currency for foreign-exchange at a fixed exchange rate

Alternatives to central banks:
- Transitional central banking institution
- Supranational central bank
- Currency enclave
- Open-economy central banking institution

The role of development banking
Development banks are specialized public and private financial intermediaries that provide medium- and long-term credit for development projects.

Informal Finance and the Rise of Microfinance

Traditional informal finance, Microfinance institutions (MFIs)
- Microfinance provides financial services to people otherwise with no access or only with very unfavorable terms.
- Includes microcredit, microsavings, and microinsurance
- Primary focus: very small loans for microenterprises
- Microcredit often uses group lending schemes (joint liability)
- Provides "collateral of peer pressure" to jointly repay
- An alternative without joint liability: "dynamic incentives," in which loan sizes steadily increase when loans are repaid
- Other alternatives to joint liability

MFIs: three current policy debates
- Microfinance schism—are subsidies appropriate?
- Should credit be integrated with education, health, or other programs?
- Should MFIs undergo commercialization, whereby an NGO providing microfinance is converted into a for-profit bank?

Potential limitations of microfinance as a development strategy. Microfinance is a powerful tool, but it needs to be complemented with other development and poverty policies

Reforming Financial Systems

Financial liberalization, real interest rates, savings, and investment
- Rationing
- Financial repression

Figure 15.1 The Effects of Interest-Rate Ceilings on Credit Allocation

Financial policy and the role of the state

Stiglitz: seven financial market failures:
1. The "public good" nature of monitoring financial institutions
2. Externalities of monitoring, selection, and lending
3. Externalities of financial disruption
4. Missing and incomplete markets
5. Imperfect competition
6. Inefficiency of competitive markets in the financial sector
7. Uninformed investors

Debate on the role of stock markets

Fiscal Policy for Development
Macro stability and resource mobilization. Taxation: direct and indirect.
Five factors of the taxation potential of a country
1. Level of per capita real income
2. Degree of inequality in the distribution of that income
3. Industrial structure of the economy and the importance of different types of economic activity
4. Social, political, and institutional setting and the relative power of different groups
5. Administrative competence, honesty, and integrity of the tax-gathering branches of government

Table 15.2 Comparative Average Levels of Tax Revenue, 1985–1997, as a Percentage of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>OECD countries</td>
<td>36.6</td>
<td>37.9</td>
</tr>
<tr>
<td>Argentina</td>
<td>30.6</td>
<td>32.6</td>
</tr>
<tr>
<td>Pacific</td>
<td>31.7</td>
<td>31.6</td>
</tr>
<tr>
<td>Europe</td>
<td>30.2</td>
<td>39.4</td>
</tr>
<tr>
<td>Developing</td>
<td>17.5</td>
<td>18.2</td>
</tr>
<tr>
<td>Africa</td>
<td>19.6</td>
<td>19.8</td>
</tr>
<tr>
<td>Asia</td>
<td>16.1</td>
<td>17.4</td>
</tr>
<tr>
<td>Middle East</td>
<td>18.5</td>
<td>18.1</td>
</tr>
<tr>
<td>Western Hemisphere</td>
<td>17.6</td>
<td>18.0</td>
</tr>
</tbody>
</table>

Fiscal Policy for Development
1. Personal income and property taxes
2. Corporate income taxes
3. Indirect taxes on commodities
4. Problems of tax administration

State-Owned Enterprise and Privatization
State-owned enterprises (SOEs)—public corporations and parastatal agencies owned and operated by the government. Improving the performance of SOEs.

Privatization: theory and experience

Public Administration: The Scarest Resource
Administrative capability is a scarce public resource in the developing world. The administrative component of economic development should not be underestimated