Why Doesn't Capital Flow from Rich to Poor Countries?

Introduction:

Lucas sets the stage by addressing a fundamental question: why doesn't capital flow from wealthy nations to poorer ones as expected? He begins by referencing simple neoclassical models of trade and growth, which suggest that capital should naturally migrate to less developed countries due to the promise of higher returns on investment. However, he highlights the stark contrast between these theoretical predictions and observed realities.

Differences in Human Capital

One reason is that workers in poorer countries often have less education and fewer skills. This means they are not as productive as workers in richer countries, making these countries less attractive for investment.

External Benefits of Human Capital

Skilled and educated workers create a better working environment for everyone. In richer countries, this environment boosts overall productivity, making them even more attractive for investment compared to poorer countries where such benefits are lacking.

Capital Market Imperfections

Problems like political instability and weak legal systems in poorer countries make investors wary. Investors fear they might lose their money because of these risks, so they prefer to invest in richer, more stable countries.

International Differences in Tax Policies

Different tax rules in different countries can also affect where investors choose to put their money. Some countries have tax policies that are more favorable to investment than others.

Conclusion

Lucas concludes that the lack of investment in poorer countries is due to a combination of factors, including differences in worker skills, the benefits of skilled environments, political risks, and tax policies. More research is needed to fully understand and address these issues.