Thirteen

MAKING THE INVESTMENTS NEEDED TO END POVERTY

At the most basic level, the key to ending extreme poverty is to enable the poorest of the poor to get their foot on the ladder of development. The development ladder hovers overhead, and the poorest of the poor are stuck beneath it. They lack the minimum amount of capital necessary to get a foothold, and therefore need a boost up to the first rung. The extreme poor lack six major kinds of capital:

- Human capital: health, nutrition, and skills needed for each person to be economically productive
- Business capital: the machinery, facilities, motorized transport used in agriculture, industry, and services
- Infrastructure: roads, power, water and sanitation, airports and seaports, and telecommunications systems, that are critical inputs into business productivity
- Natural capital: arable land, healthy soils, biodiversity, and well-functioning ecosystems that provide the environmental services needed by human society
- Public institutional capital: the commercial law, judicial systems, government services and policing that underpin the peaceful and prosperous division of labor

- Knowledge capital: the scientific and technological know-how that raises productivity in business output and the promotion of physical and natural capital

How to overcome a poverty trap? The poor start with a very low level of capital per person, and then find themselves trapped in poverty because the ratio of capital per person actually falls from generation to generation. The amount of capital per person declines when the population is growing faster than capital is being accumulated. Capital is accumulated, in turn, in a balance of two forces, one positive and one negative. On the positive side is the capital accumulated when households save a part of their current income, or have a part of their income taxed to finance investments by the government. Household savings are either lent to businesses (often through financial intermediaries such as banks) or invested directly in family businesses or equities traded in the market. Capital is diminished, or depreciated, as the result of the passage of time, or wear and tear, or the death of skilled workers, for example, because of AIDS. If savings exceed depreciation, there is positive net capital accumulation. If savings are less than depreciation, the capital stock declines. Even if there is positive net capital accumulation, the question for growth in per capita income is whether the net capital accumulation is large enough to keep up with population growth.

HOW THE POVERTY TRAP WORKS AND HOW FOREIGN AID HELPS OVERCOME IT

Figure 1 shows the basic mechanics of saving, capital accumulation, and growth, and figure 2 shows how a poverty trap works. In figure 1, we start on the left-hand side with a typical household. The household divides its income into consumption, taxation, and household savings. The government, in turn, divides its tax revenues into current spending and government investment. The economy's capital stock is raised by both household savings and by government investment. A higher capital stock leads to economic growth, which in turn raises household income through the feedback arrow from growth to income. We show in the figure that population growth and depreciation also negatively affect the accumulation of capital. In a "normal" economy, things proceed smoothly toward rising incomes, as household savings and govern-