Paul D'Anieri, International Politics: Power and Purpose in Global Affairs (Belmont, California: Wadsworth, 2012).

11

The Problem of Global Inequality

CHAPTER OUTLINE

◄ A young boy brings food to his family members, who work at a garbage dump in New Delhi, India.
AP Photo/Gurinder Osan, File

LEARNING OBJECTIVES

After completing this chapter, the student should be able to . . .

1. Identify different ways of defining and measuring poverty, and articulate the implications of using different definitions and measurements.
2. Discuss the UN Millennium Development Goals.
3. Explain the problem of late development and the challenges faced by late developers.
4. Identify strategies for late development, and analyze the strengths and weaknesses of these strategies.
5. Contrast competing explanations of the success of the "Asian Tigers."
6. Evaluate the role of foreign aid in economic development.

Consider the Case

India: From Riches, to Rags, to . . . What?

In 1700, prior to British colonization, India controlled roughly the same share of the world economy as did all of Western Europe.[1] By the time India became independent in 1947, its share of the world economy had fallen to roughly 4 percent, and it was one of the poorest countries in the world. How did colonialism produce this result? What kinds of policies would reverse this trend? Since independence, reduction of poverty and establishment of consistent economic growth have been central issues for India's governments. A variety of strategies have been pursued.

At the time of independence, India's leadership believed that colonial connections were the main source of poverty and that disconnecting from the global economy would bring development. The initial development strategy, therefore, focused on achieving national independence, which had political benefits as well. Moreover, in keeping with the predominant thinking of the time, the state took a prominent role in the economy, controlling the largest industries in an effort to allocate resources strategically, while leaving smaller sectors to the market. By 1980, however, not much progress had been made. India remained mired in poverty and was growing much more slowly than other Asian economies.

In 1991, India undertook a major change of course, ending restrictions on foreign investment and reducing state control of various parts of the economy, a trend that has continued since. Recently, India has experienced a technology and services boom as both Indian and Western firms have sought to take advantage of the country's comparatively cheap but well-educated workforce. After growing at an annual rate of only 0.8 percent from 1900 to 1950 India's economy grew at an annual rate of 6 percent from 1980 to 2002 and 7.6 percent from 2002 to 2006.[2] At the same time, although poverty has been reduced, it is widespread, and inequality is high.

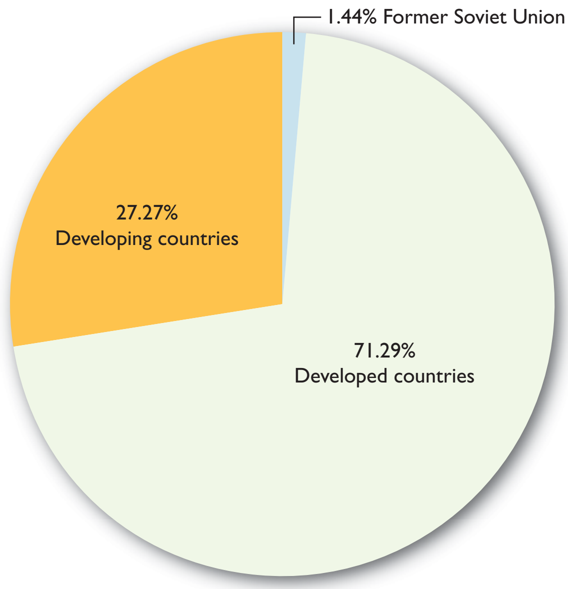
What factors explain India's success after centuries of poor economic performance? Can the policies adopted since 1991 continue to create growth or must other measures now be taken? Can India reduce inequality as its overall wealth grows? These questions remain unanswered, even as the country is poised to become one of the world's largest economies in coming decades.

Even though overall world wealth has increased dramatically since World War II, poverty remains widespread in the world today and inequality continues to grow steadily. The gap between the wealthiest and the poorest societies continues to widen, as shown by the following statistics:

- Between 1980 and 2000, many countries, including Russia and most of Latin America, actually moved backward in terms of their relationship to the average world GDP.[3]
- Between 1990 and 2000, poverty *increased* in thirty-seven of sixty-seven developing countries for which data were available.[4]
- Since 1960, annual per capita income in the world's twenty poorest countries has increased only slightly, from $212 to $267, while the economies of other countries have boomed.[5]
- Of the roughly 6 billion people in the world, 2.5 billion live on less than $2 per day, and 1.2 billion (roughly four times the population of the United States) live on less than $1 per day.[6]

The grinding poverty of the world's poorest countries stands in stark contrast not only to the vast wealth of the wealthy countries, but also to the progress made in many other formerly poor countries that are now closing the gap with the wealthiest. These glaring statistics raise three fundamental questions: Why is poverty so persistent? Why is inequality growing? What can be done to reduce poverty and inequality? There are no simple answers, as the rest of this chapter will demonstrate.

Figure 11.1 Percentage of World GDP, 2007



Source: http://www.ers.usda.gov/Data/Macroeconomics

Ethics and Self-Interest in Combating Poverty

Why should we address poverty in the world? The answer seems self-evident, but different actors—states, international organizations, NGOs, individuals—have a range of motives with regard to this issue. The way different actors think about poverty and inequality will influence the priority they attach to the problem and the strategies they adopt.

Perhaps the most obvious reason to seek to reduce poverty is normative—it seems immoral or unethical not to try to do something. Nearly every religious credo in the world places considerable value on the willingness of the wealthy to aid the poor. On a less doctrinal level, nearly everybody who sees pictures of starving children with bloated bellies feels that something ought to be done to help. Professional ethicists also provide detailed philosophical arguments showing that the wealthy have an ethical duty to help alleviate poverty.[7]

Self-interest is also a motive in efforts to stem poverty. Poverty has global effects that the governments of rich countries perceive an interest in fighting. First, poverty is viewed as an underlying factor in a much broader range of political problems that affect wealthy countries. Although there is considerable doubt about whether there is a direct link between poverty and terrorism, it is still widely believed that reducing poverty would decrease the supply of recruits to terrorist groups and would reduce the willingness of societies to support or tolerate terrorism. More broadly, the hostility toward the West that seems to grip some societies is at least in part linked to resentment over gaps in wealth and might be moderated by economic development.

Second, poverty is seen as a source of a wide range of problems that spill over from poor to rich countries, including immigration, crime, and health threats. Much migration, historically and today, is motivated by the desire to escape conflict, but much more, not only today but throughout history, has been driven by the desire of immigrants to go where economic opportunities are greatest. In North America and Western Europe, where illegal immigration is a major policy problem, reducing poverty in the "sending" countries is a potential solution.

Poverty also has an effect on the level of transnational crime. Economic desperation clearly makes individuals more willing to break the law in order to get by. For example, in South America and in Central and South Asia, it is very difficult to convince impoverished peasants to stop growing crops for drug production when they cannot feed their families any other way. The result is a ready supply of drugs for customers in wealthier parts in the world, which fosters social problems there.

Poverty also makes it much harder to combat environmental problems.[8] Very few people would choose to starve to save an acre of rainforest or an endangered species, but that is, in effect, the choice that many people face every day. It is much easier to save the environment from a position of wealth.

Third, poverty actually undermines economic growth in rich countries. Poor people do not buy much. This keeps overall consumer demand lower than it otherwise might be.

The Culture Connection

Pop Stars and Global Poverty

Since the 1980s, a small number of pop stars have become increasingly vocal advocates for fighting world hunger. They strive to use their personal popularity and visibility to get their fans to be more concerned about world hunger and to bring pressure to bear on politicians to do more.

The pioneer in this movement was George Harrison, the Beatles guitarist, who in 1971 organized a concert at New York's Madison Square Garden to raise money to fight hunger in Bangladesh, which was suffering famine after its war for independence with Pakistan. The "Concert for Bangladesh" featured Harrison's friend Eric Clapton, fellow ex-Beatle Ringo Starr, and Bob Dylan, among others.

This movement was rekindled in 1984 by the Irish singer Bob Geldof, lead singer of a band called the Boomtown Rats. With famine threatening millions in Africa, Geldof organized "Band Aid," a group of nearly forty British rock stars, including David Bowie, Paul McCartney, and Sting, to record "Do They Know It's Christmas?" The song and its accompanying video became enormous hits in both Europe and the United States. American stars, led by Michael Jackson and Quincy Jones, then joined the cause. Their group, called USA for the World, included Ray Charles, Bob Dylan, and the six Jackson siblings, and produced the song "We Are the World," which also became a number-one single. In July 1985, two concerts were held simultaneously, one at Philadelphia's JFK Stadium and the other at London's Wembley Stadium, to raise money to fight global hunger. After a time, however, the efforts of rock stars and their fans to combat hunger waned.

More recently another Irish rock star, Bono (Paul Hewson), of the band U2, has been the most vocal and visible celebrity focusing attention on global poverty and hunger. Bono has even been included in meetings of world leaders on the issue. He has become a regular at gatherings such as the World Economic Forum in Davos, Switzerland. In February 2005, the *Los Angeles Times* argued in an editorial that Bono should be chosen to run the World Bank.[1] That seemed entirely unlikely (George Bush chose Deputy Defense Secretary Paul Wolfowitz), but it demonstrated Bono's emergence as a serious player in discussions of global poverty.

AP Photo/Laurent Gillieron/Keystone

Bono with former British Prime Minister Tony Blair and Liberia's President Ellen Johnson-Sirleaf at the World Economic Forum in Davos, Switzerland.

Critical Thinking Questions

1. Can popular musicians have an important influence on shaping the behavior of states with regard to matters such as global poverty?
2. What long-term effects might efforts such as massive rock concerts have on efforts to reduce global poverty?

PHOTO © ISTOCKPHOTO

[1] "Bono for the World Bank," *Los Angeles Times,* February 25, 2005, Section B, p. 12.

Moreover, because poverty generally prevents people from becoming highly educated, it leads to lower worker productivity. The health problems and political instability that come with poverty further inhibit overall productivity. In sum, poverty is bad for the economy.

U.S. President George W. Bush captured the range of motivations for combating poverty in a 2002 speech: "We fight against poverty because hope is an answer to terror. We fight against poverty because opportunity is a fundamental right to human dignity. We fight against poverty because faith requires it and conscience demands it. We fight against poverty with a growing conviction that major progress is within our reach."[9] For all these very practical reasons, the wealthy countries often perceive a self-interest in helping the poor. It is often easier to justify spending taxpayers' money to pursue national self-interest than to pursue the ethical agenda of poverty reduction. However, the pursuit of poverty reduction based on self-interest often has bizarre effects on who gets helped and how.

Defining and Measuring Poverty

Despite the previously cited statistics showing the persistent problem of poverty in the world, there are also statistics that show a much less dire situation. This different view results in part from the different comparisons being made. The poorest countries continue to lag behind, but another group of countries has made steady progress in income growth. To make sense of the barrage of statistics, which often seem contradictory, it is necessary to understand differences in what is being measured.

Poverty versus Inequality

Traditionally, **poverty** was defined in absolute terms, as a condition characterized by comparatively low income, a definition referred to as "income poverty." However, many economists, such as the Nobel Prize-winning poverty scholar Amartya Sen, reject that definition in favor of one that focuses on relative capabilities—on the range of choices open to an individual.[10] Thus, the UN Commission on Human Rights defines poverty as "a human condition characterized by the sustained or chronic deprivation of the resources, capabilities, choices, security and power necessary for the enjoyment of an adequate standard of living and other civil, cultural, economic, political and social rights."[11]

poverty
The lack of sufficient income, which is often accompanied by insufficient nutrition, housing, and other necessities. Poverty can be defined in absolute terms as "income poverty" or in relative terms, with a focus on the range of choices open to individuals.

In this view, poverty is defined in relative terms. However, poverty is often measured in *absolute* terms, such as income, in part because such data are more readily available. In contrast to poverty, *inequality* is inherently comparative; in measuring inequality, the question becomes, "How much wealth or income does one person have compared to someone else?" It is very possible that a person's income is growing, but more slowly than that of others. As a result, income is increasing but so is inequality. Does this mean poverty is increasing or decreasing? Questions like these make it essential to evaluate the nature of the statistics.

When examining individual welfare, analysts and policy makers are often concerned with absolute poverty: Do individuals have enough income to avoid malnutrition, to get basic health care, housing, and education? Politics, however, is also deeply concerned with issues of equality (both within and between countries). In many discussions, therefore, simply preventing people from starving or freezing to death is rarely considered the goal of economic policies. Reducing inequality in the population and keeping people moving upward economically are also important goals.

per capita GDP
The average income of the people in a country.

purchasing power parity (PPP)
A measure used to calculate GDP that takes into account that goods cost different amounts in different countries.

Human Development Index (HDI)
A measure of poverty, produced by the United Nations Development Programme, that supplements per capita GDP (at purchasing power parity) with measures of life expectancy, literacy rates, and average years of schooling.

Gini coefficient
A statistic developed by Italian statistician Corrado Gini to compare the incomes of the top and bottom fractions of a society.

Gender Development Index
A measure, published by the UN, of the economic equality of men and women.

MEASURES AND STATISTICS

Several different methods of measuring poverty and inequality are in widespread use.

- **Average income: Per capita GDP** refers to the *average* income of the people in a country. It is calculated by dividing the overall annual income of the country by the population. It is probably the most widely used statistic because it is among the easiest to determine. However, it is also one of the most misleading, especially in societies where there is considerable inequality. In such a society, for every millionaire whose income is far above the average, there must be thousands of others whose income is far below the average. So to the extent that a country has a small number of wealthy people who make a disproportionate share of income, per capita GDP tends to underestimate poverty.
- **Average income adjusted for cost of living:** One problem with traditional GDP figures is that they do not take into account that goods cost different amounts in different countries. Thus, it is difficult to imagine how anyone survives in a country with a per capita GDP of $500. However, $500 goes further in many poor countries than it does in rich countries. Calculating GDP at **purchasing power parity (PPP)** takes this fact into account by figuring in the different cost of goods. The difference can be significant: in 2007, for example, China's per capita GDP was measured at $2360 using normal methods, but at $5370 using the PPP method.[12] Purchasing power parity is widely considered a better statistic by economists but is less frequently used because calculating it requires a great deal of data on comparative prices.
- **Basic human needs approaches:** Some measurements have tried to get away from reliance on income figures and to focus on what actually matters—people's living conditions. This change in measurement approach accompanies shifts to policies that aim at providing for these basic human needs. One widely used measure is the **Human Development Index (HDI)**. Produced by the United Nations Development Programme, the HDI supplements calculations of per capita GDP (at purchasing power parity) with measures of life expectancy, literacy rates, and average years of schooling.
- **Inequality:** Some analysts seek to focus solely on the question of inequality within a society. To do this, they often use a statistic known as the **Gini coefficient**, which compares the incomes of the top and bottom fractions of society. The coefficient ranges from zero to one, with one representing a situation in which one person has all the income and everyone else has none and zero, representing a situation in which everyone has equal income.
- Gender equality: The **Gender Development Index**, published by the United Nations Development Programme, measures the economic equality of men and women. It is similar to the Gini coefficient, but it compares men and women rather than the poorest and richest. High-ranking countries include Norway, Iceland, Sweden, Australia, and the United States

Table 11.1 Gini Coefficients of Various Countries

Highest (Most Inequality)	Lowest (Least Inequality)	Selected Other Countries
Namibia, 0.743	Denmark, 0.247	China, 0.469
Lesotho, 0.632	Japan, 0.249	Mexico, 0.461
Botswana, 0.630	Sweden, 0.250	United States, 0.408
Sierra Leone, 0.629	Czech Republic, 0.254	Russia, 0.399
Central African Republic, 0.613	Norway, 0.258	India, 0.368
Botswana, 0.605	Slovakia, 0.258	United Kingdom, 0.360
Bolivia, 0.601	Bosnia/Herzegovina, 0.262	Australia, 0.352
Haiti, 0.592	Finland, 0.269	Canada, 0.326

Source: Data are from UN Human Development Programme, "Human Development Indicators," *Human Development Report 2007/2008*, pp. 281–284, at http://hdr.undp.org/en/media/HDR_20072008_EN_ Indicator_tables.pdf (at .94). Low-ranking countries include most of the countries of sub-Saharan Africa, such as Niger (.28), Burkina Faso (.32), Mali (.33), and Burundi (.33). Women are especially disadvantaged in countries where poverty is harshest.

Given all these different ways of measuring poverty and inequality and the trends in the world today, it is possible to reach very different conclusions about the overall state of affairs.

- Many countries in Asia and in Central Europe that were formerly poor are now reducing the gap with the wealthiest countries. These countries provide evidence that both overall poverty and inequality are decreasing.
- Another group of countries, mostly in Africa, have made almost no progress at all, and in some cases are worse off than they were in 1980, even in absolute terms. This group of countries suggests that there has been no improvement in the worst cases of poverty and that overall inequality (defined as the gap between the richest and poorest) has increased.
- In nearly every country, gaps between the wealthiest and the poorest are growing, after a century in which they tended to narrow.
- There are major gender gaps in wealth, especially in the poorest countries. Many economists now believe that the economically disadvantaged status of women harms not only the women, but also the overall economy.

The UN Millennium Development Goals

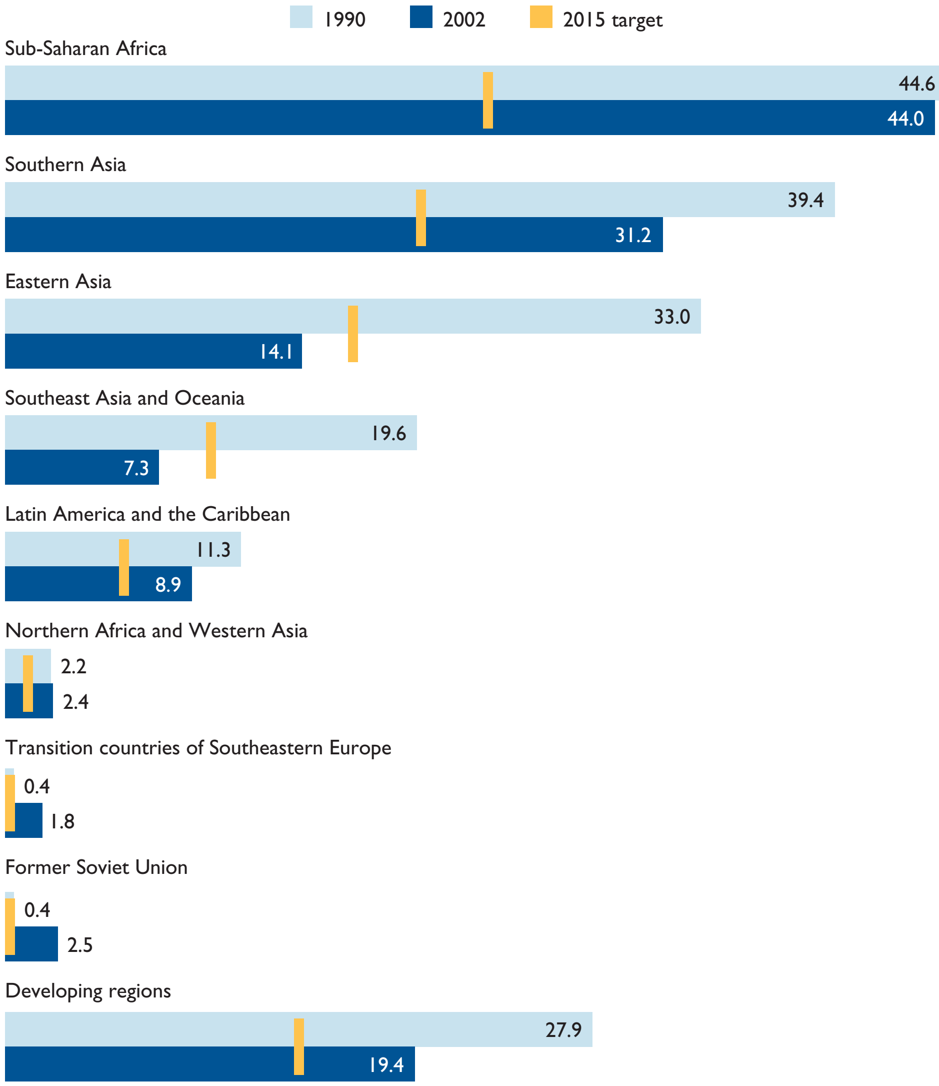
In 2000, the United Nations established the **UN Millennium Development Goals**, a set of goals with accompanying targets to achieve in the coming years and decades. One aim of establishing these goals was to create a greater sense of urgency and a greater claim on resources. In other words, one goal was to get wealthy states to acknowledge that addressing poverty and inequality is important for development. The specific targets were intended to provide some concrete standard against which to measure change in the coming years. Consider a few examples.

UN Millennium Development Goals
A set of goals and accompanying targets set by the UN, aimed at addressing poverty and inequality.

- Goal 1: Eradicate Poverty and Extreme Hunger
  - Target 1. "Halve, between 1990 and 2015, the proportion of people whose income is less than $1 a day."
  - Target 2. "Reduce by half the proportion of people who suffer from hunger."
- Goal 8: Develop a Global Partnership for Development
  - Target 2. Develop further an open trading and financial system that is rule-based, predictable, and nondiscriminatory and includes a commitment to good governance, development, and poverty reduction—nationally and internationally.
  - Target 5. "In cooperation with the private sector, make available the benefits of new technologies—especially information and communications technologies."[13]

Some targets are more easily measured than others. Progress on daily income levels can be assessed by statistical analysis as shown in Figure 11.2. But it is much harder to determine whether the international trading system has been reordered according to the stated goals. By mid-2007, halfway through the fifteen-year timeline for achieving the goals, it appeared that few goals would be achieved on time. Perhaps this should not be surprising, since inequality has been centuries in the making. Whether the targets are met is only part of the point.

Figure 11.2 Percentage of People Living on Less Than $1 a Day, 1990–2002



Source: http://www.unicef.org/factoftheweek/index_35457.html. Reprinted by permission.

The Historical Roots of Inequality

Global poverty and inequality are not recent developments. Rather, they have emerged over time. In their search for solutions, different schools of thought place different emphasis on the significance of poverty's historical roots. Economic structuralists tend to argue that inequality was produced by colonialism and will persist unless specific steps are taken to reverse the effects of colonization. Many others believe that, whatever the roots of poverty, the solutions lie simply in the adoption of sound economic policies today.

Economic inequality has not always been as pronounced as it is today. At different points in history, civilizations around the world flourished and outperformed other regions. The fantastic tombs of the Egyptian pharaohs were built at a time when Europe and North America had rather primitive societies. The Muslim world achieved great advances in mathematics while Europe was mired in the Dark Ages. Until the middle of the last millennium, there was a relatively low level of inequality across states.

In 1750, the countries that are today considered the developing world produced 73 percent of global manufacturing output, while the United States and Europe together produced only 23.3 percent. By 1900, the figures were practically reversed: The United States and Europe produced 85.6 percent and the developing countries only 11 percent.[14] Similarly, per capita incomes in Europe and Asia were roughly equal in 1800, but by 1900, the wealthier European states had average incomes 10 times those in Asian countries.[15] As Herman Schwartz put it, "One of the great peculiarities of history is that an economically marginal, technologically backward set of religiously fractionalized and fanatic peoples 'governed' by virtually no administrative apparatus managed to conquer most of the world in about 300 years."[16]

How did this happen? Generations of scholars have tried to answer this question. Several explanations, not all mutually exclusive, have emerged. One school of thought contends that European societies developed political systems that encouraged innovation and investment, which are crucial to growth. Because of the advent of the sovereign state and capitalism in early modern Europe, in this view, governments had some incentives to let commerce flourish rather than controlling it. Moreover, the development of capital markets facilitated the investment needed to discover more productive technologies and put them to use. These factors, it is argued, led to the industrial revolution in Europe, and not elsewhere. In this view, Europe's domination of the rest of the world was not a cause of Europe's wealth, but a result of it: Once Europe had moved ahead economically, it was easy to dominate.

This view is rejected by various economic structuralists and by other historians as well, who see the European colonial conquest of the world as central to Europe's economic development and to the impoverishment of the rest of the world. By shipping gold and silver from Mexico and Peru, for example, Europeans forcibly transferred wealth directly from Latin America to finance European development. Control over trading relationships ensured that raw materials would be extracted from colonies and that manufacturing, where most of the money was made, would be carried out in Europe. The U.S. colonies broke out of this relationship through the American Revolution, but by the time most other colonies gained their independence, they were in a position of poverty and political weakness relative to Europe. In other words, decolonization provided political independence but not economic independence.

There are other views as well, but these two broad perspectives underline the key debate today. Did Europeans discover the secrets of wealth generation and surpass other countries, or did Europeans conquer and exploit others to achieve development at the expense of the underdevelopment of their colonies? The answers to these questions are linked not only to notions of responsibility for global poverty, but also to proposed solutions. Those who believe that Europeans simply discovered the best economic system tend to contend that the key to development today is for others to develop the same kinds of systems—democratic and market-oriented—that prevail in the developed economies. Those who see development and underdevelopment as essentially linked tend to believe that some restructuring of economic relations between rich and poor is required.

The Problem of Late Development

Even if Europe got ahead of the rest of the world simply by developing better economic and political institutions, it does not necessarily follow that other states can take the same path. The **problem of late development** is that those states that are developing later have to contend with something that the first developers did not: economic competition from more advanced states.[17]

Early developers enjoy what economists call **first-mover advantages**, three of which are especially relevant.

problem of late development
The economic challenge faced by developing states because of economic competition from more advanced states.

first-mover advantages
Advantages enjoyed by firms or countries that first enter a new industry, including advantages gained from economies of scale, network effects, and access to investment funds.

The History Connection

The Opium Wars

In the early nineteenth century, British merchants were buying increasing amounts of goods (much of it tea) in China for resale in Britain. To achieve a balance of trade, the British hoped to sell goods in China as well. Then, as today, China was seen as a potentially lucrative market. (There were over 400 million people in China in the mid-nineteenth century.)

Although many British goods did not sell well in China, the British did succeed in selling opium (a powerful narcotic, derived from poppy plants, from which heroin is made). The British produced opium in their colony in India, and its sale in China became an increasingly important source of revenue. The Chinese sought to limit the trade, in part because of the negative influence on their balance of trade, and in part because of the social havoc created by widespread drug addiction. By 1839, Britain was selling over 4.5 million pounds of opium extract in China.

When, in 1840, the authorities in the city of Guangzhao (formerly Canton) seized and destroyed British opium shipments, the British Navy attacked Guangzhao and several other cities. British military superiority was decisive, and in 1842, the Chinese were compelled to sign the treaty of Nanjing, which handed control of Hong Kong to Britain (Britain controlled Hong Kong until 1997) and opened Guangzhao and other port cities to unlimited British imports of opium and other goods. Other powers such as France and the United States were then able to force identical concessions from China. The Chinese again sought to end the opium trade in 1856, and a second opium war led to another Chinese defeat and to further concessions to European states.

The great care China has taken in opening itself to trade in recent years and the resentment that sometimes seems to characterize Chinese attitudes toward the West have their roots in the humiliation China suffered in the Opium Wars.[1]

Critical Thinking Questions

1. To what extent is force used today to promote international trade?
2. How might memories of the colonial era lead to different perspectives on free trade in countries that were colonized and in colonizing countries?

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[1] See Timothy Brook and Bob Tadashi Wakabayashi, eds., *Opium Regimes: China, Britain, and Japan, 1839–1952* (Berkeley: University of California Press, 2000).

- Economies of scale: In almost every industry, goods and services can be produced more cheaply when they are produced in bulk. Those who enter an industry first can be first to build a good on a large scale. Later developers have to start small, just as the first developers did. Later developers, producing on a smaller scale and therefore at higher cost, struggle to compete with the early developers, who by then are producing on a large scale at lower cost.
- Network effects: When a particular industry begins to succeed in a certain location, other firms related to that business tend to locate in the same area in order to reduce costs. Having related firms nearby gives established businesses two advantages over new entrants. First, transportation costs are decreased. Second, the concentration of many people and firms in a particular area leads to greater innovation, by existing firms and new ones. Detroit (in automobiles) and Hollywood and Bombay (in film)

are prominent examples. More recently, the location of a few early firms in the area around Palo Alto, California, led that region, known as Silicon Valley, to dominate the global market for computers and software during the late-twentieth-century technology boom. Many other cities around the world have sought to emulate Silicon Valley's success, but building a second such center is inherently difficult because of competition from the first.

- Investment funds: In both direct and indirect ways, investment is crucial to economic development. Directly, the ability of firms to invest in new technology or to build more efficient plants will determine their success. Indirectly, those societies that invest in public goods such as education, infrastructure, and efficient administration will provide a more favorable environment for business. But where do the funds for such investment come from? They come from the profits of earlier economic activity. Therefore, those who succeed early on will have more money to invest and hence will be more likely to succeed later on.

Access to investment funds may be more available to late developers today than in past decades. The globalization of financial markets (see Chapter 10) has made it much easier for profits earned in one country to be invested in another country. Therefore, investment capital is increasingly available to developing countries that can provide promising opportunities. However, although foreign direct investment in developing countries has increased, it tends to focus on a few of the most promising countries and to ignore the neediest.

Declining Terms of Trade

A problem related to late development is that of **declining terms of trade**. The terms of trade refer to the relative prices of the goods a country imports and exports. Many developing countries have relied on exports of commodities, including agricultural products, fuels, and minerals. However, as a result of technological advances, raw materials (especially agricultural products) tend to take up an ever-smaller portion of the cost of manufactured goods. Raw materials were the costliest portion of key nineteenth-century manufactured goods such as locomotives. Today, however, the raw materials in a computer or a cell phone make up a tiny part of the overall cost. Some lucrative businesses, such as software, insurance, and banking, involve no raw materials at all. For states whose economies rely primarily on exports of raw material (including agricultural products), this fact of modern life creates a losing battle. They must export ever-increasing amounts of raw materials to earn the revenue needed to buy the manufactured goods and the services they require. In recent years, commodities, and oil in particular, have increased in price, but the overall historical trend is downward. Because colonial policies often forced colonies to abandon manufacturing and concentrate on raw materials production, many poor countries came to rely primarily on raw materials exports. They therefore suffer from this problem in addition to the broader problems of late development.

To avoid declining terms of trade, countries (as well as firms) strive to move from exporting raw materials and goods produced by unskilled labor to exporting manufactured goods and goods created by skilled labor, for which profit

declining terms of trade
Conditions of international trade that force countries that primarily produce raw materials to export ever-increasing amounts of raw materials to earn the revenue needed to buy the manufactured goods they require.

Table 11.2 Internet Users Per 1000 People, 2008

Highest	Lowest	Other Countries of Interest
Netherlands, 868	Burkina Faso, 9.2	Germany, 757
United Arab Emirates, 857	Burundi, 7.3	United States, 712
Denmark, 849	Niger, 5.4	Australia, 568
United Kingdom, 799	Congo, 4.5	Italy, 494
Antigua and Barbuda, 785	Central African Republic, 4.3	China, 223
Faroe Islands, 777	Ethiopia, 4.2	Mexico, 216
South Korea, 775	Sierra Leone, 2.3	South Africa, 86

Source: World Resources Institute, "Population, Health and Human Well-being -- Access to Information: Internet users per 1000 people" at http://earthtrends.wri.org/searchable_db/index.php?theme=4&variable_ID=554&action=select_countries

margins are highest. This transition is sometimes difficult. For example, whereas businesses in the United States and Europe now have access to cloud computing through ultra-fast Internet connections, aspiring competitors in Africa are still hoping to get reliable electricity 24 hours per day to keep their computers operating. If the Internet is the key to the future, then the rich look poised to extend their lead.

Historical Strategies for Overcoming Late Development

Ever since Britain began industrializing in the eighteenth century, those states that have followed have been seeking strategies to overcome late development. Important successes in the nineteenth century were the United States and Germany. In the twentieth century, Japan and the "Asian Tigers" managed to achieve development. Are there lessons that can be learned from these cases that are applicable today?

The United States' strategy toward competing with Britain was developed in Alexander Hamilton's "Report on Manufactures," in which he advocated protectionism against imports as a means to development. By creating steep barriers to imports from other countries, the United States gave its firms the opportunity to develop without competition from established firms in other countries. The United States also had at least two advantages that others could not easily match. The first was an enormous amount of cheap capital in the form of land that was taken from Native Americans. The second was a close historical connection with Britain, which provided much of the investment that financed the growth of U.S. industry, and of railroads in particular.

Like the United States, Germany used protectionism to help protect its "infant industries." Unlike the United States, Germany did not rely primarily on private capital markets but rather used taxation to accumulate capital, which it then invested in the economy. Germany's efforts were bolstered by a first-rate education system focused on science and technology, which directly contributed to industrialization. Japan also combined protectionism against imports with government-driven accumulation of capital for investment. After World War II, the Japanese government identified key economic sectors for investment, such as electronics, which Japan came to dominate in the late twentieth century.

These three success stories all relied heavily on protectionism in the early stages; the countries opened up markets to international competition only after their firms could compete successfully against others. The later cases, including Germany and Japan, also relied heavily on state direction of the economy. This model, therefore, became the dominant model in the decades after World War II. By the 1990s, however, it was seen as a failure and was largely abandoned. The policies that succeeded for the "late developers" may not succeed for the "late, late developers." The debate over development strategies therefore continues.

Strategies for Development Today

Different development strategies are linked to the different interpretations of the historical roots of inequality, to broader views of international political economy. Realists and economic structuralists tend to believe that Europe (especially Britain) developed at the expense of its colonies, and those who hold this view are more skeptical of free trade as a solution. They see the keys to Germany's and Japan's success in protectionism and in the role of the state. Liberals tend to see U.S., German, and Japanese success resulting from their focus on exports and embrace of free markets.

Views on development today are also conditioned by the lessons learned from the successes and failures of recent decades. In the second half of the twentieth century, three broad strategies of development dominated: import substitution (which predominated in Latin America, India, and parts of Africa), state socialism (which dominated the Soviet bloc in eastern Europe but was tried on other continents as well), and export-led growth (which predominated in East Asia). Of the three, only export-led growth retains a wide degree of credibility today, simply because the other strategies did not succeed. However, it has been difficult to figure out exactly *why* export-led growth succeeded and whether it can be replicated for "late, late, late developers."

Import Substitution

The term **import substitution** refers to the strategy of producing domestically those goods that a country has been importing. It is based on the model that succeeded for the first round of late developers, including the United States, Germany, and Japan (although it also appealed to followers of Marx). This model was widely in Latin American during and after World War II, as well as in India. In many countries, the strategy was aimed at breaking disadvantageous relationships with former colonial powers.

import substitution The strategy of producing domestically those goods that a country has been importing.

The central strategy was to shift from the production of raw materials (which has become relatively less profitable over time) to manufactured goods. Initially this would be done by replacing goods that were being imported from developed countries with substitutes produced domestically. Because these goods were already being consumed in the country, the market was established. By limiting imports, domestic producers could capture these markets. The hope was that their technology would catch up with international producers and that over time barriers to trade could be lowered. This was known as "infant industry" protection. A second perceived advantage of import substitution was an improvement in the balance of payments. By producing domestically goods that were formerly imported, states could import more technology without creating a current account deficit.

Despite this model's success in earlier cases, it did not fare well in the late twentieth century for several reasons. First, the timing was unfortunate. Just as these countries shifted out of agricultural production into manufacturing, a substantial increase in global agricultural prices in the 1970s put food importers at a disadvantage. In addition, a dramatic increase in world oil prices penalized countries where industrialization was based on cheap energy.

Second, despite protection from international markets, domestic production in most import-substitution countries did not become competitive in international markets. In the small consumer markets of a relatively poor country, production of important goods (such as automobiles) could never reach the economies of scale to make the goods competitive with those produced for much larger domestic markets or for international markets.

Third, reducing competition from foreign firms reduced the incentives for domestic firms to innovate and become more efficient. Instead of preparing firms for the international market, protection allowed them to remain inefficient. There was little incentive for technological improvement. Poor-quality or obsolete goods might succeed in a protected domestic market, but they could not compete internationally.

Fourth, because protected firms became powerful politically, politicians were hesitant to reduce their protection. As a result, protection from competition tended to become permanent instead of temporary. In many cases, protectionism became a source of cronyism and corruption, which enriched elites at the expense of economic development. For example, by maintaining protection against a particular import, a corrupt politician could provide an opportunity for a local business controlled by supporters or relatives. Or the politician could build the basis for a lucrative smuggling enterprise.

AP Photo/Bikas Das

Import Substitution. When India started making automobiles, it began by copying the British Morris Oxford model, which was already sold in India. Although Britain's Morris ceased production in 1984, the Hindustan Ambassador is still manufactured today and widely used as a taxi in India.

As time went on, these less efficient producers did not become more ready for the global market. Instead, protectionism allowed them to remain less efficient and led to higher prices domestically than in the world market. This took money out of consumers' hands, which, if saved, might have yielded more funds for investment.

State Socialism

state socialism
A strategy for development in which the state rather than the market allocates resources.

State socialism, an alternative strategy for development, emerged with the establishment of the Soviet Union in 1917 and spread after World War II to eastern Europe, China, and Cuba. State socialism was a mix of two kinds of ideologies. Most prominent was economic structuralism: the notion that market capitalism and private property led inexorably to the exploitation of one class by another. Less prominent ideologically, but perhaps more prominent in practice, was state economic planning, which provided an alternative to market-based distribution.

The Soviet Union, beginning in the late 1920s, developed a series of "five-year plans," which outlined detailed economic goals, including the quantities of different kinds of inputs and final products to be produced. These plans led to a substantial transformation of a largely peasant society into an industrial juggernaut. If one looks only at the increases in industrial production, state socialism provided remarkable results in the Soviet Union. However, a high human cost was paid: To coerce people into making the changes dictated by state planners, the government executed millions and imprisoned others in wretched conditions in Siberia. Millions more starved to death during collectivization of agriculture in the early 1930s.

Eventually, the Soviet model failed on economic as well as human grounds. As long as the central task was shifting resources from agriculture into industry, state planning was reasonably effective, if brutal. As more resources were put into industry, production increased. However, state planners could not "plan" innovation. Economic gains in the Soviet system generally came from using more resources, not from devising innovative ways to use resources more efficiently. By the 1970s, when there was no additional pool of unused labor or untapped natural resources to bring into production, the Soviet economy began to stagnate. The story in the other state socialist economies was the same. Over time, these economies grew much more slowly than those in the West, leaving their citizens much poorer.

Export-Led Growth

export-led growth
A development strategy that focuses on exporting to the global market.

In part as a response to the failures of import substitution, a group of countries in East Asia developed a strategy known as **export-led growth**. The leader in this strategy was Japan, which shifted from import substitution after World War II. But the countries that made it a model to study and to emulate were the so-called Asian Tigers. These countries—Korea, Taiwan, Singapore, and Hong Kong—used this strategy to move from being among the world's poorest countries to being among the world's richest in about a half century. This different strategy was feasible in part because the Asian states conceived of the *purpose* of development differently. They placed less emphasis on self-reliance and on severing ties with former colonial masters, and saw integration with international markets as acceptable and even desirable.

The central insight in the strategy of export-led growth is to "go where the money is." Rather than building industries to serve domestic markets, which for most poor countries are relatively small, this strategy focused on the markets in developed countries with larger and wealthier populations. In the second half of the twentieth century, going where the money was meant exporting primarily to the U.S., European, and Japanese markets.

Initially, the strategy was not to out-compete firms in the leading technological sectors of these economies, but rather to produce mass-market goods better and more cheaply. Because workers in the Asian Tigers were, at the beginning of this process, much poorer than workers in the countries with whom they were competing, wages tended to be much lower. Initially, then, much of the focus was on low-cost production based on abundant cheap labor, the strategy pursued by China today. Japanese and other Asian manufacturers recognized that the huge U.S. market could yield more sales and profits than an import-substitution strategy would allow.

Bettmann/CORBIS

The Toyota Toyopet was the first Japanese automobile exported to the United States (1957).

Export-led growth used the profits generated and expertise gained in producing such “low-end” goods to “move up the food chain.” Like Germany and Japan before them, the Asian Tigers had very high domestic savings rates, which provided the investment needed for technological advancement. In the 1960s and 1970s, the primary virtue of Japanese cars for the American buyer was that they were *cheaper* than American brands. By the 1990s, Americans were willing to pay more for Japanese cars because they were *better*. In the 1970s, Taiwan was associated in the United States with cheap radios and televisions, but by 2000, it was the world’s leading producer of laptop computers, computer motherboards, and scanners.[18]

Planners in export-led economies adopted an attitude toward the world market opposite to that of import substitution and state socialism, and this attitude apparently yielded opposite results. In the 1980s and 1990s, other Southeast Asian countries, including Malaysia, Thailand, and the Philippines, began following the Asian Tiger model, with various levels of success. In post-communist Europe, many states also adopted the position that free trade is preferable to closed markets as a development strategy.

Prescriptions for Success

The astounding economic success of the Asian Tigers led scholars and politicians alike to seek to understand their approach better, in the hope that those countries’ success could be replicated elsewhere. After two decades of debate, there has been some movement toward consensus on the key determinants of the Tigers’ success and the relevant lessons for other economies. Unfortunately, it is not clear that the conditions that led to their success still exist for those coming behind them.

THE WASHINGTON CONSENSUS

Liberals have argued that the success of the Asian Tigers is evidence that a free market approach—both domestically and internationally—is optimal. In particular, their success is seen as real-world evidence that even poor countries benefit when they follow the laws of comparative advantage and of market economics. The Asian Tigers embraced the global market, rather than retreating from it. They acknowledged that they could not compete in every sector, but rather let the market determine the niches they targeted. They were willing to import the necessary inputs and technology. By producing where they could succeed, these countries had sufficient income to import what they needed. The World Bank produced a well-known analysis of the Asian Tigers, praising the cases as a triumph of the liberal model. It stressed that state intervention in those economies was tangential to their success.[19]

This interpretation became part of what was known as the **Washington consensus** on development strategy. By the late 1980s, leaders in donor countries and in donor organizations, most importantly the IMF and the World Bank, agreed on what was required for successful development. Internationally, the Washington consensus embraced the virtues of open economies and free trade. Domestically, it focused on minimizing the

Washington consensus
A development strategy favored by leading donor countries and organizations that advocates open economies, free trade, and minimal interference by the state in the economy

The Policy Connection

Child Labor and the Sweatshop Dilemma

Much of the clothing and other consumer goods that Americans buy are manufactured in developing countries under conditions that many consider unacceptable. Hours are long, wages low, and workers' rights limited. Moreover, in some countries, children as young as five years old work in these factories. Worldwide, one child in every six between ages five and seventeen works, and the proportion is much higher in developing countries.[1]

A number of organizations have taken up the task of combating child labor and sweatshop conditions. One, the Fair Labor Association (FLA), has over 200 U.S. universities and colleges as members. These institutions became involved when students protested the fact that much of the clothing bearing their school's name was made in sweatshop conditions.

The FLA "Workplace Code of Conduct" states that, "No person shall be employed at an age younger than 15 (or 14 where the law of the country of manufacture allows) or younger than the age for completing compulsory education in the country of manufacture where such age is higher than 15."[2] The code also contains less specific provisions on wages, safety, and workers' rights. Members of the FLA commit to using contractors who are certified by the FLA as following the Code of Conduct.

AP Photo/Dado Galdieri

A boy taking a break from sorting. He is one of an estimated 50,000 Brazilian children who work at garbage dumps. Are sweatshops bad if the alternative is picking through garbage? How can the range of alternatives be expanded?

PHOTO © ISTOCKPHOTO

state role in the economy, inspired by the policies of the Thatcher administration in Britain and the Reagan administration in the United States in the 1980s. This view dominated the advice given to developing states, and implementing free market policies became a central condition of receiving aid and loans in the 1990s.

THE ROLE OF THE "DEVELOPMENTAL STATE"

Others, however, strongly dispute the view that the East Asian states were textbook examples of a liberal development strategy. Doubters emphasize three key deviations from that

However, there is another perspective on the problem, a view that might be called "economic realism." This view argues that in conditions of poverty that are unlikely to end anytime soon, child labor and sweatshop conditions might be better than the alternatives.

Columnist Nicholas Kristof of *The New York Times* traveled to Cambodia to report on the large number of people who work in the city garbage dump. People brave the filth and stink to collect things such as plastic bags and scraps of metal that they can then sell, earning roughly seventy-five cents per day. Working conditions are undoubtedly bad in many factories, he says, "But the primary problem in places like this is not that there are too many people being exploited in sweatshops, it's that there are not enough."[4]

The International Labor Organization (ILO) disputes the idea that child labor is economically efficient. The ILO produced a study showing that although it would take $760 billion over twenty years to put all children in school and to replace the income that they would make working, the payoff would be as much as seven times that figure.[5]

Critical Thinking Questions

1. What kinds of sacrifices should people in wealthy countries be forced to make in order to end child labor in the poorest countries?
2. Should child labor be banned, even if that labor provides an important source of income for families? If it should be allowed in poor countries, why not for poor people in wealthy countries?

[1]"Economics Focus: Sickness or Symptom," *The Economist,* February 5, 2004.
[2]Fair Labor Association, "Workplace Code of Conduct," at http://www.fairlabororg /all/code/index.html
[3]Nicholas D. Kristof, "Inviting All Democrats," *The New York Times,* January 14, 2004.
[4]Nicholas D. Kristof, "Realities of Labor," Op-Ed Audio Slide Show, NYTimes.com, January 14, 2004.
[5]"Economics Focus: Sickness or Symptom," *The Economist,* February 5, 2004.

model. First, in the early years of their development, none of these states were democracies. South Korea, Taiwan, and Singapore were essentially authoritarian; Hong Kong was still a British colony. The authoritarian governments in these countries suppressed labor unions, sometimes violently, which kept wages much lower than they otherwise would have been. Low wages were an essential ingredient in the industrial competitiveness in these states. Only in the 1990s, when their economic success was already established, did Taiwan and South Korea become genuine democracies. In Singapore, democracy remains limited, and Hong Kong has been transferred from colonial British control to authoritarian Chinese control.

Second, in each country, the government took an active role in accumulating capital for investment and in directing that investment into particular industries. Governments picked industries in which they believed their firms could compete, such as shipbuilding in South Korea and microprocessors in Taiwan, and channeled investment into those sectors, rather than letting the market determine investment decisions. Close connections between governments and leading firms helped favored firms get access to cheap, state-subsidized capital for investment. Domestic competition was squelched so firms could concentrate on the international market. Moreover, through various mechanisms, the East Asian states provided "infant industry" protection to those industries identified as priorities for development.

Third, the state did not merely stand aside from the economy, but helped build the legal and bureaucratic infrastructure needed for capitalism to thrive. Financial markets will not automatically lead to development if insider trading and cheating are rampant, as Russia found in the 1990s. The state must do certain jobs, and do them very well. Among these jobs is investing in public education, which has been a hallmark of success in each of the Asian Tiger countries. Math and science education in these countries is far better than in the United States, and the steady supply of engineers and scientists produced by state-run universities has been essential to the continuation of earlier successes.

This more statist interpretation of the East Asian economic miracle gained currency after the Asian financial crisis of 1997–1998. That crisis helped expose the close connections between firms and the government, which in some cases were corrupt. The phrase "crony capitalism" suddenly replaced "Asian Tigers" in discussions of the region.

developmental state
A state that takes an active role in economic development by fostering the accumulation of capital to invest in particular industries and building the legal and bureaucratic infrastructure necessary for capitalism to thrive.

An alternative model of East Asian development, emphasizing the positive role played by the **developmental state**, emerged. Those who focused on the developmental state did not reject the importance of export-led growth or the role of the market domestically. However, they believed that the state plays an essential role in accumulating capital, directing investment, and providing legal, administrative, and educational infrastructure. In recent years the success of China has increased the credibility of the notion that a strong state is as important as embracing the free market, and is more important than democracy. The economic crisis in the United States and Europe beginning in 2008 further undermined the influence of the Washington consensus.

The Post-Communist Experience

The importance of the state gained renewed attention in the 1990s in light of the experiences of the post-communist states, and Russia in particular. The post-communist states were not as poor as many other developing states, but their economies were stagnating, largely because of state control. Therefore, most of the aid and advice given to post-communist governments centered on getting the government out of the economy and introducing the "invisible hand" of the market. A particular emphasis was on privatizing state-owned businesses. In the spirit of the free market, many advisors asserted that it did not matter how privatization was achieved, or who bought the firms; what mattered was getting the firms out of the hands of the state as quickly as possible. Exposing the firms to the competitive pressures of the market would achieve several objectives: align supply and demand, weed out weak and inefficient firms, direct investment and labor toward the most productive sectors, and attract foreign investment.

However, because state apparatuses were weak and corrupt, privatizing state companies worth billions of dollars became a bonanza for those well connected enough, or corrupt enough, to rig the privatization process. As a result, governments lost billions of dollars' worth of revenue, much of the economies came under the control of a small number of oligarchs, and bribery became a way of life in the government, especially in the post-Soviet states. Democracy and the free market, greeted with enthusiasm throughout the former Soviet Union in 1991, were viewed much more skeptically a decade later. By 2007, Russia and several other states had adopted a version of capitalism that preserved a major role for the state in determining economic priorities.

The central problem in the post-Soviet cases was the absence of a state authority strong enough, competent enough, and honest enough to ensure that people and firms competed fairly in the free market. The New York Stock Exchange works so well in large part because of the effective regulation of the Securities and Exchange Commission, the government agency charged with preventing fraud, insider trading, and manipulation of the market. Without such regulation, the market could not be expected to work—yet this is essentially what was expected to happen in most of the post-Soviet economies.


Reuters/STR/London

Assassination of Andrei Kozlov, Deputy Director of the Russian Central Bank, in 2006. Days earlier, Kozlov had advocated harsher penalties for financial crimes.

Emerging Consensus?

Today, much scholarship and many international organizations such as the World Bank are arriving at a view of development strategy that embraces both the free market and the developmental state. Although important differences of emphasis remain, most specialists acknowledge that both a competent and honest state and a willingness to embrace the market are necessary to produce economic development.

The World Bank, for example, continues to advise states to increase their openness to the global economy and to minimize market-distorting policies such as protectionism, but it is also giving increasing attention to issues of "good governance" and corruption. **Good governance** refers to government that is transparent, controlled by the rule of law, accountable, and effective. Interestingly, it now seems much easier to achieve economic openness than good governance. Once a state decides to open itself to free trade, the changes are relatively easy to implement from above. However, rooting out governmental overregulation, corruption, and incompetence requires thorough transformation, and government officials who profit from corruption may have little interest in such change.

good governance Governance that is transparent, controlled by the rule of law, accountable, and effective.

The Changing International Environment

Even if there is increasing consensus on the best strategies for development, two significant barriers remain. The first is that domestic transformation is very difficult to accomplish. In much of Africa, for example, it is impossible to think about serious governmental reforms in countries that are plagued by civil wars, health crises (such as AIDS), corruption, and authoritarian regimes with little interest in such reforms.

However, even for those states that adopt sound strategies, it is not clear that the path followed by the East Asian states is still open. The East Asian economies developed during the Cold War, and this timing substantially influenced their access to markets. For Korea and Japan especially, the strategic importance of the region made the United States willing to tolerate significant trade deficits because the United States had a security interest in helping them develop. Today, there is no such strategic impetus, and every country has become much more sensitive to trade deficits. Although the WTO agreement has lowered many barriers to trade, many of the poorest states are not eligible for these benefits because they are not WTO members. Moreover, the WTO is weakest in the area in which developing countries are most competitive: in agricultural exports. For example, some of the poorest countries in the world, including Benin, Burkina Faso, Chad, and

The Geography Connection

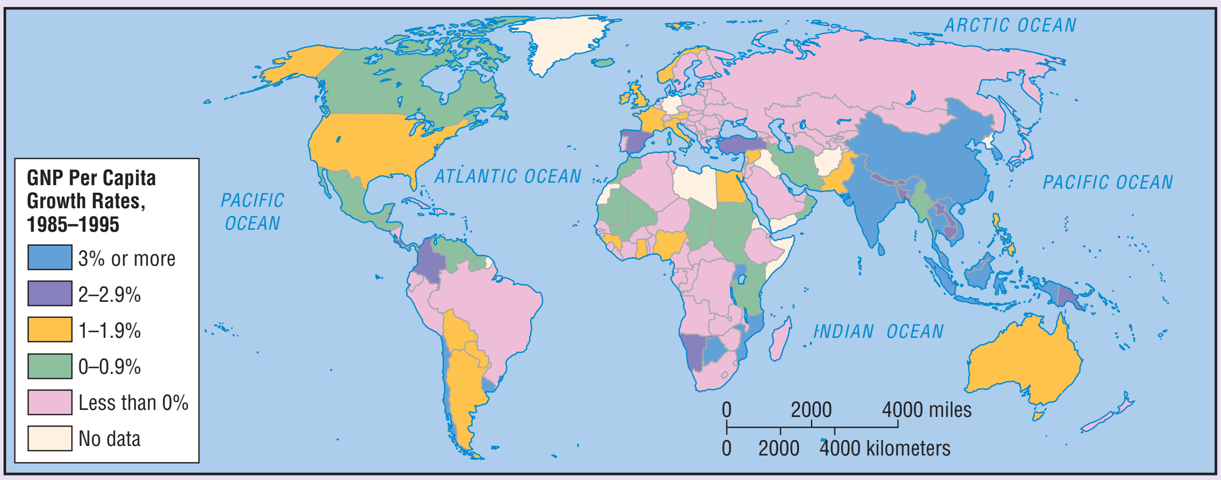
Women and Development

Examine these maps of GDP per capita and women's educational levels.

Critical Thinking Questions

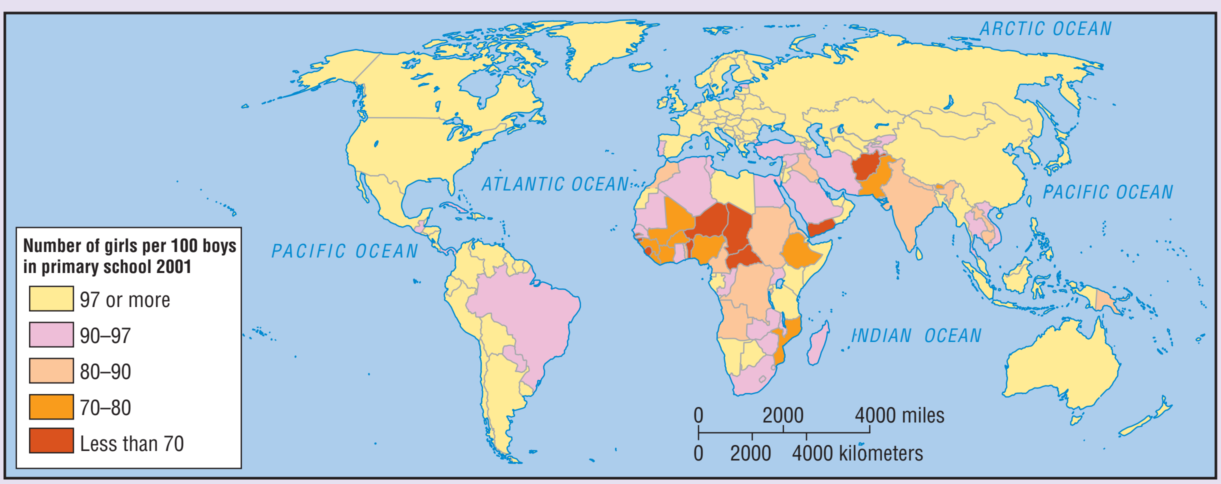
1. Where are the greatest disparities in educational level between men and women?
2. Do you see a correlation between overall levels of wealth and women's education?
3. If so, which of these factors is causing the other? Is it possible to tell this from the maps?

GNP per Capita Growth Rates



Source: http://www.worldbankorg/depweb/beyond/global/chapter4.html. Reprinted by permission of World Bank via Copyright Clearance Center.

Gender Equality and Empowerment of Women: Eliminating Differences in Education



Source: http://maps.grida.no/go/graphic/gender_equality_and_empowerment_of_women_education_status

Mali, rely heavily on cotton for export earnings. They must compete not only with producers in developing countries such as China and India, but with firms in wealthy countries such as the United States, which receive large subsidies from their governments.[20] This protectionism is the source of considerable resentment in the developing world, but interest-group politics in the wealthy countries make it difficult to abolish.

A separate, and perhaps more daunting, challenge is the increasingly competitive nature of the world economy. When the Asian Tigers were thriving in the 1970s, there were few countries using their strategy of low-wage, high-technology production for the export market. Today, many developing countries are trying this strategy, including not only the technologically advanced countries of post-communist Europe, but China and India. With over two billion people willing to work at low wages and with increasing technological sophistication, there seems to be little room for other competition on this basis. American labor has often complained that its low-wage jobs are moving to Mexico—but even Mexican workers, cheap by American standards, are finding their jobs outsourced to even cheaper labor in China.

The Role of Foreign Aid in Development

Whether out of altruism or self-interest, states, individuals, and international organizations have taken a strong interest in combating poverty and reducing inequality. Even those who are generally skeptical about the role of governments in the economy often advocate for foreign aid. The World Bank, at the height of the Washington consensus on free markets, continued to advocate and coordinate development aid. Historically, the crucial role of aid was demonstrated by the reconstruction of Europe after World War II, where the World Bank got its start. Similarly, the success of the U.S. Marshall Plan aid in rebuilding Europe (and in reducing support there for communism) provided both altruistic and self-interested justification for aid.

Over time, the approaches and strategies for international development aid have shifted as the prevailing thinking about the purposes of aid and the most effective programs has shifted. In much of the post–World War II period, development aid focused on infrastructure, technical know-how needed for development, and the investment funds that could build these things. Such projects were essential for further growth but were unlikely to be funded by private investment, either because of their public character (roads, dams, ports) or because the payoffs were of such a long-term nature that private investors would not be interested. Because private capital was in short supply, having wealthy state governments raise capital and distribute it through international organizations was seen as a solution. The hope was that by allowing states to build infrastructure, aid would create a better environment for smaller-scale private investment to succeed. That strategy characterized the post-war construction era up through the 1960s.

Under the presidency of Robert McNamara (1968–1981), the World Bank shifted from infrastructure projects to a **basic human needs approach** aimed at short-term alleviation of poverty. The belief was that if basic problems of food, shelter, and health care were not addressed, individuals and societies could not make longer term decisions and investments.

basic human needs approach
A development strategy focusing on the short-term alleviation of poverty as a prerequisite for further progress.

In the 1980s and 1990s, the goal of aid shifted again, to structural adjustment. **Structural adjustment** refers to efforts to strengthen the financial basis of a country's economy. The strategy was inspired by the focus on the free market and the role of monetary policy then ascendant in Western states (the Washington consensus). The strategy was to improve the investment climate by reducing government budget deficits and by stabilizing the value of the currency. Funding from the World Bank and the IMF was often

structural adjustment
A strategy adopted by the World Bank in the 1980s and 1990s aimed at strengthening the financial basis of a country's economy.

AP Photo/Ramon Espinosa

Members of Médecins Sans Frontières (Doctors Without Borders) work to save those wounded in a clash between Haitian gang members and UN Peacekeepers at this aid-funded clinic. Basic human needs approaches to development aim at directly addressing the problems of poor people, rather than on macro-level economic growth.

used to help states through the most difficult part of this process, and structural adjustment programs were often made a requirement for other kinds of international support.

Most recently, aid has focused on good governance. The current wisdom is that markets cannot function in the absence of a competent and honest government and that corruption plays a major role in undermining investment in particular and economic growth in general. Additionally, a focus on the UN Millennium Development Goals, with their emphasis on human development, signals a partial return to the basic human needs approach.

International aid has also played an important role in addressing emergencies and humanitarian crises around the world. Food aid has repeatedly been used to reduce starvation when food supplies have fallen short for one reason or another. International aid to refugees displaced by war or natural disasters has been important, as has immediate help to countries in times of natural disaster, such as after the Haitian earthquake of January 2010.

Shortcomings of International Aid

There is considerable debate on whether and how aid actually contributes to development. One problem with most international aid is that it goes primarily to governments. In general, this makes sense because it is governments that are generally charged with getting economies to function better. For example, the central goal of structural adjustment aid is to shore up weaknesses in a government's financial position. However, the government may be a central part of the problem, through some combination of corruption or incompetence, and even when a government is competent in general, it may be ill suited to carrying out the tasks envisioned by the aid.

If governments cannot or will not spend aid effectively, the money may be wasted. When the money in question is lent, rather than donated outright, the society faces a financial burden that it must repay. International organizations and governments have been widely criticized for lending money to corrupt Third World governments, which sometimes simply funnel the money into offshore bank accounts or into the hands of their supporters. Regardless of what happens to the money, the citizens of that country are left to pay it back through tax payments, sometimes long after the corrupt government in question is gone (along with the money). For countries that have a difficult time earning enough hard currency to fund investment, having to spend that money to pay back debts incurred by previous governments for projects that yielded no benefits is especially frustrating.

Another problem is that aid sometimes flows out of a country as quickly as it flows in. What economists call the "multiplier effect" of aid then may accrue to the donor rather than to the recipient. The **multiplier effect** refers to the fact that when money is spent (for example, on goods), the person or firm receiving the money often spends all or part of it on something else, and the recipient of those purchases does the same, and so on. Thus, a single donation has its effect multiplied as it flows through an economy, yielding profit to a succession of firms or individuals. If the money flows immediately out of the country, the multiplier effect goes with it.

multiplier effect
An economic effect whereby an increase in spending (for example, of funds provided to a country by a donor) produces an increase in national income and consumption greater than the initial amount spent. When aid flows out of a country, the benefit of aid may accrue to the donor rather than to the recipient.

This is especially true of so-called **tied aid**, which must be spent on goods or services from the donor country. Especially when tied aid comes in the form of loans, the receiving country may get little of the benefit of the aid, but be responsible for paying back the entire loan. For example, the Freedom Support Act, through which the United States provided aid to the post-Soviet states after 1991, required that much of the money be spent on U.S. grain and farm equipment, both of which were more cheaply available in Russia. The benefit to U.S. firms was obvious, but it is not clear that this provision of the act provided a substantial benefit to the Russian economy. In a similar vein, the World Bank has been faulted for requiring that significant portions of its aid be spent on technical assistance, which generally comes in the form of costly consultants from developed states.

tied aid
Aid that must be spent on goods or services from the donor country.

Some analysts support the idea of aid but believe that the shortcomings of aid are so common, and so difficult to combat, that in practice aid does more harm than good. Economist William Easterly charges that "one of the best economic ideas of our time, the genius of free markets, was presented in one of the worst possible ways, with unelected outsiders imposing rigid doctrines on the xenophobic unwilling."[21] For example, if it is true that aid can only be implemented wisely by competent governments, it is also true that countries with competent governments are among the least likely to need aid. Many would take exception with this view, arguing that substantial aid packages make it much easier for competent governments to pursue economic reforms.

A more strident school of thought disagrees with aid in principle, based on a belief in the primacy of markets. To those who believe that any interference with the market inhibits reform, aid makes the problem worse, not better. It is hard to test this theory for two reasons. First, to withhold aid altogether would be considered inhumane by many. Second, interference with market forces is practiced by every government in the world and is provided for in international agreements such as the WTO, and it is unlikely that the "pure" market would be adopted in this one area.

Multilateral Aid and the World Bank

Multilateral aid pools donations by multiple states and then distributes the aid through international organizations. There are various international organizations engaged in providing multilateral aid, including the World Bank, the IMF, and the UN Development Programme.

Among these organizations, the World Bank, based in Washington, D.C., is widely considered the most important because it is the primary vehicle for multilateral aid in terms of the amount of money disbursed. It also influences other donors. Individual governments and private lenders routinely rely upon the World Bank's evaluations in making their own decisions about aid and lending. Moreover, it has widely recognized expertise in the area of development (although many disagree with its views). As a result, the World Bank has played a leading role in defining the "best practices" in development aid for the past six decades. More fundamentally, the World Bank has shaped the very definition of "development," which is often taken for granted but which shapes the purpose of all aid activities.[22] Because it plays this central role, the World Bank has been a primary target for criticism by those who question the dominant practices.

STRUCTURE OF THE BANK

The World Bank consists of two main structures and several smaller ones. The two main structures are the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA).

The IDA focuses on the poorest countries, those who may have considerable difficulty paying back any aid. It averages roughly $14 billion per year in new loans, over half of which is spend in sub-Saharan Africa and almost another third of which is spent in South Asia. In 2009, the top five borrowers were Nigeria, Pakistan, Ethiopia, Vietnam, and Bangladesh. Its loans have a ten-year grace period on repayment of the principle; in 2009, however, 18 percent of loans were grants, meaning they do not need to be repaid. The main program areas are infrastructure (35 percent), social sector such as education and health services (26 percent), and public administration (19 percent). One sees in this funding a mix of development strategies: infrastructure development, basic human needs, and improved governance.[23]

The IBRD focuses its lending on middle-income countries and poorer countries considered to be a good risk in terms of repaying loans. South Asia and Africa each receive about a quarter of the bank's loans, with Latin American, Eastern Europe, and Asia receiving between 15 and 20 percent each. The two largest areas of focus are public administration and law enforcement (22 percent) and transportation (20 percent). Other areas of emphasis include water and sanitation, health, and education.[24]

Two smaller World Bank agencies seek to foster private investment in developing economies. The International Finance Corporation finances private investment in developing countries. The Multilateral Investment Guarantee Agency provides political risk insurance for private investors, helping protect them against political turmoil in developing countries, and therefore reducing the danger of investing.

Whereas voting on policy is based on "one state/one vote" within most international organizations, voting in the World Bank (and in the IMF) is based on the financial contributions each member makes to the Bank's lending resources. In 2009, the United States had 16.4 percent of the votes, followed by Japan with 7.9 percent, Germany with 4.5 percent, and France and Britain with 4.3 percent each. The remaining 182 World Bank member states each have less than 1 percent of the vote. Moreover, the president of the World Bank is, by tradition, always an American.

The voting structure of the World Bank is based on pragmatism. It would be impossible to get the wealthy countries to put significant resources into an organization they did not control. However, this structure is one source of dissatisfaction with the World Bank. The developing countries have little influence at the Bank. This leads to accusations that the Bank remains a semicolonial organization, in which the wealthy countries decide what will happen to the poor ones.

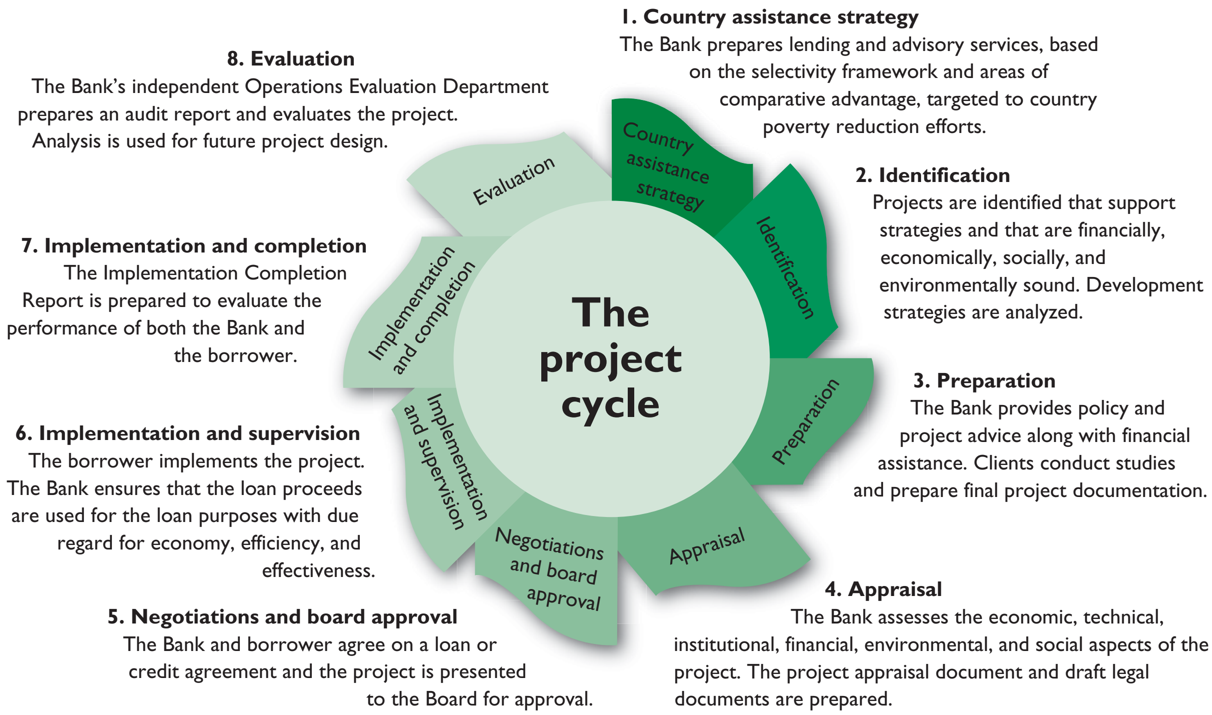
Table 11.3 Voting Shares at the World Bank, June 2010

Country	Percent of Votes
United States	16.40
Japan	7.87
Germany	4.49
France	4.31
United Kingdom	4.31
Canada	2.78
China	2.78
India	2.78
Italy	2.78
Russia	2.78
Saudi Arabia	2.78
Netherlands	2.21
Brazil	2.07
Belgium	1.80
Spain	1.74
Switzerland	1.66
Australia	1.52
Iran	1.48
Venezuela	1.27
Mexico	1.18
Argentina	1.12

The rest of the World Bank's 187 members have less than 1.12 percent of the vote.

Source: World Bank, "International Bank for Reconstruction and Development Subscriptions and Voting Power of Member Countries," at http://siteresources.worldbank.org/BODINT/Resources/278027-1215524804501/IBRDCountryVotingTable.pdf

Figure 11.3 World Bank Project Cycle



Source: http://siteresources.worldbank.org/OPPORTUNITIES/Images/projectcycle-ar03_big.gif. Reprinted by permission of World Bank via Copyright Clearance Center.

ACTIVITIES OF THE BANK

The World Bank has three important functions.

- Conducting research on development issues
- Making policy recommendations to specific governments
- Lending money

In practice, these three activities are closely linked. Policy recommendations are often linked directly to loans provided by the IBRD and IDA. In a practice known as **conditionality**, states wishing to receive loans from the World Bank must agree to certain conditions, which generally take the form of a set of policies that the World Bank believes will help promote development. Countries often resent these conditions—but when they are desperate for a loan, they feel they have little choice but to accept them. In many cases, the terms of those loans are *concessionary*, meaning that the interest rates and repayment schedules are more generous than what could be obtained in private financial markets—but in all cases the loans must be repaid whether the recipient's economy improves or not. A developing country that defaulted on loans from the World Bank would find virtually every other source of credit cut off as well. Therefore, it is important that loans are made wisely and programs implemented effectively, but that has not always been the case.

conditionality
The requirement that an aid recipient agree to a set of conditions that the donor believes will help promote development in the country.

CRITIQUES OF THE WORLD BANK

The World Bank has been the target of sustained criticism, from policy experts and social activists alike. The joint meetings of the World Bank and the IMF, held every year in Washington, D.C., are routinely the target of protests by thousands of people, and much of central Washington is shut down in order to keep protestors from gathering at the Bank's headquarters.

Protesters outside the World Bank in Washington, D.C., in 2007.

The World Bank has its own version of the rational action model of decision making and has been widely criticized for deviating from the model in various ways.

Some of the criticisms of the World Bank echo the general criticisms of development aid. Others are specific to the World Bank. The following are among the most significant criticisms of the World Bank:

- The voting procedure disenfranchises the poor countries that have the most at stake.
- Lending, unless it is highly effective, may leave recipients with debts but without much benefit.
- Conditionality undermines the sovereignty of recipient governments.
- Conditionality often requires harsh economic policies, which hurt the poorest people in the recipient countries most.
- Conditions that produce hardship can lead to unrest, destabilizing the very government the Bank is trying to help and undermining the basis for reform.
- Development projects supported by the World Bank have been focused only on narrow economic performance, and in some cases have had severe environmental consequences.
- The Bank's analysis and its conditionality policies seem to be driven by an ideology, economic liberalism, that many believe is too simplistic for the problems it addresses.

Despite the frequently bitter criticisms leveled at the World Bank, it remains one of the few available sources of investment, advice, and credibility for the development efforts of poor states. Despite the dissatisfaction with it, therefore, the rich states continue to support it financially, and poor states continue to look to it for aid.

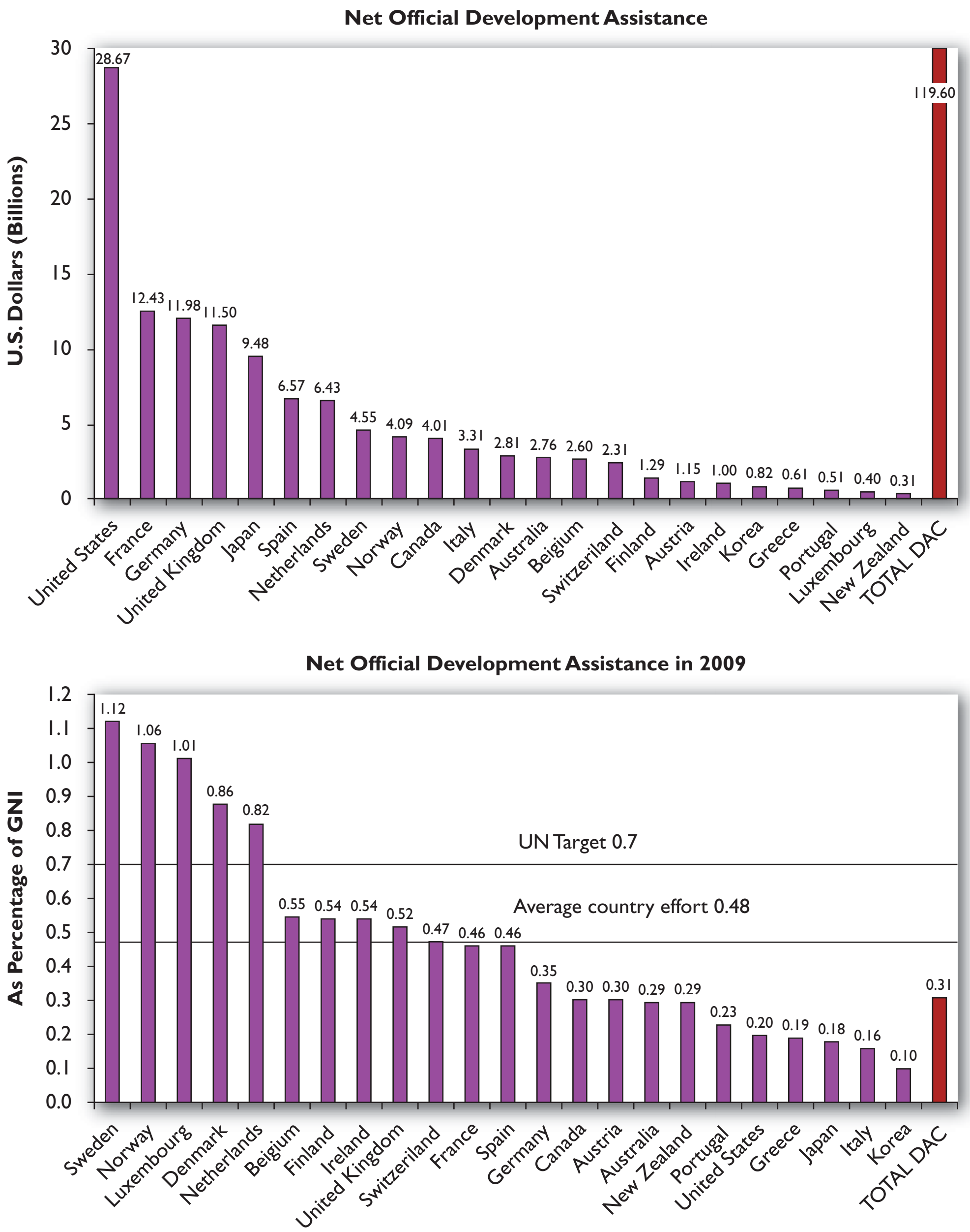
Bilateral Foreign Aid

Bilateral foreign aid, defined as aid given by one government directly to another, is almost as controversial as World Bank aid. Although there are important historical successes, bilateral foreign aid is criticized both within the donor countries and internationally.

In the United States, many politicians have criticized the amount of funding spent on foreign aid projects. Others, however, believe that U.S. aid levels are too low. Respondents to a 1995 public opinion survey estimated, on average, that U.S. foreign aid was 15 percent of the national budget. In fact, aid at that time made up less than half of 1 percent of the U.S. budget.[25] The gross overestimation of how much is being spent may have some effect on how unpopular that aid is and therefore on the likely political support for such aid. Since 1960, U.S. foreign aid has decreased from 0.52 percent of GDP to 0.24 percent.[26] As Figure 11.4 shows, the United States is the largest donor in terms of absolute dollars but is far behind in terms of aid as a percentage of GDP.

There are two main arguments against bilateral aid. First, bilateral aid is often seen as serving the geopolitical needs of the donors more than the development needs of the recipients. Thus, the single largest recipient of U.S. foreign aid in recent years has been Iraq. For the past few decades, the top recipient was not a developing country at

Figure 11.4 Aid in U.S. Dollars and as a Percentage of Gross National Income (GNI). The total net official development assistance in 2009 was about $119 billion.

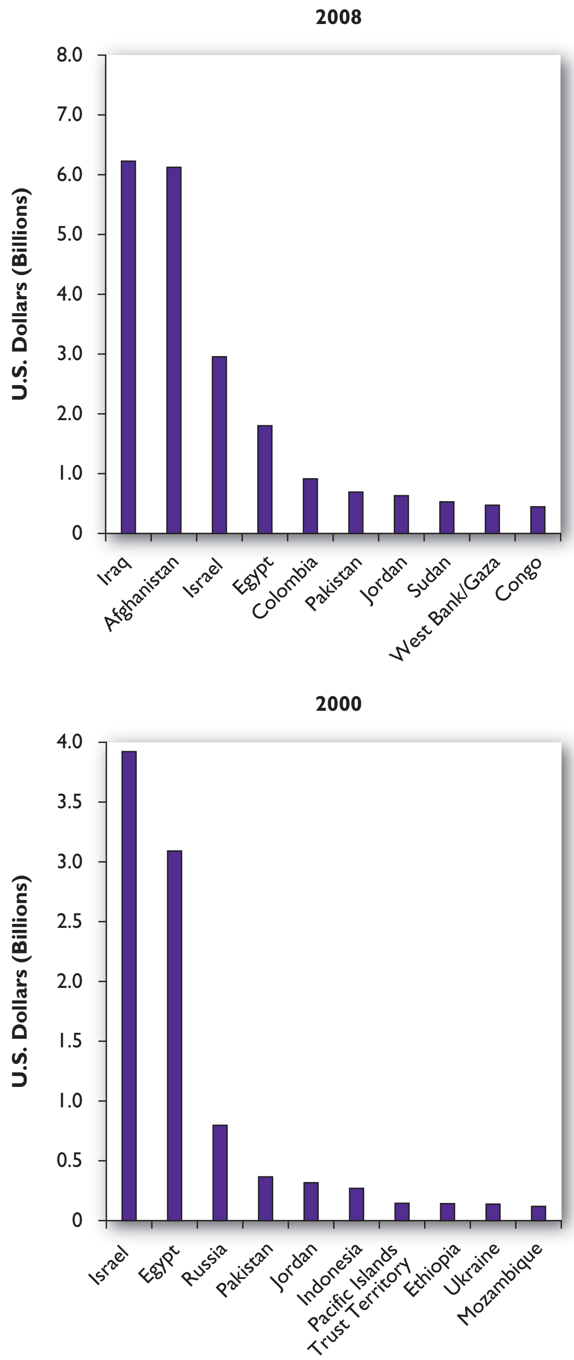


Note: DAC refers to the Development Assistance Committee, an organization of major aid-providing countries.
Source: http://www.oecd.org/dataoecd/23/14/37955301.pdf. Reprinted by permission of OECD.

all, but rather Israel, a key ally in the Middle East. Following Israel, the second biggest U.S. aid recipient is Egypt, in return for its role in the Middle East peace process. Figure 11.5, showing U.S. aid in 1994 and 2004, gives some indication as to how priorities have shifted.

Second, a great deal of bilateral aid is tied aid, which must be spent on goods and services from the donor country, such that much of the economic benefit accrues to firms in the donor states. In particular, critics point out that much bilateral aid is in the form

Figure 11.5 Top U.S. Aid and Grant Recipients in 2008 and 2000



Source: Curt Tarnoff and Larry Nowels, "Foreign Aid: An Introductory Overview of U.S. Programs and Policy," U.S. Congressional Research Service, April 2004, p.13.

of loans to buy military equipment from the donor. Such purchases contribute nothing to the economy of the aid recipient and may make the region in question less secure.

Nonetheless, foreign aid remains an important foreign policy tool, even if it is not a significant development tool for the poor countries of the world. Shifting patterns of aid programs show that countries tend to contribute where they have the most immediate foreign policy aims. In the 1990s, for example, the EU concentrated its aid efforts on the post-communist states of eastern Europe, the stability and prosperity of which were considered essential to the security and economic interests of the EU. In the past decade, China has taken on a larger foreign aid role, especially in countries in Africa with important natural resource supplies.

After the attacks of September 11, 2001, aid from various governments shifted to the states of Central Asia, which are viewed as crucial in dislodging the Taliban movement in Afghanistan and in preventing the spread of militant Islamic fundamentalism. That the governments are neither democratic nor following accepted economic development strategies was less important than that they are willing to ally themselves with the West in the "global war on terror." From the perspective of economic development, this may not make much sense, but from the perspective of national security, it makes a great deal of sense. Thus, bilateral aid is best thought of as a foreign policy tool, not as a development tool.

Reconsider the Case

India: From Riches, to Rags, to . . . What?

India's poverty at the time of independence could be blamed in large part on colonialism, but the end of colonialism did not automatically put the country on the path to rapid growth. Since then, India experimented first with an import-substitution model of development, which after several decades was viewed as a failure. Later, a model that combined export-led growth with domestic liberalization yielded better overall results, and for many, India's high-tech industries make the country a new global powerhouse to be admired and feared.

However, when examining the question of poverty, India's recent experience looks more mixed. Eighty-six percent of Indians live on less than $2 per day.[27] Twenty-nine percent of Indians live below the government-defined poverty line. Forty-seven percent of children under five are malnourished.[28]

Is India's glass "half full" or "half empty?" Clearly, most of the trends are moving in the right direction. But whether this is good news or not depends on how progress is defined. Overall, India's growth rate is faster than that of many developing and developed states. But given where it is now, it will take a very long time for India to match European standards of living, even if current trends prevail. Similarly, although the poverty rate is being reduced, inequality in India is actually growing.[29] Is it possible to devise economic development strategies that reduce not only the poverty rate, but the gap between rich and poor? This is not just a question for international economics, but for policy makers who must try to steer their countries along the uncertain path of economic development.

Critical Thinking Questions

1. How has India's recent economic strategy compared to that of the Asian Tigers?
2. Given the measures India took in 1991 to open up its domestic market to free trade and reduce government controls, what factors do you think will determine whether India's reforms will be a success?
3. How might it be possible to devise development models for countries such as India that close gaps between poor and rich as well as lifting people out of poverty?

Summary

There remains considerable debate about the causes and potential cures of global inequality and of the poverty that pervades much of the world. Does the international system breed inequality, or is free trade the route to wealth? The uneven pattern of success and failure across states indicates that neither of these arguments is always true. Recent findings indicate that what goes on in the international system is not nearly as important as domestic policies within poor countries.[30] If so, what domestic factors seem to inhibit and which seem to promote wealth creation? The debate has evolved in recent years, and there is increasing agreement on a combination of previously accepted views. Socialist approaches, in which the state makes most of the decisions in the economy, have been discredited among scholars but have made a minor comeback among governments such as that of Venezuela. To a large extent, import substitution has also been discredited. There is broad agreement that the market is essential to economic growth. However, there remains considerable disagreement on the proper role of the state. Some see the state as doing more harm than good; others see the "developmental state" as a key actor in creating and maintaining a strong market and in building internationally competitive business. After the 2008 economic crisis, state intervention also appeared useful for limiting the tendency for free markets to spin out of control

Increasingly, analysts and policy makers are coming to believe that international trade promotes economic development, as the experience of the Asian Tigers seemed to demonstrate, but many continue to argue that trade is fundamentally unfair and will lead to increasing gaps between rich and poor. Foreign aid is equally controversial. The funds allocated for it remain miniscule, and much bilateral foreign aid is aimed at political goals rather than economic development. Despite the lofty pronouncements often made about substantially reducing global poverty, it will quite likely remain a serious problem for decades to come.

Key Concepts

1. Human Development Index (HDI)
2. Gini coefficient
3. Late development
4. Economies of scale
5. Network effects
6. Import substitution
7. Export-led growth
8. Washington consensus
9. Developmental state
10. World Bank
11. Tied aid
12. Good governance

Study Questions

1. What are some different ways of defining and measuring poverty?
2. What challenges do late developers face that early developers did not?
3. What have been the major strategies adopted by late developers?
4. What contrasting explanations are there for the success of the Asian Tigers?
5. What are the main arguments for and against foreign aid?

CourseMate

Endnotes

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