

Economics

for the IB Diploma

2nd Edition



SEAN MALEY
JASON WELKER

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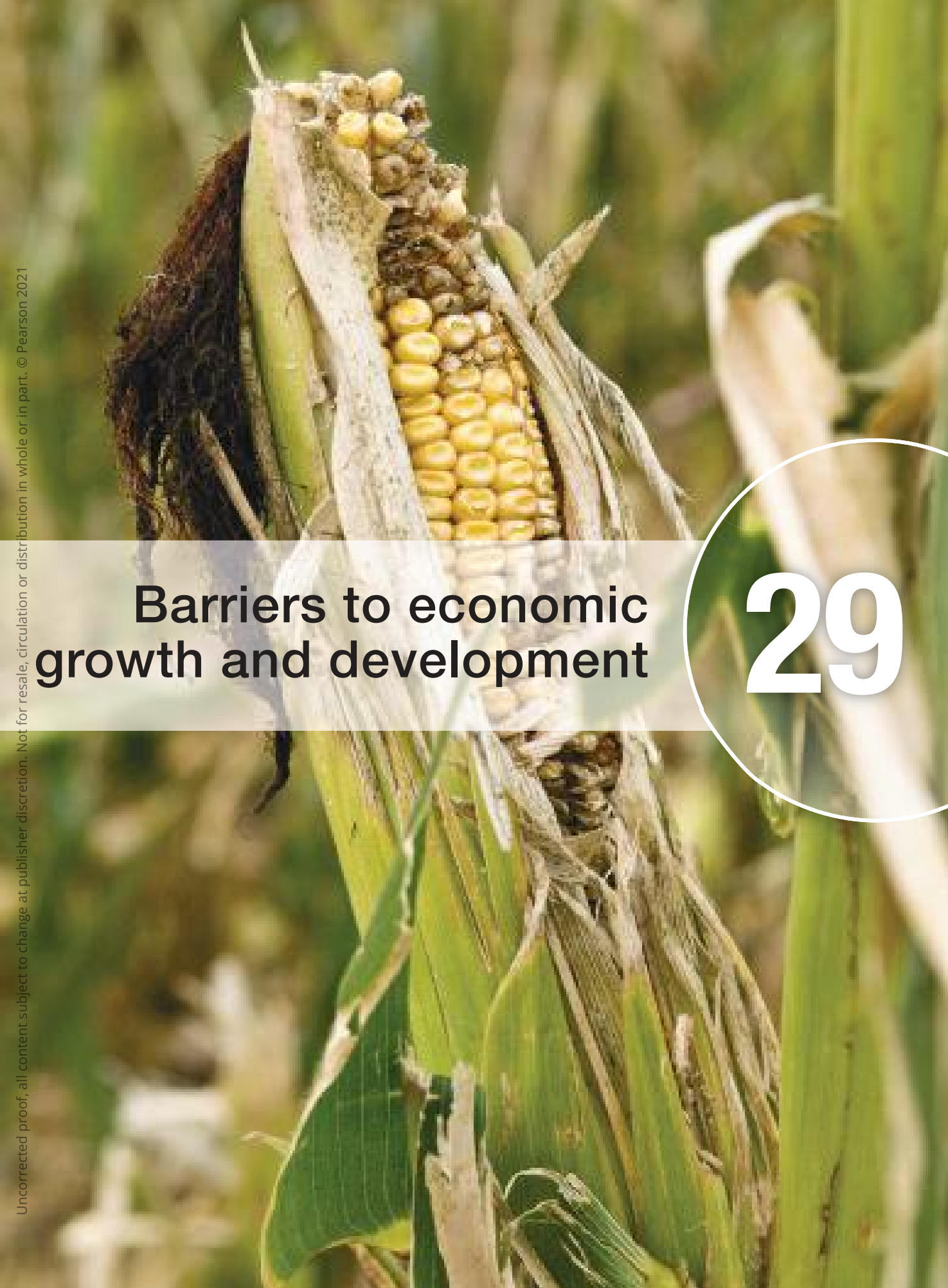
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Barriers to economic growth and development



In our last two chapters we established a definition of economic development, with an acknowledgement that sustainable development requires a broad look at human well-being that incorporates economic, social, political, and environmental considerations. We have also examined the common characteristics of less economically developed countries and looked at the different measurements of economic development, both single indicators and composite indicators.

In this chapter we will ask the question, ‘What are the barriers to economic development?’ In order for countries to overcome poverty and raise living standards to a level at which a healthy, happy life can be enjoyed by all, an understanding of the obstacles their economies face is crucial.

29.1 What is a poverty trap?

Learning outcomes

At the end of this section you will be able to:

- using a diagram, explain how certain factors can trap a country in a cycle that perpetuates poverty, including:
 - natural resource endowments
 - geography
 - education
 - poor governance
 - conflict.

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

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

What is the natural resource trap?

A poor country with few natural resources may find itself in a poverty trap for two reasons. First, without mineral, energy, forest, or marine resources it cannot sustain its domestic need for such resources. Second, it cannot export resources to earn much needed foreign exchange. Without a developed secondary, manufacturing sector, many poor countries (such as the Democratic Republic of Congo and other mineral-rich countries in Africa) depend greatly on the export of raw materials to Europe and East Asia.

A country without a secondary sector and a poor supply of natural resources, however, could find itself in a particularly difficult situation in which the foreign capital required to invest in its secondary sector is inaccessible due to the lack of exchangeable commodities from within the country. Figure 29.1 provides an

Figure 29.1 In the natural resource poverty cycle the lack of exportable commodities hampers economic development

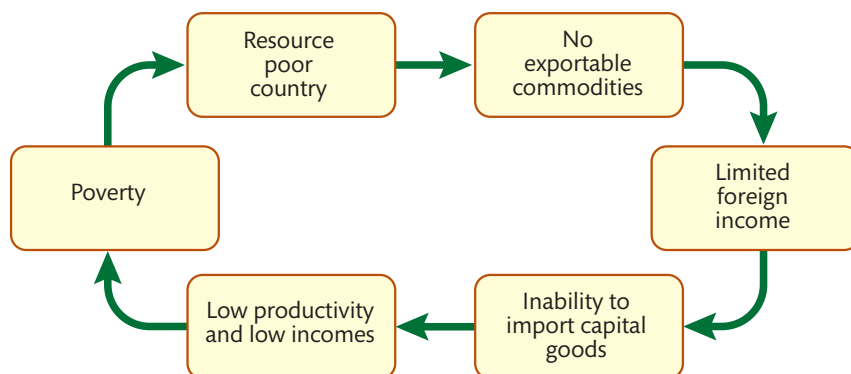


illustration of a poverty trap in which a poor country is kept poor because of its lack of exportable natural resource commodities. The trap is illustrated in a circle, or a *poverty cycle*: a self-perpetuating cycle of poverty from which the country cannot escape.

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

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

What is the geography trap?

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

A look at the map of Africa, Asia, or South America identifies many landlocked countries that are among the poorest in the world, including Bolivia, Paraguay, Niger, Zambia, Nepal, and Afghanistan.

Some of the poorest countries in South America, Africa, and Asia are landlocked and surrounded by other poor countries, a situation that makes it incredibly difficult for the landlocked country to begin a journey on the path of economic development. Figure 29.3 provides an example of the poverty cycle a landlocked country might find itself in.

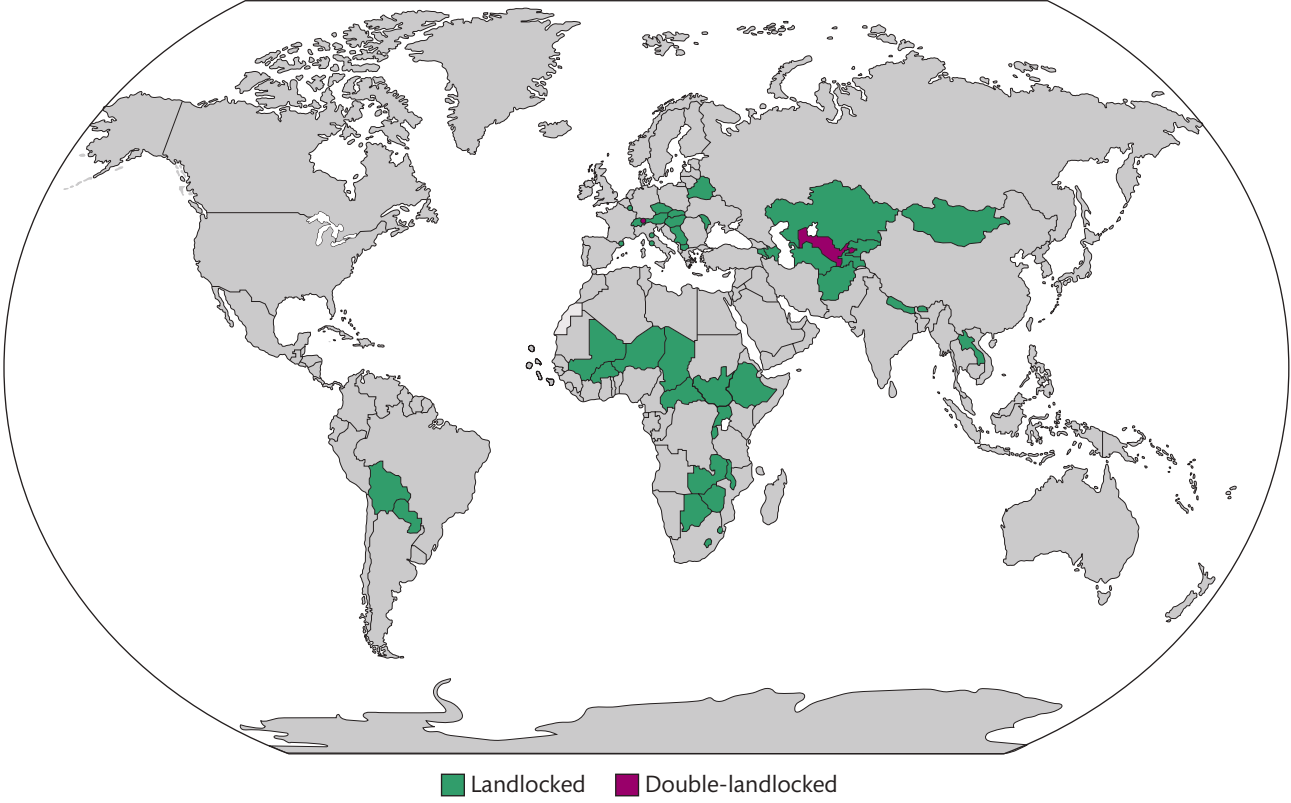


Figure 29.2 The landlocked countries of the world

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

What is the education and poor governance trap?

One of the most important functions of government is to collect taxes and provide public goods to the nation's people, including education, healthcare and

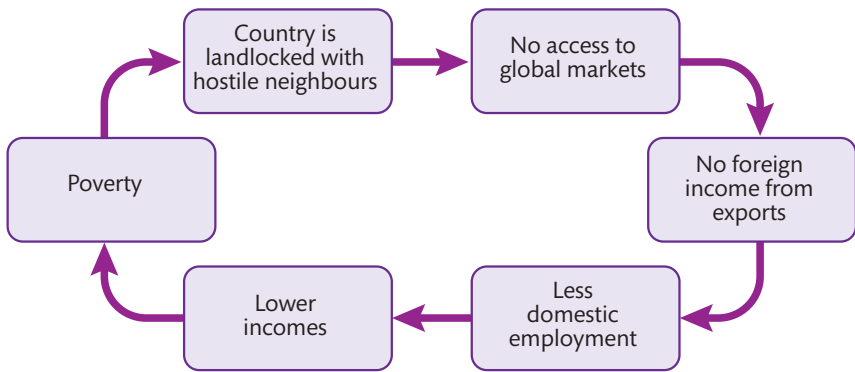
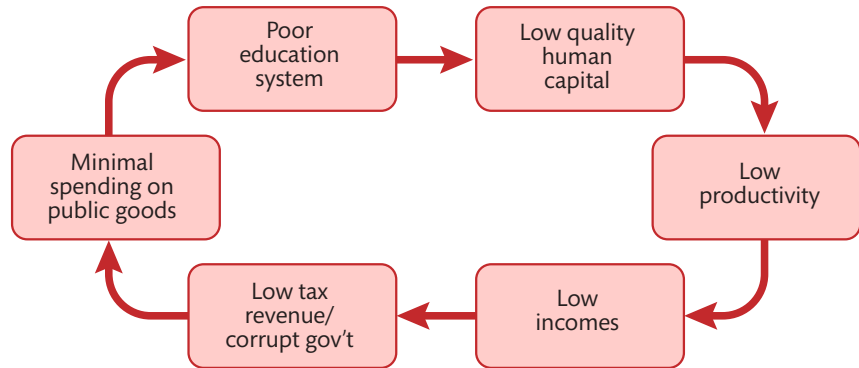


Figure 29.3 In the geography poverty cycle a lack of sea ports blocks access to global markets and stunts growth

Figure 29.4 In the education poverty cycle under-provision of education perpetuates poverty and bad governance



infrastructure. In a poor country with a corrupt government, an ineffective tax system and a poor education system, economic development is nearly impossible to achieve. And under-provision of education perpetuates the bad governance and poverty, as can be seen in Figure 29.4.

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

What is the conflict trap?

Perhaps the worst poverty trap for a country to find itself in is a conflict trap. Unfortunately, any of the three poverty traps described above can easily deteriorate into conflict, and if a country finds itself in all three situations (landlocked with poor natural resources, and a corrupt government) the likelihood of conflict arising is extremely high. Civil unrest perpetuates poverty for many reasons, but Figure 29.5 shows the basic problem with conflict in a developing nation.

Much of the conflict in poorer countries is over the resources that are needed to generate income that could then be put to work improving people's lives. But the existence of conflict ultimately intensifies the scarcity of resources and creates an environment of political and economic uncertainty that makes the country unattractive to foreign investors who might otherwise invest in the nation's economy.

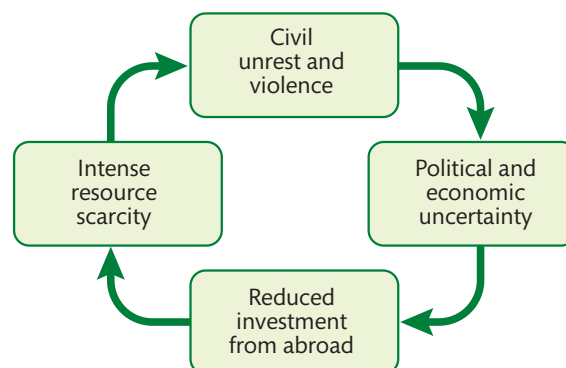


Figure 29.5 In the conflict poverty cycle scarcity of resources is both cause and effect

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

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In this way, conflict born from scarcity actually intensifies scarcity and thereby fuels more conflict. A country in which many resources are going towards waging an internal war is most certainly going to remain poor until stability is achieved and an atmosphere deemed safe for international investors is restored.

29.2 What are the economic barriers to growth and development?

Learning outcomes

At the end of this section you will be able to:

- examine the role of barriers to economic development including:
 - inequality
 - lack of access to infrastructure and appropriate technology
 - low levels of human capital
 - lack of access to healthcare and education
 - dependence on primary sector production
 - lack of access to international markets
 - informal economy
 - capital flight
 - indebtedness
 - geography including landlocked countries.

What is the relationship between inequality and economic growth and development?

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

Inequality can be considered both a cause and a consequence of underdevelopment. In a way, growth and development present a pathway towards greater equity and equality in society; after all, the larger the pie, the more there is to go around. However, a low level of economic development can also be caused by inequality, as without a level playing field and an equitable opportunity for all in society to pursue and maintain a higher standard of living, economic development can never get underway. Equity requires that all people are offered the same opportunities, including access to education and healthcare. While gaps between rich and poor might exist, they are not so great that they cannot be overcome through individual perseverance and hard work.

The picture painted here is idealistic; in reality the many other social, cultural, economic, and political barriers to economic development complicate the picture and make improved equity and a more equal distribution of income that much harder to achieve.

Why do a lack of access to infrastructure and appropriate technology slow development?

Infrastructure includes roads, highways, airports, rail track, ports, and communications technologies such as cellular towers, phone lines, and internet. It also includes a nation's stock of schools, hospitals, clinics, community centres, cultural centres, office buildings, and all other 'manufactured inputs' that contribute to economic growth and development.

A lack of access to infrastructure leaves a country in a permanent state of underdevelopment. Infrastructure is like the essential organs that support the life of a functioning economy. Roads are the arteries of commerce, telecommunications the neurons, school the brains, and hospitals the immune system. Without infrastructure, the organism that is the economy is sick and cannot function efficiently.

Where does infrastructure come from? Once again we return to a chicken and egg question. Without economic growth, a country cannot afford to invest in infrastructure, which itself is necessary for economic growth. In other words, some income is needed before infrastructure improvements can be made. For very poor countries, international aid or foreign investment could provide infrastructure, either through private investments from multinational corporations or via aid from international organisations like the World Bank (which will be explored more in Chapter 30).

What is human capital and why does it matter?

Human capital refers to the level of skill, knowledge, and education among a country's workforce. A low level of human capital occurs in countries in which access to education is inadequate, while good schooling improves human capital.

Why is it important? While growth and development can take place even in a country with low levels of human capital (an export-oriented growth strategy based on the employment of unskilled workers in agriculture, mining, or manufacturing industries, for example) there is ultimately a ceiling at which improvements in living standards will be capped without investing in human capital. The most developed countries in the world, in which households enjoy higher incomes, but also better health and a cleaner environment, are typically those in which human capital has been invested in through providing high quality education systems for decades. The jobs available to high-skilled workers are typically safer, pay higher incomes, offer more benefits like paid holidays, and take a smaller toll on the physical well-being of those who do them. Therefore, improving human capital is a sure means to promote economic growth and development.

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

How does a dependence on primary sector production affect development?

In Section 29.1 we looked at the 'resource trap' that many poor countries that are overly dependent on the production of primary commodities have found themselves in.

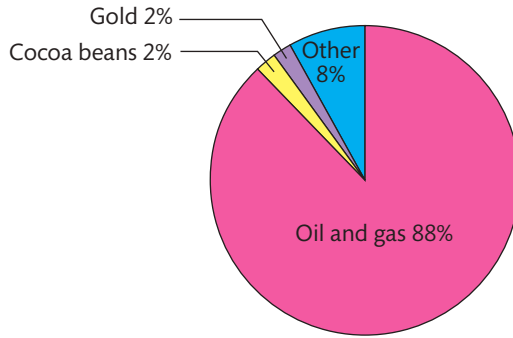


Figure 29.6 Most of Nigeria's exports are of oil and gas

Many less economically developed countries tend to over-specialise in a narrow range of products, oftentimes primary commodities such as energy resources, minerals, and agricultural goods. Consider Figure 29.6, which shows the composition of Nigeria's exports to the rest of the world.

Observe from the pie chart that 88% of Nigeria's exports are of energy resources (oil and gas). While specialisation in petroleum allows Nigeria to achieve a high level of efficiency in the production of this valuable resource, it also leaves the country highly vulnerable to fluctuations in global petroleum prices.

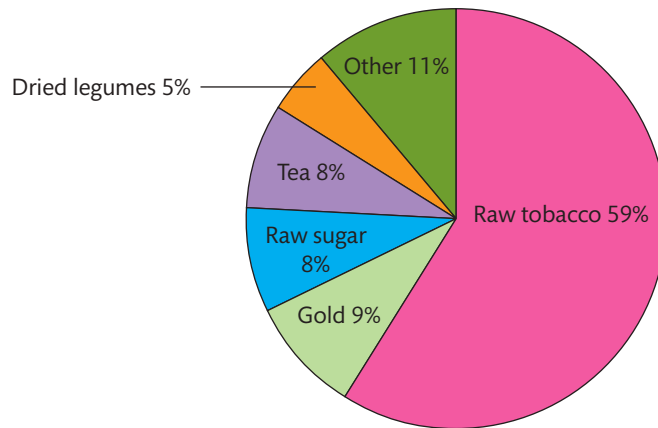
When oil prices are high, Nigeria can expect to enjoy booming export revenues, strong aggregate demand (AD), higher levels of employment and income, and a strong currency. However, when global oil prices fall, Nigeria's AD, employment, price level, aggregate output, and currency exchange rate will all decline. The current account balance will move towards a deficit and Nigeria's foreign income will fall, making it difficult to afford the imports of manufactured goods and technology that it depends on for economic development.

Consider Figure 29.7, which shows the world oil price between 2005 and 2017. As the price of its only major export fluctuated, Nigeria's economy would have experienced macroeconomic shocks as its export earnings rose and fell. When oil prices rise, Nigeria's currency appreciates as demand for its major exports increases. High export revenues and a strong currency allow Nigeria to buy imported technology and consumer goods relatively cheaply and promote improvements in economic development as the cost of welfare-improving products becomes more affordable.



Figure 29.7 Global oil price fluctuations, 2005–17

Figure 29.8 Malawi's exports are almost all agricultural goods



However, when oil prices fall, Nigeria's ability to buy those development-supporting imports decreases. The problem with primary commodities, as we learned in our microeconomic chapters, is that their prices tend to be highly volatile due to relatively inelastic demand and supply. For this reason, over-specialising in a single or a small number of primary commodities leads to instability and poses a barrier to economic development for poor countries.

Let us consider another country that is overly dependent on a narrow range of exports. Figure 29.8 shows the composition of Malawi's exports.

Malawi specialises almost entirely in agricultural goods (80% of exports), which like oil tend to have highly volatile prices on global markets due to their highly inelastic supply and demand. Consumers are not highly responsive to price changes, so changes in supply year to year tend to result in sharp spikes or dips in global price. In the short-run, supply of agricultural goods is highly inelastic, resulting in price volatility as demand rises and falls.

For comparison, let us look at the composition of goods produced in a more economically developed country, the UK. Figure 29.9 shows the UK's exports by category.

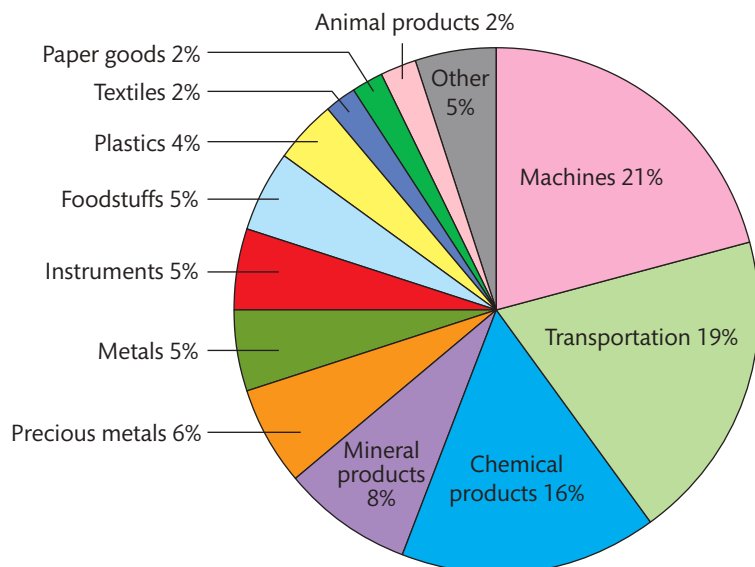


Figure 29.9 United Kingdom exports include a diverse range of goods

Obviously, the UK produces a much more diverse range of goods for export to the rest of the world, which shelters its economy from swings in the prices in any single category of goods. As a result, the UK's economy is much more resilient and able to survive the volatility that is common in the markets for primary commodities.

Does access to international markets matter?

In short, YES! Poet John Donne wrote, 'No man is an island.' In the same vein, no country is an island. I mean, yes, there are countries that are literally islands, but metaphorically speaking, no person (or country) is truly self-sufficient. The degree to which less developed countries are integrated with the rest of the global economy plays a huge role in their access both to markets for their exported commodities or manufactured goods and their ability to import the capital and consumer goods necessary for economic development.

Access to markets means more than just more places to sell exports to or buy imports from. Globalisation means financial integration as well, and at the higher levels free movement of labour and capital. Trade blocs in the developing world have increased regionalisation in less developed countries, while bilateral and multilateral trade agreements between more developed and less developed economies have broadened the markets for producers on both ends of these deals.

For all the reasons outlined in Chapter 22, Benefits of international trade, and Chapter 24, Economic integration, broadening access to global markets provides a path towards economic development. On the other hand, an inward oriented strategy through which a country attempts to achieve growth and development on its own, is bound to result in perpetual poverty and low living standards. 'Self-sufficiency is the road to poverty', argues American economist Russ Roberts. Increased economic integration, therefore, provides a pathway to prosperity.

What is the informal economy, and why might a large one affect development?

Large informal markets, or black markets, are common in less developed countries, again largely because of the lack of effective institutions such as a legal system, law enforcement, property rights, or a system of taxation. When an entrepreneur in a developing country sees a business opportunity, her natural instinct might be to take the steps necessary to meet the demand she sees, and do so at the lowest possible cost in order to maximise her own profits and well-being.

Black markets may bring to mind illicit or illegal activities, such as drugs or prostitution, but in fact, most informal markets in the developing world are just enterprising businesspeople meeting the needs in their communities, but doing so without going through the formal, official, process of starting a legal business, recording and reporting income to the government, paying taxes and licence and permit fees, and all the other 'red tape' that goes along with running a legitimate business.

In other words, black markets in themselves are not necessarily *barriers* to economic development, rather, the benefits an economy would experience from more of the informal economy becoming formalised. There are benefits to individuals who run their businesses informally, but there are costs to society as a whole, including reduced tax revenues and a diminished public sector that, were more of the economy taking

Research and inquiry

The diversity of a country's economic output is important for the level of resilience to economic shocks the economy might face. Overdependence on a small number of primary commodities, as we have shown, can present a barrier to economic development.

A great resource for visualising the composition of countries' output is available at the Observatory of Economic Complexity. Look it up in a web browser, or visit <https://oec.world>. Complete the following tasks, making observations along the way, then answer the questions that follow.

Tasks:

- 1 Choose one less economically developed country, perhaps from sub-Saharan Africa, South Asia, or Central Asia. In the search bar where it says 'Explore World Trade' type the name of the country you selected and the word 'exports'. Click enter.
- 2 Study the chart that is returned, which should show the composition of your selected country's exports.
- 3 In a separate tab in your browser, do the same thing for a more developed country, perhaps one from Western Europe, North America, or East Asia. Study the resulting chart.

With the two export charts on your screen, answer the questions that follow.

- 1 What percentage of total exports are made up by the three largest exports from the less developed country you selected? What about from the more developed country?
- 2 What are the largest exports from each of your countries?

Research and inquiry cont.

- 3 Choose one of the primary commodities that make up a significant percentage of your less developed country's exports. Do a web search for the name of the commodity and 'price chart', for example, 'copper price chart'.
 - a. Find a price chart showing the changes in the commodities price over several years.
 - b. How would you describe the changes in the commodities price over the years?
 - c. What might account for the fluctuations observed in the commodity's price over several years?
- 4 Why do the prices of manufactured goods tend to be more stable and therefore fluctuate less than the prices of primary commodities?
- 5 Why does a country's dependence on the export of a small number of primary commodities pose a barrier to economic development?

place formally, would be able to provide more of the public goods on which continued economic development depends.

What is capital flight?

Capital flight occurs when financial and physical assets are withdrawn from a country due to uncertainty over economic conditions or events that have made the country less attractive for foreign investment. Domestic capital flight occurs when domestic investors withdraw their assets and place them in safer, overseas accounts or invest in physical assets abroad rather than at home.

Capital outflows might occur due to political turmoil, such as a contested national election or a government takeover by a party hostile to foreign investment. Economic causes might include an increase in taxes on foreign investment or a decrease in interest rates that suddenly makes investments in the country less profitable to foreigners. Exchange rate fluctuations also might make foreign investors jittery and lead them to withdraw their investments.

When financial and physical capital are withdrawn from a developing country, the economy will find its capital stock decreased, slowing the rate of economic growth, or even causing a recession. Foreign investment provides a source of domestic tax revenue, so with less foreign capital in the country the domestic tax base, along with the government's ability to provide public goods like education and infrastructures, is diminished.

Capital flight can be prevented when a developing country tackles some of the other barriers to development that it faces, including political, banking and finance, property rights, and legal challenges. Stable institutions foster confidence among both international and domestic investors and create an environment more conducive to attracting and retaining international capital flows.

Is indebtedness a concern?

In the macroeconomics section of this course we learned how countries accrue debt: when a government's budget is in deficit, it must borrow money to finance that deficit, adding to the national debt. Every year a country experiences a budget deficit, its national debt grows.

Debt in and of itself is not always a bad thing. The ability to borrow funds to finance a budget deficit allows a country to fund the current and capital expenditures necessary to keep the government running, to invest in the nation's infrastructure, and to provide the public goods required for economic development.

The countries with the highest debt levels in the world are hardly on the brink of economic collapse. The USA, with a national debt of over \$20 trillion (around 100% of gross domestic product (GDP)), enjoys macroeconomic stability and a strong currency. Japan has debt that equals nearly 250% of its national income, yet it is considered one of the safest economies in the world to do business in.

The problem arises when a country's debt is mostly owed to foreign investors, AND when the burden of that debt limits the country's ability to provide necessary public goods and to invest in infrastructure. External debt, or foreign debt, is the proportion of a country's debt that is owed to international lenders, including commercial banks, governments, and international financial institutions like the World Bank and the International Monetary Fund.

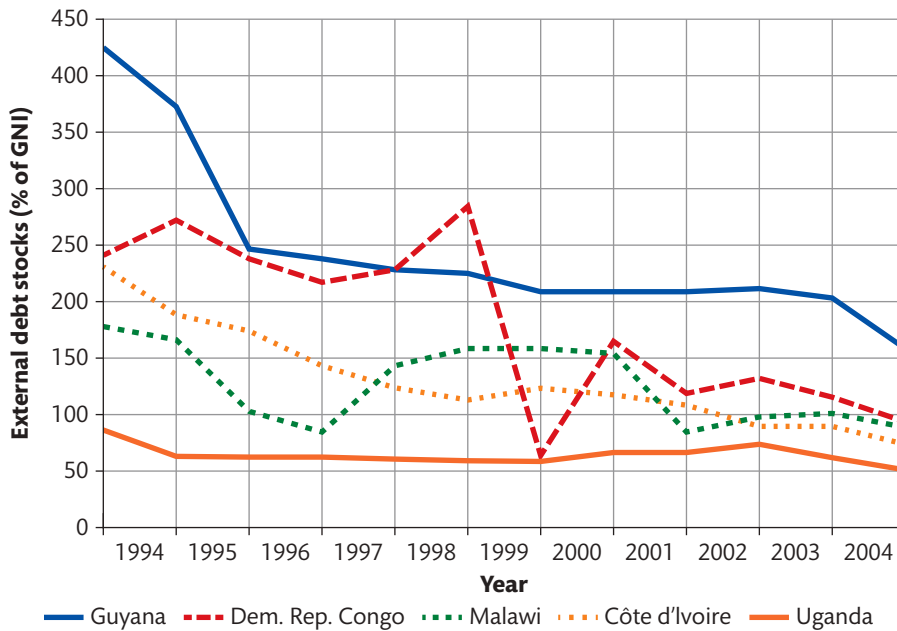


Figure 29.10 External debt stocks as a percentage of GNI for selected sub-Saharan African nations

When a less developed country accumulates a large amount of foreign debt, servicing that debt can crowd out essential spending on public goods and infrastructure, and thus limit the level of economic development in the poor country. Debt servicing refers to the money that a government must spend to pay the interest on past debts. The larger a country's foreign debt, the more of its limited tax revenues it must allocate to service that debt. If the country has to borrow money to service past debts, its total debt stock will increase.

Figure 29.10 shows the total debt stocks of several less developed countries as a percentage of their gross national incomes (GNIs) from 1994 to 2004.

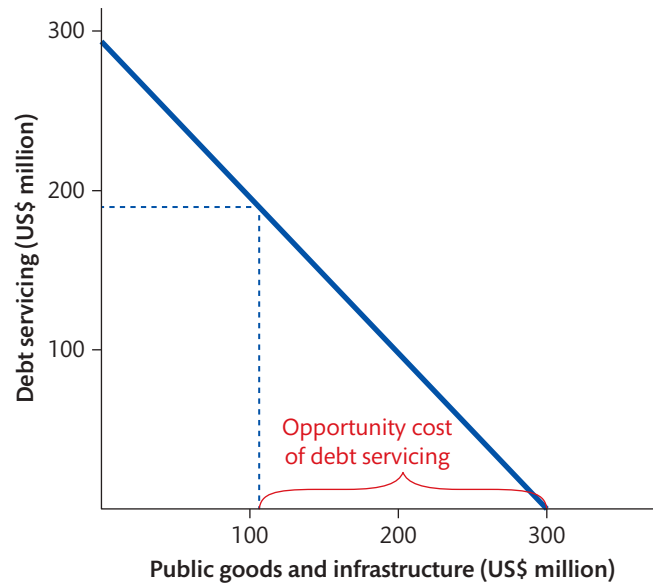
Note that nearly all the countries averaged external debt stocks of well over 100% of their GNIs over the decade from 1994 to 2004.

To give an idea of the burden high levels of external debt can put on a country's economy, consider a country that must service external debt of 200% of GNI, such as Democratic Republic of Congo (DRC) in 1999.

- Assume DRC owed external creditors 10% interest on its debt.
- With debt equal to 200% of GNI, this means that as much as 20% of DRC's total income in 1999 was owed to foreign creditors in interest payments alone.
- DRC's government must then collect taxes on its citizens of at least 20% of their total income, which would be just enough to service its debt.
- That 20% of income would then be handed over to foreign lenders, leaving DRC with little or no money to spend on infrastructure, health, or education.

High levels of external debt can result in a poverty cycle or poverty trap in which foreign debt payments limit the ability of a country to achieve economic development, requiring the government to accrue more debt, leading to higher debt servicing costs. As Figure 29.10 shows, external debt levels as a percentage of GDP have declined across sub-Saharan Africa in the decades since 2000, largely the result of debt relief efforts, which will be explored further in Chapter 30.

Figure 29.11 PPC showing the trade-off between debt servicing and the provision of public goods



The dilemma of foreign debt can be illustrated in a simple production possibility curve (PPC) model showing the trade-off between servicing debt and investing in public goods and infrastructure. Figure 29.11 illustrates the trade-off between debt servicing and public goods in a PPC model.

Assuming Guyana's GNI is \$1 billion and that the government collects \$300 million in taxes, it must spend \$200 million on interest payments to foreigners to service its debt, leaving only \$100 million to invest in public goods and infrastructure. Guyanese households lose 30% of their income to taxes, but get only 10% back in the form of public goods, while 20% 'leaks' from the economy, ending up in the pockets of foreign creditors.

Servicing international debt also creates balance of payments problems. Recall that the balance of payments consists of the current account (which measures the flow of money for the purchase of goods, income flows, and current transfers) and the financial account (which measures the flow for financial and real assets). Debt servicing leads to an outflow of funds in the financial account, moving it towards deficit.

To pay back foreign creditors, a country must have foreign currency, which it can earn from selling exports (measured as a credit in the current account). However, if a country does not have exports to sell or if the demand for or the value of its exports suddenly falls (not uncommon in less developed countries that largely specialise in primary commodities), then the ability to service its external debt is limited, and a country runs the risk of defaulting on its foreign debts. A default would result in a country being cut off from international credit markets and limit the government's ability to finance future budgets.

Do geography and climate matter for economic development?

Many observers note that some of the poorest, least developed countries in the world lie in the equatorial zones, leading them to posit that geography and climate might matter for economic development. While it is true that some of the least developed

countries do lie at or near the equator, there may be more correlation at work than causation. It is also true that some of the richest countries in the world lie near the equator. The oil-rich emirates of the Middle East, Singapore, Panama, and some of the more prosperous cities in India all lie near the equator. Geography and climate, in other words, are not destiny.

A country's geographic location can, of course, be a huge boon to economic development. Singapore is a case in point. Practically straddling the equator, Singapore began its modern history as a former British colony that upon gaining its independence in 1965 was left with a system of institutions established by the British, automatically giving it an upper hand in its path towards development. However, unlike many other former British colonies, many of which remain underdeveloped in 2020, over 50 years since their independence, Singapore was also blessed with advantageous geography.

Despite its steamy, equatorial climate, Singapore's location along key international shipping routes between the economic powerhouses of East Asia (Japan, Taiwan, China) and the large consumer bases of South Asia, Africa, and Europe, made Singapore a natural hub from which international commercial operations could be established. In this regard, Singapore's geography served as a major advantage in its path towards economic development.

As we discussed in Section 29.1, geography can pose a trap. Only a couple of thousand kilometres northwest of Singapore lies Laos, the only landlocked country in Southeast Asia, and not surprisingly a country that is far behind Singapore, and even its more immediate neighbours of Vietnam and Thailand, on its path to economic development.

Climate can also pose both an obstacle to and provide opportunities for economic development. As the global climate changes, growing warmer in an era of increased greenhouse gas emissions, some countries are experiencing changes that could accelerate development, but more are seeing the adverse effects of a warming planet. More frequent and intense extreme weather events, from floods to typhoons to droughts and forest fires, are creating environmental and human catastrophes that can set countries back in their path towards development. In some cases, entire regions are becoming uninhabitable due to climate change, leading to mass migration and putting increasing pressure on the limited resources available in already over-populated areas, especially cities, of the developing world.

Sometimes a country's climate itself can pose obstacles to development, especially if the climate is harsh and conducive to endemic diseases like malaria. According to the World Health Organization:

“Globally, an estimated 3.4 billion people in 92 countries are at risk of being infected with malaria and developing disease and 1.1 billion are at high risk. According to the World Malaria Report 2018, there were 219 million cases of malaria globally in 2017 (uncertainty range 203–262 million) and 435,000 malaria deaths ... The burden was heaviest in the WHO African Region, where an estimated 93% of all malaria deaths occurred, and in children aged under 5 years, who accounted for 61% of all deaths.”

The map in Figure 29.12, produced by the International Association for Medical Assistance for Travelers, shows the countries with high and limited risks of malaria infection.

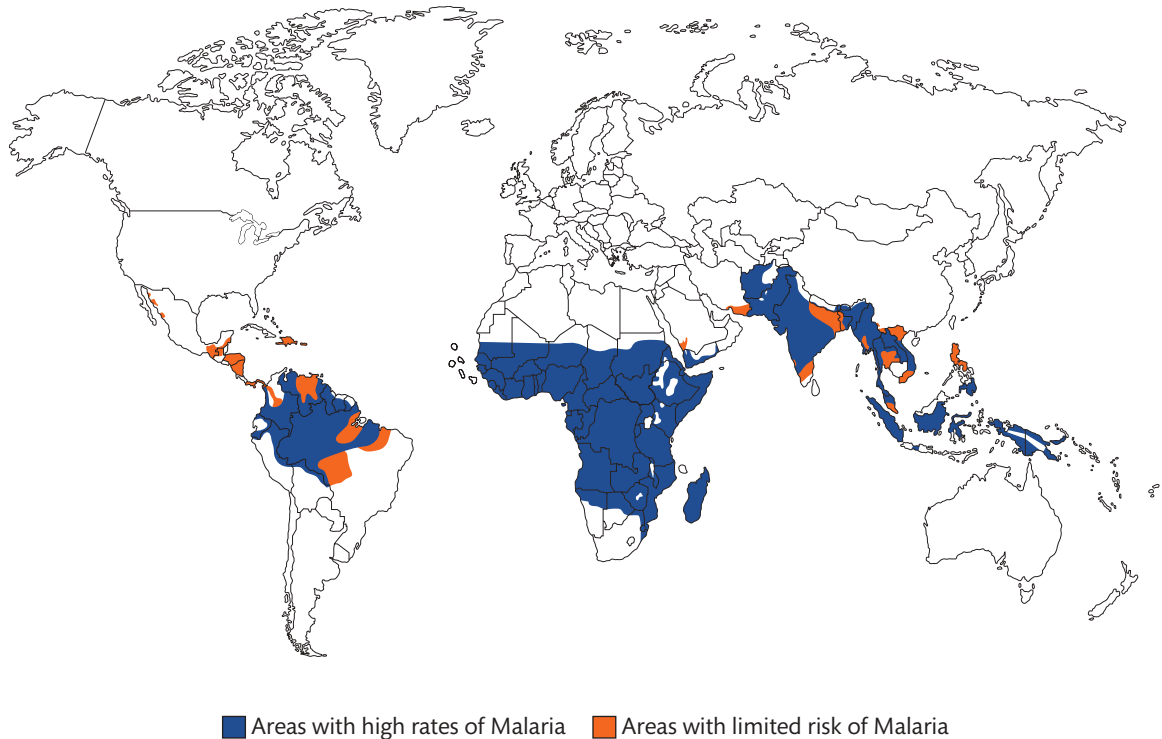


Figure 29.12 Malaria infection risks impede economic development in many countries

A climate conducive to infectious disease means a country will have to allocate its limited resources towards protecting human life from illnesses that most countries in cooler climates would never have to worry about. The 435,000 deaths in 2017, mostly among children, represent lost lives that will not grow up to participate in the growth and development of their economies. The human, social, and economic impact of climate-related diseases poses an obstacle to development across the poor world, even in the 21st century.

29.3 What are the political and social barriers to economic growth and development?

Learning outcomes

At the end of this section you will be able to:

- outline how weak institutional frameworks create barriers to economic development, including the lack of effective:
 - legal systems
 - taxation structures
 - banking systems
 - recognition of property rights
- examine the role of gender inequality as a barrier to economic development.

How does a country's institutional framework affect its ability to develop?

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

Legal system

The legal system, a key institution needed to promote growth and development, is a public good that many take for granted in a country. A legal system includes the laws themselves, which are typically agreed upon and enacted by government officials, a constitution or some foundational document on which the laws are based, and the institutions and structures for interpreting and enforcing those laws.

A legal system is a public good, meaning that it is not provided by the free market because the benefits it conveys society are non-excludable and non-rivalrous. A well functioning government is therefore needed for a sound legal system to exist, and the existence of one will assure businesses, consumers, and investors (the drivers of economic activity) that it is safe and secure to participate in a country's economy.

Without a legal system, a country is essentially in a state of chaos and anarchy: hardly the characteristics investors, entrepreneurs, and multinational corporations are looking for when deciding where to do business.

Ineffective taxation structures

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

A tax structure should be neither too progressive nor totally regressive. A progressive tax structure is one that places a greater burden on high-income earners than on low-income earners. The degree of progressivity of a country's tax system determines to some extent the effectiveness of the system at incentivising and collecting tax revenues. Too progressive and the rich will hide their income or send it abroad, depriving the economy of tax revenues. Too regressive (or not progressive enough) and the poor will shoulder a larger burden, perpetuating inequality and preventing development from occurring.

Banking system

Many developing countries lack an effective banking system that is able to offer secure deposits to savers and access to credit to borrowers. Without a functioning domestic banking system, households with money to save will likely save it abroad, leading to capital flight. Without a supply of loanable funds domestically, it becomes nearly impossible for small businesses to access credit to finance productivity-enhancing investments. Consumers also find it difficult to borrow money to invest in real estate

or to buy consumer goods, both of which make up significant proportions of more developed countries' economies' AD.

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

Such programmes differ from traditional commercial credit like that those in the rich world have access to. Entrepreneurs with access to financial capital, either through a community bank or a microcredit institution, are able to put their business skills to work employing others in providing goods and services that are in demand in their local communities. Often, the loans entrepreneurs receive are very small, as

Installation of microcredit financed solar home system, Bangladesh



little as \$100 or \$200, which may be all that is needed to acquire some simple capital equipment such as a sewing machine or a vendor stand from which the entrepreneur can begin producing output demanded by their community. The more successful borrowers eventually gain access to larger amounts of credit, allowing them to expand their businesses, employ more workers, and add more value to the developing nation's output.

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

Case study – Microcredit in action in Kenya

Microcredit is not always in the form of financial capital. Some development projects aim to put physical capital directly into the hands of poor entrepreneurs. In Kenya, for instance, a non-governmental organisation (NGO) known as WISER aims to match young entrepreneurs with the tools they need to start their own businesses using donated technology such as copy machines, laptop computers with cellular internet connections, foot pumps for water, and digital LCD projectors.

The technology is sold on credit to entrepreneurs who are required to pay back the value of the capital through their business revenues. The capital, once in the hands of local entrepreneurs, is immediately put to use providing services to the community. Here are some examples.

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

colour on a wall-sized screen. Before the projector arrived in the community, football fans had huddled around tiny black-and-white televisions with poor reception to watch football matches. The football-theatre business was the most successful of all, and paid back its loan fastest.

Property rights

If foreign investors cannot be sure that their property rights will be respected by the domestic government, they are unlikely to invest their capital into a poor country. The guaranteed protection of property rights makes a country more attractive to foreign investors and increases the amount of capital and thus the productivity and income of the nation's workforce. Domestically, a lack of property rights deters investors at even the lowest levels. Domestic entrepreneurs feel secure in their ability to reap the rewards of the business ventures when property rights are respected.

Without sound and secure protection of property rights, the entire market system is undermined, because confiscation of property, either by the government or by criminals, is a real possibility faced by prospective investors and entrepreneurs.

Does unequal access to political power and status limit development?

Inequality can extend beyond economic differences between rich and poor to gaps in political power and status. Often, economic inequality and political inequality are two sides of the same coin; political influence and status, to no one's surprise, can often be bought, giving those with the most income and wealth the ability to influence government policy in ways that entrench their own wealth and power, excluding those in society with the fewest economic resources from the political system through which the playing field could be levelled and greater equity achieved.

For evidence of the lack of access to political power and status among those on the lower rungs of the income ladder, we need only look at who the political players are in nearly every country, both more and less developed. From sub-Saharan Africa to the USA and Western Europe, national political leaders usually arrive at their posts after growing up among the elite rungs of society. It is relatively rare that someone born into poverty rises to the level of national political figure; surely if they did, more attention would be paid among the world's government to the challenges and barriers to economic development faced by the world's poor.

Does gender equality matter?

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

When girls and young women have better access to education, society's fertility rate tends to decrease. Fewer children reduce the financial burden on families in developing countries, allowing limited resources to be better applied towards the continued education. Children raised in households in which both parents are educated have

better opportunities. Better education means a more productive workforce; one in which both genders participate and in which the economy achieves a higher level of potential output than would be possible without women in the workforce. Greater national output means higher per capita incomes and an increased standard of living, thus economic development.

TOK

Quite a lot of the subject matter in this chapter is about the many problems associated with developing countries. Is an understanding of the perspective of other knowers essential in the pursuit of knowledge?

Practice examination questions

1. Read the extract below and answer the questions that follow.

Karnataka tourism set to gain from admissions fever

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

Despite a fee of ₹3,0000, there is excess demand for places. This year, a record number of 127,343 students have applied to Karnataka’s colleges. Of these, as many as 59,299, or roughly 46.7%, are from outside the state. These candidates are competing with each other for the 26,000 places in the state’s professional colleges – medical, dental and engineering.

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

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

- a. Define the following terms indicated in bold in the text:
 - i. excess demand (2 marks)
 - ii. social benefits. (2 marks)
 - b. With the aid of a diagram, explain how the social benefits resulting from the provision of education promote economic development in India. (4 marks)
 - c. Identify and explain two possible government responses to the shortage of spots at the IITs. (4 marks)
 - d. To what extent is education an essential requirement for reducing poverty in less economically developed countries like India? (15 marks)
2. Study the extract and data below and answer the questions that follow.

“Singapore is a high-income economy in South-East Asia. The country provides the world’s most business-friendly regulatory environment for

local entrepreneurs and is ranked among the world's most competitive economies. Presently, the strong manufacturing and services sectors have become the main drivers of the Singapore economy. There is a wide range of businesses, with a particular focus on high value added goods and services."

"Timor-Leste (formerly known as East Timor) is a developing economy in South-East Asia. Timor-Leste gained independence from Indonesia in 2002. The country and families were torn apart by violence in the years before independence. Nearly 70% of all buildings, homes and schools were destroyed. An estimated 75% of the population were forced to move due to the violence."

"After serious challenges, Timor-Leste has progressed, particularly due to its endowment of natural resources, especially oil. With the petroleum revenue boom, fiscal policy has been expansionary and the economy has grown rapidly as a result of government spending, focusing on major **infrastructure**, development of skills, and other institutional changes. A main goal was to generate increased and sustainable private sector investment as a means to increase job opportunities and to reduce **poverty**. These developments are starting to contribute to poverty reduction and improved social outcomes."

Table 1 Selected economic data for Singapore and Timor-Leste – 2013

	Singapore	Timor-Leste
Human Development Index (HDI) data		
HDI rank	9	128
HDI value	0.901	0.62
Life expectancy at birth	82.32	67.54
Mean years of schooling	10.20	4.42
Expected years of schooling	15.40	11.70
Gross national income (GNI) per capita (2011 purchasing power parity (PPP) US\$)	72371.23	9673.61
Other selected data		
Population (millions)	5.41	1.13
Gross domestic product (GDP) per capita (2011 PPP US\$)	71474.89	11814.79
Urban percentage of population	100.00	29.11
Foreign direct investment (FDI), net inflows (% of GDP)	20.62	4.31

- a. Define the following terms indicated in bold in the text.
- infrastructure (2 marks)
 - poverty. (2 marks)

- b. Using a poverty cycle diagram, explain how its history of violence has presented a barrier to economic development for Timor-Leste. (4 marks)
- c. Explain how its 'business-friendly regulatory environment' has contributed to economic growth and development in Singapore. (4 marks)
- d. Outline the advantages and disadvantages of Timor-Leste's dependence on the export of a single primary commodity, oil, for its economic growth and development. (8 marks)
- e. Referring to data in Table 1, discuss the importance of education and health as a determination of economic development. (15 marks)