



The Jwaneng diamond mine in Botswana is the richest in the world: It produced 11.5 million carats of diamonds in 2009. Diamonds are about one-third of Botswana's GDP.

Why Aren't All Countries Rich?

Economists have long studied how countries develop, but that work hasn't led to growth for much of the world

BY JESSIE ROMERO

The numbers are disheartening. As of 2005, according to the World Bank, 2.6 billion people were living on less than \$2 per day. Of those, 1.4 billion live in severe poverty, on less than \$1.25 per day, without access to electricity, clean water, basic medicines, elementary education, or even enough food. Millions of children and adults die each year of AIDS, malaria, pneumonia, diarrhea, and other easily preventable diseases. In Sierra Leone, for instance, the infant mortality rate is 284 deaths per 1,000 live births, compared to seven per 1,000 in the United States.

There has been progress during the past 30 years: The share of the world's population living below the \$1.25 poverty line declined from 52 percent to 25 percent, owing largely to the economic growth of China, where the rate dropped from 84 percent to 16 percent. But during the same period, the number of poor people in Sub-Saharan Africa nearly doubled, and only three countries out of 51 graduated from the United Nations' "least developed country" list (defined as having a gross national income per capita of less than \$900 per year, among other criteria).

Why do some countries thrive while others fail? Economists have pondered that question since Adam Smith published *An Inquiry into the Causes of the Wealth of Nations* in 1776, but there is still considerable debate about what poor countries should do to become rich and what rich countries should do to assist them. It is clear that sound legal, political, and economic institutions are essential to economic growth, but it is less clear how countries can acquire them — and how to feed and educate their citizens in the meantime.

Producers versus "Grabbers"

Rich countries got that way for one of two reasons: Either they have more resources than poorer countries do, or they have institutions that allow them to put their resources to effective use. Development work in the 1950s and 1960s was driven by the former belief, but the evidence suggests that institutions are what matters.

Economic growth requires cooperation; individuals and firms must come to agreements about how to organize

themselves in order to realize the gains of specialization and trade. Such cooperation requires incentives, and those incentives require legal systems that enforce contracts and property rights, and economic policies that limit predatory behavior by governments and firms. If a country's growth were determined by its original endowment of labor, land (including natural resources), or capital, there wouldn't be extreme divergence in countries in close proximity, such as North and South Korea or East and West Germany, as the late Mancur Olson, an economist at the University of Maryland, College Park, noted in a 1996 article. The difference is the national border, which marks the boundary between one set of institutions and another. Unfortunately, Olson notes, "the intricate social cooperation that emerges when there is a sophisticated array of markets requires far better institutions and economic policies than most countries have."

Abundant resources may actually lead to a "resource curse," the paradox that, on average, countries with a wealth of natural resources lag far behind countries with fewer natural resources. Despite having an estimated \$24 trillion in untapped mineral deposits, for example, the Congo is one of the poorest countries in the world.

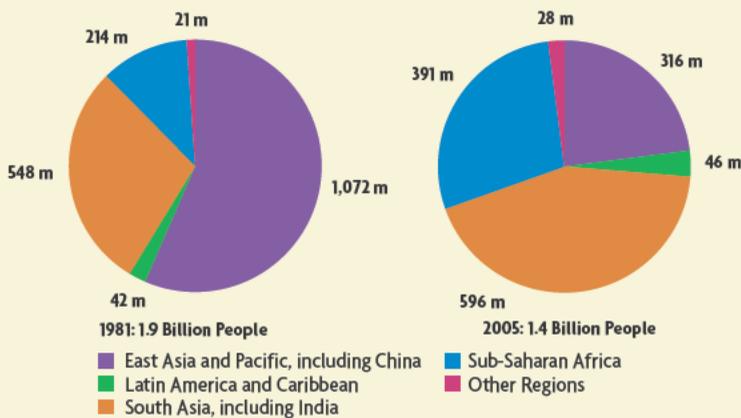
One explanation for the curse is so-called Dutch disease, whereby a boom in a commodity export (in the case of the Dutch, natural gas) leads to declines in other sectors of the economy such as manufacturing and agriculture. The volatility of commodity prices may also make countries that depend on exporting those commodities vulnerable to foreign shocks and create large deficits as governments overspend during the upswings. In the Congo, as in other countries, these problems are exacerbated by civil war and ethnic strife as different groups vie for control of the wealth.

Institutions can help countries escape the resource curse. For instance, diamonds have made Botswana one of the richest countries in Africa. Its strong democratic government developed a productive relationship with the diamond company De Beers, in contrast to the exploitative relationships that often exist when governments are weak or corrupt. Botswana exemplifies the difference between producer-

Where Do the World's Poor Live?

Number of people in millions, by region, 1981 and 2005

The total number of people living on less than \$1.25 per day has decreased globally, but most of that decrease was in China. The number of poor people increased in every other region, with the biggest increase in Sub-Saharan Africa. The share of the world's population living in poverty declined from 52 percent to 25 percent.



NOTE: "Other regions" includes Eastern Europe, Central Asia, the Middle East, and North Africa.
SOURCE: Chen and Ravallion (2008)

friendly and "grabber-friendly" countries, as Halvor Mehlum and Karl Moene of the University of Oslo and Ragnar Torvik of the Norwegian University of Science and Technology describe in a 2006 paper. They find that weak or absent institutions create incentives for entrepreneurs to specialize in rent-seeking, vote-buying, and violence, aka "grabbing." Where there are sound institutions, however, entrepreneurs specialize in production, and the country can profit from its natural resources.

A version of the resource curse is seen in "rentier" states such as Libya, where the government gets the majority of its revenues from a natural resource, usually oil. Because the government (typically autocratic) doesn't have to rely on taxing the domestic economy, it doesn't have an incentive to promote its growth, and can focus on extracting all the resources for its own gain. Libya has one of the highest GDP-per capita rates in Africa; but its unemployment rate is 30 percent, and one-third of Libyans live below the national poverty line.

Development also may depend on a country's geography and its degree of integration with the rest of the world. Versions of the geography hypothesis propose that a country's climate, natural resources, endemic diseases, or distance from Western influence, among other factors, determine a country's economic growth. Countries engaged in international trade may be highly developed because they have greater access to technical knowledge and foreign capital. But recent empirical work substantiates the idea that "institutions rule," in the words of Dani Rodrik and Francesco Trebbi of Harvard University and Arvind Subramanian of the International Monetary Fund (IMF). In a 2002 paper, they find that geography and integration do

have an effect on income, but only through their influence on institutional quality; once institutions are controlled for, the effect disappears. Institutional quality trumps the other factors; a country may draw the short end of the geographical straw, but still prosper if it has strong institutions.

The source of those institutions may go back hundreds of years, according to Daron Acemoglu and Simon Johnson of the Massachusetts Institute of Technology and James Robinson of the University of California at Berkeley. In a 2001 paper, they link the mortality rates faced by European colonial settlers to present-day institutional quality. In hospitable countries, the colonists set up "Neo-Europes," with institutions and polices that mimicked their home countries. In countries where Europeans contracted a lot of diseases and died, they set up "extractive states," focused solely on transferring wealth from the colony to the colonizer, as Belgium did in the Congo. Other economists, noting that former British colonies have fared better than former French, Spanish, or Portuguese colonies, suggest this is due to the superiority of British common law and other institutions.

Economists who see the roots of present-day poverty in a country's long history don't mean that these roots doom a country forever. So the question remains: How can poor countries grow rich?

Big Push or Invisible Hand?

Development economics emerged as a distinct discipline after World War II, as former colonies in Africa, East Asia, and Latin America gained independence and the new leaders made development a priority. With memories of the Great Depression still fresh, many Western economists thought that poor countries were too fragile to be subjected to the vagaries of the market, and the success of the Marshall Plan and Russia's rapid industrialization pointed toward heavy state planning and massive capital investment as the keys to economic growth. "Economic progress is not a spontaneous or automatic affair," Ragnar Nurkse, an Estonian-born economist who went on to teach at Columbia University, wrote in 1953. "Through the application of capital over a wide range of industries, the general level of economic activity is raised."

Many economists also subscribed to an economic model that stated that GDP growth was proportional to the level of investment in GDP. Logically, it followed that the problem with developing countries was merely a "financing gap," which could be solved by borrowing from rich countries to fund state-led infrastructure and industrialization projects. In 1960, economist and presidential adviser W.W. Rostow projected confidently that "an increase of \$4 billion [about \$30 billion today] in external aid would be required to lift all of Asia, the Middle East, Africa, and Latin America into regular growth, at an increase of per capita income of say, 1.5 percent per annum."

The World Bank and the IMF were founded at Bretton Woods in 1944 to support the reconstruction of Europe and

promote international economic stability. Their attention soon turned to helping finance the development of the so-called Third World. Today the World Bank gives out more than \$70 billion each year in concessionary loans and grants for health, education, and development projects. The IMF concentrates more narrowly on macroeconomic reforms and serving as a “lender of last resort” for troubled countries, although it, too, has moved well beyond its original function of smoothing balance-of-payments adjustments.

Not everyone agreed that what poor countries needed was a “big push” from outside. One prominent critic was Hungarian-born economist Peter Bauer, who believed that the primary purpose of development should be to expand individual choice and freedom, and who objected to Western intervention in developing countries. As early as 1948, based on a study of small-scale rubber growers in Malaysia, Bauer advocated private property rights, free markets, and the ability of poor people to respond to

Inequality and Development

Does economic growth lead to greater income inequality? And, conversely, is inequality detrimental to economic growth? As with most questions in development economics, these are difficult ones to answer.

One early attempt to link growth and inequality was that of Nobel laureate Simon Kuznets in a 1955 *American Economic Review* paper. Using data from the United States, the United Kingdom, and Germany, he found that the relationship followed an inverted “U” shape: At low levels of per capita income, growth leads to increasing income inequality, which then decreases as the country reaches higher levels of income and more workers transition to higher-skill, better-paying jobs.

The “Kuznets curve” is often interpreted as implying that greater inequality may be a necessary, but temporary, trade-off on the path to development.

Many development experts believe the Kuznets curve means that the poor are left behind by economic growth, especially when countries are starting from very low bases, but recent research suggests that growth does raise the incomes of the poor. David Dollar and Aart Kraay of the World Bank found in a 2001 paper, for example, that “growth in the overall economy is reflected one-for-one in growth in income of the poor” and does not lead to greater income inequality.

Dollar and Kraay’s work followed the research of Klaus Deininger and Lyn Squire, also of the World Bank, who in 1996 published a paper that challenged a decade of previous research which found income inequality to be a cause of slow economic growth. Economists had turned to this question after growth patterns in Latin America and East Asia suggested that the Kuznets curve trade-off didn’t hold true; East Asian countries grew rapidly while maintaining relatively low levels of inequality, but many Latin American countries had slow or zero growth and high inequality. (The figure displays income inequality by region, as measured by the Gini coefficient, a statistical measure of inequality. The higher a country’s Gini number, the greater the amount of income inequality.) Researchers concluded that higher inequality inhibited growth by leading to

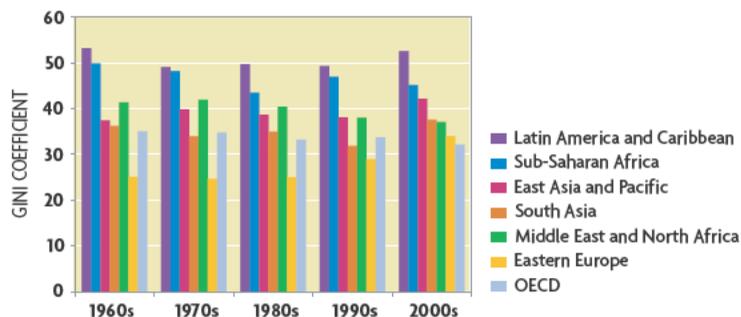
political unrest, ethnic violence, macroeconomic instability, or large fiscal deficits if poorer citizens voted for social welfare policies.

But these findings were based on cross-country comparisons, rather than on changes within a single country over time, and didn’t take into account country-specific factors such as the initial level of development or political and economic institutions, all of which influence growth and income distribution. Using an extensive new data set, Deininger and Squire did not find a significant relationship between inequality and subsequent growth, or between growth and subsequent inequality. “Rather than being governed by an unmovable universal law,” they concluded, “the evolution of income and inequality is affected by initial conditions and possibly policies.”

Rich countries also worry about inequality. The OECD held a forum in May to discuss widening income inequality in its member countries, and many commentators in the United States are concerned about the growing share of total income taken home by the top 1 percent of earners. This disparity may contribute to a host of social problems, including moderate-income households spending beyond their means in order to “keep up with the Joneses,” leading to higher divorce and bankruptcy rates, according to economist Robert Frank of Cornell University. Others make the argument that “a rising tide lifts all boats,” noting that although the tide has risen more rapidly for the rich, living standards overall have increased dramatically. — JESSIE ROMERO

Inequality by Region

Despite slow growth, income inequality is persistently high in Latin America and Sub-Saharan Africa.



NOTE: Data are not available for every country for every year. Gini is the non-weighted average of available data for the respective decade.

SOURCES: Deininger and Squire (1996), CIA World Factbook, World Bank

incentives and save for the future.

During the 1970s, the “dirigiste dogma,” as the big-push approach was dubbed by Indian-born economist Deepak Lal, came under increasing criticism, particularly as cracks appeared in the centrally planned Communist economies. “Imperfect markets are superior to imperfect planning,” Lal wrote in the 1983 book *The Poverty of “Development Economics.”*

This belief was borne out by Latin America, where the debt crisis in the early 1980s revealed that state-directed industrialization had created uncompetitive industries, widespread corruption, price distortions, and hyperinflation. On the other side of the world, however, the Asian Tigers — Hong Kong, Singapore, South Korea, and Taiwan — were growing at unprecedented rates with market-friendly policies and trade liberalization. Development economists advocated “getting the prices right,” and the World Bank and the IMF began encouraging countries in Africa, Latin America, and the Middle East to privatize industry, eliminate barriers to trade and foreign direct investment, and stabilize their currencies. Encouragement came in the form of “structural adjustment loans” (SALs), which were conditioned on countries enacting a host of policy reforms prescribed by the lenders. This approach was known as the Washington Consensus, after a list of 10 reforms published by economist John Williamson of the Peterson Institute for International Economics in 1989. The original Consensus was relatively moderate, but the term came to be popularly associated with an aggressively capitalist and pro-market approach.

Today, the structural adjustment era, like the big push era before it, is largely viewed as a failure. Between 1980 and 1999, 12 countries received 15 or more SALs, but had an average per capita growth rate of -0.5 percent, according to William Easterly, an economist at New York University. The countries that received the most loans also had persistently high inflation. And although many countries in Latin America made progress on policy reforms, growth was slow or nonexistent in these countries as well.

The reasons why SALs didn’t work are varied: Developing countries were asked to do too much, too soon; institutions weren’t in place to support the new policies; and loans kept being given out even when the conditions weren’t met, creating moral hazard and corruption. Easterly, a vocal critic of foreign aid, views SALs as just a variation on the “big push” of the 1950s and 1960s, with outside organizations imposing rapid, top-down change. Jeffrey Sachs, a proponent of aid, also is critical of structural adjustment, although he believes that the problem was a narrow focus on policy reform that actually led to too little aid being given.

Everything Old Is New Again

Some economists and international organizations now advocate ideas that harken back to those of the 1950s and 1960s. Citing the recent global financial crisis and subsequent downturn, for example, the United Nations’ 2010 *Least*

Developed Countries Report advises against dependence on the market system and calls for a development strategy based on “country ownership, structural changes, capital accumulation, and the developmental State.” In 2005, Britain’s then-Prime Minister Tony Blair gave a speech calling for a “big push” to save Africa. Also that year, Sachs published *The End of Poverty*, in which he outlines an ambitious agenda to meet the Millennium Development Goals (MDGs) established by the United Nations in 2000. Drawing on financing gap models of growth, Sachs calls for a dramatic increase in foreign aid to help poor countries increase their capital stock and thus escape the poverty trap.

A number of studies estimate that achieving the MDGs, which include reducing global poverty by half, reaching full employment, and reducing infant and maternal mortality, among other goals, would require increases in foreign aid (excluding loans) of between \$40 billion and \$70 billion per year. One problem, however, is that such estimates don’t take into account the capability of recipient countries to absorb and spend the funds. The pressure to achieve the goals could lead to “premature load bearing,” according to Lant Pritchett and Matt Andrews of Harvard’s Kennedy School of Government and Michael Woolcock of the World Bank. “There is at least a risk that pressuring countries to *appear as if* they are fully ‘modern’ and take on difficult tasks before they have the capability to do so actually creates a negative dynamic in the evolution of capability,” they write in a 2010 working paper. If a new institution collapses under the pressure, they contend, the country is worse off than if it had progressed more slowly from the beginning.

What the MDGs have in common with central planning in the 1950s and 1960s and structural adjustment in the 1980s is the attempt to find a universal solution to an important problem. But development experts increasingly emphasize the importance of tailoring efforts to the needs and culture of individual countries, rather than aiming for “accelerated modernization via transplanted best practices,” as Pritchett, Andrews, and Woolcock call it. Nearly all economists would agree, for example, that property rights are essential to economic growth. But attempts to impose Western-style land titling programs in Africa and Cambodia have not been successful. That’s because institutions are idiosyncratic to the country where they develop, explains William Savedoff, a senior fellow at the Center for Global Development, a think tank in Washington, D.C. “Even procurement systems in Sweden and Norway are different. They developed to respond to the particularities of their behavioral, linguistic, and political systems,” he says.

Accordingly, many are turning to projects at the micro rather than the macro level such as distributing water purification tablets or paying individual families to send their children to school. Healthier, better-educated people, it is hoped, will be able to participate in their own development.

One project that shows promise is increasing cell phone distribution, bypassing the large-scale infrastructure investment required for land lines. Cell phones improve market

efficiency by making it easier for farmers and traders to get information about prices, which reduces price dispersion and increase the availability of goods, according to Jenny Aker, an economist at Tufts University who has studied the impact of cell phones on grain markets in Niger. Cell phones are also being used to teach literacy classes and enable mobile banking, among other projects. Many hope that such bottom-up efforts will add up to long-term growth. Cell phones, Aker says, are “a great tool. But we still need to have investment in basic public goods that allow people to grow.”

Paying for Change

Funding for those investments comes from the World Bank, bilateral aid agencies such as USAID in the United States, and private sources such as the Gates Foundation. Developing countries received about \$130 billion from non-private sources in 2010, in addition to \$72 billion in loans from the World Bank. Many studies show, however, that aid has at best a negligible effect on growth.

Some development experts believe this is because there hasn't been enough aid — U.S. assistance is only 1 percent of the federal budget, and only 0.21 percent of GNP — but others see the problem in the nature of aid itself. Donors face pressure to disburse their funds before next year's budget is written, and thus have an incentive to keep giving even if conditions required of the aid haven't been met; recipients know that funds will arrive regardless, and thus have no incentive to meet the conditions. A lack of accountability and transparency on both sides can create waste and corruption, and a lack of rigorous impact evaluation makes it hard to know what really works.

The influx of foreign experts that comes with most aid projects also may discourage local learning and investment. “People and organizations and countries really learn by doing,” Savedoff says. “The dynamic where they turn around and say, ‘Tell us how to do it, send us your consultants and tell us your way of doing it,’ just doesn't strike me as the way that any country that's rich today got there.” Recipient governments also have to devote significant time and resources to the business of receiving aid, instead of to governance. “When you have a lot of donors and foundations coming in, they can actually undermine the ability of the local government or district to function,” Savedoff says.

Reforms to aid practices are under way. More than 100



A cell phone charging station in Uganda: There are 10 times as many cell phones as landlines in Sub-Saharan Africa.

countries and aid agencies signed the Paris Declaration in 2005, which calls for greater transparency, better measurement, and local ownership of projects. One U.S. initiative is the Millennium Challenge Corporation (MCC), created by Congress in 2004, which funds specific projects only in countries that meet established criteria for governance and economic policies. The World Bank now encourages countries to develop their own Poverty Reduction Strategy Papers rather than imposing conditions for lending from outside. But actually changing the bureaucratic structure of aid is difficult. The MCC has made a number of exceptions to its own rules, aiding countries that don't meet their criteria. And a group of African countries described the strategy papers as “structural adjustment lending in sheep's clothing,” since they are written with significant input from the World Bank and subject to its approval.

The solutions to poverty will be as heterogeneous as the causes; countries need both vaccines and property rights, and the complex links between people, communities, governments, and nations make it difficult to tease out cause and effect. But economists and policymakers on all sides of the debates continue to search for answers, motivated by the same thing: making life better for 2.6 billion people. **RF**

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