Development Economics 455
Lecture Notes 1

1. Introduction – What is Development Economics?

* **Lucas** – the problem of economic development is to account for the observed pattern across countries and across time in levels and rates of growth of per capita income

* **Is this all?** Surely, not. How to measure development – look around – want to be well-fed, clothed, healthy, no violence – the least

* high and widely accessible level of material well-being (GDP p.c.) seems a **prerequisite.**

* Development is actually **more general** – removal of poverty, malnutrition, access to clean water, raising life expectancy, reduction in infant mortality, increased access to schooling (all these for most people, not an elite!)

*However – above (could) follow more or less from growth of GDP, thus Lucas suggests an **approach to development** (reducing large set of problems to small set of variables)

2. This Course

***** will study economic transformation of **developing world** (can be defined as all countries below $9000 p.c., World Bank or 4.5 bln people)

* will see many faces of economic development (ED)
  - how informal institutions replace formal ones we see in developed countries due to missing information or inability to enforce contracts (tied labor, credit cooperatives, extended families)
  - under-functioning of markets (creates externalities, possible policy intervention; implies that **inequality** plays central role
* will explore two routes
  - how **levels** of economic attainment influence ED
  - how the **distribution** of economic attainment influences ED
* will not offer unambiguous answers to the problems of development, only teach you how to ask the right questions

3. Facts

***** Fig. 1 – population and GDP p.c. (exchange rate) – **huge disparity** (in 2006 74% of population has 20% of income; richest over 100 times richer on average than poorest; poorest 20% earn 2% of total income);

* **Are these disparities real?** Yes and no.
* **measurement issues**
  – **underreporting** of income more common in developing countries;
  - a lot of income generated for **self-consumption** (not included in GDP);
  - **prices** in many LDCs not reflected in exchange rates (because of non-tradable, incl. services)
* the above implies that disparity in country's incomes is **overstated**

***** hard to correct for first two problems but can correct at least prices – use **PPP** (purchasing power parity) method of calculating GDP.

* How? Compare how much it costs to buy **same basket of goods** in all countries that includes non-tradables to obtain a "more accurate" exchange rate between what people's incomes can buy.

- **Result:** fig. 2 – does reduce the gaps but still huge disparities; See, however, big difference in the top 8 world economies!

4. History

* over the period 1960-1995 richest 5% of the world's nations averaged a per capita income about 30 times the corresponding for the poorest 5% (interstate disparity – only 2 times!)

* hence – the entire distribution of income across countries remained **stationary**

***** however, this does not mean the ranking of countries stayed the same (East Asia, Africa, China) – **very diverse** experiences observed **within** the cross-country distribution! Thus there are **no ultimate traps to development**.

* **mobility matrix** – how many countries changed positions – history matters; greatest mobility in the middle; lack of mobility at extremes; poverty may feed on itself but also can be advantageous for rapid growth (high marginal products).

5. Better Measures of Development?

* there is also **inequality within countries** – thus higher average GDP p.c. does not say much; high inequality country can have many people suffering from malnutrition, low literacy, etc. co-existing with a very rich elite. A low inequality country even with lower income can look "better" on average. (Sri Lanka vs Guatemala, p. 27) Need **to look beyond GDP p.c.**

*** human development index** (HDI) – another measure of well-being by UNDP; it is an index – so only *ordinal comparisons* are valid!

- life expectancy at birth (reflects child mortality)
- educational attainment (literacy and school enrollment)
- GDP per capita (PPP);

* **correlation between HDI and GDP p.c. – pretty high** (fig. 2.7) – Lucas was probably right…

- GDP p.c. correlated positively with life expectancy; educ. attainment; negatively with infant mortality

6. Summary

* economic development is not just about income and its growth although they are a good proxy;

* there exist huge disparities in income across countries;

* there have been substantial changes in incomes for many countries over time although the overall cross-country income distribution has remained relatively stable.

Some Methodological Points about Development Economics (from Meier, Ray on the reading list)

- recent years – lively field, made excellent use of theory, econometrics, sociology, political science, etc.
- study of development – perhaps the most challenging in all of economics
- people wanted to study why some countries are more developed than others and sought correlations between GDP per capita and other variables such as savings rate, education, population growth rates, etc.

- moving away from the traditional notion of *convergence*
- **convergence** – basic notion that given certain parameters (savings, fertility rates, etc.) economies ***inevitably*** move towards some steady state. If these parameters are the same – same steady state!
- Idea behind convergence: suppose all is produced from capital and labor and constant fraction of income is saved. Then by the **law of diminishing returns**, countries with low endowment of capital relative to labor will have high rate of return on capital so a given addition (investment) to the capital stock will have bigger impact on output and the **poorer countries will hence grow faster than the richer** and finally converge. (Can you see evidence for this?)
- To get convergence must control for everything that affects the marginal product of investment (incl. institutions, "political climate", "corruption", etc.)
- Failure to observe convergence implies that the reason lies in one or more of those exogenous reasons above! – not that the LDMR is wrong.

- **Some Problems** with the "convergence" view of development:
    - **Limited depth of analysis** – e.g. explain underdevelopment as "this country is more corrupt; people like to save less; have different culture, etc" – but these may be **endogenous**, or outcomes of underdevelopment, not reasons for it! Need a theory that investigates this.
    - **Policy bias** – the traditional theory stresses on factors as savings, population growth, level of corruption, etc. As we saw these may be **symptoms** rather than causes of underdevelopment; if they are indeed – policy effects may be unexpected; also it matters whether we would need **one-time or continuous** policies to fix those problems.

New Theories (will talk about them in more detail later in the course)

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1. Multiple Equilibria – several dramatically different outcomes can occur given the same fundamentals (saving rate, preferences, etc);

*Due to: **complementarities and coordination failures** – can fail to pick "good" equilibrium

* Examples: corruption – I would bribe if everyone else does it but otherwise not; the very same people would not behave same way if put in different environments, e.g. immigrants to Canada

*depends crucially on people's beliefs and expectations (pessimism or optimism; **self-fulfilling expectations**)

*since it is coordination failure may need government intervention

2. Historical Dependence – the outcome is determined by some historical condition (possibly random);

* different historical conditions (e.g. initial capital stock, or initial wealth inequality) may imply different development outcomes many years later.

* "butterfly effects" are possible

3. Market Imperfections

* asymmetric information (moral hazard, adverse selection)

* (contract/law) enforcement problems

* limited/ lack of commitment (by economic actors or governments)

4. New methods in empirical work – field experiments

***** basic idea: using randomization (as in medicine) to evaluate public policies

* aim is to determine whether a policy has an impact and how large this impact is

* avoids issues with selection bias and endogeneity since the treatment and control groups are exogenously randomly chosen

* how it works: one group receives the treatment, the other does not – the key thing is that the groups are constructed to be statistically equivalent to each other

* because the groups are statistically equivalent, any effect we find from the policy change exerted on one of the groups but not the other can be attributed to the policy itself rather than to other factors

Why Can This Be Important?

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1. Leads to theories of development in which "**convergence" across countries is not automatically warranted** . This does not mean that the LDMR is wrong, simply that it may not be enough in the imperfect markets of the real world as opposed to stylized textbook economies.

2. **Does not rely on "fundamental" differences across people or cultures** (no need to worry whether Confucianism is better than Protestant ethic, different cultures, etc.)

3. The multiple equilibria theory creates a **different potential role for government policy** – places much greater weight on one-time policies to tip "bad" equilibria as opposed to permanent policies.

4. Government policy needs to address the **causes** for underdevelopment, **not the symptoms** (e.g. subsidized credit vs. credit bureaus). Sometimes neither the market alone, nor the government alone (nor maybe both, in the short run) can fix the problem.

5. There are no "magic bullets" in development – we will learn how to analyze various policies and theories critically and how to ask the right questions.