Chapter 15

HOW ECONOMIES GROW AND DEVELOP

Essentials of Economics in Context (Goodwin, et al.)

Chapter Overview

This chapter presents material on economic development and growth, including the theory behind these concepts, their measurements, and the historical context for understanding why some countries are successful at promoting development, while others seem to be "stuck" at low levels of development. You will explore issues of poverty and human development and compare data on growth rates for different countries to determine whether the world's poor countries are, over time, "catching up" to the rich countries. The chapter illustrates how investment in various types of capital (natural, manufactured, financial, human, and social) is central to achieving better development outcomes. Country diversity is a central theme; the chapter emphasizes that a "one size fits all" approach to development has produced disappointing results and that different approaches are required to improve broader well-being. In the final section, you will learn about the different kinds of economies and the role of the government in influencing economic outcomes.

Chapter Objectives

After reading and reviewing this chapter, you should be able to:

1. Explain the difference between "economic growth" and "economic development."
2. Describe general patterns of economic growth over time and across different regions and countries.
3. Discuss the relevance of GDP measures and poverty indices in evaluating the economic progress of countries and regions.
4. Explain the different theories on economic development and understand their historical context.
5. Describe the various sources of economic growth and development.
6. Describe the importance of investment on capital resources (natural, manufactured, financial, human and social) to achieve development outcomes.
7. Understand the role of the government in supporting economic development.
8. List the different kinds of economies and their relevance for understanding the process of economic development and well-being.

Key Terms

human development	poverty gap index
capabilities	multidimensional poverty index
convergence (in economic growth)	Industrial Revolution
poverty line	dependency theory

primary goods	infant industry
International Monetary Fund (IMF)	appropriate technology
World Bank	capital intensive
Washington Consensus	labor intensive
virtuous cycles (in development)	dependency ratio
bilateral development assistance	laissez-faire capitalism
multilateral development assistance	administrative capitalism
foreign direct investment (FDI)	administrative socialism
industrial policy	market socialism

Active Review

Fill in the Blank

1. When an economy has experienced increases in aggregate levels of production and income, and its real GDP has risen by some percentage from one year to the next, it has experienced economic ____________________.

2. When an economy has moved people from a situation of poverty to material plenty through investments in productive capacity and changes in the organization of work, it has experienced economic ____________________.

3. The ____________________ approach defines development in terms of the opportunities that people have to pursue important aspects of well-being, such as being healthy and having access to education.

4. The process of social and economic change that began in 18th century England and resulted in a huge increase in output per worker is called the ___________________.

5. The theory that under-development in developing countries is caused by unequal trade relations between developing and developed countries is called ____________________.

6. Self-reinforcing patterns of high savings, investment, productivity growth, and economic expansion, such as experienced by Japan and other "Asian tigers," are called _______________________.

7. The idea that poor countries are on a path to "catch up" with the rich countries due to underlying economic forces, is called ______________________.

8. Aid or loans given by the government of a rich country like the U.S. to a poor country like Ethiopia is called _________________development assistance.

9. Aid or loans given by international institutions such as the World Bank, IMF, or United Nations Development Program (UNDP) is called _______________ development assistance.

10. Suppose a U.S. company builds a factory in China to produce electronic goods. When such a private company acquires or creates assets for their own business operations in a foreign country, it is engaging in ___________________ investment.

True or False

11. The income threshold below which members of a population are classified as poor is called poverty line.

12. Additions to a nation's capital stock will automatically lead to economic growth.

13. History shows that having plentiful resources of arable land, energy, and/or minerals is a requirement for a country to have strong economic growth and development.

14. A system of private property rights is essential for economic growth.

15. The appropriate technology approach to development asks policymakers to consider directing investment towards "capital intensive" technologies to produce high-value output for export.

16. Economic growth is a necessary condition for human development.

17. The system of administrative capitalism is characterized by private corporate ownership and a substantial reliance on public administration as a mode of coordination.

Short Answer

18. Explain the difference between economic growth and economic development.

19. What is the Multidimensional Poverty Index? How is it different from income-based measures of poverty?

20. Explain the idea of convergence.

21. Explain the key argument and policy recommendation for the dependency theory.

22. What are the key recommendations of the Washington Consensus policies?

23. In what ways can aid support or deter development?

24. Explain how inflow of remittances has affected development prospects for migrant-sending countries.

25. What do we mean by industrial policy? Under what conditions might industrial policy be successful at promoting development?

26. What is dependency ratio? How does it affect the development prospects for a country?

27. What kinds of institutions are beneficial for promoting economic growth and development?

28. Is China more “developed” than India? Explain.

Problems

1. Whether worldwide inequality is increasing or decreasing is much debated in the press and popular writings. Some commentators claim that the world is getting much more equal—“just look at the progress of India and China!” Others claim that the world is getting much more unequal—“just look at the problems in Sub-Saharan Africa!” This exercise has you explore data regarding such claims.

a. Using the data in the following table, create a graph showing real GDP per capita on the horizontal axis and the rate of real GDP per capita growth for 2000-2023 on the vertical axis. Plot the data for each country.

Country	**GDP per Capita, 2023 (PPP, constant 2021 international $)**	**Percent Growth in GDP Per Capita (PPP, Annual Average, 2000-2023)**
United States	73,637	1.4
Japan	46,268	0.8
France	55,213	0.8
China	22,135	7.8
India	9,172	4.8
Bangladesh	8,172	4.7

Source: World Bank, World Development Indicators Database, 2023

b. Examining just these selected countries, is there evidence that convergence is occurring?

c. Now re-do your diagram for the following countries:

Country	**GDP per Capita, 2023 (PPP, 2021 international $)**	**Percent Growth in GDP Per Capita (PPP, Annual Average, 2000-2023)**
United States	73,637	1.4
Japan	46,268	0.8
France	55,213	0.8
Turkey	34,414	3.8
Brazil	18,554	1.4
Haiti	2934	-0.4
Burundi	857	-0.8
Central African Republic	1018	-0.7

Source: World Bank, World Development Indicators Database, 2023

d. Now is there evidence that convergence is occurring?

e. What criticism can you make about basing generalizations about world inequality on studies such as these?

Self Test

1. Which of the following was *not* one of the factors that contributed to the Industrial Revolution?

a. New agricultural techniques, new tools and machines that boosted agricultural productivity.
b. New technologies adopted in factory production that boosted output in manufacturing.
c. New communication technologies that boosted output in the service sector.
d. Supplies of cheap raw materials from other countries.
e. Access to markets in other countries in which to sell finished products.

2. The headcount poverty ratio:

a. measures the average shortfall from the poverty line
b. is a measure of the percentage of population below the poverty line
c. measures the average income of the population below the poverty line
d. looks at differences in income levels among the pool
e. Both (a) and (c) are correct.

3. The participatory rural assessment approach to measuring poverty involves:

a. identifying population below a certain income threshold
b. estimating the average income shortfall from the poverty line
c. including various elements that are critical for a decent life, in areas of physical living standards, health and education to measure poverty.
d. collecting survey data on housing conditions, income levels, and access to basic resources from local population
e. None of the above.

4. According to the dependency theory

a. development occurs through structural transformation from an agriculture-based economy to industrialization
b. urbanization is central to economic development
c. higher dependency ratio could be a hindrance to economic growth
d. under-development in low-income countries is caused by unequal terms of trade between high- and low-income countries
e. increased investment in human capital is central to economic growth

5. Which of the following was *not* one of the main policies promoted in the "Washington Consensus"?

a. Fiscal discipline
b. Development of infrastructure, health, and education
c. Market liberalization
d. Privatization
e. Trade liberalization

6. Which of the following best characterizes the record of the policies of the "Washington Consensus"?

a. The countries that most strictly followed the World Bank's market-oriented development path suffered the most severe crises.
b. Some countries in Africa were forced to make cutbacks in desperately needed health and education.
c. Countries were barred from using fiscal policy for macroeconomic stabilization.
d. Some countries that did not follow the Washington Consensus experienced notable success.
e. All of the above.

7. Which of the following is one of the trends of global economic growth in the 20th century?

a. World per capita economic output grew about fivefold.
b. The use of energy more than tripled.
c. Per capita incomes steadily increased.
d. Most of the growth came in the second half of the 20th century.
e. All of the above.

8. Which of the following factors were key to Japan's rapid economic growth in the 1950-1980 period?

a. High savings rates.
b. The investment of savings in machines and equipment to boost productivity rates.
c. Investment in human capital.
d. Promotion of exports.
e. All of the above.

9. Which of the following characterizes the global distribution of per capita GDP across countries?

a. Income per person is highest in the industrialized countries.
b. Income per person is lowest in many African and Asian countries.
c. The income per person in many industrialized countries such as U.S., Canada, Europe, and Japan is more than $25,000.
d. Many of the low-income countries in sub-Sahara have income per capita lower than $2,500.
e. All of the above.

10. Which of the following has clearly NOT been converging to rich country income levels since 2000?

a. Haiti
b. South Korea
c. Ethiopia
d. China
e. India

11. Which of the following is NOT considered by economists to be a source of economic growth?

a. Natural resources
b. Consumption
c. Savings and investment
d. Foreign sources of capital
e. Financial, legal, and regulatory institutions

12. A national system combining private ownership of capital with substantial reliance on government as a mode of coordination is known as

a. market socialism
b. administrative capitalism
c. impure communism
d. market capitalism
e. administrative socialism

13. Among variables NOT considered in the multidimensional poverty index are

a. income inequality
b. child mortality
c. school attendance
d. cooking fuel
e. drinking water

14. Which of the following is *not* one of the ingredients that can stimulate economic growth?

a. Savings and investment.
b. Technological innovation and entrepreneurship.
c. Access to domestic and international markets.
d. Contractionary macroeconomic policies to slow down aggregate demand.
e. Access to foreign capital.

15. From what sources can a developing country acquire funds to finance investments?

a. From domestic savings.
b. From bilateral assistance.
c. From multilateral assistance.
d. From private foreign banks.
e. All of the above.

16. Approximately how much in development assistance (as a % of GDP) do the rich countries give to poor developing countries?

a. Less than 1%
b. About 1%
c. About 3%
d. About 5%
e. About 10%

17. The term appropriate technology refers to…

A. increasing government spending on technological development
B. directing government spending towards technologies that are appropriate to the existing and wished-for mix of skills in workforce and to existing resources.
C. Directing foreign direct investments towards the technology sector
D. Transfer of technology from a foreign country
E. None of the above.

18. Which of the following statements is false?

   a. Industrial policy works well even if the governance structures are weak and political corruption is widespread.
   b. Market allocation of investment always ensures social priorities.
   c. Over the last few decades, the economy has drifted towards a global dualism consisting of the informal and formal sector.
   d. All of the above are false.
   e. Only (a) and (b)

19. Which of the following policies might help lower youth dependency ratio?

   a. expanding education and employment opportunities for women
   b. encouraging population growth to address labor shortages
   c. higher minimum wages for workers
   d. higher taxes on corporations
   e. all of the above

20. Which of the following is not a source of economic development?

   a. human capital including people's knowledge and skills
   b. natural capital including land, mineral and energy sources
   c. unequal terms of trade between developed and developing countries
   d. financial capital in the form of remittance flows
   e. social capital in the form of trust relations

Answers to Active Review Questions

1. growth
2. development
3. capabilities
4. Industrial Revolution
5. dependency theory
6. virtuous cycles (in development)
7. convergence
8. bilateral
9. multilateral
10. foreign direct (investment)
11. True.
12. False. Poorly planned or misguided development projects may lead to waste or even harm.
13. False. While natural resources are generally very important, there are some economies with few natural resources that have done very well (e.g. Hong Kong and Singapore, which are natural ports but have little energy or mineral resources or arable land).
14. False. Some countries, like China and Vietnam, have been successful in achieving economic growth without a system of private property rights.
15. False. The appropriate technology approach focuses on directing investments towards the technologies that are appropriate to existing and the wished-for mix of skills in the workforce and the prevailing environmental realities.
16. False. Economic growth often helps, but it is not required. Human development has many dimensions, and it could be achieved through progress in many different areas unrelated to income.
17. True.
18. Economic growth is the growth in production of output (or income), and can be measured as the percent change in real GDP. Economic development is the movement of the population from poverty into a situation of material plenty or well-being. Development is a much broader concept than growth, as it includes improvement in the quality of living through changes in non-income aspects such as access to better nutrition and housing, progress in quality of education and healthcare, decline in crime rates, and improvement in environmental quality.
19. The Multidimensional Poverty Index (MPI) considers elements that are critical for a decent life, in the areas of physical living standards, education, and health. As opposed to the income based measures of poverty that focus only on monetary measures to estimate poverty, the MPI is much broader as it follows the basic needs approach to development that focuses on the minimum quantities of basic necessities (such as food, clothing, shelter, water and sanitation) needed for a decent life.
20. The idea of convergence is that the poor countries are on a path to "catch up" with the rich countries, because they are starting off with little capital. So as they experience

increases in their manufactured capital stock, their output will grow at a faster rate than that of rich countries that are already rich in manufactured capital.

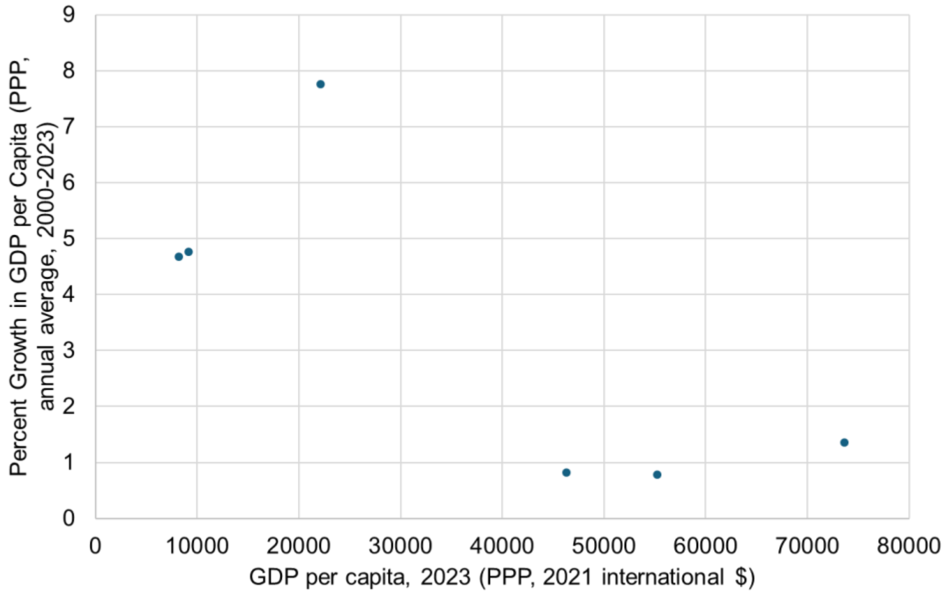
21. The key argument of the dependency theory is that under-development in developing countries is caused by unequal terms of trade (price of exports relative to imports), where developing countries export primary goods that are much cheaper than the industrial goods they import from the developed nations. The main policy recommendation is to adopt protectionist policies that promote import substitution and domestic industrialization.

22. The key recommendations of the Washington Consensus policies include fiscal discipline, market liberation and privatization, and trade liberation and openness to foreign investment.

23. While aid can support development by providing the funds to improve human and manufactured capital, most of today's poorest countries have not seen much progress despite receiving significant aid, partly because most aid comes in the form of concessional loans that has made the poor countries heavily indebted. Also, aid may deter development if it is misused by those in power to enrich themselves rather than to provide resources to the poor.
24. Remittances are a significant source of financial capital (much greater than aid) for many of the poor migrant-sending countries. Research on the impacts of remittances show gains in income and improvement in other aspects of well-being such as access to healthcare and education.
25. Industrial policies refer to government policies that are designed to enhance a country's ability to compete globally. A key requirement for industrial policy is a government that is capable of designing and implementing policies that will work well in its particular context.
26. Dependency ratio is defined as the number of people outside the working age range (normally 15-64) divided by the number of people of working age, multiplied by 100. Higher dependency ratio means that a larger part of a country's resources have to be devoted to supporting the dependent population. This is hurt the development prospects as there could be fewer resources to invest in building a country's productive capacity.
27. The beneficial institutions include: a good banking system; a good legal system with private property rights and contact enforcement; and the absence of corruption, internal conflict, and political instability.
28. Despite rapid economic growth in both countries in recent decades, China has made significantly more progress in improving the capabilities of its people. It has placed a greater priority in eliminating hunger, illiteracy, and medical neglect, and developing the economic potential of its population. However, India is ahead of China in terms of human freedom as it is a democracy, while China's government is authoritarian. Most of the development efforts in China has come from its leaders without much pressure from the public. In India, on the other hand, public protests and court decisions play a central role in influencing the process of development.

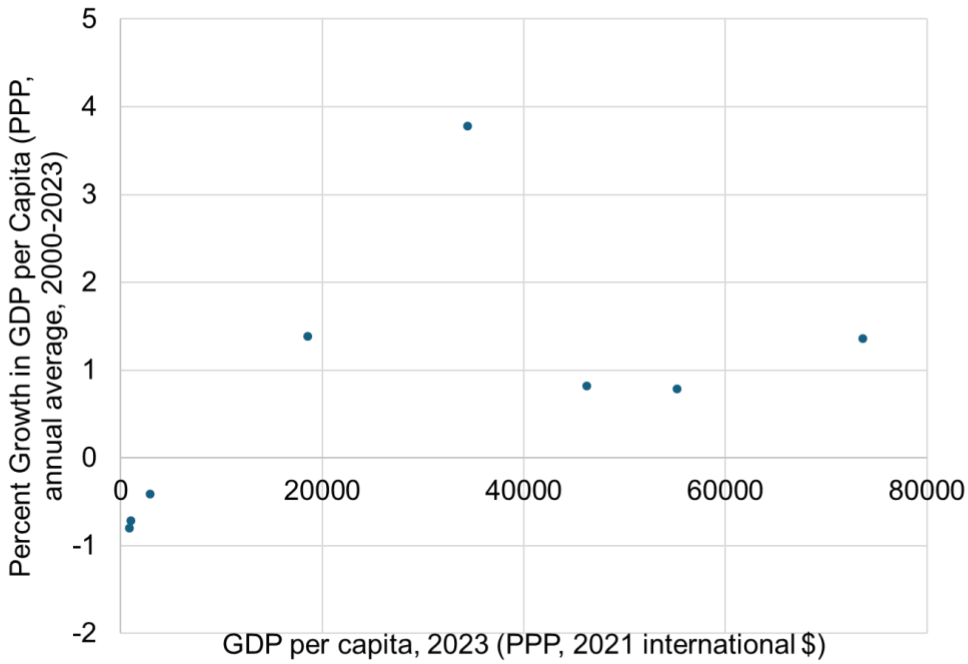
Answers to Problems

1. a.



b. Yes, looking only at this evidence, it would appear that convergence may be occurring. The poorer countries tend, on balance, to have faster growth rates than the richer countries, and are on the path to "catch up" to them.

c.



d. Now it does *not* appear that convergence is occurring, because the poor countries are growing at rates generally less than those of the developed countries.

e. Neither "study" looks at the whole picture.

Answers to Self Test Questions

1. C
2. B
3. D
4. D
5. B
6. E
7. E
8. E
9. E
10. A
11. B
12. B
13. A
14. D
15. E
16. A
17. B
18. E
19. A
20. C