Domestic factors and economic development

By the end of this chapter, you should be able to:

- identify domestic factors that may contribute to economic development
- explain how domestic factors may contribute to economic development.

There are a number of domestic factors that may act as sources of economic development and, it is fair to argue, may also act as barriers to development if they are absent or lacking in an economy. These factors are a part of the institutional framework of any country.

What do we mean by institutions and the institutional framework? Douglas C. North defines institutions as "the structure that humans impose on human interaction, and therefore define the incentives that determine the choices that individuals make that shape the performance of societies and economies over time."[1] In the next section, we look at several of these aspects of institutions, which include the organizations, structures, and rules governing or supporting economic activity.

Institutional factors affecting development

1 Education

Improvements in education improve the well-being of the population, both the educated themselves and the society as a whole. That is, education provides external benefits. Although, as we have already seen, it leads to a more efficient work force, it actually does much more. Increased levels of education mean that people are better able to read and to communicate. This, in turn, makes discussion and debate more likely and, as a consequence, may lead to social change. Changing attitudes may achieve a number of developmental aims. The benefits are widespread, but include the following.

- *Improve the role of women in society:* There is no doubt that women are empowered by education and that there are high correlations between women's education and child survival rates and fertility rates (the annual number of live births per 1,000 women of child-bearing age). The role of women in society is hugely important in terms of development. As Amartya Sen says, "Nothing, arguably,

[1] Douglas C. North, *Institutions, institutional change and economic performance,* Cambridge University Press, 1990

is as important today in the political economy of development as an adequate recognition of political, economic, and social participation and leadership of women."[2]

- *Improve levels of health:* Improved education levels, in particular literacy rates, improve levels of health in society. People, especially women, are able to communicate more fully and thus become aware of some of the hazards that face them and of some of the opportunities that exist. Individuals are able to read about, and be informed about, dangers such as HIV/AIDS, poor sanitary habits, and poor dietary habits. In addition, they are able to find out about the possibilities of such things as inoculations and water filtering.

One of the Millennium Development Goals is to "ensure that by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling." Progress has been made in the provision of education, particularly primary education, throughout the world. In almost all regions of the world the net enrolment ratio in 2006 was over 90%. The number of children of primary school age who were not attending a primary school fell from 103 million in 1999 to 73 million in 2006. However, in sub-Saharan Africa, the net enrolment ratio has only recently reached 71 per cent, even after a significant jump in enrolment that began in 2000. Around 38 million children of primary school age in this region are still out of school. In Southern Asia, the enrolment ratio has climbed to 90 per cent, yet more than 18 million children of primary school age are not enrolled.[3]

At the most basic level, the provision of education requires vast funding and this simply may not be available in sufficient quantities. Within a country there may be large disparities in the provision of education, with urban areas receiving more of the education funds than rural areas. There are also family economic conditions that prevent children from attending school; they may be needed to work within the home or farm or they may be involved in external work as "child labourers". For the most part, it is children from poor households and from families where the mothers also received no formal education who do not attend school. Enrolment in secondary schools tends to be far lower than primary schools, with the necessity of earning an income as the greatest obstacle to attending school.

2 Health care

As we have already seen, greater levels of health care, especially when combined with greater educational opportunities, will improve the levels of economic development. Although there are many factors that influence life expectancy, it would be fair to assume that there would be a strong correlation between health care and life expectancy and the HDI figures would seem to concur. Look at table 29.1.

[2] *Development as freedom*, Amartya Sen, OUP, 1999

[3] The Millenium Development Goals Report, The United Nations, New York, 2010

Country (HDI rank)	Health expenditure (Public) % of GDP	Life Expectancy Index	Education Index	GDP (PPP US$) Billions	Population (millions)
Norway (1)	17.9	0.925	0.989	251.6	4.7
Australia (3)	17.2	0.940	0.993	733.9	20.9
Canada (5)	17.9	0.927	0.991	1,180.9	32.9
Slovakia (42)	13.8	0.827	0.928	108.4	5.4
Argentina (49)	14.2	0.836	0.946	522.9	39.5
Panama (60)	11.5	0.842	0.888	38.1	3.3
Dominican Rep. (90)	9.5	0.790	0.839	65.2	9.8
Syrian A.R. (107)	5.9	0.818	0.773	89.7	20.5
Fiji (108)	9.1	0.728	0.868	3.6	0.8
Congo D.R. (176)	7.2	0.377	0.608	18.6	62.5
Sierra Leone (180)	7.8	0.371	0.403	4.0	5.4
Niger (182)	10.6	0.431	0.282	8.9	14.1

Source: Adapted from Tables H, L, M, & N of UNDP Human Development Report, 2009 (All figures 2007)

Table 29.1 Health, education, GDP, and population data for selected countries

Table 29.1 shows data for three "very high human development" countries, three "high human development" countries, three "middle human development" countries, and three "low human development" countries. With the usual warning that there are many factors that affect a single outcome, let us consider some of the relationships. It would appear that countries that spend a higher proportion of GDP on healthcare tend to have a higher life expectancy. This is obvious when we look at the specific comparison between Australia and the Syrian Arab Republic.

Australia spends 17.2% of $733.9 billion on its 20.9 million inhabitants. The Syrian Arab Republic, with a similar population, spends 5.9% of $89.7 billion on its 20.5 million inhabitants. Even though there are other factors in play, it is hardly surprising that life expectancy is considerably higher in Australia and that the Australian HDI ranking is much higher than that of the Syrian Arab Republic.

The close correlation throughout the table between the life expectancy index and the education index is also worth noting, but may be difficult to fully justify with so many other variables to consider.

There has been much progress made by many developing countries in terms of the training of doctors and nurses, the building of hospitals and clinics, and the provision of public health services such as improved access to safe water and sanitation and the widespread availability of immunisations. Throughout the world infant mortality rates have fallen, life expectancy has increased, more children are immunized than ever before and maternal mortality rates are falling. Nevertheless, there are still significant shortcomings, particularly among the low-income countries. Table 29.2 provides some evidence of the disparities that exist. While it is a very small sample it gives us an idea of the figures involved.

Country (HDI rank)	Public health expenditure per capita (PPP US$) 2006	One-year-olds fully immunized against measles (%) 2008	Births attended by skilled health personnel (%) 2003–2008	Population using improved drinking water sources (%) 2006	Population using improved sanitation facilities (%) 2006
Australia (2)	2,097	94	100	100	100
Finland (12)	1,940	97	100	100	100
Thailand (87)	223	98	97	98	96
Guyana (114)	223	95	83	93	81
Namibia (128)	218	73	81	93	35
Nigeria (158)	15	62	39	47	30
Niger (182)	14	80	33	42	7

Source: Adapted from table N, UNDP Human Development Report 2009, and UNICEF, Country Statistics 2010

Table 29.2 Selected health indicators

3. Infrastructure

A full definition of infrastructure might be "the essential facilities and services such as roads, airports, sewage treatment, water systems, railways, telephone, and other utilities that are necessary for economic activity". It should be obvious that improvements in infrastructure will lead to greater economic development. For example, better roads and better public transport allow children to get to school, adults to get to the market, and goods to get to potential buyers. A developed radio and television network can make it possible for people to link up with, and participate in, wider communities. The availability of gas and electricity is important to households for activities such cooking and food preservation. Sewage treatment improves the lot of the population, if it is universal, as does an adequate water system. Any improvement in infrastructure will, in some way, improve the well-being of the people. Table 29.3 identifies different categories of infrastructure and also gives examples of each.

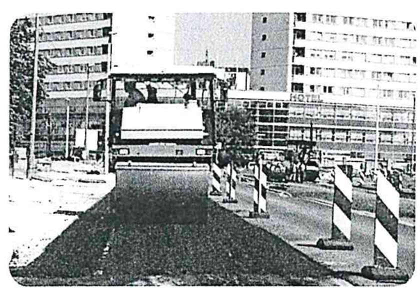
Theory of Knowledge

"There are three kinds of lies—lies, damned lies, and statistics". (This is a quotation that is attributed to Benjamin Disraeli and was popularized by Mark Twain.)

Why is this statement particularly meaningful in the field of economics?

Category	Examples
Transport	• Roads • Railways • Seaports • Airports • Public transport • Sidewalks
Public utilities	• Electricity • Gas • Water supply • Sewers
Public services	• Police service • Fire service • Education service • Health service • Waste management
Communication services	• Postal system • Telecommunication • Radio and television

Table 29.3 Categories and examples of infrastructure



Student workpoint 29.1

Be a thinker

Choose one example from each category of infrastructure listed in Table 29.3 and explain how it supports and contributes to economic activity.

4 Development Economics

4. Political stability and a lack of corruption

Countries that have political stability are more likely to attract Foreign Direct Investment (FDI) and aid, and it is more likely that domestic savings and profits will stay in the country. Increased access to FDI may be more likely to contribute to increased growth rather than development, but increased access to aid may increase development.

When there is political stability, citizens are more likely to have an input into the running of the country. Government planning is likely to be more structured and long-term and the law is likely to be more enforceable. All of these elements should lead to higher living standards of the population.

Political instability causes uncertainty and, at its most extreme, complete economic breakdown. Sudan, in Africa, is a case in point. Civil wars from 1955 to 1972, and then from 1983 to 2005, coupled with a new civil war with the western region of Darfur which began in 2003 and is still ongoing, have caused much turmoil in terms of death and displacement of the population. In addition, their neighbour, Chad, declared war on Sudan in December 2005. Such extreme political instability is bound to lead to very poor economic performance and also high levels of poverty and low standards of living for the majority of the population. The likelihood of attracting foreign investment, or even aid, becomes much smaller. A number of developing countries are experiencing civil wars as a result of ethnic and/or religious conflict or border conflicts. For example, since 1980 there have been ethnic and/or religious based conflicts in Afghanistan, Algeria, Côte d'Ivoire, Democratic Republic of Congo, India, Indonesia, Iraq, Israel, Laos, Lebanon, Mexico, Myanmar, Nepal, Philippines, Russia, Rwanda, Senegal, Somalia, Sri Lanka, Turkey, and Uganda. The loss of life, damage to infrastructure, loss of investment and sometimes aid, and political instability have undoubtedly affected economic growth and development in these countries.

Corruption is defined here as the dishonest exploitation of power for personal gain. It poses a huge challenge to both growth and development. It tends to be most prevalent where:

1 governments are not accountable to the people, especially military governments
2 governments spend large amounts on large scale capital investment projects
3 official accounting practices are not well formulated or controlled
4 government officials are not well paid
5 political elections are not well controlled, or are non-existent, i.e. there is no democracy
6 the legal structure is weak
7 freedom of speech is lacking.

Unfortunately, many of these conditions are to be found in a high proportion of developing countries. This may explain the high levels of corruption that exist in many countries.

There are many forms of corruption. These include bribery, extortion, fraud, patronage, influence peddling and nepotism. The effects of corruption are likely to hinder growth and development with a number of causative factors.

1 Electoral corruption means that the wishes of the people are not heeded. This will put a government in place that has not been voted for by the majority. It is likely that such a government will not adopt policies to benefit the electorate.
2 Corruption of any sort reduces the effectiveness of the legal system. If people can "buy" their way out of trouble there may be an incentive to act illegally.
3 Corruption leads to an unfair allocation of resources. If contracts go to the highest bidder, as opposed to the most efficient producer, then there is a market failure and resources are being misallocated. It often sustains inefficient producers, by shielding them from competition.
4 Bribes increase the costs of businesses, in cash terms and in terms of management negotiation time. This will invariably lead to higher prices.
5 Corruption reduces trust in an economy. As a result, countries may find it harder to attract foreign investment, which will often be diverted to less corrupt countries.
6 Corruption increases the risk of contracts not being honoured and this, in turn, acts as a serious deterrent to investment, both internal and external.
7 Corruption means that officials will often divert public investment into capital projects where bribes are more likely. This tends not to be important areas, such as education and health care, so it reduces the quality of government services for the people.
8 Corruption often means that officials turn a blind eye to regulations, such as those regarding construction or the environment. This can obviously have a damaging effect on individuals and the country as a whole.
9 The monetary gains from corruption are often moved out of the country. This is a form of capital flight and it reduces the capital available for internal investment.
10 The constant paying of small bribes reduces the economic well-being of the ordinary citizen.

Some interesting research figures regarding bribery from Transparency International are shown in Table 29.4.

Question: In the past 12 months, have you or anyone living in your household paid a bribe of any sort?

Answer: Yes.

Over 50%	Cameroon, Liberia, Sierra Leone, Uganda
31%–49%	Armenia, Azerbaijan, Cambodia, Ghana, Iraq, Kenya, Russia, Senegal
11%–30%	Bolivia, Czech Republic, Greece, Indonesia, Moldova, Nigeria, Pakistan, Ukraine
5%–10%	Bosnia & Herzegovina, Bulgaria, Chile, Hong Kong, India, Malaysia, Singapore
Less than 5%	Austria, Croatia, Georgia, Japan, Panama, South Korea, UK, USA

Source: Transparency International Global Corruption Barometer 2009

Table 29.4 Percentage of households making bribery payments in selected countries

Student workpoint 29.2

Be an inquirer

Go to the website for Transparency International to find out the latest corruption rankings. Investigate and compare the nature and extent of corruption in one country with very high level of human development and one with low level of human development.

5. Legal system

An honest and fully functioning legal system is almost essential if development is to be achieved. In many developing countries the legal system does not function well. Where this is the case there is no way to create and enforce contracts and there is no way to uphold property rights. Social scientists consider property rights to be essentially a "basket" of legal rights. This basket includes:

- the right to own assets, such as land or buildings
- the right to establish the use of our assets, such as adding to the building—for example an owner might want to add sanitation to a house
- the right to benefit from our assets, such as renting out our land
- the right to sell our assets
- the right to exclude others from using or taking over our assets.

Property rights allow people to own and benefit from private property, so long as the legal system and security system can support and protect these rights.

If a person cannot guarantee his or her ownership of a property, then there is no incentive to improve that property, since it is possible that the property will then be lost and the investment will have been wasted. If there are no enforceable property rights, as may be the case in many developing countries, then investment and growth will be very much reduced and economic growth may be limited. Development will be thwarted for all of the reasons above.

6. Financial system, credit, and micro-finance

Developed and independent financial institutions are essential, if economic growth and development is to be achieved, and these are often underprovided in developing countries. Most developing countries have what is known as dual financial markets. Financial markets may be defined as the institutions where lending and borrowing is carried out. The "official" financial markets are small and tend to be dominated by foreign commercial banks, which often have an outward looking emphasis to their operations and restrict their lending to foreign businesses and the already established large manufacturing local businesses. The "unofficial" markets are not legally controlled and are thus illegal. Their main operation is to lend money, usually at very high interest rates, to those who are desperate and poor enough to have to borrow it.

Saving is necessary to make funds available for investment and investment is necessary for economic growth. Saving is difficult enough in countries where there are high levels of poverty, but it is even harder if there is nowhere to save money that is safe and will give a good return. When there are weak and untrustworthy financial institutions, people with investment income tend to buy assets, such as livestock, or they tend to invest their money outside the country (capital flight).

Financial services are necessary if low-income people are to be able to manage their assets and to allow them to increase in value, thus enabling them to then invest in things that will lead to their economic development, such as health care, shelter, and education.

The difficulties associated with saving and borrowing money are a significant barrier to economic growth and development. It makes it exceedingly difficult for poor people to raise themselves out of poverty.

In developing countries poor people find it almost impossible to gain access to traditional banking and financial systems, since they lack assets to use as collateral, are often unemployed, and lack savings. Therefore, even if there is great entrepreneurial spirit, it is very difficult for people to start up businesses. If they can find a way to borrow money it is often at exorbitant interest rates. There is, however, a type of financial service that is geared specifically to the poor. This is known as micro-finance and is the provision of financial services, such as small loans, savings accounts, insurance, and even cheque books.

The provision of small loans to individuals who have no access to traditional sources is known as micro-credit. A key element of original micro-credit schemes is that they did not originate in the developed world, but rather had their beginnings in developing countries. The first schemes began in the mid-1970s with projects such as Opportunity International (1972), ACCION International (1973), Muhammad Yunus/Grameen Bank (1974/76), FINCA International (inc 1985) and The SEEP Network (1985).

Usually, the micro-credit loans are given to enable poor people to start up very small-scale businesses, known as micro-enterprises. These may include such things as roadside kiosks, bicycle repair services, market stalls, rice wine making, knitting, and woodworking. The loans give protection against unexpected occurrences and seasonal problems, and may help families to gain a regular income, start to build wealth, and thus escape from poverty.

Women have tended to be the main recipients of micro-credit, for many reasons. It is thought that women are a better credit risk—they are more likely to pay back loans. Women are usually responsible for caring for children and so any reductions in a woman's poverty will translate into improvements for the children. In many documented cases, this has allowed for more poor children to go to school. When women take loans and can begin to earn an income, their social and economic status is raised and economic development is enhanced.

Student workpoint 29.3

Be an investigator

Research and prepare a case study explaining any one example of an individual or a group of people who has benefited from a micro-credit loan.

7. Taxation

Tax revenue provides governments with the means to finance necessary public services, such as education and health care, and generally to improve the infrastructure of the country. However, this is very difficult to do if governments do not earn a great deal of tax revenue.

It is very difficult for governments to collect tax revenue in developing countries. We can consider reasons for this. Firstly, as a result of tax exemptions and inefficient or corrupt administration, it is estimated that less than 3% of the populations in developing countries pay income tax, as opposed to 60%–80% in developed

"Any process of growth that fails to improve the welfare of the people experiencing the greatest hardship, broadly recognized to be women and children, has failed to accomplish one of the principle goals of development."

Source: Michael P Todaro, *Economic Development*, Addison Wesley Longman, 2000

[4] Michael P. Todaro, *Economic Development 7th Edition*, Addison Wesley Longman, 2000

countries[4]. Secondly, corporate tax revenues tend to be low, since there is relatively little corporate activity in developing countries (although it is growing) and they also often offer large tax incentives in order to encourage domestic corporate activity and to attract FDI. Thirdly, the main source of tax revenue in developing countries comes from export, import, and excise (customs) duties. These taxes are relatively easy to collect, since they are paid when the goods pass through the country's border posts. However, it is only possible to gain significant tax revenue if the country is heavily involved in foreign trade. It is worth noting that the international trading system through the WTO, with its emphasis on liberalization of trade, may have negative implications for countries that do earn significant revenue from tariffs. Finally, as has been stated above, developing countries have problems with the administration of their tax systems in terms of inefficiency, lack of information and pure corruption. These elements, when combined, often mean that people are able to evade paying the taxes that they should.

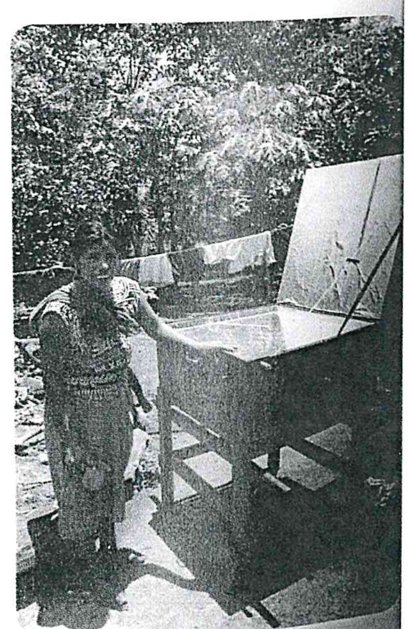
Another factor that needs to be considered is the size of the informal market. It is well known that the size of informal markets as a percentage of GDP is far greater in developing countries than in developed countries. It would also appear that informal markets are growing in almost all countries in the world.

Large informal markets once again lead to much lower tax revenues for governments in developing countries. If the incomes of people are not recorded because they are earned in informal markets, then there will be no tax paid on such income. Lower tax revenues make it difficult for governments to promote growth and achieve development objectives. Furthermore, there are other consequences. Workers tend to be unprotected in the informal markets and are very poorly paid, with little job security, poor working conditions, and no social care. Productivity in the informal markets tends to be very low; workers are often low-skilled migrants from rural areas with little education and low human capital.

8. The use of appropriate technology

Appropriate technology is technology that is appropriate for use with existing factor endowments. This applies to both production and consumption.

In terms of production, in years gone by developing countries were urged to modernize and industrialize their output. However, development economists argued that this was not "appropriate". In most developing countries there is a surplus of labour and so the appropriate technology to use would be technology that makes use of the abundant labour supply. An example of this would be giving workers capital equipment to use that is cheap to make and requires labour for its use. A well known example is the Universal nut sheller, which is a simple machine, turned by hand, that is used to shell nuts. It is cheap to make, has a long life and has a one-to-one capital to labour ratio. When used industrially, they provide greater employment than automated systems and so add to development.



In terms of consumption, a good example of appropriate technology is the solar cooker. The cooker is made from aluminium foil and plastic film, which are very cheap to purchase, and it requires sunshine to operate, which is abundant in many developing countries. The cooker aids development in many ways. It does not require wood and so there is no loss of trees, it eliminates the daily search for firewood, which frees up time for other activities, and so it helps to improve the position of women, who are most commonly responsible for cooking in developing countries.

9. The empowerment of women

In many developing countries the role of women is very much subservient to that of men. There is no doubt that giving women more empowerment, especially in terms of education, as stated earlier, could be a huge factor in the achievement of economic development.

Improving the welfare of women through greater education and improved social standing obviously leads to economic development for the women themselves. However, there are also extremely important externalities that occur when women become more empowered.

- The well-being of their families is improved, especially in terms of the health of their children. With improved education, women are better informed about health care, hygiene, and diet, all of which improve the welfare of the family.
- The education of children in the family group improve. The women pass on their own education and also see education as being more important, thus striving to achieve it for their children.
- Because of the two points above, the quality of the workforce in the country will, over time, improve, with significant effects upon growth and development.
- With greater empowerment women earn more money. Research shows that increases in the levels of income of women in developing countries lead to greater increases in health levels of families than similar increases in the income levels of men.
- With better education and social standing women have more control over contraception, marry later, and so tend to have smaller families, thus lowering the rate of population growth.

10. Income distribution

Although all countries in the world have income inequality, it is fair to say that the gap between the rich and poor in developing countries is generally greater than that in developed countries.

High income inequality can be a barrier to growth and development for a number of reasons. Firstly, there tends to be low levels of saving, because the poor save a very small proportion of their income. As we know, low saving means low investment and so low growth. Secondly, the rich tend to dominate both politics and the economy and this tends to mean that policies are followed that are more in their favour and so we do not have pro-poor growth.

Pro-poor growth occurs when economic growth leads to a fall in some agreed measure of poverty. Thus, this type of growth benefits the poor. Thirdly, high income inequality in developing countries tends to be marked by the rich moving large amounts of funds out of the economy, in the form of capital flight. Also, a large proportion of the goods purchased by the rich are foreign produced and so their consumption does not really help the domestic economy. Thus, although we usually link income inequality simply to a consequence of low levels of development, we can also see that it can act as a barrier to growth and development.

Student workpoint 29.4

Be an inquirer

This workpoint also serves as an end of chapter review exercise, as you need to be able to understand how the institutional framework of a country, including the aspects listed below, affects economic development.

Choose one of the developing countries that you investigated earlier and research the extent to which the following institutional and political factors affect its economic growth and/or development.

- The provision of education and health care
- The extent and quality of infrastructure
- Financial services/banking system
- Legal system
- Political stability
- Extent of corruption

END OF CHAPTER REVIEW QUESTIONS

Using examples wherever possible, explain how each of the following can contribute to economic development:

1 Education
2 Property rights
3 The use of appropriate technology
4 Access to credit
5 Women's empowerment