

LECTURE 25: GROWTH AND DEVELOPMENT III

- I. Beyond the Solow Growth Model
 - a. The theory that poor countries will catch up to rich countries is a consequence of a standard growth model in economics called the Solow Growth Model.
 - b. But that conclusion is puzzling. Why do we have so many poor countries? Shouldn't they have caught up by now?
 - c. Economists have looked at possible missing elements with the unfortunate conclusion that growth is hard.
- II. Investment
 - a. If investment is so valuable in developing countries, why not just invest? If private hands won't do it, foreign aid can. A relatively small amount of money can have a huge impact, after all.
 - i. Dams, roads, bridges, power plants, and other sorts of big infrastructure projects popped up (and still pop up) all over the developing world, especially during the Cold War.
 - b. But there's a reason no private hands have touched this profit opportunity. Remember, capital tends to depreciate over time. Capital requires maintenance and that maintenance requires educated labor, a regular stream of money, low corruption, and supplies.
 - c. Moreover, taking full advantage of the capital requires spillover industries to emerge. It's not very valuable to provide cheap electricity if no one knows how to run a factory.
- III. Education
 - a. Another interesting conclusion of the Solow Growth Model is that capital can only do so much for growth. The man behind the model—Nobel Prize Laureate Robert Solow—concluded that technology, not investment, is the key to growth.
 - b. So there is some truth to the idea that more education—a particular type of investment—is what's missing. Rather than developing physical capital, poor countries need to develop their *human capital* or the stuff in people's head which makes them more productive.
 - i. There's a fair amount of evidence that increasing education leads to greater productivity and the greater wages that come with it (there better be, right? Otherwise, what are you doing here?).

- ii. But as a recipe for development, it doesn't work out that way.
- c. Building a school is easy; running it is hard.
 - i. Like other forms of physical capital, schools have to be maintained and staffed. Everything from books to electricity is in short supply.
 - ii. Many governments use teaching and administration positions as political patronage. If you support the government in some key way, you'll be rewarded with a regular paycheck but not expected to teach. You don't even have to understand the subject you're teaching.
- d. Incentives matter
 - i. If you overcome these problems and gain a good education in the developing world, there is little guarantee you'll be rewarded.
 - ii. In part of the issues above, the material rewards aren't that great. People are rewarded for supporting the government, not starting useful businesses.

IV. The Mystery of Capital

- a. There are other possible reasons for poverty—overpopulation or overwhelming debt—which economists have considered. But few explanations hold as much promise as what Hernando de Soto describes in his landmark book, *The Mystery of Capital*.
- b. De Soto argues physical capital in developing countries is dead. It's an asset, not capital; it can't be used to produce other things. Land is often unregistered, homes are built illegally, and businesses start outside the formal section.
 - i. Without legally recognized collateral or an official address, people can't get a business loan. Without a legal business, they have trouble expanding or selling it. They can't use the court systems. They can't advertise.
 - ii. Recall the key aspect of capitalism: private property which is strictly enforced and clearly defined. The developed world has a solid legal system for this reason.
- c. People don't register their businesses or legally secure their land because it's really, really hard.
 - i. Armed with a research team, de Soto attempted to open a simple garment factory (one employee) in Lima, Peru. Working six hours a day, the team registered the business in 289 days. Similarly disastrous results were repeated with similar experiments in Egypt, the Philippines, and Haiti.

- ii. So people prefer to work in the extralegal sector (the black market). And it's hard to go back because that involves admitting to the authorities you've been breaking the law.
- d. The key goal, then, is legal reform. But it's very hard as it involves:
 - i. Creating competitors for politically-connected businesses;
 - ii. Changing the minds of the custodians of the current bureaucracy;
 - iii. Titling land and assets based on hundreds of different local customs;
 - iv. Untangling decades or centuries of informal history; and
 - v. Convincing millions to change how they live their lives.