Do consequences exist for developing countries experiencing significant growth which don't improve the welfare of their citizens in conjunction?

First Prize – 3rd Year Undergraduate Category

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"In judging economic development, it is not adequate to look only at the growth of GNP or some other indicators of over-all economic expansion. We have to look also at the impact of democracy and political freedoms on the lives and capabilities of the citizens."

A. Sen in *Development as Freedom*

Introduction

Thanks to thinkers like Amartya Sen, who stressed the importance of every individual's capabilities to have a real benefit from increases in growth, the focus in development economics has shifted from growth to a broader conception of human development and welfare. This essay will examine the consequences, both positive and negative, for developing countries experiencing significant growth which doesn't improve the welfare of their citizens in conjunction. The consequences to assess are both economic and social; they might affect human capital or risk of conflict and affect different groups of citizens. Firstly the paper will seek to define key concepts such as growth, developing country and welfare. Secondly, the possible positive consequences of an increase in economic inequality will be assessed; such as rise in foreign trade due to an increased demand for exports or increased availability of capital. Subsequently the essay will look at how these consequences affect groups of citizens which differ in many ways. The consequences of growth which only benefits a small elite will be assessed as well as the consequences of inequality based on gender, ethnicity, caste race or political affiliation. Such consequences might range from inefficient use of the labour force, to heightened risk of civil unrest, to increased foreign investment and exports. In conclusion the paper will assess whether these consequences are primarily positive or negative.

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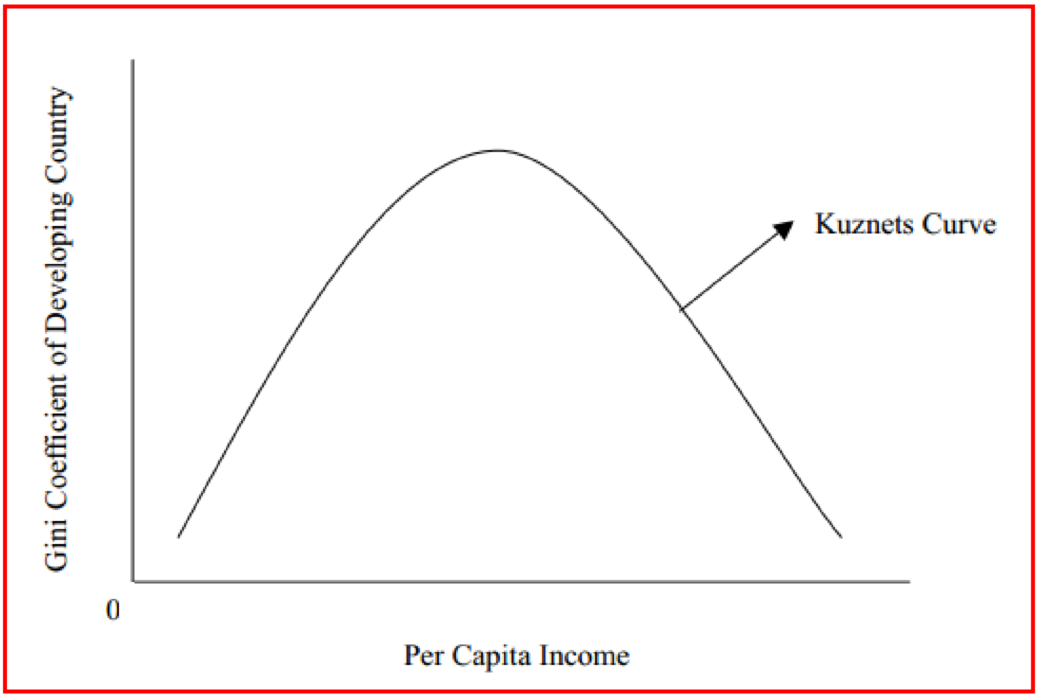
In primis, we must define the relevant terms for our discussion. We are to look at developing countries experiencing significant growth but little improvement in the welfare of their citizens. The notion of developing country will be restricted to what the World Bank refers to as 'developing economies'; i.e. low and middle-income countries, with GNI per capita below $ 12,476 (WB, 2013). Significant growth will be defined as above 5% GNI per capita growth on average over 10 years. Finally we must define what we mean by welfare. As stated earlier the focus of welfare has shifted in the past 40 years from one concerned with growth and redistribution to being concerned with freedom to achieve different capabilities (Atkinson, 1999). For this reason to assess changes in welfare we will assess changes in individual's freedom to realize economic and social capabilities. Therefore we will not only look at growth and inequality but also at human capital, education and health.

Main Argument

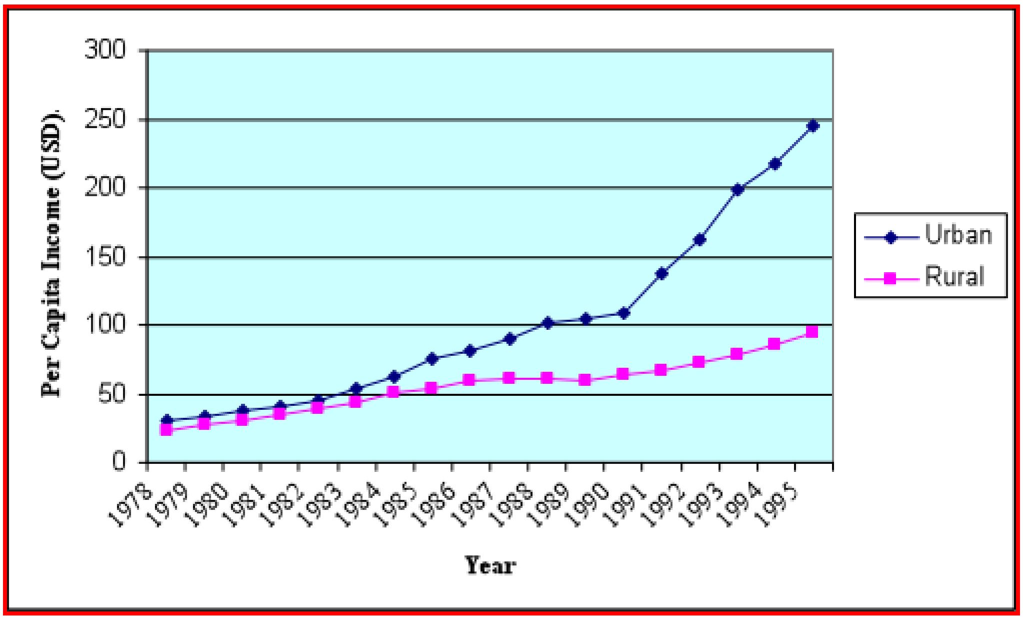
In this section we will look at the possible non-negative consequences for countries experiencing significant growth but not improving the welfare in conjunction. Crucial to the understanding of how such consequences come about is our understanding of the Kuznets curve. Simon Kuznets (1955) articulated the view that in the development process, inequality would rise as the differential between city and countryside came to dominate the development landscape, and then decline as industrialization deepened and social democracy took hold (Galbraith, 2007). This relationship is represented by a 'U' shaped curve. On the vertical axis an inequality index, usually the Gini Coefficient, is plotted against a measure of growth, as in the graph below. Economists like Kuznets argue that rising inequality is not a negative externality of growth within the free market but a natural occurrence due to wage difference in different sectors and to rural-urban migration that settles at a certain income level and diminishes after that (Kulkarni, 2006, pp. 196).



1) The Kuznets Curve. (Source: Weil, 2005, p.370.)

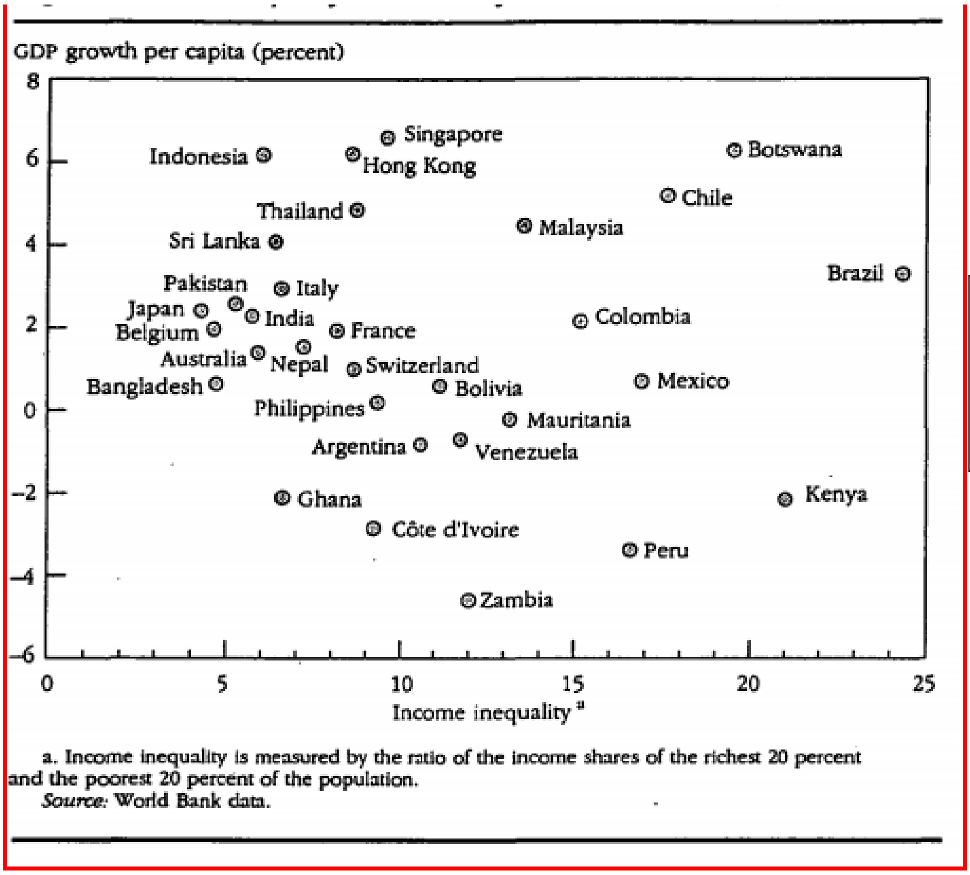
Up to the 1970s, the Kuznets hypothesis seemed to account for the experience not only of the US but also of most of the OECD countries (Aghion et al, 1999). The arguments for rising inequality being beneficial are usually posited on the advantages of having low wages. An increase in inequality means both higher availability of capital in the hands of those who can generate growth and, if wages do not rise as the economy grows, that low production costs may attract both domestic and foreign investment (Larudee & Koechlin, 1999).

Between 2002 and 2011 China averaged over 10% growth, the highest in the world in that period. (WB, 2012) Furthermore at the start of this decade China was the biggest recipient of FDI, receiving $53 billion out of $192 billion that the OECD countries invested to all emerging economies (Perkowski, 2012). But how did China reach this stage? At Mao's death in 1978 Deng Xiaoping sought development through many means, one of which was the attraction of Foreign Direct Investment .Four Special Economic Zones were established in the coastal areas (Renard, 2002, pp 90) and lower tax rates were granted to foreign investors (ibid, pp 198). This was followed by a rural-urban migration, as Kuznets predicted, with the rural population falling by 10% between 180 and 1996 (ibid, pp 149). Income inequality also rose following the economic reforms with urban per capita income increasing 700% while rural income increased by 300% as shown in the graph below.



2) Rural and Urban Per Capita Income over time in China.

China's Gini Coefficient also rose from 0.238 to 0.394 in the same time, attesting to the rise in inequality. This trend however did not settle, as China's Gini coefficient rose to 0.470 in 2005 (UNDP 2005). Some scholars ave argued that increased inequality of income and wealth generates concentrations of capital in leading sectors which is thought to be a motor for growth (Benabou, 1996; Galor & Tsiddon 1997a, 1997b). However, if the Kuznets Hypothesis holds it seems that china is in the first half of the U curve. China has not seen any signs of decrease in inequality, in fact the Gini Coefficient in 2009 was of 0.48 (CIA, 2011). The decrease in inequality that Kuznets had predicted is not taking place. Furthermore, some studies have found an inverse relationship between inequality and investment (Alesina & Perotti, 1996). Inequality has been linked to socio-political instability. The latter creates political uncertainty, which reduces investment (ibid). Stiglitz compared inequality and GDP per capita growth and shows that Hong Kong, Singapore and Indonesia achieved the same per capita growth as China but with around half the income inequality (1996 p. 166).



3) Income Inequality and GDP Growth 1970-1993.

The author also suggested that the egalitarian policies applied in these countries contributed to a more stable political and economic environment and led to faster growth through a more productive labour force (1996, pp 172). This is also argued by Birdsall et al (1995). It seems that growth can be achieved both by concentrating capital and through egalitarian policies. However, the former is more likely result in social instability while the latter is less likely to produce such social consequences. The next section will look the consequences of a significant growth combined with the accumulation of capital in the hands of few.

Classical theories, in line with Kuznets's empirical observations, state that inequality may be good for growth because it leads to higher investment from a higher savings rate amongst those the more well off (Keynes, 1920) (Kaldor, 1957); While more modern perspectives emphasize the adverse effects of inequality on the process of development (Galor & Zeira, 1993). The first case considered here is known as enclave growth. A situation where, despite significant overall GDP/capita growth, only one sector or only a small proportion of the population benefit, while the majority of the population does not experience positive consequences. Many such cases are found in resources-rich developing economies or high aid-receivers, which has given rise to the popular name; the 'resource curse' (Auty, 1993). That natural resource revenues or aid carry negative economic and social consequences may seem counter-intuitive; after all it is relatively easy revenue which in the case of aid is even intended to benefit the population as a whole. There are several mechanisms, however, whereby this easily accessible money might negatively affect the economy despite boosting growth figures in the short term. Firstly, many primary commodity-exporting or aid-receiving countries suffer from a situation known as Dutch Disease[1] (Weil, 2005, p.453-4). This is a situation where large foreign exchange inflows cause real exchange rate appreciation. Other exports, most notably manufactured goods, are rendered less competitive globally, resulting in low levels of domestic investment and an economy concentrated in few sectors. Simultaneously imports become relatively cheaper, further discouraging investment in domestic production and affecting employment and aggregate demand negatively. More so than aid funds, commodity export earnings tend to fluctuate wildly due to global price volatility causing unstable government revenues and potentially unsustainable lending practises to smooth expenditures against the expectation of future price increases. Government expenditures also tend to increase more when countries experience large foreign exchange inflows, causing 'crowding-out' of private investment, especially in small, relatively closed economies (Alichi and Arezki, 2009). Furthermore, capital-intensive resource industries tend to induce more corruption, hampering economic development, as explained in the section below (Iimi, 2007, pp. 665).

If a government acquires revenue through aid funds or through taxation of small sectors of the economy it will be less accountable to its citizens and subject to less scrutiny and therefore less concerned with the welfare of the general population. This government revenue, which is acquired more easily, than for example revenue through taxation (Platteau, 2008) encourages rent-seeking. Whereby the primary aim of politicians become to maximise revenue and their own share of it, as opposed to more efficient public service provision (Collier and Gunning, 1999, Collier, 2007). This may lead to corruption and a reorientation of the state towards the interests of the extractive industry and donors as opposed to its citizens, and is particularly common in countries with weak institutions, which holds true for many developing countries (Platteau, 2008). In such a situation, control over the state becomes an aim in and of itself, leading to inefficient use of resources and in worst-case scenarios to armed conflict and coups as has been the case in Angola and DRC amongst others (Prunier, 2009).

Thirdly, the typical drivers of enclave growth – natural resource extraction operations – are very capital-intensive but not very labour-intensive leading to little employment generation. The little employment that is generated tends to have relatively high skills requirements thus posing barriers for the average citizen in developing countries. Such enclave growth has limited linkages with the remainder of the economy, causing only limited increase in demand domestically. According to human capital theories of growth (explained below), overall GDP growth is negatively

1 Named so after the Netherlands' experience in the 1960s with a natural gas boom.

affected when the population as a whole does not benefit from short-term increases in output (Weil, 2005). Equatorial Guinea for example experienced significant growth over the past decade. However it is also the country with the world's largest differential between GDP Per Capita and HDI ranking and which saw infant mortality rise by 20% between the discovery of oil and when production reached 350,000 barrels per day (Shaxon, 2007).

The next section will assess those situations where inequality is not based on merit; namely we will look at possible consequences for countries experiencing significant growth but in which certain ethnicities, regions or genders do not benefit. Most people would not object to inequality but to the fact that the differences in reward do not correspond to any recognizable differences in the merits of those who receive them (Hayek, 1960). However, in developing economies these inequalities often do not correspond to such differences in merit. Some African leaders have developed a tendency to treat members of their tribal group with favour thus setting the stage for the rapid growth of ethno-centric favouritism and nepotism (Mulinge & Lesetedi, 1998). Kenya saw one of the fastest growths in the continent with a growth rate of 6% between 1971 and 1981 (FRD, 2007). However today, Kenya is considered by some scholars a failed state (Di John, 2010). The country has disputed boarders, a low HDI (0.509) (UNDP, 2011), 50% of the population living under the poverty line and a Gini Index of 42.5, while life expectancy at birth is 57 years, compared to 81 in the Euro area (WB, 2011). Scholars have noted how reliance on primary commodity exports poses an obstacle to economic development (Collier, 2007) while others have emphasized the problems caused by tribalism. Ethnicity/tribalism and nepotism have encouraged the spread of corrupt practices in Kenya, such as embezzlement and economic mismanagement through the appointment of under-qualified, and in some instances unqualified, but politically well-connected tribesmen to fill important positions. President Arap Moi eliminated members of other tribes from strategic political positions to install members of his own ethnicity in the 1980s (Mulinge & Lesetedi, 1998). Kenya is one of the most corrupt countries in the world, often ranking at the bottom of corruption indexes (TI, 2012). This malpractice has been found to hinder economic growth (Mauro, 1995). Since a multi-party system was reintroduced ethnic clashes between the Kikuyus and the Kalenjin have left thousands dead and over half a million displaced (Klopp, 2002); the economic and social consequences are unquantifiable.

The central mechanism whereby unequal access to employment or education may impact growth is through the opportunity costs associated with inefficient allocation of human resources. Education, training and good health will increase the productivity of the labour force, which has been shown to have positive and significant effects on growth (Barro, 2001). Several scholars have studied the relationship between average access to education and future economic growth, finding that the average years of schooling is positively and significantly related to growth and that that is true for all countries regardless of their income level (e.g. Schultz, 1961 and Barro, 2001) Human capital – the term used to indicate education, on-the-job-training, health and the like – is therefore considered a partial driver of growth (ibid.). Health care impacts growth in similar ways, whereby universal primary health care has been shown to have. positive effects on growth causing countries such as China, Rwanda and Ghana, all of which experienced significant growth recently, to make plans for universal coverage (Levey, 2012). Furthermore, health and education have significant positive economic externalities such as lower infant and maternal health mortality (Weil, 2005) and are the main determinants of development along with economic growth (UNDP, 2011).

Inequality along ethnic, racial or regional lines may have seriously negative consequences on national per capita income. The discrimination associated with Kenyan tribalism or South African apartheid has led to high crime rates and violent conflict, when the marginalised parts of the population become sufficiently dissatisfied with the situation, as is also exemplified in the recent Arab Springs. Even if we exclude Iraq and Afghanistan due to the influence of the 'War on Terror' on income and inequality, the 10 countries at highest risk of social conflict also have a Gini Coefficient of over 40 (EIU, 2013 & WB 2011). Furthermore, apart from the social and economic costs associated with conflict, keeping certain parts of the population out of the decision-making process and away from lucrative economic activity constitutes a direct wastage of resources, on top of the opportunity costs mentioned above.

Conclusion

In this essay we have looked at different situations where developing economies experience significant growth but do not improve the welfare for certain groups of citizens in conjunction; we have also looked at the possible consequences faced by such economies. We have looked at classical theories of growth, specifically Kuznets's inverted U Hypothesis, and assessed their validity for developing economies. The paper then examined economies experiencing significant growth but where only few benefit from this growth and assessed the possible consequences of said distribution. In addition, the paper looked at inequalities based on gender, regionalism and ethnicity and on how these inequalities affect growth.

Despite the classical arguments that inequality is an inherent part of the development process and potentially even beneficial for growth, we have seen economies grow equally fast with egalitarian policies. Furthermore the paper has linked inequality to a heightened risk of social and political instability, increased rent seeking, nepotism and high opportunity costs from low human capital investment. Apart from the moral question of non-merit based, unequal resource allocation, such distribution may decelerate growth thus potentially carrying significant negative consequences for the entire economy.

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