

This paper is intended to provide the student with brief background information on the poor, some of the history of developing economies, the regional differences of poverty and current debate. This is not an exhaustive treatment of any aspect of this topic.

***The richest 20% of the world's population consumes 86% of all goods and services;
the poorest 20% consumes 1.3%.¹***

Theodore Schultz opened his 1979 Nobel Lecture stating, “Most of the people in the world are poor...”² And almost 30 years later this still holds true. The World Bank estimates that 2.8 billion people live on \$2 a day. To understand the complexity of poverty, we need to understand the poor – who they are, and why they’re poor.

To put it simply, poverty is a shortage of income. However, it is a multifaceted situation – one into which people are probably born, one they have little opportunity to escape on their own, and one that deprives people of the basic necessities of life such as nutrition, healthcare, education and housing.

How do we know more than half the world's population lives in poverty?

Economists use a variety of measures to determine who is poor, such as the cost of food relative to personal income, life span, and amount of education. A typical indicator of poverty is a poverty line which serves as a standard for what it means to be poor, usually defined in terms of the amount of money needed to achieve some accepted

¹Robert A. Isaak, *The Globalization Gap : How the Rich Get Richer and the Poor Get Left further Behind*. Financial Times Prentice Hall Books. (Upper Saddle River, NJ: Prentice Hall/Financial Times, 2005), 103. Statistic taken from Barbara Crossette, “Kofi Annan’s Amazing Facts: The true Parameters of the Planets,” *The New York Times*, September 27, 1998.

² Theodore William Schultz, *The Economics of being Poor*, (Oxford, UK ; Cambridge, Mass., USA: Blackwell, 1993), 13. Delivered in Stockholm, Sweden on December 8, 1979, and first published in *Journal of Political Economy*, 88, No. 4 (1979), 639-651.

standard of consumption.³ Poverty can be “relative” when comparing one person’s assets to another’s. Typically “relative poverty” is a concern of developed nations where a portion of the population has a low standard of living compared to the average.

Conversely, if a person is unable to attain what they need to survive, they are living in a state of absolute deprivation. This type of “absolute poverty” is common in third world countries.

The World Bank uses a standard that is comprised of two elements: “the expenditure necessary to buy a minimum standard of nutrition and other basic necessities, and an amount that varies from country to country, reflecting the cost of participating in everyday life.” For the purpose of global comparison the World Bank uses reference lines set at either \$1 or \$2 per day (\$1.08 and \$2.15 in the 1993 Purchasing Power Parity)⁴.

In 2004, The International Monetary Fund (IMF) updated its classification of economies into two main divisions: advanced economies, and other emerging market and developing countries. Prior to 2004 there were three categories: advanced, developing and countries in transition. Most of the advanced countries are located in the northern hemisphere and the remaining 179 in the world are located mostly in the southern. Least developed countries (LDCs) are those with the lowest average gross national income (GNI).

In addition to macroeconomic variables, qualitative measures can indicate poverty levels. It is generally accepted that there is a correlation between life expectancy and poverty. While there are differences in life expectancy across the world, typically those

³ Abhijit V. Banerjee, Roland Benabou, and Dilip Mookherjee, eds. *Understanding Poverty*, (Oxford ; New York: Oxford University Press, 2006), xvi.

⁴<http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/ICPEXT/0,,contentMDK:20118237~menuPK:62002075~pagePK:60002244~piPK:62002388~theSitePK:270065,00.html>. World Bank, 2005.

countries with low life expectancies are those in developing countries. Life span is not just the result of access to healthcare but also higher income, literacy and education. However, literacy is difficult to quantify since there are many ways to define literacy—does one need to just know an alphabet, write their name or be able to read and write full sentences? Also, literacy cannot be a measure applied to children who are too young to become literate and those adults who are marginally literate can lapse to illiterate in a short time. The same difficulties occur when looking at education. Can you accurately measure education through a minimum set of requirements such a diploma or by a determined number of years of schooling? There is also some debate whether one can be educated without being literate referring to having the “wisdom of the people” and are highly successful within one’s own society.⁵

What causes some economies not to grow?

In addition to determining who is poor, economists debate why a country is poor. Economic growth has traditionally focused on physical and human capital accumulation and technological change. The three determinants, which appear in the literature most often, are climate, institutions, and trade.⁶ It should be noted that while these factors may help economies grow, the absence of them do not automatically determine their economic future.

The geography view states that the natural characteristics of a country affect its development. These variables include climate, natural resources, disease, transport costs,

⁵ Ali Mohammed Khusro, *The Poverty of Nations*, (New York: MacMillan; St. Martin's Press, 1999), 8-12.

⁶ Dani Rodrik, Arvind Subramanian, and Francesco Trebbi. "Institutions Rule: The Primacy of Institutions Over Geography and Integration in Economic Development." *Journal of Economic Growth* 9, (2004), 132-136.

and transmission of knowledge and technology from more advanced locations.⁷

Compared to temperate climates, tropical ones produce a poor crop yield, are subject to more disease, and are not suited to apply production technologies. There is much research that a lack of development in the tropics has been caused by low crop yield from pests and poor soil, unstable water supply, infectious disease, high transport costs, lack of seasonal changes to grow grain, and lack of coal deposits.⁸ Most of the poorest places in the world are located near the equator subject to high temperature, periodic torrential rain and tropical diseases such as malaria.⁹

The institution view maintains that economic development relies in long-lasting institutions—mainly property rights and rules of law. Europeans colonized in two different ways--settler colonies and extractive colonies. The viability of a settlement was based somewhat on its climate determined whether Europeans settled and created lasting institutions that benefited the colony (e.g., United States) or extracted the natural resources or cash crops and protected the landowners (e.g., Congo). Another component to this theory is that the institutions in place continued after the colony won its independence. The settled colonies became more democratic while the extractive ones remained in the power of a few and in some case became more extractive.¹⁰

It is argued that that the establishment of institutions is more important than the geographic factors. To illustrate this, Acemoglu et al, looked at the history of colonization starting the 1500s. If colonies were economically sound prior to the

⁷ Rodrik et al, (2004), 132-133.

⁸ William Easterly and Ross Levine, "Tropics, Germs, and Crops: How Endowments Influence Economic Development," *Journal of Monetary Economics* 50, no. 1 (2003): 3-39, <http://www.sciencedirect.com.ezp1.harvard.edu/science/journal/03043932> (accessed 11/01/2006), 5-7.

⁹ D. Acemoglu, S. Johnson, and J.A. Robinson, "The Colonial Origins of Comparative Development: an Empirical Investigation," *American Economic Review* 91 (2001), 1369-1401.

¹⁰ Easterly and Levine, 2002—referring to research of Acemoglu et al. (2001).

European's arrival they should continue to be so. On the other hand if the institutions were key to the development, then those places where good policies were put in place would get richer compared to those colonies that maintained extractive policies. Colonies in North America and Australia created societies that duplicated and/or improved European institutions protecting private property and putting controls on authority, even fighting to achieve them. In contrast, the institutions of extractive colonies in Africa, the Caribbean and Latin America put all the power into the hands of the few elite and provided little protection or rights to the majority.¹¹

The historical evidence shows a “reversal of fortune”. The richest civilizations in 1500—the Mughals in India and the Aztecs and Incas in the Americas are among the poorest today. While less-developed locations—North America, New Zealand and Australia are now much richer.¹²

Why does extreme poverty occur in developing countries?

Prior to the 19th century there was very little sustained economic growth, gradual increases in population, and little rise in living standard. Aside from kings and large landowners, the majority of people were poor and living and working on a farm.

The gap between the haves and the have-nots began at the time of the Industrial Revolution and has continued to widen ever since. The Industrial Revolution vastly improved the agricultural productivity in northwest Europe through the use of the steam engine and coal. As food production increased, prices fell, and the need to find non-farm work increased. This search for other work led to urbanization. Economists equate

¹¹ D. Acemoglu, S. Johnson, and J.A. Robinson, “Understanding Prosperity and Poverty: Geography, Institutions, and the Reversal of Fortune,” in *Understanding Poverty*, (Oxford ; New York: Oxford University Press, 2006), 19-20. Acemoglu notes that Europeans did not introduce extractive institution in many of these colonies; some were already hierarchical and non-democratic.

¹² Acemoglu et al., (2006), 24.

economic growth with urbanization. The world's average per capita income increased by approximately nine times between 1820 and 2000. However, this increase in income did not occur at the same rate throughout the world.

Other factors that contributed to this economic growth in England include a relatively open society, free speech, the Scientific Revolution, global based trade, good soil, and low risk of invasion. This rapid expansion and growth was not unique to England but continued to spread throughout Europe. Industrialization also led to the expansion of European empires throughout Asia, Africa, and the Americas. Britain's colonies (North America, Australia, and New Zealand) had land conducive to farming and economic enterprises that were similar to England. It was therefore quite easy to fold these colonies into a British empire.

In contrast, the next wave of growth from Europe to Latin America, Africa and Asia was far more turbulent, involving conflict with the non-industrialized parts of the world. The Europeans colonists empowered a small group of the native population to impose rule over the rest of the nation, such as one African tribe ruling another to work in mines and on plantations.¹³ The use of military force was not uncommon to ensure order. These colonies were set up to extract resources from a country instead of creating a lasting system of government and settlement.¹⁴

European empires controlled most of the world by the beginning of the 20th century. Because of their early lead in industrialization, global trade, and communication, European-driven economic growth seemed unstoppable. World War I brought an end to this period. In addition to the sheer number of deaths, the war also led

¹³ Esterly and Levine, (2002), 8.

¹⁴ Jeffrey Sachs, *The End of Poverty : Economic Possibilities for our Time*, (New York: Penguin Press, 2005), 40-43.

to other events—the Bolshevik revolution and the rise of the second world, and huge financial debt in Europe – especially in Germany - which allowed Hitler to rise to power. This economic instability continued through the 1930s and by the end of World War II, the international economy had broken down.

After World War II, the world needed to rebuild the global economy. Representatives from 44 countries come together at a conference held in Bretton Woods, New Hampshire, during July 1944. The Bretton Woods System laid the groundwork for three institutions: The International Monetary Fund (IMF), International Bank for Reconstruction and Development (World Bank), and the International Trade Organization (ITO). Led by the UK and the US, the group was successful in establishing the IMF and the World Bank, leaving the ITO to be decided later. Bretton Woods also established the framework for the post-WWII era, including the reconstruction of Allied and Axis economies and long term growth and stability. The United Nations (UN) was established in 1945 and the IMF and World Bank joined the UN as autonomous specialized agencies.

The Bretton Woods System relied on multinational cooperation rather than the bilateral agreements that dominated prior to the WWII. The IMF promoted economic stability and promoted a stable environment for international trade with short-term loans to stabilize currency and balance of payments. Delegates to the conference decided that a fixed exchange rate would best support a stable global trading system. The US dollar was seen as the dominant international currency. The other major contribution of the Bretton Woods conference was creation of the World Bank whose primary mission was to issue long-term loans to support development. At first the focus was the post-war

recovery of European and Asian countries. The first loan of \$250 million was given to France in 1947. During the 1950s the World Bank's lending shifted from post-war reconstruction to funding the economic development in the third world.¹⁵ By 1971, the US dollar was no longer on the gold standard and exchange rates were no longer fixed but floated according to the market.

Coined in the 1950s, the term "third world" was attributed to a group of countries emerging from foreign domination that chose not to be part of the capitalist world nor the socialist second world. The third decided that they would be self-sufficient and would do it without international trade. Their history of colonialism created a lack of trust with the outside world.

In the early 1990s the third world realized that it wanted to be part of the global economy. These countries wanted to retain their sovereignty but would abandon their Leninist-Stalinist planning. The idea of economic isolation did not work. (Sachs, p. 48) However, by the end of the 20th century, most nations of the world -- including the third world -- began adopting capitalistic principles.

How are these developing countries doing today?

Most developing countries share common characteristics such as a relatively low GNI, high population growth, limited natural resources, and high external debt (as called foreign debt). While there are similarities between developing economies, there are regional differences, differences between countries within a region, and inequality with countries. For example, while both China and India are both part of Asia and have large populations, China has had faster sustained economic growth while India's increase is

¹⁵ *Encyclopedia of the Global Economy : A Guide for Students and Researchers*. Westport, Conn.: Greenwood Press, 2006, 40-43.

modest by comparison.¹⁶ Also, Brazil and South Africa both have the largest inequality within their populations.

Overall, life in developing countries has improved; the percentage of the world's population living on \$1 per day has dropped from 28 percent in 1990 to 21 percent in 2001. Other improvements include a reduction in infant mortality and life expectancy is up to 60 to 65 between 1980 and 2002. Adult literacy has also improved, but still shows a gender gap—males rose from 78% to 83% between 1990 and 2002 and females increased from 62% to 70%.¹⁷

Brazil, Russia, India and China are the four largest emerging economies, commonly referred to as BRICs, a term coined by Goldman Sachs in 2001. These economies account for two-fifths of the total GDP of all emerging economies. China and India are usually seen as the largest in purchasing parity terms but in current dollars Brazil and Russia both produce more than India.¹⁸

Some studies suggest that economic growth in developing nations will only be attained through investments in human development. There is more evidence that shows improvements in health and education increase per capita incomes. However, to make great improvements in human development, governments will need to increase spending for social services and infrastructure to support sustained growth.¹⁹

In 2000, the Millennium Development Goals were created to address the complexity of extreme poverty and set time-based goals to end it. This set of 8 long-range goals aim for a 50% reduction in extreme poverty and hunger between 1990 and 2015 as

¹⁶ See <http://www.worldbank.org> for countries comparisons and statistics.

¹⁷ World Bank website: <http://www.worldbank.org>

¹⁸ "Emerging at Last." *Economist* 380, no. 8495 (9/16/2006, 2006): special section 8-12.

¹⁹ United Nations World Economic and Social Survey 2006: <http://www.un.org/esa/policy/wess/>.

well as improvement in the environment, education, gender equality, child mortality and disease control. So far progress has been made but there is much more to be done.²⁰

²⁰ For more information on the United Nation Development Goals see:
http://www.undp.org/mdg/basics_ontrack.shtml.

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