Chapter 1

Introduction

I invite you to study what is surely the most important and perhaps the most complex of all economic issues: the economic transformation of those countries known as the developing world. A definition of "developing countries" is problematic and, after a point, irrelevant.[1] The *World Development Report* (World Bank [1996]) employs a threshold of $9,000 per capita to distinguish between what it calls high-income countries and low- and middle-income countries: according to this classification, well over 4.5 billion of the 5.6 billion people in the world today live in the developing world of "low- and middle-income countries." They earn, on average, around $1,000 per capita, a figure that is worth contrasting with the yearly earnings of the average North American or Japanese resident, which are well above $25,000. Despite the many caveats and qualifications that we later add to these numbers, the ubiquitous fact of these astonishing disparities remains.

There is economic inequality throughout the world, but much of that is, we hope, changing. This book puts together a way of thinking about both the disparities and the changes.

There are two strands of thought that run through this text. First, I move away from (although do not entirely abandon) a long-held view that the problems of all developing countries can be understood best with reference to the international environment of which they are a part.[2] According to this view, the problems of underdevelopment must first and foremost be seen in a global context. There is much that is valid in this viewpoint, but I wish to emphasize equally fundamental issues that are *internal* to the structure of developing countries. Although a sizeable section of this book addresses international aspects of development, the teacher or reader who wishes to

[1] The *Third World*, a group of low-income countries united by common economic characteristics and often a common history of colonialism, is just as much a political as an economic concept. Narrower economic classifications are employed by several international organizations such as the World Bank. A composite index that goes beyond per capita income is described in *Human Development Report* (United Nations Development Programme [1995]). There is substantial agreement across all these classifications.

[2] This view includes not only the notion that developing countries are somehow hindered by their exposure to the developed world, epitomized in the teachings of *dependencia* theorists, but also more mainstream concerns regarding the central role of international organizations and foreign assistance.

concentrate *exclusively* on these aspects will not find a comprehensive treatment here.

The second strand is methodological: as far as possible, I take a unified approach to the problems of development and emphasize a recent and growing literature that takes a level-headed approach to market failure and the potential for government intervention. It is not that markets are intrinsically bad or intrinsically good: the point is to understand the conditions under which they fail or function at an inefficient level and to determine if appropriate policies grounded in an understanding of these conditions can fix such inefficiencies. These conditions, I argue, can be understood best by a serious appreciation of subjects that are at the forefront of economic theory but need to permeate more thoroughly into introductory textbooks; theories of incomplete information, of incentives, and of strategic behavior. Few people would disagree that these considerations lie at the heart of many observed phenomena. However, my goal is to promote a student's understanding of such issues as a commonplace model, not as a set of exceptions to the usual textbook paradigm of perfect competition and full information.

Because I take these two strands to heart, my book differs from other textbooks on development in a number of respects. Most of these differences stem from my approach to exposition and choice of subject matter. Although I do not neglect the historical development of a line of research or inquiry, I bring to bear a completely modern analytical perspective on the subject. Here are some instances of what I mean.

(1) The story of economic underdevelopment is, in many ways, a story of how informal, imaginative institutions replace the formal constructs we are accustomed to in industrialized economies. The landlord lends to his tenant farmer, accepting labor as collateral, but a formal credit market is missing. Villagers insure each other against idiosyncratic shocks using their greater information and their ability to impose social sanctions, but a formal insurance market is missing. Institutions as diverse as tied labor, credit cooperatives, and extended families can be seen as responses to market failure of some sort, precipitated in most cases by missing information or by the inability of the legal system to swiftly and efficiently enforce contracts. This common thread in our understanding is emphasized and reemphasized throughout the book.

(2) The absence or underfunctioning of markets gives rise to two other features. One is the creation of widespread externalities. Proper classification of these externalities provides much insight into a variety of economic phenomena, which appear unconnected at first, but which (in this sense) are just the common expression of a small variety of external effects. So it is that simple concepts from game theory, such as the Prisoners' Dilemma or the coordination game, yield insights into a diverse class of development-related problems. Again, the common features of the various problems yield

a mental classification system—a way of seeing that different phenomena stem from a unified source.

(3) A fundamental implication of missing markets is that *inequality* in the distribution of income or wealth plays a central role in many development problems. It isn't that inequality has not received attention in treatises on development; it certainly has. However, what has recently begun to receive systematic analytical treatment is the *functional* role of inequality: the possibility that inequality, quite apart from being of interest in its own right, has implications for *other* yardsticks of economic performance such as the level of per capita income and its rate of growth. The emphasis on the functional role of inequality runs through the book.

(4) It is necessary to try to integrate, in an intuitive and not very abstract way, recent theoretical and empirical literature with the more standard material. This isn't done to be fashionable. I do this because I believe that much of this new work has new things to teach us. Some important models of economic growth, of income distribution and development, of coordination failures, or of incomplete information are theories that have been developed over the last decade. Work on these models continues apace. Although some of the techniques are inaccessible to a student with little formal training, I do believe that all the ideas in this literature that are worth teaching (and there are many) can be taught in an elementary way. In this sense this book coincides with existing texts on the subject: the use of mathematics is kept to a minimum (there is no calculus except in an occasional footnote).

Partly because other development texts have been around for a good while, and perhaps in part because of a different approach, this text departs significantly from existing development texts in the points cited in the preceding text and indeed in its overall methodological approach.

Combining the complementary notions of incomplete information, a weak legal structure (so far as implementation goes), and the resulting strategic and economic considerations that emerge, we begin to have some idea of what it is that makes developing countries somehow "different." Economic theorists never tire of needling their friends with questions in this regard. Why is the study of developing countries a separate subject? Why can't we just break it up into separate special cases of labor economics, international trade, money, and finance, and so on? Certainly, they have a point, but that's only one way to cut the cake. Another way to do so is to recognize that developing countries, in their different spheres of activity, display again and again these common failures of information and legal structures, and therefore generate common incentive and strategic issues that might benefit from separate, concentrated scrutiny.

This approach also serves, I feel, as an answer to a different kind of objection: that developing countries are all unique and very different, and generalizations of any kind are misleading or, at best, dangerous. Although this sort of viewpoint can be applied recursively as well *within* countries, regions, districts and villages until it becomes absurd, there is some truth to it. At the same time, while differences may be of great interest to the specialized researcher, emphasizing what's common may be the best way to get the material across to a student. Therefore I choose to highlight what's common, while trying not to lose sight of idiosyncrasies, of which there are many.

A final bias is that, in some basic sense, the book is on the *theory* of economic development. However, there is no theory without data, and the book is full of empirical studies. At the same time, I am uninterested in filling up page after page with tables of numbers unless these tables speak to the student in some informative way. So it is with case studies, of which there will be a number in the text.[3] I try to choose empirical illustrations and case studies throughout to illustrate a viewpoint on the development process, and not necessarily for their own sake.

I started off writing a textbook for undergraduates, for the course that I have loved the most in my fourteen years of teaching. I see that what emerged is a textbook, no doubt, but in the process something of myself seems to have entered into it. I see now that the true originality of this book is not so much the construction of new theory or a contribution to our empirical knowledge, but a way of thinking about development and a way of communicating those thoughts to those who are young, intelligent, caring, and impressionable. If a more hard-bitten scholar learns something as a by-product, that would be very welcome indeed.

My commitment as the author is the following: armed with some minimal background in economic theory and statistics, and a healthy dose of curiosity, sympathy, and interest, if you study this book carefully, you will come away with a provocative and interesting introduction to development economics as it is practiced today. Put another way, although this book offers (as all honest books in the social sciences do) few unambiguous answers, it will teach you how to ask the right questions.

[3] Case studies, which are referred to as boxes, will be set off from the text by horizontal rules.