Robert E. Lucas, Jr. 1990. Why doesn't capital flow from rich to poor countries? American Economic Review 80(2), American Economic Association Papers and Proceedings, pp. 91-5 (May).

Mainstream economic theory states that given similar production functions and differences in factor endowments between two countries, in the country with surplus labour the marginal productivity of capital is higher than in the country with surplus capital. Given that surplus labour countries are usually poorer than capital surplus countries, capital would flow from rich to poor countries. These theory rules everything else out, and differences in capital intensity become the only explanation for differences about workers productivity.

Evidence however shows that capital does not flow from rich to poor countries to the extent predicted by mainstream economic theory. Surely, rich countries are the dominant exporters of capital, and the share of poor countries in total inflow of foreign capital has increased. However, rich countries are also the major recipients of inflows of foreign capital and the distribution of foreign capital amongst developing countries is extremely skewed towards the more advanced, richer developing countries. While the theory seems to be able to predict whom the exporter of capital is, it fails to predict correctly the direction of the flow of capital. Why is it so?

There are five possible explanations, which may actually operate together:

- *differences in human capital* may substantially reduce the difference in marginal productivity of capital, because labour ability and skills are higher in the richer country. In other words, increases in capital formation are insufficient to increase labour productivity because more capital embodies new technologies that have to be mastered. Thus, even if two economies face the same technology and production function, the differences in human capital may result in a very significant difference in labour productivity;
- *external benefits of human capital* may reduce even more (if not completely offset) the differences in the marginal productivity of capital, as more skilled and experienced workers improve the quality of the other workers, and less skilled and experienced workers reduce the productivity of the other workers;
- *political risk* associated with default, as there is some risk that the poor country, recipient of capital, may not repay the returns on capital;
- *colonial powers, or a monopolist investor,* having monopsony power over the labour market of the recipient country, and facing a huge, unskilled labour force, may choose to retard capital transfers for two reasons: the labour force is not capable to absorb new, sophisticated capital; and the "monopolist" maximises his returns by controlling wages and the supply of labour;
- *anti-foreign capital bias* in many developing countries also helps to explain why capital may not flow to developing countries. This bias may increase the political risk associated with loans.

Policy implications: (i) development of human capital is essential in developing countries; and (ii) as is the liberalisation of the foreign investment regimes, in order to attract more foreign capital.