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Creating an Environment for Growth and Prosperity

Full Length Text — Part: 3 Chapter: 15
Macro Only Text — Part: 3 Chapter: 15

To Accompany “Economics: Private and Public Choice 12th ed.”
James Gwartney, Richard Stroup, Russell Sobel, & David Macpherson
Slides authored and animated by:
James Gwartney, David Macpherson, & Charles Skipton


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The Importance of Economic Growth

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The Importance of Economic Growth

- Economic growth is important because it is a necessary ingredient for higher incomes and higher living standards.
- GDP is a measure of output and income. Growth of output is necessary for the growth of income.
- **Per capita GDP** is the nation's GDP divided by its population. Growth of per capita GDP means more goods and services per person.
- In most cases, higher levels of per capita GDP will mean that the typical person has a better diet, improved health and access to medical services, a longer life expectancy, and greater educational opportunity.
- Growth leads to more than just material goods. It also generally leads a cleaner environment and more time for leisure and recreation.

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The Importance of Economic Growth

- Economic growth makes larger outputs possible.
- This can be illustrated by an outward shift in the production possibilities curve.
- Growth means that a larger quantity of goods and services can be produced.

Consumption goods
B
A
A B
Capital goods
PPC₂₀₁₀
PPC₂₀₀₀

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The Rule of 70

- Economic growth and *The Rule of 70*:
 - Dividing 70 by a country's average growth rate gives the number of years required for an economy's income level to double.
 - Example*:
If the U.S. had a growth rate of 2.5%, how many years would it take for the income level of the U.S. to double?

$$\frac{70}{2.5} = 28 \text{ years}$$

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The Importance of Economic Growth

Annual Growth Rate	Per Capita Income Level after 30 years
4%	\$32,434
2%	\$18,114
1%	\$13,478
0%	\$10,000

- Impact of growth rate differences over 30 years:
 - Here we illustrate how countries with an initial per capita income of \$10,000 differ after 30 years for growth rates of 0%, 1%, 2%, and 4%.
 - Note how a country growing at a 4% annual rate will have a substantially higher income level than the others 30 years later.

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Key Sources of Economic Growth and Income Levels

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Sources of Economic Growth

- Sources of Economic Growth:
 - Gains from trade
 - Entrepreneurial discovery
 - Investment in physical and human capital.

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Sources of Economic Growth

- **Gains from trade:**
 - Trade makes larger outputs possible because of division of labor, specialization in areas of comparative advantage, and application of mass production techniques.
 - The gains from trade will be greater when transactions costs are lower and people are permitted to trade over a larger market area.

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Sources of Economic Growth

- **Entrepreneurial discovery:**
 - Discovery of improved products and lower cost production methods is a driving force of economic growth.
 - Technological improvement is scientific discovery while innovation is its practical application and dissemination. Each of these play a role in the development of improved products and better ways of doing things.
 - Schumpeter referred to this dynamic process as "creative destruction."
 - It is vitally important that entrepreneurs have a chance to try out new ideas, but it is also important that resources are not wasted on inefficient projects. In a market economy, profits and losses perform these functions.

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Sources of Economic Growth

- **Investment in physical and human capital:**
 - More and better machines and tools can enhance the productivity of people.
 - Education and training that improves the skill level of workers will also increase output.
 - Other things constant, countries that invest more will tend to grow more rapidly. But, investment is costly; it involves the sacrifice of current consumption.
 - High investment rates do not guarantee rapid growth. The investment must be channeled into wealth-creating projects.

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Questions for Thought:

1. If a country has sustained growth of per capita income of 5% annually, how many years will it take for income to double?
2. List five new products that have replaced older products and largely rendered them obsolete.
3. What is "creative destruction"? Explain in your own words how it influences our living standards and the quality of our lives.
4. In a market economy, what must an entrepreneur do in order to be successful? How do the actions of successful entrepreneurs influence economic growth?

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Questions for Thought:

5. What are the three major sources of economic growth? Can you think of another major source of growth that has significantly increased our living standards? If so, what is it?

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How do Institutions and Policies Influence Economic Growth?

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The Growth Process

- **Modern growth analysis** stresses that institutions and policies influence the realization of gains from trade, discovery and dissemination of improved products and production methods, and the level and productivity of investment.
- Modern analysis builds on the work of Nobel Laureate Douglass North and Peter Bauer. Other leading contributors are Daron Acemoglu (MIT), Robert Barro (Harvard), and Barry Weingast (Stanford).

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The Growth Process

- Economic growth is a complex process that generally involves a combination of several interrelated factors.
- Counterproductive policies in one or two key areas can substantially harm the overall performance of an economy.

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Which Institutions and Policies Will Promote Growth?

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Key Elements of a Sound Institutional Environment

- The following institutional elements are keys to the growth process:
 - a legal system that protects property rights and enforces contracts even-handedly,
 - competitive markets,
 - access to money of stable value,
 - minimal regulation,
 - avoidance of high marginal tax rates, and,
 - trade openness.

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Modern Growth Analysis

- Modern growth analysis stresses the importance of institutions and policies.
- Consider how the six factors mentioned in the previous slide will influence the gains from trade, discovery of better ways of doing things, and investment.

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Key Element for Growth: -- *Legal System*

- A legal system that protects property rights and enforces contracts even-handedly is necessary for the smooth operation of markets.
- Private ownership provides people with a strong incentive to develop and use resources wisely, innovate and discover better ways of doing things, and to invest and conserve for the future.
- In contrast, insecure property rights weaken the incentive to invest and to engage in entrepreneurial activity.

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Key Element for Growth: -- *Legal System*

- If contracts are not enforced or if they are enforced in a biased manner, transaction costs will be higher, trade will be riskier, and the volume of trade will fall.
- The security of property rights is often undermined by political instability, civil unrest, and war. In recent years, political instability has contributed to the dismal economic performance of several nations, including the Democratic Republic of Congo, Zimbabwe, Haiti, Nicaragua, Russia, and Iraq.

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Key Element for Growth: -- *Competitive Markets*

- When markets are competitive, self-interested individuals have a strong incentive to develop resources and provide goods that are highly valued by others.
- In a competitive setting, producers must provide goods at a low cost and serve the interests of consumers because if they don't, other suppliers will.
- The freedom to compete will encourage entrepreneurial activity and provide producers with a strong incentive to produce quality products at a low cost.

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Key Element for Growth: -- *Monetary and Price Stability*

- When the inflation rate is low and highly predictable, the risks of exchange across time periods is reduced.
- In contrast, high and variable rates of inflation generate uncertainty and thereby increase the costs of time-dimension exchanges and reduce investment. Thus, the gains from trade, entrepreneurial discovery, and investment are diminished.


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Key Element for Growth: -- *Minimal Regulation*

- Regulation is a blunt instrument and it often generates harmful secondary effects.
- Regulations that restrict entry and interfere with voluntary exchange will reduce the competitiveness of markets and the volume of trade.
- Regulations that favor some at the expense of others will encourage rent-seeking and political corruption.

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Key Element for Growth:

-- *Avoid High Marginal Tax Rates*

- High marginal tax rates reduce the incentive of people to earn, invest, and engage in other productive activities.
- High taxes also reduce efficiency by driving productive activity into the underground economy, encouraging tax avoidance, and even inducing highly productive persons to move to other countries.

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Key Element for Growth:

-- *Trade Openness*

- Like domestic trade, international trade is mutually advantageous.
- With trade, countries can specialize in the production of goods they can produce economically and trade for those that would be costly to produce domestically. As a result, joint output can be expanded and both trading partners can consume a larger, more diverse bundle of goods.
- Tariffs, quotas, and other trade restrictions reduce the gains from specialization and international trade and thereby reduce income below its potential.

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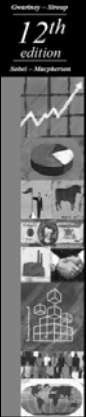
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Key Elements for Growth:

-- *A Summary*

- What can governments do to promote prosperity?
 - Governments promote economic progress when they protect individuals and their property, enforce contracts impartially, provide access to money of stable value, avoid high taxes and excessive regulation, and foster competitive markets and free international trade.


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Other Factors That Might Influence Growth and Income

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Other Views on Growth

- Through the years, economists have developed several theories about why some countries grow and others stagnate. Some are valid, while history has shown others to either be fallacious or incomplete.
- This section will consider some of these alternative views.

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Population and Growth

- In 1798, economist **Thomas Malthus** argued that if income rose above subsistence level, this would trigger a population boom that would drive income back down to subsistence level.
- Malthus argued that population would grow exponentially (*e.g. 1, 2, 4, 8, 16, etc.*) while the resources required to expand production would grow only linearly (*1, 2, 3, 4, etc.*). Therefore, any increase of income above subsistence would soon be eliminated by rapid population growth.
- Malthus was wrong because he did not understand the importance of technological improvements, innovation, and entrepreneurial discovery.

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Natural Resources and Growth

- There is a tendency to think that income differences across countries are largely the result of natural resources.
- While resources may give a country an advantage, the linkage between resources and income is weak.
 - Many high income countries have few natural resources: Japan, Singapore, and Hong Kong.
 - Many resource rich countries are poor: Nigeria, Venezuela, Indonesia, and Russia.
- **Resource Curse:**
View that abundant resources often lead to the adoption of counterproductive policies. This would weaken the link between the abundance of natural resources and income levels.

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Foreign Aid and Growth

- In the 1950s and 1960s, it was widely believed that aid from high-income countries would help poor countries invest in infrastructure such as roads and power generating facilities and that this would provide the start-up capital needed to trigger the growth process.
- While the theory sounded good, studies indicate that the aid was largely ineffective. It was often used to prop up corrupt authoritarian regimes and thereby retard needed institutional change.
- Further, aid in the form of surplus agricultural products often disrupted markets in less developed countries.
- Unless growth-oriented policies are adopted, foreign aid will continue to be ineffective.

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Climate, Location, and Growth

- Jeffery Sachs of Columbia University argues that tropical countries are disadvantaged because:
 - their hot, humid climates erode the energy level of workers and increase the risk of disabling and life-threatening diseases, and,
 - their location is far from the major markets of Western Europe, North America, and Japan.
- While income levels of tropical countries are generally lower than incomes in more temperate climates, their institutions and policies are also less consistent with the realization of gains from trade, entrepreneurship, and investment.
- The record of Singapore and Hong Kong shows that tropical countries with sound institutions can achieve impressive growth and income.

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Institutions, Policies, and Prosperity

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Institutions, Policies, and Prosperity

- Institutions and policies matter because they shape incentives and thereby influence whether individuals engage in productive, unproductive, or even counterproductive activities.
- When institutions and policies **provide** secure property rights, a fair and balanced judicial system, monetary stability, and effective limits on government’s ability to transfer wealth through taxation and regulation, individuals are encouraged to engage in productive activities.
- When the legal and regulatory environment **fails** to protect property rights and often favors some at the expense of others, individuals are instead encouraged to engage in rent-seeking, lobbying, bribes, and other counterproductive activities.

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Institutions, Policies, and Prosperity

- Unless countries adopt institutions and policies supportive of trade, entrepreneurial discovery, and private investment, they will be unable to sustain long-term growth and achieve high income levels.

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Questions for Thought:

1. Why will a nation's legal system influence its growth and prosperity? What would a legal system consistent with strong growth look like?
2. If the people of a nation are going to get the most from their resources, why is competition important? What must a firm do in order to compete effectively? If a firm is driven out of business because of inability to compete, will this adversely affect growth and prosperity?
3. When the inflation rate is volatile, how is the volume of trade affected? How will this influence the income levels of people?

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Questions for Thought:

3. When government is heavily involved in the regulation of markets, how will this influence the gains from trade and growth of the economy? How will it influence the degree of rent-seeking by business and labor groups and the campaign contributions available to politicians? Are politicians likely to enact regulations that encourage rent seeking?
4. Why might abundant natural resources generate secondary effects that would make sustained economic growth less likely? Does foreign aid generate similar secondary effects? Why or why not?

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Questions for Thought:

5. Writing at the end of the 18th century, Thomas Malthus argued that income per person would never rise much above the subsistence level. Why did he believe this? Why was he wrong?

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