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Gwartney - Stroup  
Sobel - Macpherson

## Institutions, Policies, and Cross-Country Differences in Income and Growth

**Full Length Text** — Part: 3 Chapter: 16  
**Macro Only Text** — Part: 3 Chapter: 16

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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## How Large are Income Differences Across Countries?

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## Measuring Cross-Country Differences in Income

- Countries use different currencies. Thus, the *purchasing power* of different currencies must be converted to a common denominator in order to compare incomes in different countries.
- This could be done with exchange rates.
  - But, exchange rates are influenced by capital movements and will fail to reflect the prices of goods not traded in international markets.
  - They may be an inaccurate indicator of the purchasing power of different currencies.
- Economists favor the *purchasing power parity (PPP)* method of income comparisons.

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### Measuring Cross-Country Differences in Income

- Economists favor the **purchasing power parity (PPP)** method of income comparisons.
  - This method uses the cost of purchasing a common bundle of goods consumed in each country and uses this cost to estimate the purchasing power of each currency.
  - The purchasing power of each currency is then used to convert the income levels of each country to a common currency, typically the U.S. dollar.

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### Cross-Country Differences in Income

- The following slide highlights the 2005 per person income for various high, middle and low-income countries.
- The incomes in the U.S., Ireland, and Norway are the highest in the world, in excess of \$34,000.
- The per-person income in high-income countries is about 50 times the figure for the countries with the lowest incomes.
- The incomes of less-developed countries will be understated because GDP figures generally omit household production.
  - Even after making some allowance for this, it is clear that the income differences between the high and low-income countries are huge.

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### Cross-Country Differences in Income

*The 2005 Per Person Income Levels for high-, Middle-, and Low-Income Countries measured in 2000 PPP U.S. dollars*

High-Income Countries	Middle-Income Countries	Low-Income Countries
United States \$37,267	South Korea \$19,598	Ukraine \$6,093
Norway 36,849	Hungary 15,913	China 6,012
Ireland 34,256	Argentina 12,704	Venezuela 5,900
Switzerland 31,701	Poland 12,319	Philippines 4,571
Hong Kong 30,989	Chile 10,700	Indonesia 3,419
Canada 29,693	South Africa 9,885	India 3,072
United Kingdom 29,571	Malaysia 9,681	Bolivia 2,508
Netherlands 29,078	Russian Federation 9,648	Bangladesh 1,827
Japan 27,817	Mexico 9,564	Nigeria 1,003
France 27,033	Thailand 7,720	Sierra Leone 717
Germany 26,210	Turkey 7,480	Niger 695
Italy 25,381	Brazil 7,475	Malawi 593

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## How Do Growth Rates Vary Across Countries?

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## Cross-Country Differences in Growth

- The following slide shows the growth of per person GDP during 1980-2005 for the countries with the best and worst growth records, along with the figures for high-income countries.
- Except for Ireland, the ten fastest growing economies were LDCs at the beginning of the period. The two most populace countries, China and India, are on the high-growth list.
- The high-growth economies grew at an annual rate of 3.9% or more (twice that of most high-income countries). This has closed the gap relative to their richer counterparts since 1980.
- While LDCs dominate the high-growth list, the countries with the worst growth records were also LDCs. The countries on the right side of the table are not only poor, they are falling further and further behind.

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## Economic Growth: 1980-2005

*The Growth of Per-Person GDP for High-Growth, High-Income Industrial, and Low-Growth Countries (1980-2005)*

High-Growth	High-Income Industrial	Low-Growth		
China	Norway	2.4%	Zambia	-1.0%
South Korea	United Kingdom	2.2%	Sierra Leone	-1.1%
Botswana	United States	2.0%	Central African Rep.	-1.3%
Taiwan	Japan	2.0%	Zimbabwe	-1.4%
Thailand	Australia	2.0%	Togo	-1.4%
Ireland	Germany	1.7%	Madagascar	-1.5%
Singapore	Canada	1.7%	Niger	-1.8%
Mauritius	France	1.7%	Cote d'Ivoire	-1.9%
India	Netherlands	1.6%	Haiti	-2.5%
Hong-Kong	Italy	1.6%	Congo, Dem. Rep.	-4.0%
	Switzerland	0.8%		

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## Economic Freedom as a Measure of Sound Institutions

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## Economic Freedom as a Measure of Institutional Quality

- Gains from trade, entrepreneurial discovery, and investment are largely dependent on institutions and policies supportive of voluntary exchange, market allocation, freedom to compete, and protection of people and their property from aggressors.
- These ingredients comprise the foundation of economic freedom.

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## Measuring Economic Freedom

- The *Economic Freedom of the World* (EFW) index is designed to measure the consistency of a nation's institutions and policies with economic freedom.
  - Leading scholars, including Nobel laureates Milton Friedman, Gary Becker, and Douglass North, helped to develop the EFW index.
- The EFW index uses 42 separate components to measure the consistency of a nation's institutions and policies with *personal choice*, *voluntary exchange*, *open markets*, and *protection of private property*.

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### Measuring Economic Freedom

- In order to achieve a high economic freedom (EFW) rating, a country must
  - provide secure protection of privately owned property,
  - provide evenhanded enforcement of contracts,
  - provide a stable monetary environment,
  - keep taxes low,
  - refrain from creating barriers to both domestic and international trade, and,
  - rely more fully on markets rather than governments to allocate goods and resources.
- The EFW index reflects the institutional and policy factors that theory indicates are key sources of economic growth.

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### The Most and Least Free Economies of the World

- EFW ratings are available for 99 countries during the 1980-2005 period.
- The following slide indicates the ten highest and lowest rated economies, as well as the ratings of ten other large countries.
  - Hong Kong, Singapore, Switzerland, and the United States headed the list of the most persistently free economies.
  - The Democratic Republic of Congo, Myanmar, Guinea-Bissau, Syria, Algeria, and Zimbabwe had the least free economies.

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### EFW Ratings: 1980-2005

*The Economic Freedom Rating for Top-, Middle-, and High-Rated Countries, EFW Index, Average 1980-2005*

Top-Rated Countries	Middle-Rated Countries	Low-Rated Countries
Hong Kong 8.9%	Germany 7.5%	Sierra Leone 4.6%
Singapore 8.5%	Japan 7.2%	Nicaragua 4.5%
Switzerland 8.2%	Chile 6.9%	Uganda 4.5%
United States 8.2%	France 6.7%	Nigeria 4.4%
Canada 7.9%	South Korea 6.3%	Zimbabwe 4.3%
Luxembourg 7.7%	Indonesia 6.1%	Algeria 4.2%
New Zealand 7.7%	Mexico 6.0%	Syria 4.2%
United Kingdom 7.7%	Argentina 5.4%	Guinea-Bissau 4.2%
Netherlands 7.7%	China 5.2%	Myanmar 4.0%
Australia 7.6%	Brazil 4.8%	Congo, Dem. Rep. 3.5%

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**Questions for Thought:**

1. Why do economists believe the purchasing power parity (PPP) method is a more accurate way to compare cross-country incomes than comparisons based on exchange rates?
2. How large are the income differences across countries? Why are the per capita GDP figures likely to overstate the size of the income difference between high and low-income countries?
3. How do growth rates vary across countries? Are the rich countries getting richer while the poor are getting poorer?

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**Questions for Thought:**

4. What is the Economic Freedom of the World (EFW) index designed to measure? What determines whether the rating of a country will be high or low on this index?
5. "Economic freedom is present if a country is a political democracy." – Is this statement true?

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**Institutions, Policies,  
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### Economic Freedom and Performance

- If institutions and policies are important, then countries that are economically free should outperform those that are less free.
- When considering the impact of institutions, it is important to focus on income and long-term growth rather than short-term growth, which may reflect mostly the ups and downs of business cycle conditions.

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### Economic Freedom and Income

**2005 GDP Per Capita, PPP**  
(in constant 2000 dollars)

Quartile	GDP Per Capita, PPP
Least-Free Quartile	\$3,305
Third Quartile	\$6,103
Second Quartile	\$10,773
Most-Free Quartile	\$26,013

- The per person income for countries ordered by economic freedom rating is shown here by quartiles.
- Note the strong positive linkage. Income per person in the freest quartile of countries was about eight times the figure for the least free.

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### Economic Freedom and Growth

**Growth of GDP Per Capita 1980-2005**  
(Annual %)

Quartile	Annual Growth (%)
Least-Free Quartile	0.4%
Third Quartile	2.0%
Second Quartile	1.8%
Most-Free Quartile	2.3%

- The relationship between the economic freedom of a country and its growth rate during the 1980-2005 period is shown here.
- Countries in the most free quartile grew at an annual rate of 2.3% compared to the 0.4% growth for the least-free quartile.

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### Economic Freedom and Investment

**Economic Freedom and Investment as a Share of GDP**  
(Groups are Average EFW Ratings for 1980-2000)

Group (Average EFW Rating)	Total Investment as % of GDP (1980-2000)	Private Investment as % of GDP (1980-2000)
< 5.0	19.7%	9.6%
5.0 - 7.0	22.1%	14.1%
> 7.0	23.1%	18.0%

- Here countries are divided into 3 groups, based upon their average EFW rating during 1980-2000.
- Investment is positively linked to economic freedom. This is particularly true for private investment.
  - Private investment was 18% of GDP in the freest group, while only 9.6% of GDP for the least free group.

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### Economic Freedom and the Productivity of Investment

**Change in Growth Rate per Percentage Point Change in Investment, 1980 - 2000**

Investment Type	Change in Growth Rate per Percentage Point Change in Investment (1980-2000)
Private Investment, EFW < 5	0.19%
Private Investment, EFW 5-7	0.27%
Private Investment, EFW > 7	0.33%
Government Investment	0.17%

- The estimated impact of a 1 percentage point increase in investment/GDP ratio on the annual growth rate during 1980-2000 is shown.
- In the most free group a 1 percentage point increase in private investment enhanced long-term growth by 0.33%, compared to 0.19% for the least free group.
- The estimated impact of government investment was even lower, 0.17%.

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### Economic Freedom – A Summary

- Countries with institutions and policies more consistent with economic freedom (as measured by the *EFW index*) have ...
  - achieved higher incomes per person,
  - grown more rapidly,
  - higher investment rates, and,
  - higher productivity of investment.

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## Is Institutional Change Possible?

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## The Influence of History

- Research indicates that history matters.
- Countries with colonial settlers who planned on staying tended to develop institutions and policies that protected individual property rights and limited the power of government.
  - The United States, Canada, Australia, and New Zealand provide examples.

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## The Influence of History

- In contrast, colonizers settling in harsh climates or with short-term interests in the extraction of mineral resources were more likely to choose institutions that provided few limitations on the power of government and failed to provide for protection of ownership rights and unbiased enforcement of the law.
  - Even after independence, protective institutions have been largely absent in Africa and Latin America, where the European colonizers were primarily interested in resource extraction.

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### Three Factors That Now Make Institutional Change More Possible

- While no country can entirely escape its past, at least three factors have increased the likelihood of institutional change.
  - The colonial era is over: Countries that were previously colonized by European powers are now in a position to make their own institutional and policy choices.
  - The collapse of communism has also expanded the opportunity for institutional change.
  - Substantial reductions in transportation and communication costs have increased the potential gains from the adoption of sound institutions and policies.

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### Recent Institutional Change and Economic Performance

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### Major Reformers During the 1960s

- In the 1960s, Hong Kong and Singapore both began to liberalize their economies and by the 1970s they were among the world's freest economies.
  - In 1960, Hong Kong & Singapore were poor; their income per capita was less than countries like Brazil, Argentina, and Venezuela.
- Impressive growth has led to dramatic change.
  - The per capita incomes of Hong Kong and Singapore are now much greater than Latin American countries and greater than many high-income economies of Western Europe.

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### Major Reformers During the 1970s

- In the 1970s, China and Chile each began instituting key reforms. At the time, both were among the least free economies in the world. The reform process has increased their EFW ratings substantially.
- The growth of both has been impressive.
  - China has been the world's fastest growing economy during the 1980-2005 period.
  - Chile's 3.4% annual growth rate during the same period places it just outside of the top ten. Chile now has the highest per capita income in Latin America.

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### The Reformers of the 1980s

*Countries Beginning Reform During the 1980s*

	Beginning Year of Change	2005 EFW Rating	Growth 1990-2005	Growth 1995-2005	Per Capita GDP, 2005
Bangladesh	1987	6.0	2.9%	3.3%	\$1,827
Botswana	1985	7.2	4.6%	6.1%	\$11,021
Ghana	1985	6.2	2.1%	2.4%	\$2,206
Iceland	1988	7.8	1.9%	3.3%	\$32,482
Ireland	1987	7.9	5.3%	6.0%	\$34,256
Mauritius	1985	7.5	3.8%	3.7%	\$11,312
New Zealand	1985	8.5	1.9%	1.9%	\$22,238
United Kingdom	1980	8.1	2.1%	2.4%	\$29,571
<i>Average</i>		7.4	3.1%	3.6%	\$18,114

- Data for the 8 major reformers of the 1980s is shown.
- Since 1990, per capita income for the 1980s reformers has grown at an average annual rate of 3.1%.
- The growth rates of Ireland, Botswana, and Mauritius have been particularly impressive.

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### Major Reformers of the Early 1990s

- The following slide presents data for the diverse countries adopting major reforms in the early 1990s.
- The average growth rate of these 12 countries was 3.0% during 1995-2005.
  - The growth of Estonia, Hungary, India, and Poland have been particularly impressive.
  - It will be interesting to see if these countries will be able to sustain the economic reforms and follow their growth record in the years immediately ahead.

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### Importance of the Legal System

- A sound legal system is crucially important for the realization of gains from exchange, entrepreneurial discovery, and investment.
- Almost everything people in the developed world consume is the result of gains from depersonalized exchange and extension in the size of the market. Without these gains, high levels of per capita income and modern living standards would be impossible.
- But, these gains cannot be realized without a legal system that can be counted on to protect property rights and enforce contracts fairly.
- Failure of a country's legal system to perform these functions places a constraint on prosperity.

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### The Legal System and Prosperity

- The **legal system area** (of the EFW) indicates the degree to which a nation's legal structure is consistent with the protection of property rights, unbiased contract enforcement, independence of the judiciary, and rule of law principles.
- The 24 countries with a legal system rating of more than 7.0 from 1980 to 2000 had an average per capita GDP in 2005 of \$29,404.
- In contrast, the 21 countries with a legal system rating of less than 4.0 from 1980 to 2000 had an average 2005 per capita GDP of \$3,254, about one-ninth the average for the countries with quality legal systems.

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### The Legal System and Prosperity

- Further, the 24 high-quality legal system economies had an average annual real growth rate of 2.3% during the 1980-2005 period.
- In contrast, the average growth of per capita GDP for the group with poor quality legal systems was only 0.6%.
- All of this suggests that it will be virtually impossible for countries with legal systems that fail to protect property rights and enforce contracts to move up to even lower-middle income status.

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## Rich and Poor Nations Revisited

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## Rich and Poor Nations Revisited

- Of the list of countries that either grew most rapidly or regressed & experienced falling incomes during the last 2 decades, countries with low 1980 per capita income dominate the list.
- When low-income economies have sound institutions, they can grow rapidly because:
  - they can successfully copy or emulate technologies and business practices that have been successful in high-income countries.
  - the rate of return on investment in these low-income countries will generally be higher than in capital rich, more advanced economies.

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## Rich and Poor Nations Revisited

- In order for a low-income country to benefit from the borrowing of technologies and investment capital influx, it **must** have sound institutions.
- Many low-income economies continue to perform poorly and even regress because their institutions and policies stifle gains from trade, entrepreneurship, and investment.

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## Economic Rules and Political Decision Making

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## Politics and Sound Institutions

- Economics provides direction with regard to institutions and policies that will lead to wealth creation, growth, and prosperity.
- But, these institutions are an outgrowth of the political process and there is no assurance that political decision-making will lead to sound economic institutions.

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## Politics and Sound Institutions

- Democratic political decision-making will often lead to rules that encourage unproductive and counterproductive actions because of:
  - **shortsightedness:** bias toward adoption of unproductive programs providing immediate, highly visible benefits at the expense of difficult-to-identify future costs
  - **special-interest politics:** political incentives that lead politicians to "trade" favors to interest groups for political contributions to help them win the next election
  - **rent-seeking and favoritism:** activities that provide favors to some at the expense of others, that encourage people to divert resources away from productive activities and toward lobbying, campaign contributions, and other forms of political favor seeking

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### Politics and Economics

- Achievement and maintenance of political power often conflict with sound economics.
- In recent decades, a wide variety of political processes have generated moves toward economic institutions more consistent with prosperity.
- Economists do not fully understand the linkage between political decision-making and the adoption of economic reforms consistent with growth and prosperity.
  - This is a subject of current research that will enrich the future study of economics.

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### Questions for Thought:

1. How do the income levels and growth rates of countries with institutions and policies more consistent with economic freedom compare with those that are less free? Is this surprising? Why or why not?
2. From the viewpoint of economic growth, why is the legal structure of a country important? What are some of the key attributes of a legal system that will encourage economic growth.
3. The fastest growing economies during the past quarter of a century were generally poor in 1980. Is this surprising? Why or why not?

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### Questions for Thought:

4. (a) When property rights are well defined and enforced, what determines if an exchange will take place in a market economy?  
(b) When political decisions are made democratically, what determines whether a political action will be undertaken?  
Is the difference in the structure of incentives accompanying markets and that of democratic political decision making important? Explain.

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**Questions for Thought:**

5. Do we count on majority rule to protect civil liberties such as the right to free speech, freedom of the press, the right to assembly, and religious freedom?  
Should we count on majority rule to defend economic rights like protection of one's property, freedom to trade, and the freedom to compete?  
Discuss each of these questions.

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**Questions for Thought:**

6. Compared to countries with low levels of economic freedom, countries that have a larger degree of economic freedom tend to have:

- a. higher per capita income levels, but slower rates of economic growth.
- b. lower per capita income levels, but more rapid rates of economic growth.
- c. both higher per capita income levels and more rapid growth rates.
- d. both lower income levels and slower rates of economic growth.

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*Addendum to Chapter 16:*  
**Economic Freedom  
and Quality of Life**

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### Institutions and the Quality of Life

- The graphics on the following slides illustrate the simple relationship between institutions and policies consistent with economic freedom and various quality of life indicators.
- The economic freedom data for the 99 countries available for the 1980-2005 period are divided into quartiles and then arrayed from least free to most free. The relationship between the quartiles and various quality of life indicators is illustrated.
- Many of these simple relationships will reflect the indirect impact of institutions working through income rather than a direct causal link. In other cases, the observed relation may reflect the fact that some of the variables that influence economic freedom also influence political factors like the impartiality of the legal system.

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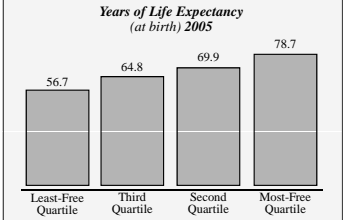
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### Economic Freedom and Life Expectancy



Quartile	Years of Life Expectancy
Least-Free Quartile	56.7
Third Quartile	64.8
Second Quartile	69.9
Most-Free Quartile	78.7

- The life expectancy at birth of people living in economies from the four quartiles is displayed above.
- People in the most economically free countries had 22 additional years of life compared to those in the least free economies of the world.

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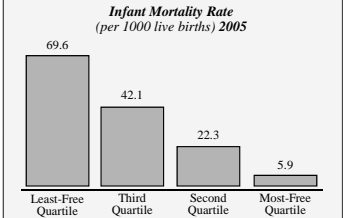
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### Economic Freedom and Infant Mortality Rate



Quartile	Infant Mortality Rate
Least-Free Quartile	69.6
Third Quartile	42.1
Second Quartile	22.3
Most-Free Quartile	5.9

- The infant mortality rate for countries declines with the degree of economic freedom observed.
- The infant mortality rate in the least economically free countries was nearly 12 times greater than that of the most free economies.

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### Economic Freedom and Tuberculosis

Quartile	Incidence
Least-Free Quartile	217.9
Third Quartile	158.4
Second Quartile	122.0
Most-Free Quartile	21.1

- The incidence of tuberculosis was much lower in the most economically free countries of the world.
- Residents of the least free economies of the world were 10 times as likely to contract tuberculosis than those in the most free countries.

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### Economic Freedom and Access to Sanitary Water

Quartile	Share
Least-Free Quartile	72.9%
Third Quartile	82.0%
Second Quartile	90.6%
Most-Free Quartile	99.2%

- Access to sanitary water increased with economic freedom.

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### Economic Freedom and Environmental Quality

Quartile	Score
Least-Free Quartile	58.9
Third Quartile	60.2
Second Quartile	70.6
Most-Free Quartile	81.0

- Studies have shown that the quality of the environment is strongly linked to income.
- And so, the relationship observed here is largely a reflection of the higher incomes achieved by the more free economies.

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### Economic Freedom Income of Lowest 10% of Earners

*Average Income of Poorest 10%, 2005*

Quartile	Average Income (\$)
Least-Free Quartile	\$905
Third Quartile	\$1,546
Second Quartile	\$2,656
Most-Free Quartile	\$7,334

- The annual income of the poorest 10% of the population increases with economic freedom.
- In the nations of the top quartile, the average income of the poorest 10% was more than eight times that of the poorest 10% from countries in the bottom quartile.

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### Economic Freedom and Political Corruption

*Corruption Perceptions Index, 2005*

Quartile	CPI Score
Least-Free Quartile	2.7
Third Quartile	3.6
Second Quartile	4.1
Most-Free Quartile	7.4

- The incidence of political corruption was lower in the more free economies of the world.
- These numbers are a reflection of the higher quality legal systems of the freer economies.

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### Economic Freedom of the World: 2005

- Intuitions and policies generally change slowly.
- Thus, we have generally focused on the quality of institutions and policies over a lengthy time frame such as 1980-2005.
- However, the recent data are also of interest.
- The following map indicates the Economic Freedom of the World (EFW) ratings for 2005.

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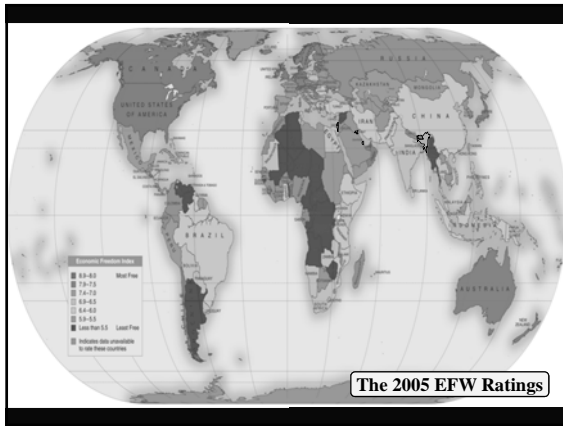
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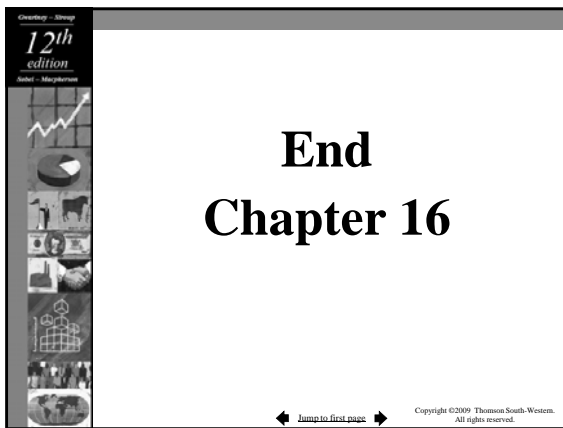
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