


Economic Growth and the Wealth of Nations

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

To Accompany “Economics: Private and Public Choice 11th ed.”
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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 both higher incomes and higher living standards.
- GDP is a measure of both output and income. Growth of output is necessary for 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.

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The Importance of Economic Growth

- Economic growth expands the sustainable output rate Y_F of an economy.
- This can be illustrated by an outward shift in the production possibilities curve ... or an increase in $LRAS$ (from $LRAS_{1995}$ to $LRAS_{2005}$).

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The Rule of 70

- 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

- Cross country differences in growth rates over a few decades substantially alter relative income.
- From 1960-2002, per capita income growth in Argentina and Venezuela was 0.5% and -0.2% respectively ... in contrast, the growth rates of Japan and Hong Kong were 4.2% and 5.3%.
- Note how the rapid growth rates of the two Asian economies dramatically altered their relative incomes compared to the other two economies.

| Country | 1960 | 2002 |
|-----------|-------|--------|
| Argentina | 4,462 | 5,585 |
| Venezuela | 6,338 | 5,683 |
| Japan | 2,954 | 16,271 |
| Hong Kong | 2,247 | 19,618 |

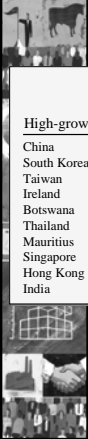
Sources: Robert Summers and Alvin Heston, *Penn World Tables, Mark 5.6* (Cambridge: National Bureau of Economic Research, 1994); and World Bank, *World Development Indicators*, CD-ROM, 2004. Copyright ©2006 Thomson Business and Economics. All rights reserved.



The Best and Worst Growth Records

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Differences in Growth Rates among Nations

The growth of per-capita GDP for high-income industrial countries, high-growth LDCs, and low-growth LDCs, (1980–2002)


| High-growth LDCs | High-income industrial | Low-growth LDCs | |
|------------------|------------------------|-----------------|-------|
| China | United Kingdom | Congo (Zaire) | -4.9% |
| South Korea | Japan | Sierra Leone | -3.3% |
| Taiwan | Australia | Haiti | -2.8% |
| Ireland | United States | Madagascar | -2.1% |
| Botswana | Netherlands | Niger | -2.0% |
| Thailand | Italy | Côte d'Ivoire | -1.8% |
| Mauritius | France | Togo | -1.7% |
| Singapore | Germany | Nicaragua | -1.4% |
| Hong Kong | Canada | Venezuela | -1.3% |
| India | Switzerland | Nigeria | -1.1% |

Sources: Derived from World Bank, *World Development Indicators, CD-ROM, 2002*; and Republic of China, *Statistical Yearbook of the Republic of China, 2004*. Only countries with a population of 2 million or more in 2002 are included in this table.

- The growth performance of less-developed countries (LDCs) is characterized by diversity.
- While the fastest growing countries in the world are LDCs, other LDCs have negative real growth.

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Questions for Thought:

1. Which of the following is true?
 - a. The fastest-growing economies in the world are mostly less developed countries.
 - b. The slowest growing countries in the world, many of which are experiencing declines in per capita GDP, are less developed countries.
2. “Other things constant, low income countries should be able to grow rapidly because they can either emulate or import at a low cost proven technologies from countries with higher incomes.”
 - Is this statement *true*?

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What Determines Whether a Country Will Grow or Stagnate?

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The Growth Process

- Economic growth is a complex process that generally involves several interrelated factors.
- Economists stress the importance of three major sources of economic progress:
 - investment in physical and human capital,
 - technological advances, and,
 - institutional and policy changes that improve the efficiency of economic organization.

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Points to Keep in Mind

- While investment is a key source of growth, the level of investment will be influenced by the quality of the institutional environment.
- While natural resources can be helpful, many countries with abundant natural resources nonetheless remain poor.
- While technology is an important source of growth, access to modern technology does not guarantee growth.
 - More advanced technology is of little value when the institutional and policy environment undermines the potential attractiveness of entrepreneurial & innovative business activity.

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Points to Keep in Mind

- If technology alone was the driving force underlying economic growth, most low-income countries would be growing rapidly because they could simply copy (*or purchase at low cost*) the more advanced technology of the high-income economies.
 - But this is not what we observe.
- Counterproductive policies in just a few key areas can substantially harm the overall performance of an economy.

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Key Elements of a Sound Institutional Environment

- The following institutional elements are **keys to the growth process**:
 - secure property rights and political stability,
 - competitive markets,
 - stable money and prices,
 - free trade,
 - open capital markets, and,
 - avoidance of high marginal tax rates.

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The Role of Government and Economic Progress

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Role of Government and Economic Progress

- The economic, political, and legal environment is a major determinant of economic growth.
- Governments help promote economic growth when they focus on two core functions:
 - Provision of a legal, regulatory, and monetary environment that enforces contracts and protects people and their property from the actions of aggressors (*both domestic and foreign*), and,
 - Provision of a limited set of public goods like roads and national defense that are difficult to provide through markets.


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Role of Government and Economic Progress

- As governments expand beyond these core functions, however, the beneficial affects will eventually wane and become negative.

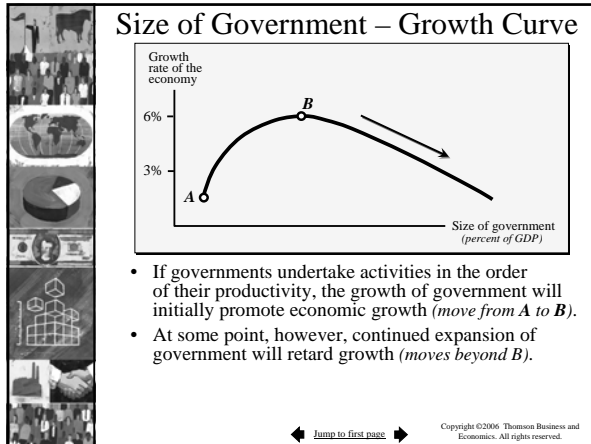
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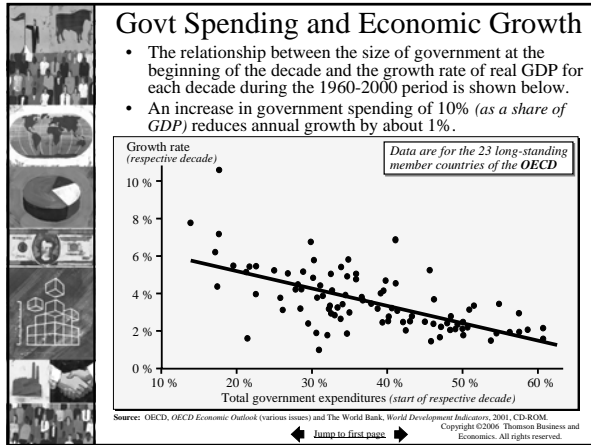


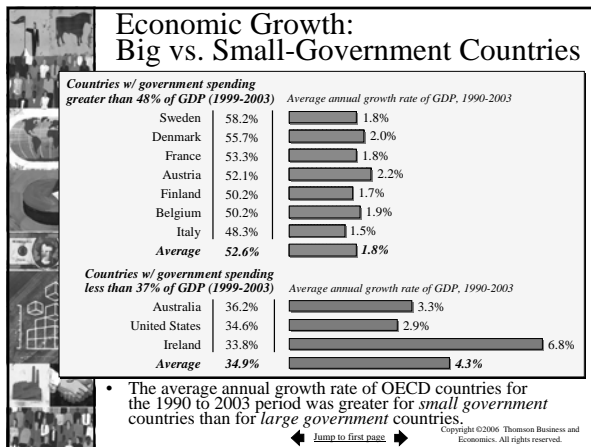
The Size of Government and Economic Growth


- There are four major reasons why expansion in the size of government beyond the core protective and productive functions will eventually retard economic growth.
 - High taxes & borrowing impose increasing deadweight losses on the economy.
 - Diminishing returns cause the rate of return derived from government activities to fall.
 - The political process is much less dynamic than the market process.
 - A larger government becomes more heavily involved in the redistribution of income and regulatory activities.

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Questions for Thought:

1. "Most low income countries are poor because they lack the necessary natural resources for development."
-- Is this statement *true*?
2. "In recent decades the highest rates of economic growth have been achieved by high income countries with the largest government expenditures as a share of GDP."
-- Is this statement *true*?


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Questions for Thought:

3. Which of the following is most important if a country is going to achieve and sustain rapid economic growth?
 - a. large government expenditures as a % of GDP
 - b. institutions & policies supportive of competition (*open markets*) and freedom of exchange
 - c. free elections and political democracy
4. The growth records of Japan and Hong Kong during the last 50 years indicate that an economy can grow rapidly without:
 - a. securely defined property rights
 - b. abundant domestic resources
 - c. significant capital formation
 - d. adopting modern technology

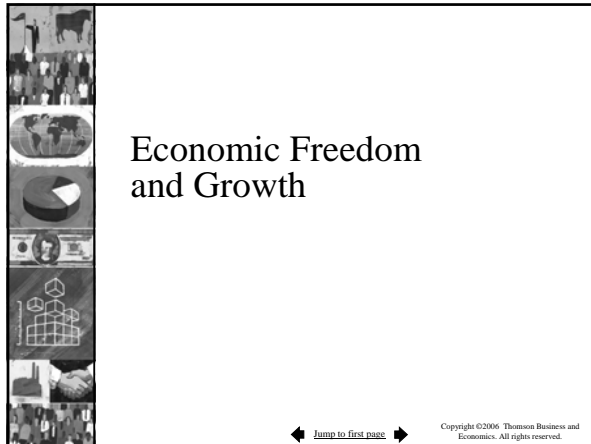
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Questions for Thought:

5. Which of the following is *true*?
 - a. International trade makes it possible for a nation to use more of its resources producing items it can supply economically and less producing goods that can be supplied domestically only at a high cost.
 - b. Trade barriers such as tariffs and import quotas will protect domestic jobs, expand employment, and help a nation achieve a higher standard of living.

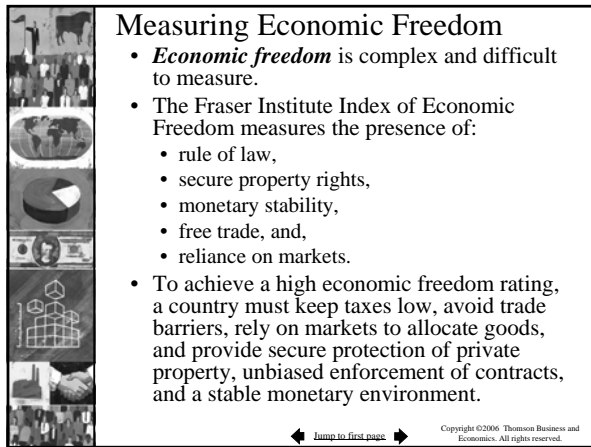
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Economic Freedom and Growth

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Measuring Economic Freedom

- **Economic freedom** is complex and difficult to measure.
- The Fraser Institute Index of Economic Freedom measures the presence of:
 - rule of law,
 - secure property rights,
 - monetary stability,
 - free trade, and,
 - reliance on markets.
- To achieve a high economic freedom rating, a country must keep taxes low, avoid trade barriers, rely on markets to allocate goods, and provide secure protection of private property, unbiased enforcement of contracts, and a stable monetary environment.

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The Most and Least Free Economies of the World

• The Fraser Institute uses 38 different components to rate the economic freedom of more than than 120 countries.

• The overall summary ratings for the 10 most & 10 least free economies during the 1980-2000 period are shown here.

• Both the per capita income levels and the growth rates of the **free** economies were substantially higher than for those **less free**.

• Note that this freedom index is designed to measure **economic freedom** rather than political freedom, civil liberties, or the degree of democracy.

Source: James Gwartney and Robert Lawson, Economic Freedom of the World, 2004.

Most free (1980-2000 summary rating)

| | |
|----------------|-----|
| Hong Kong | 8.7 |
| Singapore | 8.3 |
| United States | 8.0 |
| Switzerland | 7.9 |
| Canada | 7.5 |
| United Kingdom | 7.5 |
| Netherlands | 7.4 |
| Luxembourg | 7.3 |
| Germany | 7.3 |
| Australia | 7.3 |

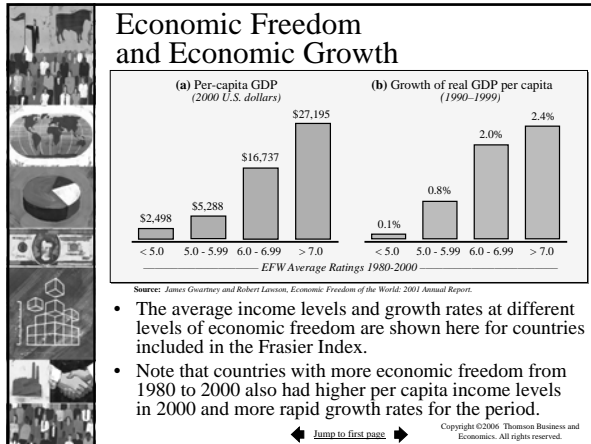
Least free (1980-2000 summary rating)

| | |
|-----------|-----|
| Iran | 4.2 |
| Brazil | 4.2 |
| Syria | 4.0 |
| Ghana | 4.0 |
| Nigeria | 4.0 |
| Nicaragua | 3.9 |
| Uganda | 3.9 |
| Algeria | 3.8 |
| Myanmar | 3.7 |
| Congo | 3.6 |

(Dem. Rep. of)

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Questions for Thought:

- "Economic freedom is present if a country is a political democracy."
-- Is this statement *true*?
- "Sound institutions and policies are the key to economic growth. If a nation creates an environment conducive for economic growth, people will supply and develop the resources and technology."
-- Is this statement *true*?
Is the proper economic environment more important than the supply of resources?

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Questions for Thought:

- Adam Smith argued that the wealth of nations was dependent upon gains from
 - specialization and trade,
 - expansion in the size of the market, and,
 - the discovery of better (*more productive*) ways of doing things.
 Was Adam Smith right? Are there other factors that you would add to his list?
- In order to achieve a high economic freedom rating, a country must ...
 - rely on a strong central government to make economic decisions.
 - be a political democracy.
 - refrain from the imposition of barriers that limit voluntary exchange.

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Questions for Thought:

5. On average, countries that have a larger degree of economic freedom tend to have ...

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

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**End
Chapter 16**

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