1 Looking for fundamenal causes of growth

Economic performance

y, GDP, consumption per capita, etc.

$\uparrow$

"Proximate causes"

Physical and human capital, productivity

"a country is rich bc it is rich"

$\uparrow$

"Fundamental causes"

???

2 Four possible explanations

What are the fundamental factors capable of explaining differences in endowments of technology and physical and human capital among countrie?

2.1 Luck

Countries with very similar characteristics experience different paths of economic growth. Proposed explanaitons

1. **Small differences** with long-run consequences
2. Conncected to **Selection of multiple equilibria** (Poverty traps) $\leftarrow$ more complex production functions allow for multiple equilibria
3. **The big push** (may explain industrialization in the Uk)
   - **A firm's investment decision** depends upon expectations about other firms' investment choices
     - Technological complementarities
     - (Aggregate) demand externalities
   - **coordination failures**

		Everybody else	
		High investment	Low investment
Individual	High investment	y^H, y^H	$y^L - \varepsilon, y^L$
	Low investment	$y^L, y^L - \varepsilon'$	y^L, y^L

   - **why** do these failures persist over time?
     - **Role for political leaders**: Jones & Olken(QJE2005)investigate the effects of leaders' death! (stronger in autocratic countries). Note how far awat this framework is from the traditional representative agent model!
     - **This explanation calls for other causes** (institutional and/or political?) Luck? can simply be institutions! firms star investing as they see the right environment!

2.2 Geography

Different channels through which geography may affect growth:

- **Climate** → **Montesquieu (1748)**: climate influences the utility function and "*effort*"
- **Natural resources** → **Myrdal (1968)**: low agricultural productivity hampers industrialization
- **Topography** & Unhealthy environment → **Sachs, the burden of diseases**; geography (e.g. topography) affects disease persistence and spread

Challenges textbf to the geography hypothesis:

- **Significant heterogeneity** in outcomes across countries with similar geography
- **Time-series evidence**: some poor countries become rich ⇒ geography is fixed, but performance changes. This suggets geography alone cannot explain growth

Example:

- *South Korea vs. North Korea*: same geography, diverging economic outcomes due to differences in institutions and policies

2.3 Culture

Def: Culture encompasses the **Beliefs and values** that influence individual economic behavior.

Two main channels:

- **Individuals' utility:**
  - Affects leisure vs. work decisions, savings, risk aversion
- **Cooperation and trust:**
  - Key for resolving market failures (*e.g. coordination failure*)

Examples (on who studies uh channels):

- **Religion:** In Becker
  - Religion affects physical capital, human capital, labor, technology (traditional solow)
  - BUT ALSO shapes preferences, norms, institutions

Open issues:

- Strong **overlap** between culture and informal institutions
- Culture is relatively time-invariant (**What is the policy proposal?** Become Protestant?)
- *North vs. South Korea:* same culture/geography, divergent outcomes. Suggests culture matters less than other exogenous shocks

2.4 (Formal) Institutions

Idea: Institutions that encourage the accumulation of production factors (K, H) and innovation (A) promote long-term economic growth.

- We like this field because institutions can be modified through collective action. However, they tend to be persistent over time.

Key identification problem:

- Which institutions matter most for growth? (*which ones?*)
- What form should institutions take? (*which forms?*) Longstanding academic debate:

- The traditional *"consensus"* view (see first part)
- Alternative perspectives (second part)
- Ongoing emergence of a new *"consensus?"*

- How measure institutions?

2.4.1 Which institutions matter most for growth?

- **ECONOMIC INSTITUTIONS**
  - **Contracting institutions**
    - Regulate contracts between market agents (organize horizontal relationships).
    - *Help individuals contract in the market, avoid bad Nash equilibria.*
  - **Property rights institutions**
    Provide insurance to citizens and investos against expropriation by elites / politicians
    - Institutions that guarantee property rights
    - Ensure protection of physical and intellectual property.
    - Regulate vertical relationships (citizens vs. elites, politicians, foreign investors).
  - **Fiscal and monetary institutions and policies**
    - Ensure macroeconomic stability.
  - **Other institutions** (eg educaiton system)
- **POLITICAL INSTITUTIONS** (eg democracy)

2.4.2 Which are Growth enhancing institutions, and hence what forms our institution should have?

1. Theory

- Individuals aim to maximize income/wealth
- Two strategic options:
  1. Increase the size of the economic "pie" (via innovation, entrepreneurship)
  2. Increase one's share of the pie (via redistribution)
- HENCE, Growth-enhancing Institutions should favor strategy (1) = support private entrepreneurship to promote innovation. The core idea behind the WB ease of doing business is that the state role is to create an environment where businesses can flourish and innovate. The idea is that the private sector can create jobs, lift people out of poverty and create more opportunities for the economy to prosper. Research demonstrates a causal relationship between economic freedom and gross domestic product (GDP). Policy reforms are used to catalyze private investment.

2. How to support and promote innovative private entrepreneurship?

A. $\mathbb{E}$(gains from innovation) > $\mathbb{E}$(costs of innovation)

1. INTERNAL LIBERALIZATION: Reduce costs of starting a new business: *make it easy to start and grow a business*:
   - **Start the business**: Registration times ↓,
   - **Start the business**: Ease in hiring and firing workers ↓ (labor market refulation),
   - **Ger a location**: Ease in obtaining cosntruction permits, getting electricity rgistering property ↑,
   - **Access finance:** Credit access ↑,
   - **Secure business environmetn**: Proteciton to shareholders ↑,
   - **Secure business environmetn**: Protection against bankruptcy ↑,
2. PATENT PROTECTION AND INTERNATIONAL LIBERALIZATION: Increase gains from innovation: *protect returns, e.g. patents.* To do so:
   - Strengthen economic institutionsm **Secure business environment**:

- – *Institutions that protect property rights*: physical and intellectual property, <u>vertical</u> relationships
- **improve day to day business operations**: Open the economy (imitation)
  - import foreign technology
  - trade across borders: enlarfe the marekt!
  - Foreign Direct Investments (FDI)
- **Secure business environmetn**: Avoid high taxation — disincentive to investment

B. $\mathbb{E}$(net gains from innovation) > $\mathbb{E}$(net gains from redistribution)

3. <u>REDUCE RREDISTRIBUTION: Discourage unproductive activities such as excessive redistribution</u>
   - Positive effect of inequality (with some limits):
     differences in prices of labor ⇒ incentives for education
   - Economic inefficiencies from redistribution:
     distorts optimization problems

C. Other necessary but not sufficient conditions:

- Education policy
- Macroeconomic stability

D. INTERNATIONAL LIBERALIZATION: Preserve incentives over time

4. <u>Keep 1, 2, 3 working in the LR</u>
   - Antitrust law (*authorities*)
     But often relatively slow and weak enforcement

   - Open markets (trade and capital)
     Operates through market forces to preserve competition

A valid recipe for all countries!!!!!!! :)))

3. Role of the state in this framework (Bardhan 2016) The state must be:

- **Strong enough** to enforce rule of law, contracts, property rights
- **Not too strong** to interfere with the security of prpoerty rights or distort market incentives

ALL OF THE ABOVE IS GREATLY IN LINE WITH THE WASHINGTON CONSENSUS

3 The Washington Consensus (Neoliberal economic policy)

Definition and Origins

- Term coined by **John Williamson** in 1989, who was asked to come up with a list of **10 policy recommendations** that “everyone in Washington would agree were needed more or less everywhere in Latin America”.
- Reflected a shift in global economic thinking after the Cold War: liberalization, privatization, and stabilization became the new orthodoxy.

The 10 Recommendations

1. Fiscal discipline
2. Reordering public expenditure priorities (Switching expenditure in a pro-growth and pro-poor way,)
3. Liberalizing interest rates
4. A competitive exchange rate
5. Trade liberalization
6. Liberalization of inward FDI
7. Tax reform (moderate marginal rates)
8. Privatization
9. Deregulation (easing entry and exit barriers)
10. Protection of property rights

Three core rules (in brief):

- **Liberalize** — trade and labor markets
- **Privatize** — public enterprises
- **Stabilize** — budget balance and inflation control

Large ingluence in itnernational isntituions (IMF, WB) and in the structuring of the EU, and in shaping institions in develpiong countteis, also due to **Conditionality**: policy adoption required for aid or investment.

Critiques and Limitations

- **Intellectual bubble** (Krugman, 1995):A political economy cycle, in which government were persuaded to adopt Washington Consensus policies because markets so spectacularly rewarded them.
- **Disappointing outcomes** in many developing countries led to four main strands of criticism:

1 & 2. "Benevolent" explanations

- **1. Incomplete list**: needs an "Augmented Washington Consensus" to cover more domains.
- **2. Poor implementation**: corruption, missing reforms of some markets.
- Problem: these explanations are hard to falsify.

3. Inadequacy of "One-size-fits-all" strategies

more infra

4. Inadequacy of the theoretical foundation of the neoclassical growth model

more infra