LSE EC1B5 Macroeconomics

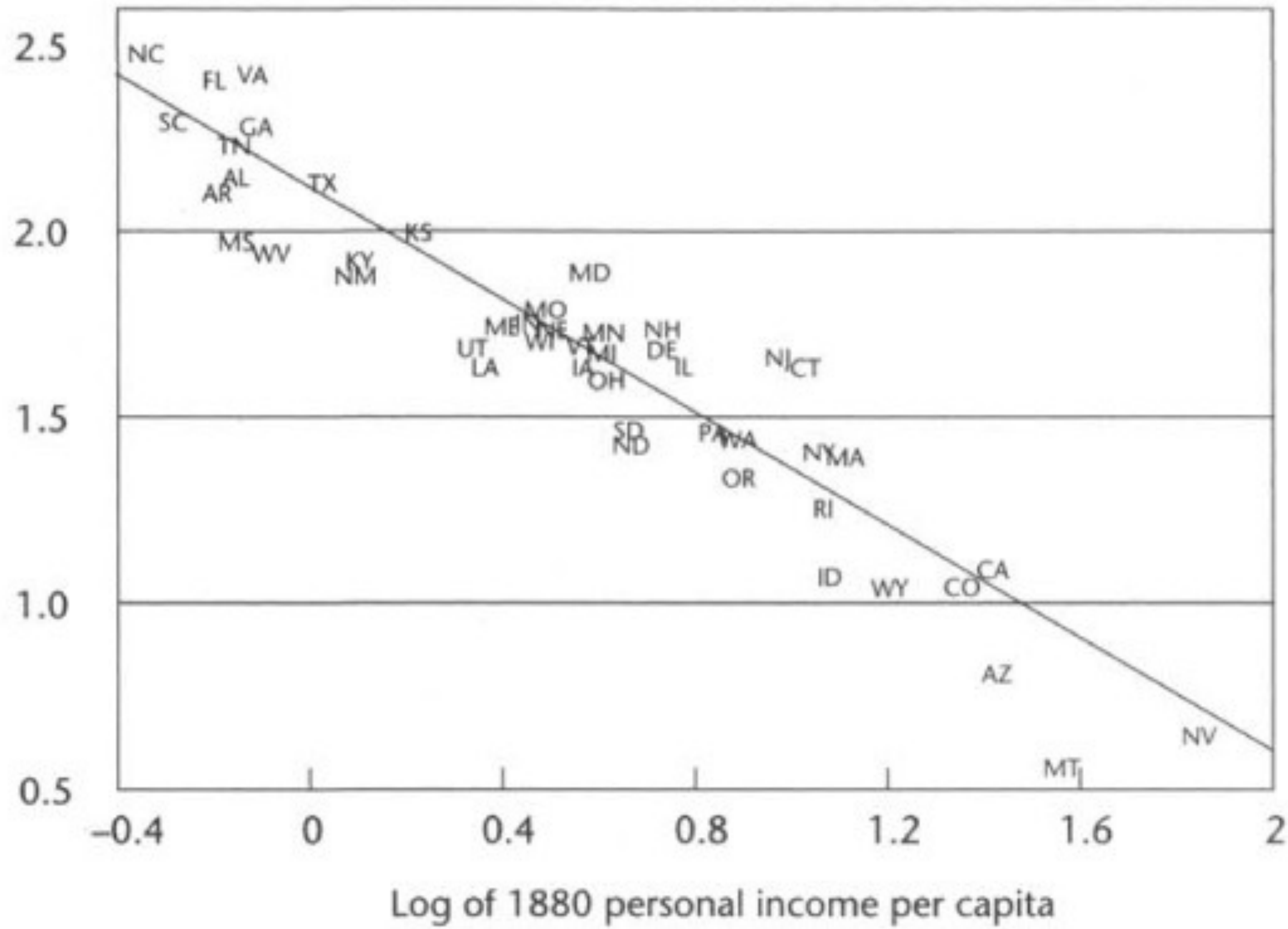
Handout 6

Why isn’t the Whole World Developed?

Key Ideas

1. Proximate and fundamental causes of prosperity
2. Fundamental causes: geography, culture, and institutions hypotheses.
3. Institutions: Inclusive and extractive

Conditional Convergence



Average annual growth rate of income per capita in the U. S. states between 1880 and 1990 against the logarithm of income per capita in 1880.

Proximate causes of prosperity

High levels of factors of production such as physical capital, human capital, and technology that result in a high level of GDP per capita.

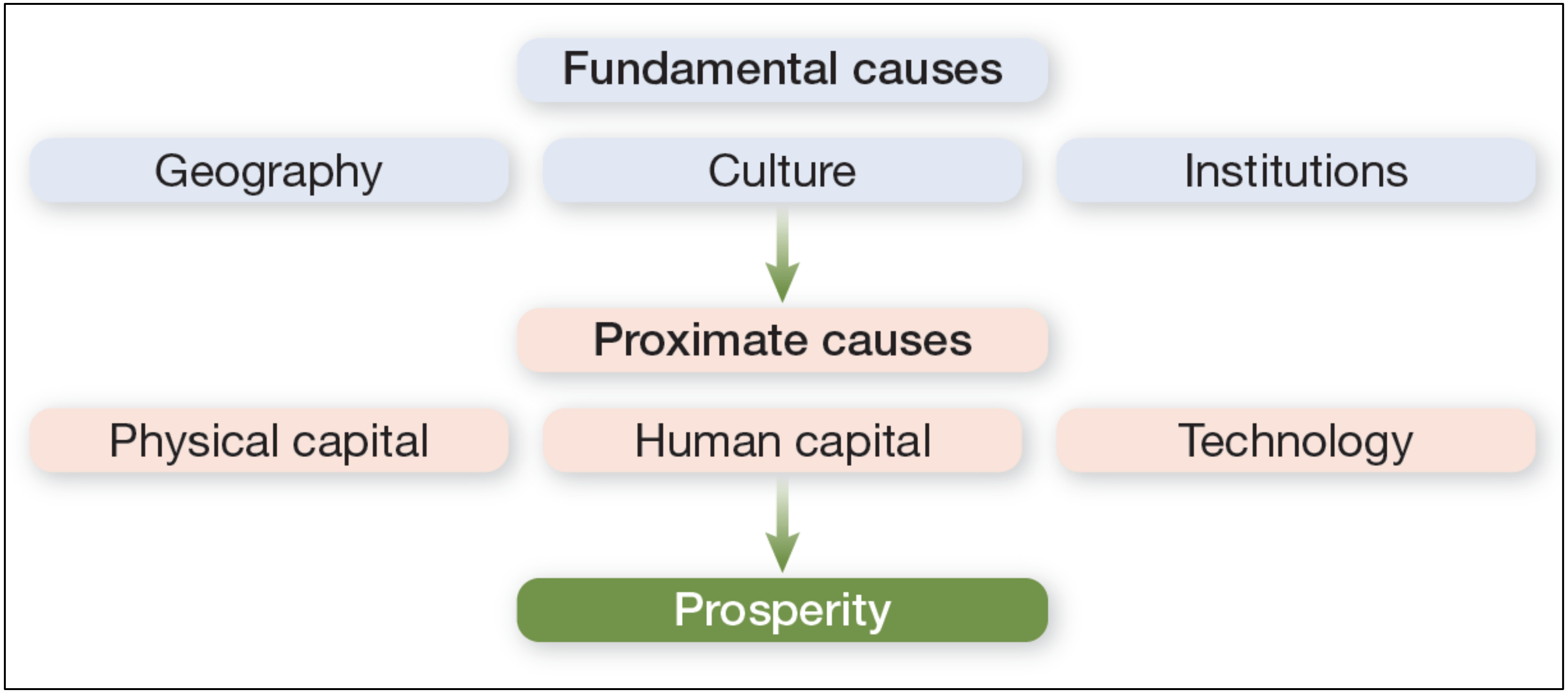
The factors of production are proximate causes because they link high levels of prosperity to high levels of the factors, but without providing an explanation for why these factors are high.

Fundamental causes of prosperity

The root reasons for the differences in the proximate causes.

The fundamental causes are ultimately the deep determinants of economic development.

Proximate Versus Fundamental Causes of Prosperity



Fundamental causes can be classified into three categories or theories:

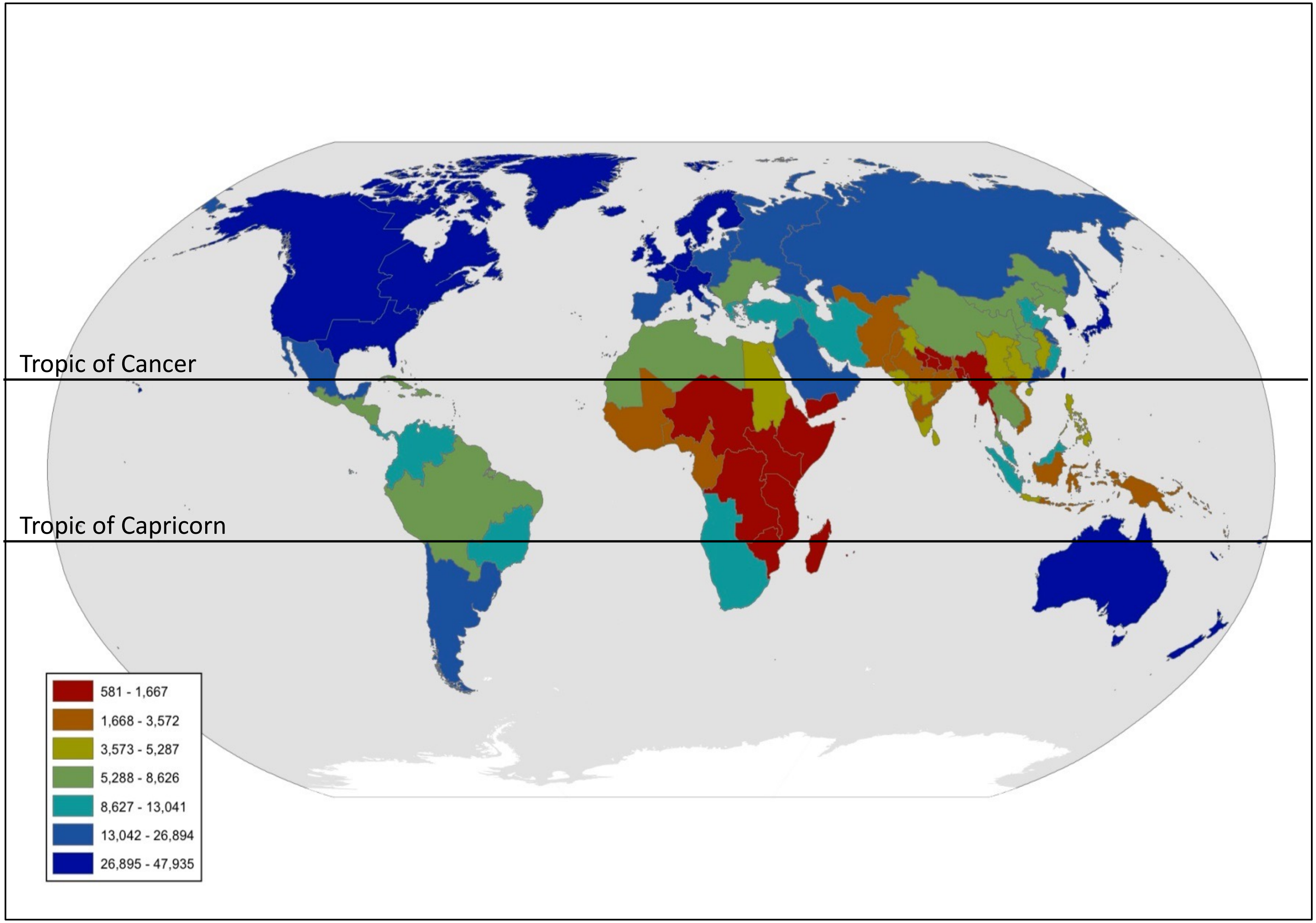
1. Geography hypothesis
2. Culture hypothesis
3. Institutions hypothesis

Geography Hypothesis

The **geography hypothesis** claims that differences in geography, climate, and ecology are ultimately responsible for the large differences in prosperity observed around the globe.

The following map of the world reveals that economies with low levels of GDP per capita are located in tropical areas, while those with high levels are in temperate areas (outside the tropics).

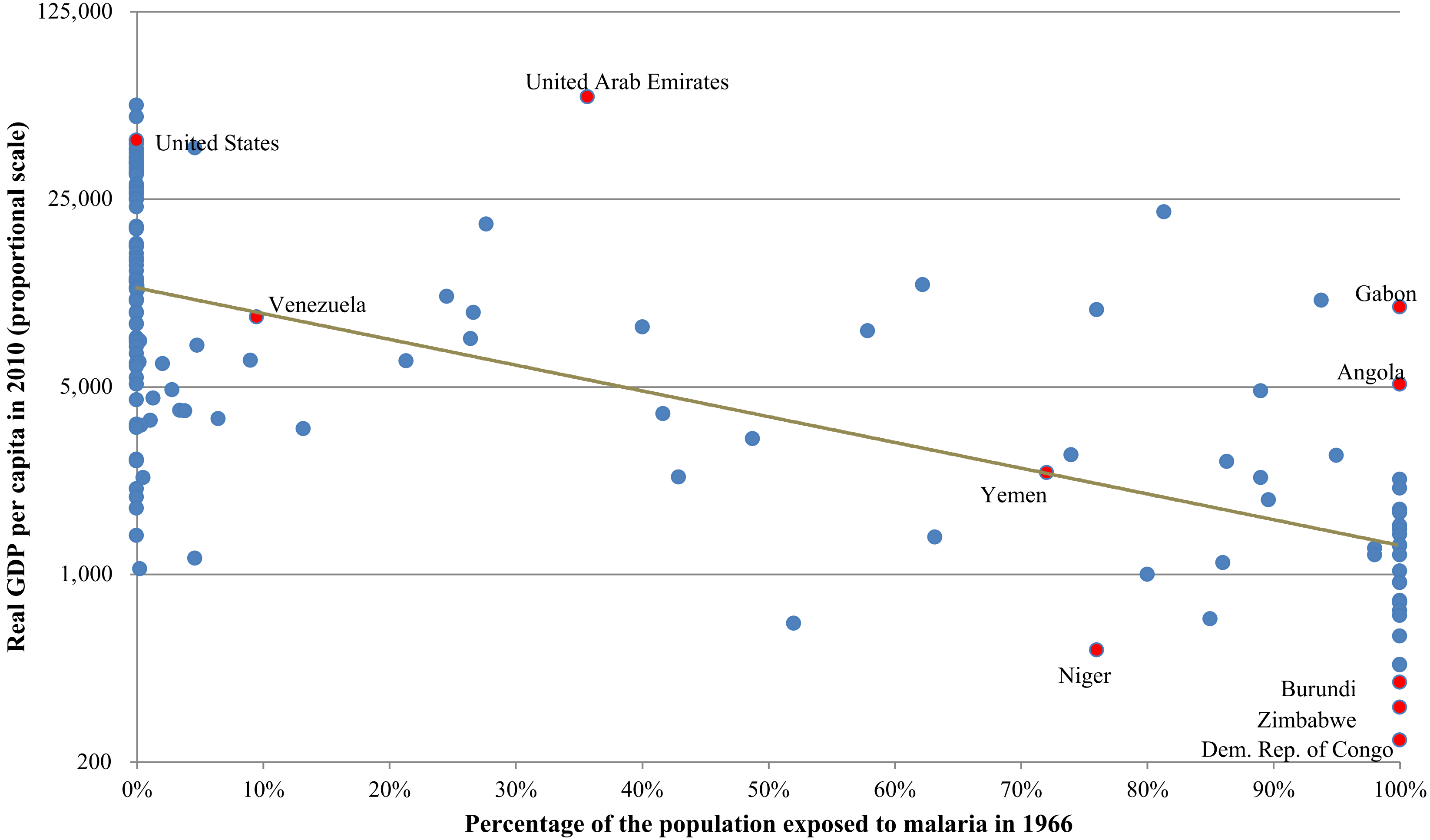
Geography Hypothesis



Geography Hypothesis

- In the past, the philosopher Montesquieu and the British economist Alfred Marshall argued that tropical climates decreased work effort.
- Economist Jeffrey Sachs and geographer Jared Diamond argue that tropical climates are more prone to infectious diseases such as malaria and dengue fever, which result in poverty.

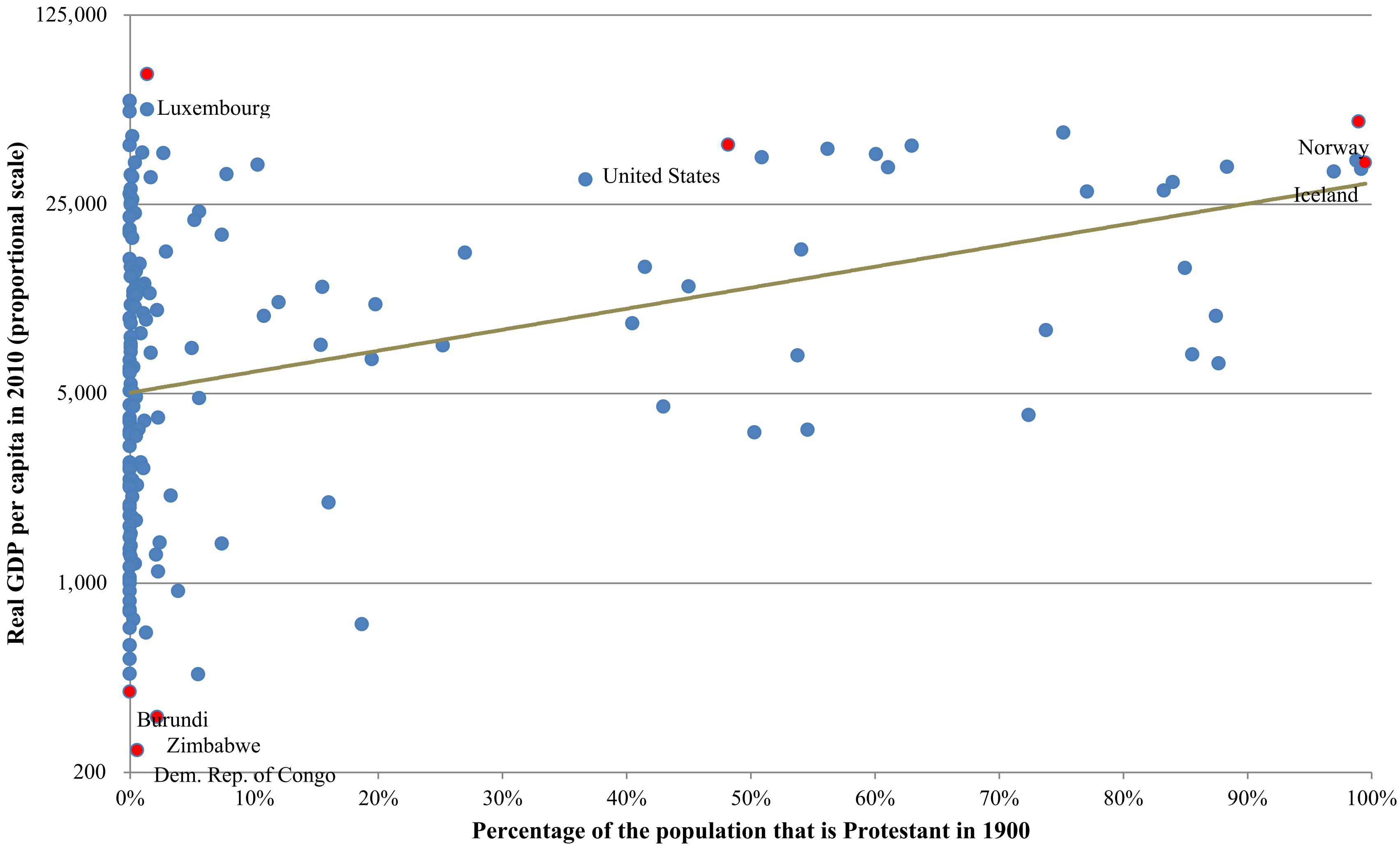
Test of Geography Hypothesis



Culture Hypothesis

- The **culture hypothesis** claims that different values and cultural beliefs are ultimately responsible for the large differences in prosperity observed around the globe.
- In 1905, the sociologist Max Weber argued that Protestant beliefs lead to a greater work effort, higher savings, and increased income – Protestant work ethic hypothesis
- In the 1990s, the political scientist Samuel Huntington talked of a “clash of civilization” between the West and Islam.

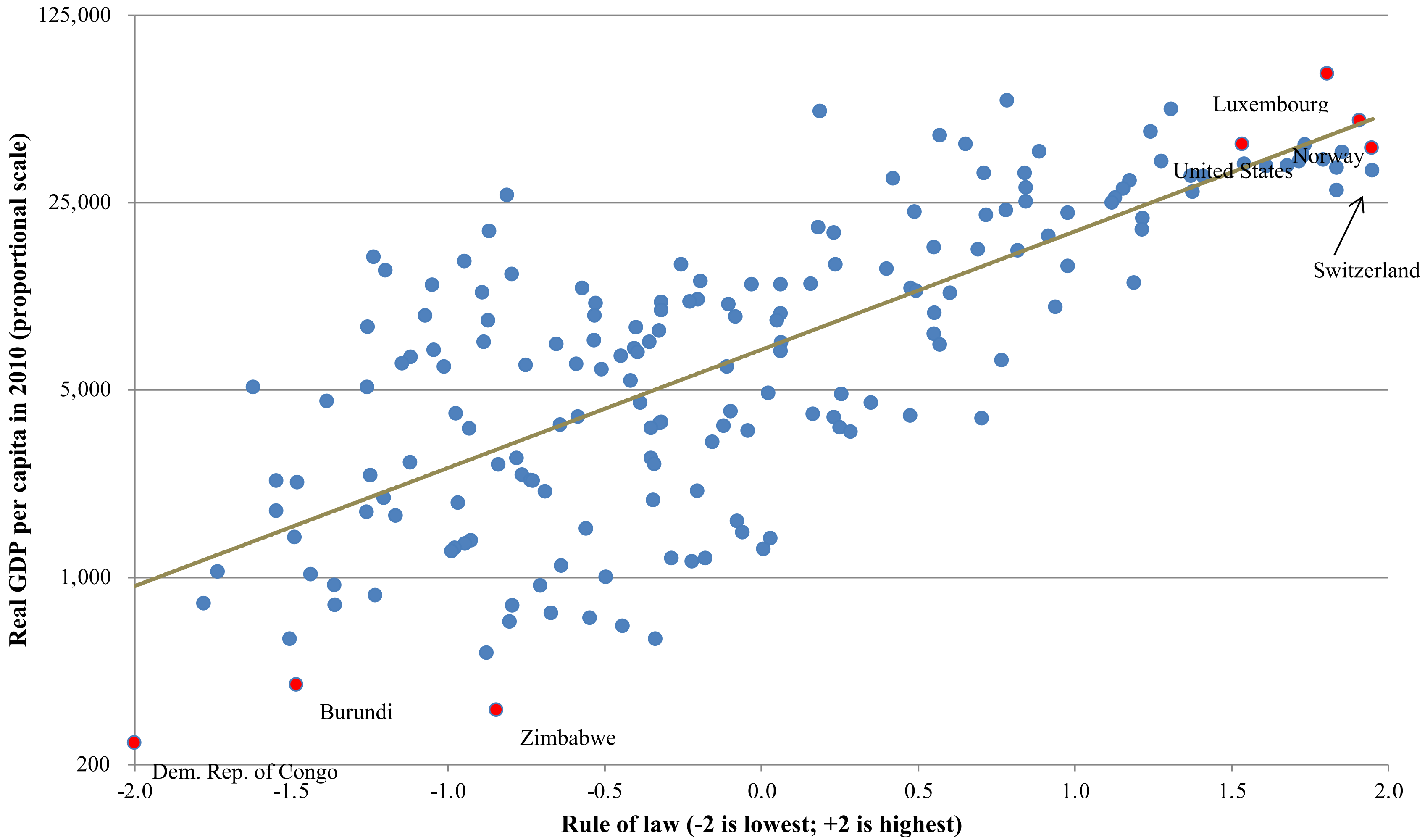
Test of Weber’s Protestant Work Ethic Hypothesis



Institutions Hypothesis

The **institutions hypothesis** claims that differences in the way societies organize themselves and shape the incentives of individuals and businesses (so-called economic rules of the game) are ultimately responsible for the large differences in prosperity observed around the globe.

Institution Hypothesis



Institution Hypothesis

Institutions have three important features:

1. They are determined by individuals.
2. They place constraints on behavior.
3. They shape human behavior by determining incentives.

Institution Hypothesis

Institutions affects choices between productive activities (e.g. innovation) and unproductive activities (rent-seeking) – William Baumol, 1990..

- Ancient Rome- inventor turned to the emperor for a reward, instead of turning to an investor for capital with which to put his invention into production.
- Medieval China: aim was to climb the ladder through imperial examinations such as in Confucian philosophy and calligraphy.
- Medieval Europe: wealth and power were pursued primarily through military activities

Divided Countries

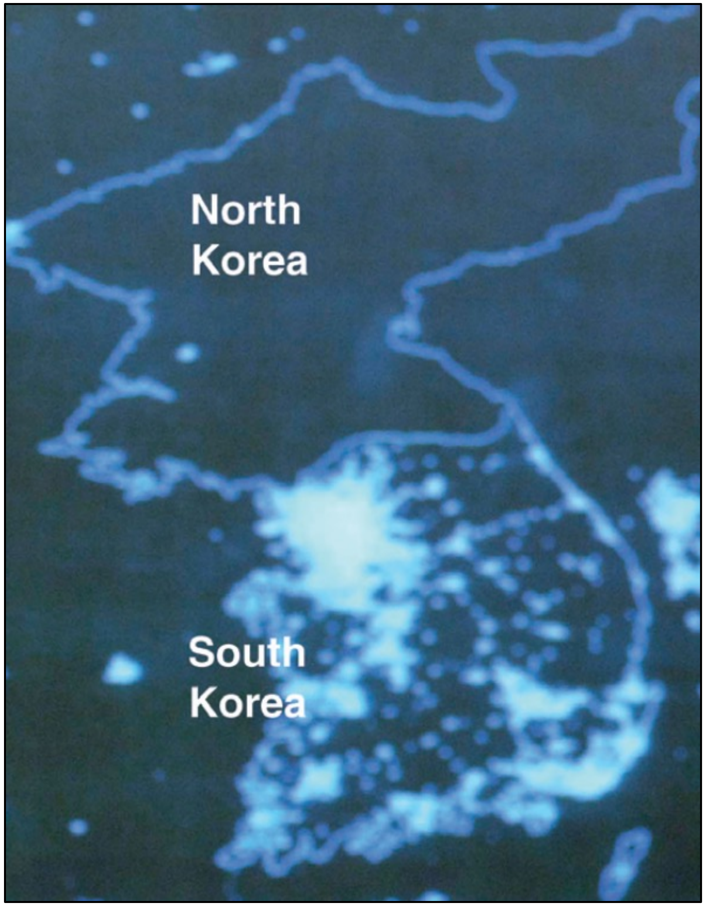
The role of institutions can be seen from the growth experiences of divided countries

- In 1990, GDP per capita in West Germany was 2.5 times higher than in the East
- North Korea and South Korea

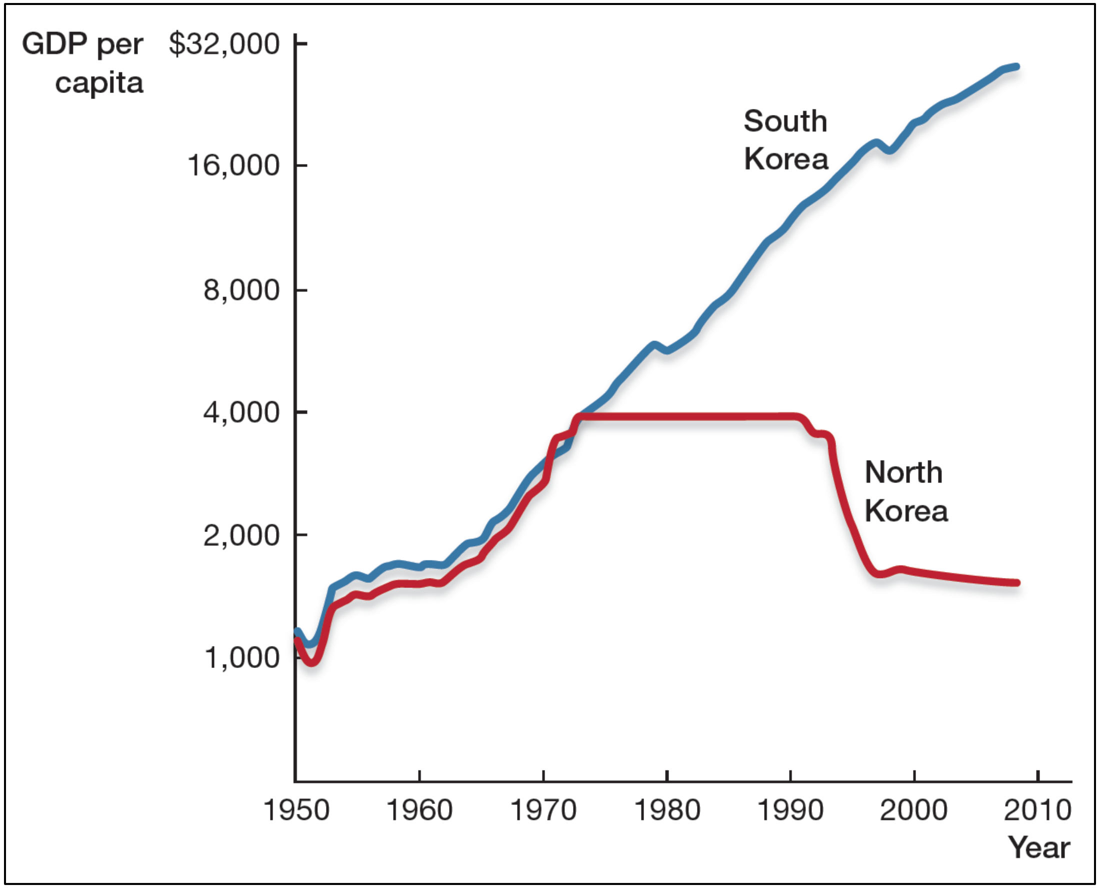
North and South Korea

In the 1940s, North and South Korea were a single country, with a unified language, culture, and geography.

In 1947, the country was split into two countries by an agreement between the United States and the Soviet Union.



GDP per capita in North and South Korea
PPP-adjusted, 2005 constant dollars



North and South Korea

By 2010, North Korea was an economic "disaster," with a GDP per capita of $1,500, while South Korea was an economic "miracle," with a GDP per capita of close to $30,000.

What happened?

Was it geography? Was it culture? Was it institutions?

North and South Korea

The South Korean autocratic government of Syngman Rhee and Park Chung-hee adopted a market-based economy, providing incentives for investment in physical and human capital.

The North Korean dictatorship of Kim Il-Sung and his son Kim Jong-Il adopted a strict communist system (called *Juche*) that outlawed private property and banned markets.

Economic institutions

Aspects of society's rules that concern economic transactions.

Economic institutions include:

- Protection of property rights and ownership
- Impartiality of the justice system
- Financial arrangements between savers and borrowers
- Regulations concerning new businesses or occupations

Inclusive economic institutions

Institutions that support and encourage economic transactions and, as such:

- Protect private property
- Uphold law and order
- Allow and enforce private contracts
- Allow free entry into new lines of business and occupations

Extractive economic institutions

Institutions that remove resources from the economy and, as such:

- Do not protect private property
- Do not enforce private contracts
- Interfere with the workings of markets
- Restrict entry into new lines of business and occupations

Why Extractive Economic Institutions?

Why would a country adopt extractive economic institutions if they retard economic growth?

- The notion of **political creative destruction** predicts that economic growth destabilizes existing regimes and reduces political power.
    - (Joseph Schumpeter creative destruction for technological change)
- Rulers such as Kim Jong-Un of North Korea use extractive economic institutions to maintain political power.

Further Readings