

# EC569 Economic Growth Government (Lecture 11)

İlhan Güner  
School of Economics  
University of Kent

March 26, 2018

# Introduction

Importance of government policies on economic growth

- North and South Korea
- East and West Germany
- China (before and after liberalization)

# Overview

- Defining the proper role of the government
- How government affects growth
- Why poor countries have bad governments
- Challenges for economic growth

# Defining the Proper Role of the Government

## The Case of Government Intervention in the Economy:

### Market failure:

- public goods
  - non-rivalry & non-excludable: national defense, public health, rule of law, infrastructure
- externalities
  - social net benefit  $\neq$  private net benefit
  - R&D subsidies
  - patents
  - education
- natural monopoly
  - high sunk cost: public utilities (electricities, natural gas, water, public transportation)
- coordination failure
  - industrial policy: supply chain, infant industry

# Defining the Proper Role of the Government

## The Case Against Government Intervention in the Economy:

### Government failure:

- lack of incentives/information for the government to operate properly
  - inefficient state enterprises/government-owned banks
  - industrial policies lead to rent-seeking
- government failure  $>$  market failure ?
  - privatization and deregulation

### Equity-efficiency trade-off in redistribution:

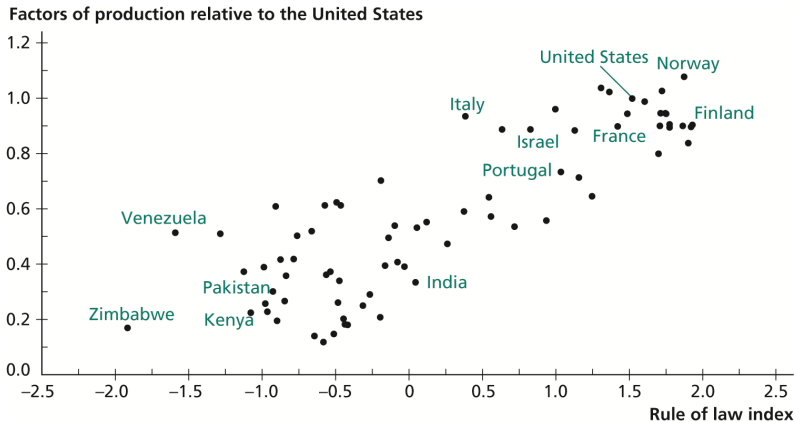
- benefit of redistribution: higher equity
- cost of redistribution: lower efficiency, bureaucratic cost

# How Government Affects Growth

## Rule of law:

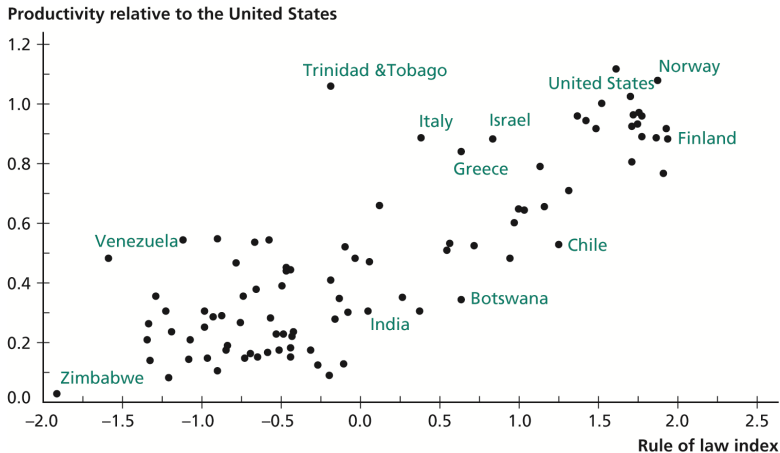
- a reliable legal system should lead to high factor accumulation
  - without property rights no one would save/invest
- a reliable legal system should lead to high productivity
  - without contract enforcement no one would trade: no division of labor

# Figure 12.1: Rule of Law and Factor Accumulation, 2009



Source: Kaufmann, Kray, and Mastruzzi (2010). Data are scaled to have a standard deviation of 1.

## Figure 12.2: Rule of Law and Productivity



Source: Kaufmann, Kray, and Mastruzzi (2010). Data are scaled to have a standard deviation of 1.



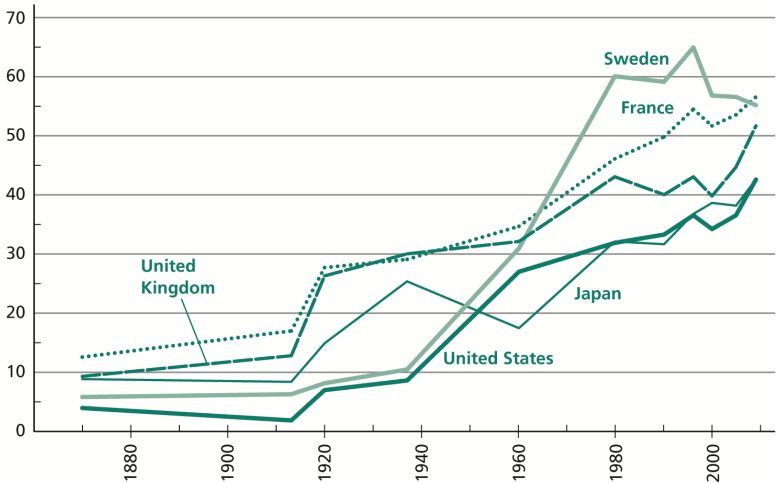
# How Government Affects Growth

## Taxation, Efficiency, and the Size of Government

- Wagner's law
  - the size of a government will increase as countries become richer due to more complex regulations and advanced public goods provision
  - increase in expenditure requires increase in taxes
- Taxes and output
  - increase in tax rates leads to lower efficiency
    - distortionary taxes discourage economic activities
    - dead weight loss represents the efficiency loss

# Figure 12.3: Growth of Government Spending, 1870–2009

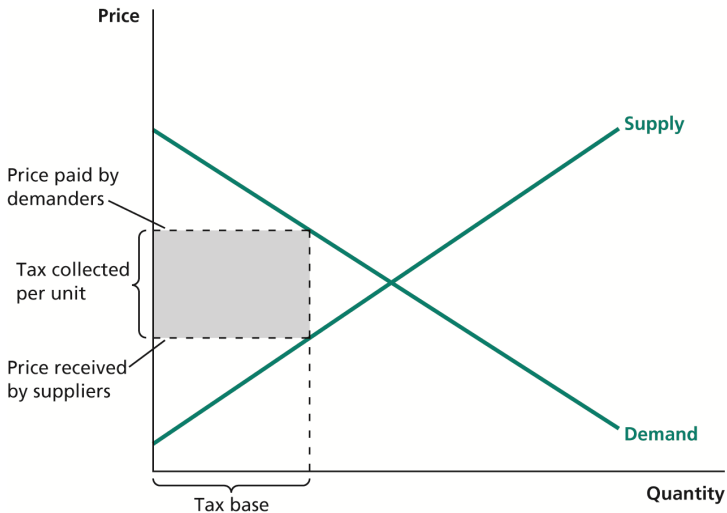
Government spending as a percentage of GDP



Source: "The Future of the State," *The Economist*, September 20, 1997, OECD.

Year

Figure 12.4: Effect of a Tax



# How Government Affects Growth

## Planning and Other Industrial Policies

- State enterprises
- Government-owned banks
  - China: 98% of bank assets (2006)
  - India: 75%
  - Egypt: 65%
  - Israel: 46%
  - Germany: 42%
- Marketing boards
- protection of infant industries with tariffs

# Planning is not always a failure

- The above policies always failed
- South Korea
  - public enterprises in steel and petro-chemicals
  - directed investment into selected industries
  - tariffs to protect infant industries
  - public enterprises operated as autonomous, profit-seeking entities
- Taiwan
  - foreign firms were able to sell products in Taiwan only with technology transfer
- weaned infant industries from protection
  - Korea: protection conditional on growing export
  - Taiwan: protection conditional on meeting productivity targets
- Planning works when administered by an efficient, honest bureaucracy

# How Government Affects Growth

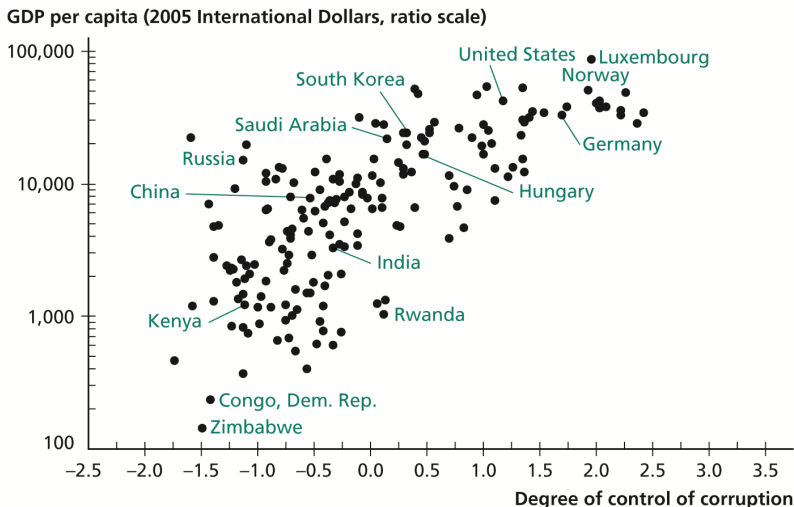
## Civil conflicts

- looting
- flight of refugees
- destruction of capital
- restriction of commerce
- weakening of social capital
- diminished supply of public goods
- humanitarian costs

# Why Governments Do Things That are Bad for Growth

- Some other goals
  - national defense, the arts, foreign aid
  - anti-pollution regulations
- Corruption
  - waste of government revenue
  - lower efficiency of production
  - undertake policies solely to generate more opportunities for bribery
  - undermine rule of law
- Self-preservation
  - new technologies can redistribute economic power
  - rising education may introduce destabilizing new ideas
  - movement of population from farms to cities may lead to revolutionary class
  - trade carries dangerous ideas

# Figure 12.5: Government Corruption versus GDP per Capita, 2009

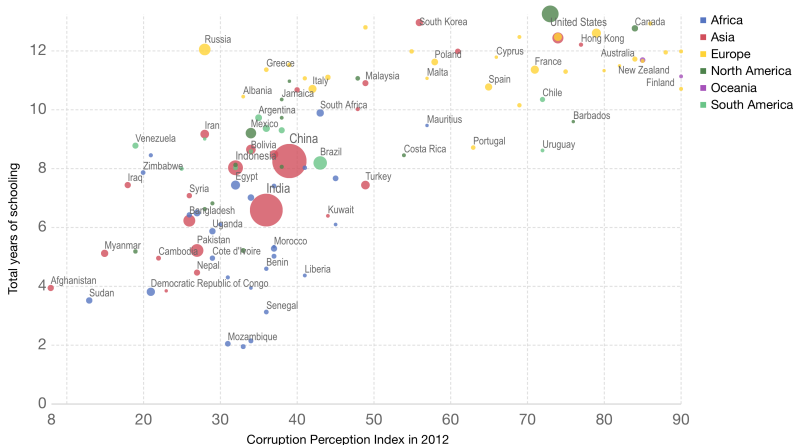


Source: Kaufmann, Kray, and Mastruzzi (2010).



# Average years of schooling vs. Corruption Perception Index, 2010

Education in the vertical axis is measured using average years of schooling (2010 data). Corruption in the horizontal axis is measured using Transparency International's Corruption Perception Index (2012 data, lower values reflect higher perceived corruption). Colors reflect world regions.



Source: CPI (Transparency International (2016)), Lee and Lee (2016)

OurWorldInData.org/corruption/ • CC BY-SA

# Government Regulation: Helping Hand or Grabbing Hand

Djankov et al. (2002)

- Bolivia: follow 20 procedures, wait 82 days, pay \$2,696 to establish a business
- Canada: 2 procedures, 2 days, \$280
- Helping hand
  - regulate entry of new firms to protect consumers from low-quality products
  - limit negative externalities such as pollution
- Grabbing hand
  - benefit government bureaucrats
  - benefit people with good connections to government

## Government Regulation: Helping Hand or Grabbing Hand, cont'd

Djankov et al. (2002)

- Data supports grabbing hand
- Countries with more regulations did not have less pollution, higher-quality consumer products, or better health
- More democratic countries tend to have fewer regulations

# Why Poor Countries Have Bad Governments

- Poor countries tend to have bad governments
- Are these countries poor because of their bad governments?
- Is bad government a symptom of poverty?

## Causation Running from Income to Government Quality

- Until 1871, British army officers were appointed and promoted by purchasing of their positions
- History of New York City, *a cesspool of corruption*
- Yet, these countries and cities are now advanced economies with better governments
- Rich countries can afford to pay their civil servants reasonable wages
- larger pie to split, less of the destructive competition

# Causation Running from Government Quality to Income

- South Korea vs North Korea
- Some countries have bad government that have nothing to do with their income, (e.g. former colonies)

# Institutions and Income

1380

THE AMERICAN ECONOMIC REVIEW

DECEMBER 2001

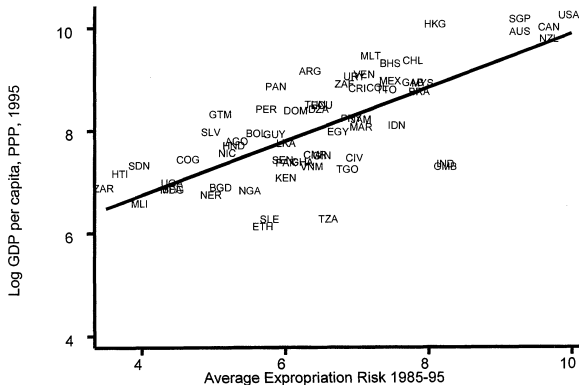


FIGURE 2. OLS RELATIONSHIP BETWEEN EXPROPRIATION RISK AND INCOME

Source: Acemoglu, D., Johnson, S., & Robinson, J. A. (2001). The colonial origins of comparative development: An empirical investigation. American economic review, 91(5), 1369-1401.

# Protection against expropriation risk

Related to:

- property rights enforcement
- checks against government power
- independent judiciary
- equal access to education
- civil liberties



# Institutions and Income

Instrument: settler mortality rate

1384

THE AMERICAN ECONOMIC REVIEW

DECEMBER 2001

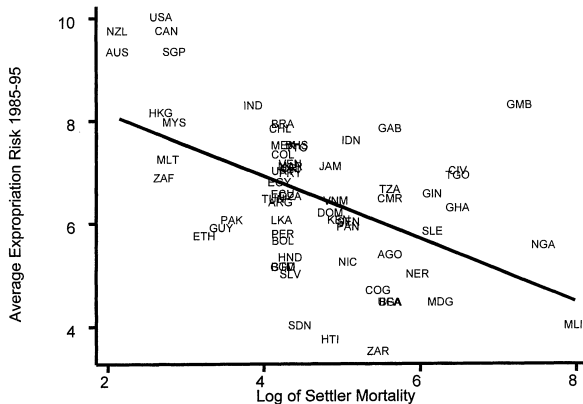
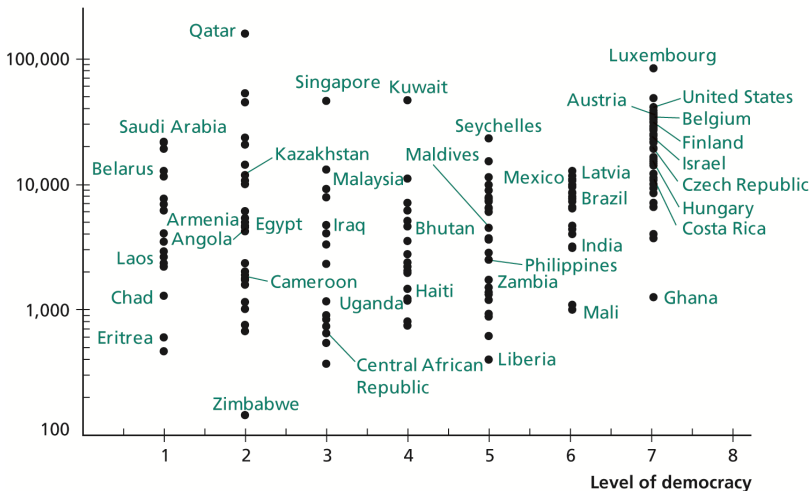


FIGURE 3. FIRST-STAGE RELATIONSHIP BETWEEN SETTLER MORTALITY AND EXPROPRIATION RISK

Source: Acemoglu, Johnson, and Robinson (2001)

# Figure 12.6: Democracy and GDP per Capita

GDP per capita, 2009 (2005 International Dollars, ratio scale)



Source: Freedom House (2011).

# Democracy and Economic Growth

- Political rights are greater in rich countries
- Democracy may not always good for economic growth
- positives
  - limits on the powers of rulers, avoid corruption
- negatives
  - prone to political instability
  - policies favoring short-run gains rather than long-run growth

## India vs China

- In 1980, India: \$1,018 income per capita
- China: \$714
- average growth rate, China: 1975–2009: 7.9% per year
- India: 3.7% per year
- licensing of new investment projects
- modernizing regulations
- building infrastructure
- bickering between different levels of government
- changes of direction when politicians came into power

# Challenges for Economic Growth

What have we learned?

- Many things are related to growth
  - causation tends to run in both directions
- We can construct models to explain causalities
  - selection of the model is up to the researcher
  - are the assumptions reasonable?
  - does the model pass empirical tests?

# Challenges for Economic Growth

What remains to be studied?

- Policy tools are multi-dimensional
  - trade-offs due to resource constraints: R&D and production etc.
  - spill-overs through externality: human capital and technology growth etc.
- Policy goals are multi-dimensional
  - economic growth
  - business cycles
  - income inequality
  - national defense
  - environment
  - culture

# Challenges for Economic Growth

What remains to be studied?

Policy implications should be drawn carefully

- policy tools/goals are multi-dimensional
- the situation of each country is different
  - what are the institutions in each economy?
  - what is the social preference in each economy?

## Conclusion

- rule of law is unambiguously good for economic growth
- complete government direction of the economy does not work
- government planning and the protection of infant industries with tariffs have often but not always failed
- no consensus on optimal size of government or the optimal degree of income redistribution



# What have we learned?

