Economic Growth and Development: Coursework Assignment 2

Matěj Adámek

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University of Plymouth

Student: 10531306

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Assignment description

Critically discuss - using both theoretical arguments and evidence - how economic/political institutions can affect economic growth by focusing on:

- how they would affect the "proximate determinants" (i.e. factors of production and productivity)
- channels/mechanisms involving
  - geography/climate, and/or
  - inequality, and/or
  - culture
  - (note: these include channels/mechanisms in which institutions interact with, are affected by and/or affect one/many of these other factors).

Political and economic institution exist to provide society with a service that influences socioeconomic climate, ultimately attempting to facilitate and sustain economic growth in the long run. The paths taken to achieving such objective have varied among countries and over the course of history, as did the degree to which they succeeded. This essay attempts to reveal and assess modern-day instruments political and economic institutions may utilize to promote both short- and long-run growth rate of total per capita output in a direct as well as indirect way.

The proximate determinants, which have immediate effect on growth are limited to factors of production and productivity. Factors of production include physical and human capital, while productivity, may be decomposed into efficiency and technology. These effects effects were presented in deductive literature (Romer 1994, Solow 1956) concerned with modelling economic growth, and empirically inspected through growth accounting (Denison 1980). Although both streams confirm their validity, explanation of cross-country differences in the proximate determinants of growth must be explained through other variables, the fundamental determinants of growth. (Hausmann & Rodrik 2003)

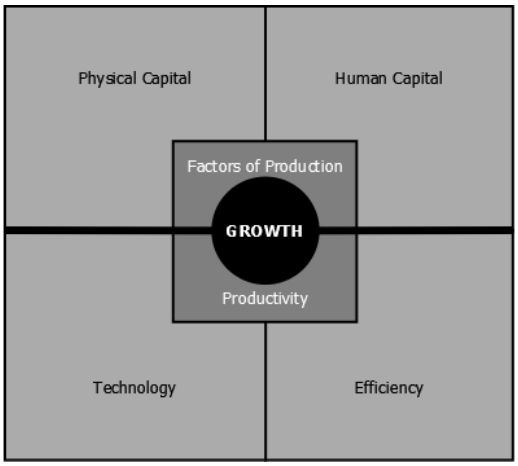

Figure 1: Proximate determinants of growth

These fundamental factors are seen as mainly determined by influence of institutions, broadly defined by North (1983) as "humanly devised constraints that shape human interaction," in addition to constraints coming naturally from the environment. (Acemoglu & Robinson 2008) Institutions of the modern day had developed sequentially from cultural, through political, to economic. While key to historical progress of development, cultural habits and attitudes are of informal nature and not extensively captured in legislation[1] and therefore hard to reform, hence further not analyzed on their own, but in interaction with political and economic institutions.

Firstly, as communities grew, individualism in societies helped political institutions to develop through centralization of power. This had not only caused cultural unification into a society and homogenization, improving level of social capital, but also enabled governance and organization of individuals for benefit of the group, providing base, and major influence, for institutions of economic nature.

Two extreme examples of political systems are democracy and autocracy.

Democracy on the other hand provide individuals with more power and freedom, allowing them to take on actions based on individual incentives, their long-run stability may be

[1] with exception of religion in persisting theocracies

negatively affected by short-run interest of politicians elected by the public[2], as implied by the theory of political business cycle (Drazen 2000). This suggests that in result of fast-paced restructuralization of the economy seeking boost in growth, in combination with relatively low investment in fundamentals, rapid growth of episodic nature occurs.

Autocracy on the other hand, while enabling long-term planning and hence progressive investment in a number of key fundamental determinants of growth, may exhibit higher degree of conservatism in both government and the society, potentially leading to blocking of innovation from abroad, over-exploitation of existing industries, and consequently slow to no structural change. (Gurr et al. 1990) Ultimately, this had been observed to result in steady but low economic growth. (Rodrik 2013)

As per Rodrik (2000), Acemoglu & Robinson (2008), the key functions of economic institutions necessary to facilitate growth in market economy are property rights enforcement, market regulation, macroeconomic stabilization, social insurance, and conflict management. Further, this essay will focus on the particular institutions, inspecting channels through which they affect proximate determinants of growth. In addition, empirical studies of both quantitative and qualitative aspects of their country-specific implementation shall be discussed and potential dangers identified.

Firstly, private property rights are necessary to provide incentives for entrepreneurs to invest into physical capital in form of ownership of the capital and hence the returns on the investment. Rodrik (2000) however suggests that even in the absence of formal property rights, these incentives may be generated through attributing sufficient control rights over a firm to an individual, using Chinese entrepreneurship as an example.

In addition, expanding property rights onto intellectual assets provides the first key requirement for research and development sector, i.e. allowing innovators to receive monopolistic rents using patented technology, eventually drives improvement in technology. (Gould & Gruben 1996) Nevertheless, it is important that patents are in effect only temporarily, to allow diffusion of technology across the economy. (Aghion et al. 2005)

This brings in the need for market regulating institutions, the main objective of which is defined by economic system they seek to sustain.

Under central planning, they gain full control over resource allocation, but on the other hand remove or significantly reduce the degree to which entrepreneurial property rights are granted, eliminating private incentives to invest. This had been shown to reduce the rate of investment as well as stall technological research due to lack of returns under the centrally controlled prices. (Acemoglu & Robinson 2008)

Within market economies, market regulation is still necessary, mainly to prevent anti-competition behavior and market failures resulting from imperfect information, which may be caused individualism. On the other hand, some natural monopolies exist, especially to provide public goods such as infrastructure and create and maintain infrastructure for industries, which would otherwise present with high barriers to entry.

International trade, is another area where regulatory institutions intervene. While open to trade, countries may impose regulations such as import tariffs and quotas or provision of subsidies to domestic importers. Such behavior is known as protectionism and often causes inefficiencies. (Carlin & Soskice 2014) A domestic industry may become less competitive once country is open to trade, either due to geographic constraints, or lower degree of productivity. Factors of production redistribution may therefore be considered.

[2] i.e. reelection

Subsidies within the sector may promote improvement of human capital stock as well as investment potentially enabling technological imitation and diffusion. Nevertheless, it may be efficiency constraint causing this disadvantage, such as unfavorable climate, lack of natural resources, or disproportion of production factor costs. For this reason, protectionism may be preventing specialization of the economy on potentially high-rent industries. (Weil 2016)

Moreover, foreign investors may be attracted by such opportunity, causing financial inflows into the country and hence fostering GDP growth through correction for this misallocation on the one hand, but reduce the degree of national pride and cause profit outflows in the future on the other.

Susceptibility to corruption and may be one of the causes of market failures even with such institution in place, effectively reducing investment through reduction in the degree of trust. (Mauro 1995) Such occurrence may be caused by income inequality or high degree of individualism and self orientation. In addition, ethnic or linguistic polarization may cause favoritism, causing sub-optimal degrees of competition in various sectors.

Thirdly, macroeconomic stabilizing institutions such as central banks and employment offices are necessary to research and ensure appropriate allocation of production factors.

Labor mobility is an example of desirable especially targeted at of direction of labor force to areas rich in natural resources, facilitating more appropriate allocation of production factors, driving efficiency and subsequently human capital in given sector. Finally, positive effect may be observed on social capability caused by creating densely populated area in the region. (Temple & Johnson 1998)

Based on the assumptions of growth models, any unemployment can be seen as misallocation of production factors, and should therefore be minimized. Cyclical unemployment may be corrected for by regulation of inflation and maintenance of stable wage levels. The efficiency of central bank policy is dependent on nature of expectations, which are formed by central bank credibility requiring a degree of trust, a culturally rooted constraint. (Carlin & Soskice 2014) Structural unemployment may on the other hand requires fast-paced requalification of workers.

In order to control for income inequality and reduced social mobility, institutions for social insurance are required. These include redistribution of tax revenue over the current and future labor force not only through transfer payments, but also indirectly by investment in education and healthcare.

While education in itself had been proven to create income inequality, it also introduces social mobility, if funded publicly to a sufficient degree. This therefore provides more or less equal opportunities for individuals, mainly on inter-generational level, to accumulate human capital and move upwards in the income distribution through. Although this approach may a higher expense for the government in the short run, compensation in form of increased human capital stock both directly and through spillovers is more than sufficient, and hence growth-promoting. Furthermore, education has been shown to positively affect social capability,

Similarly, healthcare has an impact on human capital stock through increase in life expectancy, which in turn enables its accumulation through experience. (Lorentzen et al. 2008) On the other hand, with longevity and aging population typical for many developed countries, and given constant fertility rate, the increase in dependency ratio may cause capital dilution. For this reason, another institutional function that developed are retirement funds.

This incentive further promotes private savings, providing means for more investment project through the credit system. Requirement for such instrument to work is however for-

ward orientation of society, which is rooted in culture and may be difficult to change, especially when redistributive policy not only provides a safe ground in case of layoffs. The same transfer payment also potentially induces increase in opportunity costs of labor, driving unemployment upwards.

Finally, conflict management requires attention, not only to enforce written agreements, but also to establish general rule of law in the country, discouraging behaviors acting against the interests of broad society. Such institution may have positive impact on the degree of trust between individuals and stabilization of cultural values, but may on the other hand increase the degree of cultural fractionization in non-homogeneous societies with conflicting values, and drive social capital downwards. Additionally, particularly strict legal systems may even reduce individuality of society.

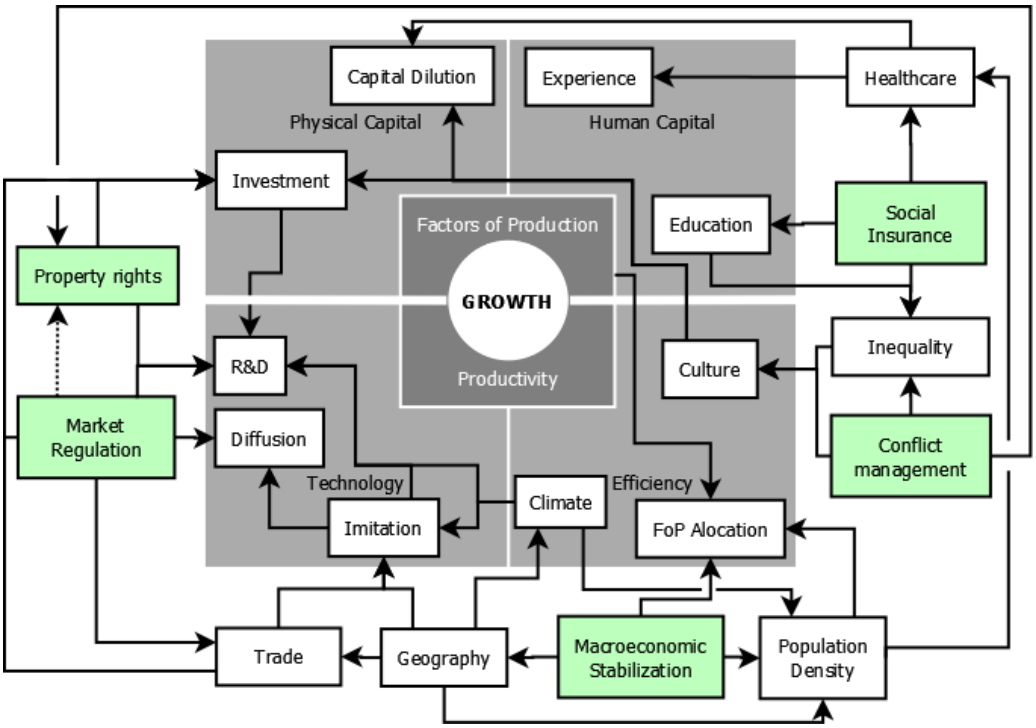

Figure 2: Interaction of Institutions

In summary, economic and political institutions exist to organize society and facilitate total output growth respectively. The key economic policies include property rights enforcement, market regulation, macroeconomic stabilization, social insurance, and conflict management. Essentially, all such economic institutions depend on, and influence, cultural institutions within given country, which is why all must be imposed with awareness of the nature of society. Additional factor determining function of economic institutions is the political system, i.e. a political institution determining time orientation of structural transformation and investment in fundamentals.

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