Chapter 7
Institutions and economics growth

7.1 Institutions: Promoting productive activity and growth

- Institutions are the laws, social norms, traditions, religious beliefs, and other established rules of behaviors that provide the incentives that rational people react to.

- Institutions determine how promptly a society takes advantage of the many opportunities to raise human welfare.

- In order to promote economic growth, institutions should provide incentives for individuals to work hard and save some portion of their incomes, for entrepreneurs to take risks and pursue opportunities, for firms to seek cost reductions and improve their products, and for government policy makers to use tax revenues efficiently, provide public goods, and design cost-effective programs to accomplish well-defined and agreed-to goals.

- Institutions are particularly important for inducing people to engage in productive and innovative activities that add to total output rather than transfer activities that only redistribute output.

- By productive activities we mean activities that result in an increase in the output of welfare-enhancing consumption goods or investment goods.

- Transfer activities are those activities that transfer welfare-enhancing goods from one person or group to another without increasing the total amount of goods produced in the economy.

- Examples of transfers are taxation, government transfer payments theft, begging, fraud, fund-raising, blackmarl, and children's allowances.

- How much effort is directed toward transfers, and how much is directed toward production, directly affects and economy's per capita output of welfare-enhancing goods and services. Many forms of transfer activity can discourage the types of activity that increase the rate of long-run growth of per capita output.

- The most effective institutions are those that lead people to be innovative or productive from a long-run perspective, so that there will be economic growth.

- In countries where property rights are clearly defined and strictly enforced, crime will seldom pay; hence, rational people are more likely to engage in productive activity than in theft.

- However, in countries where the law is not clearly defined or enforced, rational people will more often opt to steal rather that to produce.

- In a lawless economy, the rate of growth and long-run welfare are likely to be much lower because innovation, saving, and investment tend to affected by the lack of protection of property rights.

7.2 Institutions and transaction costs

- According to Douglass North, the fundamental causes of economic growth are the institutions that lower transaction costs.

- Economic growth requires that institutions enable individuals, groups and firms to engage in the necessary exchanges of goods, services, property, and assets.

- In the early stages of economic growth, exchange takes place largely in small communities with common ideologies and common sets of rule and traditions.

- As economic growth occurs, communities become larger, exchanges more complex, and exchanges extend to people in other communities other regions, and other nations.

- There is a used for more sophisticated institutions, some involving a third party such as government.

- However, Douglass North points out two reasons showing that government would not promote efficient institutions like property rights in order to promote economic growth and well being.

i) Rules and the privileged may be able to increase revenue and income by restricting transactions, undermining property rights, or focusing income on certain people or activities that are easy to tax or exploit.

ii) Efficient institutions may not benefit the special-interest groups that are vital for the survival of the ruler or oligarchy. Thus, political expediency cannot ensure economically efficient institutions.

- Douglass North distinguishes four variables that are the most important determinants of transaction costs:

i) The cost of measuring the value of goods and services to be exchanged

It relates to the costs of information about goods and services, about the transactors, their honesty, their ability to pay, and the possibility that they will honor an agreement.

ii) The size of the market

The larger the market, the more likely that transactions occur between people who do not know each other and that two people will never transact again in the future, and thus there is no part experience to draw on and no need to establish a reputation.

iii) The cost of enforcement

As in large markets, when transactions become impersonal, a body of law, courts, and the coercive power of some authority to enforce judgments become necessary if complex transactions are to be carried out.

iv) Ideology and convictions

Transactions will be easier even in impersonal markets if the people transacting share some conviction about the justice and appropriateness of the society and economic system within which they are acting.

However, North suggests that specialization and division of labor may produce contrasting and conflicting views of fairness and justice of institutional arrangements. Hence, transaction costs may be increased.

7.3 How institutions affect economic growth

- If technology is an externality to investment or production, as the investment externalities model and the learning-by-doing model suggest, investment requires the enforcement of contracts, the protection of property rights, and national defense. In addition to facilitating transactions, institutions that help maintain high and stable levels of production improve the learning-by-doing process.

- The Schumpeterian models of technological progress not only point to a need for the enforcement of contracts and protection of property rights, but also insist that there be free enterprise. Barriers to entry must be removed, and entrepreneurs should not be restricted in the type of activities they can undertake.

- Innovation and the creation of new ideas also require other institution such as freedoms to work and promote new ideas.

- Institution should encourage the free flow of ideas from aboard, and this means that international trade and investment should not be curtailed and that the flow of people should be encouraged.

- For example, tax system should not burden successful businesses, nor should they subsidize failing businesses. If new firms are discouraged or prevented from replacing existing firms through innovation, there will be less innovation, and human welfare is the loser when innovation slows or ceases.

7.4 Empirical studies of institutions and economic growth

- Xavier Sala-Martin tested institutional variables that determine the economic ‘climate’, the incentive structure that guides individual actions, the level competition, and government regulation of markets. They all turned to be statistically significant.

- Sala-Martin also found that countries whose populations are mainly Buddhist, Confucian, and Muslim have faster-growing economies, ceteris paribus, while countries whose people are mainly Catholic or Protestant grow more slowly.

- Political variable such as the number of revolutions and coups, war, an index of the rule of law, lack of political rights, and an index of civil liberties (1 is the greatest degree of liberty, 10 is the lowest), all have negative signs.

- Institutions related to international trade and finance representing as the number of years the economy has been opened, the black-market foreign exchange premium (a measure of how much exchange restrictions distort the exchange rate), and another index of exchange-rate distortions, all show statistically significant.

- Some regions such as Latin America and sub-Saharan Africa have more than their share of low-growth economies.

- Hall and Jones found that the institutional variables explain over 75% of the variation in levels of per capital income across countries of the world. If institutions were all the same across countries, the variation in per capital incomes would be less than one-fourth of what we observe.

- Hall and Jones also found that each component of the production function such as total factor productivity, capital, and human capital will be affected by the institutional variables. Hence, poor institutions reduce the amount of capital stock per worker, the amount of human capital per workers, and the total factor productivity (level of technology) of the economy.

- Philip Keefer and Stephen Knack used three sets of qualitative measure of institutions, i.e. measure of the security of property and contractual rights, measures of the rule of law, and measure of the quality of government bureaucracy, to test the statistical significance of institutional variables on economic growth. Their results strongly confirmed that economies that protect property rights, that adhere to the rule of law, and whose bureaucracies are relatively competent catch up to developed countries more rapidly.

- Gwartney, Lawson, and Block sought to define the relationship between economic freedom and economic growth. Among the measures of economic freedom were the legality of holding foreign assets, inflation, the volatility of monetary policy, public spending as a % of GDP, the size of the state-owned sector of the economy, the pervasiveness of price controls, financial regression, barriers to market entry, subsidies and transfers as a % of GDP, marginal tax rates, the seventy of the military draft, the freedom of international trade, and restrictions on international capital flows.

- Their findings point out that the countries ranked in the group of economically free countries grew on average at over 3% during 1975-1995 period. In countries with the lowest grades in economic freedom, per capita output shrank by 1.5% per year during the 1975-1995 period.

- Stanley fisher used three variables to represent the macroeconomic polities of governments. The first two variables are the rate of inflation and the budget deficit reflecting the soundness of monetary and fiscal polities. The third variable is the distortion in the foreign exchange markets relating to international trade and investment policies.

- He found that a stables macroeconomic environment, with a low rate of inflation and a small budget deficit, is conducive to sustained economic growth. Moreover, in his causality testing he also suggests that macroeconomic policy deficits reduce investment and productivity growth.

7.5 The institution of property rights

- One of the important institutions that have enabled economies to carry out more complex transactions and facilitate economic growth is the protection of property rights.

- Property tights eliminate the free-rider problem inherent in any organization where there is communal ownership and a sharing of the profits.

- After 1920, in Mexico land was to be confiscated from large landowners and distributed to cooperatives of peasants, which would administer the land and award parcels for occupancy to individuals. The land would remain in the hands of the cooperative but individuals could continue to occupy their allotted parcels of land as they farmed on land. They could even pass the allotment on to their offspring. But they would be no title of ownership.

- Property rights provide greater freedom of choice because assets can be accumulated as a store of wealth, which can be converted into other assets or consumption as the need arises.

- Property rights permit resources to move more easily from one application to another as an economy grows and changes because property ownership facilitated sales and purchases of assets and productive factors.

- Markets for land, equipment, and materials are not possible without well-defined private ownership, and without markets the transfers needed for the smooth transition of an economy are much more difficult.

- Property ownership also acts as a great incentive for innovation and investment. Costly innovation can occurs only if the entrepreneur is assured the reward of her or his innovative activity.

- Similarly, the saver and investor will tie up their wealth in long-run projects and assets only if their ownership of the projects and assets is ensured.

- Well-defined property rights will promote economic efficiency and economic growth.

7.6 Intellectual property rights and technology

- Copyrights and patents are now referred as intellectual property rights.

- A patent is a formal recognition of one person's invention and the right of that person to the exclusive use and marketing of that invention.

- A copyright gives an author or composer of a creative work the exclusive right to decide how his or her word or symphony is to be used.

- Copyrights and patents had been issued before 1710. There is evidence that the ancient Greeks used patent to encourage innovation. But the practice was not used until 1700s.

- Patents and copyrights make invention and creativity a more lucrative activity, because the property right gives the inventor (1) exclusive use of the new idea and (2) the ability to extract a price from others who can productivity use the idea.

- As Romer suggest, the property rights accorded by a patent or copyright permit the owners of intellectual property rights to recover their up-front costs in the form of monopoly rents or licensing fees from others who can apply the new idea more profitably. Patents and copyrights are an important institution for stimulating technological progress.

- David Gould and William Gruben found that stronger intellectual property rights protection corresponds to higher economic growth rates in a cross-country samples.

- Edwin Mansfield found that foreign direct investment and joint ventures, two channels through which technology can move across borders and thus stimulate economic growth, are directly related to the degree of protection of intellectual property rights.

- Patents and copyrights are not costless institutions. Other institutions should be required such as investigators, police, courts, and prisons. The proper enforcement requires sophisticated institutions and talented people.

- Another difficulty with patents and copyrights is deciding how long the protection of ideas should last. On the one hand, the purpose of patents and copyrights is to provide an incentive for creative and inventive activity, and thus the length of patent and copyright protection determines the reward to inventors and discovers. On the other hand, a longer period of patent protection may not result in faster overall technological progress.

- Naomi Lamoreaux and Kenneth Sokoloff contend that making idea and creations marketable increases the values of an innovation. This also promote the dissemination of ideas to those who are in the best position to exploit them. Hence long-run growth will be increased.

- The Uruguay Round established uniform rules about copyrights and patent in order to replace the diverse sets of national rules that have developed over the past several hundred years.

- The United States has provided patent holders with protection for 17 years following the issurance of the patent. Some European countries offered protection for up to 50 years. Copyrights in the United States protected authors for 50 years after their deaths.

- Developing economies and communist countries had weak or nonexistent patent and copyright protection. Of course, communist governments never encouraged private ownership of anything, especially ideas.

- The differences in patent and copyright laws meant that an author in a country where copyrights were protected might find his or her book pointed without his or her permission in another country where there was no copyright law. Such books could be sold at much lower prices. Such differential treatment of intellectual property reduced the earnings of authors and inventors.

- As for patents, members of the WTO have agreed to provide patent protection for 20 years from the date of application for products and process, with equal treatment for nationals and foreigners. Despite signing the WTO agreement, these terms were very difficult to enforce. The fact is not all countries view patents and copyright from the perspective of long-run economic growth.

- Some countries such as India have openly defied other countries' patents by arguing that their countries' levels of development freed them from the obligation of paying for ideas that are owned by people or corporations in developed economies.

- That is why most developed countries insisted on negotiating a uniform set of rules on intellectual property rights during the WTO's latest trade negotiations.