

Chapter 8

Government Institution And Economic Growth

8.1 Introduction

- The rapidly expanding involvement of governments in economies throughout the world, with government taxation and expenditure as a share of GDP rising from less than 10% of GDP at the turn of century to nearly 50% by the late 1990s in the most developed economies and even approaching 30% in some developing economies.
- The role of government in the economy is not merely to tax and spend part of the economy's income. Government maintains institutions that are very important for economic growth. Protection of property rights, police protection, a judicial system to administer justice and enforce contracts, national defense, and bank regulation are some of the beneficial government activities.
- In fact, the market system could not function without certain government institutions.
- There are also many cases of government failure. The coercive power that government holds over individuals is easily abused.

8.2 The positive role for government

- Adam Smith thought the government should do in order to provide the proper institutional framework for markets to function efficiently.
- Smith's first function of government : “ The duty of protecting the society from the violence and invasion of other independent societies.”
- National defense is a necessary function of government. Without national security, the investment decisions, innovation, and research efforts will not be optimal.
- Smith's second function of government : “ The duty of protecting every member of the society from the injustice or oppression of every other member of it.”
- Financial markets would largely cease to exist if constraints could not be enforced. No one would lend money if there was a high probability that they would not be paid back in the future.

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- Smith's third function of government : “ The duty of erecting and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain.”
- The government, by taxing, can cover the cost of providing public goods such as national defense, the park in the center of the city, police protection, the fire protection, and the national weather service.
- Standard textbook analysis of externalities suggests that in the case of positive externalities, the activity generating the externalities should be subsidized by the government.
- Externalities to investment and production are capable of overcoming diminishing returns to investment. Education, as a positive externality, where the benefits that society gains from people's education exceed the gains to the individual who acquires the education. These positive externalities enhance economic growth.
- External effects on the rate of technological progress from investment suggests that investment subsidies might be called for. Production should be subsidized since nearly everyone in the economy benefits from the learning-by-doing process. The government's best policy is to maintain stable macroeconomic policies that promote full employment and keep output at the maximum level permitted by the available resources and technology.
- Economically efficient change may require the authority and force of government.
- From a growth perspective, discrimination against people with new ideas and entrepreneurial traits can be very detrimental to long-run welfare. Laws and regulations against discrimination could improve the performance of the economy.
- Where markets face several informational problems, the government can play a third-party role of forcing parties to intertemporal transactions to reveal more information. The government can, under the threat of punishment, enforce the requirement that the information revealed be correct and complete.
- A government-operated legal system that enforce contracts can help to eliminate many moral-hazard problems inherent in intertemporal transactions by letting signatures to contracts recover damages when the terms of the contract are not met.
- Moral-hazard problem will hinder financial transactions since when borrowers have

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acquired a loan, they will behave differently than they would without the loan.

8.3 Government failure

- Firstly, government failures come from the lack of information. Government seldom knows enough about the economy and how it will behave in the future to engage long-run welfare-enhancing planning.
- Secondly, government failures come from the diversion of government's power from pursuing the general welfare to promoting the welfare of some at the expense of others.
- If the government has important discretionary power over economic affairs, members of the government can all easily divert that power from its intended public purpose and put it to private use.
- Rent seeking activity is a common occurrence as people attempt to use government power to their advantage.
- Rent-seeking activities are the things that people do in order to gain transfers of wealth at the expense of others.
- In the early 1970s, the Turkish government imposed a policy of restricting imports. Many very talented individuals spend most of their working hours lobbying the government officials who issued import permits.
- The cost of rent seeking in Turkey in the early 1970s may have been as much as 14% of the national product. It added nothing to Turkey's output of welfare-enhancing goods and services but used up resources that could have been used to produce welfare-enhancing goods.
- Some rent-seeking activities are illegal activities such as bribery and threats. Corruption is widespread in many countries of the world.
- So-called under-the-table payments are a common means of getting bureaucrats and politicians to skew government institutions in one's favor. Much corruption is a direct result of the rent-seeking process.
- Paolo Mauro tested the effect of corruption on economic growth by using three measures: (1)

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the integrity of the legal environment and the judiciary, (2) the regulatory environment and “red tape” faced by firms and entrepreneurs, and (3) the predominance of actual corruption and questionable payments.

- Mauro found that corruption is highly significant as an independent variable of economic growth. Further analysis showed that corruption works through investment; the higher is corruption, the lower is investment. Government institutions, and their determination to corruption matter a lot for economic growth.

8.4 Informal economic activity and economic growth

- The coexistence of formal and informal sectors is what happens when rational people in a single economy are constrained by poorly functioning institutions.
- Informal markets are a process that can generate high incomes and low incomes, involves many independent entrepreneurs and workers, and can make substantial contributions to an economy’s total output and people’s welfare.
- The informal sector almost always produces goods and services that are similar, or even identical, to those produced in the formal sector, for example, restaurant meals, haircuts and taxi rides.
- The basic difference between formal and informal activities depends not on the characteristics of the goods and services produced, but on whether the production process conforms with all legal requirements.
- Informal markets are likely to arise in all economic systems. Overall, informal activity is a lower percentage of all economic activity in developed countries.
- Two obvious reasons why developing economies tend to have more informal activity. First, developing economies’ formal institutions are less economically efficient, and second, lower levels of income in developing economies make complying with rules, regulations, laws, and social norms more costly.
- The informal sector can be viewed as favorable to economic growth. Increased transactions permit more specialization and hence, more economic growth.
- Moreover, informal activity as a long-run force that can bring about improvements in a

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country's institutions.

- Informal activity could undermine the gains from rent-seeking activities such as lobbying for government regulations and other forms of protection against competition.
- The informal sector also creates a growing special-interest group that will lobby for change in the existing institutions. The millions of people working in the informal sector would prefer institutions that permit markets to function freely so that their hard work and entrepreneurial activity can be free to function legally.
- Nevertheless, informal economic activity is technically illegal. Informal production and commerce are subject to greater risk. The lack of formal property rights in the informal sector means that intertemporal transactions are difficult.
- Long-term contracts cannot be enforced in the courts, and police protection is often not provided. The lack of formal property rights also means that there is little opportunity for small producers and merchants to grow into larger businesses. Hence, there is less investment and less innovation, and economies of scale cannot be exploited.

8.5 Economic growth, democracy, and freedom

- Some observers believe that both political and economic freedoms are mutually reinforcing. An expansion of political rights, more democracy, fosters economic rights and tend thereby to stimulate growth.
- Political freedoms are the extent of democracy which is measured by the role of elections.
- Economic freedoms are in the form of free markets and small government that focus on the maintenance of property rights.
- The interplay between political institutions and economic outcomes involve the effect of the standard of living on a country's propensity to experience democracy.
- The standard of living can be measured by real per capita GDP, life expectancy, and a smaller gap between male and female educational attainment. These measures are used to predict democracy.
- The Lipset (1959) hypothesis stresses that there is a strong positive linkage from prosperity

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to experience democracy Lipset emphasizes that increased education and an enlarged middle class are receptive to democratic political norms. Private organizations and institutions can check on dictatorship.

- Sometimes, democracies are imposed by former colonial powers or international organizations. Hence, democracy does not sustain. For example, the political freedoms installed in most of the newly independent African states in the early 1960s did not tend to last.
- Some non-democratic places such as Chile, South Korea, Taiwan, Spain, and Portugal experience substantial economic development tending to become more democratic.
- The countries of Central and Eastern Europe have been advanced economically for some time, eventually became more democratic.
- At low levels of political rights, an expansion of these rights stimulates economic growth and investment.
- In extreme dictatorships, an increase in political rights tends to raise growth because the benefit from limitations on governmental power.
- Democratic institutions provide a check on governmental power and thereby limit the potential of public officials to accumulate personal wealth and carry out unpopular policies.
- Once a moderate amount of democracy has been attained, further expansion reduces growth and investment because the dominant effect comes from income redistribution and social programs.
- The success of the Asian Tigers, none of which were democratic countries during most of the period of their rapid growth, led many writers to suggest that autocratic governments may have an advantage in introducing the fundamental changes necessary to bring rapid economic growth.
- The transformation of Chile from a slow grower to an economic success occurred during a repressive military dictatorship.
- However, empirical studies do not support the hypothesis that democracy inhibits economic growth since many writers find that authoritarian governments are repulsive.

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- Based on pre-1980 data, Roger Kormendi and Philip Meguire found a weak positive effect of political freedom on a country's rate of growth.
- They made several empirical studies on the relationship between democracy and economic growth. Their studies have not been able to establish a positive relationship democracy and growth, but neither have they confirmed the original hypothesis of a negative relationship.
- A recent study by John Dawson used data on political freedom and civil liberties but did not find a statistically significant relationship between political freedom and economic growth.
- Dawson finds that economic freedom in the form of free markets and property rights leads to political freedom.
- Robert Barro reports that there is some indication that political freedom is positively correlated with economic growth for lower level of political freedom but is negatively correlated as nations approach full democracy.
- Barro suggests that in places that have already achieved a moderate amount of democracy, a further increase in political rights impairs growth and investment because the dominant effect of democracy on growth comes from the intensified concern with income redistribution.
- Barro found a strong statistical relationship between democracy and prior levels of national income, a finding that, like Dawson's results, suggests that prosperity promotes democracy.
- Adam Przeworski and Perendo Limongi state that we do not know whether democracy fosters or hinders economic growth.
- One cannot conclude that more or less democracy is a critical element for economic growth.
- From empirical studies shown, we can conclude that autocratic and repressive political systems do not have any apparent advantage in generating economic growth.
- Even though democracy does not seem to have a positive influence on growth, economics that grow do tend to become more democratic and to increase their political freedoms.
- China has experienced one of the very highest rates of economic growth over the past two decades. But China is also not a democracy. In 1989, Chinese authority brutally crushed a

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political demonstration in Tiananmen Square, and 10 years later dissidents and religious protectors were still punished for the act of expressing their opinion in public. Can the autocratic government of China maintain its power in the face of continued economic growth?

- Several Asian Tigers have moved toward democracy. Taiwan has a new democracy, Korea has an elected government, Indonesia and the Philippines have made solid strides toward political freedom.
- Government tax revenues have fallen sharply since the inception of market reforms in the late 1970s. The east coast provinces, such as Guangdong, have thrived in the low-tax, free-market environment. Whereas total tax revenue was 31% of national output in 1978 when the reform began, by 1995 it had fallen below 10%.
- The economy grew fourfold since 1978, but tax revenue changed little. With the fear that increased taxes might slow economic growth, the government has stated it does not intend to rescind any of the tax benefits in the near future.
- There are no signs of an impending collapse of the communist government of China. But as the very rapid economic growth continues, will there be political change in China?