

How Is It Possible For The Poor Countries To Become Rich?

Zdravka Nikolova, University Bocconi, Italy, Master of Science in Economics

“Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic”. D. North

1 Introduction

There is a little consensus about the fundamental causes of the large differences in income per capita across countries. However, differences in institutions have received a considerable attention recently. For instance, countries with better institutions with less distortionary policies and more secure property rights will invest more in physical and human capital, and will use these factors more efficiently to achieve a greater level of income per capita (e.g., Douglas C. North and Robert P. Thomas, 1973). Thus poor countries can get rich if they improve the quality of their institutions. For instance, countries that are different for a variety of reasons will differ both in their institutions and in their income per capita¹.

2. Why Are Some Countries Poorer Than Others? Literature Review.

The most important questions that have bothered economists and policy makers in the field of economic growth and development over the years are: Why are some countries poorer than others? Can and how poor countries can get rich? Which is the main factor that determines the growth rate and prosperities of a given country? Classical economists, such as Adam Smith (1776), David Ricardo (1817), and Thomas Malthus (1798), and, much later, Frank Ramsey (1928), Allyn Young (1928), Frank Knight (1944), and Joseph Schumpeter (1934), provided many of the basic ingredients that appear in modern theories of economic growth. These ideas include the basic approaches of competitive behavior and equilibrium dynamics, the role of diminishing returns and its relation to the accumulation of physical and human capital, the interplay between per capita income and the growth rate of population, the effects of

¹For an empirical investigation you can refer to Acemoglu D., Johnson S., Robinson J., 2012, *The Colonial Origins of Comparative Development: An Empirical Investigation*. There the authors provide an empirical investigation about the effects of institutions on income per capita and estimate the impact of institutions on economic performance. They argue that at some level institutions matter. Witness, for example, the divergent paths of North and South Korea, or East and West Germany, where one part of the country stagnated under central planning and collective ownership, while the other prospered with private property and market economy.

technological progress in the forms of increased specialization of labor and discoveries of new goods and methods of production, and the role of monopoly power as an incentive for technological advance. The next and more important contributions were those of Solow (1956) and Swan (1956). One prediction from these models, which has been exploited seriously as an empirical hypothesis only in recent years, is conditional convergence. The lower the starting level of per capita GDP, relative to the long-run or steady-state position, the faster the growth rate. This property derives from the assumption of diminishing returns to capital; economies that have less capital per worker (relative to their long-run capital per worker) tend to have higher rates of return and higher growth rates. Another prediction of the Solow–Swan model is that, in the absence of continuing improvements in technology, per capita growth must eventually cease. This prediction, which resembles those of Malthus and Ricardo, also comes from the assumption of diminishing returns to capital.

3. Financial Integration As A Major Factor For Economic Growth And Per Capita Convergence.

More recently, many scholars sustained the idea that the flow of capitals from more advanced, capital abundant countries to less advanced, capital scarce ones can contribute positively to economic growth and prosperity². Thus international capital mobility facilitates an efficient allocation of savings by channeling financial resources to their most productive uses, thereby increasing economic growth and welfare around the world. Thus the potential advantage of adopting the euro has been perceived as very important for New Member States (NMSs) because it could contribute positively to long term growth and stability. It has great impact on economic performance through several micro and macroeconomic channels: the stability-oriented macroeconomic framework, access to liquid markets, more trade and foreign direct investment, lower transaction costs and increased competition. Thus according to the intertemporal neoclassical model, countries with lower per capita income may attract foreign capital due to higher growth perspectives. They should consume more and save less in anticipation of higher permanent income. Investment is expected to exceed savings, implying external deficit over the catching up process. Instead of convergence, since 1990 the dispersion of the current account deficit among member states has increased sharply. In particular the current account in Greece, Ireland, Portugal and Spain has been increasing while the current account in Finland, Germany, Netherland and Austria has been decreasing (see figure 1). The same patterns can be observed for the countries in Eastern Europe. Over the past fifteen years these countries have transformed from communist states to market economies. Many transition countries run a sizable current account deficit in the context of their catching-up process (see figure 2). Some academics contribute these divergent patterns to the European economic convergence process (Blanchard and

²See Blanchard and Giavazzi (2002). There the authors argue that the fall in the saving investment correlation, particularly marked after the euro, was a positive sign of increasing integration, with the capital flowing from the more advanced, capital-abundant economy to the less advanced, capital-scarce ones.

Giavazzi (2002), Ahearne et al. (2007) and Arghyrou and Chortareas (2008)). The theory of intertemporal maximization suggests that countries with different level of economic development will experience a diverging current account balance as a consequence of a convergence process. In particular when the real and the financial markets are integrated we should expect that countries with a lower GDP per-capita income attract domestic and foreign investment as higher productivity and economic growth promise extra return in the future. Thus the theory suggests that the Southern countries should accumulate more net foreign debt, while the Northern countries should act as their net creditors. This is exactly the case (see figure 3). However, when looking closely at the data we find out that the economic convergence hypothesis does not stand up with empirical facts. For instance, differences in real GDP-per capita are persistent. In particular between 1999 and 2007 we can see that economic integration has triggered almost no real income convergence among North and South (see figure 4). Moreover Southern countries let their competitiveness deteriorate and now exactly those countries suffer more from the crisis.

4. The Role Of Institutions For Economic Growth And Development.

Theory based on capital accumulation, innovations, capital inflows, economy of scale alone cannot explain why some countries produce, export and are more competitive and rich than the others. And if these theories are able to provide a fundamental explanation for economic growth then why technology and innovations developed faster on some continents (countries) rather than on others? A fundamental explanation of comparative growth is differences in institutions. Economic outcomes are determined by the economic institutions in the society. Many scholars such as John Locke, Adam Smith³, John Stuart Mill⁴, Douglas North have emphasized the important role of the economic institutions. They are important because they influence the structure of the economic incentives in the society. For instance, if there is no property rights, individuals will not be willing to invest in physical or human capital or adopt more efficient technologies. Economic institutions plays an important role in the distribution process as they determine who gets profits, revenues and residual rights of control. For instances, if the structure of the market is not perfect, or if the markets are ignored (as it was the case in the former communist countries), then the resources and the gains from trade are not allocated efficiently. Thus some countries are poorer than the others because the former have “worse economic institutions than the others”. Economic institutions, by determining the collective choices of the society influence the economic performance⁵. Hence they are major factor of cross-country differences in economic growth and prosperity. Political

³For instance in his discussion of mercantilism and the role of the markets

⁴See the discussion in Jones (1981): society are economically successful when they have good economic institutions and it is this institutions that are the cause of prosperity.

⁵Both Adam Smith and Alfred Marshall argued that sharecropping was an inefficient way of organizing agriculture because it gave incorrect incentives to tenants

institutions, similar to economic institutions, determine the constraints and the incentives of the major actors in the political sphere⁶. Moreover, political power determines economic institutions. If political institutions place much of the political power in the hands of a single individual or a small group, then economic institutions that provide property rights for the rest of the populations are difficult to sustain. Thus good economic institutions are more likely to arise when political power is in the hands of a broad group with significant investment opportunities. European colonialism can be used as a “natural experiment” to provide an empirical evidence for the role of the economic institutions in determining the long-run growth. We can look at Slovenia as other example: Slovenian’s economy build up internal and external imbalances in the years before the financial crisis. In the years before the crisis there was a rapid growth, credit expansion and strong domestic demand. Slovenia relied mainly on foreign funding. It experienced high real estate price, loss of competitiveness and deterioration in the net international investment position. Friction to the labor market contributed to the slow adjustment. For instance, in construction sector the employment remained at over 70% despite the collapse in investment. The reason for this can be found in the strong labor market protection of permanent contracts.

5. Conclusion

Any society goes through social movements and fads, in which economically useless things become valued or useful things become devalued temporarily. Society adopts an innovation or a solution superior to the existing unsatisfactory technology only if it is compatible with the society’s value. It is not true that there is continents where the society tended to be innovative and continents where society have tended to be conservative⁷. On any given continent at any given time there is innovative society and conservative one. Innovations and capital accumulations are not causes of growth, they are itself growth. The economic growth and prosperity are determined by political power and economic institutions. Institutions actually design the incentive structure of the economy and provide an environment suitable for innovations and technological progress. In this way they help to allocate the resources to their most efficient uses. Thus a poor country can get rich if it creates “good” economic institutions that provide security of property rights and equal access to economic resources to a broad cross-section of society. This does not imply equality of opportunity but it implies that a society where only a small fraction of the population have well-enforced property rights does not have good economic institutions. Economic models, based on preferences, technology and factor endowments alone cannot explain the economic growth and development of a given country. Thus they fail to answer the question how it is possible for a poor country to become rich.

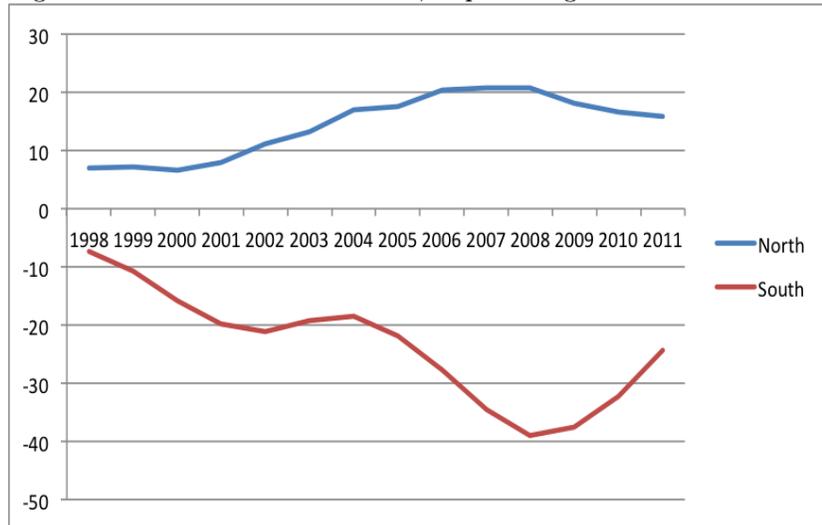
⁶You can see the early work of Perotti (1993), Persson and Tabellini (1994) who developed dynamic models where political mechanisms and outcomes can have important influence on growth rate

⁷For more insight look at “The fates of human society” by J.Diamond

Conflict over resources, production, rent-seeking and redistributive conflict have important implications for growth. Moreover, bad economic institutions, can lead to market imperfections that in turns lead to the existence of multiple Pareto-ranked equilibrium. As a consequence a country can get stuck in a Pareto-inferior equilibrium, associated with poverty.

Figures

Figures 1. Current account balance, in percentage of GDP

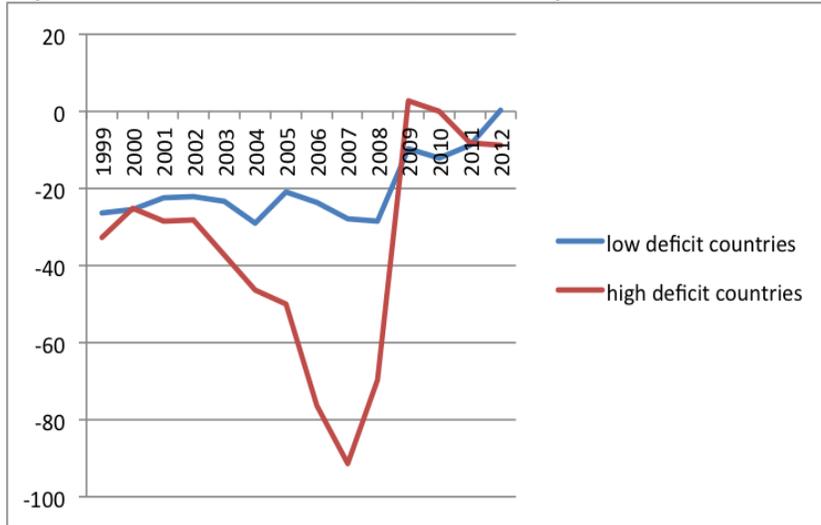


Source: Eurostat

North includes Germany, Austria, Netherlands and Finland

South includes Spain, Greece, Ireland and Portugal

Figure 2. Current account balance, in percentage of GDP

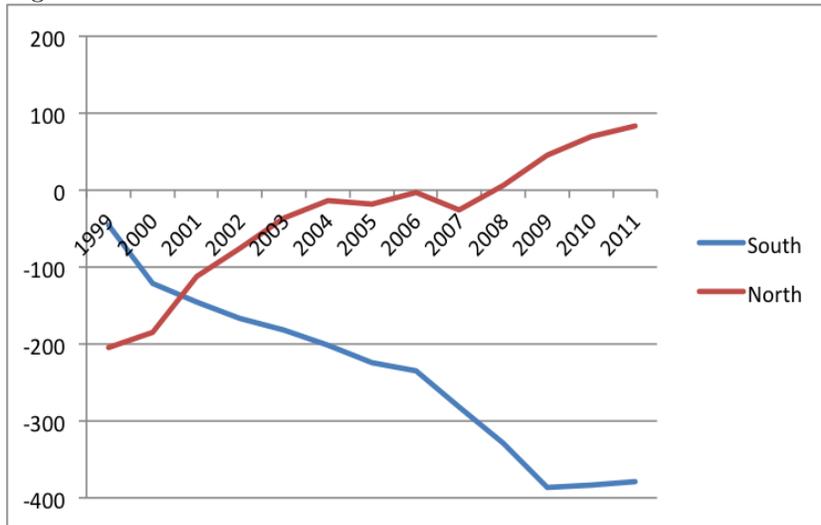


Source: Eurostat,

Low deficit countries: Poland, Slovenia, Slovakia, Hungary, Czech Republic

High deficit countries: Estonia, Latvia, Lithuania, Romania, Bulgaria

Figure 3. Net International Investment Position

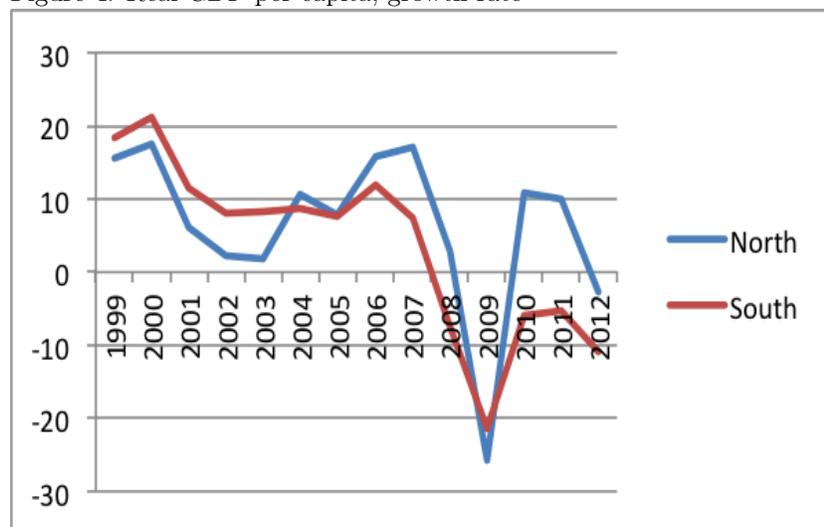


Source: Eurostat,

North includes Germany, Austria, Netherlands and Finland

South includes Spain, Greece, Ireland and Portugal

Figure 4. Real GDP per capita, growth rate



Source: Eurostat,
North includes Germany, Austria, Netherlands and Finland
South includes Spain, Greece, Ireland and Portugal

References

- [1] Acemoglu D., Jhonson, S., Robinson, J.A., 2005, Institutions as a fundamental cause of long-run growth, Handbook of Economic Growth, Vol.1, Elsevier, B.V.
- [2] Acemoglu D., Jhonson, S., Robinson, J.A., 2001, The colonial origins of comparative development: An empirical investigation, American Economic Review 91 (5), 1369-1401
- [3] Alesina, A., Perotti R., 1996, Income distribution, political instability and investments, European Economic Review 40, 1203-1225
- [4] Alfaro, Laura, Sebnem Kalemli-Ozcan, and Vadym Volosovych, 2007, Capital Flows in a Globalized World The Role of Policies and Institutions, University of Chicago Press
- [5] Ahearn, Alan, Birgit Schmitz, Jurgen von Hagen, 2008, Current Account Imbalances in the Euro Area, in Challenges of Globalization, Imbalances and Growth, eds. Andres Aslund and Marek Dabrowski, Peterson Institute for International Economics, Washington
- [6] Barro J., Xavier Sala-i- Martin, Economic Growth, 2004, second edition, MIT press

- [7] Barzel, Y., 2001, A Theory of the State: Economic Rights, Legal Rights, and the scope of the State, Cambridge University Press, New York
- [8] Blanchard, Oliver, Francesco Giavazzi, 2002, Current account deficit in the Euro Area: the end of the Feldstein-Orioki puzzle?, Brookings Papers on economic activity, Vol. 2, pp.147-186, Brookings, Washington
- [9] European Commission, 2010, Quarterly report on the Euro area, The impact of the global crisis on competitiveness and current account divergences in the euro area, Volume 9, No 1
- [10] Hicks, J.R., 1969, A Theory of Economic History, Oxford University Press
- [11] Holinski, Nils, Clemence Kool and Joan Muysken, January/February 2012, Persistent Macroeconomic Imbalances in the Euro Area: Causes and Consequences, Federal Reserve Bank of St. Louis Review, 94(1), pp. 1-20