

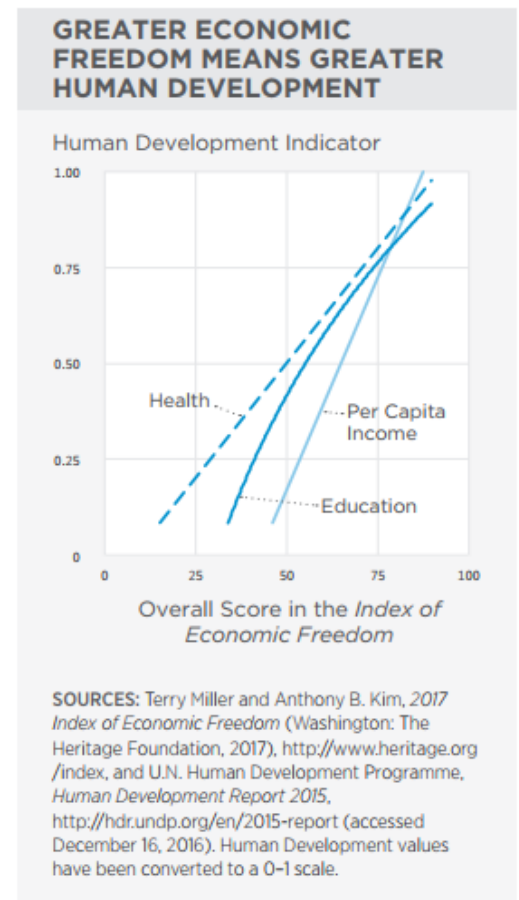
LECTURE 10: GROWTH AND DEVELOPMENT

- I. The Good News
 - a. The good news is that it does not have to be this way.
 - i. Economic growth solves most of the problems of the developing world. Greater material wealth can pay for better roads, sanitation, electricity, education, and so on.
 - ii. South Korea is a good example of this. In the 1950s, it was an incredibly poor country. Now it is one of the wealthiest countries in the world (with incomes comparable to that of the average of the European Union).
 - b. Growth is not a *zero-sum game*: if one group becomes wealthier, other groups don't have to become poorer.
 - i. This is because long term growth comes from greater efficiency, primarily through technology, not from reallocation.
 - ii. Because it's not a zero-sum game, we want all economies (both rich and poor) to grow.
 - iii. But we'd also like stable growth. Long run growth is great, but that's in the long run. In the meantime, people would like to keep their jobs and live lives stable enough so they can plan.
 - iv. Uncertainty is misery, too.
 - c. Not only is growth not a zero-sum game, we don't need a lot of growth to make a big difference.
 - i. *Rule of 70*—remember this? The number of time periods it requires to double a value roughly equals 70 divided by how fast it's growing.
 - ii. Suppose an economy's GDP grows at 7% a year. That means it takes $(70/7=10)$ 10 years for the GDP to double.
 - iii. China's growth rate in 2016 was 6.7%; India's was 7.1%.
 - iv. The US economy grew at 1.6% in 2016; how long would it take our GDP to double at that rate?
 - d. There's yet more good news: poor countries have an easier time growing quickly compared to rich countries.
 - i. It all boils down to decreasing marginal benefit. The benefit in this case is productivity.

- ii. Labor in rich countries tends to have a lot of capital and thus their workers are quite productive (it's one of the reasons wages are high). Giving them more capital increases their productivity, but not by much.
 - iii. But labor in poor countries has little capital and thus cheap labor. Just a small amount of capital creates huge productivity gains. Investment and efficiency follow.
 - iv. It's the difference between getting your first laptop and getting your eighth; which makes you more productive?
 - v. As capital flows into the developing country, wages rise and the marginal productivity of capital falls. Eventually, poor countries catch up to rich countries.
 - vi. China's the current poster-country of the theory of convergence. Its growth rate has been tremendous but lately wages have been increasing. It's no longer the low hanging fruit of production.
 - vii. There are other examples of countries coming up quickly from very low levels of wealth: Germany and Japan after WWII and South Korea, Hong Kong, Singapore, and Taiwan after the Korean War.
- e. So why aren't all countries equally wealthy? That leads us to...

II. Development as Freedom

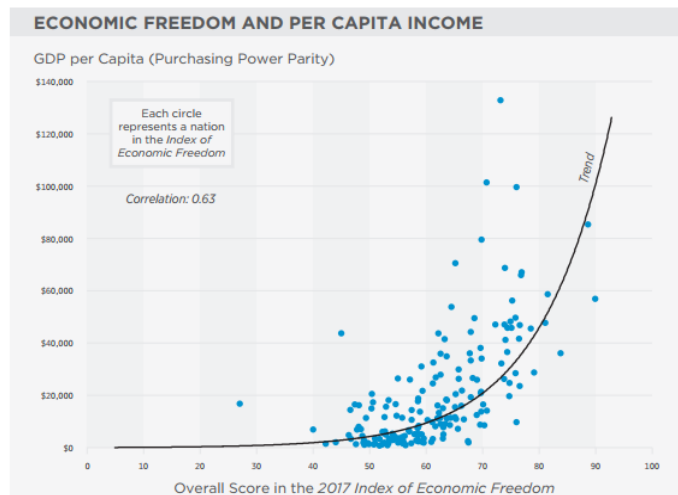
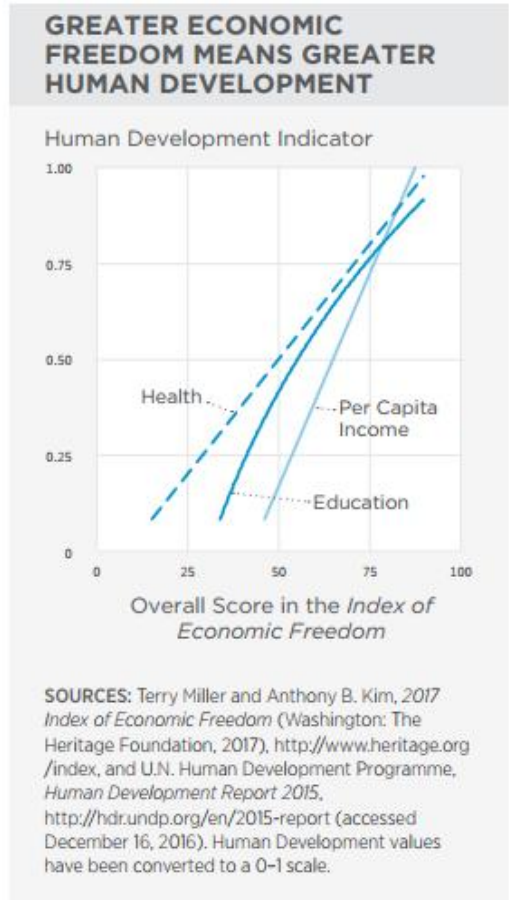
- a. Historically, economic development occurs in free societies. This "free society" can mean a lot of different things and the recipient of the 1998 Nobel Prize in Economics, Amartya Sen, outlined key freedoms needed (each a necessary condition):
 - i. *Political freedoms*. Countries need free and fair elections as well as government transparency. This also includes cultural aspects such as equal treatment and respect.
 - ii. *Economic freedoms*. Citizens need freedom of opportunities which includes free access to credit (borrowing money).



iii. *Quality of life freedoms.* Society needs a social safety net, included basic access to health care, shelter, and food. In order to act on the other two freedoms, people need to be free to live securely.

b. The Economic Freedom Index

- i. Published by the Heritage Foundation, the EFI measures economic freedom on four broad measures: rule of law, size of government, efficiency of regulation, and the openness of the markets.¹
- ii. These measures incorporate a wide variety of considerations, from how much people trust their government to how easy it is to trade with other countries.
- iii. Economic freedom correlates with other important measures, such as life expectancy and average income. These charts are from the 2017 Economic Freedom Index Report.²



¹ <http://www.heritage.org/index/book/methodology>

² http://www.heritage.org/index/pdf/2017/book/index_2017.pdf

- c. This measure doesn't include all of Sen's freedoms but it at least highlights the importance of some of them.

III. The Mystery of Capital

- a. There are many possible reasons for poverty—overpopulation or overwhelming debt—which economists have considered. But few explanations hold as much promise as what Hernando de Soto describes in his landmark book, *The Mystery of Capital*.
- b. De Soto argues physical capital in developing countries is dead. It's an asset, not capital; it can't be used to produce other things. Land is often unregistered, homes are built illegally, and businesses start outside the formal section.
 - i. Without legally recognized collateral or an official address, people can't get a business loan. Without a legal business, they have trouble expanding or selling it. They can't use the court systems. They can't advertise.
 - ii. Recall the key aspect of capitalism: private property which is strictly enforced and clearly defined. The developed world has a solid legal system for this reason.
- c. People don't register their businesses or legally secure their land because it's really, really hard.
 - i. Armed with a research team, de Soto attempted to open a simple garment factory (one employee) in Lima, Peru. Working six hours a day, the team registered the business in 289 days. Similarly disastrous results were repeated with similar experiments in Egypt, the Philippines, and Haiti.
 - ii. So people prefer to work in the extralegal sector (the black market). And it's hard to go back because that involves admitting to the authorities you've been breaking the law.
- d. The key goal, then, is legal reform. But it's very hard as it involves:
 - i. Creating competitors for politically-connected businesses;
 - ii. Changing the minds of the custodians of the current bureaucracy;
 - iii. Titling land and assets based on hundreds of different local customs;
 - iv. Untangling decades or centuries of informal history; and
 - v. Convincing millions to change how they live their lives.
- e. See [this Planet Money episode](#) for an interview with De Soto.