PUZZLING QUESTIONS OF ECONOMIC GROWTH

by Leszek Balcerowicz and Andrzej Rzonca

Observation of economic reality reveals interesting facts and sparks several questions. For example: why did Australia split economically from New Zealand in spite of the fact that the latter is often considered as a paragon of free-market economic reforms? Why did Austria, which maintains state-controlled enterprises, nearly catch Switzerland, which still had at the beginning of the 1970s more than fifty percent higher per capita income? What is the source of difference in economic growth between Estonia and Slovenia? Which of the two attained bigger success in systemic transformation? Why is Mexico so much poorer than Spain, even though in 1960 it was more affluent? Why has Venezuela, which in 1950 enjoyed a per capita income higher than that of Norway's—who currently exports significant amounts of petroleum—became even poorer than Chile? How did it happen then that Venezuelan currency, which until the 1970s was among the most stable in the world, ceased to be respected by Venezuelans themselves? Why did Chile, who during the 1970s and 1980s was strained by harsh crises, surpass other Latin American countries in terms of per capita income? Why did Costa Rica remain behind Puerto Rico even though during the 1970s the latter fell from the 10 fastest growing economies in the world to among the slowest? In what respect does Puerto Rico resemble former East Germany? Why did "communist" China surpass "capitalist" India? Why, in spite of this Chinese economic miracle, is there such disparity in per capita income of mainland China in relation to Taiwan? How did the disparity in income increase from two-fold in 1950 to six-fold in recent years? Why did Pakistan grow so much slower than Indonesia, although in the later country there have been systematic returns to extensive state intervention, and during 1997 and 1998 it experienced one of the most severe crises in the economic history of the world? Why does the Dominican Republic, which resides on the same island as Haiti, attract significantly more tourists than Haiti?

This book attempts to answer these questions. They belong to a larger question, which is at the center of this book also: where do the differences in economic growth come from?

Explaining the causes of these differences is one of the fundamental tasks of economics. This issue is fundamentally important not only from an analytical point of view, but also practically

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Leszek Balcerowicz is the former Deputy Prime Minister and Minister of Finance respected for implementing the Polish economic transformation program. His reforms led to a successful introduction of a market economy, in the 1990s. Between 2001 and 2007 he was the chairman of the central bank of Poland. During this period inflation had been reduced from above 10% a year to about 2%. He is a Chairman of the Board of Bruegel; Head of Institute for Comparative Studies at the Warsaw School of Economics. Balcerowicz is a recipient of twenty honorary doctorates, a member of the Group of Thirty, and a Board member of the Peterson Institute.

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speaking. Economic growth is the only the way for effectively rescuing societies from poverty and for increasing standards of living. As long as the economy grows then income of most members of the society grows as well. For example, income of the poorest one-fifth of South Korea—one of the economic tigers of the world—is approximately four times higher than the income of the most affluent one-fifth on the Korean peninsula prior to the Korean War and it is seven times higher than income earned by the average North Korean. In our book, readers will encounter numerous surprising examples of speedy economic growth and examples to the contrary.

Without economic growth, the only mechanism enabling some to become richer is for others to become poorer. However, when you work towards slicing the income pie, it may lead to a reduction in its size. There are many countries in the world who suffer significantly lower per capita incomes than several decades before! This book allows the reader to be better acquainted with the experience of two such countries: Venezuela and Haiti. Both of these countries have per capita incomes lower than what they had in 1950.

There is a vast amount of research on this subject of economic growth, but much remains to be done. Representatives of a particularly influential school of thought, referred to as “growth theory”, focus on proximate causes of economic growth such as accumulation of capital, increases in employment, and improvements in the productivity of the factors of production, (labor and capital). This theory does not provide—in our view—convincing explanation of the differences between rates of growth. It is because the proximate causes, on which it focuses, require explanation themselves. Because of this weakness in the above paradigm, more and more research searches for deeper causes of the differences in the rate of growth in time and among countries. The studies usually deal with institutions and their systems. Our book belongs to this field of economic research.[1] The reader, however, will also find references to some of the most prominent studies in the area of growth theory. Our own research on economic growth is introduced by a review of other work dealing with this important issue both on theory of economy as well as political economy.

This review allows us to suggest that this book essentially differs from other research dealing with economic growth. Most frequently other books either focus on — what we call — systematic forces of growth, (that is to say those which operate all or most of the time), but neglect breakdowns in growth or analyze various types of shocks, but do not consider their impact on the long term growth problems. Other research either deals with proximate causes of economic growth or with deeper and more complex forces—institutions. Finally, most of other case studies either deal with a larger group of countries or focus on one country (case studies).

Our book differs in every respect from the research mentioned above.

- Systematic forces of growth and effects of various shocks are analyzed here jointly in an integrated context. As it turns out, the differences in the frequency and/or magnitude of shocks, influence the average rate of economic growth, even in the very long run. In

[1] Institutions are more and more frequently considered in models of economic growth, albeit still in very simplified form—most frequently as a singular parameter, in singular equation, whereas in real life they exert complex influence on every kind of economic choice made by enterprises or households.

every comparison of countries analyzed in this book, worse results are always suffered by those countries where there were more frequent or deeper crises. Moreover, among all analyzed countries the worst results were in Haiti and Venezuela, the countries characterized by most frequent crises, while the best results—in China and India which were characterized by high stability of the growth path.

- We concentrate on deeper causes of growth, on institutions in particular, but we also carry out the conventional growth accounting allowing us to identify the proximate causes everywhere where it can contribute to deeper understanding of institutional determinants of growth. Simultaneously we identify situations in which undertaking such an accounting isn't sensible.

- We compare an especially selected pair of nations. As shown in chapter one, such an approach allows us to avoid many weaknesses of standard methods.

The book comprises twelve chapters.

Chapter one serves as an introduction to the broad subject of economic growth. In this chapter we describe the importance of economic growth for the standard of living for societies. We present the differences in the rate of long-term growth both across time and other nations. We point to the significant impact of shocks on the rate of growth. We systematize the research methods on economic growth. Finally, we present the research method applied in this book and introduce conceptual and analytical framework used in further chapters.

Chapter two deals with the impact of institutional systems on the systemic forces of economic growth. We introduce here the distinction between two types of mechanisms of growth: first, the only potentially universal and enduring growth mechanism which is the one based on innovation. Second, situation – specific mechanisms, i.e. those which exist only in some initial situations shaped by some types of institutional systems or distorting economic policies. Those mechanisms are transitional, i.e. they expire after a certain time. We introduce the notion of institutional barriers to growth and the typology of institutional systems incapable of systematic long-term growth. We also identify cases where such growth may be attained. Finally, we define and analyze a set of reforms which are capable of setting in motion the long-term growth.

In chapters three through eleven we analyze periods in which there emerged differences in rates of growth and – as the result – in the per capita income between especially selected pairs of countries: Australia and New Zealand, Austria and Switzerland, Estonia and Slovenia, Mexico and Spain, Chile and Venezuela, Haiti and the Dominican Republic, Puerto Rico and Costa Rica, China and India, and Indonesia and Pakistan. A majority of the cases were selected in such a way as to having —at least at the beginning— many similarities, in particular in factors which are rather difficult to measure, such as culture. Such a selection enables us to isolate important differences in various institutions when considering economic growth. What's more, the entire group of nations considered is diversified enough to enable us to draw certain generalizations regarding key long-term determinants of the rate of growth of per capita income.

Chapter twelve contains a summary. We present here the main findings of the respective comparative studies and we draw conclusions based on the entirety of our research. They can be summarized in the following nine points.

1. Our research shows significant influence of shocks on economic outcomes in almost all considered countries.

2. Even though shocks occurred in the majority of countries studied, they were characterized by varying frequency and magnitude.

3. Those shocks didn't happen by chance. Almost always they were caused by policies of a given country.

4. Economists still don't know sufficiently why institutions responsible for the stability of the economies are not being strengthened even though their weakness has a high social costs. What's worse, our knowledge is also very limited regarding what form of these institutions would most effectively reduce both the frequency and magnitude of economic shock.

5. Specific countries differed significantly, not only in the fragrance or magnitude of shocks related to the institutions responsible for economic stability, but also in the strength of the systematic forces of growth, linked to the strength (or change) in another set of institutional variables which we call 'propelling institutions'. In the countries we've studied, only some changes strengthened these institutions, while in many cases the enacted changes led to their weakening.

6. The mere fact of economic shocks does not diminish the importance of the propelling institutions for economic growth. Differences in these institutions explain to a large extent the increasing or decreasing differences in the income per capita among the studied countries and sometimes they explain the whole difference.

7. The most important propelling institutions, i.e. those which strongly influence long-term rate of growth, are the following ones:

    - the structure of ownership in the economy and more specifically, the share of state-owned versus privately-owned enterprises;

    - the structure of property law, especially the extent of freedom of private entrepreneurship

    - degree of protection of persons' private property rights, including the level of corruption which limit these rights

    - intensity of competition among suppliers, strongly dependant on the extent of economic freedom, including country's ownership structure and the form of property rights.

- fiscal position of the state, which depends primarily on the dynamics of social expenditures in relation to GDP.

8. There exists some states (forms) of propelling institutions which are sufficient to block economic growth, independent of other institutions (institutional growth barriers).

9. The fastest rate of economic growth occurs in those countries which have inherited strongly distortive economic system, and rapidly remove these distortions (i.e. release transitional growth mechanisms) while introducing a package of reforms which is broad enough to set in motion the most important — and potentially — lasting growth mechanism, i.e. that which is based on innovations.

We hope that this book reaches many readers: those who teach economics and their students, policy makers, but also the recipients of these policies, or the broader public. It is our hope that for each of these groups it will be helpful to better understand the causes of economic growth.