

Growth Theory Since Solow and the Poverty of Nations:

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Wealth of Nations

- Enormous variation in the wealth of nations and living standards across the globe.
- What are the causes?
- What can we do about it?
- How do we expect the world distribution of income will change in the future?

Economic Development and Economic Growth

- Two different approaches:
 - Economic development: understand the micro processes keeping poor individuals and nations in poverty.
 - Economic growth: understand the macro process of societies and regions growing and structurally transforming their economies.
- Traditionally viewed as two different subdisciplines of economics.
 - But essentially asking the same questions.
 - More unity...
 - Both in questions and in methods.

Solow Growth Model: Past and Present

- Baseline Solow model; growth driven by:
 - capital accumulation
 - exogenous technological progress
- Augmented Solow model; also
 - human capital

First Conceptual Revolution

- Technology is not exogenous.
 - Arrow in the 1960s: technology and knowledge fundamentally different from other goods.
 - Romer, Aghion-Howitt, Grossman-Helpman: models of endogenous, sustained growth in the long run because of innovation and invention.
 - Equally, perhaps more, important: technologies endogenous because of diffusion and adoption of technologies.

First Conceptual Revolution (continued)

- To understand the wealth and poverty of nations, we have to investigate **technological differences**
- Poor nations are poor because
 - they do not use the best available technologies
 - they do not use their technologies and factors efficiently.
- But why?

Traditional Development Perspective

- Societies are poor because
 - inefficient contractual arrangements
 - dysfunctional credit markets
 - lack of investment in new technologies
 - poor health and human capital
- But why?

Second Conceptual Revolution

- Look for “fundamental” causes of differences in
 - human and physical capital
 - technology
 - market structure
- What could they be?

Competing Views

- **Geography view**: importance of ecology, climate, disease environment, geography, in short, factors outside human control.
- **Institutions view**: importance of man-made factors; especially organization of society that provide **incentives** to individuals and firms.
- **History's accidents**: some countries are unlikely and trapped in underdevelopment.

“Institutions” Matter

- Most plausible fundamental cause: “institutions”
- Change in economic success in many instances (e.g., reversal among former European colonies, growth takeoffs South Asia) evidence against both the geography and historical accidents views.
- Social organizations and institutions likely to be important for the process of development.
- But what are these institutions?
 - Need to be more micro, rather than the macro “catch all” emphasis on institutions.
 - Need [a theory of “institutions”](#).

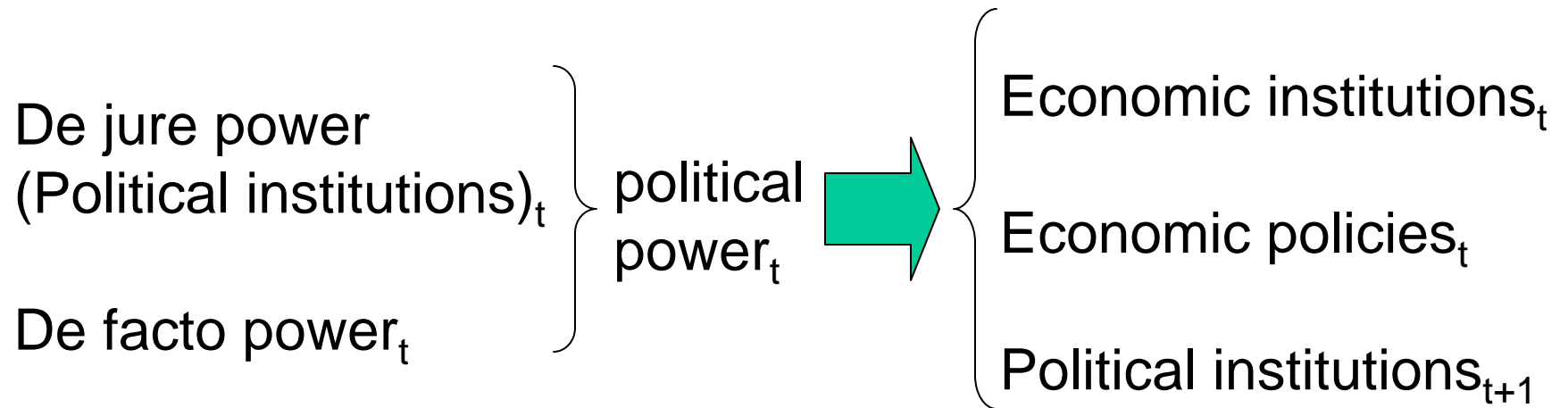
Towards A Theory: Social Conflict and Power

- Economic institutions essential for the prosperity of nations
 - But also benefit different groups and individuals → **social conflict**
- Importance of political power in resolving social conflict
 - **de jure power**, regulated by (political) institutions
 - **de facto power**, brute force, collective action problem, mass movements, guns and violence, paramilitaries...

Towards a Framework

- In the presence of social conflict;
 - political power → economic and political institutions.
 - good institutions emerge when they benefit those with power.
 - political institutions → de jure political power
 - Constraints on elites often conducive to better institutions.
 - de facto political power → political institutions → de jure political power, both today and in the future.
 - Toward a theory of institutional change
 - political power → institutions → political power
 - Source of persistence.

Snapshot Summary



What Can Be Done?

- Important to encourage political reform.
- But how?
- We are far from an answer, but:
 - Success stories: Neo-Europes, South Korea, Taiwan, Botswana, Mauritius, Eastern Europe.
 - Major effects of large reforms;
 - The Glorious Revolution in England
 - The impact of the French Revolution on 19th-century Europe.
- Pitfall to be avoided:
 - Dealing simply with the symptoms not the fundamental causes.
 - Ignoring internal dynamics.

Pitfalls of Reform

- Dealing with the symptoms rather than causes.
 - Example: macroeconomic and exchange-rate policy.
 - Often bad policy outcome of underlying bad “institutions” (political institutions, dist. of de facto and de jure power).
 - Potential for **seesaw effect**
 - Reform in one sphere make things worse in others.
 - Example: Ghana and the exploitation of cocoa producers
 - Reform of distribution of power and deep institutions more important
- Ignoring internal dynamics.

Example of Seesaw Effect (1)

- Washington consensus and anti-inflation policy in Latin America from 1985 onwards
 - Inflation: manifestation of social conflict, redistributive conflicts and weak institutions in 1980s,
 - e.g., “populism”
- End of inflation
 - Anti-inflation policy, independent central banks, and some structural changes (e.g., privatization)
 - But little growth after 10-15 years and continued crises, e.g., Argentina or the Andean region
 - IMF’s ex post assessment for Bolivia: character of state and business environment has not changed
 - In other words, distribution of **de facto power** largely unchanged

Example of Seesaw Effect (2)

- World Bank has made great progress with *Doing Business* indicators;
 - Legal formalism for courts
 - Costs of registering new business
 - Costs of raising credit
- But are these enough?
 - Symptoms versus causes
 - High cost of doing business are symptoms of underlying structural problems and distribution of **de facto power**.
 - Even if push hard on one or more of these dimensions, would this weaken the power of the elite?
 - More comprehensive reforms to change the distribution of power in society by encouraging reform of “deep institutions”

Internal dynamics

- “New Columbia School”: limit interference with independent countries’ institutions
- But all IMF-World Bank involvement has effects on institutions;
 - disastrous effects when aid is poured without thinking of institutional linkages
 - sometime beneficial side effects from micro policies
- The issue is not to ignore internal dynamics
 - Problems in [Iraq](#)
 - Attempts to impose political institutions from outside and above, without thinking through the impact on the balance of power between groups and what the next step will be.

Hope for Development Policy?

- Traditional development economics: much about interventions.
- The political economy dimension cautions against interventions.
- But, still hope for development policy
- Reforms on multiple dimensions to avoid the seesaw effect
 - Deal with causes rather than symptoms
- Understanding the impact of reforms and policies on internal dynamics
- Plenty of success stories giving hope
 - Botswana, Mauritius
 - No radical intervention from outside, but outside help still important
 - Important to end most severe civil conflicts and wars