

## Macroeconomics

### Topic 3: “Explain the importance of institutions, including private property rights, in economic growth.”

Reference: Gregory Mankiw’s *Principles of Macroeconomics*, 2<sup>nd</sup> edition, Chapter 12 (p. 253-4).

We can easily describe the general characteristics that will cause some economies to grow more rapidly than others: the size of the labor force, the accumulation of physical and human capital, its natural resource endowment, and the rate of technological improvement, for example. The growth that an economy experiences will be determined, partly,<sup>1</sup> by the institutions in that economy. A country’s institutions can be thought of as its economic infrastructure.

Suppose in one country that 100 percent of the people believe in a religion in which they are taught that a Great Chicken will see to it that they get everything they deserve without working for it. Furthermore, they should adopt no new ways because it is not the Great Chicken’s will. In addition, this country has an educational system in which 80 percent of the course material is concerned with romantic literature, while only 5 percent of the curriculum is concerned with science and mathematics. The remaining 15 percent is devoted to all other subjects including the history of folk music. If, in another country, the accepted religion teaches that you get what you work for and a much larger percentage of the educational material, 85 percent, for example, is devoted to science, mathematics, and analytical thinking, which country’s economy is likely to grow more rapidly?

We can break institutions down into two types: public and private. Private-sector institutions exist for all sorts of reasons, but they must satisfy their clientele or they will not survive in the long run. It is clear that many, if not most, private-sector institutions have goals other than economic development, a church being one of those, a soccer club another. Interestingly, the more profit oriented a private-sector institution is, the more likely it is to actually try to meet its clients’ demands.

Many private-sector institutions have a direct bearing on economic development. A privately-owned banking system acts to gather the saving (non-consumption) that is carried out by the household and business sectors and lend it to those institutions that want to borrow. If the banking system is looted, as happened three different times under the Suharto regime in Indonesia, for example, then this institution cannot lead to more vigorous economic growth, no matter how effective it is in encouraging saving. If the government directs the banking system to make loans at below market rates to designated borrowers, then the banking system will be inefficient as a financial intermediary and economic development will be slower than it otherwise would be. This latter situation is what happened in South Korea, for example.

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<sup>1</sup> Long run economic growth is also affected by accumulation capital (both physical and human) and by improvements in technology. Please review the gateway topic 2 notes for a discussion of that component of economic growth.

Public-sector institutions play important roles also. Public-sector institutions range from the legislative, executive and judicial branches themselves to governmental groups like the central bank (The Federal Reserve System in the United States), and other agencies.

It is important to note that it is perfectly legitimate for a society to try to attain goals that do not promote economic development. These goals, however, may in fact actually work directly in opposition to economic growth and development. Policies to more evenly distribute income, for example, will generally cause economic growth to be lower than would otherwise be true. Redistributing money from wealthier individuals will tend to cause them to work less hard while giving more to the poor may cause them to work less hard also.

Governments that encourage a smooth transition from one set of office holders to another increase political stability. Changes in government to reflect the society's wishes are important. Office holders who do not face elections (political rigidity) generally become less responsive. Economic development is more probable with political stability and less so with political rigidity.

Governments adopt various policies, and those policies can affect the ability of an economy to grow during the long run. Welfare policies that reward those who do not work because they are disinclined to work will hinder growth. An example would be welfare rules that might keep people on the dole longer than they would otherwise be.

Spending on programs that reward inefficient activity will inhibit economic development. Agricultural subsidies, for example, cause factors of production to be devoted to goods that should not be produced. Imagine the malallocation of resources if the government were to subsidize the production of buggy whips, because existing demand is no longer sufficient to justify a "larger" output of buggy whips; hence, buggy-whip producers are going out of business. All one has to do is substitute rice or cotton for buggy whips.

An important institution is that of justice and the ability through that institution to enforce property rights. Property rights give a person or family or firm the ability to protect what is theirs. For example, assume that your family likes melons as part of its diet. The family has allocated land, which it has prepared for growing melons. It makes certain that the plants are watered regularly, and it protects them against animal predators that also like new leaves and fresh melons. Now assume that across the valley lives the McSlacks, a family not known for its industriousness. It is Mrs. McSlacks' birthday, and the family is throwing a barbecue. The McSlacks decide that melon would be a good dessert during what is forecast to be a very warm evening. Unfortunately, the McSlacks have not raised any melons, but they know where some are.

Property rights give your family the right to do whatever you want with your melons, including telling the McSlacks that they can pick some whenever they wish. On the other hand, property rights also give your family the right to restrict melon consumption to your family alone or to sell any you don't consume at the market held every Saturday

morning. It is your utility from consuming melons or making money by selling melons that is the reward for taking the time and making the effort to raise melons that makes it worthwhile.

Just as important as the existence of private-property rights is that they must be enforceable. If property rights cannot be enforced, then their existence is not worth much. If your family does not have legal recourse to those violating its private property rights, then your family may find itself raising melons for everyone in the neighborhood except itself. The result would be that your family would stop raising melons. Property rights given the holders of copyrights and patents the ability to gain from their work. If you work, then you and those you choose get to benefit. Others cannot sponge off your efforts without your permission. They give your Uncle Fred the right to spend his winnings from the Lotto on whatever he wishes, for example. If he decides to risk part of his winnings and start a business, society will be better off if he guesses right about a profitable business and is successful. Without property rights, he might not be able to do so. Alternatively, it is private property rights that make it financially feasible for pharmaceutical companies to spend great amounts of money trying to come up with a new medicine. Without property rights, it wouldn't pay for a company to spend the funds for research if it couldn't sell the product later without facing competition.

If you have written a book or composed a symphony, you can get a copyright. Most everyone wants to have written a book; they just don't want to write it. They want to have composed a piece of music that others will enjoy; they don't actually want to compose a piece of music. A copyright grants the individual the ability to benefit from those who don't actually do; they just consume.

Property rights grant people the ability to benefit from the gains from their efforts. Remember that individuals respond to incentives and people will generally be as lazy as they can be. Hence, people need incentives to work. Property rights give a person the ability to be rewarded for their work. Generally, the more valuable the work they do, the greater the reward. Hence, economic growth in the long run will be faster with enforceable property rights than without them.

The ability of an economy to develop will be directly related to its institutions. The more institutions a country has that promote development, the more rapidly it will develop. The more effectively institutions operate to promote development, the more robust economic development will be. The opposite conditions also hold. Countries may choose to emphasize any number of goals. If they select goals other than economic development, that is most likely what they will get. costs. Therefore, accounting profits are higher than economic profits.