Political Economic Digest Series-13

Dear Political Economic Digest Series participant,

Welcome back to the new issue of the political economic digest after a break. In this series, we'll be discussing about sources of economic progress for a country. This issue's reading is a chapter from the book called "Common Sense Economics: What everyone should know about wealth and prosperity" written by three prominent economists.

Why do some countries grow rapidly, while others stagnate or even regress economically? Why are incomes per person so much higher in some countries than others? Economists have asked these questions since Adam Smith=s era in the eighteenth century. Capital investment and new technology clearly contribute to growth, but they do not take place in a vacuum. Countries must have certain characteristics that allow their people to interact productively with one another. Sound institutions B the legal rules and customs, both formal and informal, that guide behavior B and sound government policies are the central elements of the growth process. Just as one or two weak players can substantially reduce the overall performance of an athletic team, a counterproductive institution or policy in one or two key areas can substantially harm the performance of an economy. This section will discuss the major factors that underlie the growth process and explain why per capita incomes differ substantially across countries.

1. **Legal system: The foundation for economic progress is a legal system that protects privately owned property and enforces contracts in an even-handed manner.**

The legal system provides the foundation for the protection of property rights and enforcement of contracts. As we discussed in Element 4 of Part I, trade moves goods toward people who value them more and makes larger outputs possible as the result of gains from specialization and large-scale production methods. To reduce the uncertainties accompanying trade, a legal system must provide evenhanded enforcement of agreements or contracts. This will increase the volume of trade and help promote economic progress. The other critical role of the legal system is to protect property rights. Trade depends on property rights, and a legal system must protect property rights if an economy is to prosper. Property is a broad term that includes ownership of labor services and ideas, including religious views, as well as physical assets such as buildings and land. Private ownership of property involves three things: (a) the right to exclusive use, (b) legal protection against invaders B those who would seek to use or abuse the property without the owner's permission, and (c) the right to transfer to (that is, exchange with) another.

Private owners can decide how they will use their property, but private owners are held accountable for their actions. People who use their property in a manner that invades or infringes upon the property rights of another will be subject to the same legal forces that protect their own property. For example, private property rights prohibit me from throwing my hammer through the screen of your computer, because if I did, I would be violating your property right to your computer. Your property right to your computer restricts me and everyone else from its use without your permission. Similarly, my ownership of my hammer and other possessions restricts you and everyone else from using them without my permission.

The important thing about private ownership is the incentives that emanate from it. A legal system that protects property rights and enforces contracts in an evenhanded manner provides the foundation for capital formation and gains from trades, which are the mainsprings of economic growth. In contrast, insecure property rights, uncertain enforcement of agreements, and legal favoritism undermine both investment and gains from trade. Throughout history, people have tried other forms of ownership such as cooperatives, socialism, and communism. These experiences have ranged from unsuccessful to disastrous. To date, we do not know of any institutional arrangement that provides individuals with as much freedom and incentive to serve others by using resources productively and efficiently as does private ownership within the framework of the rule of law.

2. Competitive markets: Competition promotes the efficient use of resources and provides a continuous stimulus for innovative improvements.

Competition occurs when there is freedom of entry into a market and alternative sellers are present. Rival firms may compete in local, regional, national, or even global markets. Competition is the lifeblood of a market economy.

Competition places pressure on producers to operate efficiently and cater to the preferences of consumers. Competition weeds out inefficient producers. Firms that fail to provide consumers with quality goods at competitive prices will experience losses and eventually be driven out of business. Successful competitors have to outperform rival firms. They may do so through a variety of methods, including quality of product, style, service, convenience of location, advertising, and price, but they must consistently offer consumers at least as much value as is available from rivals.

What keeps McDonald’s, General Motors, or any other business firm from raising prices, selling shoddy products, and providing lousy service? Competition provides the answer. If McDonald's fails to provide a tasty sandwich at an attractive price delivered with a smile, people will turn to Burger King, Wendy's, Subway, Dairy Queen, and other rivals. Even the largest firms will lose business to small upstarts that find ways to provide consumers with better products at lower prices. For example, when Wal-Mart was nothing more than a few small stores in the south; Sears were a retailing giant. Firms as large as General Motors and Ford will lose customers to Honda, Mazda, Toyota, and other automobile manufacturers if they fall even a step behind in providing the type of vehicle people want at competitive prices.

Competition gives firms a strong incentive to develop better products and discover lower-cost methods of production. Because technology and prices change constantly, no one knows precisely what products consumers will want next or which production techniques will minimize costs per unit. Competition helps discover the answer. Is retail marketing over the Internet the greatest new idea since the shopping mall? Or is it simply another dream that will soon turn to vapor? Competition will provide the answer.

In a market economy, entrepreneurs are free to innovate; they need only the support of investors (often including themselves) willing to put up the necessary funds. The approval of central planners, a legislative majority, or business rivals is not required. Nonetheless, competition holds entrepreneurs and the investors who support them accountable, because their ideas must face a "reality check" imposed by consumers. If consumers value the innovation enough to cover its costs, the new business will prosper. But if consumers find that the new product is worth less than its costs, the business will fail. Consumers are the ultimate judge and jury of business innovation and performance.

3. **Limits on Regulation: Regulatory policies that reduce trade also retard economic progress.**

As we previously noted, trade promotes social gain B a larger output and more income than would otherwise be achievable. When governments limit cooperation through trade, they stifle economic progress. Governments stifle trade in various ways. First, many countries impose regulations that limit entry into various businesses and occupations. If you want to start a business or provide a service, you have to acquire a license, fill out forms, get permission from different bureaus, show that you are qualified, indicate that you have sufficient financing, and meet various other regulatory tests. Some officials may refuse your application unless you are willing to pay a bribe or contribute to their political coffers. Often well-established and politically influential businesses that you would be competing against can successfully oppose your application.

Hernando de Soto, in his revealing book The Mystery of Capital, reports that in Lima, Peru, it took 289 days for a team of people working six hours a day to meet the regulations required to legally open a small business producing garments. (In an earlier book, The Other Path, he revealed that along the way, ten bribes were solicited and on two occasions it was necessary to pay the bribes in order to get permission to operate legally.) In many cases, if you are financed with foreign capital you face an additional maze of regulations. Policies of this type reduce the freedom of exchange by stifling business competition, encouraging political corruption, and driving decent people into the underground (or what de Soto calls the "informal") economy.

Second, regulations that substitute political authority for the rule of law and freedom of contract will tend to undermine gains from trade. Several countries make a habit of adopting high-sounding laws that grant political administrators substantial discretionary authority. For example, in the mid-1980s customs officials in Guatemala were permitted to waive tariffs if they thought that doing so was in the "national interest."

Such legislation is an open invitation for government officials to solicit bribes. It creates regulatory uncertainty and makes business activity more costly and less attractive, particularly for honest people. The law needs to be precise, unambiguous, and nondiscriminatory. If it is not, it will be a major roadblock to gains from trade.

Many countries have imposed regulations that interfere with and undermine the use of contracts, or voluntary agreements to deal with various issues. This has been particularly true in the labor market. Minimum wage legislation, forcing collective bargaining agreements on non-consenting parties and dismissal regulations substitute government regulations for contractual agreements. A number of European countries require employers who want to reduce the size of their work force to (a) obtain permission from political authorities, (b) notify the dismissed employees months in advance, and (c) continue paying the dismissed employees for several more months. These regulations may appear to be in the interests of workers, but the secondary effects must be considered. Regulations that make it costly to dismiss workers also make it costly to hire them; employers will be reluctant to take on additional workers because of the costs they will have to incur. As a result, the growth of employment in countries that impose extensive labor market regulations will be stifled. It will be very difficult for new labor force entrants to find jobs, and high unemployment rates, particularly for workers under age 35, will result. Indeed, the restrictive labor market regulations of most Western European countries are the primary reason why their unemployment rates have been 4 or 5 percentage points higher than the United States during the last couple of decades.

4. **An efficient capital market: To realize its potential, a nation must have a mechanism capable of allocating capital into wealth-creating projects.**

   Consumption is the goal of all production. However, to increase production it is sometimes necessary to use resources to build machines, heavy equipment, and buildings that will produce the desired consumer goods. Capital investment (the construction and development of long-lasting resources designed to help us produce more in the future) is an important potential source of economic growth. Resources (such as labor, land, and raw materials) used to produce these investment goods will be unavailable for the production of consumer goods If we consume all that we produce, no resources will be available for investment. Therefore, investment requires savings (giving up current consumption). Someone (either the investor or someone willing to supply funds to the investor) must save in order to finance investment. Saving is an integral part of the investment process. Not all investment projects, however, are productive. An investment project will enhance the wealth of a nation only if the value of the additional output derived from the investment exceeds the cost of the investment. When it does not, the project is counterproductive and reduces wealth. Investments can never be made with perfect foresight, so even the most promising investment projects will sometimes fail to enhance wealth. To make the most of its potential for economic progress, a nation must have a mechanism that will attract savings and channel them into the investments that are most likely to create wealth.

In a market economy, the capital market performs this function. The capital market, when defined broadly, includes the markets for stocks, real estate, and businesses, as well as loanable funds. Financial institutions such as stock exchanges, banks, insurance companies, mutual funds, and investment firms play important roles in the operation of the capital market.

Private investors such as small business owners, corporate stockholders, and venture capitalists place their own funds at risk in the capital market. Investors will sometimes make mistakes; sometimes they will undertake projects that prove to be unprofitable. If investors were unwilling to take such chances, many new ideas would go untested and many worthwhile but risky projects would not be undertaken.

In a world of uncertainty, mistaken investments are a necessary price that must be paid for fruitful innovations in new technologies and products. Such counterproductive projects, however, must be brought to a halt. The capital market assures that this will happen over time. Private investors will stop wasting their funds on projects they come to recognize as unprofitable and unproductive. They have a strong incentive to search for the best information, to insist on a flow of accounting information from the firms they invest in, and to monitor closely the projects using their funds.

Given the pace of change and the diversity of entrepreneurial talent, the knowledge required for sound decision making about the allocation of capital is far beyond the scope of any single leader, industrial planning committee, or government agency. Without a private capital market, it is hard to see how investment funds could be consistently channeled into wealth-creating projects.

When investment funds are allocated by the government rather than by the market, an entirely different set of factors comes into play. Political influence rather than market returns will decide which projects will be undertaken. Investment projects that reduce rather than create wealth will become far more likely.

5. Monetary stability: Inflationary monetary policies distort price signals, undermining a market economy.

First and foremost, money is a means of exchange. It reduces transaction costs because it provides a common denominator into which all goods and services can be converted. Money also makes it possible for people to gain from complex exchanges involving the receipt of income or payment of a purchase price across lengthy time periods. And it provides us with a means to store purchasing power for future use. Money is also a unit of accounting that enhances our ability to keep track of benefits and costs, including those incurred across time periods.

The productive contribution of money, however, is directly related to the stability of its value. In this respect, money is to an economy what language is to communication. Without words that have clearly defined meanings to both the speaker and listener, communication is impossible. So it is with money. If money does not have a stable and predictable value, it will be difficult for borrowers and lenders to find mutually agreeable terms for a loan; saving and investing will involve additional risks; and time-dimension transactions (such as payment for a house or automobile over time) will be fraught with additional danger. When the value of money is unstable, many potentially beneficial exchanges are not made, and the gains from specialization, large-scale production, and social cooperation are reduced.

There is no mystery about the cause of monetary instability. Like other commodities, the value of money is determined by supply and demand. When the supply of money is constant or increases at a slow, steady rate, the value or purchasing power of money will be relatively stable. In contrast, when the supply of money expands rapidly and unpredictably compared to the supply of goods and services, the value of money declines and prices rise. This often happens when governments print money or borrow from a central bank in order to pay their bills.

Politicians often blame inflation on such scapegoats as greedy businesses, powerful labor unions, big oil companies, or foreigners. But this is a ruse – a diversionary tactic. Persistent inflation has a single source: rapid growth in the supply of money. A nation’s money supply is its currency, checking accounts, and traveler’s checks. When that supplies increases faster than the growth of the economy, the result is inflation, a general increase in prices.

Inflation undermines prosperity. When prices increase 20 percent one year, 50 percent the next year, 15 percent the year after that, and so on, individuals and businesses are unable to develop sensible long-term plans. The uncertainty makes the planning and implementation of capital investment projects extremely hazardous. Unexpected changes in the inflation rate can quickly turn an otherwise profitable project into a personal economic disaster. Rather than dealing with these uncertainties, many decision makers will simply forgo capital investments and other transactions involving long-term commitments. Some will even move their business and investment activities to countries with a more stable environment. As a result, potential gains from trade, business activities, and capital formation will be lost.

Also, when governments inflate, people will spend less time producing and more time trying to protect their wealth. Since failure to accurately anticipate the rate of inflation can devastate one's wealth, individuals will divert scarce resources away from the production of goods and services and into learning more about the future rate of inflation. The ability of business decision makers to forecast changes in prices becomes more valuable than their ability to manage and organize production. Funds will flow into investments like gold, silver, and art objects, on the hope that their prices will rise with inflation, rather than into more productive investments such as buildings, machines, and technological research.

As resources move from more productive to less productive activities, economic progress slows.

6. Low tax rates: People will produce more when they are permitted to keep more of what they earn.

When high tax rates take a large share of income, the incentive to work and use resources productively declines. The marginal tax rate is particularly important. This is the share of additional income that is taxed away at any given income level. For example, in the United States in 2003, if a taxpayer with $40,000 in income earned an extra $100, he or she had to pay $25 of that $100 in tax. The taxpayer faced a marginal tax rate of 25 per cent. As marginal tax rates increase, the share of additional earnings that individuals are permitted to keep goes down.

There are three reasons why high marginal tax rates will reduce output and income. First, high tax rates discourage work effort and reduce the productivity of labor. When marginal tax rates soar to 55 or 60 percent, individuals get to keep less than half of their additional earnings. When people are not allowed to keep much of what they earn, they tend not to earn very much. Some, perhaps people with working spouses, will drop out of the labor force to work at home where their work is not taxed. Others will simply work fewer hours, retire earlier, or take jobs with longer vacations or a more preferred location. Still others will be more particular about accepting jobs when unemployed, refuse to move to take a job or to gain a pay raise, or forget about pursuing that promising but risky business venture. High tax rates can even drive a nation's most productive citizens to countries where taxes are lower. These substitutions will reduce the size and productivity of the available labor supply, causing output to decline.

Of course, most people will not immediately quit work, or even work less diligently, in response to an increase in the marginal tax rate. For a person who has spent years training for a particular occupation, the best choice is probably to continue working B and working hard B especially if that person is in the peak earning years of life. But many younger people who have not already made costly investments in specialized training will be discouraged from doing so by high marginal tax rates. Thus some of the negative effects of high tax rates on work effort will be delayed for years.

High tax rates will reduce productivity and gains from trade in other ways, too. Employment taxes (or payroll taxes) drive a wedge between the employer's cost of hiring a worker and the employee's take-home pay. The employer pays more to employ this worker than the worker receives in pay. As this gap becomes larger, employment will decline as the cost of hiring increases and some workers leave the work force or shift to the underground economy, even though legal protections are less certain and property rights less secure.

High tax rates will also cause some to shift to activities in which they are less productive because they do not have to pay taxes on them. For example, high taxes will drive up the costs of skilled painters, perhaps leading you to paint your own house, even though you lack the skill to do it efficiently. Without high tax rates, the professional painter would do the job at a cost you could afford, and you could spend your time doing work to which you are better suited.

Second, high tax rates will reduce both the level and efficiency of capital formation. High tax rates repel foreign investment and cause domestic investors to search for investment projects abroad where both taxes and production cost are lower. This reduces investment and the availability of productive equipment, which provide the fuel for economic growth. Domestic investors will also turn to projects that shelter current income from taxation and away from projects with a higher rate of return but fewer tax avoidance benefits. These tax shelters enable people to gain personally from projects that do not enhance the value of resources. Scarce capital is wasted and resources are channeled away from their most productive uses.

Third, high marginal tax rates encourage individuals to consume tax-deductible goods in place of nondeductible goods, even though the nondeductible goods may be more desirable. When purchases are tax-deductible, individuals who purchase them do not bear their full cost, because the expenditure reduces the taxes they would otherwise pay. When marginal tax rates are high, tax-deductible expenditures become relatively cheap. In the United Kingdom in the 1970s, the British-made luxury car, Rolls Royce, was very popular. One reason may have been that marginal tax rates were as high as 98 per cent. When someone facing that rate could buy a car as a tax-deductible business expense, why not buy the most expensive car? Such a purchase would reduce the owner's taxable income enough to cover almost all of the cost. After marginal tax rates fell to 70 per cent, it is said that sales of Rolls Royces went down dramatically.

7. **Free trade: A nation progresses by selling goods and services that it can produce at a relatively low cost and buying those that would be costly to produce.**

The principles involved in international trade are basically the same as those underlying any voluntary exchange. As is the case with domestic trade, international trade makes it possible for each of the trading partners to produce and consume more goods and services than would otherwise be possible. There are three reasons why this is so.

First, the people of each nation benefit if they can acquire a product or service through trade more cheaply than they can produce it domestically. Resource endowments differ substantially across countries. Goods that are quite costly to produce in one country may be economical to produce in another. For example, countries with warm, moist climates such as Brazil and Colombia find it advantageous to specialize in the production of coffee. People in Canada and Australia, where land is abundant and population sparse, tend to specialize in land-intensive products, such as wheat, feed grains, and beef. The citizens of Japan, where land is scarce and the labor force highly skilled, specialize in manufacturing such items as cameras, automobiles, and electronic products for export.
Trade will permit each of the trading partners to use more of its resources to produce and sell things it does well, rather than having them tied up producing things at a high cost. As

the result of this specialization and trade, aggregate output increases and people in each country are able to achieve a higher standard of living than they could otherwise attain.

Second, international trade allows domestic producers and consumers to benefit from the economies of scale typical of many large operations. This point is particularly important for small countries. With international trade, domestic producers can operate on a larger scale and therefore achieve lower per-unit costs than would be possible if they were solely dependent on their domestic market. Trade makes it possible for the textile manufacturers of Hong Kong, Taiwan, and South Korea to enjoy the fruits of large-scale production. If they were unable to sell abroad, their costs per unit would be much higher because their domestic textile markets are too small to support large, low-cost firms in this industry. With international trade, however, textile firms in these countries are able to produce and sell large quantities and compete effectively in the world market.

International trade also allows domestic consumers to benefit by purchasing from large-scale producers abroad. Given the huge design and engineering costs of planes today, for example, no single country is likely to buy enough planes from one company to cover the full cost of their production. With international trade, however, Boeing and Airbus can sell many more planes, enough to cover their production costs. As a result, consumers in every nation can fly in planes purchased economically from such large scale producers.

Third, international trade promotes competition in domestic markets and allows consumers to purchase a wider variety of goods at lower prices. Competition from abroad keeps domestic producers on their toes. It forces them to improve the quality of their products and keep costs down. At the same time, the variety of goods available from abroad provides consumers with a much greater array of choices than would be available without international trade.

The experience of the U.S. automobile industry illustrates this point. Faced with stiff competition from Japanese firms during the 1980s, U.S. automobile manufacturers worked hard to improve the quality of their vehicles. As a result, the reliability of the automobiles and light trucks available to American consumers, both those made abroad and those made domestically, is almost certainly higher than it would have been without competition from abroad.

Governments often impose regulations that restrain trade. These can be tariffs, quotas, exchange rate controls, or bureaucratic regulations on importers or exporters. All increase transaction costs and reduce the gains from exchange. As Henry George noted in the quote above, trade restraints are like a military blockade that a nation imposes on its own people. Just as a blockade imposed by an enemy will harm a nation, so too will a self-imposed blockade in the form of trade restrictions.

Non-economists often argue that import restrictions can create jobs. When analyzing this view, it is important to keep in mind that it is production that really matters, not jobs. If jobs were the key to high incomes, we could easily create as many as we wanted. All of us could work one day digging holes and the next day filling them up. We would all be employed, but we would also be exceedingly poor because such jobs would not generate goods and services that people value.

If we are going to achieve higher living standards, we must expand the availability of goods and services that people value. Trade helps us do so. When residents are permitted to trade with whomever they want, domestic consumers can find the lowest prices and the most value from their expenditures. Similarly, domestic producers can sell their goods and services wherever they can get the highest prices for the value they produce. As a result, consumers get more for their money, and resource owners produce more goods and services that people value. It is this expansion in production and consumption, not just jobs, that underlies higher income levels and living standards.

Food for thought

1. After reading the above text, how do you relate the above mentioned principles in the context of Nepal? Are they the reasons for Nepal's poor economic performance?