

WHY GROWTH RATES DIFFER

The question why some countries are growing faster than the others is the central one in economics. It is in fact the old question about the nature and the causes of the wealth of nations (Smith, 1776). In retrospective view of economic growth this question is often formulated as “why the West got rich before the Rest?” and “why some developing countries are catching up with the West, but others do not?” Unfortunately, there is no consensus among economists what exact policies are needed for engineering high growth (Popov, 2011).

Many agree that institutions is the crucial factor of economic growth in the long term (Rodrik, Subramanian, and Trebbi, 2002; Rodrik, 2004), but there is less agreement on what determines the institutional strength. This chapter uses objective measures of the institutional capacity (shadow economy and murder rate) to trace the trajectories of institutional developments in the Global South and discusses the hypotheses to explain these trajectories.

Growth, policies and institutions

Here we consider only state institutions, or to be more precise – state institutional capacity defined as the ability of the state to enforce rules and regulations. Subjective measures of the state capacity – indices of government effectiveness, rule of law, corruptions, etc. – have a number of shortcomings (Popov,

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2011b), so I suggest objective indicators, such as crime rate, murder rate², the share of shadow economy – the ability of the state to enforce its monopoly on violence and monopoly on taxation.

The general rule is that developed countries, East Asia, South Asia and MENA countries have murder rates of 1-10 murders per 100,000 inhabitants and shadow economy of less than 30% of GDP, whereas in SSA, Latin America and some former Soviet Union republics (Baltics, Belarus, Kazakhstan, Moldova, Russia, Ukraine) the murder rate is higher by the order of magnitude (10-100 murders per 100,000) and the shadow economy is way over 30% of GDP. Economic growth in large regions of the Global South correlates strongly with the murder rate and shadow economy (negative correlation – the higher the murder rate and the shadow economy, the lower is growth). East Asia is ahead of everyone in terms of growth, followed by South Asia and MENA, while Latin America, SSA and FSU are falling behind.

In fact, the murder rate and the share of the shadow economy – the objective indicators of the institutional capacity of the state – turn out to be the best institutional predictors of the long term growth rates of GDP per capita. In regressions for over 50 years (1960-2013) for 80 countries for which data are available, up to 40% of variations in GDP per capita growth are explained by the level of development (GDP per capita) and institutional indicators (murder rate and share of shadow economy). These regressions are quite robust and hold for different sub-periods (1960-75, 1975-2000, 2000-13). Among variables that are not directly related to growth, such as investment rate, population growth rates, etc., state institutional capacity turns out to be the single most important predictor of growth.

The negative relationship between growth rate and state institutional capacity as measured by the murder rate and the share of shadow economy is obvious too.

The usual objection to these regressions is that institutional capacity variables are endogenous, i.e. not only they influence growth, but are influenced by growth themselves. The data for the murder rate and for the shadow economy are for the

² Crimes, especially non-violent, are registered better in developed countries than in developing countries. Here I use the murder rate – in most countries grave crimes, like murders, are registered most accurately.

years of 2002 and 2005 respectively – the very end of the investigated period of economic growth (1960-2013), which may be a problem since the cause should of course precede the effect in time. However, the data on murders and shadow economy for the earlier period are largely missing³ and it is possible to run reasonable cross-country regressions (40 observations) only for the very recent short period. The results for growth in 2000-13 period with data on shadow economy and murders for the 1990s are very strong, but the period is too short to proxy long term growth.

The standard way to deal with the endogeneity is to look for the instrumental variables, but it is virtually impossible to find such variables for institutions that are not correlated with growth. It is possible though to argue that murder rates did not change much in recent half century, and in this case the endogeneity argument does not hold: the murder rate is not influenced by economic growth or is influenced so little that changes during half a century are not significant. In most countries the murder rate did not change much in 1960-2013. Exceptions are countries/territories affected by turmoil, wars and/or transition from communism to capitalism (Northern Ireland in the 1960s, Cyprus in the 1970s, Russia and former Soviet republics in the 1990s – neither of these experienced fast growth).

The crucial question then is what determines institutional capacity of the state, if not economic growth. Why some countries have strong institutional capacity for many decades and enjoy rapid growth, whereas others are locked in a trap with poor institutions and low growth?

Genesis of institutions

There are two major schools of thought that offer different answers to these questions (see Popov, 2014, for description and references), one recognizes key role of institutions, the other – does not. One (evolutionary or Western) school hypothesizes states that countries that we now call developed, or the West, acquired

³ For 20-30 observation, these regressions hold for 1975-2013 period with data on shadow economy and murders for the middle of the growth period – the 1990s.

in the 16th century and afterwards some features and institutions that were absent in more traditional societies (Landes, 1998; Mokyr, 2002—to name just a couple of contemporary authors). The list of these features ranges from abolition of serfdom and protestant ethics to protection of property rights and free universities.

Another school (Oriental) questions the logic of evolution triggered by social forces themselves (Diamond, 1997; Pomerantz, 2000; Wong, 1997 – once again, just to give several contemporary examples) and pays special attention to seemingly minor historical events—fortunate and unfortunate, but mostly accidental – that pre-determined the development of countries and continents for centuries to come. “In this view, – explain the editors of the book that examines important unrealized counterfactuals in human history, – Western dominance was the by-product of natural forces that reflect no credit on Western civilization: geographical accidents such as location of mountains and coastlines, geological accidents such as the ready availability of coal or gold or arable land, climatological accidents such as the timing of the ice ages or the direction of the ocean currents, and biological accidents (not always so accidental) that affect the susceptibility of various population groups to lethal diseases” (Tetlock, Lebow, Parker 2009)

In recent decades the rise of Asia gave additional credibility to theories that reject the superiority of Western economic model and the inevitability of the Western success. “As Japan, the Asian Tigers and China developed into major economic powers, - writes Ian Morris, – more and more scholars concluded that theories explaining West’s success through long-term cultural, environmental, or racial causes simply could not be right. The big story in the world history, they began suggesting, was not the long-term inexorable rise of the West; it was the tale of multipolar world, which the West had only recently, temporarily, and perhaps even accidentally come to dominate” (Morris, 2013, p. 2).

The problem with these explanations is that there were many countries before the 16th century with social structures that possessed or were conducive to many of the same features that are credited for the growth acceleration by the Western school and with many minor accidental events that are said to promote growth by the

supporters of the Oriental school. But these countries never experienced productivity growth comparable to the one that started in Britain and the Netherlands in the 16th century and later – in the rest of Europe (0.2-0.3% a year in 1500-1800 and 1% and more a year afterwards).

A different interpretation accepted in this paper is that dismantling traditional collectivist institutions in Western countries was associated with increased income inequality and even decrease in life expectancy, but allowed the redistribution of income in favor of savings and investment at the expense of consumption (Popov, 2014). The elimination of collectivist (community) institutions was a risky experiment that put masses of population below the subsistence minimum and caused a reduction or slowdown of growth of the population – the foundation of the military might (number of people – number of soldiers) in the Malthusian growth regime.

Early attempts to ensure the priority of the rights of individual over the rights of the community at the expense of collective interests and low inequality (Greece, Rome, Byzantine) led to the impoverishment of the masses, higher mortality and foreign conquest. Only in Northwest Europe in the 16-18th centuries this policy somehow succeeded for the first time in history.

It is not the abundance of competition or entrepreneurship or ideas for technological innovations that allowed the West to accelerate the growth rates of productivity by the order of magnitude, it is first and foremost the abundance of savings and investment that resulted from growing income inequalities and allowed to increase the capital/labor ratio and to cast in metal the ideas for new products and technologies. To put it differently, the West became rich not due to its inventiveness and entrepreneurial spirit, but due to cruel and merciless dismantling of community that previously provided social guarantees to the poorest.

When the same pattern was applied to developing countries (through colonialism — Latin America, Sub-Sahara Africa, or voluntary Westernization in an attempt to catch up – Russian Empire), it resulted in the destruction of traditional institutions, increase in income inequality, and worsening of starting positions for catch-up development. This group of countries replicated the Western exit from the

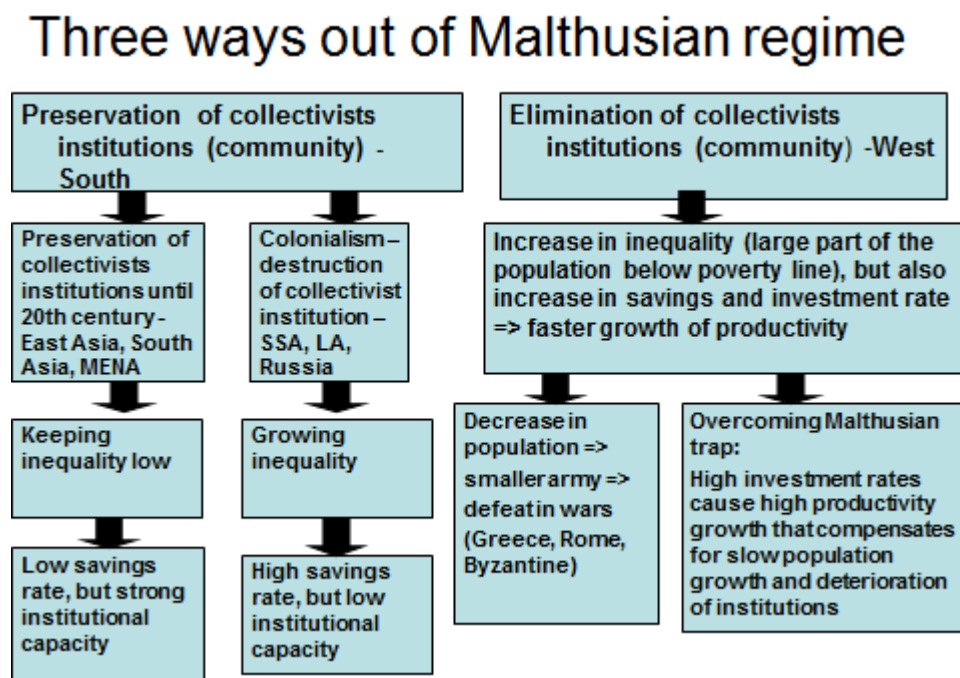
Malthusian trap – they experienced immediate increase in income differentiation, the rise in savings and investment and in the growth of productivity, but at a price of rising social inequality and deterioration of institutional capacities.

Other developing countries (East Asia, South Asia, and Middle East and North Africa – MENA) were less affected by colonialism and managed to retain their traditional institutions. This delayed the transition to modern economic growth (Kuznets, 1966) until mid-20th century, but allowed to preserve good starting position for economic growth – low inequality and strong institutions. Eventually slow technical progress allowed them to find another (and less painful) exit from the Malthusian trap—increased income permitted to raise the share of investment in GDP without major increase in income inequality, without worsening of institutional capacity and decrease in life expectancy.

More Westernized countries of the Global South (LA and Russian Empire) raised their savings-investment rate and exited Malthusian trap earlier than the others, in the 18th century, but at a price of undermining necessary conditions for future growth – low inequalities and strong institutions. So LA and Russia experienced some acceleration of growth afterwards, but it was not enough to catch up with the West. Colonization of SSA (except for South Africa), unlike colonization of LA and Westernization of Russia, did not result in any considerable transfer of technology and human capital, but only increased inequalities and undermined institutions. So SSA countries were disadvantaged on all counts and had the worst growth record in the world. On the contrary, most of less Westernized countries of East and South Asia and MENA managed to preserve low inequality and efficient collectivist institutions. Their savings-investment ratios stayed at a level below 10% until mid-20th century, so they did not grow before that, but once saving started to increase gradually, it turned out they have all preconditions for fast growth. Some of them became economic miracles, rapidly catching up with the West (East Asia), others were speeding up their development in recent decades (South Asia), while others (MENA countries) are probably best positioned to accelerate their economic growth in the future.

The general model of global divergence is presented at the scheme below (Popov, 2014). Like all schemes this one is a simplification: it does not allow capturing all the diversity of circumstances, but allows tracing the main factors responsible for changes. The fact is that today there are two major groups of developing countries: one (East and South Asia, MENA) has relatively low inequalities, strong state institutions (low murder rate and share of shadow economy) and high savings and investment rate, the other (Latin America, Sub Sahara Africa, Russia and some former Soviet republics) has high inequalities, weak state institutions (high murder rate and shadow economy) and low savings and investment rate. Quite predictably the first group grows faster than the second.

Scheme. Explanation of the global divergence in growth since the 1500s



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