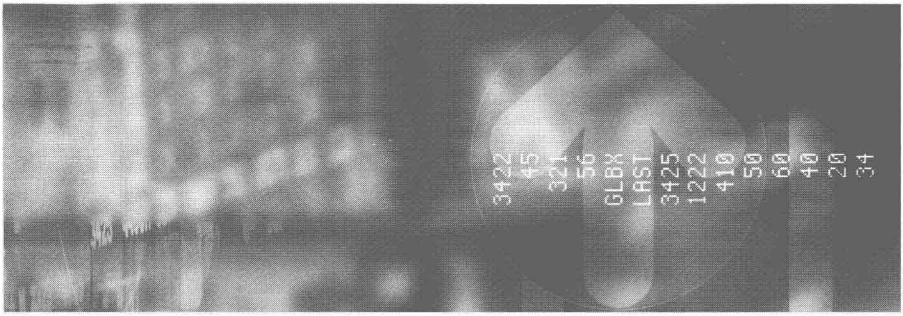
The Economics of MACRO issues

OGER LEROY MILLER
ANIEL K. BENJAMIN

The Economics *of* MACRO issues



Roger LeRoy Miller
Institute for University Studies
Arlington, Texas

Daniel K. Benjamin
Clemson University
and PERC, Bozeman, Montana

PEARSON
Addison
Wesley

Boston San Francisco New York
London Toronto Sydney Tokyo Singapore Madrid
Mexico City Munich Paris Cape Town Hong Kong Montreal

Editor-in-Chief: Denise Clinton
Acquisitions Editor: Adrienne D'Ambrosio
Editorial Assistant: Jonathan McCarey
Managing Editor: James Rigney
Senior Production Supervisor: Katherine Watson
Marketing Manager: Stephen Frail
Design Manager: Regina Hagen Kolenda
Cover Designer: Regina Hagen Kolenda
Digital Assets Manager: Jason Miranda
Senior Manufacturing Buyer: Hugh Crawford
Production House: Orr Book Services
Composition and Prepress Services: Parkwood Composition
Printer and Binder: Courier Westford
Cover Photo: © 2002 PhotoDisc

ISBN: 0-321-19751-8

HB171.M544 2002
330.973'0931–dc21 2002025585
1 2 3 4 5 6 7 8 9 10—CRW—07 06 05 04 03

Dedication

To Morris Lauterman,

Thanks for your support when
I requested it and thanks
for your continuing friendship.
Good guys don't come in last,
they come in first.

R.L.M.

To Donna Benjamin,

With admiration and gratitude for all you do,
especially your intensive work
with the three boys in your life.

D.K.B.

Preface

If you were to do a careful review of front-page stories in newspapers over the last few years, you would be struck by the prominence of macroeconomic issues. Indeed, changes in the unemployment rate, inflation, the federal budget deficit, the international balance of payments, interest rates, and Social Security seem to dominate the economic news.

What we find surprising is the air of certainty that reporters, politicians, and commentators exhibit when they discuss macroeconomic issues. This is particularly disturbing because, for the most part, macroeconomic discussions in the mass media are not only far from accurate but, in many instances, dead wrong. Reporters and politicians have been subjected to so many myths about macroeconomic issues over the years that, typically, they have become unable to distinguish the true from the false. A few examples should whet your appetite.

- Consider Social Security. You will find out in Chapter 13 that, despite regular news stories pinpointing the date on which the Social Security Trust Fund will run out of funds, there is no possibility that the trust fund will ever go bankrupt. Why? For the simple reason that the Social Security Trust Fund is a paper fiction that has no bearing on who is eligible for Social Security or how great their benefits will be.
- You will discover in Chapter 25 that every time politicians try to help out domestic industries by imposing extra taxes or quotas on imported goods, they actually damage the overall state of the economy—making the average American worse off. The fact is this: we pay for imports by exports. Therefore, when we reduce imports, we ultimately reduce exports, reduce employment in export industries, and make ourselves poorer.
- Even though you routinely see and hear in the media that the Federal Reserve System (called the Fed) decides what interest rates are, nothing could be further from the truth. As you will learn in Chapter 20, the Fed ultimately has *no* control over the inflation-corrected rate of interest (the so-called real rate of interest).

In general, an analysis of macroeconomic issues requires only basic economic concepts, ones that are universal across time, cultures, and economies and can be used in debates about appropriate national economic policies. The chapters that follow are neither complex nor difficult. Good economics–like all good science–is simple, and we have subjected our writing to this same test.

We hope that you have as much fun reading this book as we had writing it. Both of us have worked on macroeconomic issues for many years. We continue to do so because we are optimists. We believe that the more people know how to analyze national economic problems, the greater the chances that correct policies will be put into effect.

A number of reviewers thoroughly read and commented upon the manuscript of this book. They include

Harjit K. Arora *Le Moyne College*
Thomas Dee *Swarthmore College.*
Andrew R. Herr *St. Vincent College*
William H. Rogers *University of Northern Colorado*
Charles T. Rubin *Dusquesne University*
Robert D. Seeley *Wilkes University*
Alex Tabarrok *George Mason University*
Richard Vogel *Farmingdale State University of New York*

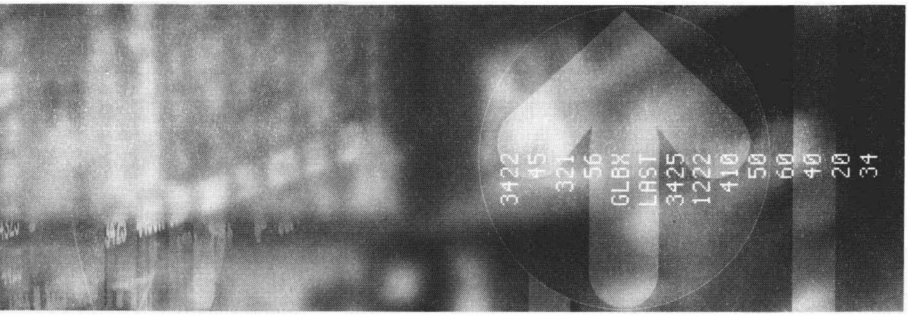
Although we have not been able to incorporate all of their comments, our attempts to do so have markedly improved the final product. All errors remain, of course, solely ours.

Our special thanks go to Sue Jasin of K&M Consulting for her expert typing and editing and Robbie Benjamin for her unstinting demand for clarity of thought and exposition. We also wish to thank our editors at Addison Wesley, Adrienne D'Ambrosio, Victoria Warneck, and Rebecca Ferris, for their encouragement and help in this project. Finally, we thank John Orr of Orr Book Services for his expert and rapid production job on this project.

R.L.M.
D.K.B.

Contents

PART ONE



The Miracle of Economic Growth

1

Rich Nation, Poor Nation

Why do the citizens of some nations grow rich, while the inhabitants of others remain poor? Your initial answer might be, "because of differences in the **natural resource endowments** of the nations." It is surely true that ample endowments of energy, timber, and fertile land all help increase wealth. But natural resources can be only a very small part of the answer, as witnessed by many counterexamples. Switzerland and Luxembourg, for example, are nearly devoid of key natural resources, and yet decade after decade, the real incomes of citizens of those lands have grown rapidly, propelling them to great prosperity. Similarly, Hong Kong, which consists of but a few square miles of rock and hillside, is one of the economic miracles of the last century, while in Russia, a land amply endowed with vast quantities of virtually every important resource, most people remain mired in economic misery.

Unraveling the Mystery of Growth

A number of recent studies have begun to unravel the mystery of economic growth. Repeatedly, they have found that it is the fundamental political and legal **institutions** of society that are conducive to growth. Of these, political stability, secure private property rights, and legal systems based on the **rule of law** are among the most important. Such institutions encourage people to make long-lived investments in improvements to land and in all forms of physical and human capital. These investments raise the **capital stock,** which in turn provides for more growth long into the future. And the cumulative effects of this growth over time eventually yield much higher standards of living.

Professor Paul Mahoney of the University of Virginia, for example, has studied the contrasting effects of different legal systems on economic growth. Many legal systems around the world today are based on one of two basic models: the English **common law system** and the French **civil law system.** Common law systems reflect a conscious decision in favor of a limited role for government and emphasize the importance of the judiciary in constraining the power of the executive and legislative branches of government. In contrast, civil law systems favor the creation of a strong centralized government in which the legislature and the executive branch have the power to grant preferential treatment to special interests. Below we show a sample of common law and civil law countries:

Differing Legal Systems

Common Law Nations	**Civil Law Nations**
Australia	Brazil
Canada	Egypt
India	Germany
Israel	Greece
New Zealand	Italy
United Kingdom	Mexico
United States	Sweden

The Importance of Secure Property Rights

Mahoney finds that the security of property rights is much stronger in nations with common law systems, such as England and its former colonies, including the United States. In nations such as France and its former colonies, the civil law systems are much more likely to yield unpredictable changes in the rules of the game–the structure of **property and contract rights.** This in turn makes people reluctant to make long-term fixed investments in nations with civil law systems, a fact that ultimately slows their growth and lowers the standard of living of their citizens.

The reasoning here is simple. If the police will not help you protect your rights to a home or car, you are less likely to acquire those assets. Similarly, if you cannot easily enforce business or employment contracts that you make, you are much less likely to make those contracts–and thus less likely to produce as many goods or services. And if you cannot plan for the future because you don't know what the rules of the game will be in ten years, or perhaps even one year from now, you are far less likely to make the productive long-term investments that require years to pay off. Common law systems seem to do a better job at enforcing contracts and securing property rights and thus would be expected to promote economic activity now and economic growth over time.

When Mahoney examined the economic performance of nations around the world from 1960 until the 1990s, he found that economic growth has been one-third higher in the common law nations with their strong property rights than it has in civil law nations. Over the 30-plus years covered by his study, the standard of living–measured by real per capita income–jumped more than 20 percent in common law nations compared to civil law nations. If such a pattern persisted over the span of a century, it would produce a staggering 80 percent real-per-capita-income differential in favor of nations with secure property rights.

Other Institutions Are Important Too

Economists William Easterly and Ross Levine recently have taken a much broader view, both across time and across institutions, assessing the economic growth of a variety of nations since their days as colonies. These authors examine how institutions such as political stability, protection of persons and property against violence or theft, security of contracts, and freedom from regulatory burdens all contribute to sustained economic growth. They find that it is key institutions such as these, rather than natural resource endowments, that explain long-term differences in growth and thus present-day differences in levels of real income. To illustrate the powerful effect of institutions, consider the contrast between Mexico, with a per capita real income of about $9,400 today, and the United States, with a per capita real income of about $38,200. Easterly and Levine conclude that if Mexico had developed with the same political and legal institutions that the United States has enjoyed, per capita income in Mexico would today be *equal* to that in the United States!

The Historical Roots of Today's Institutions

In light of the tremendous importance of institutions in determining long-term growth, Easterly and Levine go on to ask another important question: How have countries gotten the political and legal institutions they have today? The answer has to do with disease, of all things. The 72 countries examined by Easterly and Levine are all former European colonies, where a variety of colonial strategies were pursued. In Australia, New Zealand, and North America, the colonists found geography and climate that were conducive to good health. Permanent settlement in such locations was attractive, and so the settlers created institutions to protect private property and curb the power of the state. But when Europeans arrived in Africa and South America, they encountered tropical diseases—such as malaria and yellow fever—that produced high mortality among the settlers. This discouraged permanent settlement and encouraged a mentality focused on extracting metals, cash crops, and other resources. This in turn provided little incentive to promote democratic institutions or stable long-term property rights systems. The differing initial institutions helped shape economic growth over the years, and their persistence continues to shape the political and legal character and the standard of living in these nations today.

No Property Rights Means No Property

Recent events also illustrate that the effects of political and legal institutions can be drastically accelerated—at least in the wrong direction. When Zimbabwe won its independence from Britain in 1980, it was one of the most prosperous nations in Africa. Soon after taking power as Zimbabwe's first (and thus far only) president, Robert Mugabe began disassembling that nation's rule of law—tearing apart the institutions that had helped it grow rich. He reduced the security of property rights in land and eventually confiscated those rights altogether. Mugabe also has gradually taken control of the prices of most goods and services in his nation and even controls the price of its national currency, at least the price at which Zimbabweans are allowed to trade it. The Mugabe government has also confiscated large stocks of food and much of the value of anything that might be exported out of or imported into Zimbabwe. In short, anything that is produced or saved has become subject to confiscation, so the incentives to do either are—to put it mildly—reduced. As a result, between 1980 and 1996, real per capita income in Zimbabwe fell by one-third, and since 1996 it has fallen by an additional one-third. Unemployment is rampant, investment nonexistent, and in 2003 the inflation rate in Zimbabwe passed the 200 percent per year mark. In less than 25 years, the fruit of many decades of labor and capital investment has been destroyed, because the very institutions that made that fruit possible have been eliminated. It is a lesson we ignore at our own peril.

For Critical Analysis

1. Consider two countries, A and B, and suppose that both have identical *physical* endowments of, say, iron ore. But in country A, any profits that are made from mining the ore are subject to confiscation by the government of A, while in country B, there is no such risk. How does the risk of expropriation affect the *economic* endowments of the two nations? In which nation are people richer?
2. In light of your answer to the previous question, how do you explain the fact that in some countries there is widespread political support for government policies that expropriate resources from some groups for the purpose of handing them out to other groups?