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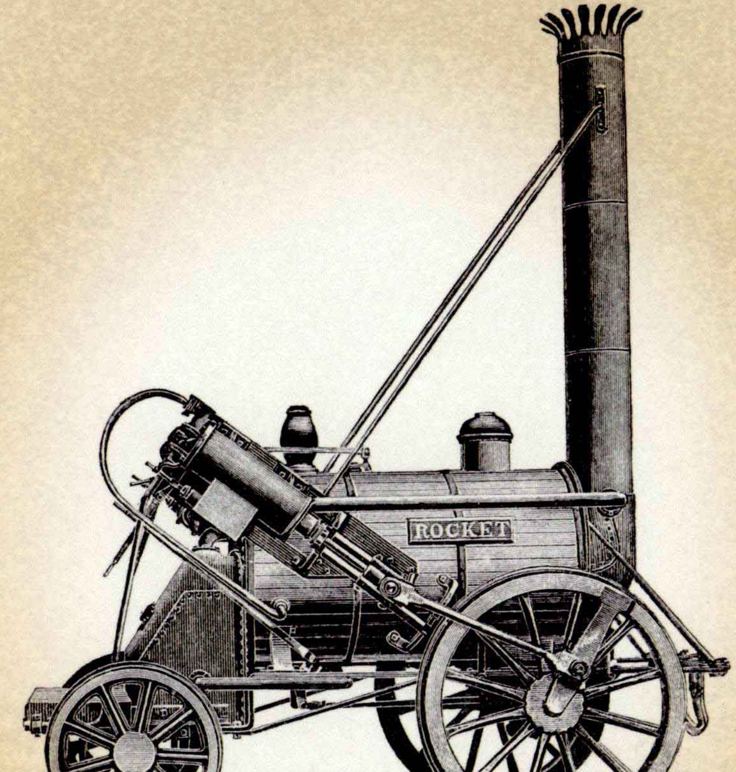
Exploring Root Causes

SAMBIT BHATTACHARYYA



Growth Miracles and Growth Debacles

Exploring Root Causes

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Preface

> No new light has been thrown on the reason why poor countries are poor and rich countries are rich.
> Paul Samuelson (1976), *Illogic of Neo-Marxian Doctrine*, p. 107.

Wide variations in living standards are observed across countries. Going further back in time, we notice that this variation is largely attributable to economic performance across countries since the start of the sixteenth century and not just how they performed post-Second World War. This book presents, in two parts, a detailed account of this process of divergence, the data involved and policies for the future. The first part opens with theories of institutions, geography, human capital, trade, religion and culture, and state formation and war explaining this divergence. Following which, it discusses some empirical results and illustrates the difficulties in quantifying the relationships between root causes and economic development. The novelty of the book is the 'unifying framework' which explains the process of development in Western Europe. This framework is also compared with growth narratives in other countries and continents namely Africa, China, India, the Americas, Russia and Australia. A narrative style is adopted throughout to create a bridge between the empirical literature and history. The 'unifying framework' is an attempt to merge all seemingly disparate theories of economic progress. The main message is that diseases and geography matter at an early stage of development. Institutions, however, become much more important as the economy develops. Geography and, in particular, disease epidemics are a crucial explanator of lack of development in Africa. In contrast, in China and India, the Malthusian population growth and disease cycle was broken fairly early and institutional weaknesses played a crucial role in their respective declines. In the Americas and Australia, colonial institutions were a crucial factor. In Russia, it was crippling political institutions of the nineteenth century and restrictive political and economic institutions of the Soviet Union that did the damage.

The second part of the book focuses on growth promoting policies. First, it documents some macro evidence on the role of policy in yielding growth. It shows that trade can benefit nations in situations when institutions are adequately strong. Property rights and contracting institutions are good for growth. Market stabilizing institutions are good for growth and regulations are important only up to a certain extent. Second, it outlines growth promoting policies namely the 'first principles of growth'. They are property rights, contracts, regulatory institutions, rule of law, macroeconomic stabilization, representative politics, human capital investments, market access and international trade. Third, it discusses the cases of India and China, two recent success stories. It shows how these countries have preserved incentives for private investments even without rigidly following the first principles. But more importantly, they have been able to create institutions which are well grounded in local traditions and culture and are also able to create appropriate incentives for investments. Fourth, the book outlines steps that could be taken to facilitate growth in situations of state failure, disease trap, poverty trap and scarcity of skilled workers.

Acknowledgements

I gratefully acknowledge discussions with my colleagues and friends at different stages of development of this project. In particular, I would like to thank Jeffrey Williamson and Tim Hatton for sparing their time to discuss some aspects of this project. I would also like to acknowledge help and encouragement from Prema-chandra Athukorala. I have benefited from comments by and discussions with Akihito Asano, John Braithwaite, Steve Dowrick, Gary Magee, Mark Rogers and Jonathan Temple. I also gratefully acknowledge financial support from Jonathan and Jennifer Oppenheimer. Last, but not least, I would like to thank my wife and family for their love, affection and words of encouragement. The majority of the manuscript was written when I was a research fellow at the Arndt-Corden Division of Economics of the Australian National University.

Contents

1. Introduction

Hidaya Mohamed is a fifth grade student. She dreams of going to the Benjamin Mkapa Secondary School, one of the better government schools in her town, but no one in her family has received secondary education before. Her older brother does not go to school and her sister is in a government primary school. Her mother, a single parent, earns a living selling maandazi (traditional buns) which is not enough to finance Hidaya's dream. 'I don't think I can go there,' reflects Hidaya. 'My mother can't pay her contribution and I don't know who can help me.'[1]

Hidaya's family resides in Tanzania. The average income per capita in Tanzania today is $1141, which is approximately one-sixty-third of what it is for Luxembourg, the richest nation in the world.[2] Tanzania is poor in spite of its rich natural resource endowments of diamonds, gold, iron ore, coal, natural gas and nickel. Tanzanian soil is suitable for coffee, cotton and clove plantations. In spite of all this, the Tanzanian development record is disappointing. A colonial history marred with slave trade reveals a very sad tale of exploitation and underdevelopment. Even after independence in 1961, things did not change much. Almost all of the small and big development initiatives of the government in independent Tanzania culminated in disastrous failures. One of the better known accounts of disaster is that of the Morogoro Shoe Factory. The Morogoro Shoe Factory was established in Tanzania with the help of the World Bank in the 1970s. It was endowed with labour, machinery and the latest shoe-making technology. But it hardly produced any shoes, only utilizing 4 per cent of its capacity, largely due to the absence of production incentives for the firm (Easterly, 2001). The plant was not well designed either. It had aluminium walls and no ventilation system, which was unsuitable for the Tanzanian conditions. After two decades of struggle, production finally stopped in 1990.[3] Tanzania now stands as one of the poorest countries in the world, struggling with poverty, high infant mortality, HIV/AIDS and malaria. By 2001, Tanzania had accumulated external debt worth $6.7 billion which was cancelled under the Heavily Indebted Poor Countries (HIPC) Initiative.[4] The Tanzanian economy in its current state cannot generate enough wealth to ensure a decent living standard for someone like Hidaya. Hidaya's story is not unique. There are many more like Hidaya in the poor tropics and subtropics whose minimum aspirations cannot be fulfilled because their respective economies fail to generate enough wealth for them.

The obvious question that follows is the most common yet crucial in the field of economic development. Why is there a 63-fold difference in income per capita between Luxembourg and Tanzania? The question is common because it has been addressed by social scientists on numerous occasions over the last 50 years. However, it is important to note that this debate is far from being over. It is perhaps fair to say that we are only starting to understand the complex process of development. It is crucial because it has the potential to improve living standards and reduce the proportion of people who are suffering from starvation, poverty and deprivation.

In the past, the main focus of the literature was to discover and evaluate proximate causes (physical capital accumulation, technological progress and so forth). In recent years, however, there has been a welcome shift in the focus. Economists have stressed the importance of root causes (institutions, human capital, religion and culture, openness to trade and geography) in their quest for growth. Ever since Francois Quesnay wrote about the giant economic machine in 1763, the development literature has always been in search of the factor that propels the machine (see Banerjee, 2007, p. 125). No wonder that phrases of the likes of 'Holy Grail of growth' and 'Elixir of growth' have been used so many times in the literature. Perhaps the idea of an all encompassing law governing society is too irresistible to the researchers of the dismal science. The recent literature on the root causes of economic progress is not an exception. A lot of effort has gone into identifying the root cause. As a result the abovementioned explanations are often posed as competing explanations of economic development. Needless to say, this need not be the case. It will be surprising if the process of development, as complex as it is, turns out to be a result of a single factor. Perhaps the most likely outcome is a series of causally interlinked explanations.

I make an attempt to establish some of these linkages. In the first part of this book, I provide empirical evidence on the role of root causes. I also offer a unifying framework for Western Europe – a development success story. The framework links the seemingly competing explanations of long-run development. Then the framework is put to the test by comparing and contrasting it with the historical process of development in the Americas, Africa, China, India, Russia and Australia. It appears that the framework does well in explaining the development process in these different continents. In the second part of the book, I focus on policies that could improve growth. I provide contemporary macroeconomic evidence on policies that may have worked better for growth. I then outline the first principles (property rights, contracts, rule of law, regulation, macroeconomic stability, representative politics, access to markets, human capital investments and trade) that are essential for growth. I also discuss the case of India and China, two recent success stories, and how they have applied the first principles. The book concludes with a discussion of growth policy in situations of state failure, poverty trap and scarcity of skilled labour. All along, I take into consideration the following issues. First, the literature is rich with various explanations and theories of development. However, it is difficult to find a single source which covers the literature well. I make an attempt here to fill this vacuum. Hopefully, graduate students working on this topic will find this useful. However, my attempt to cover the literature may not be exhaustive. Nevertheless, I do make a conscious effort to cover all of the major studies in history, economics and politics. Second, I make an attempt to present the material in a non-technical fashion wherever I can. However, some technical materials are presented in Chapters 3, 4, 6, 7 and 8. These models are followed by a non-technical summary of the main message. Therefore, I am assuming that this is not an insurmountable hurdle for readers outside the discipline. Furthermore, readers may also choose to skip the technical parts and focus on the summary instead. In my view, this will have very little impact on their understanding of the main message of the book. To put it simply: readers won't miss much by skipping the technical details. Nevertheless, only time will tell how successful I am in making it within the reach of the elusive 'intelligent layperson'. Third, for the sake of brevity, I skipped technical details in some cases.

The analysis proceeds in two parts. The first part focuses on the role of history and the second part is more concerned about contemporary growth policy. Chapter 2 in Part I introduces the core empirical fact in the literature – the Great Divergence. Using simple diagrams from previously published research, I take a brief look at the growth miracles and growth debacles of the last millennium. I give special attention to the economic performance of North America, South America, Africa, the United Kingdom, Western Europe, Southern Europe, Russia, China, India and Indonesia. I also revisit the 'reversal of fortune' hypothesis proposed by Daron Acemoglu, Simon Johnson and James Robinson.

Chapter 3 critically evaluates theory and evidence on the root causes of economic progress. It begins by distinguishing between root and proximate causes. It also shows how the idea of root causes can be augmented into a standard Solow growth model. Some of the prominent political economy models and theories of institutions are reviewed in this chapter. It is followed by a review of theory and evidence on the role of institutions, the role of religion and culture, the role of geography, the role of trade openness, the role of human capital and the role of state formation and war.

Chapter 4 presents empirical evidence. It highlights some of the problems related to the empirical estimates in the root causes literature. It shows that malaria is crucial in explaining long-run development in Africa. It shows that factors such as institutions are statistically insignificant in an African sample.

Chapter 5 presents the 'unifying framework'. The framework describes the trajectory of capitalist development in Western Europe. It compares and contrasts the Western European trajectory with the trajectories of Africa, the Americas, China, India, Russia and Australia and tries to establish what deep structural factors are behind the development or lack of development of these regions. My conjectures are backed by the existing empirical evidence. Empirical evidence drawn from published research is presented with limited technical details. However, the source research papers are cited so that interested readers can follow it up if they please. In this chapter, I also try to present a case that the African process of development is different from the rest of the world. I argue that high incidence of malaria has an adverse impact on household savings which dampens growth.

Part II of the book focuses on contemporary policymaking. Chapter 6 presents evidence on the role of trade in promoting development over the last two decades. It shows that trade is effective only when a country is above a certain threshold level of institutional quality. Chapter 7 shows that a country's institutions could be improved through trade policy. It presents theoretical explanation and empirical evidence in support of such view.

Chapter 8 tackles a related issue of institutional effectiveness. It empirically tests which institutions were more effective in delivering growth over the last two decades using international panel data. It finds that property rights, contract and macroeconomic institutions are important. Regulatory institutions are also important but overregulation is not good for growth. Political institutions come out to be statistically insignificant.

Finally, Chapter 9 concludes with a list of policies essential for growth. I call this list the first principles. I argue why they are important for growth. I also discuss the Chinese and the Indian cases to illustrate how important it is to apply the first principles so that they are best suited for local conditions. I outline a way forward in situations of state failure, poverty trap and scarcity of skilled labour.

Without doubt, collectively the literature has made immense progress towards understanding and identifying the root causes of economic progress. However, a lot of work remains to be done to establish linkages between factors. This book is an attempt to explore these linkages.

NOTES

1. Hidaya's story is quoted from an article titled 'All these children want is a decent education' by Sakina Zainul Datoo published in the October 2003 edition of the journal *Africawoman* on page 3. The online source of this article is the following: http://www.africawoman.net/newsdetails.php?NewsID=182&AuthorID=53&CountryID=12&NewsTypeID=6&IssueID=24
2. These are figures for 2007 expressed in constant 2005 'international' dollars adjusted for purchasing power parity (PPP) differences. The source is the World Development Indicators (WDI) Online, The World Bank.
3. The story of the Morogoro Shoe Factory is quoted from Easterly (2001, p.68).
4. The Heavily Indebted Poor Countries (HIPC) Initiative was established in 1996 as a joint collaboration between the World Bank and the International Monetary Fund (IMF). The aim of the initiative is to reduce the excessive debt burdens faced by the world's poorest nations. In 1999, the international community endorsed enhancements to the HIPC initiative allowing more countries to qualify for HIPC assistance, accelerating and deepening the delivery of relief, and strengthening the link between debt relief and poverty reduction.

PART I

History and economic development

2. The Great Divergence: an account of the growth miracles and growth debacles since AD 1000

As I have illustrated in the introduction with the Tanzania and Luxembourg example, living standards do vary enormously across countries. Let's take stock of the situation by subjecting this empirical fact to close examination. In Figure 2.1, I plot the trend in per capita income in seven different countries over the period 1950 to 2004 using data from the Penn World Table version 6.2. What I notice is, indeed, a significant variation in standard of living across countries. China, India and Brazil seem to be part of a completely different club when compared with the living standards in the United States, Australia and the United Kingdom. The other important point to note is that the difference across countries is persistent and there is very little change in relative positions since 1950. Therefore, it is quite

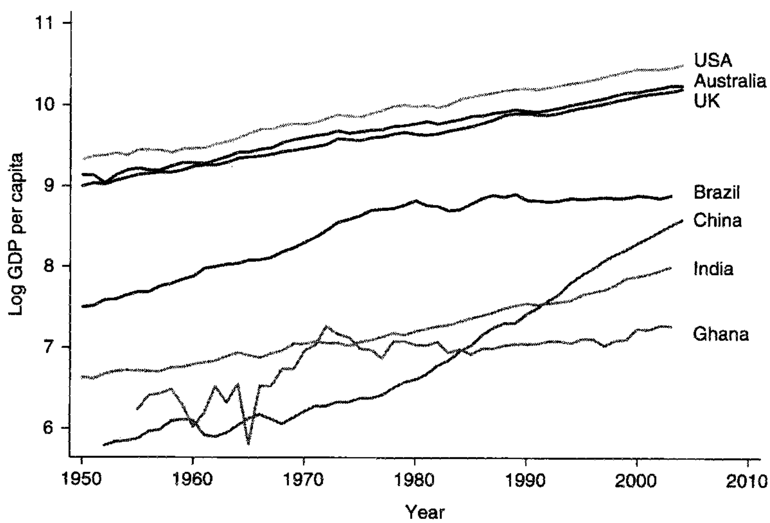
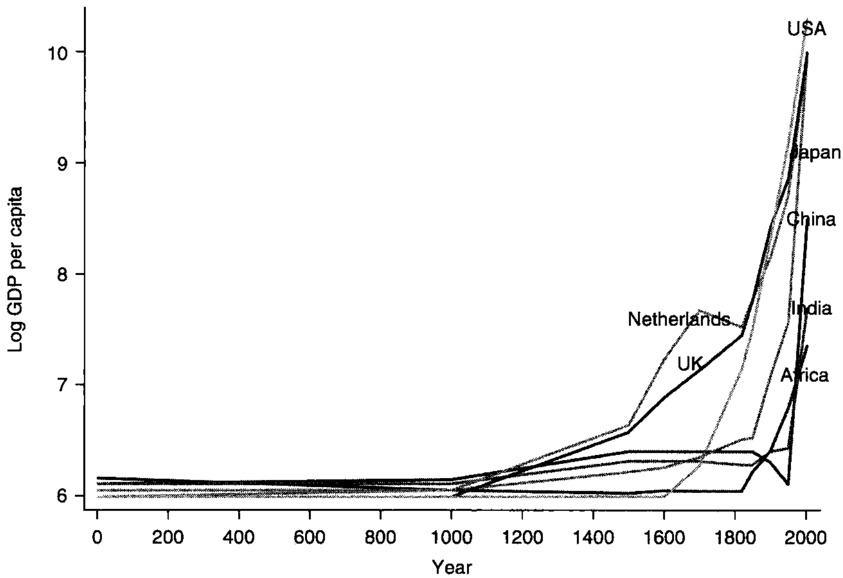


Figure 2.1 Evolution of per capita income in USA, Australia, UK, Brazil, China, India and Ghana over the period 1950 to 2005



Source: Author's plot using data from Maddison (2004).

Figure 2.2 Evolution of per capita income in USA, UK, the Netherlands, Japan, China, India and Africa over the period AD 1–2003

evident that the origin of this divergence is certainly not the post-war period of 1950 to 2004. To trace out the origin, we need to look further back.

Looking further back in time, of course, is a challenge. Do we have the data to do this successfully? The answer is yes, thanks to the excellent research done by economic historians over the last four decades. The most widely used numbers are from Angus Maddison's (2004) *The World Economy: Historical Statistics*. However, there is no consensus among historians regarding the validity of these numbers. Some historians argue that the values for China, Japan and other parts of Asia were comparable or even higher than those in Western Europe in the late nineteenth century. Needless to say, Maddison's figures show the opposite. I shall come back to some of these debates very briefly later. Nevertheless, this debate is not central to my story and the majority of historians agree on the broad patterns of evolution of income across countries since AD 1.

In Figure 2.2 we plot the evolution of per capita income since AD 1 in the United States, United Kingdom, the Netherlands, Japan, China, India and Africa. What we notice is quite striking. Prior to 1400, living