Economic Policy #09

Growth Policies

Growth Policies

- Measuring growth
- Stylized fact about growth
- Growth enhancing policies

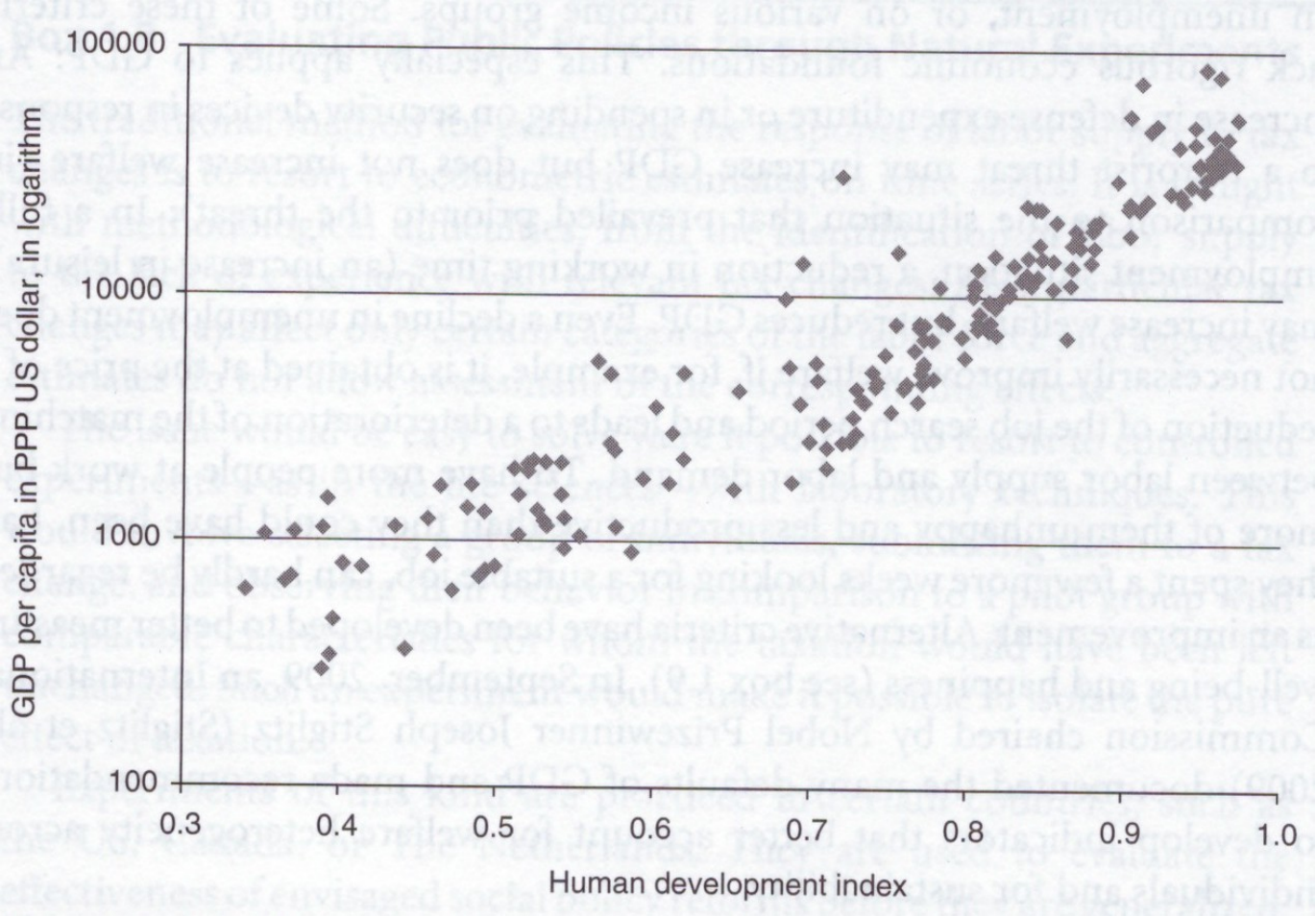
Growth vs. stabilization policies

- Stabilization policy seeks to mitigate short-term cyclical fluctuations whereas growth policies aim at raising potential level of production in the long run.
- But, there are interrelations between long-term trends and short-term fluctuations because of:
  - *precautionary behavior:* excessive inflation is bad for long-term growth
  - *unemployment hysteresis:* skills of unemployed workers deteriorate and they become less employable even in boom
  - *creative destruction:* disputes about cleansing effect of recessions vs. depreciation of capital goods and firm-specific knowledge if the failing companies are not the least-effective ones

Measuring economic growth

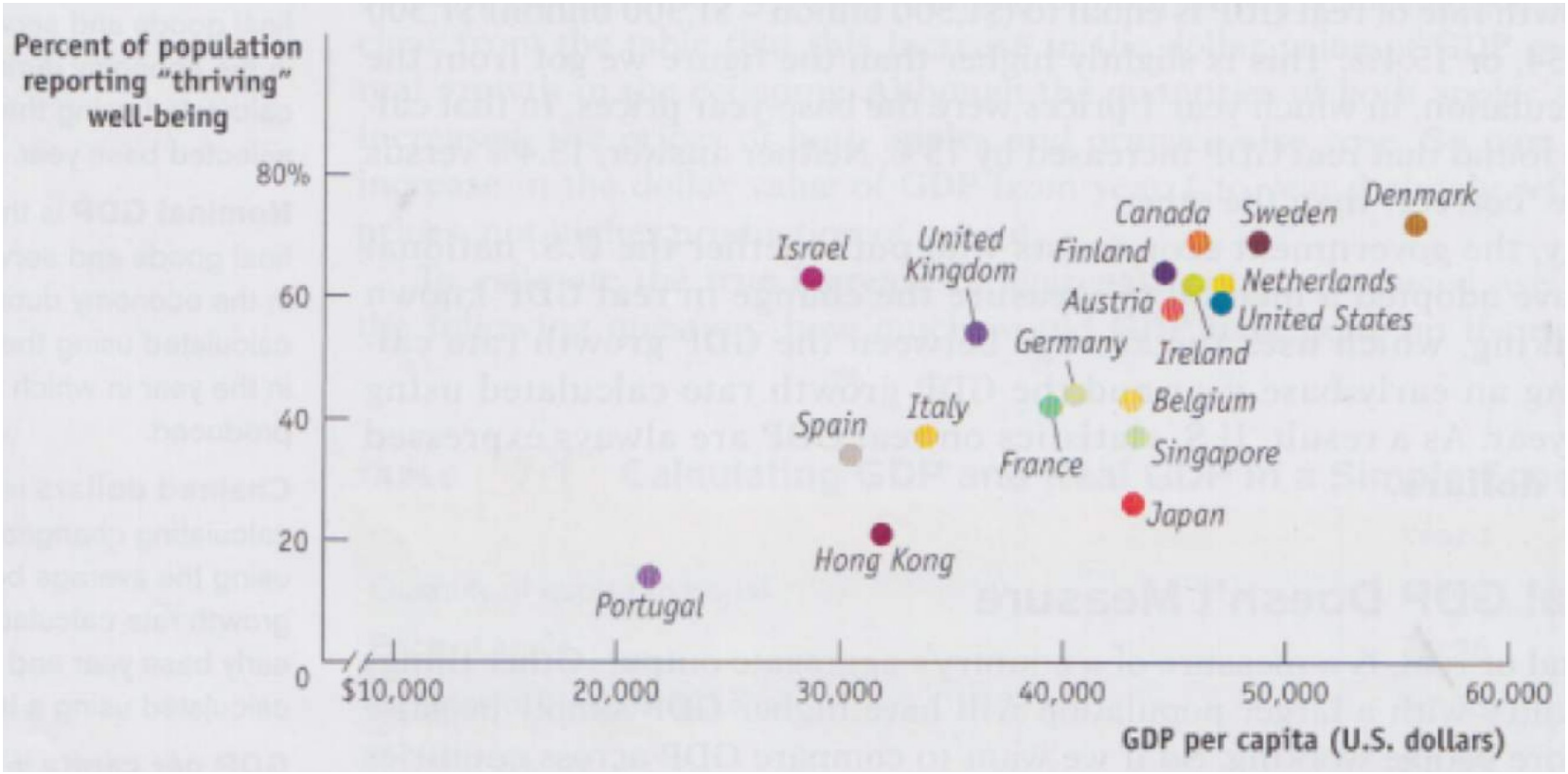
- GDP per person (per capita) corresponds to the average standard of living
- Labor productivity reflects effectiveness of production system
- HDI or GNP => measure of development
- Comparability issues (prices, exchange rates ...)
- GDP per person is not well-being
  - correction for: pollution, working time, life expectancy, precariousness, inequality, sustainability

GDP vs. HDI (2007)



Source: Bénassy-Quéré et al. (2010)

Growth and happiness (2010)

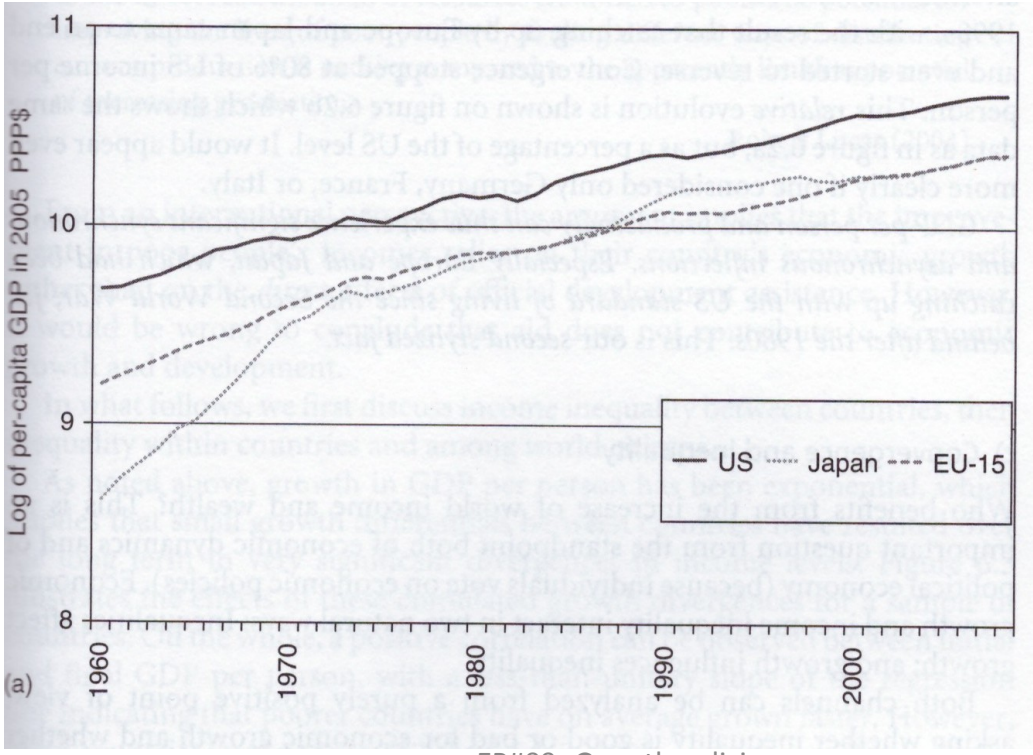


Some stylized facts about growth

#1 Growth is a recent phenomenon by historical standards.

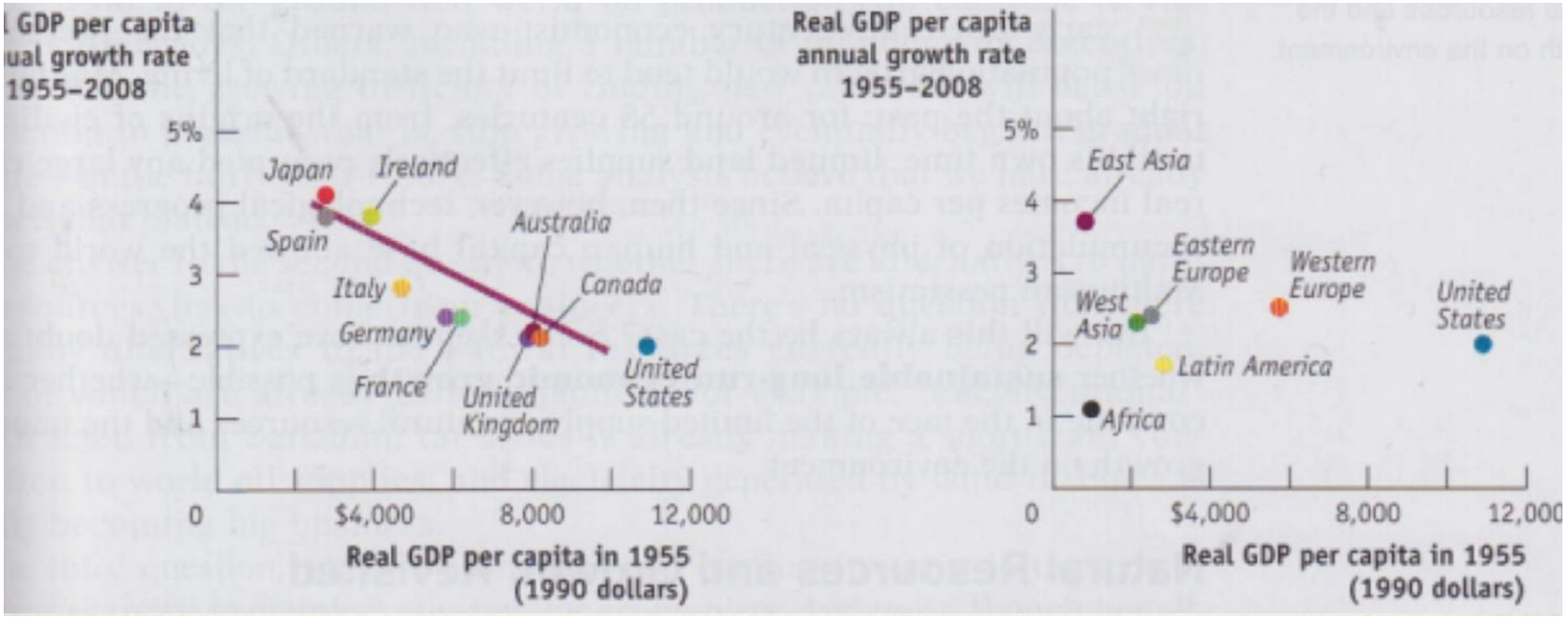
Some stylized facts about growth

#2 GDP per person and productivity can experience significant synchronous and asynchronous inflections across countries at similar development levels



Some stylized facts about growth

#3 Some countries have caught up towards the richest countries, some have not and even further diverged.



Some stylized facts about growth

#4 No stable relationship between inequality and growth, but growth tends to increase inequality within rich countries.

#5 Among advanced economies, technological change and growth may increase income inequalities.

Growth and income distribution: a two way relationship

Growth → inequality

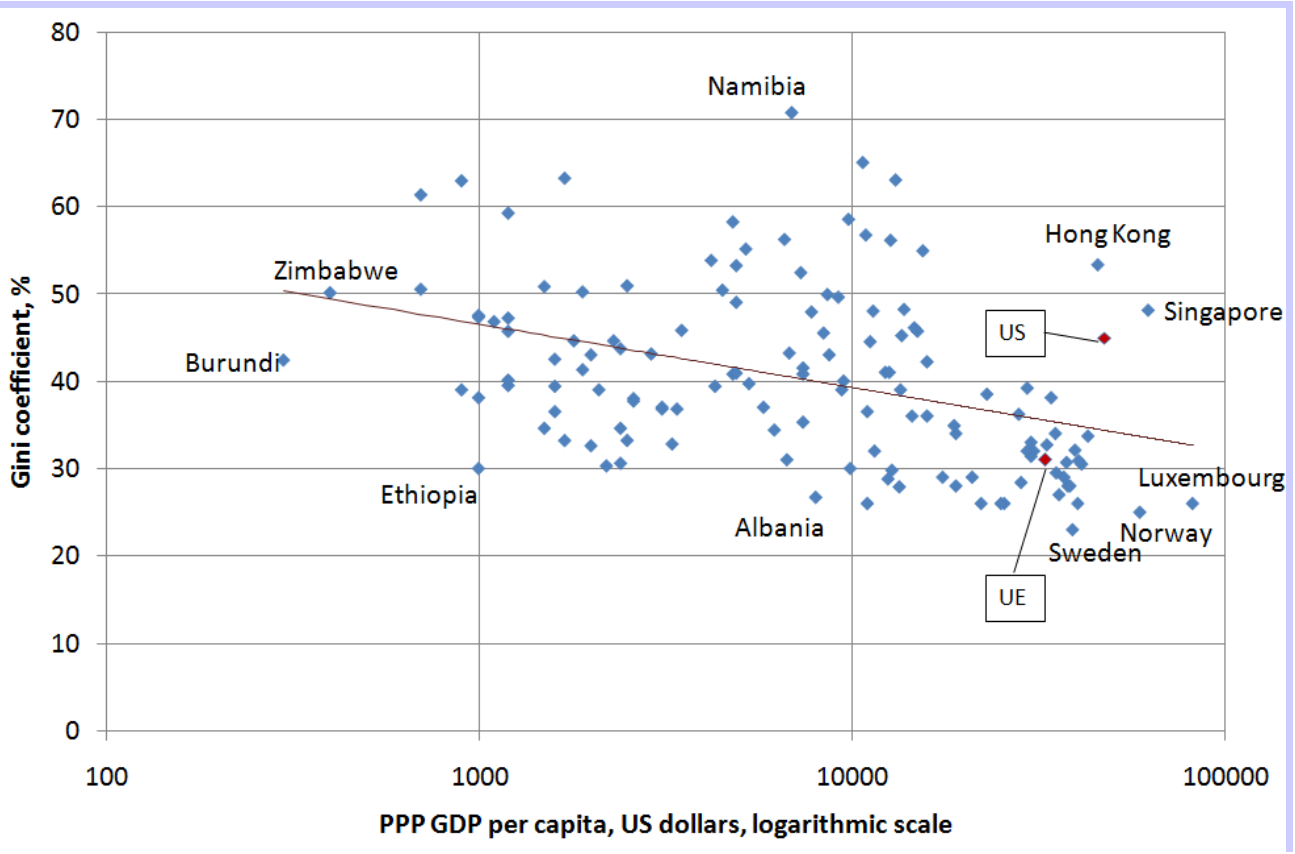
- Kuznets (1955): U-shaped relationship between development level and income inequality
- Unequal access to finance, education

Inequality → growth

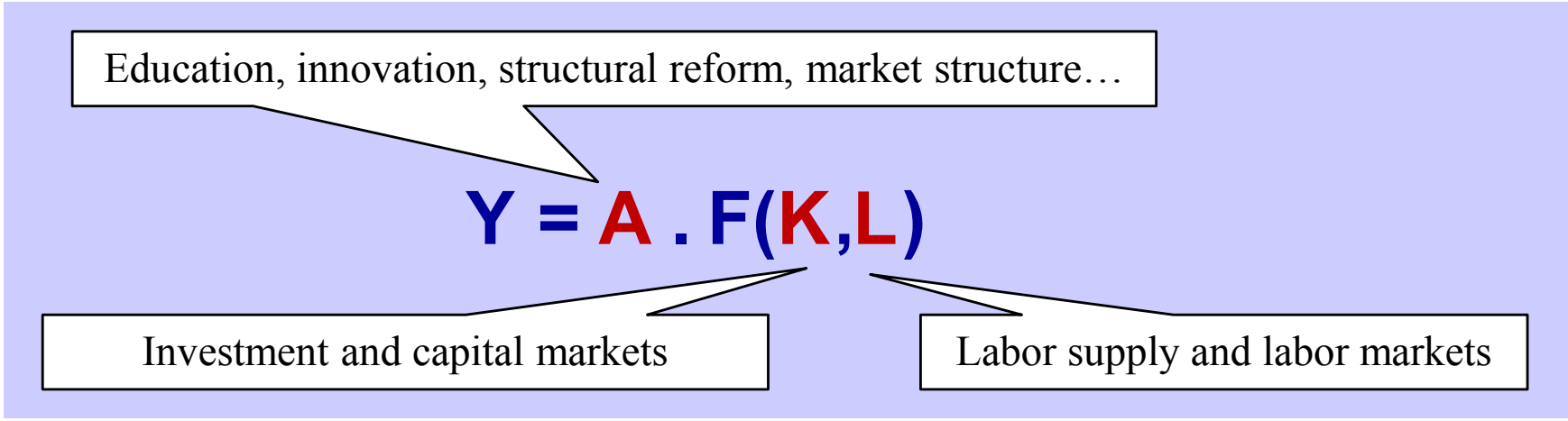
- Risk of political instability/deadlock
- Demand for redistributive taxation (Alesina and Rodrik, 1994)
- Trickle-down growth: “A rising tide lifts all boats” (J.F. Kennedy)

Growth and income distribution

Fig. GDP per capita versus Gini coefficient



Theoretical background



Theoretical background (cont.)

- In the short run (a few months to a few years), potential output is exogenous; growth is dominated by cyclical fluctuations and by stabilization policies
- In the medium run (a few years), governments can influence potential output through investment and labor supply
- In the long run (many years), GDP and the labor/capital mix are determined by demography, technology, institutions and market structures

Education

- Public financing is justified by credit constraints and unequal access to knowledge It is difficult to assess private and social return to human capital
  - relative returns of primary vs secondary education depend on ‘distance to frontier’

Discrepancy between Europe and US in total expenditures on tertiary education. But money is not enough..

R&D and innovation

- Market imperfection: investments to R&D are constrained by the unavailability of funds
- Social return on research spending generally exceeds its private return

=> Public funding of fundamental research and university clusters

=> Incentives to private funding of applied research

  - Intellectual protection
  - Innovation-friendly competition regime

=> Channelling private savings towards R&D and innovative SME financing, e.g. through tax rebates

Unequal R&D effort

- R&D expenditures in 2007 in % of GDP
  - Japan: 3.4%; US: 2.7%; EU-27: 1.8% out of which France: 2.1%, highest = Sweden: 3.6%, lowest = Cyprus: 0.4%
- Different dynamics:
  - US: new innovating SMEs
  - EU: firms already in place
- In the US, innovating firm creation encouraged by:
  - risk capital and initial public offerings
  - lower entry cost
  - more favorable resolution law

The role of competition and intellectual property

- A difficult balance to strike:
  - Excessive competition / weak intellectual protection are bad
  - But firms in place should be challenged and patents can be used as deterrent to competition
- Recent examples:
  - EC vs Microsoft
  - European Parliament discussion on software patentability
  - WTO 'TRIPs' agreement for antiretroviral drug production in low- income countries

Public infrastructures

- Government intervention is needed, because:
  - many infrastructures are natural monopolies
  - infrastructures involve externalities
  - market cannot finance infrastructures by itself

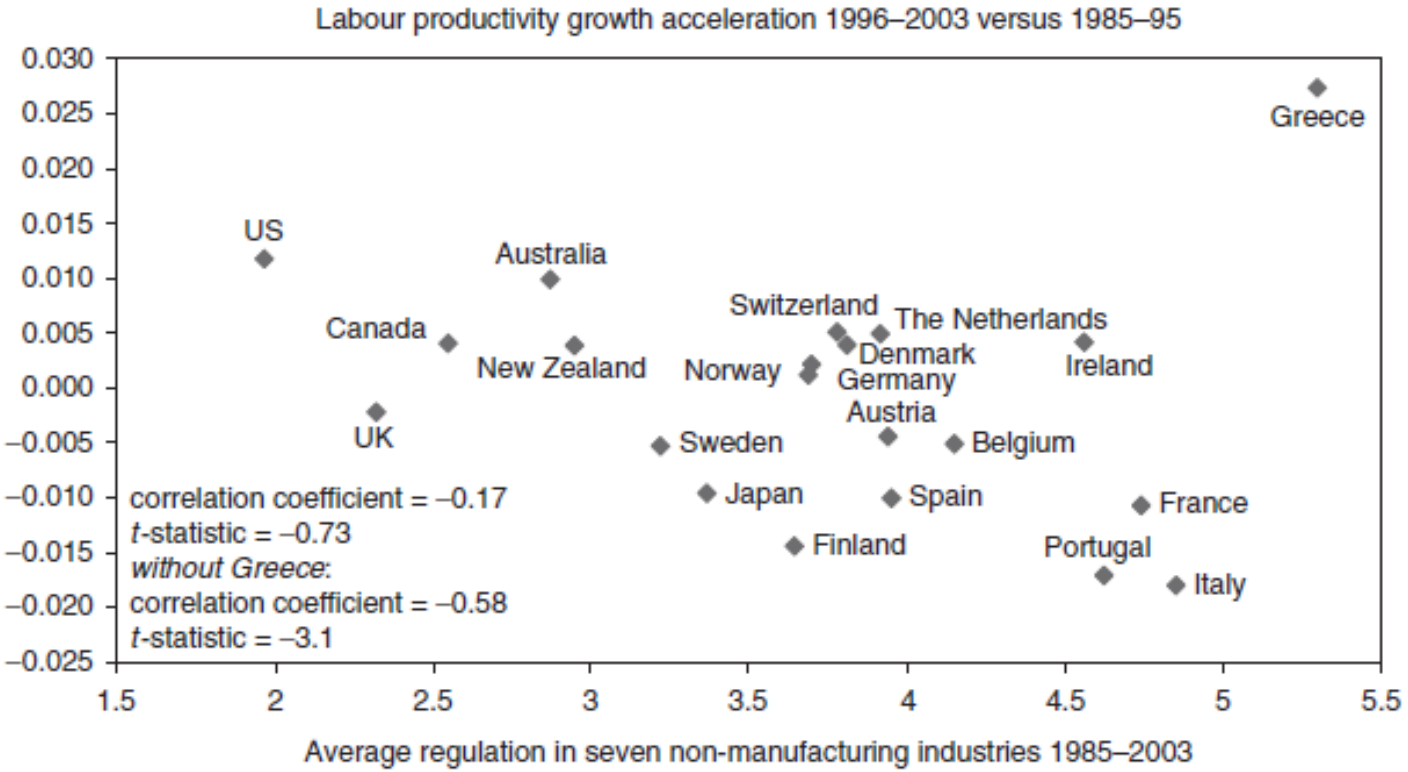
  => European networks program, *public-private partnerships*

Labor supply

- How to increase labor supply?
  - Through family-oriented policies
  - Immigration
  - Welfare-to-work:
    - in-work benefits
    - pension reforms

Making markets work better (cont.)

Fig. Product market regulation and labor productivity acceleration in OECD countries



Developing financial markets

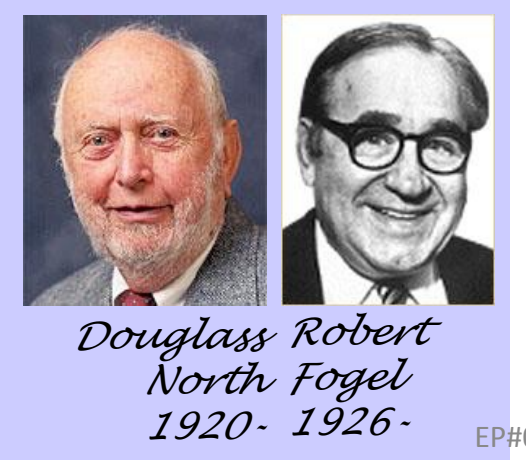
- Often neglected in growth strategies
- Channels on influence on long-term growth:
  - lower cost of capital
  - Higher savings
  - Better allocation of capital
- Major issue in post crisis period: is there a trade-off between financial stability and growth?

Countering distance and history

- There is trade-off between geographical equity (e.g. EU structural funds) and economic efficiency (e.g. 'competitiveness clusters')
- Transport infrastructures may encourage agglomeration rather than dispersion => increasing inequality between regions
- First best solution: agglomeration + lump-sum transfers to low-income regions

Growth and institutions

Institutions: "The humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self-imposed codes of conduct), and their enforcement characteristics."
D. North and R. Fogel (1990)



Improving institutions

General recommendations:

- create legal framework which is conducive to private initiative
- put in place effective market regulation
- achieve macroeconomic stability

It is difficult to identify a set of specific recommendations because of different institutional set-ups.

Growth and institutions

Graph 4: Canonical relationship between "good governance" and income level