Economic Policy #07

Growth Policies

Growth Policies

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

Growth vs. stabilization policies

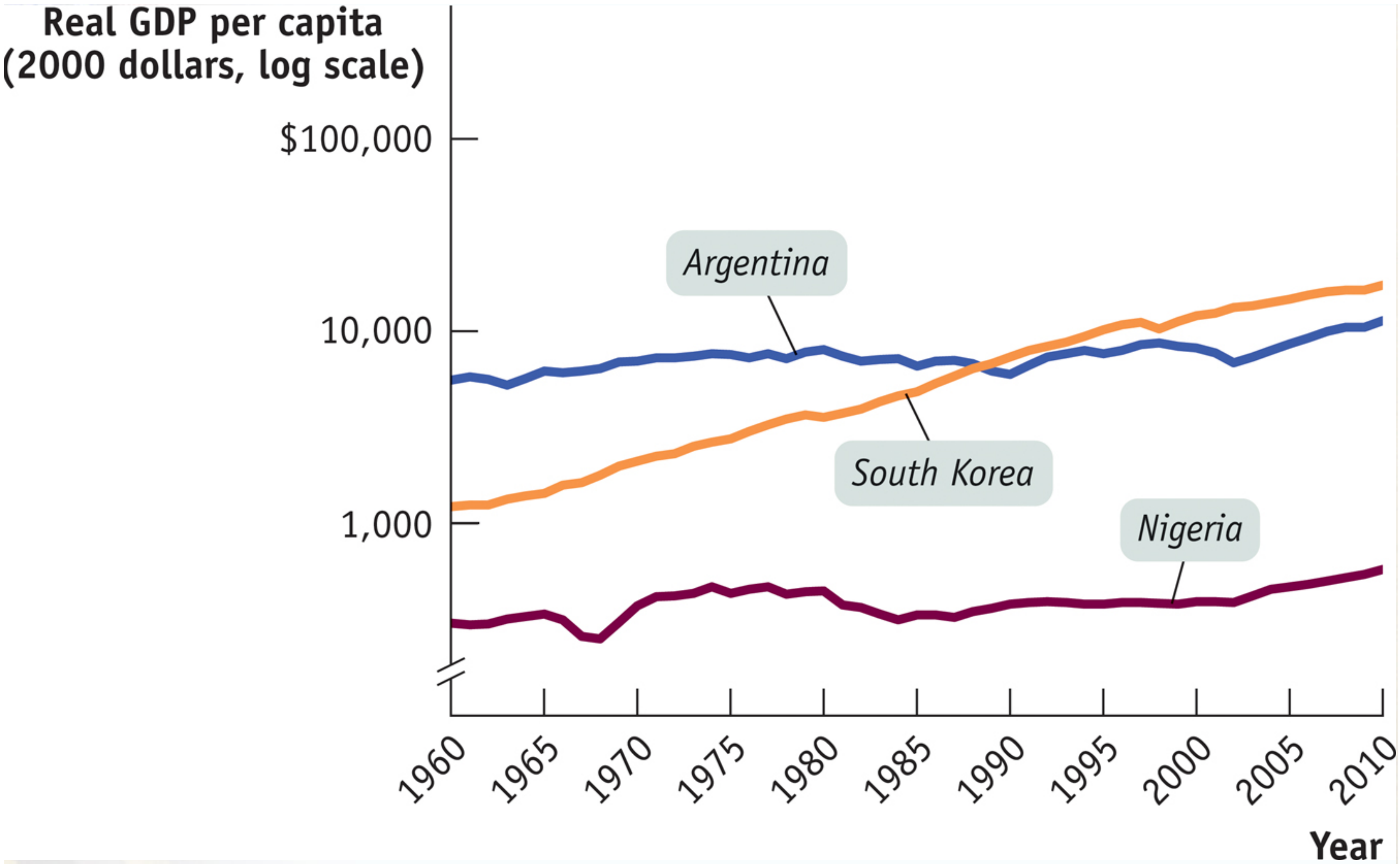
- Stabilization policy seeks to mitigate short-term cyclical fluctuations whereas growth policies aim at raising potential level of production in the long run.
- But, there are interrelations between long-term trends and short-term fluctuations because of:
  - *precautionary behavior:* excessive inflation is bad for long-term growth
  - *unemployment hysteresis:* skills of unemployed workers deteriorate and they become less employable even in boom

Why growth matters

- Anything that effects the long-run rate of economic growth – even by a tiny amount – will have huge effects on living standards in the long run.

annual growth rate of income per capita	percentage increase in standard of living after…		
	…25 years	…50 years	…100 years
2.0%	64.0%	169.2%	624.5%
2.5%	85.4%	243.7%	1,081.4%

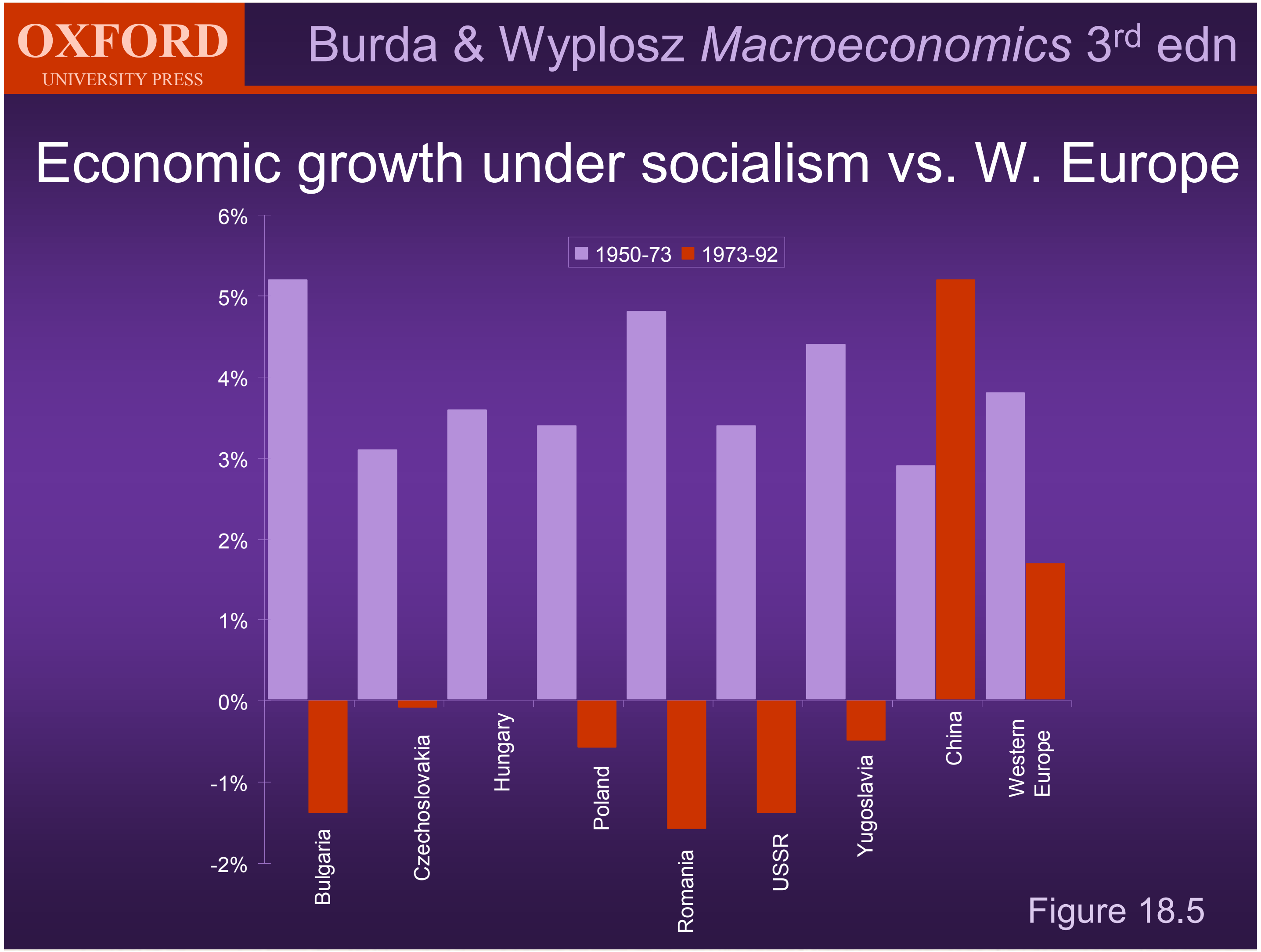
Three stories of economic growth: success, disappointment and failure



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

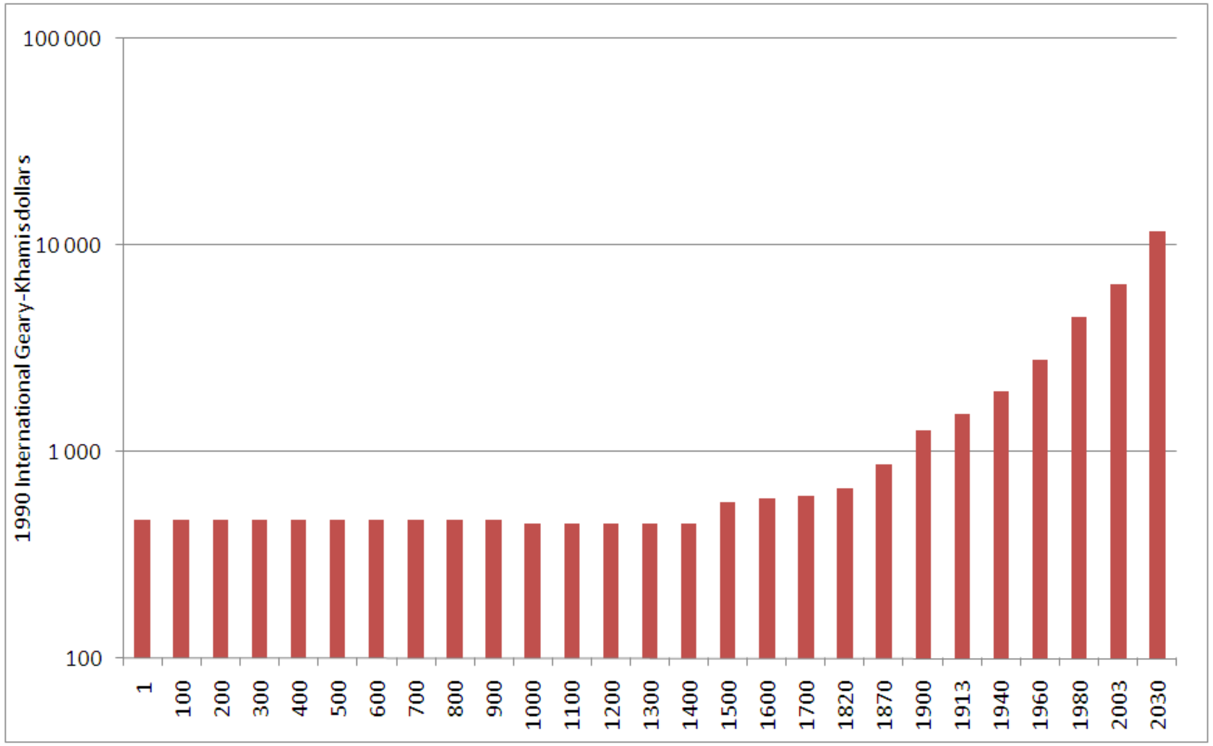
Economic growth: CPEs vs. Western Europe



Some stylized facts about growth

#1 Growth is a recent phenomenon by historical standards.

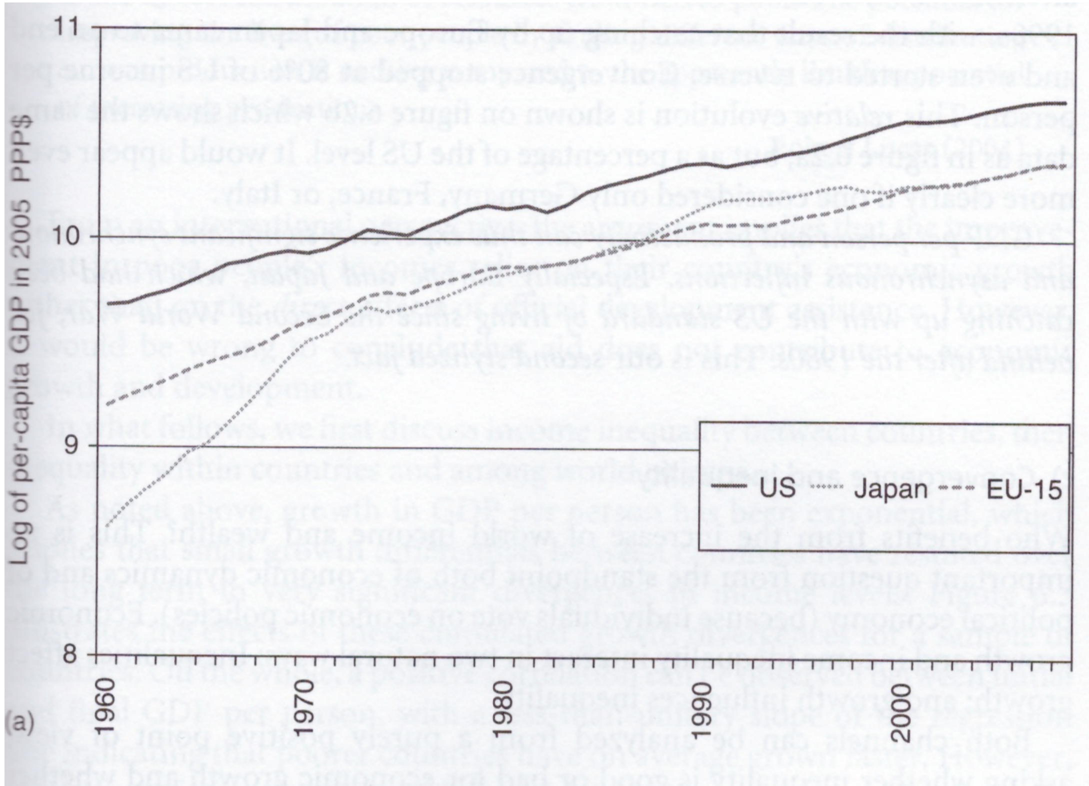
World GDP per person since year 1



Source: Maddison (2007).

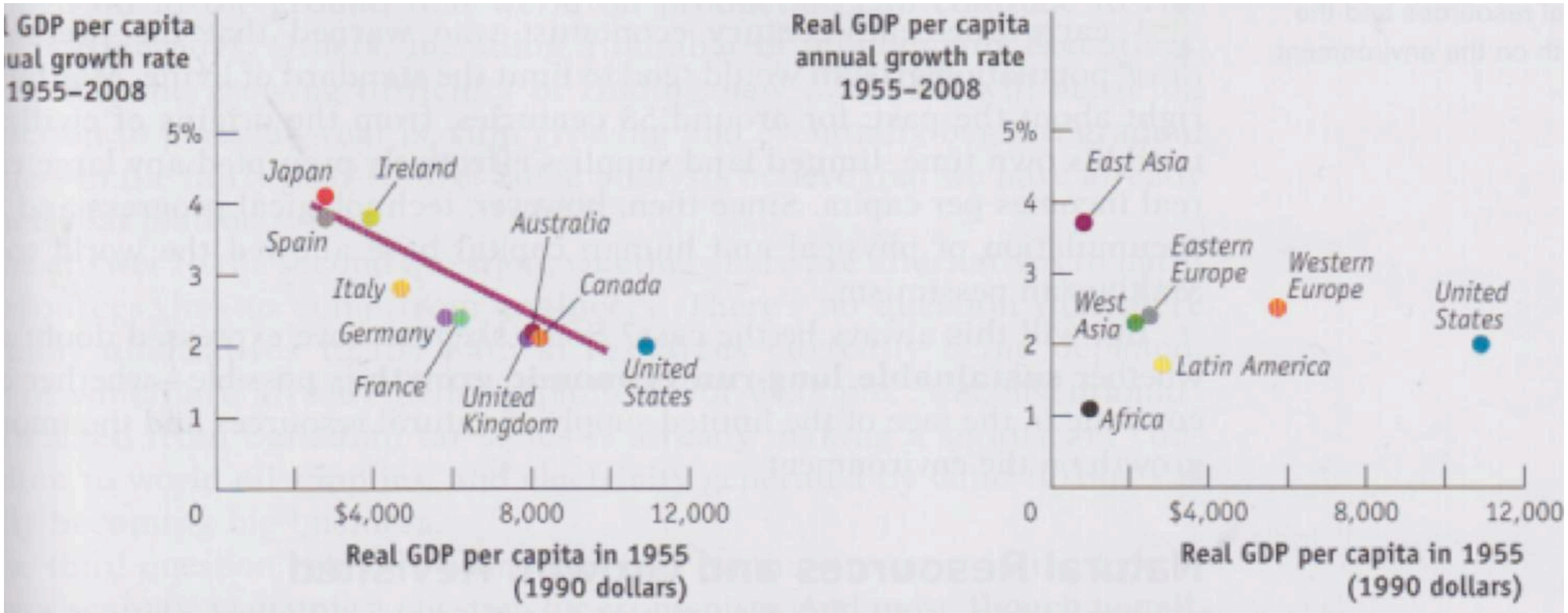
Some stylized facts about growth

#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

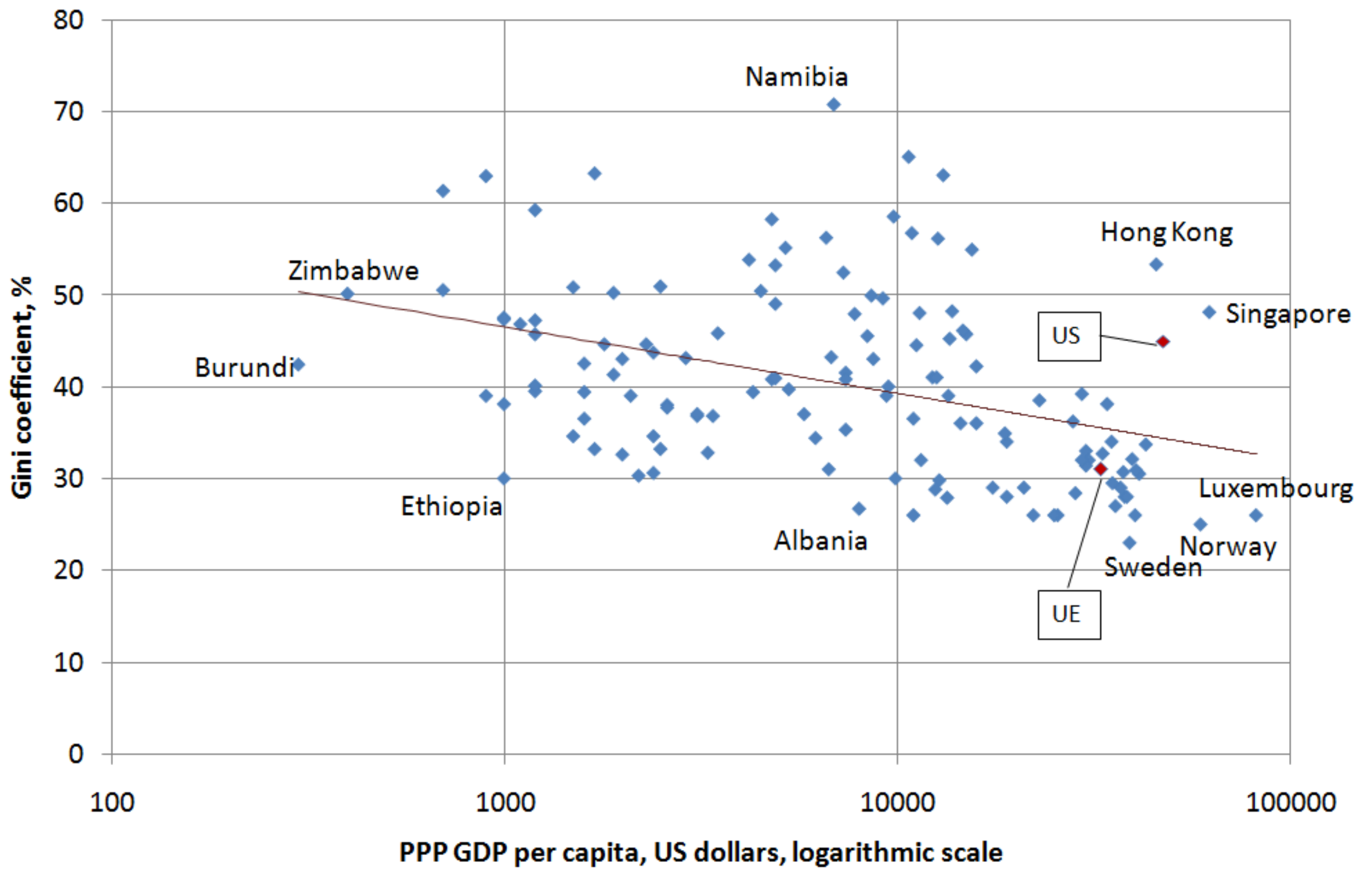
- Kuznets (1955): U-shaped relationship between development level and income inequality
- Unequal access to finance, education

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

Education, innovation, structural reform, market structure…

$$Y = A \, . \, F(K,L)$$

Investment and capital markets

Labor supply and labor markets

Theoretical background (cont.)

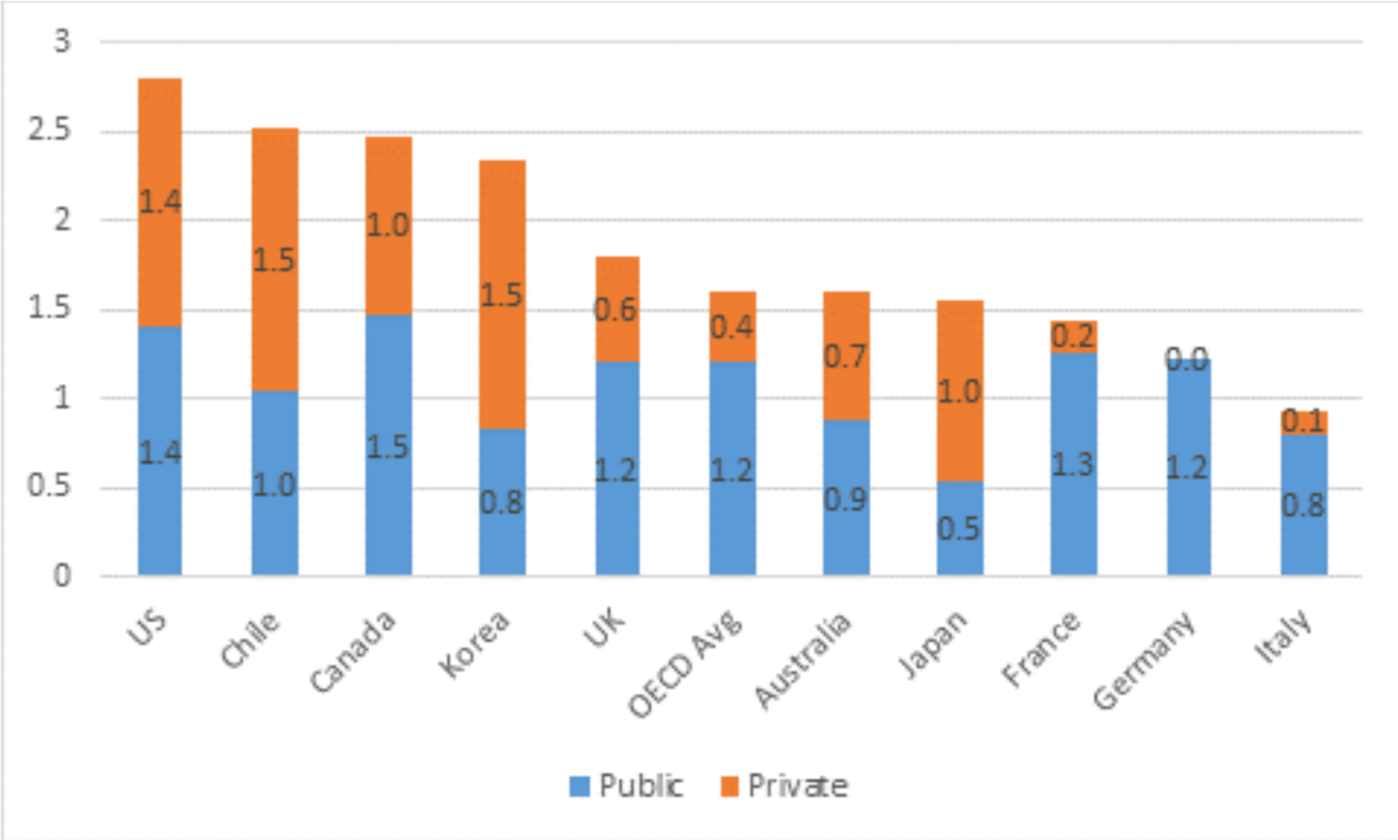
- In the short run (a few months to a few years), potential output is exogenous; growth is dominated by cyclical fluctuations and by stabilization policies
- In the medium run (a few years), governments can influence potential output through investment and labor supply
- In the long run (many years), 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..

Spending on tertiary education (% GDP)



Source: OECD (2015)

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

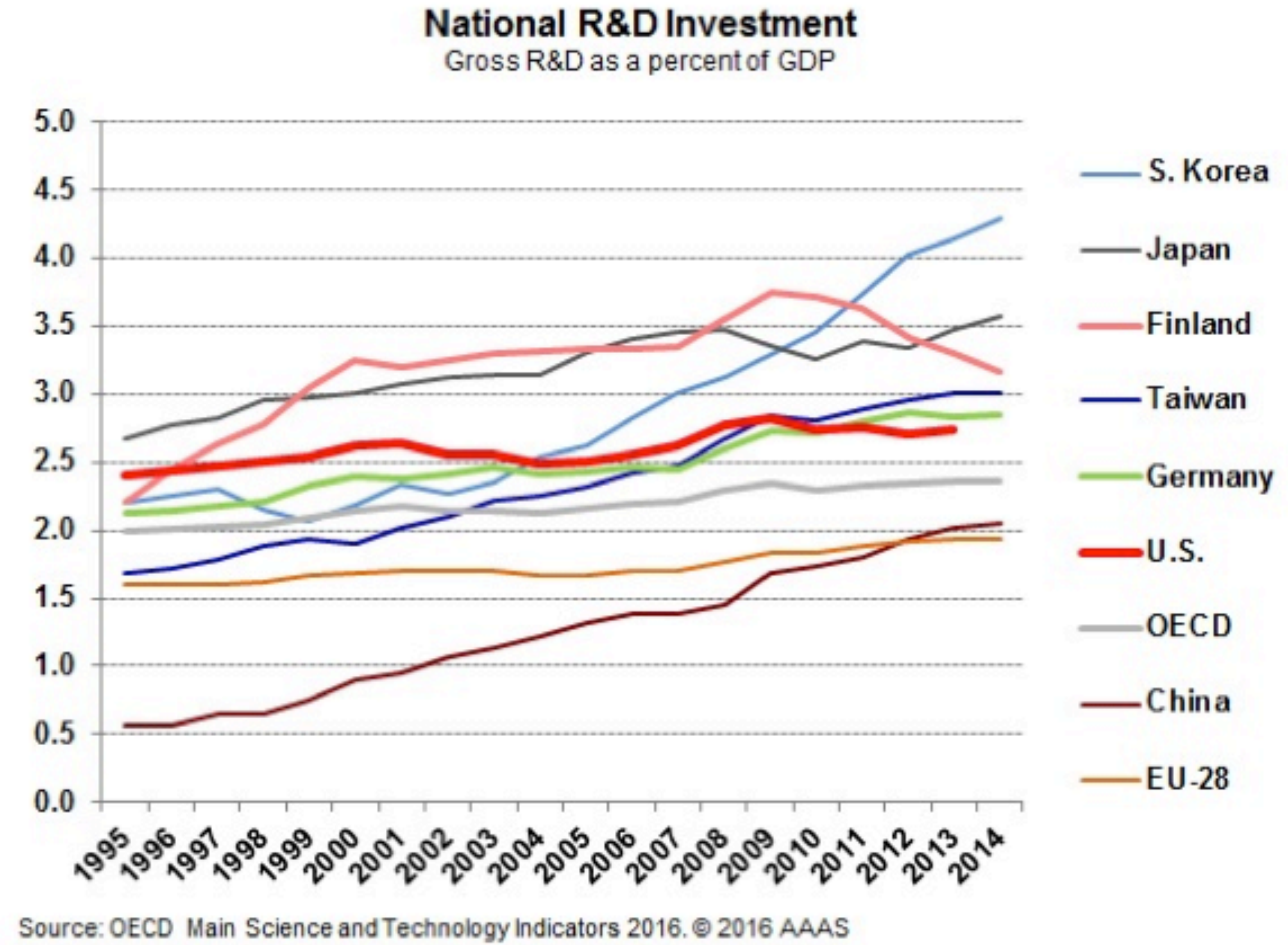
=> Public funding of fundamental research and university clusters

=> 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:
  - Discrepancy among countries (see next slide)
- 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


National R&D Investment
Gross R&D as a percent of GDP
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
S. Korea
Japan
Finland
Taiwan
Germany
U.S.
OECD
China
EU-28
Source: OECD Main Science and Technology Indicators 2016. © 2016 AAAS

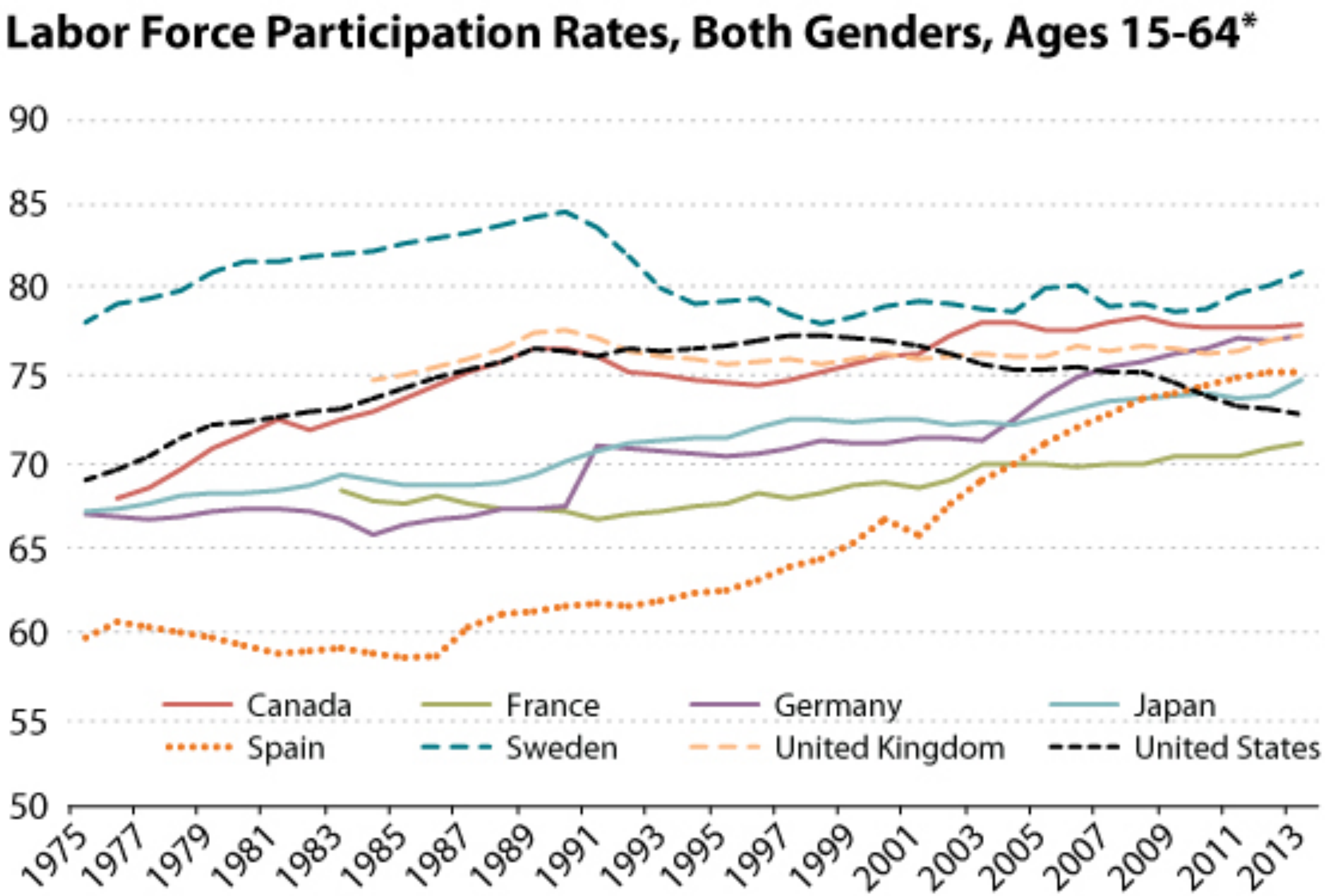
Public infrastructures

- 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

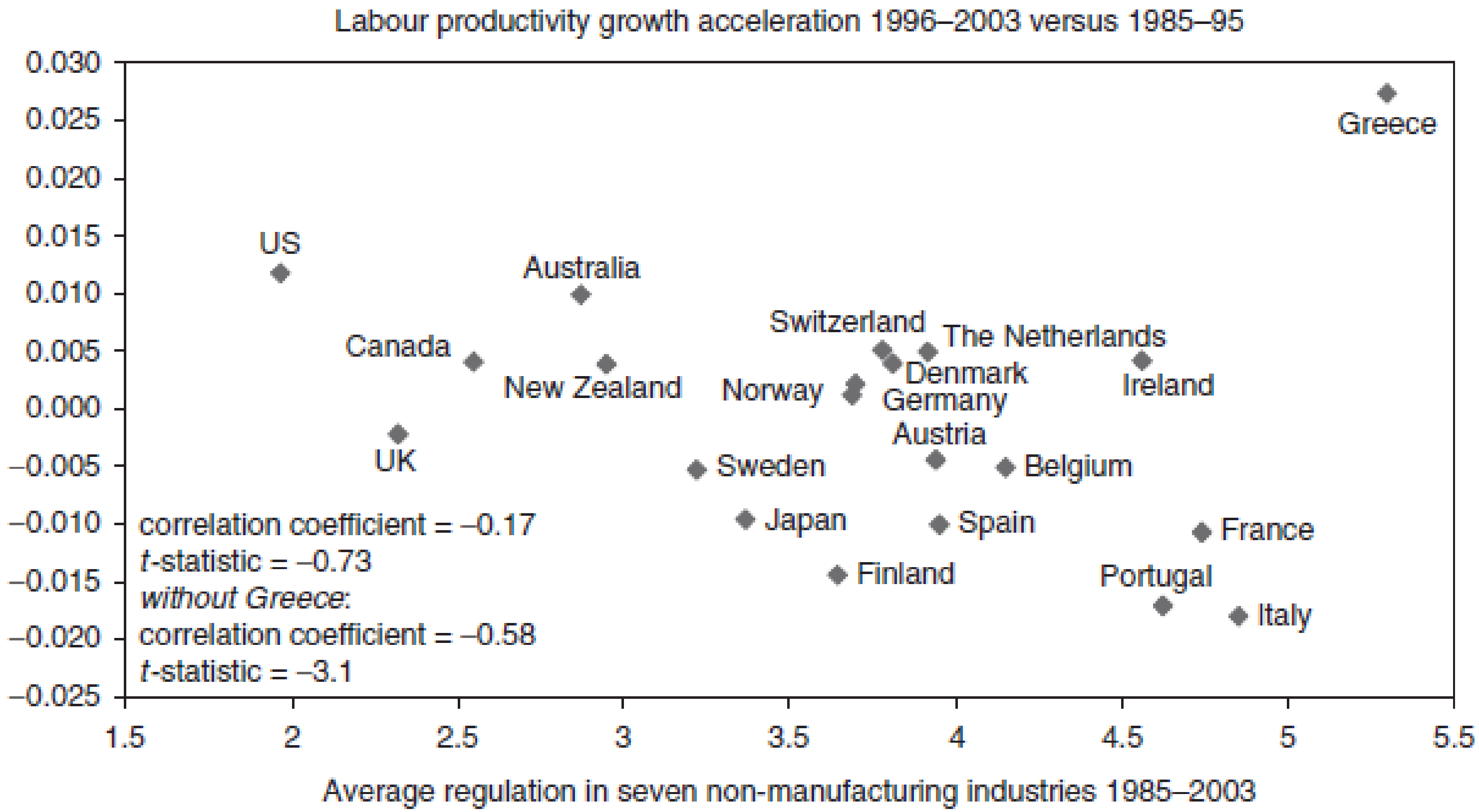
- How to increase labor supply?
  - Through family-oriented policies
  - Immigration
  - Welfare-to-work:
    - in-work benefits
    - pension reforms



Source: Dvorkin&Shell (2015)

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?

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)


Douglass North 1920-


Robert Fogel 1926-

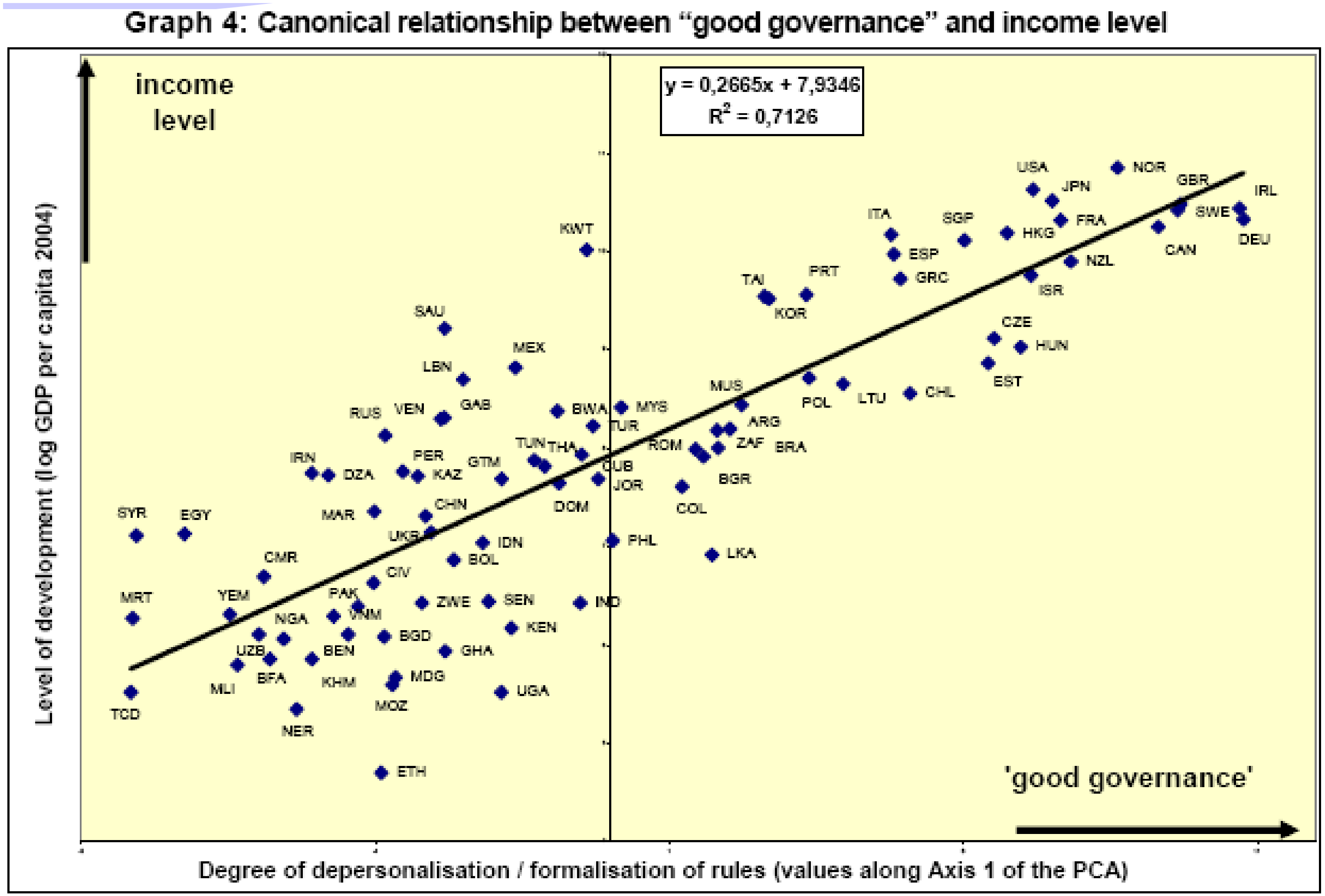
Improving institutions

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



Reference textbook

Bénassy-Quéré, A. et al. *Economic Policy : Theory and practise*. Oxford University Press, 2010. ***Chap. 5***