In growth we are still divided. Why?

Economic wealth – the right policies, or just luck? asks Dan Ben-David

WHY IS IT that some countries are so rich and others so poor? Did you know, for example, that in 1985 the average American made over 3 per cent more than the average German, 40 per cent more than the average Japanese, nearly 50 per cent more than the average UK citizen, and 5,500 per cent more than the average Ethiopian?

These calculations are made using what economists call purchasing power parities, or PPPs. PPPs are much more accurate than official exchange rates. However, when the latter are used to convert foreign output levels to a common US dollar denomination, the picture becomes even grimmer still.

These gaps nearly defy the imagination. A glimpse at average growth rates between 1960 and 1992 indicates that several of these income gaps are actually much smaller today than they once were, while many others have grown substantially. What is going on here? What did some countries do that others did not? Are there "right" growth-enhancing policies that a country can implement to put it on the right track? Or is it just a matter of luck – being in the right place with big piles of resources?

Look who's rich – the US, Canada, the oil-exporters, and so on. Maybe the explanation is luck. If you have the natural resources, you have made it. But if that is true, how does one explain Japan or Hong Kong? In fact, if one wants to take the resource story further, how is it possible to explain what happened in Argentina and Chile, among the wealthiest countries in the world over 100 years ago?

Is it regional? Maybe. The Europeans happen to be almost uniformly wealthier than any other continent. But why? If you look south across the Atlantic, a hundred years ago South America might have been the continent countries might have wanted to emulate. What did they do wrong, and could what they underwent even be ascribed to policy?

And what of Asia? A century ago, who would have put Japan, Korea, Hong Kong, Thailand and some other east Asian countries among the world's leaders. But look at them today. And why go back just one hundred years? What happened to the booming Chinese civilisations of the Ming dynasty, or the Mayans in Mexico, or the Romans, the Greeks before them, or the Egyptians before them?

Is it policy, or is it luck? One might approach the issue of growth from an entirely different perspective. Rather than focus on this country or that, an alternative might be to focus on the growth of technology in general. We could say that technology grows at some given rate all the time. Countries at the leading edge grow at the rate that technology grows – unless they mess up and fall back.

Under this assumption, technological progress just keeps right on going, regardless of who the leader is at any given point in time.

As for countries which happened to have been way behind, they don't have to invent everything. They can merely concentrate on copying things. Surely that should make them grow relatively fast as they catch up to the leaders? If one looks at the East Asians, for example, one might be able to conclude that their seemingly miraculous growth rates cannot be sustained forever. They merely reflect a catching-up on the part of the countries. Once they have caught up, then they have to move from imitation to innovation, and then they will grow like everyone else at the forefront.

Some national income gaps are much smaller today than they once were, while others have grown substantially

So, maybe policy does have something to do with why growth rates vary from country to country, and within countries over time. But is it reasonable to assume that the state of technology improves at a constant rate? That is the assumption of the Solow growth model, which was until recently the primary theoretical framework chosen by economists for thinking about the growth process.

Well, what would be the implications of this assumption? The world's leading countries are currently growing at roughly 2 per cent a year. Suppose that we assume that this is the rate at which the edges of the envelope are being expanded. Could this rate of expansion really have been constant ever since the dawn of time?

One way to address this question is to extrapolate backwards. At 2 per cent average growth per year, the implication is that at the time that Columbus sailed westward in 1492, the average person in the wealthiest country in the world would have made less than $1 (in today's value) during an entire year. You cannot sustain life by producing so little, hence it is clear that income levels must have been higher.

But if that is the case, then incomes could not always have been increasing at a 2 per cent rate. Growth must have been substantially slower in the past and it must have been increasing over time. People living 500 years ago lived in pretty much the same conditions as people living 1,000 years ago. It is only in the past couple of centuries that growth rates really picked up.

This is indeed consistent with the numbers that Angus Maddison finds. Mr Maddison determines the leading countries (in terms of labour productivity) over the past three centuries and calculates their productivity growth rates. The Netherlands, which led the world between 1700 and 1785, did not grow at all during this period. By 1785, the country had been overtaken by the United Kingdom, which attained productivity growth of an annual half of one per cent during the years 1785-1820. This increased to about one-and-a-half per cent from 1820 to 1890. From that point, the United States took over the lead and grew at an average rate of 2.3 per cent.

So two conclusions may be drawn. The first is that fast growth is not a birthright. Policies may be enacted that can move a country to the fast track, or to a lower, and possibly slower, growth path. The second is that the technology envelope is not moving forward at a constant pace either. It has gone from the near-zero growth that persisted for centuries and even millennia, to roughly 2 per cent annual growth in the century which is now approaching its end.

It is probably not too hard to guess which types of policies most people would consider beneficial from a growth perspective, and which types of policies might diminish a country's growth potential. Educational attainment, adequate infrastructure and preservation of property rights would most probably be among the important beneficial ingredients, while corruption, waste and mismanagement of resources would probably be among growth-diminishing characteristics.

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