

## Why Countries Grow

by:  
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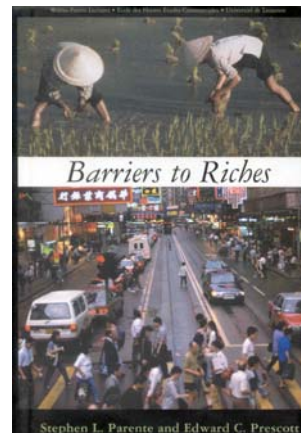
Most regional economists think long and hard about why their particular state or region grows or does not grow. Over the years, I have read hundreds of articles and studies on this matter. Most of the analyses appropriately end up in the “circular file.” This is because they don’t analyze the core concepts of what makes a region grow and prosper. Instead, they push a specific agenda, measure the irrelevant, or just assume that a variable is important without even examining that assumption.

It is important to understand our region’s strengths and weaknesses. A proper understanding of our underlying economic attributes allows for efficient and effective economic development and public policy planning.

During the past several months, I have examined the issue of economic development from a slightly different perspective. The perspective included in this article is a global one and includes the examination of the fundamental concepts associated with why nations as a whole are rich or poor. This very macroeconomic concept is then applied to our particular region. Interestingly, when broken down to the fundamentals, the study of why Arizona thrives may be strikingly simple.

### Current Research

Books on the subject of why nations prosper identify a number of influencing conditions, including the effect of government bureaucracy, the need for a legal system that is fair and dependable, the defense of property rights, and the need for government to not be invasive in a company’s ability to implement new technologies at a reasonable cost. The most intriguing research, in my opinion, was presented in a book titled Barriers to Riches by Stephen Parente and ASU’s own Ed Prescott. The book creates a theoretic framework based on a real world view of why some countries are rich and others are poor.



To summarize, whether a country is or is not rich is largely a function of how its citizens organize both politically and economically. It is argued that one of the most important factors has to do with how a government does or does not create roadblocks to competition and profitability at the individual company level. Such roadblocks can discourage the efficient use of the latest technologies and, thus, inhibit growth of productivity.

The research suggested that, in today’s world, virtually every country is privy to the same basic technologies, either through information on the internet or through multinational companies that have similar operations throughout the world. Prescott and Parente state that the income discrepancies that we see throughout the world are “the primary result of

country-specific policies that result in constraints on work practices and on the application of better production methods at the firm level.”

More specifically, such constraints include excessive regulation or red tape, trade barriers, work place rules on ability to hire and fire, need for licenses, subsidies, government support of monopoly, excessive union power, and other barriers to competition. “Such barriers at the individual production unit level imply differences in output per unit of composite input at the aggregate level, that is, differences in Total Factor Productivity”. More directly stated, this means that less well off countries realize less output for the same level of input. Since incomes are based on societal productivity, the aforementioned barriers create less wealthy societies.

The book then goes through several examples of how some countries became rich while others did not because of these barriers, but it also gives examples of the growth miracles that have occurred in Japan, South Korea, and even China. In summary, the book states, “Poor countries do not need to create new ideas to increase their standard of living. They need only apply existing ideas to the production of goods and services...” In other words, they do not have to recreate the wheel. In order to increase productivity and output, barriers to the adoption of more productive technologies such as work place constraints, barriers to free trade and other barriers to competition, need to be limited.

#### Is Human Capital the Difference?

Intellectual capital differences were also explored. It is common sense that the better educated, hardest working countries must also post the highest incomes, right? The answer is not as one would expect. If the countries with the best education system or those with the strongest work ethic caused that country to be the most productive, then that country should be most productive across the board. That is not the case. For example, while the U.S. has the highest level of productivity in the services area, Japan has the highest level of productivity in the manufacturing of autos and steel. Thus, it appears that constraints that affect the ability of the individual company to operate more effectively, not education or work ethic, create differences in output per unit of input.

The contention is that, at the global level, business practices that discourage the best use of new technologies at the company level or a closed intellectual border may trump any benefits of higher education and strong work ethic. Overall, small differences in productivity can overtime produce significant differences in wealth.

#### What is the Relevance?

It appears that the countries that are poor are poor because of internal issues such as excessive government workplace regulation, monopoly protection, laws that discourage competition or free trade, and the effect that these actions have on the ability of the individual firm to incorporate the most productive technologies and be profitable. Removing these barriers has been shown to enhance a country’s ability to increase its standard of living.

Does this tell us anything about why an individual political subdivision within a single country may grow since they have many, but not all, of the same barriers? The answer, I believe, is it could.

While the analysis of local policy is not exactly akin to the global analysis of the *haves* and *have nots* from the book, the authors do indirectly provide another perspective on the importance of and ability to attract base industry companies. Base industry companies are the companies that can locate anywhere but choose to locate in areas that allow for significant profit potential.

The good news is that many of the barriers to riches that have been identified as being highly relevant are not natural constraints, but instead imposed through political and social systems. Countries can change their practices and improve their fortune. At the global level, those countries that have governments that get out of the way of production and do not significantly inhibit the use of technology tend to generate higher levels of wealth, all else being equal. The good news for our state is that we similarly have control over our destiny and it is within our power to improve our competitive position. At the local level, policies such as limited regulation, workplace regulation, competitive tax policy, etc., can be a factor in regional development. These competitive issues and opportunities for local wealth enhancement are explored further in the article, “Why State’s Grow” (see: [www.arizonaeconomy.com/content/Special\\_Interest.aspx](http://www.arizonaeconomy.com/content/Special_Interest.aspx)).

