



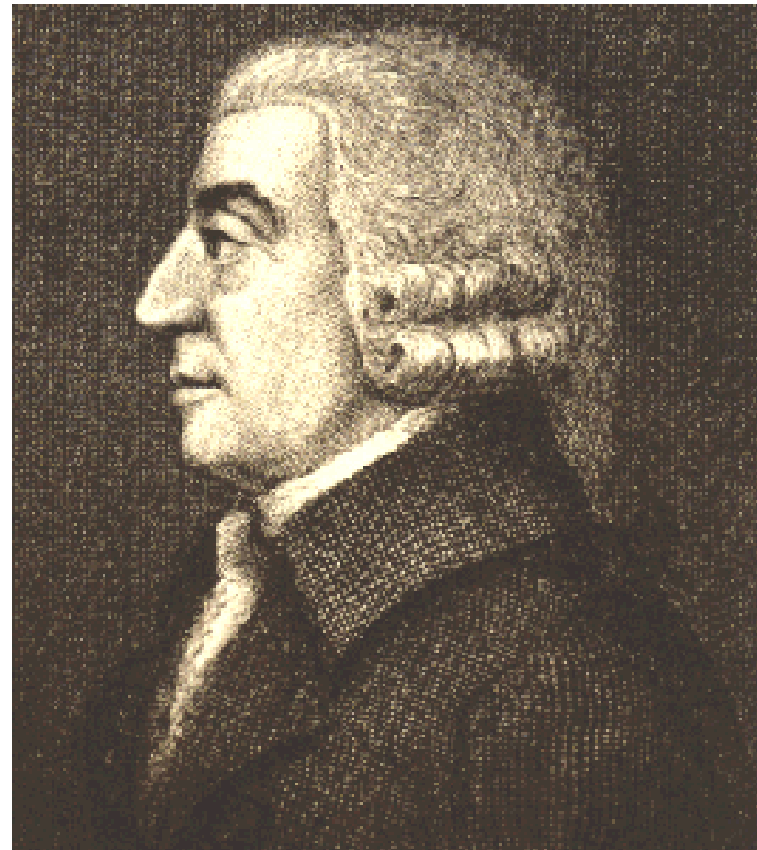
# CHAPTER 12

---

Government

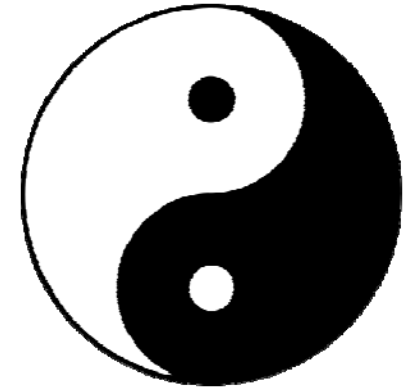
# Adam Smith 1755

- Little else is requisite to carry a state to the highest opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things.



# Laozi (6<sup>th</sup> century BC ?)

- The founder of **Taoism** - the first cohesive school to advocate little or no interference by the government in economic and social affairs.
- Laozi advocated minimal government intervention and low taxes.



## The Origins of the Phrase “Laissez-faire”

- The French phrase “Laissez-faire” was coined by Vincent de Gournay (1712 – 1759).
- The doctrine and even the name of “Laissez-faire” may have been inspired by the Chinese concept of **Wu Wei** (“without action”).

The image shows the Chinese characters for 'Wu Wei' (無為) in a bold, black, calligraphic style. The characters are arranged vertically, with '無' (Wu) on top and '為' (Wei) on the bottom. The brushwork is expressive, with varying line thickness and some ink bleed-through, giving it a traditional aesthetic.

# Government policies have significant impact on the economy

## North vs. South Korea

- After the Korean war (1953) both countries were devastated
- Both countries had similar natural resources, similar capital and similar levels of education
- In 2000, income per capita in South Korea is 16 times that of the North

# Hyundai Genesis (South Korea)



# Pyeonghwa Hwiparam (North Korea)



# East vs. West Germany

- After WWII (1945) both countries were devastated
- Both countries had similar natural resources, similar capital and similar levels of education

# West Germany (Mercedes)



# East Germany (Trabant)



# China (Great Leap Forward 1958)

Mao Zedong



## China (Great Leap Forward 1958)

- The plan by Chairman Mao Zedong was:
  - Restructuring agriculture into “communes”
  - Commune-based “backyard blast furnaces”
- Results:
  - Harvest fell by 25% between 1958 and 1960, but local officials reported that it doubled
  - 30 million people died of hunger

## What is wrong with communal industry?

- Halle and Berry both have two buckets that can be used to carry water to the city. Each makes only one trip to the city, and each bucket can be sold for \$5. Carrying the buckets to the city requires considerable effort. Both Halle and Berry would be willing to pay \$2 each to avoid carrying one bucket to the city and an additional \$3 to avoid carrying a second bucket to the city.

## What is wrong with communal industry?

- a. Given market prices, how many buckets of water will each of them carry to the city?

Bucket	0	1	2
Cost	0	\$2	\$3
Benefit	0	\$5	\$5
<b>Profit</b>	<b>0</b>	<b>\$3</b>	<b>\$2</b>

Answer: each will deliver 2 buckets, and each will have a profit of  $(5-2) + (5-3) = \$5$

## What is wrong with communal industry?

- b. Suppose instead that Halle and Berry must share the revenues from selling the water **equally**. Given that both of them are self-interested, what is the number of buckets that each of them will carry to the city?

## What is wrong with communal industry?

		Berry		
		0	1	2
Halle	0	0, 0	2.5, 0.5	5, 0
	1	0.5, 2.5	3, 3	5.5, 2.5
	2	0, 5	2.5, 5.5	5, 5

## What is wrong with communal industry?

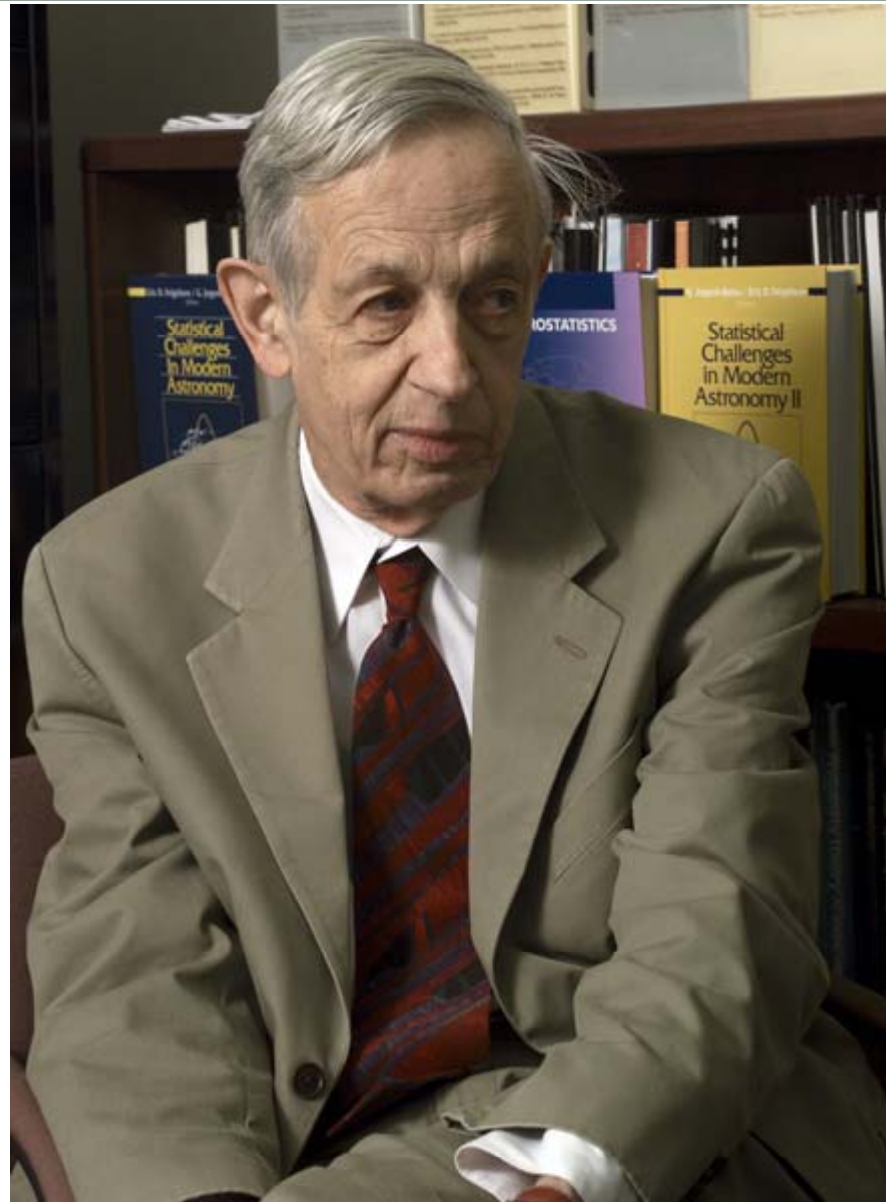
- The “best” outcome that will maximize their utility will be  $(2, 2)$ , i.e. each should carry 2 buckets. **But  $(2, 2)$  is not an equilibrium in this game.** Given that Halle carries 2 buckets, the best response for Berry is to carry only 1 bucket. And similarly, given that Berry carries 2 buckets, Halle would want to carry only 1.

## What is wrong with communal industry?

- **Nash equilibrium** – a combination of strategies such that each player's strategy is a best response to the other players' strategies. The players play a Nash equilibrium if no player wants to deviate from his strategy given the strategies of other players.
- The only Nash equilibrium in the above game is (1, 1) with payoffs (3, 3). When one person works hard, there is less incentive for others to work hard, if they share the output.

# John Nash

- Nobel Prize in Economics 1994



# China (1978 Liberalization)

- Deng Xiaoping



## China (Deng Xiaoping 1978 – Liberalization Plan)

- Communal land leased back to peasants. They could sell their surplus production.
- Easing restrictions on private enterprises (share of GDP produced by government owned enterprises fell from 78% in 1978 to 27% in 1998).
- Economic zones that encouraged foreign investment.

## China (Deng Xiaoping 1978 - Liberalization Plan)

- International trade as a fraction of GDP increased by a factor of 4.
- Income per capita increased by a factor of 4 during 1978 – 2001. (About 7% annual growth of GDP/capita. This is the most spectacular growth episode in human history since it involved 1/6 of the world population).

## 12.1 The Role of Government in the Economy

- The cases **for** government intervention
  - Market failure (public goods, externalities, monopolies).
  - Coordination (on which side of the road to drive)
  - Income redistribution

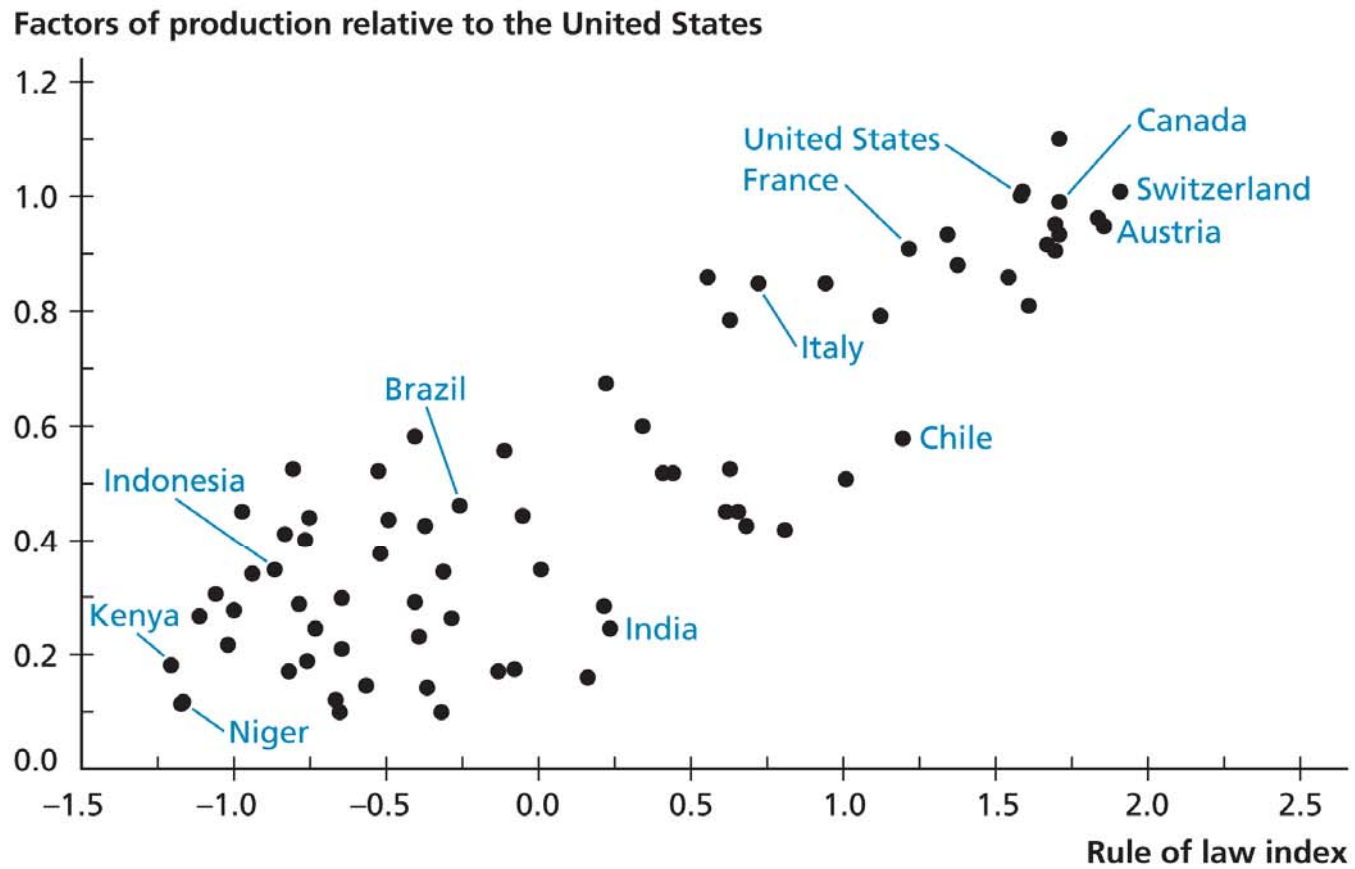
## 12.1 The Role of Government in the Economy

- The cases **against** government intervention
  - Market failure is replaced by **government failure**
  - Equity-efficiency tradeoff. Redistribution lowers efficiency.

## 12.2 How Government Affects Growth

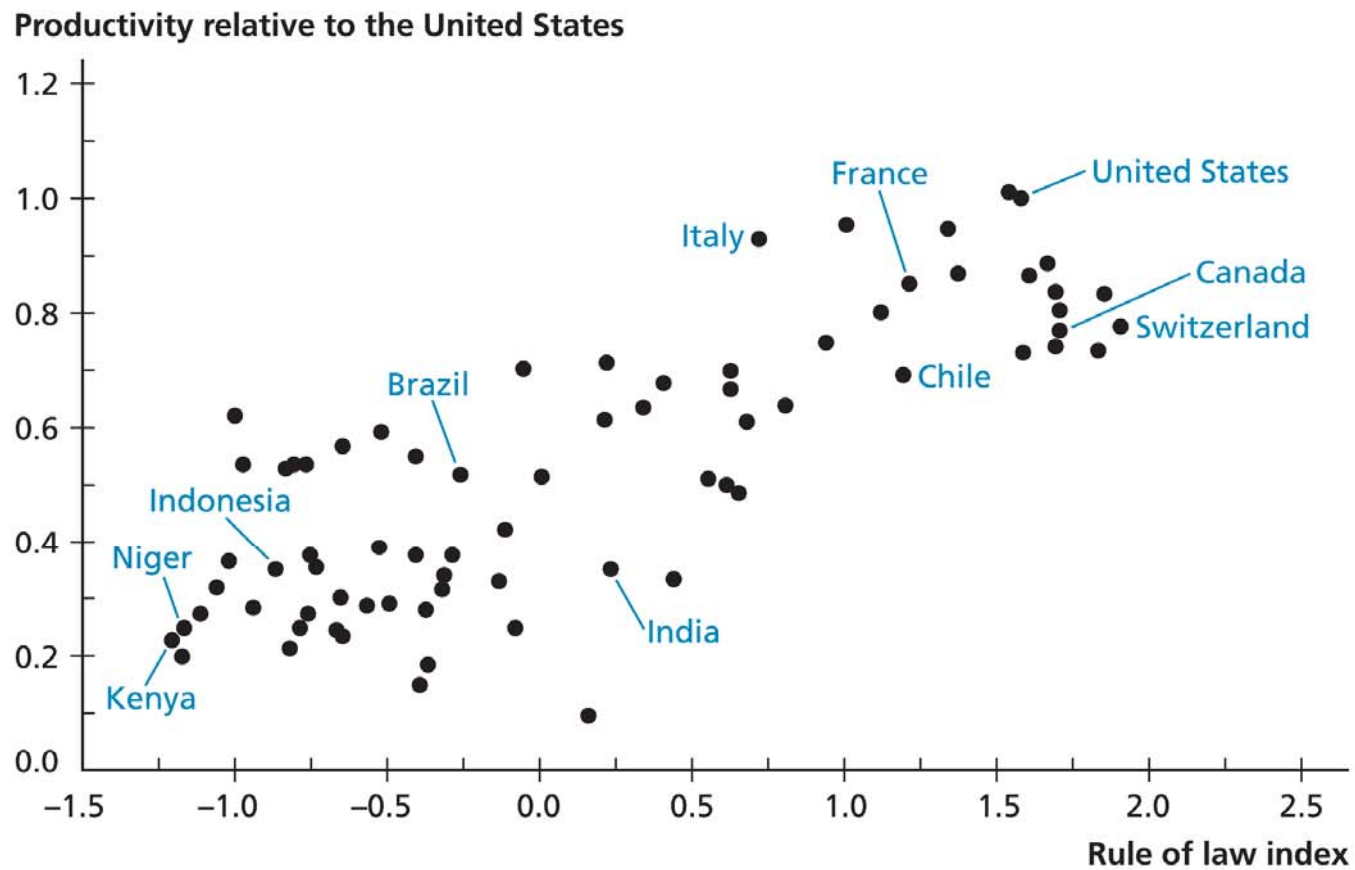
# 1. Rule of law

**FIGURE 12.1**  
**Rule of Law and Factor Accumulation**



Source: Kaufmann, Kray, and Zoido-Lobatón (2002). Data are scaled to have a standard deviation of 1.

**FIGURE 12.2**  
**Rule of Law and Productivity**

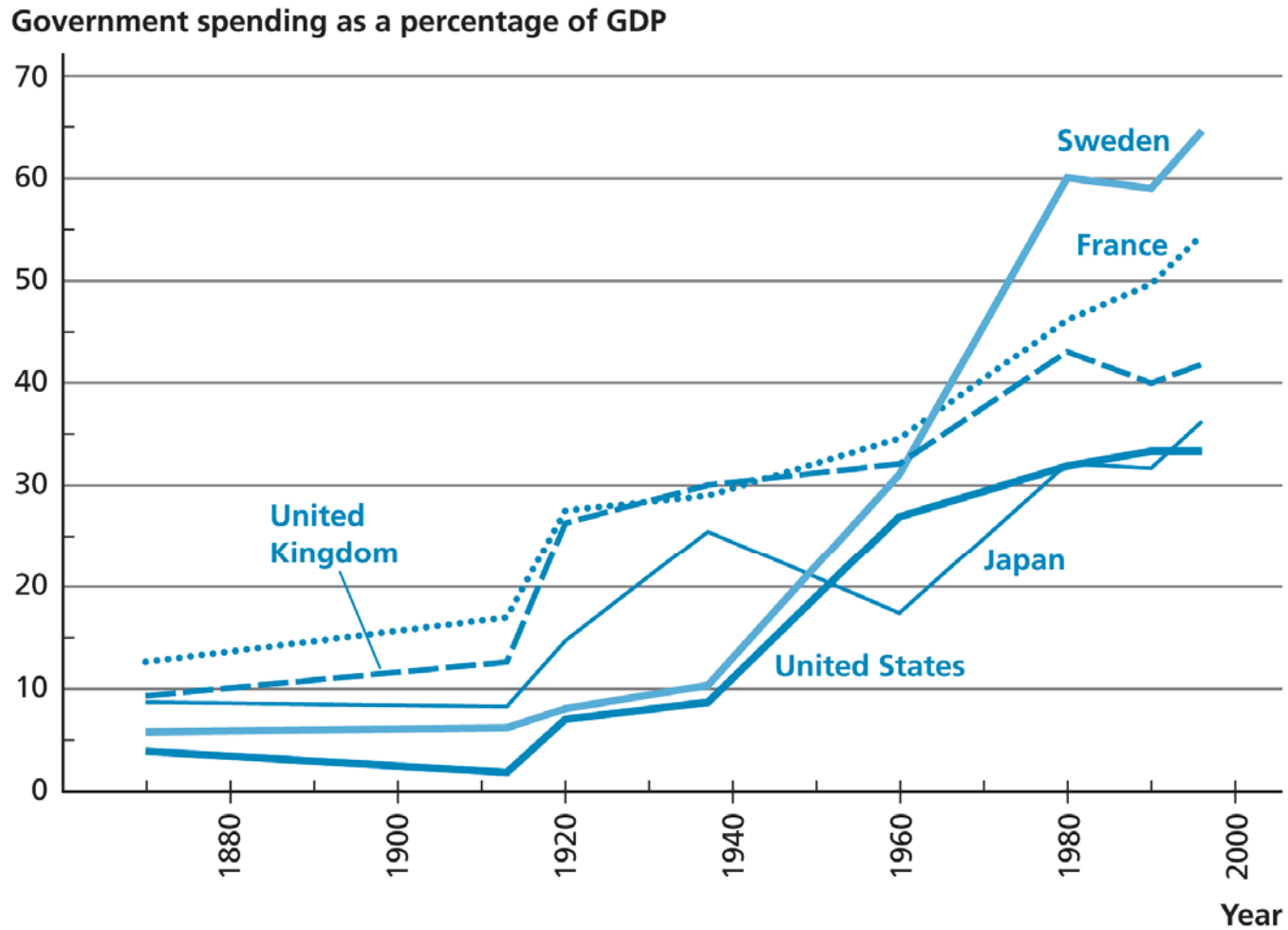


Source: Kaufmann, Kray, and Zoido-Lobaton (2002). Data are scaled to have a standard deviation of 1.

## 2. Taxation, efficiency, and the size of government.

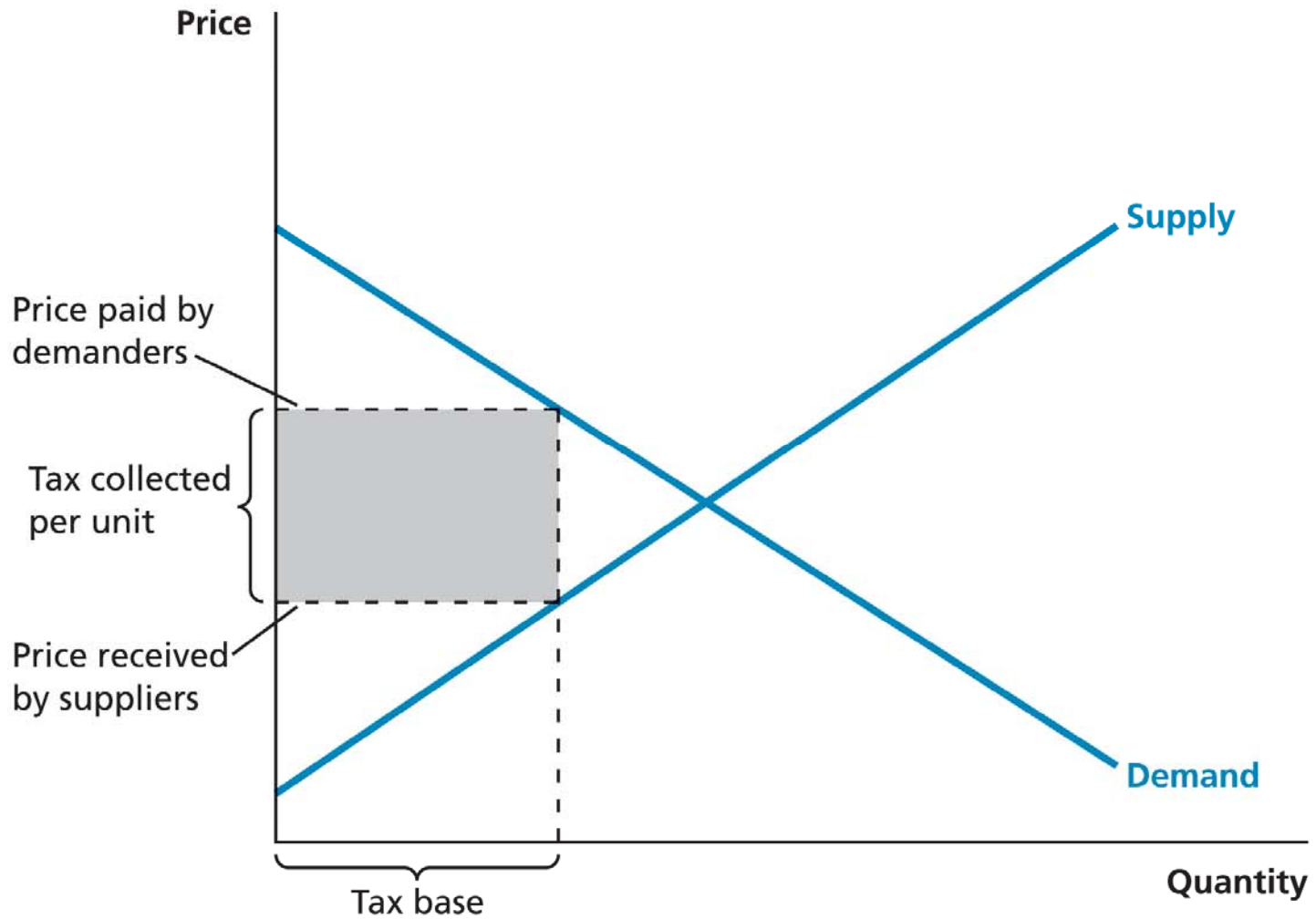
- Bigger governments collect more taxes, which we know are inefficient (in most cases).

**FIGURE 12.3**  
**Growth of Government Spending, 1870–1996**



Source: "The Future of the State," *The Economist*, September 20, 1997.

**FIGURE 12.4**  
**Effect of a Tax**



## 3. Planning and other industrial policies

- State enterprises
- Marketing boards (in some countries farmers are required to sell crops to government enterprise).
- Trade restrictions (tariffs, quotas to protect “infant industries”).

## 12.3 Why Governments Do Things That Are Bad for Growth

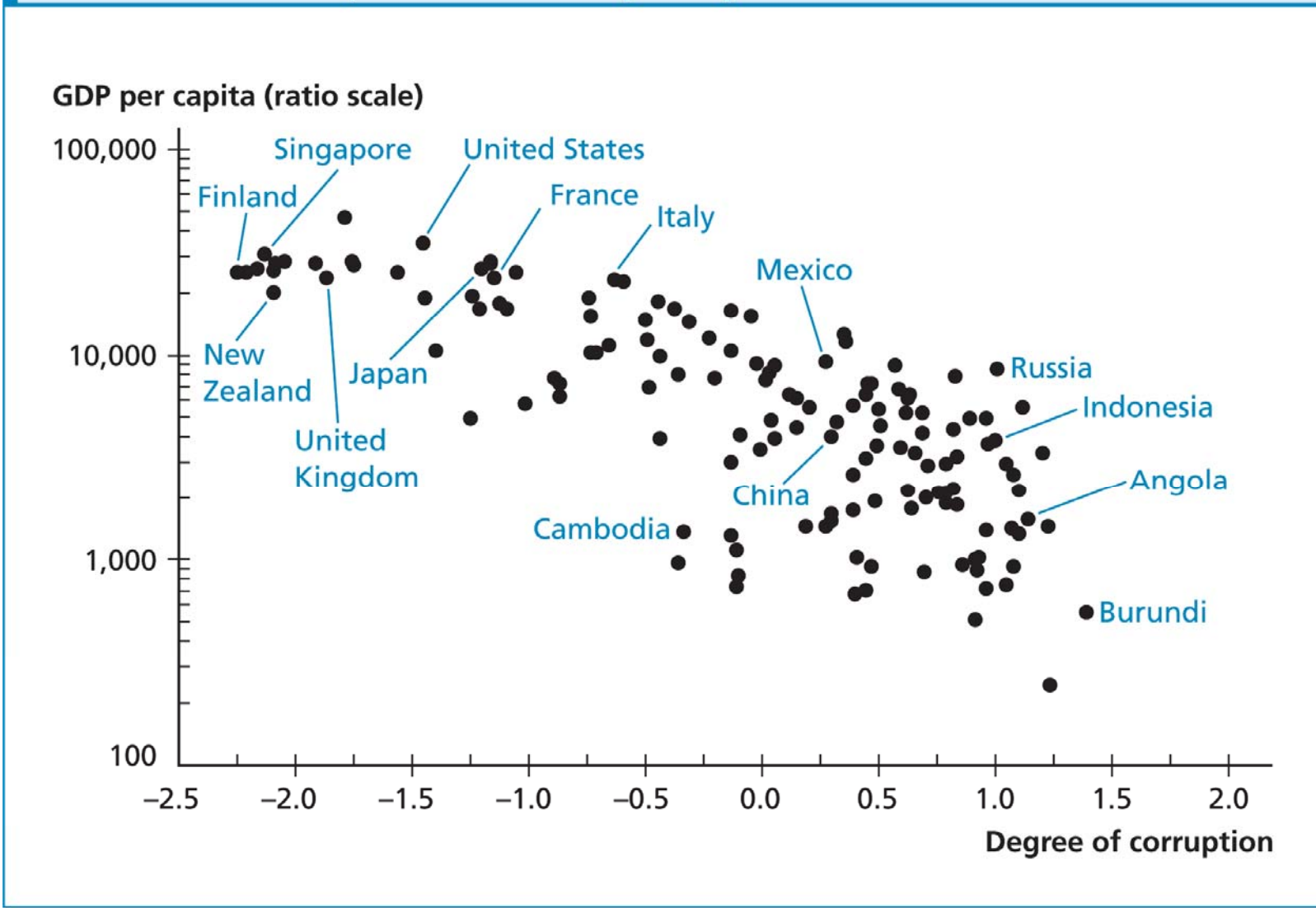
# 1. Governments have other goals

- For example, governments have a goal of redistribution of income, national defense.

## 2. Corruption and Kleptocracy

- **Kleptocracy** – rule by thieves.

**FIGURE 12.5**  
**Government Corruption Versus GDP per Capita, 2000**



Source: Kaufmann, Kray, and Zoido-Lobaton (2002).

## 3. Self Preservation

- New technologies may redistribute income from groups that support the government to other groups.
- Trade with the outside world may bring new ideas.

## Mobutu Sese Seko (President of Zaire)

Rwanda asked him to help fight rebels. He replied “I told you not to build any roads... Now they are driving down them to get you”.



## Lack of growth can also threaten existing regimes

- Emperor Meiji promoted growth

- Emperor Meiji (1868 – 1912). “ Rich Country, Strong Army”. During 45 years Japan became a world power.
- Hired 3000 foreign experts ([o-yatoi gaikokujin](#) or 'hired foreigners') in the fields of science, engineering, English teaching, navy, army.
- Adopted market economy, established stock market, banking, unified currency, subsidized big corporations (Mitsui, Mitsubishi).



## 12.4 Why Poor Countries Have Bad Governments?

- Are poor countries poor **because** of bad governments or is a bad government a **result** of countries being poor?
- Answer: some of each.

## Causation running from income to government quality

- Rich countries can afford to pay their civil servants reasonable wages, and thereby reduce the motivation for corruption.

## Causation running from government quality to income

- Often there is an obvious reason why some countries have bad government, **and it has nothing to do with their income.**
- Example – **colonialism.** Of the 30 most corrupt governments, 22 are former European colonies.

## How colonialism created bad governments?

- Colonial powers installed government systems designed to maximize revenue extracted from the colonies.
  - Beginning of 20<sup>th</sup> century, France extracted 50% of the GDP of its colony Dahomey
  - 1880-1920 Congo (Belgium Colony) 5-10 million natives died as a result of colonial brutality
  - When the Europeans left, they left the regimes in place

## How colonialism created bad governments?

- Europeans drew borders without regard to ethnic composition of population.
- They also played one ethnic group against another as part of the strategy “divide and conquer”. After the Europeans left, wars and struggle for power started and still going on.

Question: why did the United States, Canada and Australia (all former colonies) did not have bad governments?

# Answer

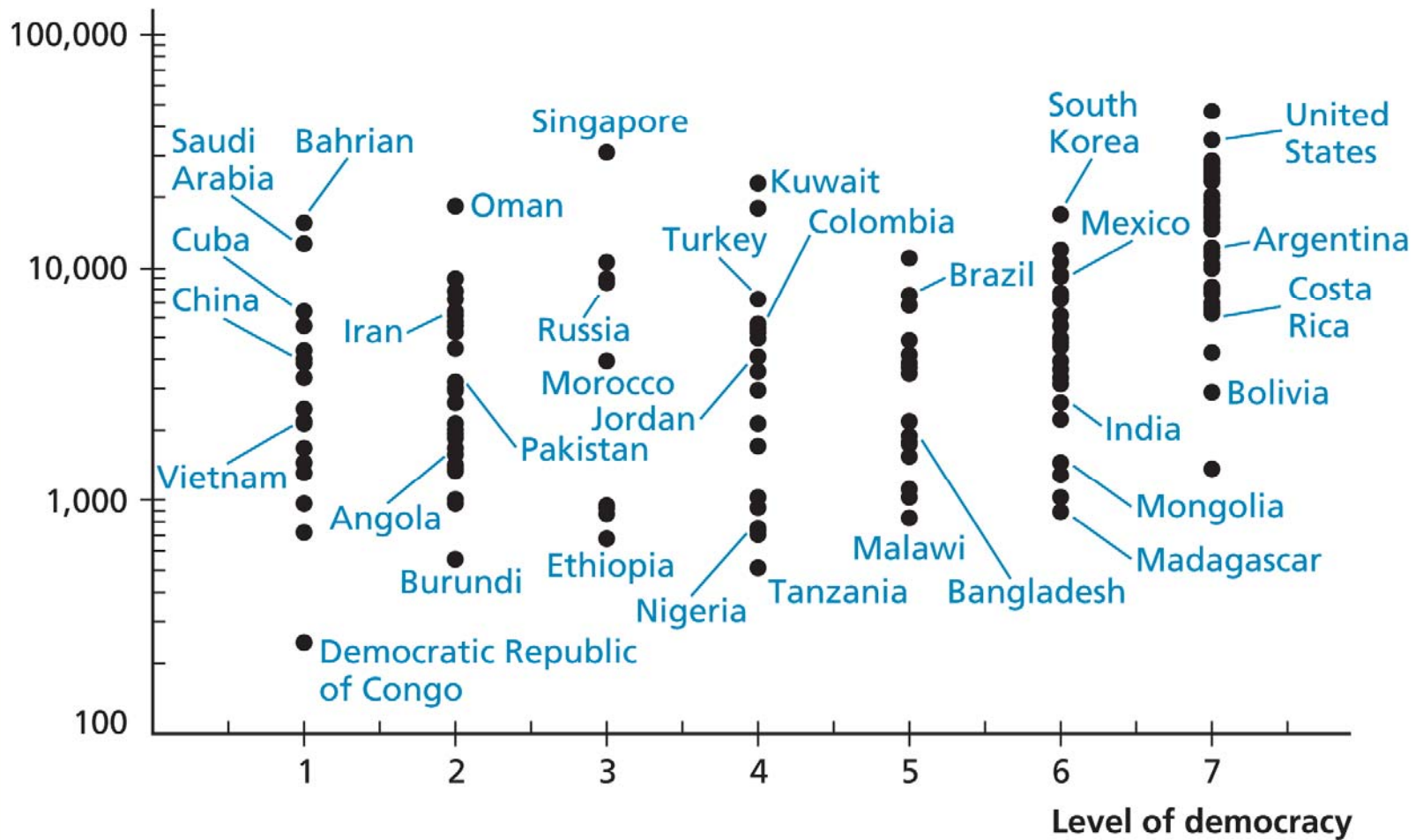
- Colonies with large number of European settlers, tended to establish governmental systems similar to Europeans.

# Democracy and growth

- Is democracy important for growth?

**FIGURE 12.6**  
**Democracy and GDP per Capita**

GDP per capita, 2000 (ratio scale)



Source: Freedom House (2001).

# Democracy and growth

- Is democracy important for growth?
  - We saw in the above graph there is a positive relationship between political freedom and GDP/capita.
  - Democracy sometimes is perceived as not stable. Case study: India vs. China. Currently China receives 10 more foreign direct investment than India.