

Spring 2010

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Recommended Citation

Makhija, Nishant, "Economic Growth of Nations" (2010). *Economics Graduate Research Papers*. Paper 4.
https://scholarworks.sjsu.edu/econ_grad_unpub/4

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Economic Growth of Nations

SJSU

Law and Economics
Research Paper

May 15, 2010

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Abstract

In this paper, I have attempted to find various factors that contribute to the growth of any nation. I analyzed Hernando de Soto's theory in his book, "The Mystery of Capital", Bruce R. Scott's research on impact of public policies on business environment, and Claudia R. Williamson research on the informal and formal property laws, cultural differences, and their influence on capital formation and economic development. I conclude that the development of western nations occurred due to confluence of many factors over the period of two centuries. Many political, social, and economic reforms were required. Culture, religion, differences in common and civil laws, and ethnic and linguistic diversity play significant roles in the development of any nation. Effective institutions for economic activities, policies, and enforceable rule of law are also very essential preconditions.

Economic Growth of Nations

Hernando de Soto's theory, well described in his book, "The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else". Hernando de Soto is known for his work on informal economies and on the importance of business and property rights. His work and writings emphasize that no nation can have a strong market economy unless most of its people are active participants of its economy.

Bruce R. Scott is a professor of Business Administration, particularly interested in studying the impact of public policy on the business environment. He has spent several years studying the concept of capitalism and development, well described in his book, "Capitalism: Its Origins and Evolution as a System of Governance".

Claudia R. Williamson is an assistant Professor in Economics Department of Appalachian State University. His research is based on the informal and formal property laws, cultural differences, and their impact on capital formation and economic development.

Hernando de Soto's work and writings emphasize that no nation can have a strong market economy unless most of its people are active participants in the economy. Exclusion of most of its economic actors results in two parallel economies, legal and extralegal. According to him, the elite minority enjoys the economic benefits of the law and globalization, whereas the majority of entrepreneurs are stuck in poverty, and all of their assets remain as dead capital in the shadows of the law. These extralegal communities create their own rules for protecting their assets, while trying to engage in business as much as possible. The problem with these extralegal communities is that they formulate their own social, political, and economic systems that introduce high transaction costs and rent-seeking. According to him, due to the immature and flawed legal property systems of developing nations, it becomes virtually impossible for the

majority of their economic actors and their assets to gain a stake in the market. This happens regardless of the level of talent and enthusiasm they possess. Mr. Soto claims that the assets in developing and former communist countries primarily serve only their immediate physical purposes, whereas in the Western countries, the same assets also live a parallel life as capital outside the physical world. Assets can be used to put in motion more production by securing the interests of other parties, such as collateral for a mortgage, or by assuring the supply of other forms of credit and public utilities. Mr. Soto understands the importance of stable currencies, open markets, and private businesses, but he believes that without legally enforceable integrated property rights and legal registration systems, the assets cannot be rated and valued to their real value.

Mr. Soto compares current extralegal systems and gray market conditions of undeveloped nations with market conditions two hundred years ago of the western world. At that time, even in the western world, there were extensive legal efforts to protecting legitimate providers by enforcing strong laws against gray market competition, leading to corruption and disobedience of the law. Nations such as France and Russia faced revolutions because of their strong laws against extralegal entrepreneurs. Some nations adapted their laws quickly and started institutionalizing the extralegal systems, moving in the direction of forming integrated legal property rights system. This institutionalization of extralegal systems provided enormous benefits to the actors who owned and maintained assets. The resulting integrated legal property system protected property titles, relieving actors from carrying burdens of protecting their property interests. Giving them the ability to concentrate on exploring full economic potential of their assets. This reform brought drastic changes in the economy. It made the assets fungible in the financial markets, actors accountable and credit worthy.

Claudia R. Williamson (2008) claims, "In order for formal institutions to stick, and thus promote economic development, formal institutions must map onto the informal rules". Countries that fall into the strong formal and informal rules category experience much higher levels of development than those that fall into the category of strong formal, weak informal rules. He also claims that countries that built their formal institutions off

of their informal rules are achieving much higher level of economic development, whereas, the countries where governments have imposed formal institutions without considering the informal institutions are the poorest. According to him property rights institutions, have substantial impacts on economic development. He refers to Douglass North (1990), arguing that the costliness of exchange and production is a result of institutions. Insecure property rights increase transaction costs, which in turn reduces capital formation, and Peter Bauer (2000) argues that capital formation is an outcome of institutions, essential for an economy to progress from subsistence production to market production. Property rights institutions provide incentives, facilitate production and exchange, accelerates capital accumulation, investment, technological innovation, and entrepreneurship. Hence, property rights ultimately promote economic growth. This research is consistent with Mr. Soto's findings.

Williamson also advocates the role of religion in economic development, it is suggested that different religions may have diverse effects on economic development. For example, it is suggested that Protestantism promotes hard work and individualism that leads to higher levels of economic development. He also acknowledges the importance of the differences in common and civil laws. Legal origin is shown to shape financial, legal, and economic institutions and outcomes. Common law, imposed during British colonization, is referred to as English legal origin. The French, Scandinavian, and German colonizers imposed civil law systems. He also emphasizes the importance of possible effects of ethnic and linguistic diversity on development. An ethnically and linguistically diverse population may find it difficult to overcome its differences to engage in widespread trade and exchange. Different ethnic groups may also pursue different public policies leading to political instability. Culture may be more important for initial growth, but its significance diminishes once the institutions of economic freedom are established.

A similar argument can be found in Hofstede (2001), where he defines one of five dimensions of culture as individualism versus collectivism. This aspect of culture defines the relationship between an individual and the collective that exists within a

society. In some societies, individualism is promoted and seen as beneficial, whereas, in other individualism is seen as selfish and alienating. Traditional societies with strong hierarchal religious following are more likely to promote the collective over individuals. This relationship not only matters for the way that groups live together, but also affects people's attitudes, functioning of institutions, and the structure of social and economic interactions. A more individualistic society will encourage anonymous market transactions, entrepreneurship, and more risk-taking activities. However, societies that promote collective over individuals may suppress economic interactions that would have produced beneficial results the society. Empirically, Hofstede verifies that countries with a higher individualism score outperform countries with a higher collectivism score.

Common people get confused when they think about capital; they assume that capital and money to be the same concept. Whereas, money is only one of the many forms in which capital travels. Money facilitates transactions, allowing us to buy and sell things, but can't regenerate itself, whereas, live capital has the capability to reproduce. Undeveloped nations and former communist nations have large sums of capital, for example, Egypt and Haiti, but that capital is not actively participating in their economic system. In order to bring the dormant capital to life, these countries need to initiate necessary macroeconomic and legal reforms. Reforms designed to protect property rights and create opportunities for people to participate in both domestic and global economy. These property interests must be tracked and documented under a standard legal system. This legal protection will make assets widely fungible and transferable. Without such legally enforceable and provable title to property, without a representational process that abides the law, these assets remain as lifeless capital. Such assets are unable to support credit and remain less attractive to any investors or purchasers. People in undeveloped or underdeveloped countries hold these resources or assets in defective forms; for example, houses or buildings built on land whose ownership property rights are not recorded, unincorporated businesses with vaguely or undefined liability, industries located in areas where prospective buyers or investors cannot reach. Because the legal property rights of these possessions are not documented in an integrated system, they cannot be turned into live capital, cannot be traded beyond the limited local circles where actors trust each

other, and cannot be considered as collateral. On the other hand, in western countries, legitimate property can be easily used as collateral, as equity for investment; as an address for collecting taxes and bills; as a point for the identification of actors for commercial or judicial purposes; and as a point of charging for public utility services.

These legal titles when incorporated into integrated property system can enhance the flow of information of these assets, significantly increase the purchasing power of owner, and expand transferability in a broader market. Thus, capital becomes flexible, productive, and its purchasing power becomes widely available for productive purposes. Such legal representations can enable buying and selling of assets without physically going to the market and confirming its physical characteristics. This becomes possible because accountability greatly impacts transactions in such markets. The integrated system imposes accountability and legal restraint, it enforces the owners to fulfill contracts, pay their debt obligations, and abide by the law. Legally enforceable and recorded representations of title to homes and other real assets provide a way to track the credit history of their owners, provide addresses to process and collect taxes, bills and debts, a basis for providing universal public services and utilities, and the foundation for creation of securities based on home or real asset mortgages. In order to have these products and services, a mature financial and legal property system is required. Such financial and legal systems can evolve by means of many pragmatic steps going through many trials and errors over many centuries. In Western countries, this process is hidden in many legislative artifacts, statutes, regulations, and institutions that govern the entire system, and it is almost impossible to understand how the system as a whole works. Once the foundation of this system is in place, the entire industry facilitates the use of these assets, starting from brokers, title companies, insurers, appraisers to escrow agents, and many others.

Around two centuries ago, the United States and European nations had similar market conditions. In most of today's underdeveloped world (containing 80 percent of the world's population) these conditions still prevail. People in undeveloped countries are not impoverished; they engage in productive activities, but in grey markets. Because

these assets are outside the legal recognition needed to turn them into live capital, their gray market activities remain undercapitalized. It's not that these people do not want to be a part of the legal system; it's the incredible amounts of bureaucratic hurdles that are required to overcome in their nations to legitimize their assets. Even after overcoming these hurdles, these asset owners have to engage in grey market operations. Since grey market is not accounted in most of the econometric analysis and poverty statistics, most potential assets in these undeveloped countries never get realized or identified. Leading to economy with lack of capital, and constrained exchange.

Mr. Soto's emphasis on legal property system is valid but not complete, factors such as cultural differences, Hofstede (2001), religion, Williamson (2009) government's industrial policy, sense of civic responsibility, and widespread public support for political and economic freedom are also equally important in determining the wealth of any nation. Mr. Soto notes that many Latin American countries have tried the capitalism on different occasions during the last two centuries and have failed all the times. He also doesn't put emphasis on other factors such as, numerous market weaknesses and lack of budgetary and monetary discipline, which also play major roles in economic stagnation. For example, Argentina's currency became stable but it's the budgetary process that remained uncontrollable.

A well-defined legal property system is most important for capital to become live, but in reality, even if the property rights are documented, enforced and incorporated, the amount of live capital generated depends on the effectiveness and profitability of the rights that the creditor possess. This effectiveness may vary from one country to another. Based on the Economic freedom index of the world, the legal system of undeveloped nations is underdeveloped, and its effectiveness to promote commerce is also inadequate. Similarly, a strong financial system is also required for capital to become live. Financial systems of underdeveloped countries are not mature enough for the actors to get full benefit of their legal assets. For example, bank credit may not be accessible or available for small business expansions even if the actor has a legal asset to use as collateral. Government policies such as heavy taxes, regulations, and corruption in the

administrative departments may make legitimate business unprofitable. Physical infrastructure of the country also plays important roles in resurrecting the capital. In other words, an optimal balance of all the aforementioned factors is required for any economy to develop and run at its full potential. All factors such as physical safety for persons and property, enforcement of contracts, education (human capital), modern bankruptcy and commercial laws, elimination of restraints on foreign and local competition, and relatively favorable risk vs. reward ratios are required. Harvard Prof. Bruce Scott in his book "The Concept of Capitalism" emphasizes some of the importance of these factors that widely stifle growth and development in underdeveloped nations.

Mr. Soto points out that the leaders of undeveloped nations are missing the phenomenon that people are spontaneously and continuously organizing themselves into distinct extralegal groups until the administrative departments of the government can provide them with an integrated legal property system. He believes that in most of undeveloped nations, the leaders do not care whether people of their country live or die, they concentrate on their own and their supporters' wellbeing and self-interests. Claudia R. Williamson makes a similar point about governments choosing a suboptimal path in favor of state rather than its subjects, "In practice, the process of formalizing informal institutions is not always in the interest of the public. Instead, governments may choose to formalize in such a way that is inefficient and suboptimal as long as it benefits the state".

Mr. Soto points out that almost all property owners would be willing to assume modest taxes if becoming legitimate did not overburdened them with many other difficulties and costs. I argue, that this can only be possible if those businesses can operate more profitably legitimately even after paying taxes, otherwise, they may not have any incentive to integrate themselves into the new legal property system.

Conclusion

Mr. Hernando de Soto's research gives some insights about the initiation of a process known as economic development of a nation by forming an integrated legal property system, but I claim that simply giving legal titles to owners is not enough. The development of western nations happened due to confluence of many factors that includes trial and error over the period of two centuries. Many political, social, and economic reforms were required to bring the capital of western countries to life. I agree with Williamson's research about the importance of culture, religion, differences in common and civil laws, and ethnic and linguistic diversity in the development of any country. Effective institutions for economic activities, policies, and enforceable rule of law are very essential preconditions for economic development, not just the legalization of assets or property. I also agree with Prof. Bruce Scott research stating the importance of maintaining competitive capitalist markets that works for all instead of few with political influence and power.

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