

Seventh Edition

Principles of
Economics

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CHAPTER
25

**Production
and Growth**

In this chapter, look for the answers to these questions

- What are the facts about living standards and growth rates around the world?
- Why does productivity matter for living standards?
- What determines productivity and its growth rate?
- How can public policy affect growth and living standards?

A typical family with all their possessions in the U.K., an advanced economy



GDP per capita: \$36,010

Child mortality rate: 0.5%

High school enrollment: 98%

A typical family with all their possessions in Mexico, a middle income country

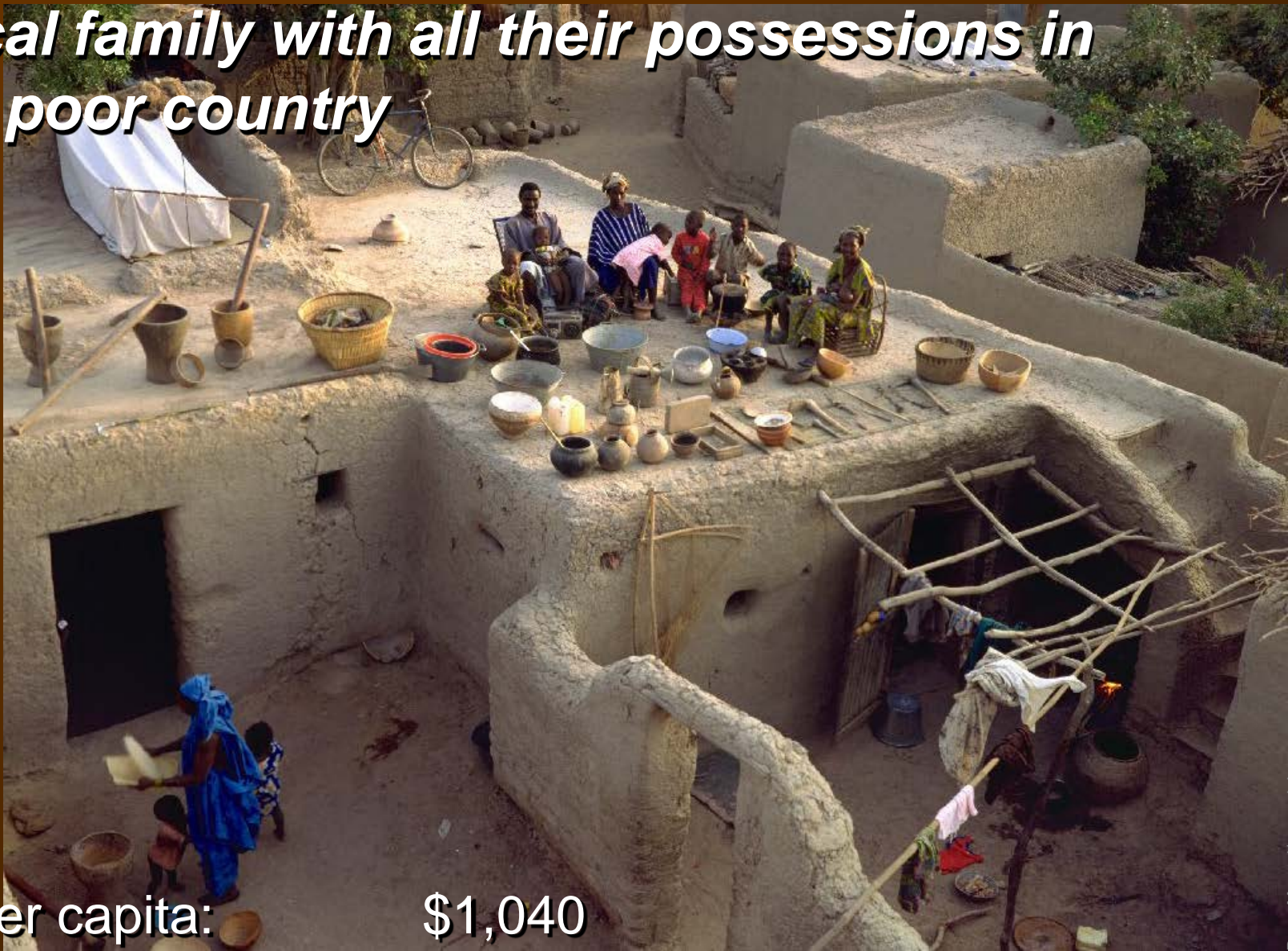


GDP per capita: \$15,390

Child mortality rate: 1.6%

High school enrollment: 71%

A typical family with all their possessions in Mali, a poor country



GDP per capita: \$1,040

Child mortality rate: 17.6%

High school enrollment: 31%

Incomes and Growth Around the World

FACT 1:

There are vast differences in living standards around the world.

	<i>GDP per capita, 2012</i>	<i>Growth rate, 1970–2012</i>
China	\$9,233	7.5%
Singapore	\$61,803	4.7%
India	\$3,876	3.3%
Japan	\$35,178	2.1%
Spain	\$32,682	1.9%
Israel	\$31,869	2.1%
Colombia	\$10,583	2.0%
United States	\$49,965	1.8%
Canada	\$42,533	1.7%
Philippines	\$4,410	1.4%
Rwanda	\$1,354	1.4%
New Zealand	\$32,219	1.4%
Argentina	\$17,917	1.4%
Saudi Arabia	\$31,729	1.2%
Chad	\$1,493	0.6%

Incomes and Growth Around the World

FACT 2:

There is also great variation in growth rates across countries.

	<i>GDP per capita, 2012</i>	<i>Growth rate, 1970–2012</i>
China	\$9,233	7.5%
Singapore	\$61,803	4.7%
India	\$3,876	3.3%
Japan	\$35,178	2.1%
Spain	\$32,682	1.9%
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Incomes and Growth Around the World

Since growth rates vary, the country rankings can change over time:

- Poor countries are not necessarily doomed to poverty forever, e.g. Singapore incomes were low in 1960 and are quite high now.
- Rich countries can't take their status for granted: They may be overtaken by poorer but faster-growing countries.

Incomes and Growth Around the World

Questions:

- Why are some countries richer than others?
- Why do some countries grow quickly while others seem stuck in a poverty trap?
- What policies may help raise growth rates and long-run living standards?

Productivity

- Recall one of the Ten Principles from Chap. 1:
A country's standard of living depends on its ability to produce g&s.
- This ability depends on **productivity**, the average quantity of g&s produced per unit of labor input.
- Y = real GDP = quantity of output produced
 L = quantity of labor
so productivity = Y/L (output per worker)

Why Productivity Is So Important

- When a nation's workers are very productive, real GDP is large and incomes are high.
- When productivity grows rapidly, so do living standards.
- What, then, determines productivity and its growth rate?

Physical Capital Per Worker

- Recall: The stock of equipment and structures used to produce g&s is called **[physical] capital**, denoted **K**.
- **K/L** = capital per worker.
- Productivity is higher when the average worker has more capital (machines, equipment, etc.).
- i.e.,
an increase in **K/L** causes an increase in **Y/L**.

Human Capital Per Worker

- **Human capital (H):**
the knowledge and skills workers acquire through education, training, and experience
- **H/L** = the average worker's human capital
- Productivity is higher when the average worker has more human capital (education, skills, etc.).
- i.e.,
an increase in **H/L** causes an increase in **Y/L**.

Natural Resources Per Worker

- **Natural resources (N)**: the inputs into production that nature provides, e.g., land, mineral deposits
- Other things equal, more **N** allows a country to produce more **Y**.
In per-worker terms, an increase in **N/L** causes an increase in **Y/L**.
- Some countries are rich because they have abundant natural resources (e.g., Saudi Arabia has lots of oil).
- But countries need not have much **N** to be rich (e.g., Japan imports the **N** it needs).

Technological Knowledge

- **Technological knowledge:** society's understanding of the best ways to produce g&s
- Technological progress does not only mean a faster computer, a higher-definition TV, or a smaller cell phone.
- It means any advance in knowledge that boosts productivity (allows society to get more output from its resources).
 - e.g., Henry Ford and the assembly line.

Tech. Knowledge vs. Human Capital

- Technological knowledge refers to society's understanding of how to produce g&s.
- Human capital results from the effort people expend to acquire this knowledge.
- Both are important for productivity.

The Production Function

- The production function is a graph or equation showing the relation between output and inputs:

$$Y = A F(L, K, H, N)$$

F() is a function that shows how inputs are combined to produce output

“**A**” is the level of technology

- “**A**” multiplies the function **F()**, so improvements in technology (increases in “**A**”) allow more output (**Y**) to be produced from any given combination of inputs.

The Production Function

$$Y = A F(L, K, H, N)$$

- The production function has the property **constant returns to scale**: Changing all inputs by the same percentage causes output to change by that percentage. For example,
- Doubling all inputs (multiplying each by 2) causes output to double:

$$2Y = A F(2L, 2K, 2H, 2N)$$

- Increasing all inputs 10% (multiplying each by 1.1) causes output to increase by 10%:

$$1.1Y = A F(1.1L, 1.1K, 1.1H, 1.1N)$$

The Production Function

$$Y = A F(L, K, H, N)$$

- If we multiply each input by $1/L$, then output is multiplied by $1/L$:

$$Y/L = A F(1, K/L, H/L, N/L)$$

- This equation shows that productivity (output per worker) depends on:
 - the level of technology (**A**)
 - physical capital per worker
 - human capital per worker
 - natural resources per worker

ACTIVE LEARNING 1

Discussion question

Which of the following policies do you think would be most effective at boosting growth and living standards in a poor country over the long run?

- a.** Offer tax incentives for investment by local firms
- b.** " " " " " by foreign firms
- c.** Give cash payments for good school attendance
- d.** Crack down on govt corruption
- e.** Restrict imports to protect domestic industries
- f.** Allow free trade
- g.** Give away condoms

ECONOMIC GROWTH AND PUBLIC POLICY

Next, we look at the ways
public policy can affect
long-run growth in productivity
and living standards.

Saving and Investment

- We can boost productivity by increasing **K**, which requires investment.
- Since resources scarce, producing more capital requires producing fewer consumption goods.
- Reducing consumption = increasing saving. This extra saving funds the production of investment goods.
(More details in the next chapter.)
- Hence, a tradeoff between current and future consumption.

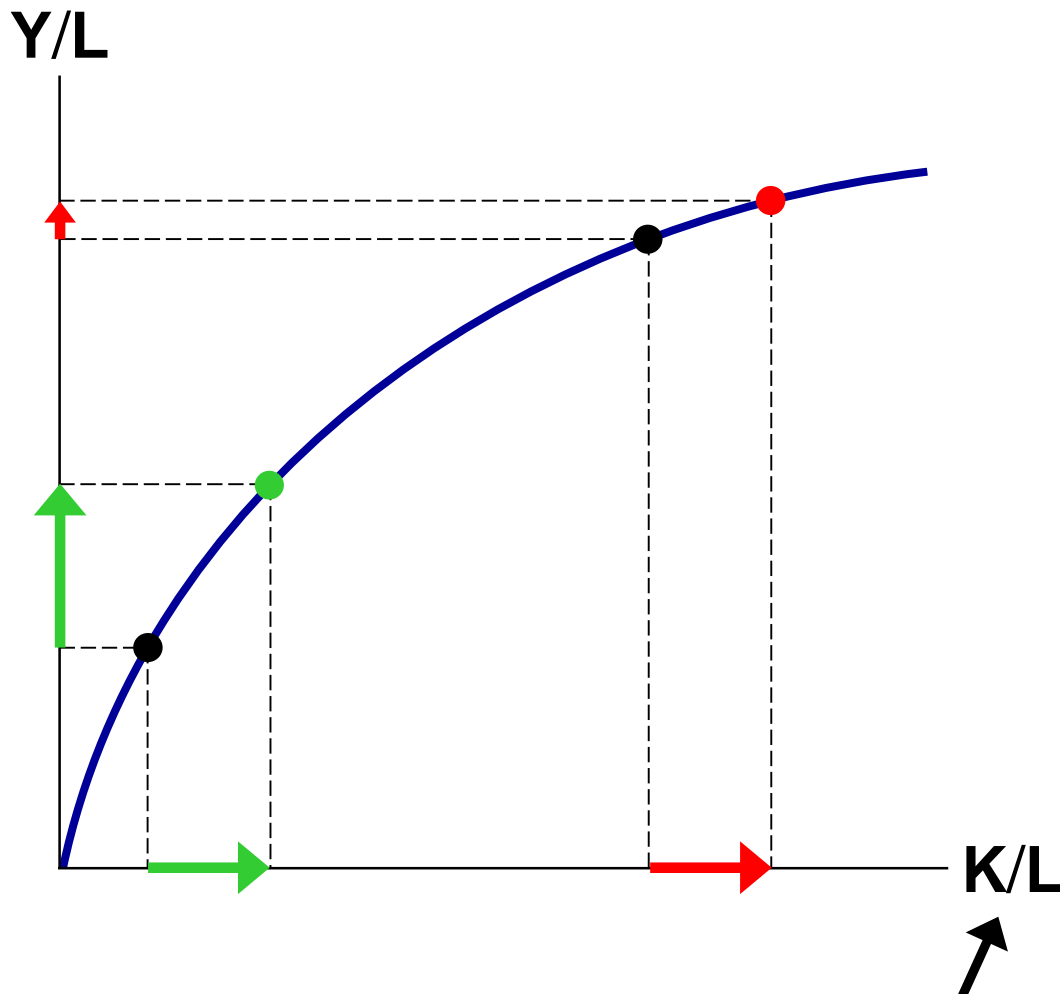
Diminishing Returns and the Catch-Up Effect

- The govt can implement policies that raise saving and investment. (*Details in next chapter.*) Then **K** will rise, causing productivity and living standards to rise.
- But this faster growth is temporary, due to **diminishing returns to capital**: As **K** rises, the extra output from an additional unit of **K** falls.....

The Production Function & Diminishing Returns

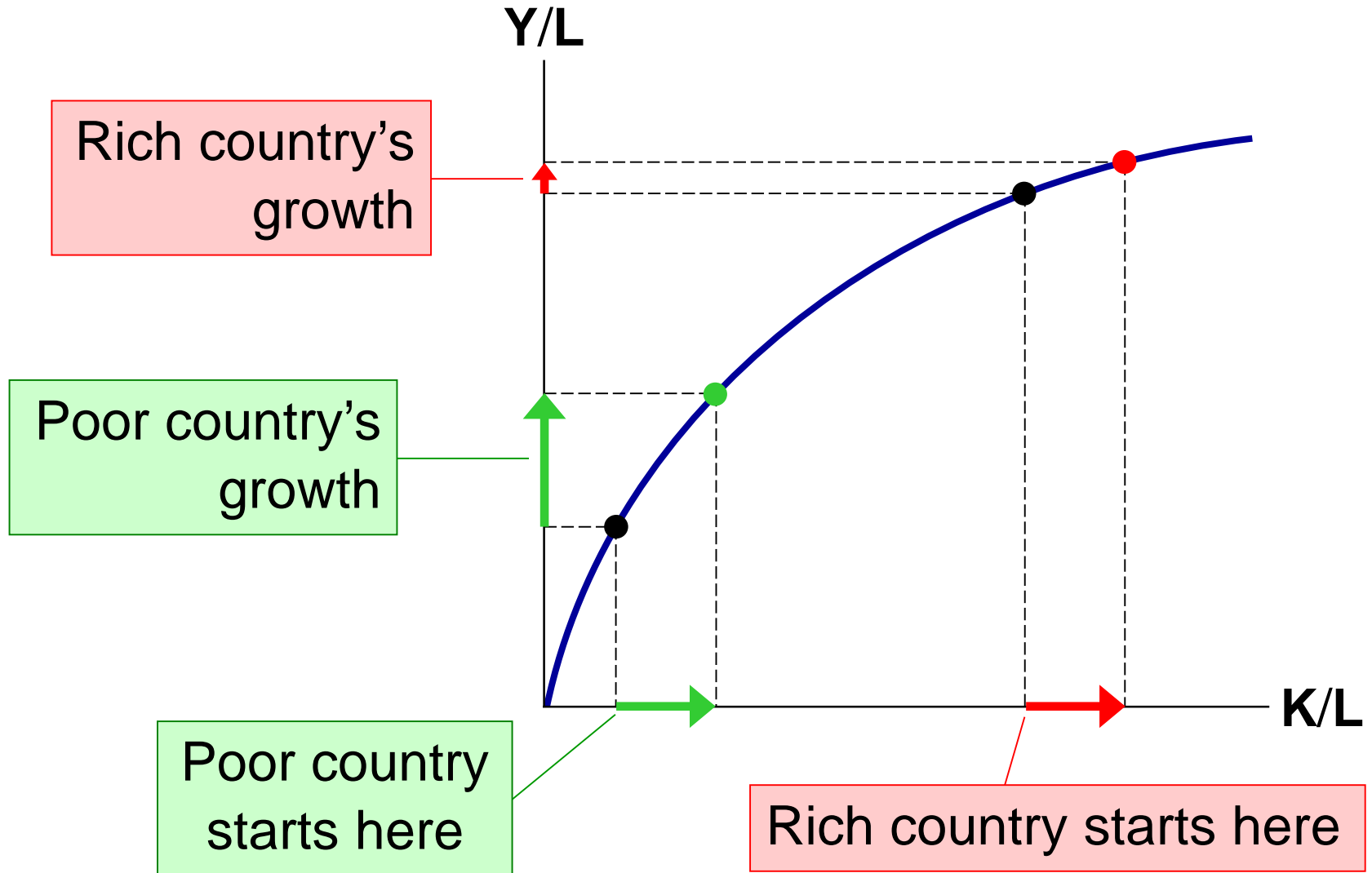
If workers have little **K**, giving them more increases their productivity a lot.

If workers already have a lot of **K**, giving them more increases productivity fairly little.



Capital per worker

The catch-up effect: the property whereby poor countries tend to grow more rapidly than rich ones



Example of the Catch-Up Effect

- Over 1960–1990, the U.S. and S. Korea devoted a similar share of GDP to investment, so you might expect they would have similar growth performance.
- But growth was $>6\%$ in Korea and only 2% in the U.S.
- Explanation: the catch-up effect.
In 1960, K/L was far smaller in Korea than in the U.S., hence Korea grew faster.

Investment from Abroad

- To raise **K/L** and hence productivity, wages, and living standards, the govt can also encourage
 - **foreign direct investment:**
a capital investment (e.g., a factory) that is owned & operated by a foreign entity
 - **foreign portfolio investment:**
a capital investment financed with foreign money but operated by domestic residents
- Some of the returns from these investments flow back to the foreign countries that supplied the funds.

Investment from Abroad

- Especially beneficial in poor countries that cannot generate enough saving to fund investment projects themselves.
- Also helps poor countries learn state-of-the-art technologies developed in other countries.

Education

- Govt can increase productivity by promoting education—investment in human capital (**H**).
 - Public schools, subsidized loans for college
- Education has significant effects: In the U.S., each year of schooling raises a worker's wage by 10%.
- But investing in **H** also involves a tradeoff between the present & future:
Spending a year in school requires sacrificing a year's wages now to have higher wages later.

Health and Nutrition

- Health care expenditure is a type of investment in human capital—healthier workers are more productive.
- In countries with significant malnourishment, raising workers' caloric intake raises productivity:
 - Over 1962–95, caloric consumption rose 44% in S. Korea, and economic growth was spectacular.
 - Nobel winner Robert Fogel: 30% of Great Britain's growth from 1790–1980 was due to improved nutrition.

Property Rights and Political Stability

- Recall:

Markets are usually a good way to organize economic activity.

The price system allocates resources to their most efficient uses.

- This requires respect for **property rights**, the ability of people to exercise authority over the resources they own.

Property Rights and Political Stability

- In many poor countries, the justice system doesn't work very well:
 - Contracts aren't always enforced
 - Fraud, corruption often go unpunished
 - In some, firms must bribe govt officials for permits
- Political instability (e.g., frequent coups) creates uncertainty over whether property rights will be protected in the future.

Property Rights and Political Stability

- When people fear their capital may be stolen by criminals or confiscated by a corrupt govt, there is less investment, including from abroad, and the economy functions less efficiently. Result: lower living standards.
- Economic stability, efficiency, and healthy growth require law enforcement, effective courts, a stable constitution, and honest govt officials.

Free Trade

- **Inward-oriented policies**

(e.g., tariffs, limits on investment from abroad) aim to raise living standards by avoiding interaction with other countries.

- **Outward-oriented policies**

(e.g., the elimination of restrictions on trade or foreign investment) promote integration with the world economy.

Free Trade

- Recall: ***Trade can make everyone better off.***
- Trade has similar effects as discovering new technologies—it improves productivity and living standards.
- Countries with inward-oriented policies have generally failed to create growth.
 - e.g., Argentina during the 20th century.
- Countries with outward-oriented policies have often succeeded.
 - e.g., South Korea, Singapore, Taiwan after 1960.

Research and Development

- Technological progress is the main reason why living standards rise over the long run.
- One reason is that knowledge is a **public good**: Ideas can be shared freely, increasing the productivity of many.
- Policies to promote tech. progress:
 - Patent laws
 - Tax incentives or direct support for private sector R&D
 - Grants for basic research at universities

Population Growth

...may affect living standards in 3 different ways:

1. Stretching natural resources

- 200 years ago, Malthus argued that pop. growth would strain society's ability to provide for itself.
- Since then, the world population has increased sixfold. If Malthus was right, living standards would have fallen. Instead, they've risen.
- Malthus failed to account for technological progress and productivity growth.

Population Growth

2. Diluting the capital stock

- Bigger population = higher **L** = lower **K/L**
= lower productivity & living standards.
- This applies to **H** as well as **K**:
fast pop. growth = more children
= greater strain on educational system.
- Countries with fast pop. growth tend to have lower educational attainment.

Population Growth

2. Diluting the capital stock

To combat this, many developing countries use policy to control population growth.

- China's one child per family laws
- Contraception education & availability
- Promote female literacy to raise opportunity cost of having babies

Population Growth

3. Promoting tech. progress

- More people
 - = more scientists, inventors, engineers
 - = more frequent discoveries
 - = faster tech. progress & economic growth
- Evidence from Michael Kremer:
Over the course of human history,
 - growth rates increased as the world's population increased
 - more populated regions grew faster than less populated ones

ACTIVE LEARNING 2

Review productivity concepts

- List the determinants of productivity.
- List three policies that attempt to raise living standards by increasing one of the determinants of productivity.

Answers

Determinants of productivity:

K/L, physical capital per worker

H/L, human capital per worker

N/L, natural resources per worker

A, technological knowledge

Policies to boost productivity:

- Encourage saving and investment, to raise **K/L**
- Encourage investment from abroad, to raise **K/L**
- Provide public education, to raise **H/L**

Answers

Determinants of productivity:

K/L, physical capital per worker

H/L, human capital per worker

N/L, natural resources per worker

A, technological knowledge

Policies to boost productivity:

- Patent laws or grants, to increase **A**
- Control population growth, to increase **K/L**

Are Natural Resources a Limit to Growth?

- Some argue that population growth is depleting the Earth's non-renewable resources, and thus will limit growth in living standards.
- But technological progress often yields ways to avoid these limits:
 - Hybrid cars use less gas.
 - Better insulation in homes reduces the energy required to heat or cool them.
- As a resource becomes scarcer, its market price rises, which increases the incentive to conserve it and develop alternatives.

CONCLUSION

- In the long run, living standards are determined by productivity.
- Policies that affect the determinants of productivity will therefore affect the next generation's living standards.
- One of these determinants is saving and investment.
- In the next chapter, we will learn how saving and investment are determined, and how policies can affect them.

Summary

- There are great differences across countries in living standards and growth rates.
- Productivity (output per unit of labor) is the main determinant of living standards in the long run.
- Productivity depends on physical and human capital per worker, natural resources per worker, and technological knowledge.
- Growth in these factors—especially technological progress—causes growth in living standards over the long run.

Summary

- Policies can affect the following, each of which has important effects on growth:
 - Saving and investment
 - International trade
 - Education, health & nutrition
 - Property rights and political stability
 - Research and development
 - Population growth
- Because of diminishing returns to capital, growth from investment eventually slows down, and poor countries may “catch up” to rich ones.