

## 6.2: A Healthy Climate for Economic Growth

### Learning Objectives

- Identify factors that contribute to a healthy climate for economic growth
- Explain the importance of the rule of law, property rights, and contractual rights in supporting economic growth

While physical and human capital deepening and better technology are important, equally important to a nation's well-being is the climate or system within which these inputs are cultivated. Both the type of market economy and a legal system that governs and sustains property rights and contractual rights are important contributors to a healthy economic climate.

A healthy economic climate usually involves some sort of market orientation at the microeconomic, individual, or firm decision-making level. Markets that allow personal and business rewards and incentives for increasing human and physical capital encourage overall macroeconomic growth. For example, when workers participate in a competitive and well-functioning labor market, they have an incentive to acquire additional human capital, because additional education and skills will pay off in higher wages. Firms have an incentive to invest in physical capital and in training workers, because they expect to earn higher profits for their shareholders. Both individuals and firms look for new technologies, because even small inventions can make work easier or lead to product improvement. Collectively, such individual and business decisions made within a market structure add up to macroeconomic growth. Much of the rapid growth since the late nineteenth century has come from harnessing the power of competitive markets to allocate resources. This market orientation typically reaches beyond national borders and includes openness to international trade.

### Rule of Law and Economic Growth

Economic growth depends on many factors. Key among those factors is adherence to the **rule of law** and protection of **property rights** and **contractual rights** by a country's government so that markets can work effectively and efficiently. Laws must be clear, public, fair, enforced, and equally applicable to all members of society. Property rights are the rights of individuals and firms to own property and use it as they see fit. If you have \$100, you have the right to use that money, whether you spend it, lend it, or keep it in a jar. It is your property. The definition of property includes physical property as well as the right to your training and experience, especially since your training is what determines your livelihood. The use of this property includes the right to enter into contracts with other parties with your property. Individuals or firms must own the property to enter into a contract.

Contractual rights, then, are based on property rights and they allow individuals to enter into agreements with others regarding the use of their property providing recourse through the legal system in the event of noncompliance. One example is the employment agreement: a skilled surgeon operates on an ill person and expects to get paid. Failure to pay would constitute a theft of property by the patient; that property being the services provided by the surgeon. In a society with strong property rights and contractual rights, the terms of the patient–surgeon contract will be fulfilled, because the surgeon would have recourse through the court system to extract payment from that individual. Without a legal system that enforces contracts, people would not be likely to enter into contracts for current or future services because of the risk of non-payment. This would make it difficult to transact business and would slow economic growth.

The [World Bank](https://www.worldbank.org/) considers a country's legal system effective if it upholds property rights and contractual rights. The World Bank has developed a ranking system for countries' legal systems based on effective protection of property rights and rule-based governance using a scale from 1 to 6, with 1 being the lowest and 6 the highest rating. In 2012, the world average ranking was 2.9. The three countries with the lowest ranking of 1.5 were Afghanistan, the Central African Republic, and Zimbabwe; their GDP per capita was \$1,000, \$800, and \$600 respectively. Afghanistan is cited by the World Bank as having a low standard of living, weak government structure, and lack of adherence to the rule of law, which has stymied its economic growth. The landlocked Central African Republic has poor economic resources as well as political instability and is a source of children used in human trafficking. Zimbabwe has had declining growth since 1998. Land redistribution and price controls have disrupted the economy, and corruption and violence have dominated the political process. Although global economic growth has increased, those countries lacking a clear system of property rights and an independent court system free from corruption have lagged far behind.

A general orientation toward markets does not rule out important roles for government. There are times when markets fail to allocate capital or technology in a manner that provides the greatest benefit for society as a whole. The role of the government is to correct these failures. In addition, government can guide or influence markets toward certain outcomes. The following examples

highlight some important areas that governments around the world have chosen to invest in to facilitate capital deepening and technology:

- **Education.** The Danish government requires all children under 16 to attend school. They can choose to attend a public school (*Folkeskole*) or a private school. Students do not pay tuition to attend *Folkeskole*. Thirteen percent of primary/secondary (elementary/high) school is private, and the government supplies vouchers to citizens who choose private school.
- **Savings and Investment.** In the United States, as in other countries, private investment is taxed. Low capital gains taxes encourage investment and so also economic growth.
- **Infrastructure.** The Japanese government in the mid-1990s undertook significant infrastructure projects to improve roads and public works. This in turn increased the stock of physical capital and ultimately economic growth.
- **Special Economic Zones.** The island of Mauritius is one of the few African nations to encourage international trade in government-supported *special economic zones* (SEZ). These are areas of the country, usually with access to a port where, among other benefits, the government does not tax trade. As a result of its SEZ, Mauritius has enjoyed above-average economic growth since the 1980s. Free trade does not have to occur in an SEZ however. Governments can encourage international trade across the board, or surrender to protectionism.
- **Scientific Research.** The European Union has strong programs to invest in scientific research. The researchers *Abraham García* and *Pierre Mohnen* demonstrate that firms which received support from the Austrian government actually increased their research intensity and had more sales. Governments can support scientific research and technical training that helps to create and spread new technologies. Governments can also provide a legal environment that protects the ability of inventors to profit from their inventions.

There are many more ways in which the government can play an active role in promoting economic growth that we will explore more in later modules. A healthy climate for growth in GDP per capita and labor productivity includes human capital deepening, physical capital deepening, and technological gains, operating in a market-oriented economy with supportive government policies.

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#### Learning Objectives

[glossary-page][glossary-term]contractual rights: [/glossary-term]

[glossary-definition]the rights of individuals to enter into agreements with others regarding the use of their property providing recourse through the legal system in the event of noncompliance[/glossary-definition][glossary-term]rule of law: [/glossary-term][glossary-definition]the process of enacting laws that protect individual and entity rights to use their property as they see fit. Laws must be clear, public, fair, and enforced, and applicable to all members of society[/glossary-definition]

[glossary-term]special economic zone (SEZ): [/glossary-term]

[glossary-definition]area of a country, usually with access to a port where, among other benefits, the government does not tax trade[/glossary-definition][glossary-page]

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