

# Economic Development and the Rule of Law

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The opinions expressed are my own and not necessarily those of the Federal Reserve Bank of Saint Louis or the Federal Reserve System.

# Caveat Emptor!

- ❖ I know little about the law, per se.
- ❖ I aim for reasonable accuracy but not depth.
- ❖ The discussion will be as much about government policy as the law.

# The Agenda

- Describe governmental roles in the economy...
  - Mostly descriptive, some normative
- What do governments do?
  - Enforce property rights
  - Tax and spend
  - Regulate externalities
  - Reduce the risk to entrepreneurship
  - Promote competition
  - Reduce systemic risk
- Lessons from the Asian miracle

# Property rights

- ❖ People won't work hard if they can't keep their stuff.
- ❖ How can they lose their stuff?
  - People from foreign countries can take it.
  - Your own government can take it.
  - Your fellow citizens can take it.



# Property rights

- ❖ How do governments protect your stuff?
  - National Defense
  - Police / criminal justice / courts
  - Legal restrictions on government confiscation
    - ❖ “[N]or shall private property be taken for public use, without just compensation.” – 5<sup>th</sup> Amendment to the US Constitution

# Property rights

- ❖ Contract law
  - Contract law is more important in Western societies.
- ❖ Individual property rights are important.
  - No one can develop common property.
- ❖ Rights to intellectual property
  - Patents, copyrights

# Property rights: Patents

- ❖ CW: Patents provide incentives for investment.
- ❖ Reality: Huge increase in patents in last 40 years.
- ❖ Trivial patents deter innovation.
- ❖ An ideal system would be helpful.
- ❖ No patent system might be better than reality.
- ❖ Any patent system tends to be captured.

# Property rights: Patents

- ❖ Boldrin and Levine (2013) suggest reforms
  - Time limited
  - Limit what can be patented.
  - Limit patents that hinder innovation.
  - Tailor patents to the sector.
  - Goal should be the abolition of patents.

Boldrin, Michele, and David K. Levine. "The case against patents."  
*The Journal of Economic Perspectives* 27.1 (2013): 3-22.

# Taxes and Spending

- ❖ Government should buy public goods or subsidize positive externalities.
  - a **public good** is non-excludable & non-rivalrous
  - True public goods are fairly rare...
- ❖ Governments often buy
  - Defense
  - Criminal justice
  - Infrastructure: roads, bridges, canals
  - Education
  - Basic research

# Taxes and Spending

- ❖ Government funds spending with taxes
  - Borrowing is just delayed taxation.
  - Printing money is an inflation tax.
- ❖ We want taxation to be ...
  - “Fair,” meaning progressive
  - Non-distortionary
    - Distortions rise with the square of the tax rate
  - Difficult to evade

# Taxes and Spending

- ❖ Tariffs used to be very important taxes
  - International trade is easy to monitor and easy to convert to cash.
- ❖ Fairness vs. non-distortionary objectives
  - “Fair” taxes are levied heavily on the well-off
  - Non-distortionary taxes must keep rates low and so must be levied widely.

# Taxes and Spending

- ❖ Taxing negative “externalities” is “fair” and makes people happier.
  - Externalities are non-market actions that affect people not involved in the transaction.
  - Examples: pollution, anti-biotic resistance, systemic risk.
  - The tax reduces the harmful activity & funds the govt.
  - These are called “Pigouvian” taxes
  - There are also positive externalities associated with knowledge and education and beauty.

# Taxes and Spending

- ❖ EMs often have poor tax collection.
  - High rates of informal work / tax evasion.
- ❖ EMs often must tax the “international” sector at high rates.
  - Informal sector vs. sector with international firms making tradable goods.
  - High tax rates in formal sector distort investment.

# Reduce the Risk to Entrepreneurship

- ❖ Entrepreneurship is risky for individuals.
- ❖ Society benefits from entrepreneurs.
- ❖ The entrepreneurs take the risk.
- ❖ Society should subsidize entrepreneurship because it will be underprovided.

# Reduce the Risk to Entrepreneurship

## ❖ Safety net

- Health care; unemployment benefits.
- Tradeoff: Safety net requires distortionary taxes.

## ❖ Bankruptcy

- Again, there is a tradeoff.

## ❖ Limited liability

- Bondholders generally bear the risk.

# Promote Competition

- ❖ Monopolies
  - Higher P, lower Q than in competitive market.
  - Monopolies are bad for consumers.
- ❖ Hard to find “natural monopolies.”
  - Long distance phone service was broken up.
- ❖ Most monopolies are govt. grants.
- ❖ The CW is that the govt. needs to break up “monopolies.”

# Promote Competition

- ❖ Anti-trust
- ❖ The era of the trust-busters
- ❖ Hard to show that trusts actually hurt consumers.
  - Did prices go up?
  - Can trusts/cartels really drive competitors out of business and then raise prices super high?
- ❖ Caveat: I am always against cable TV companies.

# Reduce Systemic Risk

- ❖ Bank runs
  - Banks borrow short and lend long.
  - Banks can make bad investments.
  - Depositors can withdraw their money.
  - Multiple equilibria: Even good banks can have runs.
- ❖ Why do we care about bank runs?
  - Disintermediation can bring the whole economy down.
  - This is systemic risk.

# Reduce Systemic Risk

- ❖ Solutions to bank runs
  - Deposit insurance
  - Emergency lending from private consortiums of banks
  - Emergency lending from the govt or a central bank.
- ❖ Regulation of bank activities
  - Especially regulate bank lending
  - Regulation can be much broader.

# Financial regulation in EMs

- ❖ EMs have highly regulated financial systems
- ❖ Govts direct lending by banks or own the banks.
- ❖ Many restrictions on investments
- ❖ K controls for international transactions.
- ❖ The sequence of reforms is important.

# Lessons from the Asian Miracle

- ❖ Several Asian countries have grown amazingly in the last 100 years.
  - Japan, South Korea, China, Hong Kong, Singapore, and Taiwan.
- ❖ What did we learn?
  - Personal relations and interlocking organizations can substitute for contract law.
  - Industrial policy is overrated.

# Summary

- Enforce property rights
- Tax and spend
- Regulate externalities
- Reduce the risk to entrepreneurship
- Promote competition
- Reduce systemic risk
- Lessons from the Asian miracle

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# The End