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Why Some Countries Are Rich While Others Are Poor

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Abstract This paper examines various determinants of whether a country is rich or poor. Since Adam Smith, countless economists have attempted to explain the differences between wealthy and poor nations. Many policy makers and governments across the globe have attempted to address these differences, but the wealth gap continues to widen between wealthy and poor nations. While research reveals many factors are at play, this paper seeks to show that an abundance of trade and the presence of strong institutions are powerful predictors of good economic development in countries throughout the world. GDP growth and trade are strongly and positively correlated. As exports as a percentage of GDP rise in a country, GDP growth usually follows. In addition, strong institutions, including both formal and informal, can have drastic effects on the economic development of a country. Without an abundance of trade and strong institutions, a country may be mired in poverty for decades.

Introduction

Adam Smith (1723-1790) explained why some countries were rich while others poor in his 1776 seminal book *The Wealth of Nations*. Since Smith, and despite efforts by economists and government to explain differences between wealthy and poor nations, the wealth gap continues to widen. Several factors may determine to some degree the wealth of a nation. These include, but are not limited to decentralization, corruption, democracy, education, trade, and institutions (Werlin 2003). While these factors may influence economic development and wealth levels in a country, an abundance of trade and the presence of strong institutions may be the most powerful predictors of good economic development.

Background

Studies show decentralization of power away from a centralized government entity increases economic growth drastically. Iimi used cross-country data from 1997 to 2001 and found that fiscal decentralization has a significant positive impact on per capita GDP growth (Iimi 2005). Other researchers have found that government decentralization in general has a significant and positive impact on economic growth in countries across the globe (e.g., Lin & Liu 2000; Rondinelli 2006). Exceptions of course abound. The "tiger" economies of South Korea and Singapore, Japan, and China since Deng Xiaoping, are a few examples.

Corruption within the government has also been shown to have a strong impact on economic development. Blackburn and Forgues-Puccio (2010) found that corruption is generally bad for the economic development of a country, and the chances of a government being corrupt can be affected by the level of development in a country. According to Blackburn et al. (2010) corruption in the form of bureaucrats taking bribes can have devastating impact on an economy. Bureaucrats conspire with taxpayers to evade taxes, leading to a loss in tax revenue that could be put toward productive investments.

Countries with a democratic government system are also more likely to experience higher levels of economic development. However, researchers have had some trouble untangling the reverse causality effects between democracy and economic growth. According to Przeworski (2004), democracies are more likely to come about as countries become more economically developed. The more well-off a nation is, the higher the probability that it will sustain a democracy (Lipset). Other interesting ties between democracy and economic development emerge. Burkhart and Lewis-Beck (1994) used a dataset that utilized observations from 131 different countries to determine the relationship between the two factors. Economic development could spur the development of democracy, but democracy does not always spur economic development. This conclusion is an interesting contrast to previously mentioned studies. While economic development may help a democracy develop, it is not a given that democracy creates new economic growth, although it may help sustain it.

Education is also inextricably tied to the economic development of a country. Understandably as the average level of educational attainment increases, economic development tends to rise in a country. Studying the effects of education in Africa, Bloom et al. (2006) observes that increasing the tertiary education stock in Africa raises the long-run steady-state level of African GDP per capita by about 12%. In addition, raising the amount of educational attainment in Africa would cause faster technological growth and higher incomes for Africans across the board. Ozturk's (2008) findings support this conclusion: education raises productivity and creativity and promotes entrepreneurship and technological progress. Countless other studies show a strong tie between economic development and education (e.g., Gylfason 2001; Klasen 2002; Lin 2004)

While these factors may have influences on economic development in a country and help determine why some nations are rich while others are poor, an abundance of trade and the presence of strong institutions may be among the most powerful predictors of good economic development.

Trade

Adam Smith spoke highly of the effects that trade and the division of labor have on an economy. Understanding how the division of labor works at a micro level is essential in understanding why trade is helpful in economic development.

Examining a preindustrial society clarifies the division of labor. Many individuals at the time grew their own food, made their own clothes, and worked on their own properties to provide themselves with things they needed to survive. They would change jobs and tasks they were performing often to satisfy their needs. However, as the world became more industrialized, individuals began specializing in certain jobs and occupations. Rather than providing every good their families needed, people became proficient at producing one or a few items and then trading with others based on their needs. This trade led to efficiency gains as individuals became more skilled in their trades and innovated to make their lives easier.

Expanding this idea of division of labor outward to a global perspective, David Ricardo's theory of comparative advantage becomes significant. In a simplified two country example of world trade, Ricardo's theory is easily understood. If Country A is well-suited and better at producing clothes than Country B, while Country B is well-suited and better at producing food, then Country A will specialize in producing clothes while Country B will specialize in making food. The two countries will then trade to fill their needs. As countries across the globe become involved in this type of trade with every good imaginable, efficiency gains happen.

Past studies have found this beneficial relationship. Awokuse (2011) discovered increases in both imports and exports in a country tend to lead to higher levels of GDP growth and economic development. Trade between countries which specialize in comparative advantages tends to benefit all parties involved. Busse and Koeniger (2012) had similar findings showing both increased levels of imports and exports help to increase GDP levels.

Simple correlations between the amount of trade taking place in a country and GDP growth show this relationship. Figure 1 below illustrates this correlation.

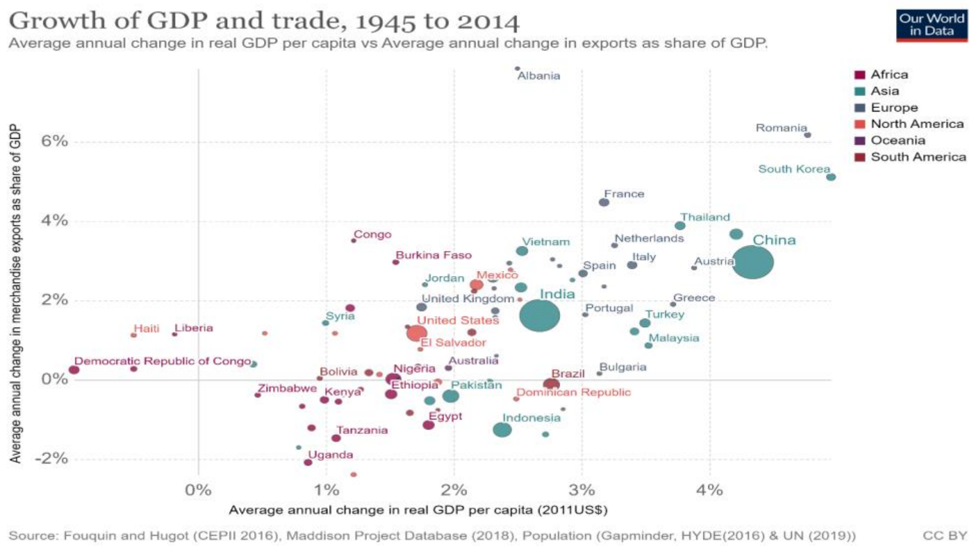

Figure 1

The data show a strong positive correlation between the average annual change in merchandise exports as a share of GDP and average annual change in real GDP per capita (Ortiz-Ospina 2020). As countries become more open to trade, GDP growth and economic development seemingly follow.

The effect of imports on GDP growth and prices can be observed in data as well. According to a policy brief by the Mercatus Center, cheaper imports from nations like China and Mexico have helped reduce inflation in the US (Boudreaux & Ghei 2017). Prices have been held down by about two percent for every one percent share of the market by imports from nations like China and Mexico. This gives Americans more money to spend on other products. Increased imports also lead to more competition, reducing imported-input costs for businesses, reducing production costs and increasing economic growth. Both increased imports and exports help increase economic development and growth.

However, much of the literature surrounding trade and economic growth come with caveats about which types of countries benefit most from trade. The types of institutions present in a country and the level of economic development already present in a country determine how much it will benefit from an increase in trade.

Institutions

Institutions, both formal and informal, can have significant effects on the economic development of a country. Institutions are the rules of the game in any economy or country. Formal institutions may include laws that protect certain rights, like property rights. Formal institutions include government agencies, like the IRS or the Federal Reserve. Informal institutions could include established structures like free markets, banking systems, culture or families. According to Peter Boettke (2018), "if the institutions present in a society promote social cooperation under the division of labor, then the gains from trade and innovation will be realized." Thus, good institutions promote economic growth and development and help countries benefit from increased levels of trade. However, if institutions "hinder social cooperation under the division of labor, then life will devolve into a struggle for daily existence" (Boettke 2018).

Much of the literature around institutions, trade, and economic growth point out that under-developed countries with poor institutions do not benefit as much or at all from trade. Pascali (2017) studied the period from 1870-1913 when the first boom of trade globalization occurred throughout the world. From observations of the effects the newly invented steamship had on trade and economic growth, one of Pascali's main findings was that only a small number of countries, those characterized by more inclusive institutions, benefited from the increased trade integration caused by the invention of the steamship. Gould and Ruffin (1995) provide evidence countries that have stronger educational systems with higher literacy rates and economies more open to trade grow about 0.65 to 1.75 percentages points more than closed economies. Tabellini (2010) concluded similar results when examining the effects of culture on economic development. Tabellini examined the effects values and beliefs like trust, respect for others, and confidence in individual self-determination, have on economic growth. He found cultures and institutions that promote these values are strongly correlated with higher levels of economic development. Ovilvie and Carus (2014) concluded in their research public-order institutions have been better at enabling markets to function than private-order institutions. They found that property rights are a public-order institution strongly correlated with higher levels of GDP growth.

Looking at correlational data for a country's control of corruption score and GDP per capita, we easily see a strong positive correlation. Figure 2 below shows this data.

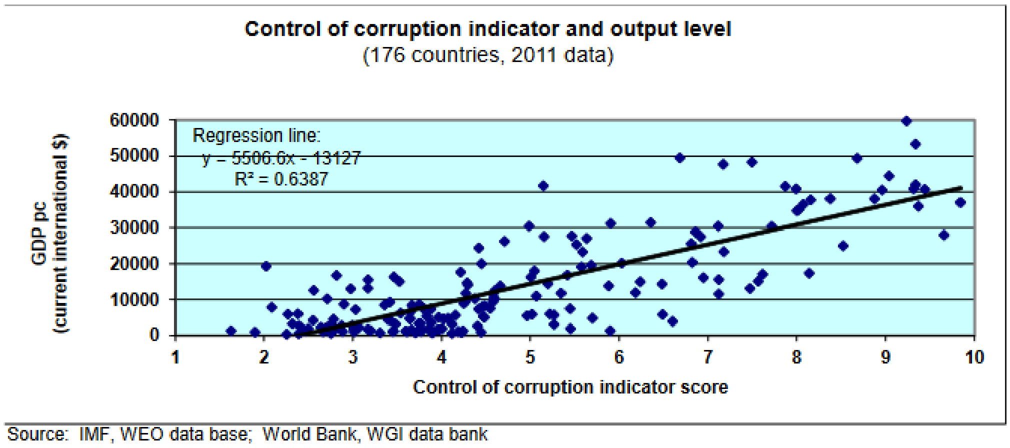

Figure 2

Countries with strong institutions would have limited amounts of corruption in theory. From this data provided by the World Bank, we can see countries with lower levels of corruption and better institutions tend to have higher levels of GDP per capita (World Bank 2013).

Clearly, institutions matter for economic development and growth. Higher levels of trade can certainly help increase economic growth through the division of labor. But without good institutions to support the economy and populace, some of those gains from trade will never be realized and the benefits will be lost. Developing and maintaining good institutions should be a top priority for nations around the globe.

Conclusion

While trade and institutions are not the only factors that determine whether a nation is rich or poor, they do have a large influence on the economic development of any country. As shown, countries with higher levels of trade tend to experience higher levels of economic growth and are generally more economically developed. However, without good institutions that give structure to society, the benefits from trade may not be realized entirely. Without good institutions, a country may be mired in poverty for decades. It was also shown that under a veil of ignorance, actors would strive to have high levels of trade present in their hypothetical societies, as well as good institutions that provide strong structures and rules to the game. Trade and good institutions are vital for economic development and growth.

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