

From poverty to prosperity

The past...?

The historian A.J.P. Taylor observed that the only lessons from history are that there are no lessons. As in so many other things here too Taylor got it dead wrong. That he was a life-long socialist is perhaps no coincidence. History can tell us plenty about how to handle ourselves in the future. But we must know where to look and what to look at.

At least this has become evident when we look at the lessons of economic growth. Once upon a time there was a common view that capitalist development was a luxury not suited for economically backward countries. Britain may have industrialised by allowing market forces to prevail more or less unchecked. But this was readily dismissed as atypical, even amongst the advanced capitalist economies. In the relatively more backward conditions of Continental Europe during the 19th century there was less scope for the economic individualism which marked the Industrial Revolution in Britain. In Germany investment banks played a prominent role in industrialisation and in the even more backward Russia of the late 19th and early 20th centuries the state had to step in and mobilise resources for growth in the absence of the entrepreneurs who were not available to do the job.

So it was a common orthodoxy for most of this century that economically backward countries could not become developed by leaving it to the market. Economic freedom was an indulgence for those already affluent. Hence the popularity of the “Soviet experiment”. On the face of it, here was a poor country which had become rich over a short period by avoiding the “anarchy of the market”. Sacrifices had to be made, to be sure, but the tough-minded consensus was that they were inevitable unless the poor countries chose to be locked into a global capitalist system where they would be cast for a role of permanent inferiority. Forced-draught industrialisation was the only way. Somehow, Stalin was “really necessary”.

The theory...?

That this kind of argument now comes across as so frankly weird is a reflection of how times have changed. Socialist-type solutions of economic backwardness have failed in a big way, and for a reason which should have been obvious all along: they took no account of human nature, of the incentives human beings need to act in a continuously productive way. One of the more amusing spectacles of the late 20th century is the sight of lifelong enthusiasts for “planning” trying to convince themselves that all their intellectual apologetics and contortions had not been so much wasted effort. But of course they were.

Still, the supporters of the market economy have not had it all their own way. In an obvious sense, capitalism has delivered the goods. Clearly, there was a correlation between high living standards and economic freedom. Yet how the one brought the other is not so evident. As the *1998 Index of Economic Freedom*, sponsored by the Heritage Foundation and the *Wall Street Journal*, has pointed out, “From the 1960s to the mid-1980s, the dominant academic theory of what causes economic growth was the Solow Growth Model, named after Nobel Laureate Robert Solow. From both a factual and a policy viewpoint, this theory has performed poorly”.

The Solow model assumed the primacy of capital accumulation. A poor country could only grow by saving more and accumulating physical capital. But even so, this “would bring only a one-time boost in income”. Long-run growth was due to “technological innovation”, about which Solow did not pretend to know very much. One of his main critics, Joan Robinson of Cambridge, claimed that for Solow technology and thus growth fell like manna from heaven. There was little that economists could say about growth or that governments could do to promote it.

Also, traditional growth theory predicted “convergence”. Poorer countries would generally grow faster than the rich countries and come closer to them in economic status. This has not happened. Some poorer countries have grown very fast indeed, but most of them have not.

...and recent theory?

So, until the arrival of New Growth Theory in the 1980s, all we had were correlations. But there was no well-developed theory to explain why free economies grew faster. It all changed with a 1983 article on “Increasing Returns and Long Run Growth” by Paul Romer of the University of Rochester. Romer’s argument was simple. Economies can experience permanently higher rates of growth by adopting the right policies. Once they are in place growth would feed on itself. Society’s productive capacity could in principle improve indefinitely. By the same token, the price for choosing wrong policies would rise. Poor choice is no longer a once-offer, reflected in a temporary downturn in the productive capacity of society. There are both virtuous and vicious circles. Once decisions have been made they are liable to have consequences from generation to generation. Growth or decline become built into the fabric of society.

In the new approach choosing the correct policy becomes crucial, for it also means that technology, institutions and human capital are the subject of human choice. It is not as if every country, rich and poor, is doing about as well as it can, given the resources at its disposal. This is the Panglossian view, that the rationality of individuals brings countries pretty much close to their differing potentials. It would follow that scope for improvement is strictly limited.

The institutionalists...

But there is little evidence for this conclusion. In 1996 Mancur Olson, one of the leading theorists on why nations rise and decline, put it as follows after a survey of the evidence:

“the large differences in per capita income across countries cannot be explained by differences in access to the world’s stock of productive knowledge or to its capital markets, by differences in the ratio of population to land or natural resources, or by differences in the quality of marketable human capital or personal culture...The only remaining plausible explanation is that the great differences in the wealth of nations are mainly due to differences in the quality of their institutions and economic policies”.

Olson has his disagreements with New Growth Theory. He argues that it “can readily explain why countries with high per capita incomes can grow as fast or faster than low-income countries”. But, he claims, it does not predict the relationship that has actually been observed, viz., “the fastest-growing countries are never the countries with the highest per capita incomes but always a subset of the lower-income countries”. But his explanation is right in line with the assumption that it is correct institutions and policies which account for growth.

Poor countries on average compare badly with rich countries in these respects. So they do not experience catch-up growth and “they need not grow faster on average than the rich countries”. But those which do “adopt relatively good economic policies and institutions enjoy rapid catch-up growth: since they are far short of their potential, their per capita incomes can increase not only because of the technological and other advances that simultaneously bring growth to the richest countries, but also by narrowing the huge gap between actual and potential income”.

Not only do the penalties for wrong choices rise in magnitude, but so do the rewards for poor countries which make the right decisions. During the 1970s and 1980s the four fastest growing countries in each decade were low-income countries.

...and incentives...

So Olson concludes: “The best thing a society can do to increase its prosperity is to wise up. This means, in turn, that it is very important indeed that economists, inside government and out, get things right. When we are wrong, we do a lot of harm. When we are right – and have the clarity needed to prevail against the special interests and the quacks – we make an extraordinary contribution to the amelioration of poverty and the progress of humanity. The sums lost because the poor countries obtain only a fraction of – and because even the richest countries do not reach – their economic potentials are measured in the trillions of dollars”.

The basic message is that if the structure of incentives is right then a country will become more prosperous. Of course, this assumes a few things. Special interests with a vested interest in protection may be so strongly entrenched that they will survive the most vigorous attempts to dislodge them. The increasingly rigid labour market in South Africa is becoming a classic example of the power of rent-seeking groups more concerned with the redistribution of a slowly growing national output than with increasing its size.

...and now the facts...

The great strength of the *1998 Index of Economic Freedom* is the detailed statistical corroboration it provides for what the latest developments in growth theory would predict. The Index measures how well 156 countries score on a list of 10 broad economic factors. The lower the score the less the level of government interference in the economy and the higher the economic freedom. 50 independent economic variables were grouped into the 10 economic factors:

- Trade policy
- Taxation
- Government intervention in the economy
- Monetary policy
- Capital flows and foreign investment
- Banking
- Wage and price controls
- Property rights
- Regulation
- Black market

“Using one of the largest datasets designed for comparisons of inter-country growth, Heritage analysts found statistically significant relationships both between the Index and country-by-country levels of economic development and between the Index and economic growth rates”.

The most striking, but not, by now, the most surprising finding is the close correlation between economic freedom and economic growth. For example, “Countries with repressed economies or mostly unfree economies in 1996 experienced negative per capita income growth on average over the period from 1980 to 1993. Free economies, and to a lesser extent mostly free economies, on average experienced positive real income growth”. The economy with the lowest overall score was Hong Kong with 1.25, the one with the highest was North Korea with 5.00. Not much room for surprise here.

As for recipes, by now they are not so surprising either. Capital accumulation, that is, increasing the stock of physical capital available for each worker in the economy, would definitely be a good thing. One way of providing incentives for accumulation is to protect property rights and to make individuals and firms feel that rewards for productive activity will not be expropriated by parasites in power. Governments should be kept small. Economies should be open to foreign trade and

investment. Government regulations and controls are liable to raise costs, discourage innovation, encourage rent-seeking, and should be kept to a minimum. Increasingly, growth theorists have seen investment in human capital as crucial and more beneficial to the recipients than supposedly benevolent expenditures on “social justice”.

...and the lessons

What could be more persuasive, especially after the collapse of socialism? The fact that so many countries are still economically unfree and paying the penalty in terms of increasing impoverishment, suggests that corroborated theory is not enough for the adoption of desirable economic policies. Interest groups with muscle can always be relied upon to pursue their own ends at the expense of the rest of society.

We can see this depressingly clearly in South Africa. Under apartheid organised white labour had huge influence for harm under the Nationalist government. Under the ANC black trade unions seem intent on a course which may perhaps benefit their own members for a while, but is bound to discourage investment and can only add to unemployment.

Perhaps surprisingly, South Africa’s overall score is up to 2.90 this year after the steady 3.00 of the previous three years. The Index comments: “The African National Congress...seems committed to economic liberalization, fiscal austerity, and privatization, although social programs and other state interventions intended to improve the lives of previously disenfranchised black South Africans may undermine this agenda”.

Just how severe this undermining is liable to be the Index may not fully appreciate. We have relatively good scores for Wages and Price Controls and for Regulation, viz., 2 for each category. But the Index points out that current labour legislation “could lead to the de facto imposition of wage controls” and that “increased political pressure to practice more affirmative action in the hiring and firing of personnel can be expected”.

Already the evidence is coming in that affirmative action in the private sector is quite the flop which could have been predicted. Businessmen see it for what it is, as a discriminatory policy to give sheltered employment to unqualified blacks. To make it stick, more intervention will be required. The ANC has never shown any inclination to back down from its own version of racism. Perhaps our slight rise in the economic freedom rankings will only be temporary.

One thing at least is obvious. We are still a long way from getting the structure of incentives right.

Further reading

- Gwartney J, Lawson R, and Block W (1996 & 1997). *Economic Freedom of the World 1975-1995 & Economic Freedom of the World 1997 – Annual Report*, The Fraser Institute, Canada.
- Johnson BT, Holmes KR, and Kirkpatrick M (1998). *1998 Index of Economic Freedom*, Heritage Foundation, Washington and *The Wall Street Journal*.

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