

# Growth theories and their application to the beloved country

Henry Kenney

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## Foreword

The purpose of FMF *Monographs* is to use the analytic method of political economy to shed light on how best the promotion of free markets will improve the workings of the South African economy. In particular, authors are urged to apply the microeconomic approach of studying how individuals, firms and households behave in response to either naturally occurring environmental events or to institutional frameworks which have either evolved over time or been imposed by statute.

Business over the last thirty six months has been accused in a number of fora of an ‘investment strike’. The implication of reduced investment is reduced employment. There then follows lower or negative economic growth, higher numbers of jobless and greater levels of poverty and other undesirable social dysfunctionalities. Firms invest to make returns. They select investment destinations according to where they believe the returns are highest. Investors, of course, are not interested in either the recent political or economic arithmetic of a country (except in so far as it affects their view of the future). Rather they are concerned with profits tomorrow and how likely they believe these future profits to be. In this *Monograph* Henry Kenney ponders why economies grow at different rates and whether investment levels in South Africa relative to other countries are unusually low. The answers are linked to investment levels, expected returns to investment, and the view that returns to investment in South Africa are not *expected* to be great and hence investors tend to select more attractive locations.

In Book IV of *The General Theory* Keynes (1936) discussed The Inducement to Invest. First he highlighted the marginal efficiency of capital in terms of *expectation* of yield (i.e. prospective returns) (p.136). Investment does not occur without hope of returns. But “the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities” is not enough (p.161). It is the *state of confidence*... to which practical men always pay the closest and most anxious attention” (p.148 – italics in original). Most investment decisions are the result of “animal spirits” (p.161-2). And “if the animal spirits are dimmed and the spontaneous optimism falters...enterprise will fade and die”. Keynes notes that, like it or not, investment depends “on a political and social atmosphere which is congenial to the average businessman”. It is the instinctive urge for gain, on which “spontaneous activity...largely depends”, not objective, impartial investment appraisals, which are *ex ante* impossible to carry out (p.162-3).

Keynes, of course, is correct. And if we follow his definition to the letter we should go no further. We cannot second-guess the entrepreneur.

Businesspersons go where they believe returns are highest. The “belief” component is the most intangible but most important part of any investment appraisal formula. This is the issue Kenney puts in perspective in the pages below.

Unfortunately “returns” is also an ambiguous expression. It can mean profits. Profit seeking (if successful) creates wealth. It can also mean rents, which (if successful) simply transfer wealth. But the incentive to better oneself can result in either profit- or rent-seeking. Further, rent-seekers include not only investors, but also trade unionists, politicians, civil servants and most other members of society. How can we ensure profit-seeking dominates? Secondly, how is economic growth linked to successful profit-seeking? The answer is not at first obvious. But without that answer policies to encourage profit seeking may be misdirected.

The neo-classical model of growth implied that there were diminishing returns to capital. As investment rose, a higher growth rate would follow – for a time. But as the ratio of capital to labour increased diminishing returns to capital would eventually set in. Growth in per capita incomes could not be sustained forever. This has not happened. The impact of innovations, for example, has outweighed diminishing returns.

The implication of that model was that countries would converge in their growth rates or income levels. Poor countries would at first have relatively high marginal products of capital because of their low capital-labour ratios. The capital stock would increase more rapidly than in the rich countries. So poor countries should converge to the income levels of the rich countries as their capi-

tal-labour and capital-output ratios become increasingly similar. Eventually, the have-nots would catch up. This has not happened either.

Endogenous, or new growth theory, attempted to explain the lack of convergence by looking for causes *within* economies. The argument was straightforward. Economies can experience permanently higher rates of growth by adopting the right policies. Once adopted 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. 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.

What then are these broad, right or wrong policies that create the environment where human beings seek profits rather than rents? What are the institutions that need to be in place to facilitate value-adding rather than value-subtracting activity?

Kenney emphasises that bad institutions and policies are NOT just euphemisms for "culture". Identical cultures often experience different levels of wealth-creating success (e.g. West and East Germany, North and South Korea and the two Chinas). Nor is the issue one of lack of knowledge, excess of population, or lack of capital, all of which can flow more or less freely between countries. It is rather the putting in place of appropriate policies and institutions that facilitate wealth-creating behaviour, and which discourage rent-seeking activities.

In short, incentives for trade and exchange are required. These incentives include a framework of contract law, protection of private property and sound money. Traders must know their property will remain their own until they voluntarily relinquish it; they must know that when relinquished they can enforce any agreement to trade at minimal cost; and the money they agree to accept in exchange must be regarded as retaining its value after completion of the trade. This simple, but not simplistic, analysis of why contractual freedom of exchange coupled with optimal and low contract monitoring and enforcement costs is more conducive to economic prosperity than is the alternative has long been "known". But there was a lack of data that applied across enough countries over long enough time periods to show the close links between economic freedom and economic growth. These gaps have now very substantially been filled.

Do countries with more economic freedom grow more rapidly? Do they achieve higher income levels? Do changes in economic freedom affect income growth? It may seem odd now, but these questions were once debatable. But the evidence is now in. All of the questions can be answered in the affirmative.

What is South Africa's position in the big picture? There are two main studies in the area (one by the Fraser Institute) both of which use objective measures to assess the issues. Between 1970 and 1990, according to Fraser, South Africa's composite freedom rating fell inexorably as the barriers to free exchange caused or associated with *apartheid* accrued. With the release of Mr Mandela in 1990 and the associated deregulation of most aspects of society the composite rating had risen by 1995.

But that tells us only of South Africa. It does not tell us where we fit in globally. Much of the world has liberalised in the last few decades, and those that liberalised most have grown fastest and achieved the highest economic targets. When our freedom rating was at its lowest (in 1985-86) our place in the ranking of economic freedom was 47<sup>th</sup> – with 46 countries ranked as 'more free'. After 1985 Western Europe went through its massive phase of privatisation, Eastern Europe threw off the Communist yoke, and Russia declared independence from the USSR. South Africa liberalised, certainly. But so did much of the rest of the world. By 1997 our rating had jumped but our ranking remained at 47. There were still 46 nations ranked as more free. There were still 46 other economies that, by this yardstick, were more attractive as investment destinations.

Why have we not done better? Certainly it's tough to be a leading revolutionary when many other countries are also passing successfully through radical times. The second main study of economic freedom, also using objective parameters, is that provided by *The Wall Street Journal*/Heritage Foundation. Although the two studies are broadly similar in their conclusions the latter report (in its most recent 2001 edition) shows South Africa slipping back in absolute terms to be rated as a 'mostly unfree' economy. The country's recently introduced labour laws, its approach to

social redistribution, and its lack of success in curbing crime and corruption are among the factors cited as causing this trend reversal.

Kenney points out that successful countries, such as Australia, Ireland, New Zealand and Poland, have each been subject to a deregulatory “big bang “. Whether in some or all of the lessening of labour market controls, removal of foreign exchange controls or a transition from communism. Quick reform across a broad front is a common denominator. But what can be said of the two apparent successes, Korea and Malaysia? Kenney puts forward some interesting analyses. Malaysia is a multi-ethnic country. Affirmative action has been practised there, as it was in South Africa in the 1950s to 1970s. The target group in both cases benefited. Can this process not be repeated again in South Africa? Growth and affirmative action can clearly go together, but they have a cost. The cost may not have net negative effects, however, provided the country strikes it lucky in other ways. (In Malaysia’s case the international price of rubber and palm oil rose, and oil reserves were discovered: South Africa had the gold price bonanza.) What lessons can be learned from South Korea? Two decades of an economy on a war footing resulted in a highly disciplined market place. That foundation began to crumble in the 1970s when the military and security imperatives diminished. The resulting attempts to steer the economy when state security was less crucial resulted in misguided investments and large scale bureaucratic rent seeking.

Keynesian ‘animal spirits’ have most successfully been raised in countries where there has been ‘big bang’ deregulation. But perhaps a society can only cope with one revolution in a given period. Our political ‘big bang’ in 1994 maintained (approximately) our economic freedom ranking. The nature of that change brought with it some inevitable regressions in certain areas. For example in the restructuring of the parastatals, what reform there has been has been slow and piecemeal and lacks the credibility that can breed enthusiasm. Much of the unsatisfactory pace of privatisation seems to be due to a fear of affronting one or other of the so-called ‘social partners’. A faster and more determined approach to selling off state assets would generate foreign exchange, provide the possibility of ‘buying-off’ opposition from organised labour by allocating equity to union members, and provide government with resources for transfer to the poor. A key requirement would be to minimise the numbers and powers of ‘gravy-train’ intermediaries. The giving of an explicit completion date to East Germany’s privatisation agency, the *Treuhandstadt*, could be a useful model for South Africa to follow. Its function complete, it has long since been wound up.

Mr Kenney’s arguments will not be universally agreed to. As with all FMF publications this *Monograph* does not necessarily reflect the views of the Directors, members or staff of the Foundation. However all who are concerned about levels of investment, employment and economic growth in South Africa should give the arguments serious consideration.

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## The author

Henry Kenney studied at the University of Cape Town and the London School of Economics. He has lectured on economics and economic history at the Universities of Port Elizabeth, Cape Town and the Witwatersrand. A conceptual and a practical economist, Kenney has been on the editorial staff of *The Financial Mail*, and worked for a period as the Senior Economist of the Chamber of Mines in Johannesburg. He is the author of numerous academic articles in international journals. His books include *Architect of Apartheid* (Jonathan Ball, 1981), the definitive and widely acclaimed study of the career of Dr HF Verwoerd; and *Power, Pride and Prejudice* (Jonathan Ball, 1991), the first and still the major public choice economic analysis of Nationalist rule in South Africa from 1948 through to the release of Nelson Mandela in 1990.

# 1 Background

Businessmen will go where the returns are highest. If they can maximise profits by extracting government protection against foreign or domestic competition, they will do so. They will devote resources to capturing whatever monopoly rents appear to be on offer. They will reward lawyers and economists to lobby politicians and advance specious arguments why their own special interests should get preferential treatment. Job creation, the national interest, multiplier effects – these are some of the intellectually disreputable reasons which go on display to justify the redistribution of income to particular interest groups at the expense of the rest of the population which has to foot the bill.

There is nothing unusual about this. Economists call it rent-seeking, the devotion of resources to activities which do not increase national output. Nor are businessmen alone especially prone to such behaviour. All individuals respond to incentives and they will, when possible, form interest groups which pursue above-average returns for their own. Trade unions are obvious examples of rent-seeking bodies, intent on capturing benefits for their constituents even when the benefits may be at the expense of non-members and of economic growth. The American economist, Mancur Olson, has aptly described interest groups which behave in this manner as “distributional coalitions” (1982).

This is why the standard exhortations by politicians to interest groups to place the national interest above their own are naive at best, and usually fraudulent. No one can expect them to respond in a manner which is so contrary to the way in which politicians and civil servants themselves carry on. The evident answer would be to devise incentives which would impel individuals and their organisations to pursue their self-interest in a way that would enhance economic growth, instead of blocking it. But when we observe the vast majority of countries today, most of them from the so-called Third World, it is easier said than done. We are contemplating a situation which, for once, seems to bear out the old saw about the rich getting richer and the poor getting poorer.

If we know that economic growth is good for people who wish to be less poor, but we can also observe its less-than-universal prevalence, the obvious question becomes: What are the determinants of long-term growth? It is a subject which, after years of neglect, has once more come into its own.



## 2 The theory of growth

During the 1950s and 1960s the neo-classical model of growth was the economic orthodoxy. The basic implication of neo-classical theory was that there were diminishing returns to capital. As savings rose, so did investment, which would result in a higher growth rate – for a time. But as the ratio of capital, whether physical or human, to labour increased diminishing returns to capital would eventually set in, which meant that growth in per capita incomes could not be sustained for ever. Of course, this has not happened in the economies which have achieved high levels of economic development. The standard explanation here has been that diminishing returns to capital were offset by technological innovation. However, such change was exogenous. It came from outside and was not explained by the theory itself. So the unsatisfactory situation was that long-run growth depended on technological improvements, about which economists could say little, nor was it evident that governments could do much to promote them.

Once the technological advances were in place, growth in per capita incomes would equal the annual rate of productivity improvement. It could come from different sources. Knowledge could advance through better organisation and management. Alternatively, such improvements could be embodied in new equipment. But neo-classical theory did not explain what actually determined annual rates of productivity growth.

The implication of the flawed neo-classical model was that countries would converge in their growth rates or income levels. Poor countries would at first have relatively high marginal products of capital because of their low capital-labour ratios. Assuming the same rates of domestic saving as the rich countries, as well as the same rates of technical progress and growth in the labour force, the capital stock would increase more rapidly than in the rich countries. So poor countries should converge to the income levels of the rich countries as their capital-labour and capital-output ratios become increasingly similar. Eventually, the have-nots would catch up with the haves because of their higher rates of economic growth.

That this has not happened, yet, is stunningly obvious. To sceptics and cynics, groups which are not necessarily mutually exclusive, it would come across as another demonstration of the irrelevance of “traditional” economics. Not only do lagging countries not tend to converge on the leaders, but the evidence suggests that technologically advanced countries can grow indefinitely without slowing down.

### **“New” growth theory**

There were attempts to salvage standard growth models by adjusting for variations in domestic savings rates and population and labour force growth rates. The question then became: Did per capita income levels tend to converge after adjustment for such variations? This was known as conditional convergence. If sighted it was supposed to confirm neo-classical theory after all; diminishing returns to capital still prevailed and convergence was once more in place. Its absence was taken as support for endogenous, or new growth, theory.

This latest model of growth emerged during the 1980s as an attempt to explain trends which were not, seemingly, well accounted for by the older growth theory. In particular, it was associated with a 1986 article on “Increasing Returns and Long-Run Growth” by Paul Romer of the University of Rochester. Romer’s argument was straightforward. Economies can experience permanently higher rates of growth by adopting the right policies. Once adopted, 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-off affair 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.

The central feature of new growth models has been that technological progress, previously accepted as exogenous, or a given, becomes explicable within the model itself. In standard economists’ jargon, the rate of technological advance is endogenous.

## **Property and incentives**

In particular, the reward to entrepreneurs for research and innovation is crucial. Their incentive is the transient monopoly they enjoy from the introduction of a new product or a new technology. For a while they gain above-average returns before new entrants to the market bring their profits down to the competitive level. The appropriate specification of property rights makes commercial research and development rewarding and so makes possible that technological advance which may indefinitely offset diminishing returns to capital.

In this approach, choosing the correct policy is crucial. It means that technology, institutions and human capital are the subject of 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 would be the Panglossian view, that the rationality of individuals brings countries pretty much close to their differing potentials. The gains from trade have already been exploited and the scope for improvement is strictly limited.

There are, or may be, no diminishing returns to capital in new growth theory. An increase in investment, whether in physical or human capital, and spending on research and development (R&D) may generate external economies resulting in productivity improvements which offset the tendency towards diminishing returns. Countries which benefit from such external economies may find themselves growing at permanently higher rates than countries which do not.

The actual historic record since the Second World War has tended to confirm the implications of endogenous growth theory, much to the surprise of those who believed that the worldwide convergence of economies was on the agenda. The economic historian, David Landes, has summarised what used to be the orthodoxy: "The conventional wisdom has always been that lateness is an advantage; that the gap between what is and what can be is a tremendous opportunity; that the follower country can profit from the experience and knowledge of its predecessors and avoid their mistakes; and that by mobilising resources and allocating them energetically to the right uses, it will in fact grow faster than its forerunners" (p.8).

At one time it seemed that the record provided evidence for this thesis. In the 19<sup>th</sup> century Britain, Germany and Russia industrialised substantially, with the two latecomers experiencing "spurts" of growth which could be, and were, interpreted as evidence that late development offered advantages over first-comers like Britain, stuck in traditional ways and less quick on their feet in identifying the arrival of new opportunities.

Here was one way of making sense of the past. It has been criticised, but at least had a superficial plausibility and could not be summarily dismissed. But since then the evidence for the advantages of being late has been less compelling. Landes cites some of the obvious examples: "Thus the high growth rates of countries such as Taiwan and Korea (7 and 8 percent per capita over a period of decades) show that it can still pay to be late...On the other hand, the moderate success of others and failure of still more have led some to argue that lateness is now a growing handicap" (pp.8-9).

The obvious question is: Why some late-comers (and then only a few) and not the rest (which are very many indeed)?

Mancur Olson, known for his contribution to the theory of collective action and his account of the rise and decline of nations, has addressed himself to this issue. His conclusions are that the facts do not fully support either old or new growth theory. Olson found that "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. Albeit at a high level of aggregation, this eliminates each of the factors of production as possible explanations of most of the international differences in per capita income. 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" (p.19).

This would not come across as immediately obvious to those politicians in the Third World and their intellectual apologists in the First World who like to believe that the continued poverty of

so many nations is somehow due to exploitation by the rich countries rather than to the incompetence and corruption of the rulers of the less-developed world. Landes cites “these alleged sources of failure. They are familiar to all of us: colonialism or neo-colonialism, unequal trade, underdevelopment (a noun derived from a newly invented transitive verb, to underdevelop), peripherality, dependency”. But, while conceding that there was “some truth in all of these” (which is perhaps conceding too much), Landes believes that “they are more the symptoms than the explanation of development failure”. For one thing, most of these “alleged sources of backwardness” apply to Korea and Taiwan, and “many of them apply to the British colonies in North America, even to the early American republic, and to Meiji Japan”.

Landes concludes, in words which President Thabo Mbeki and any other African rulers still open to reason would do well to heed, “even if this bill of indictment were true, it would not pay to dwell on it. It leads to self-pity, myopia, and counter-productive policies. At the extreme, it would suggest complete delinking and economic isolation. Also, there is nothing so self-defeating as the transfer of responsibility and blame to others, if only because there are limits to altruism. After an initial surge of guilt, generosity wanes; it is a wasting asset. Indeed, the greater the benefit to others of unequal arrangements, the less likely they are to surrender them. The market, like God, best helps those who help themselves” (pp.10-11).

If the differences between rich and poor countries cannot easily be explained by old growth theory, by new growth theory, or by the find-the-villain evasions of hordes of Third World rulers, then what does account for them? Mancur Olson has disposed of some of the standard explanations which have had some claim to intellectual respectability.

### **The role of knowledge**

One contention is that there has been differential access to the available stock of productive knowledge. Poor countries have only been able to benefit from the modern technologies developed in the rich countries at an exorbitant cost, or so a popular notion would have it. Yet there is little evidence that rapidly growing Third World countries have found this an obstacle.

Olson cites the case of South Korea, for which some “striking data” are available for the years from 1973 to 1979. “In Korea during these years, royalties and all other payments for disembodied technology were minuscule – often less than one-thousandth of GDP. Even if we treat all profits on foreign direct investment as solely a payment for knowledge and add them to royalties, the total is still less than 1.5 percent of the *increase* in Korea’s GDP over the period. Thus the foreign owners of productive knowledge obtained less than a fiftieth of the gains from Korea’s rapid economic growth”.

The particular case illustrates the general point, viz. “the long-familiar assumption that the world’s productive knowledge is, for the most part, available to poor countries, and even at a relatively modest cost”. So differences in per capita income across countries find no ready explanation “in terms of differential access to the available stock of knowledge” (p.8).

### **The role of migration**

Another standard explanation is the alleged overpopulation of poor countries. Because of the low ratio of land and other natural resources to population, marginal products and wages in poor countries must, it seems, be low as well.

If this view is correct it would follow that “large migrations from poorer to richer societies will, if other things (like the stocks of capital) remain equal, necessarily reduce income differentials” (p.10). Yet the evidence does not support the proposition. Considerable migrations from “overpopulated” to “under-populated” regions have not reduced such differentials. In spite of the massive European migration to the United States between the closing of the US frontier in 1890 and the imposition of American immigration restrictions in the early 1920s, there was no gradual narrowing of per capita income differentials between Europe and the United States. And after the end of the Second World War many of the European countries which had in the 19th century experienced a large outmigration to America “did nearly close the gap...when they had relatively little em-

igration to the United States, and when their own incomes ought to have been lowered by a significant inflow of migrants and guest workers". Also, between 1945 and 1961, when the Berlin wall was constructed, "there was a considerable flow of population from East to West Germany, but this flow did not equalise income levels" (p.11).

There is other evidence which supports the proposition, viz. large migrations have not resulted in the levelling of income levels which the argument from overpopulation would predict. Not only that, but "Many of the most densely settled countries have high per capita incomes, and many poor countries are sparsely settled" (p.12). Among the latter, Brazil, Kenya and Zaire, are examples of countries with low per capita incomes which have low population densities. India of course is densely settled, but West Germany has been more so, as are Belgium, Japan and Holland.

Olson's conclusion brings us to the heart of the matter. He finds that the evidence for all countries for which data are available indicates that "there is a *positive* and even statistically significant relationship between these two variables: the *greater* the number of people per square kilometre the *higher* per capita income" (p.12). Given the indisputability of the law of diminishing returns, we must ask ourselves what it is that offsets the operation of the law.

"The argument offered here suggests that perhaps countries with better economic policies and institutions come to have higher per capita incomes than countries with inferior policies and institutions, and that these higher incomes bring about a higher population growth through more immigration and lower death rates. In this way, the effect of better institutions and policies in raising per capita incomes swamps the tendency of diminishing returns to labour to reduce it" (pp.12-13).

This would contradict the view of the famous 18<sup>th</sup> century scholar, Dr Pangloss, that everything is for the best in the best of all possible worlds. In such a habitat, all countries are doing about as well as they can given their particular endowments. All opportunities for gain have been exhausted because that is what follows logically, virtually inevitably, from the optimising behaviour of participants in markets. As economists would put it in their inimitable way, economies are on the frontiers of their aggregate production functions. It follows "that output is as great as it can be, given the available resources and the level of technological knowledge" (p.5).

If this is true, then it would also follow that there is little scope for the advice of economists about how to improve the performance of economies. There are many, both inside and outside the discipline of economics, who would not regard this conclusion as counter-intuitive. There are those, non-economists to a man (and woman), who would regard economists as spouters of meaningless mumbo-jumbo. But many economists, while perhaps not agreeing with this judgement of their profession, would argue on theoretical grounds, given certain plausible assumptions about the human tendency to exploit opportunities for gain, that there is little that they can do to make the world a better place. At any particular moment it is about as good as it gets. Of course, only a sketchy knowledge of history would suggest that this view is so evidently absurd that it is liable to discredit the whole discipline of economics.

There are actually strong reasons for believing that everything is not optimal, that deliberate decision-making by individuals, and policy-makers especially, can make countries better off. This is the gist of Mancur Olson's argument and is right in line with the central thrust of the new institutional economics. This is certainly implied by the failure of international migration to confirm predictions based on the law of diminishing returns to labour. Perhaps even more telling is the evidence relating to the allocation of capital across countries.

### **The role of capital**

Countries with high per capita incomes have far higher capital intensities of production than do poor countries. They are capital-rich, while Third World countries use relatively little capital. If the assumptions of Dr. Pangloss were correct then it could be expected that the marginal product of capital, i.e. returns to capital, would be very considerably higher in capital-scarce countries than in those where it is abundant. Given such discrepancies in return it would mean that capital would migrate in huge quantities from rich to poor countries. As Olson puts it: "Capital should be struggling at least as hard to get into the third world as labour is struggling to migrate into the high-wage coun-

tries. Indeed, since rational owners of capital allocate their investment funds across countries so that the risk-adjusted return at the margin is the same across countries, capital should be equally plentiful in all countries” (p.14).

Obviously, the world economy is not even close to such a state. The markedly unequal allocation of the global stock of capital, especially given the extreme mobility of capital in the world today, suggests not so much that opportunities for gain are not being exploited, but that rational owners of capital believe that the returns from investing in poor countries are really quite low. For whatever reason, the poor countries have not been achieving their potential. They can evidently do a good deal better, provided their rulers create an appropriate environment for increasing the returns on investment.

What is more, if countries were on the frontiers of their aggregate production functions, capital and labour would move in opposite directions, the former going to capital-scarce countries and labour going to those where it was in short supply. But this has not been happening. They often move in the same direction, with both “sometimes trying to move out of some countries and into some of the same countries” (*ibid*, p.15).

We are looking at a familiar conclusion. The economic policies and institutional defects of some poor countries may deter inflows of both labour and capital.

### **The role of culture**

Lastly, there is the argument based on differences of culture. Economic historians have often maintained that the values and attitudes of individuals and groups may promote or inhibit economic development. This was put in its classic form by the German sociologist, Max Weber, who argued nearly a century ago that the values associated with Protestantism, especially Calvinism, at the time of the Reformation in the 16<sup>th</sup> century were highly conducive to the capitalist enterprise which was then becoming so prominent a feature of the West European economic landscape. Protestants supposedly saw worldly pursuits and the achievement of material success as part of their “calling”, and pleasing in the sight of God. Hence the Reformation found a congenial breeding-ground among the commercial and industrial middle-classes. Hence it was that capitalism was most advanced in countries like England and the Netherlands and that Catholic countries like Spain and Italy became economic backwaters during the course of modern history.

The Weber thesis about religion and the rise of capitalism has been often and plausibly criticised, but it has provided the model for arguments about the relation between cultural factors and economic performance. One of the most articulate proponents of the importance of culture has been David Landes, who early made his academic mark by holding that the social value system of France was largely responsible for retarding the country’s rate of economic growth in the 19<sup>th</sup> century. French entrepreneurs were allegedly averse to risk and sharp competition, more interested in steady profits than in large sales, while the family character of firms made it difficult to benefit from economies of scale. Landes has continued to be impressed by the possible strength of culture in shaping economic outcomes. In reply to arguments that values and attitudes change in response to economic opportunities and the possibility of material advance, he has stated that they “do change, but slowly, and their force and influence vary with circumstances. Many religious values operate, for instance, to impede the mobility and openness conducive to efficient allocation of resources and rational economic behaviour. Worse yet, insofar as economic development entails changes in social structures and relations, vested cultural values, like vested material interests (they are in effect interests), can become a potent force for resistance, to the point of overturning governments and reversing the course of development. These setbacks, moreover, can be self-reinforcing, for the same cultural values that helped bring them about are also a precious source of consolation. The worse things get, the more the clock turns back, the more some people cling to what they know and feel and need” (p.11).

This is pretty eloquent, even persuasive, but economists are still reluctant to deal with such messy and unquantifiable things as values and attitudes. It is famously difficult to establish cause and effect; there is always the fear that economists will end up peddling those windy generalities

which they tend to associate with the discipline (if that is the word) of sociology. However, insofar as personal culture is a determinant of economic performance the implications for improved economic performance are pessimistic. Attitudes do not change overnight. It takes time to wipe out the effects of many years, perhaps even centuries, of socialisation in non-achieving values.

Fortunately, there is evidence that suggests otherwise – that with economic performance it is nurture and not nature that is decisive. There is the striking experience of migrants from poor countries to the United States: “New immigrants from countries where per capita incomes are only a tenth or a fifth as large as in the United States have a wage more than half as large as comparable American workers” (Olson, p.17). In other words, in spite of the difficulties such migrants may have had in adjusting to a quite different cultural and economic environment, they experienced a dramatic increase in their productivity, clearly implying that the culture and values they brought with them were no fundamental obstacle to their material advancement.

At the macro-level, there is the dramatic evidence from countries which have been divided during the course of human events, but which share the same cultures and values. The economic performance of West Germany has been far superior to that of East Germany. Hong Kong and Taiwan have performed a good deal better economically than mainland China, while the differences between the two Koreas are an object lesson in how little cultural baggage counts in influencing economic achievement.

This comparison only confirms the overriding theme in the argument so far. Countries with similar historic cultures may perform in spectacularly different ways. When we contemplate the respective Germanies, Chinas and Koreas, there is one fact which cannot be ignored. Economic performance is most intimately linked with differences in economic policies and institutions.

### **Institutions and incentives once again**

Olson finds one especially striking objection to both old and new growth theory. Neither can explain why the fastest-growing countries are always a subset of the poorer countries. There has been no general tendency for low-income countries to close the gap between themselves and the rich countries. Old growth theory implies convergence, which has not been happening. New growth theory, with its stress on the externalities which accompany investment and increases in stocks of human and physical capital, suggests that rich countries will grow either faster or at least as fast as poor countries. This does not quite fit the facts. Neither theory predicts “the relationship that is actually observed: *the fastest-growing countries are never the countries with the highest per capita incomes but always a subset of the lower-income countries*” (p.20; italics in the original).

As poor countries usually have economic policies and institutions which do not make possible the exploitation of opportunities for catch-up their growth on average has been disappointing. “But any poorer countries that 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 their actual and potential income” (*ibid*). So the old argument that poor countries may catch up with rich countries because of their ability to exploit the gap between the potential and the actual may still be true. But this ability does not come automatically. Some countries acquire it, after painful lessons in how not to do things. South Korea is one of the depressingly few examples. Those which never acquire it are too numerous to mention.

So we find that there is no necessary connection between low per capita incomes and rapid economic growth. However, when low-income countries have adopted policies and institutions which favour growth, they have expanded at rates much faster than those of the fastest-growing rich countries. In the 1970s the four countries (apart from the oil-exporting countries) which had the fastest rates of growth of per capita income (Botswana, Malta, Singapore and Korea) grew more than five times as fast as the United States. In the 1980s the four fastest growers (Korea, China, Botswana and Thailand) grew four times as fast as the United States. “They outgrew the highest income countries as a class by similarly large multiples. All of the four fastest-growing countries in each decade were low-income countries” (*ibid*).

There is more to come. As the poor countries as a group fall behind the rich countries, the gap between the actual and the potential widens, which opens up the possibility of still higher rates of growth for low-income countries which manage to adopt the appropriate policies and institutions. So the prediction would be that those which succeed in doing so would do still better in narrowing the gap between themselves and the highest-income countries; still more impressive growth records would be the outcome.

### **Incentives – how to structure institutions**

Olson concludes that “economic performance is determined mostly by the *structure of incentives* – and that it is mainly national borders that mark the boundaries of different structures of incentives...” (p.22; italics in the original). This of course is in line with current thinking by economists on the causes of growth, especially with what has come to be known as the New Institutional Economics. As one of the most prominent adherents of this approach, Douglass North, has put it, “Institutions provide the incentive structure of an economy; as that structure evolves, it shapes the direction of economic change towards growth, stagnation or decline” (1991, p.97).

But North has also pointed out what is confirmed by the experience of most Third World countries in the late 20<sup>th</sup> century: “economic history is overwhelmingly a story of economies that failed to produce a set of economic rules of the game (with enforcement) that induce sustained growth. The central issue of economic history and of economic development is to account for the evolution of political and economic institutions that create an economic environment that induces increasing productivity” (p.98).

Now, at the beginning of the 21<sup>st</sup> century, we know a good deal more about why some economies grow and others do not. This is not because the methods of the “social sciences”, of which economics is probably the least backward, come very close to those of the natural sciences. At one time, “social scientists” hoped that the methods of the hard sciences, especially physics, could be applied to the study of society, yielding generalisations comparable to the disciplines they sought to emulate.

Of course, this was a totally unwarranted exercise in hubris. There has never been a science of society amounting to anything, despite the claims of Marxists or of the followers of Talcott Parsons in the United States. The followers of Marx have found that their predictions about the fate of capitalism have proved laughably wrong. The Parsonians have only come up with a collection of pretentious and empty generalisations which have helped immeasurably to give sociology a bad name.

There are excellent reasons for this. In studying the behaviour of human beings in society it is usually impossible to set up laboratory experiments which isolate the relevant relationships and exclude the impact of the supposedly irrelevant. *Ceteris paribus* does not often hold, if it ever does. And of course humans are aware that they are being observed, which is bound to affect their conduct. As David Hume put it nearly 250 years ago (understanding by “moral philosophy” what nowadays would be referred to as the “social sciences”): “When I am at a loss to know the effects of one body upon another in any situation, I need only put them in that situation, and observe what results from it. But should I endeavour to clear up after the same manner any doubt in moral philosophy, by placing myself in the same case with that which I consider, it is evident this reflection and premeditation would so disturb the operation of my natural principles, as must render it impossible to form any just conclusion from the phenomenon”. In short, it is impossible to escape the subjectivity inherent in human behaviour. So emulation of the methods of the physicists in the study of society is only a dream, unlikely ever to be realised.

### **Governing the market?**

Even so, the 20<sup>th</sup> century has produced enough evidence to make possible general statements about the conditions under which economic development is most (and least) likely to take place. Controlled laboratory experiments may rarely be feasible when humans are involved, but the course of history has produced massive de facto experiments, at enormous cost to those who were involved without their consent, but which have produced fairly conclusive evidence about how economies

grow. This of course refers to the so-called socialist experiment, the most massive venture in social engineering in history, and also the most resounding failure.

When in 1917 the Bolsheviks seized power in Russia they could count on plenty of sympathy and support in the capitalist countries of Western Europe. It was only a major punctuation in an intellectual trend which held that the market was incapable of achieving certain objectives. Throughout most of the 20<sup>th</sup> century the state tended to encroach on the territory of the market. The authors of a recent account of “the battle between government and the marketplace”, have succinctly summarised the course of events and the reasons why it happened as it did: The state’s “victories were propelled by revolution and two world wars, by the Great Depression, by the ambitions of politicians and governments. It was also powered by the demands of the public in the industrial democracies for greater security, by the drive for progress and improved living conditions in developing countries – and by the quest for justice and fairness. Behind all this was the conviction that markets went to excesses, that they could readily fail, that there were too many needs and services they could not deliver, that the risks and the human and social costs were too high and the potential for abuse too great” (Yergin and Stanislaw, p.11).

The trend has been reversed. It had to wait till the end of the 20<sup>th</sup> century, but the turning-back of the interventionist tide appears decisive, so much so that debate about the relative merits of socialism and capitalism comes across as proof of intellectual backwardness and plain ignorance of facts which can no longer be denied.

### **Analysis and insight – and some data**

Believers in free markets had of course “known” for a long time that economic freedom was more conducive to economic prosperity than planning and state ownership. But intuitively plausible as this may have seemed, there was no general agreement about how economic freedom should be defined and measured. And there was also a lack of data which applied across enough countries over long enough time periods to show the close links between economic freedom and economic growth.

These gaps have now very substantially been filled. Within half a decade the results of scholarly research have been coming in at a steady pace; they have shown that liberty and prosperity keep close company. The pioneering effort was *Economic Freedom of the World: 1975-1995* by James Gwartney, Robert Lawson and Walter Block. Co-published in 1996 by 11 economic institutes around the world, the study was the outcome of a series of six conferences sponsored by the Fraser Institute of Vancouver and the Liberty Fund of Indianapolis between 1986 and 1993. The 62 conference participants included some of the world’s top economists, including three winners of the Nobel Prize.

On the basis of its examination of 102 countries over a 20-year period, the study compiled an index which measured ways in which governments restrict economic freedom. The index had 17 components, which shows that economic freedom is a many-sided thing. It is not simply reflected by the amount of public spending relative to GDP, or by the degree of state ownership of industry. These do enter the index, but it also includes price controls, industrial regulation, exchange controls, the level and impact of marginal tax rates, the level and variability of inflation, subsidies and transfers between citizens as a share of GDP, and the presence of conscription. They come down to some broad questions. Does government protect the money in your pocket from eroding in value through inflation? To what degree does government decide what should be produced and consumed? To what extent does government take from you to give to others? How free are you to enter into dealings with foreigners?

The authors of the study rated the 102 countries on each of the components on a scale of 0-10. Zero meant complete unfreedom relating to the measure involved, and 10 amounted to total freedom. Once the ratings had been obtained, the authors had to decide what weight to apply to each. For instance, did strict exchange controls matter more for economic freedom than high marginal tax rates? As it was unlikely that they all mattered equally, the authors of the study decided to rely on a survey of the views of the 62 economists who attended the six conferences between 1986 and 1993.



The findings of the study were emphatic. They showed that countries with the most economic freedom grew most rapidly over the 20-year period, ie, at an average of 3.3% per annum per capita GDP. So rapid growth was reflected in higher income levels. By the same token, countries with the lowest level of economic freedom achieved in 1994 the lowest level of GDP, viz. \$1 650 per capita in 1985 dollars.

As the authors put it: “There were no exceptions – every nation that significantly improved its rating also achieved solid economic growth. On the other hand, economies that moved away from economic freedom were characterised by sluggish growth and decline”.

The findings also revealed that the six countries with persistently high economic freedom ratings throughout the 1975-95 period (Hong Kong, Switzerland, Singapore, the US, Canada and Germany) were also in the top ten in terms of GDP per head in 1993-5. The implication is that high levels of economic freedom should be consistently maintained over a number of years, so that expectations about their lasting nature should establish themselves. “Thus”, the report stated, “countries that move steadily and consistently toward economic liberalisation are likely to achieve a higher level of economic performance than those that shift back and forth between liberal and restrictive policies”.

It follows that countries with persistently low ratings could have been expected to register declining real incomes. And so they did, places with such unsurprising names as Nicaragua, Iran and Somalia.

So there is a close connection between economic freedom, economic growth and rising living standards. But why should economic freedom be so important? Essentially, because it is about property rights and choice. Intrusions on property rights by governments inevitably harm incentives. High marginal tax rates, subsidies, industrial policy, lavish welfare handouts, all these blunt the incentives of those who would otherwise seek out profitable trading opportunities.

A country's economic performance, then, depends most crucially on the quality of its institutions. This has been well put by the Harvard economist Robert Barro, who has done a good deal of empirical work on the causes of economic growth, providing further corroboration for the findings of the Fraser Institute's report: “Differences in institutions have proven empirically to be among the most important determinants of cross-country differences in rates of economic growth and investment. Consequently, basic reforms that improve institutions provide one of the best routes for transforming a country over the long run from poverty to prosperity” (p.31).

### **Incentives and democracy – a meaningful relationship?**

Still, even if we accept that institutions matter overall, it becomes important to determine which aspects of institutions are most important in promoting long-run economic growth. This is somewhat more controversial. However, here too there are empirical findings which suggest that some features of institutions are decidedly more important than others in improving economic performance.

As Barro points out: “One strand of recent research focuses on democracy – specifically, on the strength of electoral rights and civil liberties. The second strand emphasises property rights and legal structures that promote the rule of law” (*ibid*). Milton Friedman argued in *Capitalism and Freedom* (1962) that democracy and the rule of law are mutually reinforcing and that both improve economic performance. Former US Secretary of State, Madeleine Albright, has gone further and maintained that democracy is necessary for economic growth, that it is a prerequisite for better economic performance. Both these views have a certain fashionable ring to them, especially Albright's, but the evidence suggests that both are wrong.

The theoretical arguments for secure property rights and an adequate legal framework as essential for economic growth are fairly clear-cut. They are about incentives. Insecure property rights are a deterrent to hard work and investment as individuals cannot be sure that their efforts will bring them the rewards they could otherwise anticipate. High crime rates endanger property rights, as do high rates of taxation and the strong prospect of government expropriation. A well-functioning legal system appears to be an essential requirement for vigorous business activity. Its absence will result in contracts which are neither clearly specified nor enforced. If, for instance, the law does not en-

force the repayment of loans then productive investments will be less. If trade unions can flout collective bargaining agreements by staging illegal strikes then businessmen will be inclined to go elsewhere for higher returns.

The theoretical impact of democracy on growth is more problematic. Greater democracy, in the form of universal franchise, may bring strong pressures for redistribution from the rich to the poor. Huge income disparities within a country may be politically destabilising, and they have pretty universally come to be seen as undesirable. The trouble is that the minimum amount of transfers which may be acceptable in the interests of political stability could well be exceeded. A programme of limited redistribution could acquire a momentum of its own, with predictable effects on the incentives of the "rich" to work and invest as their tax rates increase.

Against this must be set the reduction of social unrest which could result from the equalising of income distribution. "Specifically, transfers to the poor may reduce incentives to engage in criminal activity, including riots and revolutions. Since social unrest reduces everyone's incentives to work and invest, some amount of publicly organised income redistribution would contribute to overall economic activity. However, even a dictator would be willing to engage in transfers to the extent that the decrease in social unrest is worth the cost of the transfers. Thus the main point is that democracy will tend to generate 'excessive' transfers from the standpoint of maximising the economy's total output" (Barro, p.32).

For the actual measurement of democracy, Barro relies on the Freedom House concept of electoral rights: "Political rights are rights to participate meaningfully in the political process. In a democracy this means the right of all adults to vote and compete for public office, and for elected representatives to have a decisive vote on public policies" (*ibid*). Relying on this concept, Barro ranks countries on a scale of zero to one, with zero corresponding to fewest rights and one to most rights. For instance, in recent years the United States and most other countries in the OECD received the value of 1.0, indicating that they were fully representative democracies. Other countries with this rating in 1998 were Bolivia, Israel, Uruguay, and South Africa. In the same year countries which qualified for a zero rating were China, Iraq, Syria, and several countries in sub-Saharan Africa. Midway between democracy and dictatorship in 1998 were such countries as Turkey, Paraguay, Senegal, and Uganda.

The empirical findings show that the world average of electoral rights at first declined after 1960. At the start of that year the mean of the electoral rights index, covering 99 countries, peaked at 0.66. It fell to a low point of 0.44 in 1975, but subsequently rose to 0.61 in 1998 (covering 138 countries). Since the mid-1970s, then, there has been a marked democratisation, although the level for all countries has not yet reached the value of 1960 (making due allowance for problems in the comparability of data between these years).

The main reason for the decline in the world average of electoral rights after 1960 is what happened in sub-Saharan Africa. From a peak of 0.58 in 1960 (20 countries) the index fell very steeply to 0.19 in 1977 (43 countries). It was only after 1989 (0.19) that the index began to rise noticeably, reaching 0.40 in 1998. The explanation for these trends is well-known. After independence in the early 1960s most African states jettisoned the trappings of democracy and became one-party states. The partial trend toward democratisation since 1989 has to an extent reflected pressure from international aid agencies. But it is probably too early to describe this partial reversal as yet another manifestation of the "African Renaissance".

Constructing a rule-of-law index is a bit more challenging. As Barro puts it: "The empirical challenge has been to measure" property rights and the rule of law "in a reliable way across countries and over time". He regards the best indicators available as coming from international consulting firms that advise clients on the attractiveness of countries as places of investment. "These investors are concerned about institutional matters such as the prevalence of law and order, the capacity of the legal system to enforce contracts, the efficiency of the bureaucracy, the likelihood of government expropriation, and the extent of official corruption" (p.35).

Here Barro relies mainly on the data provided by the monthly publication, *International Country Risk Guide*, of the consulting company, Political Risk Services, "especially useful because

it covers over 100 countries since the early 1980s". He found that "the index for overall maintenance of the rule of law (also referred to as "law and order" tradition") turns out to have the most explanatory power for investment and economic growth" (*ibid*).

Converting the rule-of-law variable to a zero-to-one scale to make it comparable with his electoral rights index, Barro found that the United States and most of the OECD countries had values of 1.0 for the rule-of-law index in recent years. In 1999 however Greece was rated at only 0.50, Spain at 0.67, and Belgium, France, and Portugal at 0.83. Outside the OECD, countries rated at 1.0 in 1999 were Hungary, Malta, and (perhaps surprisingly) Morocco and Singapore.

During the 1990s the world average of maintenance of the rule of law expanded. Presumably because of the lack of data, the period covered for this index is shorter than that for the electoral rights index, 1982 to 1999, with 88 countries covered in 1982-83 and 114 since 1985. The average began at 0.50 in 1982, but only began to rise significantly after 1991, reaching a peak of 0.71 in 1996, but falling to 0.65 in 1999.

The evidence suggests that countries which are strong in terms of rule of law are also strong on democracy as measured by the extent and effectiveness of electoral rights. Even so, these indicators do not invariably coincide, which is grist to the mill of students of the relationship between these variables and economic performance. "Thus, there are many cases in which the rule-of-law index is high while the electoral-rights index is low, and vice versa. The cross-country differences between rule of law and electoral rights make it possible to distinguish empirically the effects of these institutional characteristics on economic growth and other variables" (p.38).

There are countries which maintained strong law and order but were weak on democracy. In 1998 China had a rule of law index of 0.83 but an electoral rights index of zero. Other countries with large positive gaps between rule of law and electoral rights were Egypt (0.67 and 0.17), Hong Kong (0.83 and 0.33) and Singapore (1.00 and 0.33).

There were also countries where electoral rights were high in relation to the rule of law. "Countries in this group maintained a lot of democracy, but they were relatively weak in terms of property rights and legal protections" (*ibid*). In 1998, for instance, the Dominican Republic, Greece, and Uruguay all had electoral-rights indices of 1.00, but each had a rule-of-law index of only 0.50. Both Bolivia and Honduras had an electoral-rights index of 0.83 but a rule-of-law index of a mere 0.17. South Africa belongs to this somewhat unprepossessing group (in terms of economic performance), with a rule of law index in 1998 of 0.50, but an electoral rights index of 1.00. Ominously enough, Barro makes a point of singling out this country: "South Africa was downgraded for rule of law from 0.50 in 1998 to 0.33 in 1999. Hence, the gap between electoral rights and rule of law in South Africa probably was even larger in 1999" (p.48).

Barro's findings with respect to the effects of improved rule of law, on the one hand, and the extent of democracy, on the other, on economic growth are unequivocal. It is worth quoting him in some length:

"The estimated effect of improved rule of law on growth is quantitatively large. Specifically, a rise by one category (among the seven used) in the Political Risk Services index is estimated to raise the growth rate on impact by 0.5 percent per year. A change from the worst rule of law (0.0) to the best (1.0) would contribute 3.0 percent per year to the growth rate". But, as he points out, this would only apply to extreme cases, such as Haiti and Zaire, "that began as total institutional disasters".

Better rule of law could have its effect in promoting growth by encouraging investment. "However, most of the positive effect of the rule-of-law index on economic growth applies for a given value of the ratio of investment to GDP. This effect would involve improved productivity of resources and the encouragement of investments that are not measured by the standard national-accounts variable" (pp.40-41).

Democracy shapes hardly at all in promoting economic growth, or, as Barro puts it, the overall relation is "statistically weak". There are both dictatorships and democracies with high and low rates of growth. Democracy is not necessary for growth, nor is dictatorship. There is evidence that growth rises initially when a country changes from dictatorial to democratic rule because of the

benefits in the limitations on arbitrary governmental power. But the increase of electoral rights beyond a certain limit may inhibit growth and investment because of “an intensified concern with social programs and income redistribution” (p.41).

### **Human capital and education**

There is also a possible reverse relationship, between prosperity as cause and democracy and the rule of law as effects. It has long been common to argue that democracy will only flourish once certain material conditions have been met, with increased education and a larger middle-class playing prominent roles in this relationship. Whatever the explanation, the empirical regularities are there. “In particular, increases in various measures of the standard of living forecast a gradual rise in democracy. In contrast, democracies that arise without prior economic development – sometimes because they are imposed by former colonial powers or by international agencies – tend not to last” (p.42).

An especially important variable making for greater democracy is the accumulation of physical and human capital. Higher levels of primary schooling in particular, as against secondary and higher education, have predictive value for the extension of electoral rights. It is early education which seems to matter.

### **And inequality**

Another finding, which has strong policy implications, is that greater income inequality is negatively related to democracy. When a country has huge income disparities it is liable to be politically unstable. There would be a case for some redistribution from the relatively affluent to the poorest. The obvious difficulty would be that once redistribution is begun it may well acquire a momentum of its own in response to the political agendas of demagogues in power. So when a country has wide income inequalities the combined objectives of political stability and economic growth would ideally require a strategy of limited redistribution. Not too much, but not too little, which of course is easier said than done.

The evidence also tells us something novel about the relationship between democracy and the rule of law. A popular argument has been that democracy and the rule of law are mutually reinforcing. More of one will lead to more of the other a bit later. But the facts suggest an asymmetrical relationship. More democracy tells us nothing about what will happen to the rule of law in the future. On the contrary, it depends on a country's level of economic development. If an economically backward country, previously with no or limited electoral rights, finds itself with all the trappings of democracy, including universal franchise, the chances are that these institutions will not last, as a minimum level of economic development appears to be a prerequisite for democratic government. It also means that it is unlikely that there will be greater rule of law as a consequence of greater democracy. Or so the available data indicate.

Greater rule of law may however lead to greater democracy, albeit indirectly. The results do not show that a higher level for rule of law predicts “future increases in the extent of democracy”. Yet it appears that the indirect connection is strong. “An expansion in the rule of law promotes economic growth...and leads thereby to higher levels of per capita GDP over time. The levels of school attainment would probably also rise along with per capita GDP. Then the higher values of per capita GDP and schooling would tend to raise the value of the democracy index. Through these channels, an improvement in the rule of law would, in the long run, lead to more democracy” (pp.44-45).

The evidence and the arguments from different sources thus support similar conclusions. Institutions are decisive in the promotion of economic growth, and some institutions are more important than others. Those which encourage economic freedom are the ones which matter because they involve property rights and choice. Intrusions on property rights by governments inevitably harm incentives. High marginal tax rates, subsidies, industrial policy, lavish welfare handouts – all these blunt the incentives of those who would otherwise seek profitable trading opportunities.

When property owners are not protected against the power of the state to grant privileges to special interest groups (whether trade unions, industrialists seeking special favours, empire-building

bureaucrats, or receivers of welfare), then trade will be restricted and costs will rise. Just as important, property owners need shelter from the powerlessness, or unwillingness, of the state to protect them against the depredations of the criminal and the corrupt, both within government and outside it. The resulting climate of uncertainty must reduce the incentive of individuals to engage in productive activities.

### 3 Policies and performance – some comparisons

The general relationship between economic freedom and economic development finds overwhelming confirmation in the historic record. Still, a more detailed examination of the experience of particular countries should, in principle, throw additional light on what it would take to succeed in the circumstances of South Africa. This will involve a comparative analysis of the economies of eight countries, viz. Australia, Brazil, Ireland, Malaysia, New Zealand, Poland, South Korea, and Turkey. (An obvious question is why these eight and not eight others? And why eight, and not nine, or seven? The answer to this must not be found in the exposition by the present author, who was simply given the selection and instructed to go ahead, as part of the terms of his contract.)

It is of course possible that economic development in these “comparator” countries may help us to understand what it would take for the South African economy to advance to more satisfactory levels of performance. They provide, for one thing, a fair amount of diversity. Three of them (Australia, New Zealand, and Ireland) belong to a group of which South Africa, once upon a time, was automatically assumed to be a member, i.e. the First World. Two are developing countries which have done well in terms of economic growth (Malaysia and South Korea) and two are Third World members which have done markedly less well (Brazil and Turkey). The seventh is Poland, emerging with some measure of success from a defunct socialist system and attempting to make free markets work. Presumably there would be lessons here for a country which has had to endure its own version of encompassing interventionism.

#### **Australia, Ireland and New Zealand**

As can be expected, the countries within this group which enjoy the most economic freedom are New Zealand, Ireland, and Australia (respectively ranked 3, 6, and 7 out of 123 in 1997/98 by the Fraser Institute). They have some unsurprising features in common. They all score highly in terms of the protection of property rights. They have efficient legal and judicial systems which enforce contracts. Prospects of government expropriation are remote.

All three countries pursued stable monetary policies, reflected in exceedingly low rates of inflation during the 1990s, between 1 and 2 percent. New Zealand may in fact have placed too much stress on monetary restrictiveness during the latter part of the decade. In 1998 the economy entered recession, partly induced, it seemed, by the reliance on target interest rates to control the money supply.

Low levels of protectionism prevail, with average tariff rates ranging from 3 to 3.5 percent. Australia has had non-tariff barriers in the form of strict health requirements on agricultural goods, some quotas, and some stringent standards requirements and design rules. New Zealand has had hardly any non-tariff barriers, but has maintained a small list of prohibited imports. Ireland has been the most restrictive of the three, maintaining strict plant and animal health standards which have inhibited the importation of meat and vegetables. But it is the relative openness to trade of all three these countries which is the dominant impression.

They have fared less impressively in keeping down the fiscal burden of government. Both Ireland and Australia perform poorly vis-à-vis the other comparator countries as well as South Africa. Their tax rates are very high. The top income tax rate in Ireland is 46 percent and in Australia it is 47 percent. Their respective corporate tax rates are 28 percent (compared with 32 percent in 1997) and 36 percent. New Zealand's top income tax rate is 33 percent, which is also its corporate tax rate.

Government spending as a percentage of GDP is high in these countries, but at least in New Zealand it is the downward trend which has been impressive. In 1990 such expenditure came to 50 percent. After that it began a steady decline, reaching 42.3 percent in 1997. Transfers and subsidies fell even more dramatically over the period, from 27.5 percent to 12.4 percent. In Australia the total share of government spending as a percentage of GDP is less than it is in New Zealand. Here too it has been going down, but far less dramatically. From a high of 38.5 percent in 1985 it was still 35.8 percent in 1997. Also, since the mid-1970s subsidies and transfers have been increasing. In Ireland

the drop in government spending as a share of GDP has been most spectacular, from 54.8 percent in 1985 to 37.7 per cent in 1997. This was largely due to the reduction in the size of the national debt and the accompanying interest payments.

From Ireland and New Zealand the main lesson we can learn is that Big Bangs are important. A dismantling of controls can result in a marked transition to a higher level of affluence. In 1970 Ireland had an economic freedom ranking of 22 (out of 70), which had fallen to 28 in 1990. Yet five years later it had gone up to 6, where it has stayed ever since. Its economic freedom score rose from 7.3 (out of a maximum of 10) in 1990 to 8.6 in 1995. The most dramatic change was in the freedom to hold foreign currency accounts. In 1990 the restrictions were almost total; five years later they had gone completely. The top marginal tax rate of 48 percent in 1995 may still have been high, but five years before it had been 58 percent. The rate of inflation fell from 5.2 to 0.4 percent. Price controls, never high, were further relaxed. In 1995 only 2.1 percent of Ireland's total revenues came from state-owned enterprises and from government ownership of property.

The more attractive economic environment was reflected in an increased supply of skilled workers, partly because Irish who would have looked for better jobs abroad stayed at home and partly because of net immigration. Labour-force participation also went up as more women remained in employment after marriage.. Availability of skilled labour at reasonable rates of pay in turn provided a stimulus to higher levels of foreign direct investment. Between 1990 and 1997 the annual growth rate was 6.6 percent.

The Irish economy could however still benefit from further reforms. Despite impressive growth, double-digit unemployment persisted throughout the 1990s, reflecting on the one hand transfer payments which reduced the cost of being without a job and, on the other, labour market regulations which raised the cost of hiring and firing.

As far as Big Bangs go, the most spectacular success story to date has been that of New Zealand. In 1985 its economic freedom rank was 32 (out of 107) and its economic freedom score was 6.2. Five years later its rank was 10 and its score was 8.1. By 1995 the respective figures were 3 and 9.1. New Zealand had advanced more rapidly to economic freedom than any other country over the decade.

It registered significant improvements in all the components of economic freedom. Monetary reforms, which aimed at price stability and held the central bank accountable for failure to reach a pre-announced and stable rate of inflation, resulted in a fall in the rate of price increase from 14.2 percent in 1985 to 2.7 percent in 1990 and 2.3 percent in 1995. Restrictions on the ownership of foreign currency, comprehensive in 1985, had gone completely by 1990. During the same five years, top marginal tax rates went down from 66 percent to 33 percent. The labour market was de-regulated and trade unions were deprived of most of the special privileges and immunities they had enjoyed before. Price controls were abolished and agricultural subsidies were phased out. Tariffs were reduced and international trade became almost completely liberalised. Government consumption declined although it remained relatively high at just under 19 percent in 1997. By contrast, transfers and subsidies went down impressively, from 27.5 percent of GDP in 1990 to 12.4 percent in 1997.

But the two steps forward have been followed by a step backward as the unions have fought back for the restoration of their privileges. The return of the Labour Party to power in 1999 has led to the partial eclipse of the free-market reforms of the previous 15 years. The Employment Relations Act has now limited the ability of individual workers to opt out of union representation. A union may consist of as few as two employees. All employers, whether unionised or not, are legally compelled to allow union organisers on their premises to recruit workers, a right only enjoyed by unions, which alone can engage in collective bargaining on behalf of employees.

These measures are obviously highly retrogressive. It is possible, perhaps likely, that the free-market reforms in New Zealand have acquired such momentum that the ERA only represents a temporary reversal of a trend which has had conspicuous results in the form of higher levels of prosperity.

This last statement has been challenged on the grounds that liberalisation has left New Zealand poorer than before. GDP per head since 1984 grew by only 0.9 percent a year, which compared poorly with the 1.5 percent of the pre-reform years of 1971-84. But, as *The Economist* has pointed out in a recent appraisal of the New Zealand economic experiment (2 December 2000), it is not reforms over the whole period since 1984 which should be judged. In particular, labour-market deregulation only took place in 1991. Since 1992, GDP has grown by an average of 3 percent a year and GDP per head by 2.2 percent, which is just above the OECD average.

## **South Korea**

Of the four “developing” members of the comparator countries, South Korea has long been singled out as one of the highest of the Third World achievers. We are told that it is a showpiece of capitalist development – of what market forces can do if they are just left alone. But there is an alternative story. South Korea supposedly illustrates the urgent need for the guiding hand of the state in developing countries.

About the phenomenal nature of Korea’s growth there can be no doubt. Paul Krugman has described it very well: “In 1963 South Korea instituted an economic reform that, to everyone’s surprise, began the transformation of a poverty-stricken nation, surviving largely on US aid, into one of history’s great success stories. Over the next thirty-four years, per capita income in Korea rose by almost 7 percent per annum, a ninefold increase in little more than one generation. One way to put this in perspective is to notice that in 1963 South Korea was probably poorer than Britain had been in 1800 – poorer, perhaps, than Britain had been since the seventeenth century. By 1997 the Koreans had reached more or less the per capita income of Britain in the early 1960s” (p.24).

The obvious question is: How come? Just why did this transformation take place? And does the South Korean case hold out lessons for other “emerging” countries like, say, South Africa?

The state has played a large role in Korean economic development. And, as this development has been so impressive, it is tempting to conclude that the causal relationship is close. Without the guiding hand of the state the Korean economy would not, it seems, have grown as fast as it has done for nearly four decades. Perhaps, but it is also possible that market forces have played a larger role than it has been common to credit them with.

It is fairly clear that government spending has not provided the major impetus to growth, for it has been quite modest by international standards. It has increased over the years, but in 1997 it was still only about 20 percent of GDP. In addition, it has not so overtly been in the form of handouts for parasites, the emphasis being on education and public works rather than on transfers and subsidies. Tax rates have been moderate and have been declining. The top marginal tax rate was 89 percent in 1980 but had fallen to 48 percent by 1997. So the fiscal burden of government in South Korea has not been severe.

One big advantage the South Korean economy has enjoyed over those of many other developing economies is that property rights are secure. Political and civil freedoms have been curtailed and South Korea is only a democracy with many qualifications, but the country has had a legal system which has effectively enforced contracts and so made possible a variety of gains from specialisation and trade.

It remains true that the economic role of the state has provided an incentive for all kinds of rent-seeking activity. The Korean government has relied on familiar devices to promote economic development: taxes and subsidies, credit rationing, licensing, and plenty of regulations, including strict controls over direct foreign investment.. What must be explained is why such policies have apparently been compatible with an extraordinary rate of economic growth. The standard economic argument would be that such measures distort incentives and encourage the waste of resources in the pursuit of redistributive gains. Critics of the market would argue that, in the case of Korea at least, this has not happened. In fact, they believe, judicious state intervention has actually made possible the Korean achievement.

An enthusiast for the Korean version of industrial policy has put it as follows: “The Korean government’s practice of selective intervention has entailed tradeoffs between realising dynamic



economies and creating institutions that will be viable in the long run". He has found that in Korea there was the overriding objective of achieving "dynamic efficiency in the sense of attaining international competitiveness within an explicit medium-term time horizon". Information relevant to judging comparative advantage was "sought continuously from every possible source".

In practice there were mistakes, which were "a primary cause of the dramatic deterioration in Korea's industrial performance at the end of the end of the 1970s". These mistakes tell us a good deal about the harm that can result when the state supersedes the market. "Plans were rigidly pursued for lengthy periods in the late 1970s without regard to the accumulating evidence of problems that were being encountered". Also, the "number of industries that was targeted in the mid-to-late 1970s was too large to permit the achievement of a critical mass of human resources in most of them". And finally, the comparative advantage of well-established industries was often disregarded. "These industries were excessively crowded out of markets for labour and capital in the late 1970s by the large demands of the targeted infant industries; the result was a sharp decline in export growth" (Westphal, pp.57-8).

The magnitude of the errors raises the question when selective intervention may be successful and when not. On closer examination the "Korean miracle" did not so entirely disregard market forces as true believers in state intervention would like to think. The role of the state was not as decisive in promoting growth as popular mythology would have it.

In fact, the argument rests on assumptions which are somewhat counter-intuitive. First, there is the notion that politicians and bureaucrats can pick winners. The history of Third World industrialisation abounds with examples to the contrary, of uncompetitive firms and industries sustained at some considerable cost to taxpayers. There is of course no theoretical reason why the state should be able to identify superior performers better than does the marketplace. The once-common assumption that it could do so simply disregarded the costs of information. Every schoolboy knows, or should know, that it is a function of the market to provide information about relative scarcities. If the "state", consisting as it does of highly fallible individuals with no claims to omniscience, disregards market signals, it is because it has superior information at its disposal. To date the evidence for this claim is about zero. The evidence to the contrary is huge and still accumulating. Yet all too often it has just been taken for granted that the South Korean state has had such privileged access.

There is an argument which may have some validity, viz. that in some circumstances the signals of the market may be superseded because of some higher objective. Most obviously, this applies to wartime, when the existence of the state itself may be at stake. After the Korean war, the survival of South Korea as an independent country was very much in the balance. Its military rulers were acutely aware of the continuing danger from the North. Foreign aid from the United States was declining, the country was devastated, and most of its industrial capacity had been destroyed. In the circumstances the promotion of industrial development based on an export drive seemed a natural response to the overriding imperative of national survival. Or at least that was the view of the South Korean strongman, General Park Chung Hee, and his colleagues after the military coup of 1961.

So Korean industrialisation was, initially at least, not a market-driven phenomenon. At first, state assistance to exports was across the board, but eventually protection and subsidies settled on a number of preferred industries. The state deliberately sponsored the growth of large holding companies, the famous (or notorious) *chaebols*, which controlled diversified industrial groups. Especially from the 1970s the government sponsored the development of heavy industries such as steel, shipbuilding and machinery, which were protected from domestic competition and given plenty of assistance to establish themselves in export markets.

This kind of growth could succeed for a while, but it depended on virtually military-type regimentation with strict controls over labour. As the economy became more complex the original pattern of industrialisation became increasingly obsolete. Predictably enough, rent-seeking by privileged interests had become deeply entrenched. One of its manifestations was massive corruption. Also, most Korean growth was not based on improved efficiency. Rather it was growth of inputs,

especially capital, which primarily accounted for growth. It even appears that the efficiency with which inputs were used declined during the course of development.

Sacrifice was therefore a main feature of Korean growth. Working hours were exceedingly long and during most of the 1970s negative real interest rates prevailed on the deposits of South Korean savers. Investment was stimulated, but discontent with the status quo became more vocal and widespread.

So, after the 1970s, the South Korean economy became far more responsive to market forces. There was, obviously, much opposition from established interests, but continued economic expansion made financial and import liberalisation inevitable, as well as greater labour market flexibility and less emphasis on indicative planning.

The Korean experience gives little support to the enthusiasts for state intervention who had their dreams shattered by the end of the Soviet Union and were forced to look elsewhere for statist near-utopias. The military rulers of South Korea had no special insight into their country's comparative advantage. They had a different agenda, which was national survival. And even if they were disinterested pursuers of the national interest, as they saw it, the system they erected made possible huge corruption and rent-seeking. Not least, it was a system based on labour repression, which should make it unappealing to professed "democratic socialists" who dislike the market but yet claim to believe in freedom of choice. The economic development of South Korea in the latter half of the 20<sup>th</sup> century confirms at least two things, viz. that picking winners is difficult if not impossible, and reliance on the benevolence of politicians and bureaucrats is likely to be a hazardous business.

Yet, whatever the rigours of South Korean growth, in one crucial respect it was inescapably tied to the market. The country was committed to exports and thus exposed to international competition. The domestic market was of course largely insulated from foreign competition, but the discipline of having to export meant that the Korean economy could never retreat into self-sufficient backwardness.

## **Malaysia**

The other Third World high achiever amongst the comparator countries has been Malaysia, which presents some problematic evidence. What makes it possibly of especial relevance to South Africa is that it has been a racially divided country where the Chinese minority, with its entrepreneurial skills, commercial traditions and relatively high living standards, had for long been the object of envy and resentment to the more numerous but economically less affluent Malays. The country's post-colonial development was in fact shaped by the need to solve its "Chinese problem".

After the anti-Chinese riots of 1969, following a strong Chinese showing in the elections, democracy was suspended and a "New Economic Policy" was introduced which was aimed at achieving both growth and redistribution. By this was meant of course affirmative action to favour the indigenous Malays and it took the familiar forms. For instance, all business enterprises were to have at least 30 percent Malay participation. Malays were granted lower mortgage rates by the government than were non-Malays.

Now it seems counter-intuitive that such policies could have gone side by side with economic growth, which indeed was a necessary condition for their success. In addition, state ownership was extensive, regulations were plentiful and the bureaucracy was large.

One thing is clear. Malays did benefit markedly from affirmative action programmes. In particular, the establishment of a Malay business community was significantly advanced. Public enterprises were set up to train and employ Malays. Administrative regulations encouraged Malay employment in private-sector companies. Companies wishing to expand their operations had to set aside part of their new capital for Malay ownership. The price of shares offered to Malays was lower than the market value. The emphasis throughout was on equality of results in terms of racial "representivity", to use the illiterate jargon which has become fashionable in South Africa. The Malay share of the wealth of the corporate sector increased from less than 2 percent in 1970 to 18 percent in 1990, although still less than the original target of 30 percent.

At the same time, while affirmative programmes were being implemented economic growth was taking place, suggesting that development and redistribution are not incompatible. Could it be that in this respect at least Malaysia may be a role model for other countries where differences in wealth and skills tend to coincide with ethnic divisions?

Of course, this is possible, but we must first look at the reasons for Malaysia's economic advance while redistributive policies were being put in place. For one thing, the country struck it lucky. At this time the international price of rubber and oil palm went up, while rich oil reserves were discovered in the 1970s. So economic windfalls did a good deal to help offset the economic inefficiencies inherent in policies designed to advance one group at the expense of another.

Also, during this decade the Malaysian government took some steps toward economic liberalisation which helped to cushion the effects of discriminatory policies. Most conspicuously, the previously high restrictions on the ownership of foreign currency were removed, protection of private property rights by the courts was more strictly enforced (within the limitations of affirmative action), and restraints on international trade were substantially reduced. Growth during the 1970s came to 7.8 percent per year.

But by the beginning of the next decade the New Economic Policy was showing signs of strain. The government had expanded public enterprise and made large but unproductive investments in heavy industry. Hence during the 1980s there was a shift to the market. Government consumption as a percentage of the total went down. The top marginal tax rate, 60 percent in 1980, had declined to 45 percent in 1990 and had fallen to 30 percent in 1997.

The Malaysian experience suggests that growth and affirmative action can go together, but that their co-existence is hardly automatic. There are in addition obvious downsides. Governments which pursue policies that favour one group in preference to others place their legitimacy at risk. And it naturally not only encourages ethnic polarisation but also accentuates divisions within the new privileged groups. Certainly in Malaysia there has been the entirely predictable outcome that the growing Malay middle class, which it was the policy of the government to create, has been able to influence official decisions in its favour and at the expense of poorer Malays. All this encourages authoritarian rule. Indeed, in Malaysia affirmative action got under way after democracy had been suspended. The government of Mahathir Mohamad has become increasingly dictatorial and arbitrary, to which the recent unfortunate experiences of his railroaded deputy Anwar Ibrahim are a vivid testimony. A policy of racial preferences may not have been the sole, or even main, reason for these trends, but it is difficult to believe that they did not facilitate them.

## **Brazil**

Brazil is a country which has some similarities with South Africa, but fortunately the differences are, at present, still greater than what they have in common. They do share extreme income inequalities. Although South Africa has long been noted for its income disparities, which so largely still coincide with racial distinctions, in Brazil they are still more pronounced, with the richest 10 percent of the population earning just less than 48 percent of total income. Here too, although Brazil has often been held up as a paragon of racial harmony compared with benighted places like South Africa, income differences largely correspond with racial divisions. Adult illiteracy is also high, at 16 percent of the total.

The potential for social instability in Brazil is therefore considerable. It would seem that any future growth would involve some redirection of public spending to reduce the most marked inequalities. Ideally, of course, funds generated in the process of development should be available for reinvestment. In the long run, this would benefit the poorest members of society, even if it is only via the trickle-down effect. But the time for this to work may not be enough.

Brazil is therefore an extreme case of the explosive possibilities which may be inherent in a situation where income inequalities are very wide and can plausibly be presented as manifestations of racial oppression. In South Africa we have not, probably, reached this stage, but Brazil presents the kind of scenario which may emerge here if our growth performance continues to be as poor as it has been for the last few decades.

Brazil also resembles South Africa in that it has not made rapid progress in improving its economic freedom rankings and scores. Brazil's score was 5.6 in 1970 but declined steadily to 3.2 in 1985, the outcome of a monetary policy which resulted in hyperinflation, highly protectionist trade policies, government enterprises widely spread throughout the economy, weak protection of property rights, high marginal tax rates, and rigid exchange controls. These were the years of military government and attempts at central planning. Since then Brazil's rating has gone up to 5.9 in 1997, only slightly above where it had been just less than 30 years before. South Africa's score over the same period was higher but also changed little, falling in fact from 7.6 in 1970 to 5.6 in 1985 and then rising to 7.3 in 1997, a striking comment on the anti-freemarket nature of government policies during the apartheid years.

Today Brazil is still attempting to recover from the years of military rule. It does not appear to be doing very well. Both tariff and non-tariff barriers are high, although the former have been coming down in recent years. Government spending as a proportion of GDP exceeded 30 percent in 1998. The top income-tax rate in the same year was 27.5 percent, up from the 25 percent of 1997. Inflation remains very high, with a weighted average annual rate of 45.8 percent from 1989 to 1998. Although the property rights of foreign investors are fairly safe, the court system is inefficient and subject to political and economic pressures. Wage and price controls have for long been part of the Brazilian economy. Regulation is not as high as it used to be, but it still restrains business activity in a number of areas such as the environment, labour, and finance. There are also controls on foreign investment in "strategic industries".

In all there are plenty of features of contemporary Brazil which would be familiar to South Africans. It is surely not surprising that the most up-to-date report available, *The 2001 Index of Economic Freedom* of the Heritage Foundation, places both South Africa and Brazil in the category of economies which are "mostly unfree". However, since 1996 Brazil has slightly improved its score, while South Africa, after showing progress in the years immediately afterwards, over the past year registered a noticeable decline in its economic-freedom rating.

Such a comparison suggests that countries may easily get stuck in low-achievement traps, where advance towards greater economic freedom tends to be slow and may easily be reversed.

## **Turkey**

Turkey is a country which, until only a few years ago, could be described as economically backward compared with South Africa. Before the 1980s the Turkish economy was relatively closed with the state playing a pervasive role in the direction of economic affairs. But during that decade the government introduced a number of free-market reforms which set the country on a new course. It became legal to hold foreign-currency bank accounts, tax rates were reduced, tariffs fell very sharply, exchange-rate controls were relaxed and the trade sector grew substantially.

The state has continued to play a significant role in basic industries, banking, transport, and communications. However, the private sector has grown rapidly and the Turkish economy has become far more integrated into world markets. Tariff rates have fallen considerably. There are relatively few restrictions on foreign investment.

A major weakness of the Turkish economy has been monetary instability, reflected in a very high rate of inflation averaging more than 70 percent during the 1990s. Also, the rule of law is not always up to scratch. Officials have plenty of discretionary power, although recent governments have attempted to curb their power by reducing the size of the bureaucracy and imposing a performance evaluation test for civil servants. Given the importance of sound rule of law to continuous economic growth, which in Turkey has averaged 2.5 per annum since the 1980s, it is obviously important that government does more to strengthen the independence of the judiciary and reduce corruption, which is fairly prevalent in the public sector.

Turkey clearly still has a long way to go, but its advance towards a freer economy has been steady, although not spectacular. There have been steps backward, yet the basic theme is of the transition from a basically unfree to a basically free economy, to use the terms of the Heritage Foundation. The watershed was the introduction of free-market reforms in the 1980s. They were

across a broad front, not piecemeal. The Turkish experience confirms the general impression derived from studying the economic development of the comparator countries over the last two or three decades, viz. that when economic liberalisation is the issue, pussy-footing will not do. Change should be comprehensive. And it also shows that it is feasible, despite the resistance of interest groups which feel threatened by alterations to the status quo.

## **Poland**

Poland offers obvious lessons to South Africa. Both countries have been faced with the transition from a highly statist, authoritarian economic system, which became increasingly untenable in both human and economic terms, to a more market-based system which would mitigate the damage inflicted by the interventionist years and make possible the improvement in the very low standards of average per capita income.

Poland has been one of the success stories of post-Communist Eastern Europe, which seems odd. When Communism collapsed in 1989 the economy appeared a basket case, an extreme example of one of the centrally-planned “shortage economies” of the Communist world. The country had incurred huge loans which it could not repay and it was importing enormous amounts of food which it could barely pay for and which contributed to a massive balance of payments crisis.

Here too the best answer was a form of “big bang”, or shock therapy, as it came to be known in Latin America. The assumption of the new Polish government was that gradualism could not work so the necessary “critical mass” required comprehensive changes and their rapid application. And this is what happened on 1 January 1990, when most prices were freed, the currency was devalued and made convertible, taxes were reformed and a restrictive monetary policy was adopted. The government deficit was to be reduced from seven to one percent of GDP.

At first the shock was very considerable. Instead of the estimated 45 percent rise, prices went up by 78 percent within days. Shortages continued. But after the initial unpleasant impact, markets began to work. Farmers began to bring their produce to town, bypassing the state distribution system and selling direct to the consumers. This happened to industrial wares as well. Prices began to come down.

The Polish experience has not been an unmixed success. The rate of privatisation has been slow, but the number of small businesses has grown vastly in response to consumer demand. The fiscal burden of government remains high. The top income tax rate is 40 percent, and government spending in 1998 equalled more than 43 percent of GDP. In this respect Poland is very similar to South Africa, but it has far lower levels of protectionism. Property rights also receive higher levels of protection, if only because of a lower degree of criminal activity.

The result has been that Poland and South Africa have been moving in different directions, from mostly unfree to mostly free in the first case, and the opposite in the second. Here too the moral appears to be that shock therapy – market reform, a big bang, call it what you will – does work in bringing about a transition from the economically unenviable to the more palatable.

## 4 And now South Africa

Against this background, we may wonder how far South Africa has gone since the end of apartheid to ensure an environment which gives individuals the incentive to pursue their own interests by making productive investments, as against devoting themselves to improving their welfare by means of redistribution and crime. The short answer, elaborated below, is that there has been some improvement, but that it could have been a good deal better, not only in terms of local expectations but also, and especially, in terms of what other countries in parlous economic straits of their own have achieved. If countries like New Zealand and Ireland were able to advance markedly toward a freer economic dispensation, reflected in better living standards for their inhabitants, why not the new South Africa?

South Africa's advance towards economic freedom over the last ten years has been noticeable but not spectacular. What is more, its rating has been virtually unchanged. In 1990 it was 48<sup>th</sup> out of 115 and in 1997 it was 47<sup>th</sup> (Fraser Institute, 2000, p.72). It may be argued that as long as the progress is there, it does not matter all that much if we do not keep up with the Down Under and Eastern European counterparts of the Joneses. Getting ahead is all that matters. So what if others are just a bit faster than we are? As long as we get there eventually. And of course there are more important things than material affluence. Perhaps, but again, perhaps not.

In fact, staying where we are in the relative ranking of nations is really not such a mighty fine thing, implying as it does that we are not all that good at playing catch-up. To return to Mancur Olson, while the developing world as a group may not have grown as rapidly as the developed countries as a group, nevertheless a subset of low-income countries has actually grown more rapidly than the latter – countries like Hong Kong, Taiwan, and Singapore. Olson holds, and he is difficult to refute, perhaps because he is close to the truth, that these super-performers have managed to exploit the possibilities inherent in the huge gap between their productive potential and that of the developed world, which is already at the limits of its potential. For low-income countries there are huge gains to be made by exploiting the gap between what they are and what they can be. But they need an appropriate institutional framework, which is usually prominent by its absence. And this is why so many lag and indeed fall behind in a big way.

South Africa's unremarkable performance in moving toward economic freedom, its steady mediocrity in just maintaining its global freedom ranking, would seem to indicate that it is not doing as well as it can – that it is an under-achiever on various fronts. The country is not making the most of exploiting the gap between itself and the economically most advanced countries. But South Africa has always had claims to being the most advanced economy in Africa, the power-house of the continent, as the hackneyed expression has been. It would have been a reasonable presumption that South Africa was well-placed to catch up, relatively developed but not too much so. Yet we have not been doing well; the signs are that a major institutional overhaul is necessary before we can do much better.

### **The South African dilemma**

One reason why we are not doing better is familiar. It is all the fault of apartheid. Its social evils were devastating, and we are still living with their legacy. This has been the common refrain of the government and the ANC ever since the advent of democracy. High unemployment, falling living standards, crime and violence – all these are somehow due to the white supremacy which a succession of minority governments, both before and after 1948, had attempted to maintain, no matter what the human and economic cost.

Blaming the previous masters is an old ploy. In the Soviet Union, capitalism proved to be an exceedingly resilient survivor; its continued heritage seemed to be responsible for whatever went wrong with an economy that never managed to deliver on the higher living standards promised by the Bolsheviks. This kind of talk has even found some academic support. It has become fashionable for scholars from various disciplines to theorise about the continued sway of the past. Theories of

path dependence have become popular. Even quite small decisions may set societies on a course which it may later be difficult to undo. How much more entrenched and difficult to eradicate would not be the effects of a prolonged and disastrous social experiment like apartheid?

It is tempting to dismiss such stories as mere special pleading, designed to cover up the avarice, corruption and incompetence of a later generation of looters. No doubt there has been plenty of dishonest self-exculpation on show. And of course it is true that, path dependence notwithstanding, there must come a time when it is no longer credible to blame the bad old predecessors for all the ills a polity is heir to. This said, it is unfortunately also true that in South Africa we are still living in the immediate aftermath of a massive effort at social engineering that came close to destroying the very fabric of society. The celebrated, and conservative, American sociologist, William Graham Sumner, made the point very well more than 80 years ago, when he said: "It is not possible to experiment with a society and just drop the experiment whenever we choose. The experiment enters into the life of the society and can never be got out again". Like it or not, policies designed to maintain white rule over a black majority, and pursued with singular tenacity over many years, left South Africa with an institutional framework which in major ways was ill-designed to promote more rapid economic growth.

## **Education**

One of the most overt and corrosive legacies of apartheid has been the inferior education blacks had to endure. Some education is no doubt better than none, as the rising school-enrolments amongst Africans under apartheid testified only too well. There were rewards in the market-place even for those with only a modicum of education. Blacks who received an education were a relatively privileged minority. But their schooling remained abysmally inferior to that received by whites, both in quantity and quality. In the future of separate freedoms the Nationalists so confidently designed there was no room for highly educated Africans in the "white" areas. What university-education blacks did obtain was at ethnic colleges in no way comparable to the established white universities, to which only a few Africans were admitted by special ministerial dispensation. When majority rule came, there was an overt shortage of skilled and semi-skilled Africans. At the primary level too, schooling had always been conspicuously worse than that received by whites, only aggravated by the pseudo-revolutionary posturing which announced that acquiring even elementary skills was of no importance as long as liberation had not arrived. In brief, the distribution of human capital was heavily skewed in favour of the white and, to a lesser degree, the Indian and coloured sections of the population.

Rent-seeking is common in all economies including the most developed and capitalist ones. It differs from profit-seeking in a crucial respect. The pursuit of profit is directed at the creation of wealth. Successful makers of profit benefit themselves by satisfying the wants of consumers. Altruism does not enter into it. It is simply a question of getting the incentives right. Rent-seeking is a different kind of animal and is directed at the transfer of wealth. It is about the redistribution of resources.

Rent-seeking has heavily pervaded the South African past. One legacy of our peculiar history has been that the rent-seeking of white supremacy has made virtually inevitable a whole host of different kinds of rent-seeking, designed to benefit the "historically disadvantaged". The recipients may be different but the effects on growth are just as inimical. Even if we had a highly-skilled black force equipped to deal with the requirements of a modern economy, a fair amount of interest-group entrepreneurship would have been entirely predictable. Black trade-unions, like their white counterparts under apartheid, could have been expected to claim special privileges for themselves. And so they have, even if it has been at the expense of many thousands of Africans who have found themselves priced out of the labour market. However deplorable, this is how trade-unions, and special-interest groups in general, behave, wherever they are found. Their own interests and those of their members come before any alleged public interest. It is rational behaviour which holds no surprises for the economist.

But the very lack of skills required for the running of a modern economy has led to a reliance on other means of advancement for those Africans able to exploit their political bargaining power. In particular, racism has been an indispensable means of rent-seeking, reflected in the demands for affirmative action in all spheres of life, including sport and academic appointments. The pretence of course is otherwise. As Cyril Ramaphosa, then Secretary-General of the ANC, put it in a masterpiece of doublespeak at an early stage of the new South Africa, "We want to deracialise South African society so that people stop looking at themselves in racial terms. But you do that by making sure that each institution reflects the true character of our country" (*The Economist*, May 20 1995).

Of course what has been happening since then has been the re-racialisation of South Africa, with none of the references to non-racialism which used to be fashionable in what now seems those impossibly naive early days. The government of Thabo Mbeki has been explicit in treating affirmative action as primarily a means of black racial advancement, with merit and competence mere secondary considerations, insofar as they count at all. Universities like UCT and Wits, which used to pride themselves on their liberal, non-racial heritage, have collaborated enthusiastically in finding reasons, however specious and unrelated to academic achievement, for promoting and appointing blacks, with no overt indications of shame. Private firms have been obliged by law to make their workforces "representative" of the population at all levels, subject to stiff fines for non-compliance. Most visibly, it has led to a good deal of "black empowerment" in the form of a small number of Africans who have used their political ties to the ANC to excellent effect in securing for themselves lucrative contracts for public works and token senior positions with white firms.

The thrust of the re-racialisation of South Africa has been to contribute new dimensions of low productivity to a labour force which has long been notorious for its absence of skills. To that "normal" level of rent-seeking which could be expected of a country at South Africa's level of development, there have come additional elements deriving directly from the white-supremacist past. White racial obsessions at the highest level have been replaced by the racial obsessions, natural and contrived, of South Africa's new rulers. Faced by their manifest inability to promote the kind of growth which would reduce unemployment and raise the living standards of millions of impoverished Africans, they have taken the easy way out and resorted to harping on racial divisions as a substitute for not delivering on a host of unfulfilled promises. Beating the racial drum has traditionally been tempting as a way of mobilising political support in South Africa. The political pay-offs to racism have tended to be rich.

The most disastrous legacy of white supremacy has however been the collapse of law and order in the new South Africa. Under the apartheid regime the rule of law was a one-sided thing. The property rights of whites were sacrosanct; those of Africans were flouted in many and demeaning ways. But there was a kind of rough justice. The investing classes knew that they were reasonably safe in having their property rights protected and enforced; the insecurities of business activity largely went to African entrepreneurs attempting to make an honest rand in the "white" areas. Injustice and oppression were still compatible with a substantial amount of economic growth, so much so that in South Africa today the self-consciously tough-minded like to contemplate the past through a romantic haze ("I am not a racist but...") where workers knew their place and capitalists were (relatively) free to get on with their job of satisfying effective demand. Businessmen may have been increasingly disaffected with PW Botha and his authoritarian ways but they continued to believe that a few appropriate changes here and there would create the right kind of climate in which the economy could thrive. It is a sign of the times that this era should now seem so irretrievably gone.

The most dangerous moment for a bad government comes when it begins to reform, as Tocqueville so aptly observed. It was only the *kragdadigheid* of the Nationalists which kept South Africa in the apartheid straitjacket. Once their resolve to remain on top began to erode and liberalisation spread, so did a lawlessness which has shown no signs of disappearing. The previous enforcement of the rule of law was so one-sided, the police were so blatantly an instrument of white domination, that the whole notion of law and order came into disrepute.



The police force itself appears to be deeply divided on racial lines. Black policemen regularly accuse their white colleagues of racism, probably with reason, given the past of the SAP and the unlikelihood of traditional racial attitudes disappearing overnight. Racial animosities can of course be restrained, provided the incentives are right. But they are not, for the remuneration of the police has for many years now been wretched. Members of the force tend to be poorly educated and the resources at their disposal are notoriously inadequate. Even if the police had the incentive to pursue and capture criminals, they are poorly equipped to do so. And when villains are apprehended they all too often receive absurdly light sentences. Law-enforcement in South Africa is rightly perceived by the public as verging on the farcical. It is no wonder that South Africa's law-and-order rating has declined so drastically in recent years.

Yet all the evidence shows that a high law-and-order index is an essential, if not sufficient, condition for more rapid growth. This in itself is enough to make the country unattractive to foreign investors, most of whom have little interest in repairing any historic injustices suffered by Africans here or anywhere else. The mere fact that we find ourselves in the unprepossessing (economically considered) company of countries like Bolivia, Honduras, Uruguay, and Jamaica, with plenty of democracy but "relatively weak in terms of property rights and legal protections" (Barro), speaks volumes about the current South African condition. Protection of private property rights is a precondition for growth. In South Africa it is under greater threat every year. So a discrediting of law and order has been a major inheritance of the ANC from the Nationalists. But history has no iron laws; there is nothing which says that a government must be bound by what was left to it by its predecessor, tempting as the present rulers may find it to blame our present discontents as the fatal legacy of white minority rule.

Could there be other explanations of South Africa's disappointing performance since the early 1970s? Could it be that South Africa is just another victim of the "African disease", making it impossible, or at least exceedingly difficult, to achieve a growth rate which would make life better for all its people? As *The Economist* recently posed the question in a widely cited article, "Does Africa have some inherent character flaw that keeps it backward and incapable of development?" (13 May 2000). Is it really the "hopeless continent"?

### **Africa: A special case?**

There are good reasons for regarding Africa as hopeless. In its editorial *The Economist* puts it succinctly: "No one can blame Africans for the weather, but most of the continent's shortcomings owe less to acts of God than to acts of man. These acts are not exclusively African – brutality, despotism and corruption exist everywhere – but African societies, for reasons buried in their cultures, seem especially susceptible".

The reasons have nothing to do with race, but history is still with us. Geography and climate did not encourage the emergence of nation states on the European model. Drought, flood and disease left their toll. Nor did imperial rule do much to improve matters. The much-maligned "colonialists" were not around long enough for the establishment of states geared to the requirements of democracy and economic growth, but their rule was enough to undermine African institutions and values. African states "were simply bequeathed by departing imperial powers who left highly centralised, authoritarian states to a tiny group of western-educated Africans who rushed in and took over. Some of these states, such as Congo, were established by Europeans as businesses to be milked for profit. Their successors simply continued the practice. Africa has an abundance of valuable minerals and some good land, attracting outsiders to extract the raw materials and ignore the rest. Independence often meant little more than a change in the colour of the faces of the oppressors".

In these new states power has been personalised, resulting in the undermining of national institutions and the spread of sham democracies. International aid has had no noticeable effect for the good. It has instead placed more resources in the hands of the robbers. And it has promoted dependency and the refusal of Africans to help themselves.

There is evidence that “in the right circumstances, Africans can greatly improve their lives”. Mozambique had been growing at a rate of 5% a year since the end of its civil war, until the floods came. Uganda had growth rates of 7% in the 1990s. “But real change needs something deeper than quick spurts of growth”.

*The Economist* concludes: “More than anything, Africa’s people need to regain their self-confidence. Only then can Africa engage as an equal with the rest of the world, devising its own economic programmes and development policies. Its people also need the confidence to trust each other. Only then can they make deals to end wars and build political institutions: institutions that they actually believe in”.

If we accept, for the sake of argument, that this diagnosis of the ills of Africa is correct, are there grounds for regarding South Africa as an exception? Yes, up to a point, but there are also similarities between South Africa and other African states which suggest that we too can go down the road of gangsterism, corruption and decay.

*The Economist* cites the Economic Commission for Africa, which says that most of sub-Saharan Africa cannot do better than the area’s 2.5% growth as a whole because these countries do not have the basic structures for development. Be that as it may, the Commission mentions three exceptions, viz. Botswana, Mauritius and South Africa. And this is also the crux of the matter. South Africa has had the inestimable advantage of more than three centuries of “colonial” rule. Politically correct mythology would have it as a story of unrelieved oppression, of expropriation, exploitation and underdevelopment. There were plenty of these horrors, no doubt, but if that had been all then South Africa would have been just another African basket case.

The white “settlers” brought with them human and physical capital which could not have been supplied from an unpromising African environment. They established an infrastructure for what became the most advanced economy on the continent, which, after the discovery of minerals, for a long time grew at an impressive rate, i.e. it was both high and sustained. Rent-seeking and discrimination there were in abundance, but they were compatible with material advance which benefited the whole population, however unequally distributed the gains. Between 1920 and 1980, South African economic growth was equivalent to an average compound rate of growth of 5% per annum. Real growth per capita averaged over 2% during this period.

International comparisons will help to place this in perspective. Between 1855 and 1950, British real gross national product grew at an average rate of 2% per annum. Per capita incomes grew by an average 1.2% per annum. In the United States, GNP grew by 3% per annum between 1890 and 1970, with an average per capita growth rate of just less than 2%.

South Africa, in fact, is the one country in Africa which has experienced what has come to be known as modern economic growth. “Formally, modern economic growth may be defined as a rapid and sustained rise in real output per head and attendant shifts in the technological characteristics, factor proportions, and resource allocation of a nation. By ‘rapid and sustained’ is meant average annual growth per head of population of around 1.5 percent or more lasting over at least a half-century. This is about the average rate in the half-century before World War I of a group of fifteen nations that were leaders in modern economic growth” (Easterlin, p.31). This is exactly what South Africa experienced for most of the 20<sup>th</sup> century, whatever the disappointments of the last few decades. Foundations were laid which have not been destroyed, even by the last years of Nationalist rule and the first years of ANC government.

Yet one of the lessons of history is that growth carries with it no guarantees. A country can achieve sustained growth and then lose momentum, lapsing into stagnation and even decline. Argentina is perhaps the classic example. Economic growth is hard to come by and easy to forfeit.

Here is where South Africa runs the serious risk of being infected with the “African disease”, of being victim of practices which have brought economic chaos to many countries. The obvious recent example is Zimbabwe, where Mugabe inherited an economy which was, by African standards, developed and prosperous. Yet over 20 years he and his fellow-robbers have managed to bring it to the verge of ruin. Economic policy, when it was not just plain looting for personal enrichment, bore the stamp of the Leninist ideology which Mugabe brought with him to power and which he

seemed to think, in spite of all the evidence, was appropriate for the running of a modern economy. But most of the time ideology was simply a facade for incompetence, at best, and parasitism, at worst.

Now it may be objected that there are huge differences between the rulers of Zimbabwe and of South Africa. So there are. Whatever Mbeki's faults, he is light-years away from being another Mugabe. He should try to maintain that distance. Apologists in the liberal South African press, who seem to be impressed by their own tough-minded realism, have argued that behind-the-scenes pressure is more effective than public denunciation, which would only antagonise an unstable character like Mugabe. The trouble is that this hushed diplomacy has had little effect.

What is much worse, Mugabe has done wonders in confirming traditional stereotypes of sub-Saharan Africa as the heart of darkness. Foreigners have always tended to see black Africa in undifferentiated terms. So the perception is that what happens in Zimbabwe is liable to happen in South Africa too. Foreign investors, if they needed it, now have another reason to keep their distance. And at home business confidence has taken a knock. A recent opinion survey by the Stellenbosch Bureau for Economic Research showed a sharp fall in South African business confidence. Events in Zimbabwe played an important part in this increased pessimism about the future.

It does not help to say that the South African government has nowhere endorsed a land grab on Mugabe lines. Mbeki's failure to take a strong stand has sent out the wrong message to local businessmen, already nervous about the decline of law and order under the ANC. Their fears have only been confirmed by loose talk from ANC rank and file about the need for land reform, which may well be overdue, but replete with threats about the possibility of events to the north duplicating themselves here if white farmers, of whom many have already been murdered, do not respond in the appropriate manner.

This has also been the South African government's greatest weakness. It has not been forceful enough in promoting policies which are clearly in the interests of economic growth. It has done too much to pass laws which can do growth no good.

Even if South Africa has improved its economic freedom rating during the past decade (and here the evidence is mixed), its efforts can best be described as too little and perhaps too late. There is, for instance, privatisation. It appears that the ANC, or at least its top leaders, have come to accept it as a policy which would be good for the economy. But progress has been slow, suggesting that the government is unduly sensitive to interest groups which are deeply suspicious, and apprehensive, of market forces. Organised labour in the form of Cosatu is the obvious villain here.

We often hear that the government is committed to integrating South Africa in the global economy and that the slow pace of privatisation is a mere temporary expedient, a sop to a labour movement which is losing its influence but remains powerful. We will get there eventually, so we hear. Well, perhaps. The trouble is that time is of the essence. The only gradual move toward greater economic freedom has meant that South Africa has done no more than remain midway among rated countries and, more likely, has been declining in relative terms, which has prevented it from capturing the potentially huge gains from catching up with the most economically-advanced countries.

It is not the slow pace of privatisation alone which has inhibited more rapid economic growth. The high and continuous crime rate is the most obvious indicator that the protection of property rights is flimsy. The connection between secure property rights, incentives and growth is by now well-established. It is the one sure refutation of the old canard that history teaches no lessons. Bismarck supposedly said, "Fools say that they learn by experience. I prefer to profit by others' experience". If the experience of other countries, both those which have grown fast and others which have not, has anything to tell us it is that South Africa will not have the kind of growth which will eliminate unemployment and raise living standards if the present crime wave continues. But the authorities give every proof of being helpless in the face of an irresistible force. Future researchers will no doubt be gratified in being presented here with an object lesson in how not to protect law and order.

Few murderers are convicted and hardly any car-jackers, respectively one in six, and one in 50 (*The Economist*, 29 May 1999). We appear to have the world's highest rape rate, while the 1998

murder rate of 58.5 killings per 100 000 South Africans, according to some recent official statements, is nearly ten times the US rate of 6.3 murders per 100 000 Americans (Thompson, p.87).

As a prominent authority on South African history has put it in a recent article in *Foreign Affairs*, "The rich live behind walls topped with barbed wire; the poor cope as best they can. For many, crime is a way of life – the only way to survive. Organised gangs are now responsible for much large-scale crime in South Africa. Some are indigenous; others are run by foreigners, notably Nigerians and Russians. They export large quantities of drugs and stolen cars, often in collusion with police or other officials. The exceptional prevalence of crime is a drag on the South African economy and a cause of the dearth of foreign investment and the emigration of people with skills" (*ibid*, pp.87-8).

The present situation will continue as long as the authorities display the total lack of urgency which has characterised them up to now. They have excelled at paying lipservice to the eradication of crime. Their practice has been different. Given the exceptionally poor quality of so much of the police force it can hardly be otherwise. They are badly paid, often corrupt and sometimes criminals themselves. Nearly a quarter of the force is functionally illiterate.

Most South Africans, black and white, can call on personal experience to tell their own horrifying crime story. It is likely that on this matter of fighting crime a still deeply divided society will come as close as it possibly can to a national consensus. It is a puzzle that the government should have been so lackadaisical on crime prevention when there are no major and organised interest groups to offend and the potential economic payoffs are so palpable.

Corruption is a close companion of crime. In South Africa corruption is not close to taking over the whole country, as it has in some African countries like Liberia. But South Africa does resemble many African countries after independence, where gravy trains soon began to roll with increasing numbers of trucks with more and more passengers. Many blacks have made full use of their "historically disadvantaged" status to enrich themselves at the expense of the rest of society. Corruption has flourished not only in the police force but also in the provincial administrations and in the Departments of Social Welfare, Safety and Security, and Justice. In this respect at least, South Africa shows strong indications of having been infected with the African disease. Thabo Mbeki is given to making hardline statements about corruption at ANC congresses, but doing little about it in practise, even when opposition politicians repeat his own condemnations of illicit wealth-seeking.

### **Political economy**

It has become common to argue that organised labour is losing its clout with the government, and that trade unions will no longer be allowed to dictate the making of economic policy as they seemed to do in the earliest days of ANC rule when Tito Mboweni was Minister of Labour. The demands of integration into the global economy and the international division of labour will in future come first, or so we are told.

Mbeki and his colleagues in government quite likely believe what they say, but they appear to underestimate the urgency of the need to undo the damage that has already been done. The laws passed under the leadership of the sainted Mandela increased governmental regulation of the labour market and imposed additional costs on business. Entrenching the right to strike, promoting affirmative action and employee participation in decision-making, providing protection against dismissal – all these may have been admirable in terms of the furthering of human rights (although that is not self-evident), but they did nothing to promote labour market flexibility in a country where unemployment is huge and increasing. So when Mboweni described the legislation he introduced as "labour friendly", he was not being quite accurate. He should have said "organised labour friendly", which is also why it did little to advance the human rights of the many thousands of Africans not privileged to belong to trade unions.

There have been varying estimates of the unemployment rate, but a third of the workforce appears to be a realistic estimate. Not only do measures which promote labour-market inflexibility price the poorest out of jobs, raise the labour costs of employers and inhibit growth; they have made

a substantial contribution to the decay of law and order. Difficult as it may be to quantify these effects, the logic is compelling. When growth is slow and employment in the formal sector difficult to come by, the unemployed will look to other opportunities to make a living. The record of the last decade has shown that in South Africa “crime does pay”.

Research on the economics of crime suggests that criminals are rational decision-makers. If law enforcement is feeble and the returns from illegal activities are superior to those from being unemployed, then we can expect that the crime rate will increase. However unpleasant this has been for respectable citizens, rich and poor, it can hardly come as a surprise. It is an entirely predictable outcome of an environment of low growth and far higher labour costs than can be justified in a country with South Africa’s factor proportions. Misguided labour legislation can only have made a substantial contribution to unemployment, the slow rate of economic expansion and the continued erosion of the rule of law.

It follows that reform of the labour market should be at the top of the government’s agenda. But it is doubtful whether Mbeki and his advisers realise just how pressing is the need to address the problem. There have of course been many retrenchments since 1994 – more than 500 000, of which over 60% were in the private sector, especially mining. Losses in the formal sector have been partially offset by a rise in employment in the lower-paying informal sector. Between 1996 and 1998 the formal sector lost 402 000 jobs, but 320 000 new jobs came from the informal sector, excluding agriculture. Yet in a slowly-growing economy this is not nearly good enough. Labour supply is growing at 487 000 a year. Between 1996 and 1998 the number of unemployed looking for work was 3.16 million, while a further 2.47 million gave up trying. According to the Reserve Bank, 850 000 jobs were lost in the decade since 1989, “reducing the number of gainfully employed to a level last seen in 1979” (*Finance Week*, 11 August 2000).

Current labour law makes it unlikely that the corporate sector will create new jobs. So the prospects for employment growth do not look good. This is confirmed by a report of the Reserve Bank. Investment over the past year has been much too low to generate adequate growth. “Negative business sentiment” was largely responsible for this. There has been an increase in labour productivity, but it has been the result of layoffs and greater factory automation, which is frankly weird in a country with South Africa’s factor proportions. However, the cost of capital has declined persistently against wage costs, which leaves profit-maximising businessmen little choice. Jobless growth in the formal sector has once more been a hallmark of our economic performance (*Business Day*, 30 August 2000).

Cosatu will be weakened by increases in unemployment. We can anticipate that the government will be less and less inclined to accommodate organised labour. But we must doubt whether the present policy of labour-market reform by stealth and half-measures, of seeming to accommodate trade unions in some ways while weakening their ability to hold the economy to ransom, is anything near to what is required to handle the crisis that is threatening to engulf the country.

Letting the factor proportions speak through market-determined factor prices is the only viable solution to unemployment, slow and jobless growth, and the breakdown of law and order, all of which are intimately connected in South Africa today. Labour laws more suited to developed economies, which can absorb their effects, are bizarre in a country where most of the inhabitants remain impoverished. Government policy has obviously been a reflection of the strength of organised labour, but it goes deeper than that. There has been a lot of official posturing and attitudinising over such totally peripheral issues as smoking in public places, as if we can afford the luxury of such simulated outrage when millions of South Africans are struggling to survive. First World mind-sets in an increasingly Third World country are a version of self-indulgence we can probably do without.

If we adopt the appropriate market-driven policies which will reflect real and not contrived scarcities, the going will still be tough, if only because of the virtual collapse of much of our educational system. The state of black schools has long been cause for despair. High failure rates, leaked exam papers, teachers who do not teach and learners who do not learn, wretched facilities all-round

– these are typical features of black schools today. It is no wonder that so many of those who do pass find themselves pitifully unprepared for higher learning.

Not that the condition of such education is much better. The universities founded for Africans are in serious financial difficulties. Some of their administrations have proved corrupt and there have always been multitudes of students unable to pay their fees. The previous “white” universities are also in financial straits, perhaps none more so than Wits, which pays its staff poor salaries but still expects them to do serious research. Here, and elsewhere, entrance qualifications have been lowered to allow for the increased admission of black students, many of whom perform poorly. At Wits, certainly, and presumably at the rest of these formerly white institutions, pathetic and opportunistic attempts have been made to curry government favour by appointing and promoting black staff, even when their scholarly records have been inferior to those of white colleagues. Playing the race card in academic life has come to be seen, with reason, as an effective means of career advancement. Inevitably, standards have dropped. With the decline of the humanities at these universities, as well as of research, they can be expected increasingly to resemble technikons. The prospects for higher education in the traditional sense, an essential condition for a flourishing intellectual climate, are bleak in South Africa.

So even if markets are allowed to prevail in the supply of and demand for labour, we must expect that the quality of the workforce, at all levels, will not be well suited to the requirements of a modern economy, initially at least. Both under the Nationalists and now under the ANC, labour has been costly and unproductive. Organised workers will have to accept that pricing the unemployed into jobs would involve downward pressure on their own wages.

Of course, economic development has a logic of its own. We could reasonably expect that integration into the global economy would constrain South Africa to adopt measures which would undo the damage of the past, but this is bound, given the current state of policy-making, to be a long-term scenario, perhaps not all that relevant to the costs of doing business in South Africa over, say, the next 24 months.

## **Conclusion**

As we consider the separate experiences of the comparator countries, certain features stand out. Piecemeal reforms did not help in placing countries in this group on the road to greater economic freedom and higher living standards. Those which made the most rapid advance, whether from the First, Second, or Third Worlds, whether New Zealand, Poland, or South Korea, liberalised across a broad front. Brazil is one country which has not done so, and it has consistently lagged behind in the “mostly unfree” category, where South Africa now appears to have joined it. Also, market interventions come at a price. Malaysia’s much-vaunted “growth with distribution” as a rationale for affirmative action has been paid for in terms of authoritarian rule. The growth itself seems to have had a good deal to do with favourable trends in the world economy for Malaysian exports at just the right time. High South Korean growth was once closely related to policies of labour repression, which the most enthusiastic South African admirer of Korea’s alleged supersession of the market has not advocated in this country.

According to the Fraser Institute’s Economic Freedom of the World report for 2000, South Africa’s ranking was 47 (out of 123 countries) and its rating 7.3 (compared with 7.6 in 1970 and 5.6 in 1985). However, while our rating went up noticeably after 1985, associated with exchange control liberalisation (but not abolition), a declining rate of inflation, and the reduction of tariff barriers, our ranking did not. Other countries were also advancing to greater economic freedom and we conspicuously failed to move up in the rankings.

This is the most favourable interpretation. There is evidence, which seems more convincing, that we have actually regressed. The 2001 Index of Economic Freedom of The Heritage Foundation places South Africa as 81st out of 155 countries, compared with 66 among 142 five years before. What is more, our rating has also gone down. In terms of The Heritage Foundation’s scoring system, which rates countries from 0 to 5, with Hong Kong at the top with a score of 1.3 and North Korea at the bottom with 5, South Africa in 1995 had a score of 3, placing it among the mostly un-

free. It reached a high of 2.8 in 1998, just placing it among the mostly free, a ranking we maintained for the next two years. The bad news is that we have regressed over the past year. Not only is our ranking down, but our score of 3.05, lower than in 1995, places us solidly among the mostly unfree. This would probably make more sense to most South African commentators than the findings of the Fraser Institute, which appear to ignore the seriousness of official interventions in the labour market.

When we look at the experience of the most impressive achiever among the comparator countries, viz. New Zealand, we may ask: Why has all this happened in New Zealand and why is it not happening in South Africa? An obvious difference is that New Zealand governments, whatever their political complexion, had the will to carry out essential reforms. The rival political parties may have proclaimed their eternal disagreements on matters of principle, but they were united on the need to restructure the New Zealand economy and rescue it from the overregulation brought by a traditional commitment to the welfare state. Not only was there a social consensus, overriding party differences, on the need for reform, but political leaders had the resolve to carry on, even when at times the going was rough because of the dislocations which were bound to come with a more open economy.

The contrast with South Africa is obvious. Here the lack of a social consensus appears overwhelming. Two-thirds of the population may support the ANC, which has however conspicuously failed to deliver on its promises of a better life for most of the former victims of apartheid. Economic growth, when it has taken place, has been slow, barely keeping up with population increase and, notoriously by now, it has been jobless growth. The factor proportions have not been adequately reflected in relative prices. Not only are the obstacles to basic economic reforms more powerful than in New Zealand; also the political will of the government to carry out such reforms is suspect.

Abandoning the economic illiteracy of the Congress Alliance's Freedom Charter of 1956 and accepting the principles of a market economy is scarcely good enough in the parlous economic situation in which the country finds itself. At the same time, however desirable it may be, it is scarcely practical politics to expect the ANC to dismantle the structure of labour-market regulation erected by Tito Mboweni as Minister of Labour, which gives a privileged position to organised labour, gives employers the best possible incentive to lay off workers (when possible) and to automate, and entrenches the poverty of non-union workers. Yet as long as the labour market is not reformed on market principles, unemployment will increase, as will crime and social unrest. No wonder the government is so eager to set up all those "racist whites" as the primary cause of disappointed black expectations, which under the present set-up are bound to deepen and intensify.

We have become accustomed to commentators, such as politically correct white journalists and professional "experts" on labour relations, who suggest that the government has got Cosatu's measure and that in future it will be far less accommodating of the demands of trade unions for perks and privileges for their own. As unemployment spreads, their bargaining power in fact becomes weaker. No longer, we hear, will the government listen so respectfully to the unions. The constraints imposed by globalisation – the imperatives of the market – will in future receive priority.

All this sounds fine, perhaps even inspiring, for those determined to think well of the future. The trouble is that, even if it is true, a mere reduction in the political and economic clout of organised labour does not come close to what is needed if we are to move up in those economic freedom rankings, which, the evidence shows, are so decisive to a country's economic well-being. We are still looking at half-measures and palliatives, which may ensure that we retain our freedom ranking of 47 (in the relatively optimistic perspective of the Fraser Institute), but do nothing to make us formidable in the all-important game of catch-up.

We are not in an enviable situation. We need to do very much better than we are now if we are to achieve the growth which will make South Africa a class act among the economic achievers of the world. But labour market flexibility is an essential condition for such achievement. It seems clear enough however that the government's alleged lower tolerance of Cosatu demands does not include breaking out of the labour-market straitjacket which it designed itself only a few years be-

fore. This would involve a major break with organised labour. With its two-thirds electoral majority the ANC could certainly get away with it. But it does not have the political will for an enterprise which would mean a repudiation of so much of its past.

Still, it may be practicable to get closer to the desired objective in a circumspect way. Here we can find support from a perhaps unlikely source. The famous military historian, BH Liddell Hart, became very impressed with the superiority of the indirect over the direct approach in matters of military strategy. But he concluded that it was of universal applicability, "that it was a law of life in all spheres: a truth of philosophy. Its fulfilment was seen to be the key to practical achievement in dealing with any problem where the human factor predominates, and a conflict of wills tends to spring from an underlying conflict of interests. In all such cases, the direct assault of new ideas provokes a stubborn resistance, thus intensifying the difficulty of producing a change of outlook. Conversion is achieved more easily and rapidly by unsuspected infiltration of a different idea or by an argument that turns the flank of instinctive opposition. The indirect approach is as fundamental to the realm of politics as to the realm of sex...As in war, the aim of it is to weaken resistance before attempting to overcome it; and the effect is best attained by drawing the other party out of his defences" (p.xx).

The relevance to South Africa of the indirect approach would be that a commitment to liberalising the economy on as broad a front as possible would also place strong pressures on organised workers in a protected labour market to respond to competitive forces. Even if the structure of the labour market cannot be directly dismantled, for political reasons, it could be done indirectly. Insulation from the market and a relatively easy life for trade-union fat cats would become far more difficult if the economy as a whole were liberalised. Freedom, we have been told, is indivisible. Economic freedom is no exception.

In such a strategy we would see the elimination of exchange controls and tariffs, the reduction of the inflation rate to a level comparable to those of our major trading partners, a much more rapid rate of privatisation, lower marginal tax rates, and substantially reduced government spending. Not least, the rule of law would be reflected in a more rigorous protection of property rights and firm steps towards zero tolerance of murder, rape, theft and other manifestations of the impunity with which criminals operate in the new South Africa.

All these may not be the same as directly dismantling our rigid labour markets. However, the scope for substitution is pervasive in human affairs. And we know that markets work, if given a chance. A concerted move towards a freer economy may still enable us to rise substantially in the economic freedom rankings.



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