

# Growth versus Security

## Old and New EU Members' Quest for a New Economic and Social Model

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# 9

## Economic Freedom, Confidence and Growth

Steve H. Hanke

Prior to the nineteenth century, life in most parts of the world was brutish, dangerous and short. It still is in 'poor' countries but is much less so in the 'rich' ones. Indeed, life expectancies vary greatly between the developed and the less developed parts of the world. To fight the scourge of poverty and associated low life expectancies, economic growth is essential. This explains why economists have always been acutely interested in the process of economic development.

The main focus of older models of economic growth was on physical resources. In these formulations, output flowed from combinations of various inputs: land, labour and capital. In principle, then, it seemed logical to conclude that faster growth would result from infusions of additional inputs, chiefly capital, or better use of existing inputs, often thought to require government economic planning. In practice, however, such prescriptions have often been disastrous. Newer 'endogenous growth' models have identified many other variables that contribute to differences in growth rates: knowledge spillovers resulting from increases in the stock of physical capital, technology transfers, and human capital investment. Yet, even these sophisticated formulations often fail to explain observed patterns of development.

Most recently, some students of economic growth have returned to first principles. As a way of understanding the development process, they have focused on the nature of institutions and the structure of rules and norms that constrain economic behaviour. In doing so, they have rediscovered an insight contained in the works of Richard Cantillon (1680–1734), Adam Smith (1723–90) and Jacques Turgot (1727–81): economic liberty is a crucial precondition for sustained, vigorous economic growth.

Matrices that serve as proxies for economic freedom have recently been developed and are widely used. For example, the *Heritage*

*Foundation* and the *Wall Street Journal* jointly publish an annual volume, the *Index of Economic Freedom*, which now incorporates 157 countries. The *Economic Freedom of the World*, which includes 130 countries, is published by Canada's Fraser Institute. And the World Bank issues an annual, *Doing Business*, which reports on the ease of doing business in 175 countries. Data from these annuals on economic freedom show that there is a strong positive linkage between measures of economic freedom and economic growth (Hanke and Walters 1997).

This is not to deny that abundant natural resources, a highly skilled labour force, and ready availability of new technologies might enhance growth. But these factors are neither necessary nor sufficient. If resource endowments determined a national economy's fate, Venezuela would be rich while Hong Kong and Singapore would be poor, and South Korea would be as destitute as North Korea. Moreover, East Germany's highly skilled labour force should have enabled it to keep pace with West Germany before the Iron Curtain fell. And if access to sophisticated technology guaranteed prosperity, perhaps the Soviet Union would still exist.

There is considerable agreement, therefore, about the desirability of economic freedom. But what are the elements that produce such a liberal economic order? The following menu is quite encompassing:

*Private property and contract rights should be established* The following criteria should guide the establishment of private property: universality, exclusivity and transferability. Universality guarantees that all resources are either owned or ownable by a private person or entity. Exclusivity guarantees that those who own property have the exclusive right to use their property as long as that use does not harm other property owners. And transferability guarantees that owners can freely transfer their property rights.

*Fiscal order and transparency should be established* To establish control over public spending and reduce waste, fraud and corruption, governments should publish a national set of accounts that includes a balance sheet of its assets and liabilities, and an accrual-based annual operating statement of income and expenses. These financial statements should meet international accounting standards and should be subject to an independent audit.

*Budget deficits and government spending should be kept under control* One way to achieve control over the scope and scale of government is to require 'super majority' voting for important fiscal decisions: taxing, spending and the issuance of debt.

*Inflationary pressures should be kept under control* To encourage economic development, inflation rates should be kept low and predictable. For many developing nations, this inflation objective can best be achieved by abolishing their central banks and replacing them with currency boards that issue fully convertible, stable, domestic currencies, or by simply doing away with domestic currencies and replacing them with convertible stable foreign currencies (Hanke 2002a; 2002b).

*The advantages of open international trade should be exploited* Liberal trade policies facilitate the efficient allocation of resources and stimulate economic growth. This is particularly true in small economies, where real competition can only be obtained by allowing foreign producers to compete freely in domestic markets.

*Complex tax systems and excessive tax rates should be avoided* Complex tax systems coupled with excessive tax rates distort behaviour and create large disincentives to economic activity, while yielding little revenue.

*Subsidies and tax incentives for private industry should be avoided* Subsidies and tax incentives that are designed to achieve particular objectives may or may not actually assist in obtaining those goals. One thing is certain: they distort economic choices and resource allocation, and retard economic growth.

*Privileges and immunities should be avoided* For example, state-created monopoly privileges and immunities for unions, such as exclusive representation, compulsory union membership, and immunity from antitrust laws, should be avoided. Privileges and immunities distort markets and act as a drag on economic growth.

*Price controls should be avoided* Price controls, including interest rate ceilings, cannot be justified on economic grounds. They tend to vitiate the signalling role that prices should play. Hence, price controls impede the movement of resources from lower-valued to higher-valued uses and result in resource misallocation and slower economic growth.

*Market interventions and restrictions on competition should be avoided* Market intervention and restrictions on competition, such as the use of marketing boards, result in the politicization of economic life, inefficient enterprises, resource misallocation, and the retardation of economic growth.

*State-owned enterprises should be privatized* State-owned enterprises are inefficient. For example, sales, adjusted profits, and productivity per employee are lower for nationalized enterprises than they are for private firms. Taxes paid per employee are lower, sales per dollar of investment are lower, profits per dollar of assets are lower, wages and operating costs per dollar of sales are higher, sales grow at a slower rate, and, with

few exceptions (petroleum), state-owned enterprises for which accounts are presented properly generate accounting losses that are passed on to taxpayers.

*Unclear boundaries between public and private activity should be avoided* When boundaries between the public and private sector are unclear, it is symptomatic of poorly defined property rights. Ill-defined property rights distort resource allocation and retard economic growth. Government bailouts of insolvent private firms are but one example of unclear boundaries between public and private activity.

*The manipulation and repression of private capital markets should be avoided* The manipulation and repression of private capital markets distort the savings and investment process, retard foreign direct investment, promote capital flight, and generally act as a drag on economic growth.

To be successful in achieving high scores for economic freedom, confidence and credibility are of primary importance. As Keynes argued in *The General Theory*:

The *state of confidence*, as they term it, is a matter to which practical men always pay the closest and most anxious attention. But economists have not analyzed it carefully and have been content, as a rule, to discuss it in general terms. In particular it has not been made clear that its relevance to economic problems comes in through its important influence on the schedule of the marginal efficiency of capital. There are now two separate factors affecting the rate of investment, namely, the schedule of the marginal efficiency of capital and the state of confidence. The state of confidence is relevant because it is one of the major factors determining the former, which is the same thing as the investment demand schedule.

There is, however, not much to be said about the state of confidence *a priori*. Our conclusions must mainly depend upon the actual observation of markets and business psychology (Keynes 1936: 148–9).

Most economists have ignored this passage in *The General Theory*, because confidence is difficult to define, quantify and measure, and is therefore difficult to insert into any formal abstract model. Yet, it is clearly unsatisfactory to confine analysis only to definable and quantifiable magnitudes simply because they can be encapsulated into a neat definition or measured by government statisticians.

Contrary to Keynes, there is much to be said a priori about the state of confidence. For example, it seems likely that confidence is determined by the general credibility of government policy. Confidence is enhanced when governments make credible commitments to implement liberal economic reform programmes. A commitment is made more credible the more one binds oneself to the achievement of an objective. At the extreme, on a battlefield when a commander orders his troops to burn all bridges behind them to cut off avenues for their retreat, his enemies will be confident that his intentions are to fight to the last man.

A credible commitment is something that many politicians are reluctant to entertain. That said, there have been numerous cases in which politicians have made credible commitments to adopt liberal economic policies. These have involved commitments at the strategic level to the entire menu of reforms outlined above, but at the same time, only fighting at the tactical level those battles that can be won. In consequence, reform momentum was created, success was built on success, and dramatic increases in economic freedom and prosperity resulted regardless of the type of political regime or the ideology of the political party that embraced reforms.

Several examples support this conclusion. In 1965, Singapore gained its independence when it was expelled from a two-year federation with Malaysia. At that time, Singapore was backward and poor, a barren speck on the map in a dangerous part of the world. Its population was made up of a diverse group of immigrants with a history of communal tensions. However, Singapore had a leader with clear ideas on how to modernize the country. Lee Kuan Yew ruled out passing the begging bowl and accepting foreign assistance of any kind. Instead, he embraced stable money and first-world competition. Stable money was initially achieved with a currency board. Competition was attained by light taxation, minimal regulation of business and free trade. In addition, Lee Kuan Yew insisted on personal security, public order and the protection of private property. To accomplish his objectives, his central principle for organizing a 'small' government was to run a tight ship with no waste or corruption. To implement that principle, Lee Kuan Yew appointed only first-class civil servants and paid them first-class wages. Today, Singapore is one of the freest, most flexible and prosperous economies in the world. Indeed, both the 2007 Index of Economic Freedom (Kane *et al.* 2007) and the Economic Freedom of the World, 2006 Annual Report (Gwartney *et al.* 2006) rank Singapore as the second freest

economy, and, in terms of the ease of doing business, Singapore is ranked first (World Bank 2006).

Hong Kong, along with Singapore, ranks as one of the world's freest economies. Indeed, it ranks first on the two economic freedom metrics mentioned in the preceding paragraph and fifth in terms of the ease of doing business (World Bank 2006). Established as an *entrepôt* free port, Hong Kong has achieved its status as one of the freest economies in the world by making a credible commitment to stable money via a currency board, free trade, free markets, low taxes, non-intervention and personal liberty through the application of the rule of law. What makes Hong Kong so interesting is that it attained its economic freedom and prosperity in the absence of democracy. Ceded by China to the British Crown in 1841, Hong Kong became a British Crown Colony, not a representative democracy. It remained a colony until 1 July 1997, when it became a Special Administrative Region of the People's Republic of China. Hong Kong illustrates that a representative democracy, while perhaps desirable, is not a precondition for the application of the rule of law and attainment of freedom in the economic sphere.

On this important point, it is worth quoting Friedrich von Hayek at length:

But to call 'law' everything that the elected representatives of the majority resolve, and to describe as 'Government under the Law' all the directives issued by them – however discriminating in favour of, or to the detriment of, some groups of individuals – is a very bad joke. It is in truth lawless government. It is a mere play on words to maintain that, so long as a majority approves of acts of government, the rule of law is preserved. The rule of law was regarded as a safeguard of individual freedom, because it meant that coercion was permissible only to enforce obedience to general rules of individual conduct equally applicable to all, in an unknown number of future instances. Arbitrary oppression – that is coercion undefined by any rule by the representatives of the majority – is no better than arbitrary action by any other ruler. Whether it requires that some hated person should be boiled or quartered, or that his property should be taken from him, comes in this respect to the same thing. Although there is good reason for preferring limited democratic government to a non-democratic one, I must confess to preferring non-democratic government under the law to unlimited (and therefore essentially lawless) democratic government. Government under the law seems to me to be the higher

value, which it was once hoped that democratic watchdogs would preserve (Hayek 1984: 354).

Estonia is another country that has made a credible commitment to liberal economic reforms. Estonia, where the author witnessed the birth of such a pre-eminent commitment, merits attention because it has the highest economic freedom ranking of any former communist country. It ranks twelfth on both of the standard measures for economic freedom. The USSR State Council conceded Estonia's fully independent status on 6 September 1991. The economy was in shambles and the Estonians were left to use the hyperinflating Russian ruble. At the invitation of the Estonian parliament, in a presentation on 5 May 1992, the author laid out a blueprint to replace the Russian ruble with a freely convertible Estonian kroon, linked to the German mark at a fixed rate and fully backed by mark, and gold, reserves (Hanke *et al.* 1997 [1992]). The parliamentarians wasted little time in committing to the proposed currency board blueprint. On 24 June 1992, the ruble was out and a currency board-issued kroon was in. Building on this initial success, Estonia has steadfastly continued to embrace a liberal reform agenda.

In closing, it is worth stressing that there is often a wide gap between a government's rhetoric and the reality of its reforms. For example, many governments in the former Soviet Union, Eastern Europe and Latin America have come to power on liberal reform platforms, only to be swept aside in the next election. Why? The common thread running through all these cases is that reform reality has not matched reform rhetoric (Havrylyshyn 2006). Indeed, commitments to reform have not been credible, reforms have been narrow and superficial, economic freedom has not been significantly enhanced, state-imposed burdens on doing business have remained onerous, and most importantly, the scope and scale of government activity has not been dramatically reduced. In consequence, corruption has gone unchecked and remains a systemic problem. All this amounts to a recipe for superficial reformers to discredit themselves, their political parties and the ideas they have masqueraded behind.

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