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Property Rights The Key to Economic Development

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Executive Summary

Prosperity and property rights are inextricably linked. The importance of having well-defined and strongly protected property rights is now widely recognized among economists and policymakers. A private property system gives individuals the exclusive right to use their resources as they see fit. That dominion over what is theirs leads property users to take full account of all the benefits and costs of employing those resources in a particular manner. The process of weighing costs and benefits produces what economists call efficient outcomes. That translates into higher standards of living for all.

It is only in the last few decades, however, that

economists have accepted the importance of property rights. Throughout much of the history of modern economics, the subject was given short shrift. Even stalwart supporters of the market economy glossed over the subject. Not surprisingly, much bad development policy resulted from that neglect. Even if policymakers in developed countries and international institutions now recognize the critical role played by a system of private property in economic development, they are limited in what they can do to help developing countries evolve such a system. Policymakers can, however, avoid recommending policies that undermine private property.

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Why Property Rights?

The excuses for development failure are legion: lack of natural resources; insufficient funding of education, culture, religion, and history; and, recently, geographical location. As Friedrich Hayek, Nobel laureate in economics, taught us in another context, we cannot explain success by examining failure: “Before we can explain why people commit mistakes, we must first explain why they should ever be right.”¹

The question that we need to ask is why should nations prosper? We argue that the difference between prosperity and poverty is property. Nations prosper when private property rights are well defined and enforced.

The Wealth of Nations

UCLA researchers Richard Roll and John Talbott provocatively titled a paper, “Why Many Developing Countries Just Aren’t.”² Economic development has been exceptional rather than typical. As Peruvian economist Hernando de Soto points out, capitalism has been successful mainly in the West.³ The result is incredible disparities in living standards around the world.

Depending on the measure, real income varies across countries by a factor of more than 100. In 2000, real per-capita GDP was \$50,061 in Luxembourg and \$490 in Sierra Leone. Those figures are measured in purchasing power parity (PPP). Using 1995 constant dollars produces even more extreme variations across countries.⁴ Differences between neighboring countries can be huge. Depending on the income measure used, real per-capita GDP in the United States is about four to eight times that of Mexico. The socioeconomic consequences of that difference are huge and well-known. Conservatively measured, South Koreans have 17 times the income of North Koreans. That difference surely has something to do with the current tensions on the Korean Peninsula.

In the 1930s, the Finns and Estonians enjoyed a similar standard of living. The two countries are virtually neighbors. Their languages share a common linguistic root, and they are culturally similar and share many values. (Despite being a Baltic country geographically, Estonians consider themselves to be a Nordic people.) Depending on the measure employed, in 2000 the average Finn earned two and a half times to more than seven times what the average Estonian earned. Fifty years of Communist rule surely had something to do with the gap in incomes that opened between the two countries.

In the past, substantial differences existed between the standard of living in East and West Germany—two countries with essentially the same resources, education, culture, language, religion, history, and geography.⁵ Why the tremendous income differences?

Hong Kong and Singapore are city states, almost completely lacking in natural resources. They border much larger and poorer neighbors. Hong Kong in particular experienced long periods of immigration from its poorer neighbor, mainland China. Yet both island nations sustained periods of annual growth of real per-capita GDP at 5 percent for a long period. Singapore’s real per-capita GDP doubled from 1962 to 1971.⁶ The real per-capita GDP of Hong Kong, a former colony of Great Britain, now exceeds that of the mother country (\$25,153 vs. \$23,509 at PPP in 2000). The paradoxes abound. Despite its own recent economic miracle, China’s real per-capita GDP in 2000 was still just under \$4,000. Taiwan’s is over \$17,000, more than four times China’s. (Both measured in PPP.) Prof. Allan Meltzer has recently commented on these near-laboratory experiments in development:

In each of these comparisons, culture, language, and traditions are the same. Outcomes are markedly different. The countries with capitalist institutions and the market system grew richer; the others faltered or went backwards. A South Korean

now lives on an average income about equal to average incomes in the United States in 1945. His North Korean cousin, if he manages to survive, exists by eating roots and grass. My colleague Nick Eberstadt points out how much diet and living standards matter: seven-year-old South Korean boys are 8 inches taller than North Korean boys.⁷

Actual, historical economic development of countries cannot be explained by the presence or absence of natural resources. Resources are neither necessary nor sufficient for development. Development has occurred in inhospitable circumstances, and *lack of* development has occurred in countries rich in natural resources. Oil's "curse" is well known.⁸ Real per-capita income in Saudi Arabia is a fraction of what it once was. Nigeria, an oil producer, is categorized as a highly indebted poor country. And, Argentina, rich in natural resources including oil, has recently experienced a long recession due to its bad policies and defective institutions.⁹

In their empirical studies, economists correlate output with investment capital, human capital, and productivity.¹⁰ Empirical relevance aside, there is a fatal conceptual flaw in this approach. Both sides of the equation are measuring the same thing:

The left side measures a flow from wealth, while the physical and human capital variables on the right side measure the stock of wealth. Obviously, if one regresses wealth on wealth plus some "true" determinant of wealth, the latter doesn't have much opportunity to be detected as significant.¹¹

It is no wonder then that institutional determinants of growth have been neglected. Even when included in empirical studies, they compete against wealth in explaining economic growth. The modeling of the growth process has obscured it.

Our paper is not intended to be a review of the empirical development literature. Roll and Talbott do a nice job of that.¹² Our focus is on what does matter for growth: private property. We do take note of the empirical results in Roll and Talbott, however.

Roll and Talbott find that nine institutional variables explain over 80 percent of the international variation in per-capita gross national income, with property rights (+) and black market activity (-) having the highest levels of significance. The other variables are regulation (-), inflation (-), civil liberties (+), political rights (+), press freedom (+), government expenditures (+), and trade barriers (-). We commend their paper to the reader who wants more details on the empirical findings.

Before turning to the conceptual case for property rights as the primary determinant of economic growth and development, we ask why property rights had come to be neglected in the economic literature. We cannot simply blame economists' models, but must examine their theoretical underpinning.

The Economists' Oversight

In his book on the history of property rights, Tom Bethell examines the neglect of property rights in the economic literature. He concludes that the existence of private property was a presumption that underlay the work of the classical economists. Its absence was unthinkable, so its importance went undefended. As he put it, "in the Great Britain of Adam Smith's day, criticism of private property hardly ever found its way into print."¹³ Richard Pipes agrees: "If the glorification of private property reached its apogee in England, where it enjoyed the support of a large body of private owners, it first came under frontal assault in *ancient regime* France."¹⁴

Adam Smith did not neglect property rights in his legal work. The first lecture in his first series of lectures on jurisprudence began:

The first and chief design of every system of government is to maintain justice: to prevent the members of

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By the 20th century, we had the paradox that, in economics, the defenders of markets had said comparatively little about property.

society from incroaching on one another's property, or seizing what is not their own. The design here is to give each one the secure and peaceable possession of his own property.¹⁵

Smith's statement of the purpose of government is 18th century in its formulation. It is as descriptive as normative. Protecting private property is just what government did first and foremost. As Bethell explains, economists "assumed a political and legal framework comparable to that found in eighteenth-century Britain, but they neither insisted on the point, nor did they spell it out in detail."¹⁶ In France, Jean-Baptiste Say had a chapter on property in his *Treatise on Political Economy*. Apparently, the experience of the French Revolution motivated Smith to focus on the importance of property rights.¹⁷ That experience also profoundly affected such English political thinkers as Edmund Burke. The neglect by the British political economists that Bethell chronicles remains puzzling.

According to Bethell, "the phrase 'private property' barely entered the language before the nineteenth century." The 18th century Scottish philosopher Adam Ferguson spoke of "property," but without the qualification. Bethell counted a couple of uses of "private property" in *The Wealth of Nations*, and one in the first edition of Malthus' *Principles of Political Economy*. "On the whole, though, it seemed unnecessary to specify more precisely an institution that was not thought to have any workable alternative."¹⁸

Of course, the great legal theorists were very much concerned with property and its protection. Blackstone defined property as "that despotic dominion that one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the universe." But he could think of nothing "which so generally engages the affections of mankind, as the right to property." Jeremy Bentham, who disagreed with Blackstone on almost all other issues, agreed with the jurist on property, saying that the law securing property is "the

noblest triumph of humanity over itself."¹⁹

By the middle of the 19th century, however, private property was under intellectual attack. The assault came from many directions. Bethell identifies an unholy trinity of economists: Mill, Marx, and Marshall.

John Stuart Mill's famous distinction between the laws of production and the laws of distribution was the source of much subsequent mischief. The laws of production were scientific and immutable, while those of distribution were the product of man and changeable through legislation. Mill included the discussion of property under distribution. Science, not ownership, shaped production.²⁰

In a market economy, however, there is no distribution separate from production and exchange. The redistributive impulse undermines the system of private property that undergirds production and exchange. The production process, meant to operate by immutable laws, is undermined when private property is insecure. There is no production mechanism running independently of the system of rewards and penalties accruing to owners of factors of production (land, labor, and capital) in a market.²¹

Mill's bloodless account of production contrasts sharply with that of von Mises, offered 100 years later:

Ownership of the means of production is not a privilege, but a social liability. Capitalists and landowners are compelled to employ their property for the best possible satisfaction of the consumers. If they are slow and inept in the performance of their duties, they are penalized by losses. If they do not learn the lesson and do not reform their conduct of affairs, they lose their wealth. No investment is safe forever.²²

In Mises' account, production is an active, risky, and entrepreneurial venture. Production is a protean process, and the only permanent law of production is change. Mises' final observation that "no investment is safe

forever” refutes the classical economic doctrine of economic rent: there are no permanent income streams.

John Stuart Mill was among the first in a line of thinkers who believed they were witnessing the transformation of human nature. That transformation would enable a communist form of ownership to substitute for private property. As man’s nature was spontaneously transformed, everyone would learn “to feel the public interest as their own.” Mill was certainly a good enough economist to understand the shirking problem when property is owned in common. In a socialist farm or “manufactory,” however, people would be working “under the eye, not of one master, but of the whole community.”²³

We know how that system ends: in the gulag. In the mid-19th century, however, such ideas were progressive. And the younger Mill was an immensely influential thinker not only in his own century but into the next one. He authored “the most successful and most influential treatise of that age.”²⁴ And, according to Pipes, Mill “moved liberal ideology closer to socialism.”²⁵

Alfred Marshall’s *Principles of Economics* strongly influenced the course of thinking among English-speaking economists. Marshall also believed in the idea of progress. While Mill looked forward to the possibility of improvement in human nature, Marshall believed that “changes in human nature” had for the last fifty years been “rapid.” Ominously, he believed that the need for private property “doubtless reaches no deeper than the qualities of human nature.”²⁶

Marshall subscribed to the idea of progressive social change. “Men’s collective instincts, their sense of duty and their public spirit” would be better developed. Legislation would “fortify” this trend.²⁷ With the perfectibility of man, private property became unimportant.²⁸

Karl Marx, who temporally bridged Mill and Marshall, openly attacked private property. He called for its abolition. What all three agreed on was the need for human nature to change if private property were to be abol-

ished. “Marx believed it was in fact changing. So did Marshall. So their view of property was at least coherent. Today, very few people believe that human nature is changing. And we can see that such statements as Marshall’s, claiming that it had already changed, were misguided.”²⁹

The practice of 20th century communism attempted to effect a change in human nature. “Everything the Communist Party has done since the Revolution, despite changes and apparent departures from original ideas and replacement of leaders, has been directed at the transformation of human beings,”³⁰ explains Russian historian Mikhail Heller. We know the consequences of this effort.

By the 20th century, we had the paradox that, in economics, the defenders of markets had said comparatively little about property. When economists addressed private property, it was often to criticize it. Schumpeter spoke of classical liberalism’s “defeat,” and noted that “on the whole, the economic professions of all countries were politically supporters of the counter-tendencies to liberalism rather than of the still dominating liberal ones. In this sense, we can say the alliance between economics and liberalism—and, with exceptions, between economics and utilitarianism—was broken.”³¹

No one focused more on private property than Marx, but in the context of its denunciation. The Marxian view of property triumphed in much of the world in the second half of the last century. Where were the 20th century economists in the debate?

Property’s Neglect in the 20th Century

Today, it is a commonplace to observe that neoclassical economics neglected the role of property rights. What is amazing, however, is how little was written about property rights by those economists recognized as defenders of the market economy. In 1935 Hayek edited a collection of essays on the

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socialist calculation debate. Here is what he said about property rights in a long chapter introducing the problem:

To say that partial planning of the kind we are alluding to is irrational is, however, not equivalent to saying that the only form of capitalism which can be rationally advocated is that of complete *laissez faire* in the old sense. There is no reason to assume that historically given legal institutions are necessarily the most “natural” in any sense. The recognition of the principle of private property does not by any means necessarily imply that the particular delimitation of the contents of this right as determined by the existing law are the most appropriate. The question as to which is the most appropriate permanent framework which will secure the smoothest and most efficient working of competition is of the greatest importance and one which it must be admitted has been sadly neglected by economists.³²

Hayek was clearly on the mark in saying that economists had “sadly neglected” the question of “the most appropriate permanent framework” for a competitive economy. His chapter exemplifies that neglect, however. The quoted paragraph is almost empty of content. To his credit, late in life Hayek recognized the importance of property rights in economic analysis.³³

In the *Road to Serfdom*, a political treatise, Hayek made the case for private property:

The system of private property is the most important guaranty of freedom, not only for those who own property, but scarcely less for those who do not. It is only because the control of the means of production is divided among many people acting independently that nobody has complete power over us, that we as

individuals can decide what to do with ourselves. If all the means of production were vested in a single hand, whether it be nominally that of “society” as a whole or that of a dictator, whoever exercises this control has complete power over us.³⁴

The most important protection afforded to the individual by law is the protection of his property. That property provides individuals a protected domain against the state. For Pipes, property “provides the key to the emergence of political and legal institutions that guarantee liberty.”³⁵ By contrast, totalitarianism has its roots in “patrimonial” systems in which sovereignty and property are linked. It is no accident that totalitarianism “reached its consummation in the Soviet Union,” since for much of Russian history there was no distinction between sovereignty and property.³⁶

The rich and powerful contrive to protect their property even when a weak rule of law fails to protect property rights for the general population. Most of Latin America—Chile being a conspicuous exception—exemplifies that situation. For example, ordinary Venezuelans cannot title property, so they build shanties on the hills surrounding Caracas. Meanwhile, the elites live in barricaded villas. It is the absence of legal protection of private property that has blocked the democratization of both property and capitalism in that region.

In 1763, a group of German settlers in Maryland reported that “the law of the land is so constituted, that every man is secure in the enjoyment of his property,” and “the meanest person is out of reach of oppression from the most powerful, nor can anything be taken from him without his receiving satisfaction for it.”³⁷ German immigrants to the American colonies had more secure property rights in the 18th century than does a native-born Venezuelan in the 21st. Is it any wonder that the United States prospers while Venezuela stagnates? Venezuelan President Hugo Chávez, dangerous and destructive

though he may be, cannot be blamed for Venezuela's predicament. It is a problem of institutional failure, not the character deficiencies of an individual.³⁸

The rights against both the state and the powerful were secured for early Americans, such as the 18th century German settlers described above, by the protection of their person and property. That protection in turn made it possible for them to invest and take risks. More generally, the stronger the set of property rights, the stronger the incentive to work, save, and invest, and the more effective the operation of the economy. The more effectively an economy operates, the more growth it will produce for any set of resources.³⁹

Once stated, the intellectual argument for the importance of property rights is compelling. Why does an individual invest unless to gain something for himself and his family? How can he ensure that gains flowing from his activity be appropriated and secured other than through a system of well-defined property rights? To suppose otherwise, is to suppose that human nature will change. That road is a dead end.

Yet theories of economic growth still fall back on laws of production and relationships among things rather than interactions among people governed by institutions. Economists still debate whether returns to scale are increasing, decreasing, or constant. That debate, however, deals with physical laws of production, not the system of incentives and rewards shaping economic growth.

Within an economic model, there may be diminishing returns. Yet the real world looks like one of increasing returns. Adam Smith believed that returns decline in the short run, while costs decline in the long run. The short run mimicked the world of diminishing returns associated with David Ricardo and other classical economists. In the long run, entrepreneurs innovated, capitalists invested, and costs declined. Smith himself thought the pin factory provided the rationale for this pattern, while property rights theorists look elsewhere.⁴⁰

In the 20th century, one economist did

stand against the tide on the issue of property rights: Ludwig von Mises. His views on property rights anticipated many of the positions adopted by economists many years later. "Carried through consistently, the right of property would entitle the proprietor to claim all the advantages which the good's employment may generate on the one hand and would burden him with all the disadvantages resulting from its employment on the other hand."⁴¹ Rewards and costs are not internalized when laws are deficient or there are "loopholes" in liability protection. In this situation, the problem of external costs arises.⁴²

Mises analyzes the process by which individuals come to establish property rights over natural resources. He examines the costs and benefits of establishing private property rights. When land is abundant and a frontier exists, as in 19th century America, it may not pay to establish private property rights. In that environment, settlers cut down trees without regard to replenishing them. Similarly, they hunt and fish until the stocks are depleted, then moved on to unsettled areas. "It was only when a country was more densely settled and unoccupied first class land was no longer available for appropriation, that people began to consider such predatory methods wasteful. At that time they consolidated the institution of property in land."⁴³

In central and western Europe, by contrast, no such process was observed in modern times. There was no soil erosion, no deforestation. Why? "The institution of private property had been rigidly established for many centuries." Forests were privately owned, and the owners "were impelled to conservation by their own selfish interests. In the most densely inhabited and industrialized areas up to a few years ago between a fifth and a third of the surface was still covered by first-class forests managed according to the methods of scientific forestry."⁴⁴

Private property rights are only secured when the benefits of doing so outweigh the costs. That approach is familiar today. Mises' analysis, however, predates Demsetz's well-known presentation.⁴⁵ The modern property

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The emergence of a more coherent economic theory of property rights is a fairly recent phenomenon.

rights literature largely overlooked Mises' analysis. It would have benefited from it, since Mises had a more thorough understanding of the critical role of property rights than did most of his 20th century contemporaries.

In sum, with some conspicuous exceptions, neglect of property rights characterizes all too much the history of economics. As Pipes summarized it, "professional economists have paid little attention to property rights, being principally concerned with material factors making for economic growth, such as capital formation and technological innovation."⁴⁶ The emergence of a more coherent economic theory of property rights is a fairly recent phenomenon.

Economics, Property Rights, and Development

Armen Alchian, Ronald Coase, and Harold Demsetz founded the modern property rights school of economics. They sought not only to delineate the importance of a system of private property rights to the effective functioning of an economy but to identify the circumstances that lead to the assignment and formation of property rights. Alchian stated:

By a system of property rights I mean a method of assigning to particular individuals the "authority" to select, for specific goods, any use from a nonprohibited class of uses. As suggested in the preceding remarks the concepts of "authority" and of "nonprohibited" rely on some concept of enforcement or inducement to respect the assignment and scope of prohibited choice. A property right for me means some protection against other people's choosing against my will one of the uses of resources said to be "mine."⁴⁷

Coase shows that the way rights are initial-

ly assigned or partitioned does not affect the way resources are used when there are no transaction costs associated with voluntary exchanges of property and no policing costs.⁴⁸ Since there are policing costs and transactions costs associated with defining and protecting property rights, such rights will be defined and protected only when the benefits of doing so are greater than the costs.

It is a mistake to assume that the task of assigning, defining, and protecting property rights is the exclusive job of the state. Property rights developed from custom and tradition long before we had nations. In *Property and Freedom*, Richard Pipes provides an overview of the evolution of the institutions of property from primitive times to the emergence of the state. He noted that "in most countries property took the form of possession, claims to which rested not on documented legal title but on prolonged tenure, which custom acknowledged as proof of ownership."⁴⁹ Only later did property become regularized with the emergence of the state.⁵⁰

Today, property rights are often worked out among individuals or firms first and then recognized by law. However, governments at all levels continue to weaken or attenuate property rights on a daily basis with a barrage of regulations affecting the use of private property.

The two essential elements of property rights are (1) the exclusive right of individuals to use their resources as they see fit as long as they do not violate someone else's rights and (2) the ability of individuals to transfer or exchange those rights on a voluntary basis. The extent to which those elements are honored and enforced will determine how effectively prices in an economy will allocate goods and services. Both experience and theory indicate that economies with effective price systems are better at producing wealth. In short, the stronger the private property rights system, the better the economy is at efficiently allocating resources and expanding wealth-creating opportunities.⁵¹

Individuals in all societies have conflicts of interest. One way conflicts are resolved is

through competition. The property rights system in a society defines the permissible forms of competition. A private property system gives the exclusive right to individuals to use their resources as they see fit and to voluntarily transfer them.⁵² Such a system prohibits force and encourages cooperation. Indeed, economic competition is a system of social cooperation.⁵³ The broader and stronger the protection of private property rights, the more effective prices are at allocating resources, and the more effectively resources are allocated, the greater the wealth creation.

The relationship between protection of property—defined in terms of the transparency, independence, and efficiency of the judicial system—and wealth, measured in GDP per capita for 150 countries around the world, makes the point. On average, GDP per capita, measured in terms of purchasing power parity, is twice as high in nations with the strongest protection of property (\$23,769) than in those providing only fairly good protection (\$13,027). Once the protection of property shows clear signs of deterioration (moderate protection), even without a totally corrupt judicial environment, GDP per capita drops to a fifth of that in countries with the strongest protection (\$4,963). Countries with a very corrupt judicial system are also very poor on average (\$2,651).⁵⁴

Some economists raise the problem of external costs as an objection to a strong property rights system. The existence of external costs is used to justify government action to attenuate private property rights. While the existence of an externality or “market failure” is a necessary condition for government intervention, it is not a sufficient condition. Government actions have their own costs and these should be weighed against the potential benefits of such actions.⁵⁵ Yet many countries impose regulations that weaken property rights on the mere whiff of an external cost. Regulation affects economic activity because it interferes with private property rights. It does so by attempting to modify, supplant, or replace market outcomes with outcomes mandated

by government. Deregulation, as a result, responds to the realization that strengthening of property rights ensures the best use of resources.⁵⁶

Even though preserving property rights clearly enhances countries’ growth and development perspectives, assigning and enforcing property rights in some areas can be challenging. This is particularly true with respect to knowledge-based goods and economic use of some natural resources. In both cases, it is very difficult to achieve a consensus across nations either on how to define property rights or on what sort of international mechanism should be created to enforce them. In this sense, the environment and knowledge-based products will continue to be at the heart of the biggest potential conflicts on property rights. Nevertheless, the fact remains that effective protection of property is the only effective means for societies to make use of what they own, in the most efficient way, to promote both economic growth and prosperity.⁵⁷

Building strong property rights systems in poor countries is no easy task. Establishing a democratic form of government is no guarantee of a strong private property rights system. There are plenty of poor, illiberal democracies that violate or attenuate private property rights with abandon, Argentina being the most recent and flagrant example.⁵⁸ Nor is it clear that democracy is a necessary condition for the protection of property rights since property rights have been strongly protected under dictatorships (Chile) and by outside authority (Hong Kong). Yet the strongest systems seem to be in wealthy, established democracies. The source of their success stems not from strong governments but from governments focused on protection of property and individuals’ use of that property in commerce. In Hayek’s words:

It was not under the more powerful governments, but in the towns of the Italian Renaissance, of South Germany and of The Low Countries, and

Property rights developed from custom and tradition long before we had nations.

Establishing a democratic form of government is no guarantee of a strong private property rights system.

finally in lightly governed England, i.e., under the rule of the bourgeoisie rather than warriors, that modern industrialism grew. Protection of several property, not the direction of its use by government, laid the foundations for the growth of the dense network of exchange of services that shaped the extended order.⁵⁹

What would most benefit less-developed countries would be a focus on establishing and protecting property rights. Yet most aid from the United Nations, International Monetary Fund, and World Bank is directed toward other goals, and often undermines property rights. Protecting property, letting individuals pursue their own self-interest, and opening up trade offer the best chance for economic growth.

Corruption

Pro-growth development officials increasingly focus on corruption as an impediment to development. Traditionally economists have held two distinct opinions about corruption. Robert Barro has suggested that, under some circumstances, corruption can have beneficial effects.

In some circumstances, corruption may be preferable to honest enforcement of bad rules. For example, outcomes may be worse if a regulation that prohibits some useful economic activity is thoroughly enforced rather than circumvented through bribes. However, the economy will be hampered when few legitimate activities can be undertaken without bribes. Thus, the overall impact of more official corruption may be ambiguous.⁶⁰

Many economists would agree with the cost/benefit approach to corruption, if not the moral ambiguity seemingly underlying

the position. Under that approach, there is an optimal amount of law-abiding behavior. Economists would tend to agree even more strongly with Barro's position on black market activity, which he sees as an adaptation to poorly defined property rights, high tax rates, and oppressive regulation. By operating in the informal sector, individuals are able to engage in economic activity that would otherwise be lost to weak institutions and bad policies. Still, there are recognized costs in terms of inefficiency, inability to enforce contracts, and lost tax revenue.⁶¹

Hernando de Soto graphically outlined the costs to the entrepreneurs operating in the black market:

Contrary to popular wisdom, operating in the underground economy is hardly cost-free. Extralegal businesses are taxed by the lack of good property law and continually having to hide their operations from the authorities. Because they are not incorporated, extralegal entrepreneurs cannot lure investors by selling shares; they cannot secure low-interest formal credit because they do not even have legal addresses. They cannot reduce risks by declaring limited liability or obtaining insurance coverage. The only "insurance" available to them is that provided by their neighbors and the protection that local bullies or mafias are willing to sell them. Moreover, because extralegal entrepreneurs live in constant fear of government detection and extortion from corrupt officials, they are forced to split and compartmentalize their production facilities between many locations, thereby rarely achieving important economies of scale. In Peru, 15 percent of gross income from manufacturing in the extralegal sector is paid out in bribes, ranging from "free samples" and special "gifts" of merchandise to outright cash. With one eye always

on the outlook for police, underground entrepreneurs cannot openly advertise to build up their clientele or make less costly bulk deliveries to customers.⁶²

De Soto's research led him to conclude that, when it is possible for entrepreneurs to obtain title to their property and operate legally, it is worth paying taxes to avoid the costs associated with operating underground. The poor do not choose to operate illegally out of predisposition to lawless behavior. Speaking of the urban migration process in developing countries, De Soto wrote that "in every country we investigated, we found that it is very nearly as difficult to *stay* legal as it is to *become* legal. Inevitably, migrants do not so much break the law as the law breaks them—and they opt out of the system."⁶³

An increasing number of observers of developing countries decry the effects of pervasive corruption. Alejandro Chafuen and Eugenio Guzmán wrote :

Nevertheless, the same corrupt activity that might enable one person to avoid the burden of an unjust law might also allow someone else to avoid complying with just laws. The bureaucrat who accepts a bribe to help one person with a contract might also accept a bribe to leave someone else out of business. Officials who accept bribes to accelerate a regular business errand might also accept a bribe to leave someone defenseless against blackmail. Executives of U.S.-based corporations find themselves frequent victims of such bureaucratic behavior.⁶⁴

There is ample evidence that Chafuen and Guzmán were on the mark. In Roll and Talbott's recent study, corruption (the "black market" factor of the *Heritage Index of Economic Freedom*) has a large and statistically significant negative effect on per-capita real gross national income. That variable is sec-

ond only to property rights in its influence on the standard of living in a country.

Once corruption takes root, it is difficult to stamp out. The illicit payments received by government officials become part of their expected compensation. Customs agencies can become little more than schemes for collecting bribes.

One way out of this problem has been for governments to employ private firms, such as the Swiss Firm Societe General de Surveillance, to enforce the rules or even collect customs imposts. In Peru the Fujimori government licensed several inspection companies to conduct pre-shipment inspection of import commodities, which would be used as a valid reference for settlement of duties and clearance charges. This private competitive scheme enhanced customs revenue collection and reduced clearance delays.⁶⁵ The government establishes the tariff schedules and rules, but the profit-seeking firm enforces them. Its "reputational capital" at stake, the firm will employ resources to combat corruption.

Alternatively, a country can diminish the incentives for bribe payments by altering policies. Complex tariff schedules containing large variations in rates create incentives for importers to seek favorable treatment by customs officials on the category into which a good falls. Chile introduced a flat tariff schedule for most goods, which greatly diminished rent seeking. That still left a high tariff rate of 10 percent. In 1991, the government announced a policy of reducing the flat rate by one percentage point per year until the flat rate hit 6 percent in 2003.⁶⁶

Although not impossible, weeding out corruption that has taken root challenges the political system. That consideration surely led Thomas Jefferson to argue that prevention is the best cure:

Human nature is the same on every side of the Atlantic, and will be alike influenced by the same causes. The time to guard against corruption and tyranny, is before they shall have gotten hold of us. It is better to keep

If they could operate in an environment of secure property rights, the world's poor would have the solution to their own plight.

Each country must evolve its own property rights system according to its own history.

the wolf out of the fold, than to trust to drawing his teeth and talons after he shall have entered.⁶⁷

Countries that have held the wolf at bay have generally prospered. The Scandinavian countries are famous for their low level of political corruption. Despite onerous taxes, their citizens enjoy comparatively high real incomes. Finland and Denmark are often cited as favorable places in which to conduct business. With the exception of Norway (the oil curse again), they enjoy high levels of economic freedom.⁶⁸

As Chafuen and Guzmán analyze it, corruption attenuates property rights by making them insecure. In a politically corrupt society, the ability to open a business and continue to operate it is governed not by rules, but by bureaucratic whim. The rule of men is substituted for the rule of law. The greater the degree of corruption, the less secure are property rights. One would certainly expect a negative correlation between the security of private property and the level of corruption.⁶⁹

The informal sector is an outlet for entrepreneurial activity in repressed economies. That sector is a safety valve for the poor and economically disenfranchised. Nonetheless, it can itself attenuate private property rights. When “knockoffs”—goods violating copyright and trademarks—are sold on the black market, producers of the originals suffer. This is not an argument for harassing entrepreneurs in the informal sector, but for reforming the policies that channel entrepreneurs onto the black market.

Such reforms will enhance the security of private property. That in turn will bring participants in the informal sector into the formal sector. De Soto has written eloquently about how the poor benefit when means are provided for formalizing informal activity. Once an extralegal entrepreneur becomes legal and can title his assets, the whole world of credit opens up to him. His assets “can be used as collateral for credit. The single most important source of funds for new business-

es in the United States is a mortgage on the entrepreneur’s house.”⁷⁰

De Soto and his colleagues estimated the amount of “dead capital” in untitled assets held by the world’s poor as “at least \$9.3 trillion.”⁷¹ He estimated the value of savings of world’s poor to be “forty times all the foreign aid received throughout the world since 1945.”⁷² Haiti, the poorest Latin American country, exemplifies the process:

In Haiti . . . the total assets of the poor are more than one hundred fifty times greater than all the foreign investment received since Haiti’s independence from France in 1804. If the United States were to hike its foreign aid budget to the level recommended by the United Nations—0.7 percent of national income—it would take the richest country on earth more than 150 years to transfer to the world’s poor resources equal to those they already possess.⁷³

In sum, the absence of secure property rights is the cause of corruption, and the creation of private property rights would be the cure for corruption. If they could operate in an environment of secure property rights, the world’s poor would have the solution to their own plight. Indeed with their already accumulated property secured, the world’s poor would be much less so.

U.S. Policy: First, Do No Harm

All too often U.S. aid policy, bilateral and multilateral, has been counterproductive, resulting in the people of the recipient countries being harmed rather than helped. Direct U.S. economic assistance, through USAID and other agencies, and indirect assistance funneled through such institutions as the World Bank, have failed to spark economic development, and have too often sustained

corrupt institutions.⁷⁴

What Melvyn Krauss has labeled the “consensus of expert opinion” on development in the 1950s, 1960s, and 1970s has largely been proven wrong.⁷⁵ Development nostrums have led not to prosperity but to penury in all too many developing countries. Private property was omitted from the development consensus.⁷⁶

The official assistance policy of the United States, and that of many multilateral institutions, is now directed at helping developing countries develop the rule of law and a system of private property. The problem is that those efforts largely ignore the history of private property in the United States and other countries in which private rights are strongly protected. In the *Mystery of Capital*, Hernando de Soto looked for lessons from U.S. history that could be applied to developing countries. The lesson he gleaned was that each country must evolve its own property rights system according to its own history.⁷⁷

Richard Pipes focused on the history of property in two countries: England and Russia. He also presented evidence for a number of other countries, such as France, Spain, Portugal, Sweden, and the Netherlands.⁷⁸ One theme emerges from all the histories. Property and freedom emerged from a struggle over finances between a representative body and a king or ruler. When the ruler was compelled to rely on parliament or its equivalent for a permanent source of revenue, property was protected and liberty flourished. When the ruler was not so compelled, the converse resulted.

In Russia, sovereignty and property merged. Consequently, the Russian despotic ruler had no need of a representative assembly for revenue. The story was mixed in other countries. The English king became increasingly dependent on Parliament for revenue, and Parliament thereby gained supremacy. The struggle was always couched in terms of protecting property and liberty from encroachment by the king:

The originality of the English parlia-

ment, therefore, lies not in its antiquity and function but in its longevity, for it went from strength to strength, whereas its continental counterparts, with few exceptions (notably Poland, Sweden, and the Netherlands) did not survive the era of royal absolutism.⁷⁹

Exporting a country’s system of private property rights ultimately entails exporting its history and political culture. That has not been done successfully, other than through colonialism, and then only effectively in the case of the British Empire. History does not repeat itself, and the American political culture finds colonialism alien. So the scope for effective official assistance in this process is limited.

Following de Soto, we see the need for each developing country to work out the problem of evolving a system of private property in terms of its own history. The transition economies of Central and Eastern Europe had the advantage, to different degrees, of a pre-Soviet history of free economic and political institutions on which to build. In some cases, such as the Baltic countries (especially Estonia), and Poland, the transition has been truly rapid.

For countries without such a history of freedom, the process will necessarily be longer. It is unlikely to be a process attractive to outsiders. Russia is a prime example. U.S. policy is constrained in its ability to aid directly the evolution of the rule of law and private property in such countries.

Getting from Magna Carta to parliamentary supremacy in England took roughly half a millennium. Is it reasonable to assume that a country such as Russia could attain the same degree of protection of private property under a rule of law in less than a century?

What the Bush administration can and should do is to vigorously pursue trade liberalization with developing countries. Tariff and nontariff barriers hit the exports of developing countries particularly heavily, notably on agricultural, and textile and apparel exports. Many of the benefits

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claimed by advocates of aid, which are seldom realized through aid, actually accrue to international trade. Moreover, developing countries that open their markets to trade set in motion a process of institutional change that can lead to the establishment of the rule of law. Robert Zoellick, the United States Trade Representative, has proposed a number of trade initiatives to help developing countries, and the Bush Administration should pursue these.⁸⁰

Conclusion

Historical economic development can only be explained by private property, the rule of law, and other key institutions. Classical economists understood this, but didn't emphasize what they took to be obvious. As economics matured as a discipline in the 19th century, ideas critical of property rights began to take hold. In the 20th century, economists became enamored of macroeconomics and technique over microeconomics and institutions.

The rise of the omnipotent nation state in the 20th century, accompanied by the decline of classical liberal ideas, caused economists to lose sight of the fundamentals of development. Economists came to accept absurdities as fact. "Measured Soviet real GNP has grown more rapidly over the long run than have most of the major market economies," Paul Samuelson wrote in the 13th (1989) edition of his famous textbook, even as the Berlin Wall was coming down."⁸¹

The lessons learned from the economics of property rights have yet to be effectively incorporated into policy by bilateral and multilateral aid agencies. Shifting aid resources away from fashionable development programs toward institutional arrangements that protect property, improve market price systems, and reduce trade barriers may give the poor a shot at a better economic future. More likely, the countries themselves will need to evolve the needed institutions. Promoting free trade is one practical way to

advance the rule of law and protection of private property.

Notes

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1. Friedrich A. Hayek, "Economics and Knowledge," in *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948), p. 34.

2. Richard Roll and John Talbott, "Why Many Developing Countries Just Aren't," Los Angeles, UCLA, Nov. 2001 (unpublished manuscript).

3. Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000).

4. See Gerald P. O'Driscoll Jr., Edwin J. Feulner, and Mary Anastasia O'Grady, 2003 *Index of Economic Freedom* (Washington: The Heritage Foundation and Dow Jones, 2003), see table entitled "Per Capita Income throughout the World," pp. 432–35. This table is used for the subsequent comparisons.

5. Official U.S. statistics missed these differences. In 1989, the year the Berlin Wall fell, per-capita income was reported to be higher in East Germany (\$10,330) than in West Germany (\$10,320). U.S. Department of Commerce, *Statistical Abstract of the United States* (Washington: GPO, 1989), p. 822. Cited in Bethell, p. 12.

6. World Bank, *World Development Indicators Online*, www.worldbank.org/data. See also Gerald P. O'Driscoll Jr. and Sara J. Fitzgerald, "Trade Promotes Prosperity and Security," Heritage Foundation Backgrounder no. 1617, December 19, 2002, Tables 1 and 2 and pp. 6–7.

7. Allan H. Meltzer, "Leadership and Progress," The Irving Kristol Lecture of the American Enterprise Institute, Washington, February 26, 2003, p. 5. Meltzer's comparisons were the two Germanys, the two Koreas, and between China and "the Chinese diaspora in Taiwan, Hong Kong, and Singapore." Richard Pipes, the distinguished historian of Russia, makes a similar comparison in *Property and Freedom* (New York: Alfred A. Knopf, 1999), pp. 286–87.

8. Sachs and Warner found a negative correlation

- between natural resource exports and economic growth. Natural resource abundance tends to lead to higher protectionism. See Jeffrey Sachs and Andrew Warner, "Natural Resource Abundance and Economic Growth," National Bureau of Economic Research Working paper no. 5398, 1995.
9. The Argentine economy contracted 10.9 percent in 2002 and has been in recession since July 1998. The inflation rate peaked at 41 percent as the value of its currency declined 70 percent against the U.S. dollar. The government also defaulted on the public debt. "Argentina's GDP Contraction Breaks Record," *Wall Street Journal*, March 20, 2003, p. A16. Since that article was written, economic growth in Argentina has apparently resumed.
10. This discussion follows that in Roll and Talbot, pp. 5-6.
11. *Ibid.*, p. 6.
12. For a discussion of the technical issues involved in their study, see *ibid.*, pp. 8 and 13-15.
13. Tom Bethell, *The Noblest Triumph: Property and Prosperity through the Ages* (New York: St. Martin's Press, 1998), p. 95.
14. Pipes, p. 39.
15. Adam Smith, *Lectures on Jurisprudence* (Oxford: Clarendon Press, 1978), p. 5. Quoted in Bethell, p. 97. It is all the more odd that in his later book, Smith opened with a lengthy discussion of the pin factory.
16. Bethell, p. 98.
17. *Ibid.*, p. 98.
18. *Ibid.*, pp. 99-100.
19. William Blackstone in *Ehrlich's Blackstone*, ed. J. W. Ehrlich (San Carlos, Calif.: Nourse Publishing Co., 1959), p. 113; Jeremy Bentham, "Principles of the Civil Code" in *Property, Mainstream and Critical Positions*, ed. C. B. Macpherson (Toronto: University of Toronto Press, 1978), p. 53. Cited in Bethell, pp. 19 and 100.
20. Joseph A. Schumpeter, *History of Economic Analysis* (New York: Oxford University Press, 1954), p. 531.
21. Compare with the discussion in Bethell, pp. 110-11.
22. Ludwig von Mises, *Human Action: A Treatise on Economics*, 3rd rev. ed. (Chicago: Henry Regnery Company, 1966), pp. 311-12.
23. Bethell, pp. 112.
24. Schumpeter, p. 531.
25. Pipes, p. 56. Also, see Schumpeter, p. 531.
26. Alfred Marshall, *Principles of Economics* (1890; reprint, New York: Macmillan, 1961), p. 764 and 721-22. Quoted in Bethell, p. 117.
27. Bethell, p. 119.
28. As Schumpeter observed, "Marshall professed himself in sympathy with the aims of socialism and spoke without explanation and qualification of the 'evil of inequality'" (p. 765).
29. Bethell, p. 121. According to Pipes (p. 40), it was in the 18th century that philosophers began to reject the traditional concept of an underlying human nature.
30. Mikhail Heller, *Cogs in the Wheel: The Formation of Soviet Man* (New York: Knopf, 1988), p. 125. Quoted in Bethell, p. 121.
31. Schumpeter, pp. 765-66. The title of this section of the *History of Economic Analysis* is "The Defeat of Liberalism." By "liberalism," Schumpeter refers to what we now call "classical liberalism."
32. Friedrich A. Hayek, "The Nature and History of the Problem," in *Collectivist Economic Planning: Critical Studies* (1935; reprint, Clifton, N.J.: Augustus M. Kelley Publishers, 1975), pp. 21-22.
33. Friedrich A. Hayek, *The Fatal Conceit* (The University of Chicago Press, 1988), p. 36.
34. Friedrich A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944), pp. 103-4. Once again, Hayek is an economist who discusses property in his political work, but little in his economic contributions.
35. Pipes, p. xii.
36. *Ibid.*, pp. xii-xiii.
37. James W. Ely Jr., *The Guardian of Every Other Right: A Constitutional History of Property Rights*, 2nd ed. (New York: Oxford University Press, 1998), p. 16.
38. At purchasing power parity, the average citizen of oil-producing Venezuela had a real per-capita GDP of \$5,794 in 2000. By contrast, the figure in Chile, heavily dependent on non-oil commodity prices, came in at \$9,417. The U.S. figure was \$34,142. O'Driscoll, Feulner, and O'Grady, pp. 432-35.
39. See Lee Hoskins and Ana I. Eiras, "Property

- Rights: The Key to Economic Growth,” in Gerald P. O’Driscoll Jr., Kim R. Holmes, and Mary Anastasia O’Grady, *2002 Index of Economic Freedom* (Washington: The Heritage Foundation and Dow Jones, 2002), pp. 37–38.
40. In the *Wealth of Nations*, marginal costs are an increasing function of output. Innovation produces outward shifts in the cost function and the appearance of declining costs (increasing returns). At each moment in time, however, there are diminishing returns. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (New York: The Modern Library, 1937 [1776]).
41. Mises, *Human Action*, p. 655.
42. Ibid. 655–56.
43. Ibid., p. 656.
44. Ibid., p. 657.
45. Harold Demsetz, “Toward a Theory of Property Rights,” *American Economic Review* 57 (May 1967): 347–59. According to Professor Richard Ebeling of Hillsdale College, the discussion of externalities, property rights, and the tragedy of the commons in the 3rd edition (1966) of Mises’ *Human Action* is the same in the first edition (1949) and, indeed, in *Nationalökonomie* (1940). Private communication, March 25, 2003.
46. Pipes, p. 61.
47. Armen A. Alchian, *Economic Forces at Work* (Liberty Press, 1977), p. 130.
48. Ronald Coase, “The Problem of Social Costs,” *Journal of Law and Economics* (1960), pp. 1–5.
49. Pipes, p. 65.
50. Ibid., pp. 97–98. Possession, inheritance and customary law precede the state. This view is consistent with Hayek’s. See, for instance, F. A. Hayek, *Law, Legislation and Liberty: Volume I: Rules and Order* (Chicago: University of Chicago press, 1973). De Soto focuses on the absence of legal title to property in developing countries, despite the presence of well-developed states. He concludes that “the only way to find the extralegal social contract on property in a particular area is by contacting those who live and work by it.” That is, look to who possesses it and is accepted as customary owner. De Soto, p. 182.
51. See James Gwartney and Robert Lawson, *Economic Freedom of the World: 2002 Annual Report* (Vancouver, B.C.: The Fraser Institute), pp. 6–7.
52. Alchian, pp. 127–29.
53. Mises, pp. 143–45.
54. Hoskins and Eiras, p. 40.
55. This is the essential lesson of Public Choice Theory. James Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor, Mich: University of Michigan Press, 1962), see also www.econlib.org/library/Buchanan/buchCv3c1.html. This spawned a vast literature on “market failure” and “political failure.” In 1986, Buchanan won the Nobel Prize in economics partly for that contribution.
56. Hoskins and Eiras, p. 40.
57. Ibid., p. 46.
58. Fareed Zakaria, “The Rise of Illiberal Democracy,” *Foreign Affairs* (November/December, 1967), pp. 22–43. See also Fareed Zakaria, *The Future of Freedom* (New York: W. W. Norton, 2003).
59. Hayek, *The Fatal Conceit*, p. 33.
60. Robert J. Barro, “Rule of Law, Democracy, and Economic Performance,” in Gerald P. O’Driscoll, Jr., Kim R. Holmes, and Melanie Kirkpatrick, *2000 Index of Economic Freedom* (Washington: The Heritage Foundation and Dow Jones, 2000), p. 36. Compare David Osterfield, *Prosperity versus Planning: How Government Stifles Economic Growth* (New York: Oxford University Press, 1992), pp. 204–18.
61. Barro, p. 32. Compare Enrique Gherzi, *Teoría de la Corrupción* (Lima: Cecosami Editores, 2003); and Enrique Gherzi, “Economía de la Corrupción,” Centro de Divulgación del Conocimiento Económico, Caracas, Monografía 73, no date, www.cedice.org.ve/archivos/ghersi3.doc.
62. De Soto, p. 155.
63. Ibid., p. 21.
64. Alejandro Chafuen and Eugenio Guzmán, in Driscoll, Holmes and Kirkpatrick, p. 61. Compare John Mukum Mbaku, “Bureaucratic Corruption in Africa: The Futility of Cleanups,” *Cato Journal* 16, no. 1 (Spring/Summer 1996).
65. Roberto Abusada Salah, Javier Illescas Mucha, Sara Taboada Peña, *Integrando el Perú al Mundo*, (Lima, Peru: Centro de Investigación de la Universidad del Pacífico e Instituto Peruano de Economía, 1st. ed., 2001), p. 93; Richard Webb, quoted in “Mar de Fondo”, *Caretas* May 25, 1995, Lima, Peru; “Congreso Elimina Régimen de Supervisión de Importaciones” in *Diario Gestión* May 21, 2003, Lima, Peru. We thank Alejandro Caballero Aste for his research help on this point.

The Peruvian Congress has recently decided to renationalize import supervision.

66. José Piñera and Aaron Lukas, "Chile Takes a Bold Step Toward Freer Trade," *Wall Street Journal*, January 15, 1999.

67. Thomas Jefferson, *Autobiography, Notes on the State of Virginia, Public and Private Papers, Addresses, Letters* (New York: Literary Classics of the United States, 1984), p. 671. Quoted in Chafuen and Guzmán, p. 61.

68. Sara J. Fitzgerald, "Scandinavia's Changing Political and Economic Landscape," in O'Driscoll, Feulner, and O'Grady, pp. 39–47. Compare Gwartney and Lawson.

69. Chafuen and Guzmán (pp. 55–61) found a strong negative correlation between economic freedom and corruption.

70. De Soto, p. 6.

71. *Ibid.*, p. 35.

72. *Ibid.*, p. 5.

73. *Ibid.*, p. 5.

74. See the relevant discussions in the *Report of the International Financial Institution Advisory Commission*, Allan H. Meltzer, chairman, submitted to the U.S. Congress and the U.S. Department of the Treasury, March 8, 2000. Also, David Dollar and Lant Pritchett, "Assessing Aid: What Works, What Doesn't and Why," *World Bank Policy Research Report*, 1998; and William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics* (Cambridge, Mass.: MIT Press, 2001).

75. Melvyn Krauss, *How Nations Grow Rich: The Case for Free Trade* (New York: Oxford University Press, 1997), p. 86.

76. Krauss, p. 94.

77. De Soto," pp. 105–51.

78. See Pipes, pp. 151–58.

79. Pipes, p. 151.

80. Gerald P. O'Driscoll Jr. and Sara J. Fitzgerald, "Trade, Aid and Economic Growth," forthcoming.

81. Bethell, p. 28.

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