

THE POVERTY OF NATIONS

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The Condition of Poverty and the Creation of Wealth

Poverty remains an endemic state of man. The curse imposed by an angry god on Adam and his descendants describes the human fate. Man experienced over history, with rare exceptions, toil, hardship and oppression. The uncertain and stringent conditions of life challenged man's awareness. He sought for answers explaining this fate and these were couched in the form of myths and legends. An imaginative human mind invoked a fall from grace or a curse imposed by gods. Such orientations naturally affected man's expectations of liberation from the grinding burden of toil and hardship. The restoration of grace appeared to be the crucial condition for such liberation.

This elementary message emerged over the centuries in very different forms and in widely varying detail. The basic story of man's fate conveyed by ancient myths still persists with a subtle and pervasive influence. The dominant ideologies of our time promise the restoration of (at least secular) grace with the liberation from human bondage to poverty. This promise of liberation should be realized by a collective action imposing a set of explicitly designed *political* institutions as the dominant mechanism for the coordination of society.

The ancient themes still reverberate under new labels in various branches of sociology or social psychology. But their influential repercussions on the intelligentsia market have been challenged for 200 years by the evolution of economic analysis. This analysis, initiated by the Scottish philosophers of the 18th century, offered a revolutionary insight into the social context of man's life. This insight

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has hardly been absorbed or understood by the educated middle classes of western societies and even less by the professional articulators.

The Scottish tradition of economic analysis explains the emergence of social groups and "great societies" extending social interaction far beyond face-to-face associations. It also explains the emergence of political structures without invoking metaphysical entities. This tradition shows in particular how the social structure emerges as resourceful human agents interact to improve their lot according to their judgment and understanding. The social structure appears in this manner as an important but quite unintentional by-product of this interaction.

The same analysis also addresses the condition of poverty and the creation of wealth. The wealth of nations, expressed by the standard of living, depends foremost on individual effort, ingenuity, and imaginative adaptation to the environment. The natural environment together with the resources provided by nature can make a substantial difference for a nation's opportunities. These opportunities offered by nature condition the pattern of activities and the use of available human and nonhuman resources. But the possessions of natural resources do not determine a nation's wealth and do not, per se, suspend Adam's curse. Nature's heritage forms, contrary to widely held beliefs well represented by the Brandt Report on the North-South dialogue, neither a necessary nor a sufficient condition for high or rising levels of wealth. More than 50 years ago Argentina was expected to evolve on the basis of its natural resources into one of the world's wealthiest nations. It approached in contrast a pattern of permanent stagnation. We still encounter "experts" informing us that Argentina with its vast resources should really be expected to overcome, in due course, its current difficulties. Brazil should also be on this count among the wealthiest nations today. Switzerland, less favored with natural resources than Zaire, Nigeria, Mexico, and other nations, should appear among the poorer nations appealing for aid from Argentina, Brazil, Mexico and others. We may also compare Hong Kong, South Korea, Taiwan, and Singapore with more favored nations. Or consider the permanent stagnation of Tanzania and Zimbabwe in Africa or of Bolivia and Peru in South America.

Political power has frequently been singled out as a crucial factor of a more widely conceived "natural environment" which decisively affects the wealth of nations. The Brandt Report exemplifies once again this view. But history and economic analysis fail to support this claim. Nations with little power experienced over the past 100 years or more a remarkable increase in wealth. This accrual of wealth

occurred moreover not at the cost of other (more powerful?) nations but contributed actually to benefit others through an expanded economic interaction.

Poverty is characterized by a low rate of production of goods and services. The creation of wealth involves an expansion of this production. Western nations experienced this process over the last 200 years on a scale never before recorded in history. Power can simply not explain this phenomenon. Power does not produce goods, it simply absorbs and uses goods to maintain the power apparatus—a *nomenklatura*. Power, however, may be applied to extract wealth from those who produced it, an exercise that does not create wealth but actually destroys it in the final analysis. The emphasis on power thus confuses the *creation* and the *redistribution* of wealth. It also fails to understand the longer-run consequences of redistributive power. The argument based on power frequently occurs in a context linking the accumulation of wealth in Western nations with colonialism. But Adam Smith already elaborated the crucial implications of colonialism. He recognized that colonialism meant a loss in wealth for the colonizing nation combined with a domestic redistribution favoring specific groups involved in the process. This redistribution, and not any general accrual of wealth, was the historical driving force of colonization. The exercise of power applied to colonial efforts thus imposed an economic burden on the mother country.

Our attention clearly must be directed beyond natural resources and power to human effort and resourceful ingenuity. The founding fathers of modern economic analysis recognized the central importance of human capital and investment in human capital as a condition of the wealth of nations. The development of the German economy after World War II dramatically confirmed this contention. But effort and resourceful ingenuity are not “sociological data” determined by the mysteries of a “mental attitude,” a “religious commitment” or an inherited “work ethic.” Customs, traditions, and cultural values may play a role for a while. However, they will diminish in importance and behavior will adjust once the supporting conditions have eroded. Economic analysis informs us that effort and resourceful probing emerge with substantially greater frequency and intensity when human agents expect to capture the benefits of their search activity and their ingenuity. Without the incentives of potential rewards agents hardly will find it worthwhile to expend much effort and ingenuity. The magnitude and quality of effort and the intensity of search for imaginative innovations in types and use of resources is generally closely linked with the expectation of capturing the returns from these endeavors. The penalty-reward system thus conditions

the current level of human endeavor. Economic incentives also shape the accumulation of human capital expressed by the level and quality of skills and the development of nonhuman resources with the productive modification of the environment.

The power argument outlined above fails to comprehend the central role of incentives and the close link between the investment of one's efforts and the capture of expected returns. It proceeds as if there operated no incentive feedback from the distribution of the product to its supply. The argument suggests on the contrary that all goods are to be grabbed by participants in a social game. The powerful acquire the lion's share of the economic pie and the losers get the crumbs. The natural conclusion from this romantic vision is that the balance of power needs to be changed.

The message conveyed by economic analysis thus directs our attention to the conditions that encourage the application of human effort and ingenuity to the inheritance determined by history and the environment. These conditions do not depend on nature. They are determined by the social organization characterizing a society. The prevailing sociopolitical institutions condition the potential opportunities facing human agents. *They ultimately shape the incentives that guide human effort and ingenuity, and that evolve over time into customs, habits, and traditions.* Such customs and traditions, however, can be destroyed by institutional changes that lower the expectation of a link between effort and real benefit. Thus we recognize in the pattern of existing sociopolitical institutions the crucial condition for both wealth creation and the persistence of widespread poverty. A stagnant economy and persistent poverty therefore do not express a curse of vengeful gods (in the heavens or in history) to be atoned by a purifying collective action. Rather, such stagnation and poverty result essentially from the inheritance of social institutions affecting individual behavior.

The Ambivalence of the Political Structure

The nature of institutions maintaining poverty or fostering wealth creation requires some further attention. The role of the political structure, and specifically of the state, needs to be clarified in this context.

The social productivity of the political structure is best understood in comparison with a state of anarchy. An agent arranging his affairs under anarchy has the following options for the use of his resources: he can invest in production, in trade, in attempts of robbery, and in defense against others. The exposure to potential loss of resources

due to piracy by others lowers the incentive to invest in production. It also constrains the opportunity to trade. Under the circumstances productive activity addressed to wealth creation remains at a low level. All agents seem to be caught in the trap of a prisoner's dilemma. The repetitive occurrence of the basic social problem posed by anarchy, however, induces the interacting responses so well described by the founders of economic analysis and more recently elaborated by Hayek (1982). The evolution of political institutions offers in this respect a solution to the prisoner's dilemma inherent in a state of anarchy.

Consider the options available to an agent arranging his activities in the context of the political structure. He can invest his resources again in four different ways: in production, in trade, in the political process to redistribute wealth on his behalf, and in the political process as a defense against wealth redistribution schemes advanced by others. Anarchy and the political structure are thus not distinguished by presence or absence of a zero (or possibly even negative) sum game of social interaction. We recognize at this stage the peculiar ambivalence of the political structure. This structure establishes rules of the social game. Such rules substantially confine the wealth-impeding activities of anarchy but they never totally eliminate them, as exemplified by the Mafia and the Camorra. The rules therefore provide a "monopoly of violence" anchored by the political structure. This monopoly forms a necessary condition for the specification of property rights and their enforcement. Investment in production and in activities raising the level and quality of human and nonhuman resources is encouraged as a result of the greater expectation of capturing the returns under the rules of the social game. Specification and enforcement of property rights also encourage a wider range of possible transactions and provides new opportunities for mutually beneficial trade. The resulting increase in the creation of wealth expresses the remarkable productivity of a stable political structure that allows individuals to capture the benefits of increased economic efficiency.

The magnitude and extent of the benefits accruing from the political structure, however, depend on the institutional arrangements guiding the coordination of socioeconomic activities. In this context private property exhibits a crucial advantage that is not well understood by most professional articulators in the public arena. The assignment of property rights resolves a physical impossibility associated with potential social conflicts. Scarce resources cannot be controlled simultaneously by several persons. The structure of rights determines who can do what with respect to which scarce object.

This structure fully reflects the inherited patterns of resources. It mirrors in this sense the constraints imposed by nature. All resources need be owned by some person and beyond this no rights should be assigned.¹ This condition rules out the wide array of market closing and entry restricting arrangements under any name. Private property rights also guarantee the important link between effort and reward that was emphasized above. Under such a system this link is actually generalized to transactors beyond the range of owners of nonhuman resources.

No rules of the social game however can preclude a new form of wealth-impeding activities from replacing the ancient patterns of anarchic wealth impediments. The problem actually adheres to any set of rules. All political structures determine potential opportunities for manipulation *within* the rules accepted for their operations. They unavoidably offer incentives to be used for purposes of wealth redistribution among the participants of the social game. There is hardly a political institution that does not have consequences for the distribution of wealth. Agents respond to this fact by investing resources in the political process in order to generate wealth transfers from others or to ward off attempted transfers by others. This aspect of the political structure involves basically a negative sum game within the context of the socially productive positive sum game provided by a stable set of rules. The incentives to invest in the political process for purposes of acquiring wealth from others or for protective political actions lowers the allocation of resources to socially productive activities. The taxes imposed by implicit or explicit wealth transfers occurring in one form or another lower moreover the incentive to invest in production, trade, and the accumulation of resources. These consequences determine the inherent ambiguity of the state expressed by the joint operation of a positive and negative sum game proceeding in the context of political institutions organizing the social interaction.

All political structure thus involves simultaneously a wealth-creating and a wealth-impeding dimension. In contrast to the state of anarchy, however, the wealth-obstructing activities proceed in accordance to a recognized and generally accepted set of rules. Political structure thus lowers, but does not remove, the uncertainty confronting agents' *socially productive activities*. The magnitude of the lowered uncertainty or, in other words, the extent of the wealth-impeding range of activities associated with the political structure depends crucially on the detail of the sociopolitical institution. Every set of political institutions produces its specific mix of positive and nega-

¹See Meckling and Jensen (1980).

tive sum social games. The weight of wealth-impeding activities depends thus on the sociopolitical arrangements of nations.

The nature of wealth-fostering and wealth-impeding political institutions may be usefully described in rough outline. The distinction between the two dimensions of the state may be usefully introduced for this purpose. These dimensions refer to the "protective state" and the "redistributive state." This classification is essentially justified in terms of the purpose of political institutions but holds only approximately in terms of their consequences.

Robert Nozick (1974) and James Buchanan (1977) demonstrated the redistributive dimension unavoidably embedded in the protective state. The protective state encompasses a set of political institutions that define general rules offering a stable framework for agents' productive activities. Such rules involve most particularly the definition of private property, the protective arrangements of police and courts associated with this definition, enforceability of privately negotiated contracts, and stable and predictable fiscal procedures including monetary policy. The rules bearing on the government's financial affairs need explicit recognition in this context. Unpredictable explicit changes in taxation or implicit changes via erratic inflation in a world of tax rates addressed to nominal values can substantially lower the incentives of the positive sum social game. A rich variety of observations informs us that the detail of the political framework shaping the social institutions listed above substantially influences the productivity of the social game. Well-designed political structures foster the evolution of markets and improve their functioning. Moreover the higher level of predictability tends to encourage the accumulation of resources. These consequences are essential strands of a wealth-creating social process. This follows from the fundamental fact that the social institutions protected by the type of political structure under consideration assure, on average, a systematic link between effort and ingenuity applied on the one side and the resulting returns on the other. We may formulate this more generally as a set of institutions that raise the probability of a link between the consequences of actions and the agents committing these actions. They also lower the likelihood of market closing and entry restricting activities.

An alternative set of rules or institutions embodied in political structures represented by the redistributive state typically produce wealth-impeding consequences. The class of these political institutions exhibits a rich detail testifying to man's inventiveness. We may divide this vast detail into two broad groups for our purposes. One group involves constraints on choices bearing on contractual arrange-

ments and the tenure of property. The other group contains structures with direct distributional consequences and associated distortions of incentives. Although this division is neither neat nor clean, a better organization of the material may emerge from further discussion.

The argument outlined above suggests that the creation of wealth or entrenched poverty is substantially conditioned by both levels of the political apparatus, the protective state and the redistributive state. Too little of the first and too much of the second obstruct wealth creation and maintain pockets of poverty or even mass poverty. An uncertain or more or less deliberate failure to exercise the basic protective function erodes the link between *productive* effort and capture of expected returns. This experience can be observed over history and continues in our time. I have already mentioned Argentina, and we can point to the permanent political instability and longer-run uncertainty bearing on important sociopolitical institutions in Bolivia, Peru, possibly Chile in South America, Zimbabwe and other nations in Africa. The social context of these nations provides few, or weak, incentives to create wealth through productive investment. The context spurs incentives directed toward the conquest of political control with the acquisition of the associated spoils. The resulting pattern of entrenched poverty cannot be alleviated by doses of foreign aid. Such aid essentially contributes to raise the resources available to the local *nomenklatura*. It cannot replace or offset the absence of an adequate protective state.²

The realization of the basic protective function may be offset to some extent by the state's redistributive activities. Constraints on contractual arrangements and the effect of sociopolitical conditions on property tenure exemplify this aspect. The usual textbook treatment of production obscures this important point. We read that output is linked with an array of inputs via a production function. This function purportedly represents the underlying technology. This interpretation is thoroughly misleading, however. The nature of the production function is sensitively conditioned by sociopolitical circumstances. The production function actually forms the outcome of agents' optimizing responses to these conditions. It follows that variations in the admissible range of contractual arrangements or associated organizational forms modify the production function. Constraints on admissible contractual arrangements tend to lower output for any given input. Consequently they impoverish a society and obstruct the imaginative search for new modes of wealth creation.

²See Bauer (1978).

The imposition of self-management or codetermination illustrates the issue. The organizational forms may survive successfully in competition with the corporation and other forms. They may exhibit a comparative advantage for specific activities. Our experience clearly indicates however that this comparative advantage occurs over a very limited range. A coercive imposition of these forms forces, therefore, the organization of production into a mold less adapted to the coordination of resources in production. A comparative decline in output thus emerges. Detailed investigations of the incentives prevailing under self-management and codetermination confirm the results of economic analysis. These investigations also show that self-management in particular creates new social tensions and conflicts between younger and older workers, or between established workers and potential new workers entering the market.

Corporate governance is another fashionable issue that should be mentioned here. Modifications of governance are proposed in order to achieve purportedly desirable social goals. The sense of these proposals usually conveys that they impose *no* social costs and *will* achieve the desired effects. Economic analysis disillusion us on both counts. The social costs in particular will rise with the severity of constraints controlling corporate organizations.

The change in the law governing insolvency in Germany and the "comparable worth" movement in the United States offer further examples of contractual constraints. The assignment of priority rights to several months salary beyond the date of filing for bankruptcy raises the cost of capital, impedes investments, and affects employment. A systematic application of "comparable worth" procedures would seriously impede the organization of production and impose social costs in terms of lessened output of goods and services.

Pharmaceutical regulations and the admissible range for the forms of property tenure are the last examples of constraints on the production function potentially lowering welfare. The prevailing regulation of pharmaceutical products confines both contractual procedures and the choice of production processes. It has increased the cost of operation and, via the reduction in the relevant economic duration of the patent, it has lowered the expected return. Moreover, the regulatory constraints have lowered new pharmaceutical innovation and thus the achievable state of health.

The modification of the patent's relevant duration actually abrogates established property rights. Constraints on the form of property tenure can significantly impair the nature of the social production function. In many countries around the world land is frequently tended by peasants under a usufruct system. Irrespective of the

political motives behind this tenure system an examination of its operation reveals that it obstructs productivity of agricultural labor, obstructs investment that would improve the quality of land, and encourages population growth in the countryside. The collectivization of agriculture offers a particularly emphatic example of obstructive institutionalization. It eroded incentives to produce and raised incentives for a wasteful use of resources. Agricultural output naturally suffers. Socialist nations from Tanzania to Russia exemplify our case with remarkable clearness. The land tenure system imposed assured a permanent agricultural crisis.

The second strand of the redistributive state encompasses examples from the welfare system of Western societies, the oligarchic power structure of nations in the Third World, the *nomenklatura* of socialist countries, or some patterns of nonsocialist dictatorships. The welfare system of Western nations imposed a massively accelerated redistribution which lowered incentives to work, invest, and save. On the other hand it raised incentives to invest resources in the negative sum game of political processes.

The oligarchies of many nations in the Third World depend for their survival on a persistent redistribution of wealth from the countryside to the cities. Their political base is usually anchored with the populace in the cities. In order to maintain their power the ruling oligarchies find it advisable to impose low prices on agricultural products. This pattern destroys incentives to produce food, erodes incentives to invest resources in agricultural operations, and creates incentives to abandon fertile land and join the masses in the cities.

Most socialist countries operate a vast system redistributing wealth from the potentially productive sector to the *nomenklatura*—a socially unproductive sector composed of a huge military complex, an internal security and economic control apparatus. Once again this redistribution system lowers incentives for the productive use of resources. Nonsocialist military dictatorships also require for their survival a redistribution favoring the military apparatus with similar consequences for the wealth-creating dimension of the social process.

The evolution of labor markets over the past 16 years reveals that Western nations participated in their own way to obstruct, usually with the best intentions, the wealth-creating process. Unemployment in European countries stayed very low until about the end of the sixties. The pattern changed dramatically during the seventies. Unemployment rates rose to the double-digit range. Belgium and the Netherlands measured recently unemployment rates above 15 percent. With the exception of Switzerland almost all European nations experienced massive increases in measured unemployment. Politi-

cians and the media frequently attribute this development to new technologies. In the public arena one also encounters comparisons with the Great Depression. This comparison fails however. The rising trend in European unemployment occurred, in contrast to the thirties, during a period of expansionary financial policies. Moreover, as we learn from economic analysis, technology cannot explain this unemployment either. Technological innovations change opportunities. Old jobs disappear and new jobs emerge. The American experience of the last 30 years demonstrates that reasonably functioning market processes continuously create new jobs and offer new employment.

The crucial conditions pertain to the sociopolitical institutions under which markets operate. Most European countries experienced, in this context, major changes. A variety of arrangements affecting the operation of labor markets were introduced by European governments. These arrangements include measures of employment protection, liberalizations of unemployment support, increasing payroll and social security taxes imposed on employers and similar measures. Employment protection, represented among other procedures by increased compensation payments upon dismissal, raised the expected real cost of employment relative to the real return expected from employment. The same result holds for increased payroll taxes and other obligations associated with employment. It follows that either net real wages fall or employment declines relatively. These adjustments are unavoidable. As it happened, the resulting adjustments occurred in most nations dominantly in the employment-unemployment dimension. No single step or single measure introduced in this evolution involved any dramatic or crucial changes. But their cumulative effect over time did change the operation of the economy. Whatever the motivation and intention of the political decisions shaping this evolution they produced a stagnant labor market. Vast human resources are poorly used, and nations are significantly poorer than they otherwise would be. The petrification of labor markets caused by a long sequence of political decisions also endangers the future course of Western societies. Technological innovations—a necessary condition of rising wealth in our history—will increasingly evolve as a social threat in the context of petrified markets. Under the circumstances the resulting political decisions tend to obstruct the wealth-creating process even further. Proposals to lower the working time per week to 35 or 25 hours illustrate this point.

The evolution of labor markets, however important, offers just one strand to our theme about the wealth and poverty of nations. The government's fiscal operations deserve some attention in this respect.

In an investigation of the consequences of taxes and government expenditures on the pattern of resource allocation, it was estimated that the general welfare of the United Kingdom was lowered by about 8 percent. Thus taxes and most particularly expenditure patterns severely distorted the allocation of resources.

A reference also should be made to the rising tide of protectionism. The range of protectionist schemes has expanded and evolved in imaginatively subtle complexity. The rationale for and the welfare implications of protectionism have barely changed over the centuries. Protectionist policies continue to redistribute wealth, benefiting *special groups at the expense of the rest of society*. The highly visible benefit of the favored group in conjunction with the widely dispersed—and thus less visible—social costs misleads politicians and publicists into believing that protectionist institutions increase general wealth. The redistribution produced by such policies is typically associated with a comparative social impoverishment. The ideology and illusion of protectionism as a necessary condition for fostering wealth creation permeates France, South America, and influential groups in many other nations.

Conclusion

History demonstrates, analogously to biological experimentation via mutation, an endless experimentation with social organizations and associated cultural terms, attitudes, and values. These organizations yield very different survival characteristics in competition with other social groups. They also determine the long-run chances of rising wealth or entrenched poverty and disease. The intentional, and frequently unintentional, evolution of the sociopolitical institutions decisively determines, ultimately, the conditions of poverty or wealth creation irrespective of the evolution's motivating conceptions. The role of political structure, represented by the state and its apparatus, thus deserves careful and intense attention in this context. The illusion is widely held that the state produces wealth, and, more particularly, that little wealth will be created without the detailed and controlling intervention of the state.

Another illusion dominating our time and well represented among the Christian churches holds that government intervention addressed to massive redistribution cannot affect the incentives guiding the social process of wealth creation. The translation of moral fervor "to help the poor" into institutional arrangements that lower opportunities and entrench poverty is one of the saddest ironies of our age. It is a small step from such beliefs to the view, implicit in the legal

thesis of "tax-expenditures," that all wealth really belongs to the state and is conditionally and revocably leased to individual agents.

Our discussion reveals the nature of the misconception asserting a *direct* productivity of the state. The state is not a producer of wealth. It shapes *conditions* that encourage the creation of wealth. But it also frequently represents political institutions that impede expanding welfare. The state can, and frequently does, obstruct the wealth-creating process and contributes to sustained poverty. Its wealth-impeding activities yield an economic rent to a small group with access to the sociopolitical institutions. The emerging social organization of Western societies will thus determine whether a nation accumulates wealth or persists in poverty.

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