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Can the Tide Turn?

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Given that we are here to celebrate a work that is bereft of equations and charts, I thought I would try and emulate it in spirit by offering some reflections on whether the tide in favor of free markets can turn. If you are interested, however, I can point you to some empirical work that forms the basis of these reflections.

The second half of the last century seemed to have settled the debate over economic systems. Natural experiments like the one in Korea—where the South espoused capitalism and moved from underdeveloped to developed country status in a generation while the Socialist North descended into starvation and destitution—seemed to deliver a clear verdict: Capitalism is by far the best system for the production of wealth.

Yet, ironically, while capitalism has fattened people's wallets, it has made surprisingly few inroads into their hearts and minds. Many of the people taking to the streets against globalization are protesting against capitalism, which they accuse of oppressing workers, exploiting the poor, and making only the rich richer.

The tide can turn and markets can become shackled again. To prevent it from doing so, we have to understand why there was a wave in favor of free enterprise across the world toward the end of the twentieth century. We have to ask which of the then-favorable factors can change. And we have to use this understanding to prevent a reversal. Let us start by sketching why free enterprise has such a difficult time in so many parts of the world.

THE FORCES AGAINST ENTERPRISE

There is a growing consensus that for free enterprise to flourish, it needs a set of enabling institutions—a conducive legal environment, a decent super-

visory and regulatory infrastructure, a reliable accounting system, etc.

In fact, recent work by Rodrik, Subramanium, and Trebbi (2002) suggestively entitled "Institutions Rule" shows that more than trade, more than geography, institutions seem to be the strongest factor in determining levels of per capita GDP. An increase in the level of institutions (as determined by an index for respect of property rights and an index for rule of law) from the level in Bolivia to the level in South Korea would be correlated with an increase in GDP per capita of 6.4 times, roughly the difference in GDP levels between the two countries.

The focus on institutions is not new; there is a long tradition dating back, at least, to Locke and Hume. What is refreshing, however, is that it is spilling over more and more into the policy debate and into popular work.

One example is Hernando de Soto's book *The Mystery of Capital* (2000). De Soto offers a simple explanation for why the poor do not have access to credit in developing countries. The answer, according to him, is that the poor do not have access to credit because they do not have official title to their properties. If slum dwellers could use the huts in which they live as collateral, they could borrow enough to set up small businesses and escape poverty.

The problem, according to de Soto, is that many of the poor are squatters and governments do not recognize their rights. Moreover, even if the poor have legitimate claims, obtaining title to property is prohibitively long and expensive. Finally, titles are often not enforced. Without well-enforced property rights, an arm's-length credit market cannot function and the poor become captive to moneylenders who exploit them.

While de Soto identifies an important problem, the lack of clear title (and, more generally, the fact that the poor have to work in an underworld without any formal structures supporting economic activity) is part of a greater problem. Even in countries where the poor have clear title, they are prevented from borrowing by laws that effectively discriminate against them.

For instance, in some U.S. states, individuals can file for bankruptcy and retain significant assets, including a home as a "homestead exemption." While such laws seem intended to benefit the poor, who would otherwise be homeless, a study by Gropp, Scholz, and White (1997) shows that they have the opposite effect. The law effectively deprives the poor of the ability to use their single biggest asset, their home, as collateral, since lenders know they can no longer seize the asset.

Moreover, asset-based finance is just one form of borrowing. There are others. For example, widespread information-sharing networks among creditors allow borrowers to access finance on the strength of their past credit histories. First-time borrowers can also get financing because they pledge their continued access to finance as collateral. If a borrower does not repay, lenders will share that information and ensure the borrower is cut off from future credit. This is

sufficient deterrent that many borrowers continue paying, and knowing this, creditors are willing to lend. Many a small business has been started on the strength of unsecured credit card borrowings in developed countries.

That does not happen in many developing countries because information-sharing networks are underdeveloped. In fact, some countries have laws prohibiting the sharing of borrower information. Again, this has the effect of hurting the poor.

But even if we agree that underdeveloped institutions are the cause for disparities in income, there is the deeper question of why institutions are underdeveloped. At one level, the answer has to be found in politics because institutions are political. But why does politics play so differently across countries?

A hint to the answer comes from an influential World Bank study inspired by de Soto's early work. It finds that in Peru, the number of days it takes to satisfy all the permissions needed to start a new business is over 171. By contrast, the number of days it takes to obtain all the permissions to start a new business in Canada is two, and in the United States it is seven. In our own work, we have found that countries where financial markets are underdeveloped (and thus access to credit restricted) are also countries where the number of days to start a new business is high. In other words, the lack of access to credit is a barrier to entry much like the permissions needed to open businesses.

There is a deeper and broader pattern here than simply the lack of recognition of customary property rights—there is a concerted effort to limit widespread access (and not just for the poor) to markets, either by actively creating impediments or by leaving the necessary infrastructure underdeveloped. It is necessary to understand why this pattern exists in order to propose solutions.

Our Explanation

Our explanation is simple. In many countries, powerful elites oppose widespread access to markets. They have the political clout to erect direct impediments like mandatory permits to open a business or indirect barriers like an inadequate infrastructure. The reason for their opposition is obvious. These elites already get what they need from the limited markets that exist. They stand to lose if access to markets became freer and they faced competition. As a result, ordinary people never see true free market capitalism, which implies competition and equal access. They only experience the failed version, which destroys hope. Unfortunately, both systems get tarred with the same brush, and capitalism is seen as a system of the rich, by the rich, and for the rich.

All we are suggesting is a general tendency, not an ironclad law: When markets start out limited, those who already have access often have very different incentives from those who don't. If, as is likely, the former are more politically powerful because of the wealth they obtain from their privileged access to

markets, they can ensure the government does not create the conditions for wider access. Of course, they may not need to campaign actively against market-friendly infrastructure. The government may simply not be interested in the welfare of the commoner, and the politically influential and conscious classes may not see fit to change matters. Neglect can be as effective as overt opposition.

Of course, this begs the question of why initial conditions are such that only some have access. One answer may lie in historical origins. An intriguing study by Acemoglu, Johnson, and Robinson (2001) starts with the idea that the propensity of European settlers to settle in areas they colonized is negatively correlated to the extent of settler mortality rates in those areas. Not surprisingly, Europeans did not flock to areas where yellow fever and malaria were endemic, preferring to send a few overseers who could keep the more adapted locals in check. Governance was more exploitative and hierarchical in those colonies and created a small group of elite ruling over a much larger group of natives. Acemoglu, Johnson, and Robinson find a correspondence between the current quality of institutions and settler mortality. The channel may be because there was a natural creation of elites in those countries.

Similarly, one could argue that even if settler mortality in parts was low, a large local population would make it hard for many new settlers to enter. So the colonization of a country like India had to proceed through the creation of local elites who would owe allegiance to the colonizer. These elites would continue to dominate long after the departure of the colonists and the coming of independence and democracy. Gandhi's greatest fear was that the white sahib would give way to the brown sahib, and in many countries that fear has been realized.

Let us summarize our arguments. Our point is that the absence of infrastructure supporting markets in much of the world is not because developing countries do not know that well-defined property rights and transparent contracting environments are of vital importance. In only a very few countries is it because the country does not have the physical or human capital to build infrastructure. In many more, it is because there are too many interests against the building of the right infrastructure.

No wonder, then, that the poor around the world see markets as being against them, not realizing that what they experience is a very corrupted version of the markets we experience. That the elite tend to have disproportionate say in the running of markets is actually a point on which the right and the left agree—one of the few places where Chicago economist George Stigler echoes Karl Marx. But the left is wrong in saying that markets need to be replaced by the government, for that will just perpetuate the capture by the elite.

And the extreme right is wrong in saying we can dispense with the government: The absence of government can also be anticompetitive and retard free markets.

Consider another example. If you wanted to fly and there were no super-

visory authority in the airline industry and no regulations enforcing safety standards, you would be very reluctant to fly fledgling airlines. You would prefer the established ones that had the track record and the reputation. So a complete lack of safety regulations in the airline industry would favor established firms, making entry impossible and killing competition.

What we need, therefore, is a Goldilocks government, not too interventionist and not too laissez-faire, a government that is just right. The difficulty with this Goldilocks position is, of course, in implementation. If we recognize that the government is controlled by special interests, how can we hope it will create just the necessary infrastructure for wider markets without constantly interfering in their working? It is naïve to assume that money will stop mattering in politics, no matter how much electoral reform takes place. The challenge then is to get the elites behind markets rather than against them, for them to see that opportunities from expanded markets outweigh the increased competition.

HOW DID THE TIDE TURN?

Somehow, this has happened in the last three decades. Markets have been spreading. Why have politicians in countries as diverse as France and Germany or Korea and India embraced the market and attempted to provide the governance markets need? It is difficult to imagine that politicians have suddenly become more public spirited. The answer, we believe, is that the interests of the elites have changed with the opening of borders to goods and capital. This has made domestic elites press their politicians to enact market-friendly legislation.

The effect of open borders can be clearly seen in the Indian automobile industry. In the mid-1980s, the industry was protected from foreign imports. The result was that consumers had a choice between just three car models, and only one if they wanted a big car. The cars were obsolete gas-guzzlers, unchanged in design for decades. (The biggest car, the Ambassador, had been designed in England nearly forty years before.) Nevertheless, the car-starved public was willing to wait for years to be allocated one of these monstrosities. The rationale for not allowing foreign producers into India was, in part, that the domestic manufacturers would be wiped out if the market were opened up, and in part that cars were frivolous luxuries and there were more important goods for consumers to spend on. The truth was that producers were being pampered at the expense of the consuming public.

In the early 1990s, following a financial crisis, the Indian government opened the car market to foreign producers. The worst fears of the domestic producers were realized. The public abandoned them for the new foreign models, and the old manufacturers were wiped out (though since then the Ambassador has rediscovered a market as a “period” car in the West). But it simply did not make sense for the foreign manufacturers to continue sourcing their sub-

assemblies from outside India. Instead, they started developing local auto ancillary manufacturers and gave them the technological assistance to become world-class. Soon India started exporting ancillary automotive products to the developed world.

The story does not end here. An Indian manufacturer, Telco, capitalizing on the existence of world-class suppliers of ancillaries in India, started producing a state-of-the-art, indigenously designed car, the Indica. The car had teething problems at first and was rejected by a now-discriminating public. But Telco engineers went back to the drawing board, fixed the flaws, and brought out a new version that swept the market in its category. From about 50,000 cars in the early 1980s, India now produces over 600,000. Next year, it is slated to export 200,000 cars, many to the developed world. The automobile ancillary industry grew by 20 percent in sales last year and by an average of about 10 percent in the decade before that. The Indian automobile industry offers an example of what trade liberalization can bring—potentially some pain in the short run, but enormous gain in the long run.

In sum, as borders open up to the flow of goods and capital, incumbent firms now need well-functioning domestic markets so they can take advantage of the opportunities provided by the global market, as well as meet foreign competition head-on. The prospect of increased domestic competition matters less when firms are fighting on the world stage. They now back, rather than oppose, domestic markets. Put differently, competition between economies through open borders forces politicians to enact the rules that will make their economies competitive. This typically means enacting market-friendly legislation and making markets accessible to all.

This is not to say that open borders force a bland uniformity on everyone, a golden straitjacket, in the words of Thomas Friedman. Instead, they persuade governments to find the best path for their own peoples. In some countries, that might mean sixty-hour workweeks with high pay and low benefits; in others, it might mean thirty-five-hour weeks with lower pay and lots of benefits. The point, however, is that the package of work, productivity, and pay has to be competitive, which means meaningless and harmful rules have to wither away.

CAN THE TIDE TURN?

We have suggested that a primary factor in the growth of domestic markets and free enterprise across the world was the progressive opening up of borders. Clearly, other factors were also at work.

In particular, the ideas of Milton Friedman, Friedrich Hayek, George Stigler, and others of the Chicago school of economics offered a respectable alternative to Keynesian economics, which held sway in the higher echelons of economics after World War II. And unlike an increasing number of their

academic confreres, these economists did not shrink from addressing the public directly. Milton and Rose Friedman's *Free to Choose* and Friedrich Hayek's *Road to Serfdom* were popular successes (the latter after selling slowly initially) and did much to persuade generations of young people of the perils of excessive government.

Despite the widespread impact of these ideas, it would be too simplistic to couch the tide toward free enterprise toward the end of the twentieth century as simply the consequence of politicians and the public becoming convinced of their truth. If nothing else, the timing is not right. Hayek wrote his searing critique of the managed economy, *The Road to Serfdom*, in 1944, but it was only with Margaret Thatcher's accession to power in 1979 that a major government was willing to espouse his ideas. The Friedmans' oeuvre was closer in time to the presidency of Ronald Reagan, but it reflected a lifetime of ideas for which Milton Friedman had already won a Nobel Prize.

Instead, it is better to think of changes in economic attitudes as a consequence of the fortuitous combination of ideas, events, and interests, with each playing its own part. The stagflation experienced by developed economies in the 1970s was important in forcing economists to look to new ideas. With the breakdown of the Bretton Woods system, the United States, pressed by its bankers, put its weight behind making borders as open to the flow of capital as they were becoming open to the flow of goods. In turn, this unleashed competitive forces that gave domestic governments and business groups strong incentives to improve the competitiveness of their economies. That the tide was not just driven by ideas is suggested by the fact that the Socialist government of Francois Mitterand turned in the span of a few years from nationalizing enterprises to privatizing them.

This is not to say that ideas do not matter—the existence of a coherent and respectable alternative to the Keynesians in Chicago was critical in giving sympathetic politicians ammunition and in persuading the larger public. But to think that ideas are all that matter is to foster dangerous complacency. For if the expansion of the free enterprise system did not solely reflect the supremacy of the ideas behind it, those ideas may not be enough to preserve its position. Interests and events may, unfortunately, now be moving in less propitious ways. Start first with interests.

Interests

We have argued that open borders have been instrumental in increasing competition. This has forced domestic elites to create market infrastructure and expand access to goods markets and finance to everyone. Of course, the decision to open borders is itself political. It has been an easy one in recent years because the largest economies in the world, foremost among them the United

States, have become more open. Not only has this provided more opportunities for other countries that open up, it also has made it harder for countries to remain closed because with the world largely open, goods and capital can leak easily across a closed economy's borders. However, this means that open borders are hostage to the intentions of the largest economies. If they become protectionist and turn inward, smaller economies will follow. The closing of borders will weaken pro-market interests and strengthen anti-market ones.

Open borders are especially under risk in times of downturn, when the foreigner and his goods become an easy political target. But recent developments may make developed countries less willing champions of open borders: Typically, as developing countries have been persuaded to open their markets in return for developed country market access, there has been a stable political outcome. The developed countries take the high-skill, high-knowledge, high-capital-intensity end, while developing countries take the low end. Eventually, developing countries move up, but in the initial phase the high-intensity industries in developed countries, which are typically more politically powerful in their own countries, see gains and push for more openness. The result has been a strong impetus for freer trade.

Survey evidence shows that in the past, workers in nontraded industries used to be strong supporters of free trade. The big change now is that many sectors that used to be nontraded are now becoming traded. An accountant in the Philippines can now do your taxes via the Internet as effectively as someone from H&R Block across the street. The service sector in developed countries is especially unaccustomed to such competition and can react forcefully. This may alter the balance of forces for free trade, even in developed countries. Already some states in the United States are threatening to blacklist businesses that outsource processes to other countries.

The attitude of the world's largest economy is particularly important in determining whether protectionism will come to dominate the world over. And this country has sent mixed signals in the recent past. The steel tariffs were followed by enhanced farm subsidies. Politicians are entering the fray with complaints about unfair trade practices in China. More restrictions may be on the way.

Trade protectionism is particularly detrimental to capitalism elsewhere because it undercuts strong constituencies for free markets in other countries and prevents those borders from opening up fully. And if unchecked, other countries will take an eye for an eye, making the whole world eventually go blind.

Events

Corporate scandals have not helped. One of the reasons people in this country tolerate the enormous inequalities in income and wealth, say, relative to Europe, is because there is a perception that markets are fair and success is

accessible to all. Corporate scandals suggest that the CEO, his investment banker, and their friends play on a different playing field than the ordinary pensioner. The danger is that ordinary people might get disillusioned with reform and shift their support to demagogues who seek to sandbag the market. Equally bad would be if the reforms get hijacked by special interests that use the turmoil to carve out their own little privileges. Sarbanes–Oxley, intended to strengthen corporate governance, is viewed by some as the Big Accounting Firm Profit Restoration and Protection Act of 2002 because of the central role it implicitly accords to the Big Four accounting firms.

More generally, these scandals have given the free enterprise system a bad name across the world. The actions of one company, Enron, have done more to persuade the modern youth of capitalism's evils than the myriad unread(able) texts of the doctrinaire radical left.

In sum, interests and events are coalescing again but, unfortunately, in the wrong direction. As developed country governments become less sure of the cause of free markets both from the perspective of their own interests and as a moral imperative, less economically sophisticated groups take over the debate. Emotions now prevail over evidence. Misguided activists persuade developing country governments that their instinctive mercantilism and opposition to free trade are not just economically sound but also the right response for their own people. With no one championing the cause of free trade, debacles like Cancun are the unfortunate consequence.

With events and interests not cooperating, it is important that we turn back to ideas to strengthen us and to prevent the tide from turning. We need to marshal the wealth of evidence we have on the benefits of trade and engage dissident economists and demagogic activists in fruitful dialogue, instead of letting them dominate the public arena. We need to persuade the public that corporate scandals are aberrations that can be fixed rather than the norm in a system of free enterprise. We need to combat the drift in these dangerous times of reposing our faith in the government in all arenas.

But we have an example of how this can be done. Milton Friedman's life offers us a guiding beacon on how ideas can be used to hold back the power of events and interests. Let us learn from him, because the battle needs to be fought over and over again.

CONCLUSION

The developed world needs markets to grow in the developing world, not just because unrest in the latter leads to swarms of economic refugees into the former, nor just because aging, retired populations in developed countries will have to depend increasingly on productive young populations in developing countries, nor even because those markets will absorb developed country goods

today. The developed world needs a more open, competitive developing world because that is the best guarantee that capitalism in the developed world will stay vibrant, with capitalists motivated more by the opportunities for growth than by the fear of competition. We cannot let the tide turn. Instead we have to continue to break the shackles holding back markets the world over. On that depends our own future.

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