CATO Policy Report

May/June 1998 Vol. XX No. 3

The Causes of Economic Growth

by Reuven Brenner

Peter Bauer, the noted development economist, is flanked by Walter Williams of George Mason University, Steve Hanke of Johns Hopkins, and Cato's James A. Dorn at a Book Forum for *The Revolution in Development Economics*, edited by Dorn, Hanke, and Alan Walters.

Politicians and economists promise growth, prosperity, and higher standards of living. What do they mean by those terms? Is there some objective measure by which to judge whether people in a particular society, or in the world, expect technological and political innovations (including fiscal ones) to be beneficial and lead to the creation of more wealth? How can we be sure that a financial innovation, a change in company strategy, or a change in government policy makes a society better or worse?

The answer is that changes in the total market value of firms (the market value of debt and equity) in a society added to the market value of its government's outstanding obligations would be the best estimate to use in making such judgments—once financial markets are deep and transparent. When this sum increases, it means that the society's ability to generate revenues and pay back debt—whether private or public—has increased. And the contrary: when this sum drops (measured in terms of a relatively stable unit, rather than a particular currency), people signal that either their government or companies' management is making and persisting with erroneous decisions. The reason is simple: Developed, relatively unhindered financial markets prevent persistence of mistakes. By so doing, they quickly redirect the use of capital and ensure that savings and capital are deployed more effectively.

When the aforementioned sum diminishes, where does the wealth go? That depends. The smaller the ability of capital and people to move, the more their diminished value can be viewed as a permanent loss. Those things that are expected to be solid—the effort and ingenuity of people—melt into thin air. More mistakes can be expected, and their effects can be expected to last longer. The decrease thus reflects diminished expectations of generating future revenues (since every mistake is a cost). Generating future revenues is what "growth" and the ability to pay back debt mean. When capital and people move, though, the wealth that disappears in one country reappears in others.

There are few better examples to illustrate those points than the wealth created by the various diaspora of history—Armenians, Chinese, Huguenots, and Jews—as well as the poor emigrants from Europe, who built the newer continents. (Few of the rich left Europe.) The emigrants were driven out of their homelands by politics and regulations. Let us briefly look at how the movement of the most gifted and energetic of those peo-

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ple led to many of the world's economic "miracles."

Facts behind Miracles

The Cinderella stories of poor or impoverished societies suddenly leapfrogging others have provoked admiration, envy, and intense discussions about why the outdone stumbled, and the humbler rose. The riches of oil-producing Middle Eastern countries did not provoke such discussions because those countries fit the "finding treasure" pattern. But how do societies do it when they not only lack any particular natural resources but even suffer from disasters? Can other countries emulate them and achieve similar high growth rates?

The miracle of 17th-century Europe was neither Spain nor Portugal—both of which fit the "finding treasure" mold—but below-sea-level Amsterdam and Holland, whose riches were created despite natural obstacles. Later there was West Germany, rising miraculously from the ashes of World War II. There were some Asian miracles that deserve our attention, such as those of Hong Kong and Singapore. And there was the almost forgotten example of Scotland, which teaches a particular lesson.

What's common to all those miracles? The Dutch were the first European republic, both tolerant toward all religions (when the rest of Europe was still severely discriminating against many) and with sound rights to property, which opened opportunities for relatively unhindered trade and financial innovation.

But it would be misleading to say that "the Dutch" did it. The openness of the new republic attracted to Amsterdam well-connected and educated immigrant merchants and moneymen (bankers from northern Italy); Jews and Huguenots, discriminated against elsewhere in Europe, were prominent among them. They helped turn Amsterdam into the financial and trading center of the 17th-century world. It had the world's first stock market, where French, Venetians, Florentines, and Genoese, as well as Germans, Poles, Hungarians, Spaniards, Russians, Turks, Armenians, and Hindus traded not only in stocks but also in sophisticated derivatives.

Much capital active in Amsterdam was foreign owned, or owned by Amsterdammers of foreign birth. There was "globalization" during the 17th century, even if nobody bothered to use the term. The difference between then and now, of course, is largely the speed of information flows. Max Weber didn't bother to look at migratory patterns when he came up with his speculation that somehow religion—the Protestant ethic—had much to do with Amsterdam's spectacular success. Although Weber's idea has been quoted frequently enough to pass for fact, it wasn't true in Amsterdam or in any other prosperous trading cities or states. Educated and ambitious trading immigrants, with networks around the world, turned 17th-century Amsterdam into a "miracle." And the same factors have been behind other miracles as well.

The histories of Hamburg, Hong Kong, Singapore, Taiwan, and West Germany have much in common with Amsterdam's, but shared religion is not a factor. In each of those places, the state provided an umbrella of law and order, exacted relatively low taxes, and gave people a stake in what the business society was doing—thereby attracting immigrants and entrepreneurs from around the world.

Sir Stamford Raffles designed Singapore as a port at the beginning of the 19th century, and backed it with an administrative and legal system and an educational system that was open to the whole multiracial population. Trade and security brought prosperity to the penniless immigrants from Indonesia and, in particular, China. Taiwan (after the 17th century), Singapore, and Hong Kong offered immigrants opportunities denied them in China, which was dominated at first by warlords and a status-conscious bureaucracy and later by a communist bureaucracy. Hong Kong benefited from waves of immigrants from China, in particular from the inflow of Shanghai merchants and financiers when Mao Zedong "liberated" China in 1949—much as Amsterdam rose to prominence when merchants and financiers fled the Iberian peninsula in earlier centuries, when the Huguenots fled France, and when Jews fled from many parts of Europe.

Hong Kong's textile and shipping industries were initiated by immigrants from Shanghai. Those people also established a network of merchants, traders, moneymen, and manufacturers—as Jewish, Italian, Armenian, Parsee, and other immigrant groups did throughout history in various parts of the world.

The Marshall Plan

The post–World War II West German miracle fits this pattern too, though in popular memory its success is associated with the Marshall Plan. The impact of that aid has been greatly exaggerated. Historians and economists (subsidized by governments) are very good at creating and perpetuating myths. At times the myths are about nationalism, falsely suggesting that economic miracles have been due to the genius of people living within arbitrary national borders. At times they are about the extremely beneficial roles of foreign aid. Both types of myth conveniently justify increasing the power placed in the hands of government.

Economists have estimated that, from 1948 to 1950, Marshall Plan aid was between 5 and 10 percent of European gross national product, although those numbers are dubious. European statistics from that period vastly underestimate national incomes because of extensive black markets due to price regulation and confiscatory taxation. There were, after all, no miracles in Europe after World War I, when loans and aid to Europe were also estimated to amount to roughly 5 percent of its GNP. True, the world moved toward lower tariffs after World War II, which it did not after World War I. The correct inference would seem to be that miracles are linked with lowered tariffs rather than foreign aid.

So what fueled the West German miracle? From 1945 to 1961, West Germany accepted 12 million immigrants, for the most part well trained. About 9 million were Germans from Poland and Czechoslovakia. Others fled East Germany's communist paradise. Although the movement of that human capital did not appear on the books at the time, its importance can be inferred from the significantly higher ratio of working persons to total population in West Germany than in other countries in the 1950s and 1960s: 50 percent in Germany vs. 45 percent in France, 40 percent in the United Kingdom, 42 percent in the United States, and 36 percent in

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Canada. And when the European inflow stopped, new waves of skilled young employees arrived from Mediterranean lands. In other words, the West German miracle was due, not to foreign aid, but to the same features that brought about earlier and later miracles elsewhere: migration of skilled people and significantly lower tax rates.

The Scottish Miracle

The Scottish lesson, rarely mentioned in history books, shows what else can be behind economic miracles. Scotland in 1750 was a very poor country. The land was of poor quality, and illiterate people engaged in near-subsistence agriculture; there were no navigable rivers; barren mountains and rocky hills hindered communications. The main export at the time was processed tobacco. Yet, less than a century later, Scotland stood with England at the forefront of the world's industrial nations; its standard of living was the same as England's, whereas in 1750 it had been considerably lower. How did the Scots do it?

The Union of 1707 made Scotland part of England. It came under England's system of taxes, laws, and currency and was allowed access to English markets. The union also abolished the Scottish parliament, leaving Scotland without a distinct administration until 1885. That turned out to be the biggest blessing (reminding one of Hong Kong's later success under distant British rule), as it prevented the banking system and financial markets from becoming an instrument of government finance. The result was a financial market that developed in response to the demands of the private economy.

By 1810 there were 40 independent banks. The orthodoxy of the times held that banks should lend only if the loans were backed by the security of goods in transit or in process, and for no more than 90 days. In contrast, the Scottish banks were free to lend for unspecified periods of time with no tangible securities. The credits of Scottish banks thus became the precursors of junk bonds.

Bills of exchange, the main assets of banks in other countries at the time, were the least important for Scottish banks. The largest volume of loans was made to manufacturers and merchants who received credit backed only by their own signatures with two or more people as sureties. The banks flourished with tiny reserves and made irregular financial reports.

The Scottish financial historian A. W. Kerr captures the specific feature of the country's financial markets: “The comparative immunity from legislative interference which characterizes banking in Scotland until the year 1844 has been an unmistakable blessing to the country, and has saved the banks from those vexatious and unnecessary distinctions and restrictions which have hampered and distorted English banking. In Scotland, banking was permitted to develop as the country advanced in wealth and in intelligence. Nay, it was even enabled to lead the nation on the path of prosperity, and to evolve, from practical experience, a natural and healthy system of banking, which would have been impossible under close state control similar to that followed in other countries.” The country showed how, starting from scratch, to become prosperous quickly through trade and finance, unhindered by tariffs but covered by a reliable English political and legal umbrella. (Adam Smith was a Scotsman, you know.)

Contrast Scotland in that period with France, where a great majority of requests for charters for financial institutions were rejected until 1857. Only a severe depression that year led to the liberalization of procedures. Yet even in 1870, banking services in France were not what they had been in Scotland at the beginning of the century, and regulations denied small industrialists access to credit.

Scotland stands out, not only for its unique banking system, but also for the emphasis it put on education. In a piece titled “The Output of Scientists in Scotland,” R. H. Robertson presents the relevant statistics. The output of “outstanding Scottish scientists” was at its height between 1800 and 1850 and diminished rapidly after 1870. The reason? The most brilliant Scots migrated—and there was no more Scottish miracle.

Scotland's relative decline in the 20th century has been correlated with the increasing assimilation of Scottish education and banking practices to those of England (the assimilation of banking starting slowly in 1845). If a large fraction of a region's most energetic and brightest people are allowed to migrate, and the access to credit of those who remain is constrained, what can one expect but decline?

There are other lessons to be drawn from the Scottish case. Savings were certainly not a precondition for the prosperity of the Scots. They did not have any to speak of. Nor did they receive foreign aid. But once opportunities were open and financial markets developed relatively unhindered, not only did the Scots save, but their savings were put to good use. In Scotland savings moved to private enterprises, whereas in England and elsewhere they went to governments. No state interference was needed to encourage the Scottish entrepreneurial spirit. In contrast to the previously mentioned miracles, there was no large-scale movement of talent from around the world to Scotland. However, the miracle did end with the emigration of Scottish talent, more regulated financial markets, and higher taxes.

What Are the Lessons?

Human creative sparks are always there, probably randomly distributed around the world. Prosperity, though, is due not to new ideas but to the commercialization of new ideas. And the incentives to commercialize ideas depend on taxation and access to financial markets.

The great advantages of private financial markets are that they decentralize decision-making and prevent persistent mistakes. Thus, when small-scale enterprises meet financial tests, they expand. If they fail, the loss to society is much smaller than it is in the case of failed grandiose government-sponsored projects—which frequently are not allowed to fail.

Continued spending on such projects is justified by a large army of government-sponsored economists, the priesthood of our times, who never fail to come up with half-baked theories of market failures to be remedied by smart, altruistic government regulators and bureaucrats. The result of this myth creation is that good money is thrown after bad.

Economists in the future may estimate exactly how much of the spectacular performance of the U.S. economy since World War II can be attributed to the large movement to America of extremely skilled, ambitious, well-connected people from around

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the world, a world that until 10 years ago was hostile to initiative and hope. Then we will know how much the transfer of that unmeasured human capital helped cover for many costly and mistaken U.S. government policies. What should be clear from the historical evidence is that when and if the rest of the world retains its talented people, the United States will no longer be able to count on attracting them to cover its costly mistakes.

Governments have a number of options for increasing growth rates. One is to offer a package of taxes and benefits that would attract more talent and capital from abroad. Because such policy may discourage growth elsewhere, it could lead to retaliations. A better alternative would be to encourage more domestic entrepreneurship. That can be done by lowering both income and capital gains taxes, which would rapidly both increase the sums of money people would be ready to invest as venture capital and speed up the redirection of funds toward financing entrepreneurial ventures. Both effects would lead to greater efficiencies—squeezing out mistakes (and thus costs) that prevent higher growth rates.

How best do we put numerical values on wealth creation? Certainly not by government statistics that reflect mismeasured, backward-looking aggregates. The most reliable measure is instead the significant changes in the value of market securitizations—measured in a relatively stable unit of account, gold, rather than a floating paper unit. That is because the opinions of a wide variety of people who back their opinions with money have proven to be a better predictor of where things are heading than are the opinions of all those who do not.

Changes in the aforementioned value are not a perfect indicator of things to come. Nothing is. But they are a better and more reliable measure of wealth creation than are the alternatives. The one important caveat is that financial markets must have the proper depth. That is, security markets must be able to reflect expectations about the policies of government and the central bank, whose laws, policies, and regulations affect the management of companies. When there are few sources of information in a society, or if information is controlled and the players' hands are tied, the stock exchanges will not fulfill their roles. Without proper depth, they will become decapitalized.

Societies that, for political reasons, put impediments in the way of information—as China did when Xinhua, the state-run central news agency, set restrictions on all aspects of Dow Jones's business in the country—will see the same wild fluctuations on their stock exchanges that New York's exchange saw a century ago, before the Dow Jones newsletter and the innovation of annual reports. When that happens, neither security markets nor official statistics will tell us much about what is happening to growth and wealth creation. Remember: on paper, countries were growing wonderfully under communism, but those of us who grew up under communism all knew that political statistics about growth were all one great lie.

The Pseudoscience of Macroeconomics

Though the pseudoscience of macroeconomics was a myth and not a lie, it left in its wake devastating wreckage, unpleasant surprises, and a confusion of confusions. Why did it become a myth? The emphasis on national aggregates hid the reality that in one country things that people wanted were being measured, whereas elsewhere things that the rulers and the establishment wanted were being measured. The fact that behind the aggregate counting there was, initially, a strong assumption that the relation between governments and citizens is, as in a private transaction, based on an exchange of services, was soon forgotten. The macroeconomic models, summarizing the working of the economy in a few simple-minded equations, have led to the same predictions whether "production" and "output" refer to something disastrous or something positive.

Since employment by governments and governments' "output" have been added, respectively, to employment and to whatever was produced in the nongovernment sector—and since there are good reasons, although not macroeconomic ones, for governments to intervene at times to do constructive things—it is no wonder that government expenditures were found to create both jobs and output. By using those numbers unquestioned, economists transformed, with the help of extensive government subsidies to bureaus of statistics and to academics, a self-serving political idea into a neutral-sounding "scientific" debate about numbers and statistical methods, keeping political institutions out of sight. Macroeconomics thus became a nonthreatening theory that could be taught at many universities around the world.

The students became teachers and continued to try to understand the myth of macroeconomics and the illusion of comprehensible national aggregates. By the time some of them noticed that the emperor had no clothes, they may have faced the dilemma of the astronomer Kepler, who, although not believing in astrology, wrote treatises about it because the monarchs paid for them.

Economists have had either to do as he did and disguise their true beliefs or to drop out of the "scientific" enterprise. The mediocre economists have stayed and sustained the enterprise unquestioningly, writing most of the "scientific output," checking it, publishing it, and insisting that everyone should go through channels controlled by them. That is how false ideas have always been turned into "science."

To conclude, the broadest historical evidence suggests that prosperity would be hindered less if governments just created the institutions that make it possible for entrepreneurship and financial markets to flourish. We can be confident that the idea that governments can frequently do more than that is a consequence of government-subsidized myth creation. ■

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