Economic Freedom: Prosperity and Social Progress

By

Jagdish Bhagwati

*This is the text of the Keynote Speech delivered to the Conference on Economic Freedom and Development in Tokyo, June17-18 1999.

Introduction

I am delighted to be back in Japan, especially in Keidanren where I have spoken many times before. In the Preface which I wrote for the Japanese edition of one of my many books in Japanese translation, I said that there were three countries I felt special affinity to: India where I was born and raised, the United States where I have migrated and work, and Japan (which I visited in 1961 for over a month for the Indian Committee of Wise Men on Indo-Japanese cooperation and where my Japanese counterpart for the Japanese Committee was Koito Saburo and) whose literature, films and culture I greatly admire.

This is a good time to visit Japan because of the economy's performance in the last quarter which, after a protracted stagnation and even decline, has been rather good. If your Shinto gods are kind to you, you will have another such quarter and will finally snap out of the last two years of recession. But today, I will want to talk of "long-run" issues.

In particular, the theme of my talk today is economic freedom and development. And that topic too is timely because I believe that Japan is ready to enter into an era of deregulation. A movement toward deregulation has been expected, or rather hoped for, for a long time now; and it seems that the recession and Japan's brush with a "missing decade" of development, have now begun to provide just the sense of crisis that is often necessary to get a country moving towards economic reforms.

Indeed, around the world, you can see examples where statesmen have been forced by crises into reforms, whether autonomously chosen or imposed aiding institutions such as the IMF and the World Bank that impose the necessary conditionality in the form of the ultimatum: "reform or we do not assist you". The latter is, of course, what developing and transition countries that wind up being basket cases face by way of the path to necessary reforms. The

former is what Japan, a leading developed country, must follow: using the longstanding crisis of stagnation to take autonomously the necessary reform path.

Interestingly, the Soviet case is a combination of both, starting out with Gorbachev's perestroika basket of autonomous reforms and then transiting to Western and INF conditionalities driving the course of reforms (with yet no end in sight). The reforms under Gorbachev were clearly driven by the recognition among Russian leaders that the economic model of central planning could not be continued without the Soviet Union being ground down into economic paralysis. This perception was, of course, bolstered by econometric and other scholarly studies of the Soviet experience which showed that the Soviet economic growth was steadily decelerating, with the huge investment rates producing steadily lower growth rates. The econometric estimates suggest two hypotheses, which both can tell the "story" with good fits: first, that capital accumulation was running into diminishing returns and second, that the overall productivity of all resources was winding down because of economic and political conditions and lack of incentives for production, investment and innovation.[1] No one familiar with the Soviet economy would choose the first explanation as Paul Krugman did in drawing, in my view, an erroneous parallel between East Asia (where the alarm at prospective diminishing returns made little sense anyway) and the Soviet Union in his wellknown Foreign Affairs article on the "myth" of the Asian miracle. Surely, the second explanation fit the Soviet Union better. And the reforms were prompted by the realization that the Soviet model, with its huge and growing adverse impact on the economy's performance, had to be abandoned. But the reforms did not

[1] Professor Padma Desai, the Soviet and Russian economics expert at Columbia University, has written extensively on the choice between these two explanations, in several professional journals such as the American Economic Review and in a long essay that provides the Introduction to her collected essays, The Soviet Economy: Performance and Prospects, Basil Blackwell Ltd.: U.K., 1995.

succeed, for a variety of reasons, and the Russian economic performance, now driven by conditionality (of varying effectiveness), has actually plunged even further!

To return to Japan, which must follow the autonomous change model (though there is no dearth of advice and admonition from outside), I will now proceed to consider the problem of economic freedom and economic prosperity or development in a broader framework than mere deregulation implies. Indeed, the question of economic freedom has now become nearly as important as the question of political freedom: and the relevance of either or both to economic prosperity and social progress is attracting much attention.

From the viewpoint of recent historical experience, particularly in the postwar period, it is not difficult to assert that economic freedom is likely to have a favorable effect on economic prosperity, for the simple reason that the last fifty years of international experience more or less confirms the fact that wherever governments used markets more and engaged in more open policies in foreign trade and investment, indeed in more economic freedom of different kinds, their countries have tended to prosper. By contrast, those countries that turned inward and had extensive regulations of all kinds on domestic economic decision-making in production, investment and innovation, are the countries that have really not done too well.

So now we also find that many developing countries, which used to follow the alternative non-liberal path and have not done well, have also begun to renounce their old ways and have turned to what can properly called "liberal" economic reforms, essentially freeing up the economy and the energies of their people, and embarking on rapid development.

So, I must say that arguing for more economic freedom is in this sense an easy task. At the same time, it is not really easy; or, better still, we should not treat it as if it was that easy. In

fact one has to make the case for liberalization, whether domestic or in the international spheres, in a nuanced and sophisticated way.

To see this most clearly, consider the fact that, alongside the demonstrated success of trade liberalization in the postwar period in raising incomes and even growth rates (a conclusion that few economists doubt today[2]), we have also the apparent failure of capital flows liberalization as epitomized by the 1994 Mexican peso crisis that engulfed both Mexico and my good friend and fine economist, the Finance Minister Jaime Serra, and by the far more devastating Asian financial crisis that came later. Indeed, with these financial crises, the public sentiment around the world, and certainly in Asia, has turned against globalization and its associated economic freedoms, i.e. against what we used to call the Liberal International Economic Order (LIEO) in contrast to the demands for the New International Economic Order (NIEO)in the 1970s in the aftermath of the OPEC cartel's success and the first flush, and indeed the last hurrah, of the false sense that the era of Commodity Power of the poor countries had finally arrived.[3] The recent mindless outbursts by all kinds of ill-informed groups against globalization and against capitalism and markets in the streets of Seattle at the November-December 1999 meetings of the WTO and then again at the April 2000 meetings of the IMF and the World Bank are in their own ways a replay of the apparently invincible demands against the very same sorts of liberal-economic approaches that fizzled out by late 1970s when exposed to the harsh realities of economic logic and sound commonsense.

---

[2] The only recent example of an economist with some reputation who writes against the efficacy of trade as an engine of prosperity is Dani Rodrik of Kennedy School at Harvard University. But an effective riposte to his arguments has been provided by Professor T.N.Srinivasan of Yale University and myself in a joint paper to appear in a festschrift volume in honour of Professor Anne Krueger and which is available on my website, http://www.columbia.edu/~jb38 .

[3] Cf. Bhagwati (ed.), The New International Economic Order, MIT Press: Cambridge; and Bhagwati and John Ruggie (eds.), Power, Passions and Purpose, MIT Press: Cambridge.

Economic Freedom: Two Aspects

I shall divide my remarks into two parts:

(1) Assuming away the international dimension of economic freedom, I will first discuss the key economic freedoms that are relevant, both under autarky and openness, to economic prosperity; and

(2) I will then address the international dimensions of economic freedom, distinguishing among free trade, freedom of capital flows (both short-term and direct foreign investment (DFI)) and migration across national borders.

1. Key Aspects of Economic Freedom in any Economy

Three aspects of economic freedom need to be emphasized:

- property rights;
- markets versus pervasive governmental intervention; and
- ability to procure livelihood outside the public/governmental sector, i.e. absence of preponderance of governmental employment over private employment or self-employment earning opportunity and ability to use it.

Let me make a number of observations on all these elements and on how and why they contribute to economic success.

(1) Property rights and markets provide a direct effect on economic prosperity: they provide the incentives to produce and allocate resources efficiently: a case that goes back to Adam Smith and the founding of economic science. Intellectual property rights (IPR) should also fall into this category from the viewpoint of the incentive to innovate; but they do not quite do

so, from a Benthamite perspective of maximum good to society. Why? Because we have a trade-off between gains from more innovation under IPR and gains from diffusion of given innovation without IPR. But, to my knowledge, few believe that the optimum IPR is zero; and so do few believe that it extends as high as the 20-year patent rule that was forced into the World Trade Organization (WTO) by the business lobbies!

The historical evidence in favour of the economic benefits of markets and property rights is to be found in David Landes's magisterial work, The Wealth and Poverty of Nations: Why Some are So Rich and Some So Poor.[4] Landes shows convincingly how Europe's success, and China's failure, in the perspective of the last millennium's winners and losers can be put down precisely to the fact that Europe, unlike China, embraced property rights and markets. Landes's arguments are supported also by the recent regressions-based arguments of Surjit Bhalla (who is on the Panel today) and of Robert Barro which relate to postwar experience instead.

(2) Again, economic freedom in the shape of property rights and the ability to earn income outside of government surely strengthens democracy (i.e. political and civil freedom) in turn because inability to find sustenance can cripple, at least seriously handicap, political independence and dissent.

So then, economic freedom also helps economic prosperity, not just directly, but also indirectly since economic freedoms, coupled with political and civil freedoms (which they aid as argued above), are in combination the most powerful engine for prosperity.[5]

(3) I should emphasize that economic freedoms can strengthen the quality of democracy

[4] Cf. Landes, Norton, 1998. Also see the review of it by me, "The Explanation" in The New Republic, May 25, 1998, being reprinted in my selection of essays, The Policy Paradox: Foreign Failures amidst Domestic Successes, MIT Press: 2000.

as well, and hence the quality of development. This is because their growth-enhancing ability can help pull excluded groups (e.g. women, the poor) into literacy, gainful employment, better health et.al. through, first, enhanced ability to finance public expenditures and second, through their direct effect on improving their incentive to achieve greater literacy and health as well.

The former effect follows from the fact that revenues will generally improve with greater growth, at any given tax rates. The latter effect is less obvious but as plausible. Thus, if opportunities grow as the economy prospers, so will the incentive of poor parents in particular to send children to primary school rather than to work: An effect which seems to have been demonstrated in India where the huge illiteracy rates during a quarter century of low growth rates seem finally to have been dented after growth rates picked up significantly in the 1980s. Again, since the efficacy of public health expenditures depends (in several cases)to some extent on the beneficiary's own financial ability to complement what is received gratis from health authorities, this complementarity also means that greater prosperity directly improves health.

Indeed the point is quite general. The efficacy of social legislation in general depends on economic prosperity. Consider social legislation saying that if you beat up your wife, you will go to jail. But if the wife cannot walk out on you and get a job in a stagnating economy, how is she going to be able to assert her legislated rights? In short, when economic freedom produces economic prosperity, it also tends to aid in the pursuit of social progress: sometimes, all good things do go together!

(4) Finally, let me say emphatically that the absence of economic freedom is an ally of corruption. True, corruption has many fathers. But the most fertile and fecund father is what Indians call a "permit raj", i.e. an economic regime where governments demand that permits be

---

[5] See, for instance, the Rajiv Gandhi Memorial Lecture on "Democracy and Development" in my essays, A Stream of Windows: Unsettling Reflections on Trade, Immigration and democracy, MIT Press: 1998.

procured to produce, to import, to invest, to innovate, to do almost anything! It needs no particular gifts to see that such an economic regime leads to cataclysmic levels of corruption; as it did in South Asia. It also corrupts even democratic and quasi-democratic regimes into "crony capitalism" as in some segments of the economy in Indonesia.

2. International Aspects of Economic Freedom

So, I turn now to the international aspects of economic freedom, or perhaps of the LIEO, and examine whether they add to economic prosperity. These are:

- free trade;
- free capital flows
- free DFI (direct foreign investment)
- free immigration.

At the outset, let me note that, while there are important similarities among them, there are also important asymmetries, both economic and political, among them. These asymmetries mean that, if we are to push for economic freedom on all these different dimensions, we need appropriate policies to do so and one suit will simply not fit all . Indeed, the failure to understand this central fact has led to avoidable downsides in policy steps taken to liberalize further the world economic system in the last decade.

Free Trade

I would say that, except for a few diehards, few today oppose free trade. In that sense, we free traders have won the war against the protectionists. Indeed, the case for free trade is now generally seen to be even stronger than that we have usually taught, from Adam Smith, now that we consider how it can lead to greater variety in consumption, greater use of scale economies in production, and even more efficiency because it can enhance competition and prevent

entrepreneurs from going to seed in sheltered markets. In addition, I have noted recently that trade, or outward orientation, can also explain why the Far Eastern economies managed to sustain high (and productive) investment rates whereas the protectionist, inward-looking countries like India had lower (and less productive)investment rates: the latter countries' investment rates were circumscribed by the growth of the domestic market which was inevitably limited in turn by inevitably low agricultural growth rates whereas the former set of countries

Indeed, the case for free trade is now generally seen to be even stronger than that we have usually taught, from Adam Smith, now that we consider how it can lead to greater variety in consumption, greater use of scale economies in production, and even more efficiency because it can enhance competition and prevent entrepreneurs from going to seed in sheltered markets. In addition, I have noted recently that trade, or outward orientation, can also explain why the Far Eastern economies managed to sustain high (and productive) investment rates whereas the protectionist, inward-looking countries like India had lower (and less productive)investment rates: the latter countries' investment rates were circumscribed by the growth of the domestic market which was inevitably limited in turn by inevitably low agricultural growth rates whereas the former set of countries had the world economy, and a rapidly expanding one too in the 1960s) as their market.

These lessons have been widely learnt. In particular, the developing countries that, in the 1950s and 1960s, were fearful of free trade have now turned around and see trade as an opportunity, not as a peril. President Salinas and his team looked across Rio Grande and, instead of sighing like his predecessor, Porfirio Diaz who said famously: "Poor Mexico, how far from

God and how near the United States", assiduously embraced the United States as a gift arising from proximity. Similarly, President Cardoso of Brazil has renounced the celebrated dependencia thesis that he formulated as South America's best-known sociologist and now pushes for integration into the world economy instead. And that is the story around the developing world.

The problems about free trade as an engine of prosperity now surface in the rich countries instead, in what I have called an "ironic reversal". And they come principally from the labour unions and from NGOs (non-governmental organizations), the former fearful of competition from the poor countries, the latter pushing a number of trade-unrelated agendas (such as better environmental regulation) by often pretending that trade and other forms of globalization are the cause of damage in their areas of concern.

The unions' concerns about the adverse effect of trade on real wages of workers are, in my view, misplaced. Most international economists who have looked at the problem have come to the conclusion that the real wage decline in the 1980s in the United States, for example, could not be attributed to trade except for negligible fraction such as 10-15%. My own work argues that actually trade has even helped; that it has moderated the decline in real wages that was coming from technical change that was reducing demand for unskilled labour.

The notion that outsourcing of production was a threat that would reduce the bargaining power of the unions, and hence hurt their wages, also makes little sense for the US since unions cover less than 14% of the labour force anyway. Besides, the outflow of direct investment (DFI) was almost offset by the inflow of DFI during the 1980s. This is a fact often forgotten when fearful unions and politicians look only at the outflow. Thus, when I was in a BBC radio debate on globalization, with Martin Wolf of The Financial Times on my side against two vociferous

but incoherent anti-globalization “activists” on the other side, they ran a tape where the mayor of the French town from which Hoover was leaving for the UK was declaiming against multinationals abandoning locations and communities in pursuit of greed. So, I said pointedly that the mayor had not complained when Hoover, a US firm, had come to his town in France in the first place!

The politicians in the developed countries need to contend with these reactionary forces, meeting their claims against free trade head on. One only hopes they will, though one may only despair when one sees their frequent surrender to these untenable objections, at least in Washington.

Free Capital Flows

But if the case for free trade is sound and only requires forceful and repeated statement of it without apologies by our politicians in the public arena, the question of freedom of capital flows is a far trickier issue. Let me explain since you may well ask why I am not equally enthusiastic about it.

True, there are important similarities between trade and capital flows. Each time you segment a market, you incur an efficiency loss (which economists call a deadweight loss). You also lose the freedom of investors to place their money where they wish: which is an abridgement of their rights. The same is true, of course, of interference with free trade.

But then we have a basic dissimilarity on the economic front. If I exchange my toothpaste for your toothbrush, we both gain And no crisis can be imagined as a possibility. Think now of free capital flows instead. With crisis after crisis materializing, in countries as diverse as South Korea, Thailand, Mexico and Russia, I am cautious and cannot take for granted the repeated assurances that Messrs. Robert Rubin, Stanley Fischer and Larry Summers have figured out

ways of preventing such crises from materializing in the world economy as capital flows begin to occur on a substantial scale and countries are encouraged, virtually forced by pressures from the IMF and the US Treasury to dismantle barriers to capital flows.

So, if these crises will occur, until we have really figured out how to avoid them, then what I have argued in many places is that the gains from freeing up capital flows must be set against the losses from the crises adjusted for the probability that they will occur. Besides, I have also argued (in my May 1998 Foreign Affairs article that was provocatively titled by the editors as The Capital Myth) that the proponents of free capital flows have simply asserted that the deadweight gains would be "mammoth" but that they had produced no evidence that they were whereas, for trade, there were several studies of the cost of protection and we did have broad orders of magnitude (which incidentally were by no means "mammoth").

Hence, I propose prudence in moving to capital account convertibility: a suggestion that the IMF now has quietly adopted as far as one can tell. Sure enough, the proponents of free capital flows are correct in saying that greater transparency and better banking practices would help. But how come they are so sure that these are sufficient, not just necessary, to avoid the financial crises that we have repeatedly witnessed?

I am afraid that an attitude of complacency on this issue is not just unwise; it can be fatal to other, more tractable forms of globalization and economic freedom such as the case for free trade. In fact, whenever I discuss free trade with its opponents, they invariably begin today with the Asian financial crisis, as if that showed that free trade was also bad! That is of course a non sequitur; but only you and I understand that.

Was Prime Minister Dr. Mahathir right in using capital controls in Malaysia? That is a different issue from whether, say, India should embrace capital account convertibility.

Malaysia's question was instead: should it abandon capital account convertibility? We all know that Malaysia did not do badly by using capital account controls, at least by comparison with other afflicted countries. My view, however, is that this was not due to such controls per se; rather it was because, by not going to the IMF and by going alone in response to the crisis, Malaysia avoided the unduly deflationary IMF conditionality that was wholly inappropriate to its solution.

In any event, it seems clear to most of us that, when we free up capital flows, we need at least two policy instruments to accompany that: first, the monitoring of the flows to send off alarm signals if they are proving to be unduly large relative to fundamentals; and second, the willingness to use Chilean-type taxes on capital inflows when these alarm signals do go off. If we do this, then we can certainly make the freeing up of capital flows less likely to create havoc through massive reversals of inflows under panic conditions.

Freeing DFI

The freeing of direct foreign investment is a much easier problem, just like freer trade, because equity capital coming in as real direct investment doesn't withdraw itself rapidly due to panic. It is sticky. It tends to stay for the long run. Besides, the bundling together of the know-how, the management techniques, and the financial capital which a multinational investment usually involves is extremely useful.

Today, we also understand better the central truth that no country is so smart that it cannot learn from the investment and the know-how that comes in with foreign firms. Remember that, even if you have intense competition amongst yourselves and you learn from each other, you are still all part of the same culture. So there is a limit to how much you can learn from each other. You can learn far more by dealing with or competing against firms and people from

another cultural background. The creativity which follows as a result of that interaction is enormously important. Thus, I firmly believe that Japan has been depriving itself, and so has Korea for that matter, by choosing to resist foreign investment inflows and relying only on importing unbundled technology. So I see the acceptance of foreign investment as a welcome development in Japan even though it has come under the crisis conditions of the last three years.

Indeed, pursuant to what I have argued above, the thinking on direct foreign investment has also changed now among developing-country policymakers and in professional economic circles from the more pessimistic and fearful to one where DFI inflow is welcomed and attempts are being made to increase it. Doors are opening to DFI worldwide, with its advantages now seen more clearly than ever before.

But I should add that there is, as with free trade, a backlash now in the developed world instead. This comes largely from NGOs (non-governmental organizations) that see corporations primarily as evil. These viewpoints come principally from the Ralph Nader tradition. This great consumer activist began his distinguished career by taking on the defects in the car Corvair, writing his famous book, Unsafe at Any Speed. But his mindset that, therefore, corporations are out to cheat you is too simplistic and unfair. But these kinds of viewpoints find ready customers among the young and nubile students on campuses in the United States: puncturing their noses and ears and lips, they can be seen frequently in small groups of chanting demonstrators with placards denouncing corporations.

What that has done is to set off alarm bells against attempts to create codes on DFI such as the OECD's now-suspended effort at creating a Multilateral Agreement on Investment. It became a casualty to fierce opposition from the NGOs. It was also a flawed instrument since it was focused too much on the so-called "rights" of foreign investors (including of short-term

capital flows) vis-à-vis host countries and virtually omitting sophisticated and nuanced nods in the direction of host-country rights and the obligations of the foreign investors (as distinct from their rights). This highly-unbalanced code, in turn, made attempts at putting investment rules into the World Trade Organization (WTO) look altogether dangerous to non-corporate interests. Thus, a foolish OECD enterprise, reflecting the overreach of the multinationals, has cost us progress at the WTO on defining a useful set of disciplines in the area of DFI.

Immigration

Finally let me talk about immigration and say to my Japanese friends that the strength of America is basically the fact that it is continuously renewing itself. Its main strength comes from the fact that it takes in the best talent from around the world. But, no matter whom it takes in, it provides them and their children in particular with the finest economic opportunities that enable nearly everyone to reach their potential.

In fact, in my class at Columbia University, the largest number of students from a single country is from Japan. Indeed, there are so many foreign students in each class that often it seems as if the native-born Americans in the class are a minority! The remarkable thing is that these Americans welcome the foreigners with open arms: their attitudes, particularly in the universities, reflect the fact that America has been built by immigrants. There lies its uniqueness.

And that uniqueness confers on the US the enormous competitive advantage which I just noted. Last year Nikkei asked me to write an article to be published at the turn of the year regarding the next century. I wrote saying that the nineteenth century was British while the twentieth century was American. Would the next century be Pacific as often thought in the 1980s? Instead, I wrote that the twenty-first century was also likely to be American.

Why? Not because, as many believe, the US has splendid venture capital markets that can finance the new economy's entrepreneurs in Silicon Valley and elsewhere: after all, anyone can imitate that without difficulty. Certainly Japan can!

But which traditional country, particularly one such as Japan with its racial homogeneity and fear of immigration, can really open its doors as wide as the US and profit from the influx of the immigrants? It will be a long time indeed, if at all, before Japan will be able to overcome its inherited anti-immigration attitudes and catch up with the US on this important dimension. And, as long as it stays behind, the US will remain at a great advantage in its dynamism and its ability to remain Number One.

The real lesson I would like to bring to you today is that the 21st century is not going to be a Japanese century unless you can really learn this secret of US strength and come to terms with your mistake in insulating yourselves from the benefits of freer immigration. I know that Japan finds it difficult to contemplate immigration, especially from diverse ethnicities. But you do have examples of change by other societies which were not that much better at this game. For instance, Australia was once very exclusive but it has opened up to immigration from around the world, coming somewhat closer to what the United States does. And that is where you will need to go.

Of course, you cannot have completely free immigration because nation states are defined by exclusion. All I am saying is that you should have much a freer and more relaxed attitude towards this issue. At least at the level of skilled immigration, you can free up much more and try attaining that synergy, that interactive creative serendipity, which comes with it.

Concluding Remark

So I would conclude that economic freedom along all of these dimensions is the direction in which Japan has to move. Deregulation is only part of Japan's unfinished agenda: it will free up the domestic economy. But an intensive and frank look at all of the international dimensions of economic freedom as well is necessary as Japan enters the 21st century. There alone lies the hope that Japan will retain the prominence that it achieved through its remarkable, quality-manufactures-based recovery in the postwar period.