Sources of Prosperity

address by

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Good morning!

As always, it is a pleasure to be in this beautiful part of the world. It is also gratifying to see the obvious prosperity following several years of economic decline in the first half of this decade.

I participated in this conference in 1993—a time when the California economy was weak and forecast to get even weaker. When I was last on the program, in 1996, things had improved, but had not yet fully recovered from the long contraction.

If a Rip van Winkle were waking up in California today—after having fallen asleep in his economics class about 35 years ago when I was a student—he might inquire about the nature and the magnitude of the government programs that had brought about this restoration of prosperity.

More realistically, there are officials at the International Monetary Fund today who are thinking about the advice to give to countries in East Asia. Imagine that they learned of California's recession and recovery and sent a team to find out what kinds of programs were used by federal, state, and local governments to turn things around. Of course, the IMF team would be told that actions by government were part of the problem that caused California's contraction, not part of the solution in the recovery.

Twenty years ago, the entire country was in bad shape. Inflation and interest rates were high and rising. Unemployment ultimately reached almost 11 percent. The top marginal tax rate was 70 percent and the idea of <u>de</u>regulating something had not taken root.

Then, in 1981, a new administration in Washington asserted that the way to stimulate the economy was to shrink government, rather than expand it. As the menu of things that needed to be done was developed, it was very evident that many of the reforms being proposed would have effects only over a long period of time. Fortunately, we had a leader who was willing to be very patient. When told by advisors that benefits to the country might not come for 10, 15, or 20 years, President Reagan would respond, "You can accomplish an awful lot if you don't care who gets the credit." On more than one occasion he counseled his staff, "Remember what you came here to do, do it, then go back where you came from. If you start to think of the government as 'we' instead of 'they,' you've been here too long."

I think it is useful to review the *philosophy* underlying the reforms that have contributed to making this final decade of the millennium the most prosperous of the century. The premise of my remarks is simple. It is not the specific programs government puts in place that "decide" our prosperity. It is our choice of institutions, the totality of which we call the economic infrastructure, that determines our wealth and development. Indeed, I believe *the* most important element separating economic "haves" from "have-nots" is whether the role of an economy's institutions—and particularly its public institutions—is to facilitate, or to confiscate, production.

In 1776, Adam Smith published *An Inquiry into the Nature and Causes of the Wealth of Nations.* His motivation was to explain the large differences in prosperity observed across economies. That inquiry continues today, and for essentially the same reason: The gaps that separate prosperous from foundering economies remain huge. As we near the end of the 20th century, the richest countries in the world are roughly 30 to 50 times wealthier than the poorest ones—a truly astounding difference. We see not only large differences in wealth, but also tremendous variation in development. Some developing countries tripled their wealth between 1960 and 1985, while others were about three times wealthier in 1960 than they were 25 years later!

If we ask simple questions like, "Why are some economies rich and others poor?" or, "Why do economies grow at different rates?", we get a simple answer: Rich economies have greater resources per capita—more capital, both human and nonhuman, and better technology connecting the two. But this simple answer only begs another question: "Why do some economies have high levels of capital and technology, while others don't?"

In the realm of economics, controlled experiments are not possible. At rare times, though, natural experiments present themselves, and recently we have had a rather unique opportunity to study the role of the economic infrastructure in influencing nations' prosperity. During this decade, at least 15 newly created market economies have emerged within the former Soviet Empire, in addition to the newly liberated Eastern European countries. Perhaps not surprisingly, these emerging economies have experienced vastly varying degrees of prosperity. Since 1989, the five worst-performing Soviet spin-offs have seen a decline in measured output about twice that of their five best-performing counterparts.

Other examples found in the performance of the East Asian economies—both when they were booming and in the recent collapses—provide clear evidence of the importance of institutions.

One study identified four determinants of the quality of economic institutions:

1) Rules of law, sound political institutions, strong courts, and orderly succession of power.
2) Little risk of expropriation through nationalization and confiscation.
3) Honoring of public contracts and upholding of private contracts.
4) Independence of private institutions from political pressures.

Many of the so-called "miracle countries" of East Asia do not score highly by to these factors despite decades of strong growth. The recent implosion of these economies was due to the lack of a sound economic infrastructure. In many of these countries, there is a fine line between what is public and what was private. This is especially true in banking where it has been said that, "the minister's nephew or the president's son could open a bank and raise money from both the domestic populace and from foreign lenders, with everyone believing that their money was safe because official connections stood behind the institutions."

The saving and loan industry debacle in this country demonstrated what happens when one combines governmental guarantees with poor regulatory oversight. We have since strengthened our institutions to safeguard against another such occurrence. For example, publicly insured depository institutions now have to meet stricter capital requirements, and supervisory authorities have less discretion to forbear from imposing sanctions on weak firms. Such actions are necessary whenever we set up a "heads I win, tails the public loses" type of situation.

Our experience in the 1980s was repeated in the 1990s in East Asia. Implicit governmental guarantees without adequate regulatory oversight set up a speculative bubble in which an asset's value depended on returns that were not supported by the true wealth created from the underlying investments. In most of these countries, institutions similar to our Securities and Exchange Commission are largely ineffective or non-existent, internationally accepted accounting standards are not being followed, and regulations requiring full disclosure are frequently not present. This meant investors had little ability to ascertain an investment's true economic performance. Regrettably, these shortcomings did not deter foreign lenders and investors, who continued to add to the flow of 'hot money,' sustaining the bubble until it finally burst.

As one smart economist said, "Things that are unsustainable have a habit of ending." The end came once it became clear that governments did not have the resources to bail out all the bad investments. The collapse of asset prices led to insolvency of banking institutions and the withdrawal of foreign investors. The real economic costs in terms of lost output and employment are still unknown.

Unfortunately, the worst still may not be over in some of the East Asia economies. Many of these countries have poor flexibility when measured by their ability to let resources move freely to their most productive uses.

It is now apparent that there will be no quick fixes to restore prosperity in many of these countries. The task of restoring—or, in some cases, building from scratch—a sound economic infrastructure is very time consuming.

An economy's infrastructure, broadly speaking, is the climate created by the institutions that serve as conduits of commerce. Some of these institutions are private; others are public. In either case, the role of the institution can be conversionary—helping to transform resources into outputs—or diversionary—transferring resources to non-producers. Most private institutions are sustained by the value they add—either they produce or they fail. But the same cannot be said of public institutions which are sustained by the power of the state.

At the most basic level, there can be only two rationalizations for the state's participation in an economy. The first is as a social equalizer, redistributing the fruits of a nation's production under the presumption that a particular social need takes precedence over private desires. The second justification for government intervention is the assertion that markets may fail to produce an efficient outcome.

The *rationale* underlying government's role in the economy is crucial to the prosperity. In the case of equity issues, the role of the state is unambiguous. Society makes a choice to accept a lower level of wealth in exchange for some presumably higher social objective.

It is as promoter of market efficiency that the role of the state raises the most complex questions. Even if the objective is to overcome a particular market failure, once the state has been introduced into the economic system, its influence can have wide-ranging and unanticipated consequences. And these institutions, which are not bound to obey market forces, often exert influence long after their usefulness has passed.

While I am doubtful that market failures occur as commonly as activist policy-makers presume, it is clear that they ***do*** occur. The most frequently cited failure involves so-called "public goods," where providing the good for anyone makes it possible, without additional cost, to provide it for everyone. A legal system and national defense are such goods, as is a stable currency. Cumulatively, these state activities are part of the economic infrastructure called "the protection of property rights." This means, more or less, that individuals can expect to receive the product of their labor. Although people could privately undertake actions to prevent the diversion of their output (from burglary, for example), it is widely accepted that a social institution (such as a police force) is a less costly mechanism to do so. Let us be clear, however. In order to pay for the police, or courts, or jails, resources must also be diverted to the state from private persons in the form of taxes.

Indeed, once introduced into the economic infrastructure, the state cannot help but tax the productive capacity of the system. Sometimes these taxes are direct and provide the sustenance for the government enterprise. But direct taxes are probably only a small part of the overall cost to the economy. Also important are the costs borne by private agents who invest resources to minimize their tax burdens, either through tax avoidance schemes or through attempts to influence the taxing authorities.

This is the paradox of any state enterprise. While the state may be the most effective instrument in minimizing the resource diversions of private agents (for example, by protecting property rights and enforcing contracts), it simultaneously introduces the potential for the debilitating diversion of resources for its own account. It is here, I think, where the differences between economies are grossly understated.

A common distinction among governments is whether they are so-called "capitalist" or "socialist," terms that in a very broad way define the diversionary appetites of some government entities. Certainly a government committed to allowing the private ownership of capital is, all other things equal, more committed to putting in place an economic infrastructure that favors creation over diversion. But this is only part of the story. Laws, threat of expropriation, government repudiation of contracts—all of the things that cumulatively sum to the protection of property rights—are important.

These are the "common set" of characteristics that make an economic infrastructure successful. According to some studies, these characteristics are substantial enough to explain most—if not all—of the differences in prosperity that separate nations today, and I suspect they are the same set of characteristics that separated the wealth of nations in the time of Adam Smith.

A statist philosophy can also apply to jobs creation. It is common to hear aspiring political leaders declare that their number-one economic objective is to increase employment. For those of us trained in the neo-classical tradition, this is indeed a curious objective for the state!

I once heard a story about a western businessman touring China. He came upon a team of nearly 100 workers building an earthen dam with shovels. The businessman commented to a local official that with an earth-moving machine, a single worker could create the dam in an afternoon. The official's response was, "Yes, but think of all the *unemployment* that would create."

"Oh," said the businessman, "I thought you were building a dam. If it's *jobs* you want to create, then take away their shovels and give them spoons!"

The dominant view of economic policymakers, at least since the 1930s, has been that a competitive marketplace will fail to generate adequate employment opportunities, and this belief justifies state "jobs" programs. In the final decade of this century, that Depression-era way of thinking about the role of government is fading.

It is clear that the primary goal of government policy should *not* be creating *work* for people, but fostering an environment for *wealth creation*. Very poor economies are typically characterized by people who work most of their waking hours. And where one finds impoverished economies, one also finds political/economic systems that have large disincentives to create and accumulate wealth—in short, a weak economic infrastructure.

Suppose, however, that we accept the proposition that labor markets have failed to provide the right number of jobs. What sorts of opportunities should the state encourage? Given the importance politicians generally assign to the task of creating employment, it is surprising how little is known about the nature of jobs creation in market economies. Studies of the U.S. record show no identifiable, systematic factors related to industry, region, wages, employer size, capital and energy intensity, or foreign competition that would account for a significant share of the types or number of jobs created or destroyed in the economy.

Since policymakers have no clear foresight of where entrepreneurial energies will be directed in the future, it's impossible for them to predict where jobs creation should occur. For example, a few years ago, who could have predicted—let alone planned—that designing Web sites would be a rapidly growing occupation?

It is not surprising, then, that government policies which seek to direct the flow of entrepreneurial talents in an effort to promote "good" jobs, and presumably to discourage "bad" jobs, will have uncertain and potentially negative effects on economic prosperity. Government-targeted employment policies breed special interest groups that inevitably reduce the efficiency of markets in allocating scarce resources. These policies tend to persist beyond the point of any economic desirability and inhibit a necessary antecedent to jobs creation: jobs destruction. In the United States, sectors and industries that claim the highest rates of net new jobs created are generally those that have the greatest rates of jobs destroyed. Similarly, nations with high rates of jobs creation also tend to have high rates of jobs destruction.

An example of this dynamic is provided by the U.S. banking industry. Bemoaning layoffs recently announced by a major bank, a newspaper story placed the blame on "mergers, consolidation, and a steady migration of some operations … to lower-cost regions." However, research indicates that the overall impact of mergers and acquisitions on the total number of banking jobs is small, and even casual observation reveals that change has altered the nature of such jobs for the better. Today's banking positions require much better skills and provide higher pay than when the typical bank job was a low-paid teller position with little opportunity for skill-development or hope of advancement.

In modern economies, jobs creation that is not accompanied by the destruction of some less efficient, and therefore less prosperous, jobs is not conceivable. Yet, because of their imperfect vision, government jobs programs are almost everywhere *jobs protection* policies, which by extension tend to inhibit the creation of new, wealth-enhancing technology. In short, what may have begun as a well-intentioned redirection of labor resources ultimately becomes a debilitating component of the economic infrastructure. The stagnation in Europe in this decade can be traced mostly to misguided policies toward labor markets.

I began my remarks today with a simple premise—that the economic infrastructure plays a major role in the determination of economic prosperity—and that infrastructure depends crucially on the policies and actions of the state. Where the state has fostered an environment that functions as—in the words of Vaclav Klaus, the former Prime Minister of the Czech Republic—a "market economy without adjectives," economic performance has been far superior.

The "takings clause" of the U.S. Constitution, the Commerce Clause giving Congress the power to regulate interstate commerce, and James Madison's insistence on a uniform and common currency, are crucial components of our national economic infrastructure that have helped make us prosperous. Protections we tend to take for granted—such as patents, copyrights, and intellectual property rights—are largely unknown or are ineffective in many places in the world today. Without such protections, incentives for creative talents to design and develop new products and services are substantially diluted.

In the final analysis, sustainable long-term prosperity—whether at the national, provincial, or local level—occurs when human action is focused on converting productive resources into marketable goods. That's what President Reagan meant by "the magic of the marketplace."

In my opinion, the government's relationship to its citizenry is not that of an architect, engineer, carpenter, or any other metaphor implying activism. I think of the state as a nurturer of an economic garden. It cultivates a soil that allows growth to take root, wards off pests who seek to feed off the budding crop, and keeps weeds from suffocating the plant before it achieves its potential. Simply moving a factory or business to an area without the proper economic infrastructure is like planting one seedling in the middle of infertile ground. We wouldn't expect either one to survive for very long.