Economic Growth and Institutions

"I believe that free societies have arisen and persisted only because economic freedom is so much more productive economically than other methods of controlling economic activity."

M. Friedman, in Gwartney, Lawson, Block (1996), p. vii

"Across the countries of the world, annual income per capita varies by a factor of almost 100 . . . We find surprisingly good news; approximately 85 per cent of the international variation in income per capita can be explained by . . . [manmade differences in] . . . property rights, . . . black market activity, . . . regulation . . . , inflation, . . . civil liberties . . ., political rights . . ., press freedom . . ., government expenditures . . . and trade barriers."

Conclusion from a major study of differences in incomes levels , Roll—Talbott (2001)

Economic growth—the sustained rise of productivity and hence real per-capita incomes throughout the community—is a relatively new human experience[1] . It has now become the norm around the world, except in some socialist and ex-socialist countries and many of the war-and corruption-wrecked states of the third world. Real per-capita incomes have trebled over the past half-century, both in the first and the third worlds. This has been accompanied by big reductions in child mortality, massive improvements in health, longevity, job satisfaction, life opportunities and dignity—not only for small elites, but for the population at large. Even the poorest in the United States of America live better, longer and healthier lives than the middle classes of traditional, stagnant societies (Simon, 1995). Since the beginning of the Green revolution some 40 years ago, the share of malnourished people on earth has dropped from 35per cent of the world population in 1960 to 18 per cent now (Lomborg, 2001). For most people, the quality of nutrition has greatly improved and education levels have risen. 100 years ago, 75 per cent of mankind was illiterate, now all but 20 per cent can read and write. And all—except a few snobs and single-issue environmentalists, who have never known

[1] See 'Glossary' at the end of this monograph for a definition of economic growth.

genuine poverty—would agree that economic growth is highly desirable, for economic and non-economic reasons[2].

The world wide growth record and the limited number of cases of continuing stagnation suggest the questions which are at the core of this monograph, namely: What explains the take-off into sustained economic growth, first in western Europe and North America and then in Japan, East Asia, and Latin America? Why has economic growth lagged until recently in South Asia? Can one derive general lessons from this experience for India and other countries? What changes in public policy is needed to facilitate a catch-up of living standards in India with those of the affluent West?

It will be the main purpose of this essay to highlight the importance of simple, stable and universal ground rules (institutions) in coordinating human conduct in the economy and in establishing trust[3]. We will argue that certain simple rules of an overriding, constitutional quality serve to constrain self-seeking political groups and their allies. Appropriate rules open life opportunities for all by creating better predictability and security. Enterprising people can then concentrate on their own aspirations and capabilities without having to glance all the time over their shoulders to see whether their venture is imperilled by the next confiscation, the next arbitrary act by a corrupt official, the next subsidy scheme, prescriptive regulation or lawless act of someone powerful. Sustained economic growth requires that basic economic institutions are universal and are credibly enforced equally on everyone, in order to reduce the costs of transacting business. Also, proper institutions constrain social and inter-ethnic conflict and de-emotionalise political life. It is simply not constructive to have matters of daily life—such as working, buying, selling and investing—constantly embroiled in legal and political conflicts, or subjected to the undue exercise of private power and the vagaries of arbitrary or corrupt public administration.

Another way of reiterating the same would be to say that this book is about the costs of corruption in terms of economic growth and all the ensuing benefits, since corruption means nothing else but the degradation of universal and credibly enforced institutions.

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[2] If the reader has doubts about whether economic growth is worth having, he is referred to the "Insert" at the end of this Chapter.

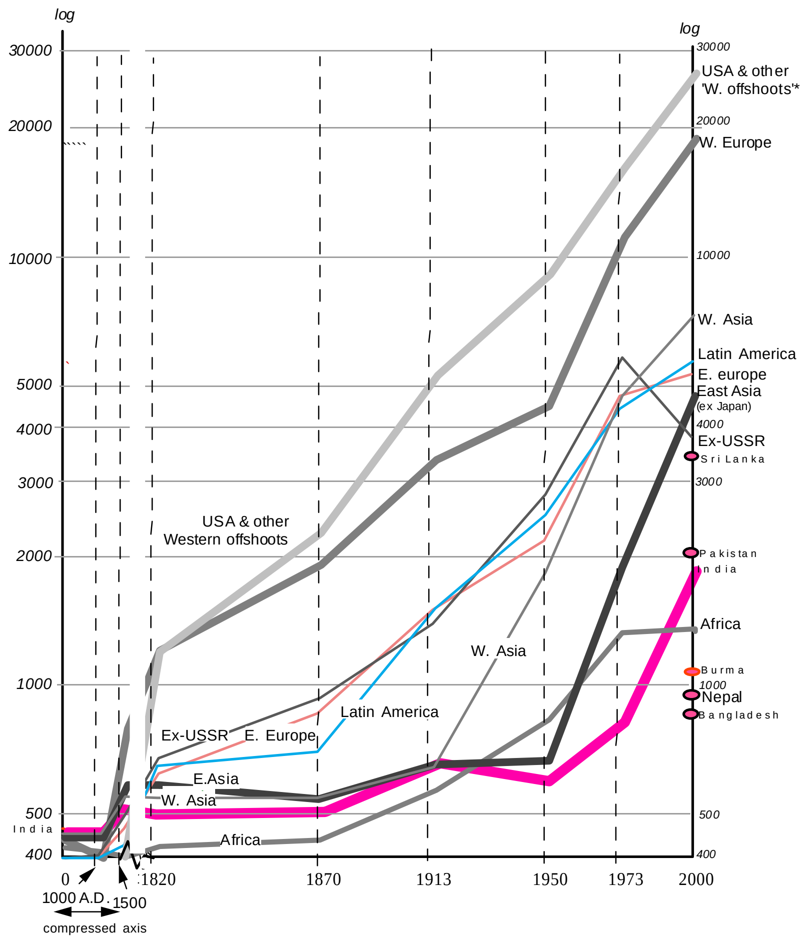
[3] See "Institution" in the Glossary at the end of this monograph. A number of terms have to be given specific and precise definitions, if we want to analyse policy issues. To assist the reader, the most important definitions have been collected in the 'Glossary' at the end of this book.

In line with a rapidly growing academic literature on Institutional Economics, the word "institution" will be used here exclusively to describe rules that carry sanctions. In the social-science literature, the term "institutions" carries many and conflicting meanings, to the extent that it becomes meaningless. Moreover, everyday language often refers to banks, universities and insane asylums as institutions; but these are organisations—durable combinations of production factors to pursue specific purposes.

World Economic Growth—A Broad-Brush Overview

Graph 1 depicts the very long-term growth experience in the world at large, taking the latest and most solidly researched data as a basis (Maddison, 2001). On the vertical axis, we show the logarithms of real per-capita incomes (measured in US-$ purchase power equivalents). This means that accelerated growth is reflected in an upward bend of the curve, and decelerations in a downward bend. Decreases in living standards—for example the decline over the past quarter century in the former Soviet Union and in a number of African countries—can also be clearly seen. On the horizontal axis, we have compressed the (necessarily crude) income estimates for the year 0, 1000 AD and 1500 AD and show the broad development since 1820. The graph draws attention to a number of important insights:

Graph 1: Long Term Economic Growth
India by International Comparison



* 'Western off shoots' = common-law immigration countries, USA, Canada, Australia, New Zealand

Source: Maddison. 2001

- In the first millennium of the Christian era, all people were poor (except a very few powerful members of the elite). Material living standards, were on an average even lower than the poorest third world countries of today. This was so because improved production was regularly outstripped by rises in the number of mouths to be fed[4]. Disease, dirt, discomfort, periodic starvation, high child and maternal mortality and a short, insecure life were normal. And no one believed that human misery could ever be overcome.
- With the Renaissance in Western Europe, and even before the start of European colonialisation, something revolutionary happened: general living standards began to rise. Some 'new-world offshoots' of Western European civilisation (North America, Australia, New Zealand) rapidly achieved, for those times, unprecedented living standards, and then kept growing relentlessly. The growth process began during intense inter-State rivalry in Europe (wars of religion) and with the emergence of individualism, the rise of critical, sceptical thinking, a market economy and slow improvements in the rule of law (see below).
- After 1820, eastern Europe, Russia and its neighbours, and Latin America took off into sustained growth. In the 19th century and the first half of the 20th century South Asia and India showed little growth in per-capita incomes, with added production being largely matched by accelerated population growth (extensive growth). Since 1950, per-capita incomes have risen, though much less than in the export-oriented East Asian countries. With a degree of liberalisation incomes rose faster towards the end of the millenium, albeit at a much lower level of income and with much less vigour than in the open, more lightly governed and more developed East Asian economies. Growth also spread to parts of the Middle East (West Asia) from the early 20th century when oil launched some countries there on a growth path. However, modernisation there did not lead to a significant rise in female education, which would have reduced birth rates as it had done almost anywhere else. West Asian countries continue to have among the highest population growth rates in the world.
- A real breakthrough came in the second half of the 20th century. Growth accelerated and carried the affluent western countries to unprecedented heights of wealth creation, as world markets were opened and more knowledge and technology were applied and utilised. The most spectacular change occurred in East Asia, where war, corruption and civil chaos had previously inflicted untold misery and where now one

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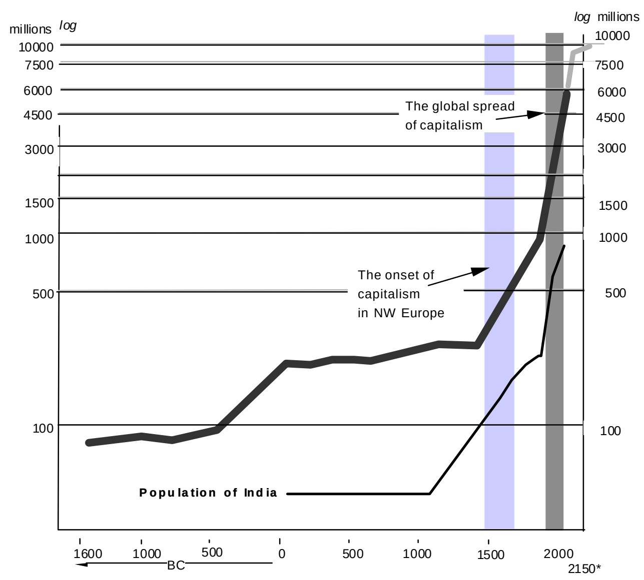
[4] This was the so-called 'Malthusian trap', named after the British economist, who in 1798 stipulated that the number of hungry mouths would always outstrip the resources to feed them. Oddly, he published this theory just when the beginnings of the industrial revolution created conditions under which this was no longer true.

autocratic government after the other launched economic and political reforms to achieve fast economic growth, typically by industrialising and exporting to the rich countries. Since 1980, even the Peoples Republic of China embarked on a rapid catch-up with the West by instituting waves of privatisation, decontrolling economic activity and opening the economy to the world market forces. More recently still, India and other south Asian countries have managed a take off into growth.

- Only Africa as a whole has remained nearly stagnant, despite rich natural resources. Some countries, like Nigeria, even managed a decline in living standards. Similarly, people became poorer in the former communist states of the USSR, where the old system collapsed and a new order was yet to emerge.
- On the other end of the spectrum, the Anglo-Saxons outside Europe and the western Europeans are now producing annual average incomes between US-$ 20-30 000 per inhabitant, i.e. some 10 to 15 times what the average Indian manages to produce.

The progressive rise in productivity and living standards has spread to more and more communities since the year 1500. The take-off into economic growth was invariably accompanied by an accelerated rise in population. The spread of economic growth beyond the old industrial countries and globalisation in the second half of the 20th century went along with an accelerated population increase (Graph 2). The main reason for this has been that greater productivity

Graph 2: World Population. The Most Recent 3600 Years and Medium-Term Prospect*



* 2150 = Medium-fertility forcast by United Nations
Sources: J. Simon (1995), p. 35; UN Population Project

has allowed more people to survive and live longer and more productive lives. More people meant bigger markets and more productive knowledge. This seems the most hope-inspiring aspect of the extraordinary history of the second half of the 20th century.

As societies grow richer and more educated, birth rates drop, so that population growth in the rich countries slows down and the population ages progressively. However, in low-income countries with low rates of female education, mainly in the Middle East and Africa, the number of poor youngsters with poor life prospects is still rising fast. Generating life opportunities in these places will have to be a major priority. An understanding of the causes of prosperity and stagnation will be crucial for this task.

The distribution of the world population is shifting considerably, with the share of Europeans and Russians—who were the focal point of the big historic conflicts of the last century—shrinking dramatically. By 2020, they are estimated to constitute only 12 per cent of the world population. By then, most people will be living in East and South Asia (nearly 30 per cent and some 26 per cent, respectively) and 13 per cent of the world population will be living in the Americas and sub-Saharan Africa each. The economic ascendancy of East Asia and a continued economic rise of North America will mean that the weight of the global economy will shift even more to the Pacific.

Economists have investigated this broad-brush picture for the past 200 years. Some have stressed that growth requires the sacrifice of current consumption for investment (saving and capital formation), better exploitation of natural resources, technical innovation, and the learning of new skills through education and training (Kasper-Streit, 1998, pp. 13–21). There is little doubt that these factors have been important, but the analysis immediately raises the question: Why have the Europeans invested more, developed their natural resources better, had more innovative entrepreneurs, and learnt more than, for example, the Indians?

Clearly, the answer cannot lie in biological traits. If this were so, one would find it hard as to why so many African Americans prosper, but not Africans in Africa and why Mexicans, once they cross the Rio Grande become economic achievers. Nor could one explain why so many East Asians, who used to live in abject misery up to the 1960s, have suddenly joined in the economic growth experience, some—such as the inhabitants of Singapore and Hong Kong—are even outperforming the West.

The Importance of Institutions

The answer lies instead, as already indicated, in certain cultural traits, social traditions and habits. A very large share of the difference between the poorest and the richest countries can be explained by the quality of the shared rules, the 'institutions', which coordinate individuals. Some communities adhere to rules which engender trust, self-reliance and incentives to perform, others have rule systems that deprive many of the fruit of their risk taking and effort. Free economies tend to be prosperous, whereas societies with pervasive restraints on economic freedom are poor (Bauer, 1972; Berger, 1987; Scully, 1992; Kasper, and Streit, 1998, and Gwartney, and Lawson, 2001; O'Driscoll, Holmes, O'Grady, 2002; Roll, and Talbott, 2001).

What are these liberating institutions? They protect individual autonomy to make free decisions. They can be considered as the software of economic development, so to speak. Good institutions make the hardware—the infrastructures, labour, skills, knowledge, natural resources, and capital—productive.

Whenever individuals interact with others, they have to trust that their counterparts will behave in predictable ways, fulfilling promises made. This fact is so fundamental that we frequently lose sight of it. Yet, when you hand a sum to a bank teller to pay an account, you trust that the teller will not steal the money and the bank will remit the funds to its intended destination. When you sign an employment contract, you trust that many matters, which are not spelt out in the contract, will be handled reasonably and without your boss exerting undue arbitrary power. When you order a book from an overseas supplier over the internet and enter your credit card number to pay for it, you rely on a large number of people, whom you have never met and never will meet. When foreign-exchange dealers conclude telephone contracts worth billions of dollars every day, they deal with complete strangers in other countries whom they have to trust blindly.

Only by trusting each other, can we properly exploit the division of labour and draw on the specialised knowledge and know-how that is held in the minds of many diverse people. Only then can we produce all the goods and services that allow us to enjoy high living standards. High living standards, indeed our very survival, thus depend on a gossamer web of rules that establish trust and coordinate our manifold, diverse activities with the plans of others. In good societies, the rules work most of the time, despite the well-known fact that people are opportunistic, forgetful and unreliable. The almost invisible rules that guide human conduct threaten rule breakers with sanctions. In corrupt societies, the rules are seen as not to apply to the powerful. People who strike deals cannot be sure that promises will be delivered. Therefore, they abstain from even attempting certain transactions. The consequence is a poor division of labour and little experimentation and innovation. As a consequence, economic growth remains elusive.

In the modern world, humanity is engaged in an incredibly complex, ever-changing division of labour. Just imagine what your living standard would be like if you were put down, all on your own, in the most favourable spot of India, but had to fend for yourself without the help of others, and the tools and provisions supplied by others! Or imagine how many people—most of them total strangers—have interacted to produce this book which you can buy for a few dollars: among them, the timber cutters and paper mill workers, the oil and chemical workers who made the printing ink, the writer, the independent reviewers and the editor, the international traders who brought some of the inputs to India, and the postal workers who transported the book. These numerous highly specialised people rely on the knowledge of yet thousands of others. Indeed, a book like this could not be written without relying on the thoughts and the discourse of innumerable others. Seen in this light, the modern division of labour and the use of so much dispersed human knowledge appear almost incomprehensible. Yet, all this is made possible because people's efforts are ordered by effective institutions.

Institutions of course matter also in non-economic relations. They provide the necessary basis for all social interaction. They form, figuratively speaking, the cement that holds communities together and allows us to conduct ourselves as members of society. Indeed, shared institutions define our culture and our society. The institutions are central to how people define themselves. If you are asked who you are, you are likely to respond: "I am a Parsi . . . a Bora", which means that you want to be known as someone playing by Parsi or Bora rules of behaviour. Institutions matter because people are not isolationist individuals, but rely on the company to bring out the best in them and to be creative and confident. They can interact with others productively only if human behaviour is by and large predictable thanks to shared and respected institutions.

People, who are guided by appropriate institutions, will find that they are not lonely. To a large extent, loneliness—the involuntary lack of personal contact with others—seems to be the consequence of a lack of effective rules of social conduct. Modern cities or shanty towns are full of many migrants who are yearning for the simple certainties and direct contacts of traditional village communities. In the modern mass society, much coordination has been shifted from the interpersonal to the collective level, from civil society and voluntary associations to administrative coordination by coercive, top-down rules. Many regret the downgrading of simple internal institutions that give scope for individual spontaneity and diversity. Imposed institutional arrangements are all too often tailored for "the masses" and breed uniformity. After all, civil society offers, so to say, an à la carte service for individuals, whereas collective government only offers a set canteen menu.

Human wellbeing in general and material productivity in particular thus depend crucially on the right kind of institutional system.

A society's institutional foundation sometimes consists of formal laws, enforced by courts and the legitimated use of force by certain government agents. But more often than not, social interactions are based on institutions that evolve and are spontaneously enforced within a community: ethical norms, customs, conventions, work practices, and professional standards. These rules are enforced in informal, but nevertheless powerful ways, such as peer pressure or the fear of losing one's good reputation. People who continually break conventions and customs will be shunned and become isolated and lonely. Those who disregard professional standards lose their reputations, and soon their business. Thus, dishonest traders in international currency markets will soon lack trading partners, as their reputation spreads. This is the reason why these markets function smoothly and often with surprisingly small costs and trading losses. These society-internal institutions are anchored in fundamental values that most of us share, such as high preferences for freedom, justice and equity. Where shared values are missing, institutional structures stand on uncertain ground and people feel insecure.

Rule adherence or otherwise by communities and governments is now widely known and communicated internationally. For example, an agency in Berlin, Germany, regularly evaluates and reports international perceptions of corruption, i.e. the quality of national rule systems and the reliability with which they are enforced (Lambsdorff, 2001). In line with what is said here, the empirical evidence shows that corrupt institutional systems reduce a nation's benefits from economic growth and globalisation. Indeed, corruption has more immediate dire consequences under contemporary conditions of global exchange (Wei, 2001)[5].

Yet, despite their central importance, the institutions and shared fundamental values are normally taken for granted. Traditionally trained economists, for example, frequently do not even mention the underlying ground rules when they explain productive activity and exchange or when they investigate why some countries manage fast economic growth and others fail[6]. They tacitly assume the right institutions to be given. However, if not cultivated with care and defended against corrupting assaults of opportunistic operators, a society's institutional infrastructure might remain stunted or might even decay. Then, the best resource endowment, the best technological knowledge and the hard work of individuals yield little economic gain. This becomes evident when one looks at countries where the institutions have been corrupted in dramatic ways, for example in present-day Russia, Vietnam, Cuba, and North Korea and even in certain states in India. Observers then often blame freak weather or foreign boycotts for economic failure, rather than a lack of effort-inspiring institutions and shared values.

Competition-supporting economic rules and the rule of law are likely to emerge and be adhered to more consistently in electoral democracies, a system of competition for (temporary) control over political and rule-making power.

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[5] We note that India was rated a paltry 71st out of 91 countries in 2001 (Lambsdorff, 2001, 14). More generally, pervasive bureaucratic corruption has made the institutions of much of South Asia fairly unreliable (Court, 2001). Modern growth theorists with a grasp of institutional economics are therefore not surprised at the low living standards and poor human condition in India.

[6] Thus, the World Bank, in its annual *World Development Reports*, took a long time to even mention the importance of institutions and still often displays a preference for the action of the 'visible hand' of the state rather than market-driven evolution.

But in many developing countries, including India, elites have often considered democracy as a way to rule society and the economy (eg. Nehru era planning and *dirigisme*), not as a way to control the powers of the rulers.

Institutional Change: From Tribal to Global Society

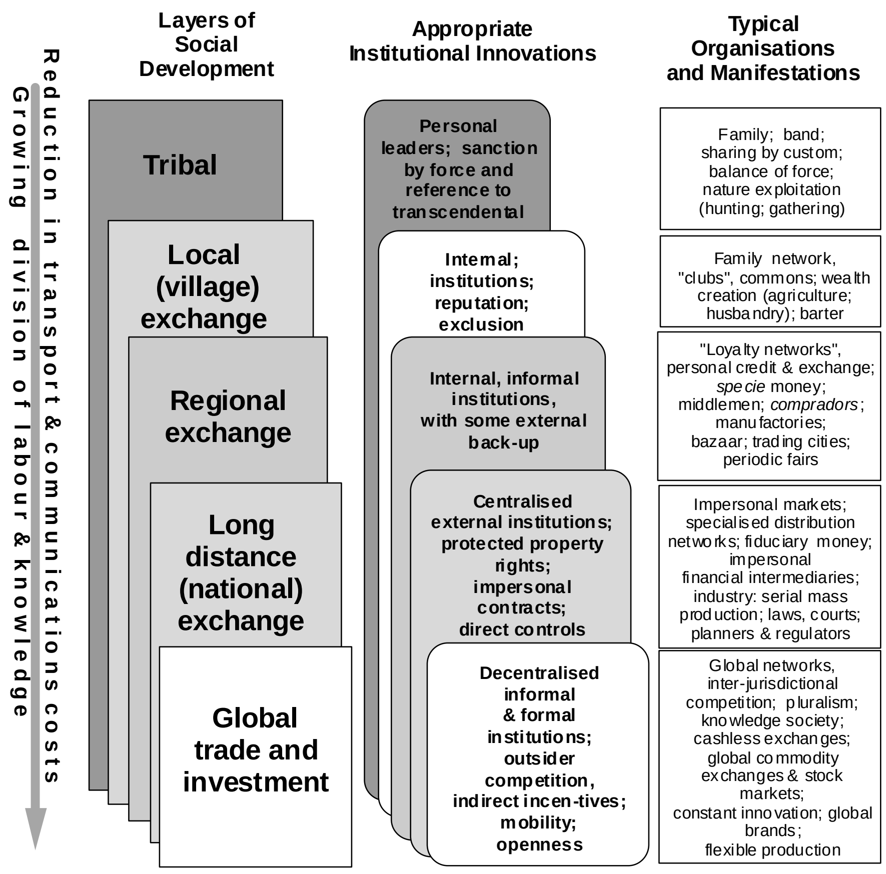
Institutions can—fortunately—be learnt and adapted, although that is a harder task than adopting new crops or investing in new infrastructural and industrial hardware. The reason is that the rules which shape social interaction are so deeply entrenched that we consider them a part of ourselves. Relearning them or adding to them also affects power structures, challenging some at the top and exposing past power and wealth to new, competitive challenges. Of course, this inflicts uncertainties on the rich and powerful, who will often resist change. The wider public will often support a conservative stance. It is after all not easy to expose familiar hierarchies and communities to open competition and the challenging, confusing dynamics of the open society.

Obviously, different "traffic rules" are needed for different types of traffic and circumstances. The foot traffic in a village may need very simple and informal rules, road traffic in Delhi requires more detailed institutional arrangements and organisational back-up, and air traffic rules have to be different yet again.

The same can be said for different types of societies. As societies developed from small tribal bands, such as pygmy hunters, to local agricultural economies with regional exchange economies, such as those of pre-colonial India, to national economies, and now the open global economy, the rule systems had to be adjusted. Each step requires that we learn an additional layer of new rules and learn to reconcile these rules with older institutions. Thus, we may interact in the global market economy, following one set of rules, but when we return to our home, we may happily return to the familiar tribal habits of interacting in a small group, perpetuating rules, which our paleolithic ancestors had developed.

Graph 3 indicates the various stages of economic development and the layers of additional institutions necessary. We know from history that refusal to adopt new rule systems can stop economic development. Institutional rigidity and corruption pave the way for persistent poverty. Thus, the Soviet central planning system proved to be acceptable for the rapid development of crude, basic industries at the expense of everything else. But the regime was incapable of coordinating broad-based innovation and the modern 'knowledge economies' on which the wealth of the West and of East Asia is based. When the Soviet system collapsed under the weight of its own failures, the very imperfect central planning system was jettisoned. Few new rules were, however, put in place in the confusion—hence the terrible economic decline, rise in mortality and poverty throughout much of Russia and its neighbourhood during the 1990s.

Graph 3: Social, Institutional and Economic Evolution



Source: W. Kasper (1997)

Small tribes of hunters and gatherers are coordinated by personal leaders, who may use force, but their rule tends to be tempered by personal empathy and bonds of kinship (Graph 3). Once a society moves from the paleolithic economy of nature exploitation to the neolithic economy of wealth creation by agriculture and animal husbandry, societies become bigger, and the rules have to be adjusted. Rules have to be developed which are anonymous and permit networking by barter and joint ownership in an exchange economy. Success in agriculture will, for example, depend on the delineation of private or group property in land and respect for the ownership of the crops growing on it. Persistent raiding and stealing may prevent a society from realising the 'neolithic revolution' (Kasper 1997a).

Once societies and economies develop regional exchange around market towns, political leaders tend to emerge who codify, refine and enforce the traditional rules of ownership and exchange. And when the exchange grows beyond regions, governments that develop more centralised, external institutions arise. For example, princes, public administrations and *kadis* cultivated sophisticated commercial law in the Arab world and parts of South Asia to facilitate trade at that level of development. In such societies, the rulers tend to enjoy considerable privileges, for example in Feudal Europe or traditional India. In early modern Europe, the institutional structures were further developed. They moved in the direction of non-discriminatory enforcement and non-discriminatory individual rights, once various rulers competed with each other to attract mobile producers and merchants (the following section will deal in more detail with the emergence of the institutions of modern capitalism).

As big nation states emerged, more emphasis was laid on public policy by national governments and national institutions that favour impersonal contracts between strangers in the market and formal controls to enforce them. In Asia, this often happened under European colonial influence and was taken much further by many of the newly independent governments, despite the fact that they lacked the organisational means to give effect to these rules they adopted. When this was combined with central planning, official import substitution and massive, ideologically driven regulation, as in India, much of the growth opportunity was wasted.

Now, as more exchange is on a global level, as investors shop for the most promising location around the world, and as the knowledge economy grows thanks to exchanges over the internet, new rule sets are needed. Many ineffectual, rigid government-run institutions are now being replaced by more decentralised, less formal institutions. Closed economies and societies with corrupt organisatons are now losing out. Openness to outside competition is productive and benefits societies if they have simple and reliable institutions that facilitate rapid change (Wei, 2001). Clearly, this requires a lot of trust and mutual understanding. People, groups and leaders who cannot be trusted, are now losing out very quickly, as their poor reputations become known around the world and no one engages in exchange with them. It is not a case of the Marxian assertion that 'the rich are getting richer and the poor poorer', but rather that the trusted are getting richer and those under a corrupt government are getting poorer.

The priority task for communities and public policy around the world is now to acquire the new rules and harmonise them with the old, inherited rule systems. Sometimes, traditional, but now counter-productive rules have to be jettisoned. Thus, economic reform—privatisation and deregulation—is being pursued under the pressures of global competition in most countries, from the US to China, from Russia to India. Old power structures, that have a vested interest in old rules, often fight back. The powerful, who make corrupt use of old rule systems, resent the disciplines imposed by global markets and the quick response of investors to corrupt or opportunistic political behaviour.

Yet, in the process, people learn that a good reputation, reliability, punctuality, good will, and flexibility constitute valuable capital assets and are worth cultivating in the interest of prosperity, freedom and justice.

The Emergence of the Institutions of Capitalism

Modern economic growth began when the institutions of capitalism—secure private property rights, freedom of contract, and the rule of law—emerged in northwestern Europe from the Renaissance onwards. Institutional evolution preceded the industrial revolution, which ushered in the extraordinary, sustained rise of living standards and its spread to a growing number of people.

Early last century, the famous German sociologist-economist Max Weber drew attention to the institutions that made capital accumulation, innovation and industrial enterprise possible in the post-Medieval Europe (Weber 1927/1995). More recently, American, Australian and European economic historians have again high-lighted how appropriate institutions and enforcement mechanisms had to be established before confident, enterprising and innovative capitalists could start the industrial revolution and augment economic growth (North-Thomas, 1973; Berger, 1987; North, 1990; Jones, 1982/87; Rosenberg-Birdzell, 1983; Weede, 1996).

Before the industrial revolution in Europe, an observer would probably have predicted industrialisation to occur in China. The technical preconditions had certainly appeared excellent for an industrial revolution in Tang and Sung dynasty China between the 7th and 12th centuries. Sustained growth might have been predicted to take off in India, where artisans and thinkers had long had skills and knowledge far superior to that of the Europeans. Why did the industrial revolution nonetheless occur in Europe?

The explanation points to the central role of institutions. European and Asian rulers had probably been equally arbitrary and opportunistic, with little interest in the material welfare of their ordinary subjects. Unlike the large Asian empires, however, the European fiefdoms were small and open. Enterprising bankers, merchants and artisans were thus able to "vote with their feet", if they felt poorly treated in a particular jurisdiction. Some rulers—initially in Venice, Florence, Genoa and Barcelona, then in Amsterdam, and later still in England and Prussia—saw mileage in constraining their own power by binding themselves through general rules. They promulgated and enforced laws that protected private property, individual autonomy to make contracts and other liberties. European city governments operated on the principle that "city air makes you free". They protected the freedom of refugees from the feudal countryside and attracted the bright and the enterprising who contributed to the prosperity of the cities (Kasper, 2001–02).

In the Middle Ages, feudal law had given each class of citizen specific privileges and obligations. However, merchants who traded between different jurisdictions found this system too uncertain and cumbersome. Corrupt, arbitrary rulers and judges were simply bad for their business. So they avoided the rule of men and government-run courts. Instead, they agreed to operate on the principle of equality before the law and began to enforce their own rules. This came to be known as the Medieval *lex mercatoria* (Custom of Merchants). It inspired certain princes, who were eager to attract trade and talented people as a means of enhancing their revenue base, to support simple and reliable rules. They began to guarantee economic, religious and civil liberties (Jacobs, 1992). Laws and courts were set up to protect the fundamental rules that became the institutions of capitalism, which secured private property and a high degree of private autonomy in using those property rights. Fraud and the arbitrary use of violence were controlled, and citizens were no longer treated like immature dependents. The rule of men became the rule of law.

Those princes who effectively protected private property and the freedoms to use it prospered. At the end of a long evolution, this gave rise to constitutional government and formal controls over the powers of the rulers, for example with the Glorious Revolution (1688) which entrenched the rule of law in Britain (Walker, 1988, ch. 3). Only thereafter could capital accumulation and entrepreneurial risk-taking proceed with confidence, triggering what was to become the industrial revolution. The creation of a citizen- and enterprise-friendly system of institutions was thus the by-product of the power rivalry among the small, open states of Europe.

By contrast, all Chinese lived "under the same Heaven". The rulers of China were not much exposed to competition with other rulers. Dissident citizens could normally not move elsewhere. From the 18th century onward, when Europe opened up and underwent an industrial revolution, China turned inward and sank into economic decline. China's inward turn under the Ming emperors was amazing since the Chinese had benefitted greatly from the expansion of international trade and low taxation in the preceding century when there had been a population explosion. But there was no competition among differing jurisdictions in the Ming and Manchu empire, no control on the central power, and hence little innovation in institutional and administrative practice. The same was true of other large empires in Asia (Jones, 1982/87). The authorities could therefore treat the merchants and the producers arbitrarily. Bureaucrats were able to discriminate with impunity. Courts could be run without due process or obeisance to any notions of procedural justice. Private fortunes could be confiscated almost anytime by opportunistic officials. Hence, there was much less incentive to accumulate and use wealth in productive, but visible ways. Much of the useful knowledge was never exploited commercially in China despite its scientific lead over Europe.

The difference between the petty states of Europe and the closed empires of Asia is highlighted by the fates of two great explorers. In the 15th century the Chinese eunuch admiral Cheng Ho had sailed as far as Java, India and East Africa and brought home wondrous tales and goods, even a giraffe. But one word from a new Ming Emperor sufficed to stop further exploration. By contrast, Christopher Columbus, whose plans for a voyage westward across the Atlantic were rejected by several potential backers, was able to shop around among the rulers till he obtained the material support of the Spanish kings—the rest is history.

In a way, the beneficial impact of open and competing jurisdictions has been replicated more recently in East Asia, where it has led to the evolution of—albeit imperfect—institutions that now constrain political power and empower citizens. In the first instance, the Japanese economy was opened up by American intervention in the mid-19th century. This triggered internal constitutional and institutional changes, the Meiji revolution. Many of the institutions that facilitated modern economic growth probably pre-existed in Japan, but were adapted to support technical and economic development (Powelson, 1994, pp. 25–39; Kasper, 1994a, b). After the second world war, the dominant centre of the East Asian world went into seclusion when it became the People's Republic of China. As a consequence, several small jurisdictions in East Asia during the 1950s and 1960s had to cope with the experience of openness and external exposure—Hong Kong, Taiwan, South Korea, Singapore, Malaysia and others. Political entrepreneurs and innovators, such a Lee Kuan Yew in Singapore, a new generation of leaders in Taiwan, General Park in South Korea and British administrators in Hong Kong, created institutions that supported spontaneous private enterprise and facilitated access to world markets, while African, Indian and Latin American rulers engaged in import substitution and protectionist intervention. Of course, the likes of Nkrumah, Nehru and Perón and their advisers had no idea what industries to develop and how—other than what their self-seeking cronies told them and what served the short-term interests of their political "tribe".

The reformist political entrepreneurs who laid the foundations of East Asian development did not act out of deep philosophical insights or the kindness of their hearts. They developed good institutions as a by-product of their pursuit of power and tax revenue, because the economy was open. At the same time, the populations of those countries adjusted their traditional internal institutions to master their precarious circumstances. Though long considered a handicap to development, Confucian ethics soon evolved from a hierarchical-static to a forward-looking set of effective institutions. Without these institutional changes, the subsequent industrial revolution would not have been possible in East Asia. The monetary and banking crisis in 1997 reminded many East Asians again of the importance of an open, non-discriminatory rule system (Kasper, 1997a). Some are now trying to enhance the rules. As their economies are maturing and the cost of land and labour is rising, institutional evolution and reform will indeed become crucial for further growth, confidence, and social harmony. And those political leaders who corrupt the rules in order to retain or exploit power (crony capitalism) will discover that capital outflows, currency depreciation and slower growth are a high price to pay.

Institutions and Value Judgements

Before we can wind up this introductory chapter, an explicit word is required about a fundamental methodological point. The discussion of institutions cannot be value-free. What follows is therefore an essay in normative economics. The arguments are influenced by the author's personal preference for a free, prosperous, secure and peaceful society. Some readers will be more comfortable with purely positive economics, for example the choice between known alternatives of how to meet human wants with known resources. But this is not very useful for understanding economic development and guiding public policy in a country like India. One has to judge what is good and bad, if one decides to suppress thievery so as to promote wealth creation by everyone (Olson, 1996).

The choice and the reform of institutions require a subjective preference for wealth creation for the benefit of the majority of citizens. The luxury of value-free analysis is therefore not available to those who discuss institutions and constitutions. These rules invariably affect fundamental human values, such as freedom, prosperity, security and peace in a community, which are dear to most people of all races. It is of course not easy to evaluate alternative institutions against such abstract criteria. But a good starting point in sorting out good from bad institutions would be to ask two questions: (a) Does this rule enhance people's freedom of choice? (b) How does this rule affect the life opportunities of the poorest 20 per cent of the population? The answer to the first question will give pointers to the central quality of liberty, the answer to the second to the equity.

I hope to show that the competitive efforts of the many in discovering and testing what serves them best normally offer superior outcomes than the centralised top-down approach of the government. The main reason for this is that government agents often simply do not know enough. They act instead on a dangerous pretence of knowledge—to cite the title of Friedrich Hayek's famous Nobel Prize lecture (Hayek, 1974/84). Political leaders are typically driven to activism by their own political and material interests. They care little what uncertainty, disadvantages, compulsion and conflict they impose on ordinary citizens. It therefore seems appropriate to explicitly acknowledge this basic fact and to foster a system of rules which empower all citizens to freely pursue their own purposes, as long as this is not to the detriment of the aspirations of others.

Insert

Economic Growth: Is it Worth Having?

Before we can leave this introductory chapter, it seems useful to discuss whether economic growth—the sustained increase in average real per-capita incomes—is desirable. Maybe this is not an issue in a poor country, such as India. But many people in the affluent West, who take high living standards for granted, have doubts about the desirability of continuing economic growth.

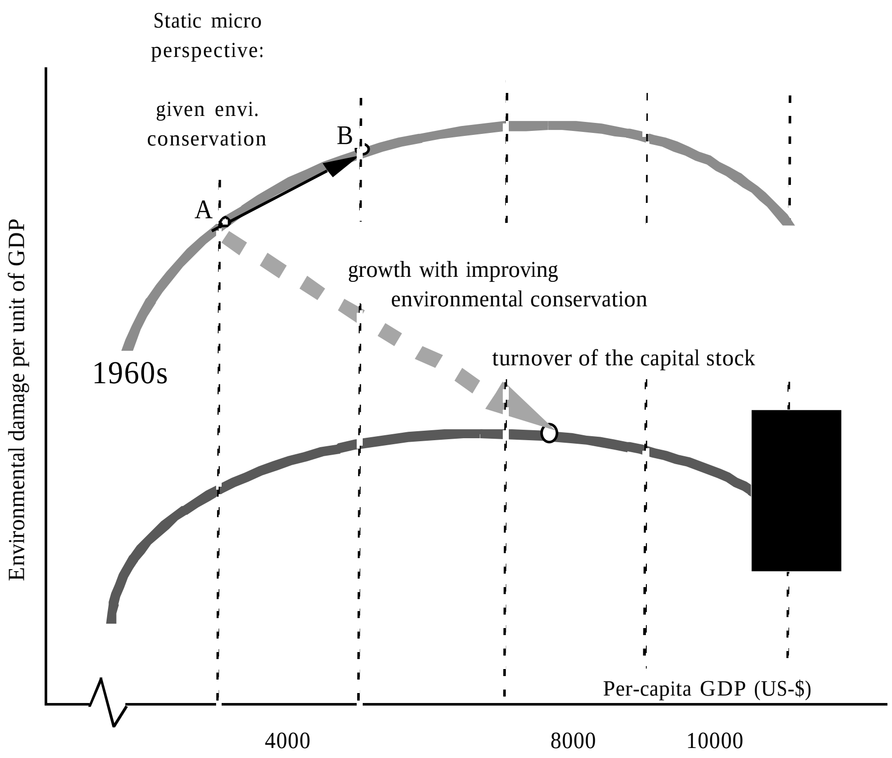
There can be no doubt that economic growth inflicts costs: The present generation has to sacrifice instant satisfaction and consumption, to put some production aside for capital formation, so that subsequent generations can produce more. Our ancestors, who gave up time to search for more food in order to shape digging sticks incurred that 'savings sacrifice'. Now, parents are forgoing consumption to send their children to costly schools (investing in human capital) or business people channel profits into improving their businesses (investing in physical capital). A second cost of economic growth is that it demands manifold structural changes.

Economies, like trees or other living organisms, inevitably change their structural composition as they grow. Thus, the income share (and the political influence) of agriculture tends to shrink as economies grow. This development was evident in the industrial revolution of the 19th century in Europe and North America. It went along with rapid urbanisation, deficient infrastructures and services, the growth of urban slums and other phenomena of early industrialisation that are familiar to the citizens of the third world now. Experience in the old industrial countries—and more recently in the new industrial countries of East Asia—has shown that this is a transient phenomenon; continuing growth goes along with better living and environmental conditions. Moreover, as incomes keep rising, manufacturing ceases to be the growth engine, and the service sector—the knowledge industries—take over, generating high incomes and relatively less pollution. Instead of an impoverished proletariat, which Karl Marx predicted, an affluent middle class grows that enjoys 'democratised amenities', going on annual holidays, driving their own cars and enjoying amenities like air conditioning, washing machines, access to the internet and modern medical care.

This evolutionary-dynamic 'macro picture' of economic development cannot always be seen clearly from the 'micro perspective' of an individual developing country. It is a common fallacy to equate economic growth with worsening pollution. A reference to the adjoining graph should expose this 'fallacy of distorted perception': When a society raises its real income from $ 2000 per annum to $ 4000 from the 1960s onward (a typical East Asian experience), people observe a rapid rise in environmental damage. Were these people able to travel abroad, they would note that rich societies (say, at incomes of $ 10,000) enjoy better environments, despite higher levels of economic activity. Switzerland or the USA cleaned up the environment as their living standards grew. But, overall, there is a much more powerful effect at work, namely the improvement of production technologies over time. By the year 2000, every level of income tends to go along with lower pollution (see graph), and progress has been the fastest in fast-growing economies because old polluting old technologies are depreciated and replaced the fastest.

The upshot is this: If one looks at one place (such as Port Harcort) and for a short period of time (static micro perspective), one has to conclude that growth is accompanied by environmental degradation. In reality, the opposite holds true if one looks at long-term evolution and the global evidence (dynamic macro perspective). As societies grow richer, they can afford to invest in cleaner environments, and innovators respond to environmental problems by developing better technologies. Environmental problems are indeed often the

Environment Textgraph: Growth and the Environment: Two Differing Views



Source: J. Norberg (2001), p. 216

result of deficient economic growth. The same can, incidentally, be said of many other alleged drawbacks of economic growth, and the lesson should be to look long term and global.

At the same time, economic growth has many benefits. It is worth listing the following (Simon, 1995; Norberg, 2001):

- Economic growth does not only generate more unwanted junk, as some allege. Markets respond after all to what people appreciate. If people are prepared to use their growing incomes to pay for better entertainment, cultural goods, education of their children, health care and better nutrition, suppliers will offer these benefits. Growing economies allow people to overcome natural calamities, for example by the distribution of emergency food aid after a bad harvest.

- Economic growth is closely associated with the reduction of absolute poverty. During the 1990s, for example, there was a telling association between the growth of per-capita incomes and the reduction of the population share of those who have to survive at or below the World Bank's poverty measure of 1 US-$ a day. Where economic growth was high, the very poor benefited too:

Region	Real income growth (%)	Change in poverty (%)
East Asia/Pacific	+ 7.1	– 12.9
South Asia	+ 3.9	– 4.0
Mideast/N. Africa	+ 0.6	– 0.3
Latin America	+ 1.8	– 4.7
Sub-Saharan Africa	+ 0.4	+ 0.1

- Growth goes along with less child mortality and longer life spans. People live healthier lives, and to remain self-sufficient into their 80s, whereas the average life expectancy in poor, traditional societies was around 40 years of age[7].
- One of the benefits of rising living standards that almost all communities desire better education, which in turn facilitate future economic growth. Rising literacy tends to be accompanied by an improved social status of women and more effective birth control. This again helps to raise productivity growth.
- As societies become more affluent and educated, people become more assertive of their innate rights and more sceptical of autocratic political control. Thus, the 1960s generation in the East Asian growth economies concentrated on economic opportunity and accepted autocratic rule. Their children had the education and material means to demand more democracy.
- If there is a political preference for economic growth, politics will promote freer international trade and investment, which experience shows to be the main driving forces of economic progress. A greater material stake in neighbouring countries, in turn, promotes peace—as the 19th century French liberal Frédéric Bastiat put it: “If goods do not cross borders, soldiers will”.
- Different from what Marxists have predicted, inequality among people in growing, free economies diminishes. Admittedly, the short-term micro

[7] Some observers have commented that globalisation and economic growth around the world have contributed to s spread of diseases, such as AIDS. This is true, just as it is a historic truth that big changes—in particular the start of animal husbandy 7000 years ago, the trade contacts between the Roman Empire and Han Dynasty China 2000 years ago, and the new trade between the Old and the New Worlds 500 years ago—have entailed the spread of new diseases. But, even allowing for these, and on balance, economic growth and long-distance exchange have helped to improve human health.

process benefits only some, who become wealthier, but not others. Moreover, the take-off into economic growth tends to offer the poor a little more, so

their forebears had just died. Over the longer term, however, higher incomes trickle down and "democratise" rising living standards. It is one of the most

economic opportunity from growth spreads quickly and evenly, and free markets and the fight against political corruption are the most effective means

- The less developed countries have also benefited from the growth in rich,

from affluent countries select those jurisdictions that offer them economic freedom and secure property rights. Attractive locations in the third world

modern industries within one generation, accompanied by most of the blessings of economic growth, as discussed above.