

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

Yet, ironically, while capitalism has fattened peoples' wallets, it has made surprisingly little inroads into their hearts and minds. Many of the people protesting in the streets against globalization are protesting against capitalism, which they accuse of oppressing workers, exploiting the poor and making only the rich richer. Unfortunately, the response of the traditional right has been to emphasize that markets are the best way of creating wealth, that this wealth will eventually trickle down, and in the long run, a policy of *laissez faire* will make us all better off. To the slum dweller in Bangladesh or Brazil, confronted by the reality of markets that don't work, such words are poor comfort.

Start with an example that seems to reflect the evils of capitalism. Sufiya Begum, a poor Bangladeshi villager needs twenty-two cents to buy the raw material for the stools she makes. For lack of better alternatives, she has to borrow this money from a middleman, who forces her to sell the stools back to him as repayment for the loan. Of course, he sets the price. Thus, Sufiya gets only two cents for a hard day's labor.

In this vignette many see the worst of capitalism. In fact, this situation could not be further away from the essence of capitalism: free access and competitive markets.

Our Explanation

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

All we are suggesting is a general tendency, not an iron law: When markets start out limited, those who already have access often have very different incentives from those who don’t. If, as is likely, the former are more politically powerful because of the wealth they obtain from their privileged access to markets, they can ensure the government does not create the conditions for wider access. Consider Russia, where following privatizations,

economic power has become concentrated in a small group of businessmen widely known as the “oligarchs”. Since they control near monopolies in natural resources, they have very little interest in promoting antitrust regulation and in opening up the market to new competition. Not surprisingly, very little has been done in both these areas.

In fact, incumbents may not need to campaign actively against market-friendly infrastructure: the government may simply not be interested in the welfare of the commoner, and the politically influential and conscious classes may not see it fit to change matters. Neglect can be as effective as overt opposition.

The tendency we suggest above can be seen even in a functioning democracy. Consider another example. Recently, the Bush Administration levied tariffs on imported steel. The alleged reason was to protect American jobs. But there are only 190,000 workers producing steel and 9 million in steel-consuming jobs. While steel prices in the United States have indeed gone up, steel prices have fallen below U.S. levels in the rest of the world as exporters redirect their steel away from the United States. This hurts U.S. industries that rely on steel as an input: they can no longer compete with foreign manufacturers who now enjoy cheaper steel inputs.

Last June, Brian Dundon, President and CEO of Advance Transformer (an electrical equipment manufacturer) testified at a U.S. International Trade Commission hearing about the costs imposed by the steel tariffs on firms like his. The tariffs created such a substantial increase in demand for domestic

steel that suppliers could not meet it all. Rather than deliver steel to Advance at a price negotiated prior to the tariffs, they chose to sell to those who would pay the higher price in the now-protected market. As a result in December 2002, Advance was forced to close its magnetic ballast assembly operations in Monroe, Wis., and move production outside the country. Advance's parent company, Philips, is now building ballast manufacturing capability in China. Far more American jobs are put at risk outside the steel industry by the steel tariffs than were saved in it. So the tariffs were certainly not in the public interest.

The truth is that the tariffs were a subsidy, not so much to the steel workers who could have been helped at lower cost to the economy through a direct handout, but to the owners and top managers of the distressed steel firms, who benefit handsomely from the tariff. The reason they prevailed is that the concentrated lobbying power of established powerful private interests often outweighs the **national** interest.

If special interests get their way even in a well-functioning democracy like that of the United States, imagine how much more powerful they are in developing countries.

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

because there are too many interests against the building of the right infrastructure.

After the 1994 Mexican crisis, for instance, the World Bank decided to help the government improve the financial infrastructure. Among the fundamental institutions that were missing was a collateral registry, where assets posted as collateral for a loan could be officially recorded so that any potential lender could be aware of what a borrower had already pledged. In turn, such a registry would make it easier for small and medium firms to raise finance against their assets, since potential lenders would now have the confidence to lend. In arguing for this registry, the World Bank experienced strong resistance from the existing banks. Why? Existing banks had enough clout that they could get this information regardless of the registry. Not only would they not benefit from it but also they would see their competitive position eroded as less established lenders could access the information and compete for business on an equal footing. Access to credit was curtailed to support the interests of the few incumbent interests!

No wonder then that the poor around the world see markets as being against them, not realizing that what they experience is a very corrupted version of the markets we experience. That the elite tend to have disproportionate say in the running of markets is actually a point on which the right and the left agree – one of the few places where Chicago economist, George Stigler echoes Karl Marx.

But the left is wrong in saying that markets need to be replaced by the government for that will just perpetuate the capture by the elite. And the extreme right is wrong in saying we can dispense with the government:

Consider another example. If you wanted to fly and there was no supervisory authority in the airline industry and no regulations enforcing safety standards, you would be very reluctant to fly fledgling airlines. You would prefer the established ones that had the track record and the reputation. So a complete lack of safety regulations in the airline industry would favor established firms, making entry impossible, and killing competition. The absence of government can also be anti-competitive and retard free markets.

How Can Free Markets Prevail?

What we need therefore is a Goldilocks government, not too interventionist and not too laissez faire, a government that is just right. The difficulty with this Goldilocks position is, of course, in how to get the mix right.

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

The effect of open borders can be clearly seen in the Indian automobile industry. In the mid 1980s, the industry was protected from foreign imports.

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

In the early 1990s, following a financial crisis, the Indian government opened the car market to foreign producers. The worst fears of the domestic producers were realized. The public abandoned them for the new foreign models and the old manufacturers were wiped out (though since then the Ambassador has rediscovered a market as a “period” car in the West). But it simply did not make sense for the foreign manufacturers to continue sourcing their sub assemblies from outside India. Instead, they started developing local ancillary manufacturers, and gave them the technological assistance for them to become world-class. Soon India started exporting ancillary automotive products to the developed world.

The story does not end here. An Indian manufacturer, Telco, capitalizing on the existence of world-class suppliers of ancillaries in India, started producing a state-of-the-art, indigenously-designed car, the Indica.

The car had teething problems at first and was rejected by a now-discriminating public. But Telco engineers went back to the drawing board, fixed the flaws, and brought out a new version that swept the market in its category. From about 50,000 cars in the early 1980s, India now produces over 600,000. Next year, it is slated to export 200,000 cars, many to the developed world. The automobile ancillary industry grew by 20 percent in sales last year and by an average of about 10% in the decade before that. The Indian automobile industry offers an example of what trade liberalization can do – potentially some pain in the short run but enormous gain in the long run.

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

Again, Indian industry offers an example. As Indian markets opened up to international competition, domestic industry felt the costs of antiquated infrastructure. For instance, the high cost of domestic finance placed them at a disadvantage relative to their foreign rivals who had access to cheap finance in international markets. Indian industry now had a strong incentive to press

for domestic reform. Interest rates that had been fixed at extremely high rates were liberalized. Competition in the banking sector increased as private and foreign banks were allowed to enter. Firms no longer had to beg permission from the government to raise money in the stock market. New automated exchanges and stock depositories sprang up. Corporate governance and market regulation were improved so that investors could get a fair deal.

The consequence has not just been a reduction in the cost of finance for firms but also a tremendous expansion of credit to consumers as the now-competitive financial sector looked for new products and customers. A study by an Indian market research firm, NCAER, finds that before 1985 less than 10% of new cars were bought with credit. In 1996-2000, 51% of the cars were bought with credit, and the number today should be significantly higher. Indians have discovered the power of credit and it is making their lives vastly richer.

With the withering of archaic barriers, and the expansion of markets in countries like India and China, we have seen the greatest increase in human wealth for the largest number of people in the history of mankind. In these two countries GDP per capita remained roughly constant between 1820 and 1950, increased 68% between 1950 and 1973 and 245% between 1973 and 2002. Just the improvements over the last thirty years represent 5 trillion dollars of more of wealth created every year in prices adjusted for purchasing power. To find out if markets are necessarily against the poor ask the Chinese entrepreneur manufacturing plastic flowerpots, who only two decades ago

was digging meaningless holes on a co-operative farm. His answer will be a resounding no.

Even in developed countries the opportunities provided by the market to those who have talent but no money have been truly breathtaking. Despite the excesses of the Internet boom and bust, something has truly changed over the last few decades. An institution like the Search Fund, whereby a graduating MBA obtains the funds to search for a buyout candidate that she will then manage, would have been unimaginable twenty years ago. Finance used to be available only for the wealthy, who had the collateral to back their promises. Now finance is available to fund the search for a dream, with the only collateral being the seeker's ambition. The talented have truly become freer to seek out opportunity, without being held back by their poverty.

Capitalism at Risk

Despite all these benefits from freer markets, it is too early to celebrate their victory. While borders have opened, they can close again. Foreign competition is now touching areas like services that used to be immune before. An accountant in the Phillipines can now do your taxes via the Internet as effectively as someone from H&R Block across the street. The service sector in developed countries is unused to such competition and can react forcefully. Already some states in the United States are threatening to blacklist businesses that outsource processes to other countries.

In times of economic distress, the foreigner and his goods become a particularly easy target. The attitude of the largest economy in the world is particularly important in determining whether protectionism will come to dominate the world over. And this country has sent mixed signals in the recent past. The steel tariffs were followed up by enhanced farm subsidies. With growing militarism, will the United States be happy to be dependent on China for so much of its manufactured inputs? More restrictions may be on the way.

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

Corporate scandals have not helped. One of the reasons people in this country tolerate the enormous inequalities in income and wealth, say relative to Europe, is because there is a perception that markets are fair and success is accessible to all. Corporate scandals suggest that the CEO, his investment banker, and their friends play on a different playing field than the ordinary pensioner. The danger is that ordinary people might get disillusioned with reform and shift their support to demagogues who seek to replace the market. Equally bad would be if the reforms get hijacked by special interests who use the turmoil to carve out their own little privileges

And in the medium term, developed countries have to confront the problem of rapidly aging populations. As we have more and more politically powerful old citizens in developed countries depending on fewer and fewer economically powerful young, new tensions over taxes and property will arise. Similarly, as old developed countries have no option but to invest in young developing ones we will have to find better ways than we have in the past of assuring the security of that investment.

Given all these challenges, what can we do to create conditions that ensure political action is public-spirited and that the rules and regulations are not made to protect the interests of a few? How can we make capitalism more politically stable in developed countries? How can we bring the poor into its fold in developing countries?

Policy Initiatives

We suggest four broad policy objectives and some examples of specific policies. Viewed in isolation, some policies might seem perverse, but when seen in the context of mutually reinforcing objectives, they are not.

Open Borders: The first is to keep borders open to the flow of goods and capital. This is especially important for developed countries because in doing so they encourage constituencies that will create better markets in developing countries. Specific policies include reducing farm subsidies, making sure that new protectionist barriers do not rise around services, and offering developing countries carrots for reducing their own barriers.

The opening up that has come about through dialogue between nations, earlier in GATT and now in the World Trade Organization (WTO), shows that international forces can curb the power of domestic lobbies. But the recent breakdown of the WTO talks in Cancun indicates that the power of domestic lobbies has not been extinguished, either in developed or in developing countries. We hope these negotiations resume in earnest because the alternative, bilateral agreements, are much more subject to the power of vested interests than a broad-based multilateral agreement.

Efficient Ownership of Productive Assets: The second objective is to encourage the transfer of productive assets into efficient hands. Inefficient owners tend to oppose rules that promote competition – they see the downside of freer markets rather than the upside of opportunity that those markets bring. One reason they do not sell out is that they get a variety of non-monetary benefits from their ownership such as perks, power, and status. In many developing countries they may also siphon off undeclared corporate income.

The current system of taxing income subsidizes this kind of ownership because such non-monetary benefits or theft are not taxed, while all the income generated by an efficient honest owner is fully taxed. One way to promote the transfer of productive assets into efficient hands is to move more from income taxes, which penalize the efficient, to property taxes, which demand owners earn on the wealth under their management. We do not advocate increasing taxes, but simply shifting their form.

Another way to improve asset ownership is to improve corporate governance. If managers of poorly run firms are fired, while the takeover market offers incompetent owners a graceful way out, then far fewer firms will be run in such a way that they need political protection. As recent academic studies show, the antitakeover legislation passed by many U.S. States at the end of the 1980s significantly increased managers and workers' pay, while it slowed down productivity increases. Hence, inefficient management such as those in steel found it easier to survive, and this created a powerful constituency in favor of anti-market actions like protective tariffs.

Iraq will provide an interesting test case for a strategy designed to make markets work for all. Before the recent war, it was estimated that 60 percent of Iraqis depended on their government for their livelihoods. It is very difficult for people who are not economically independent of the government to stand up to it. The first step to creating a truly meaningful democracy (and then functioning markets) is to ensure that economic power devolves to the people.

In Iraq, the bulk of economic power today lies in oil. While this can be privatized and the stakes distributed to the people, nothing prevents a future government from renationalizing oil wealth—oil is an easily expropriated resource. The way for an interim authority to create economic checks and balances on a future government is to strengthen the entrepreneurial and professional classes, so as to enable them to stand up to a future government. This class has been decimated by years of sanctions, and reviving it will mean

reconstructing educational institutions, repairing hospitals, and creating a new private delivery system for credit. It will also mean giving Iraqi firms and professionals preference in bidding for contracts during the period of national reconstruction. Finally, it will mean encouraging an outward focus by reducing trade barriers for Iraqi goods and services. If such a class emerges strong and confident, it will be the world's best guarantee that Iraq will stay democratic, perhaps even spreading the bug to the rest of the Middle East.

The alternative, which is a very real possibility, is that large contracts are awarded to American firms close to Washington, or to powerful local bosses that the occupying authority needs to control the territory. Such an outcome would do nothing to reduce the concentration of power that made the Saddam Hussein dictatorship possible.

A New Safety Net Focused on Individuals: The current environment – ups and downs in the stock market, corporate scandals, the failure of major public firms, and international tensions – resembles the 1930s in many ways. One should not stretch the analogy, however; a major difference is the existence of social safety nets.

Before the Great Depression only 20 percent of the labor force in Western Europe had some form of pension insurance, only 22 percent had health insurance, and unemployment insurance was almost unheard of. As a result, the massive unemployment caused by the Great Depression created a huge political demand for some form of protection.

Governments sought a scapegoat. And this was “unbridled” competition. While the United States did not go too far down this road (because the Supreme Court struck down the National Recovery Act and its provisions for government regulation of the market), other countries are still suffering the consequences of the legislation introduced in the 1930s. Italy, for example, transformed the banking industry into local cartels, with long-term adverse effects on the local economy. To this date, the areas where the cartel was tighter have less access to credit, less entrepreneurial activity, and less economic development.¹

While one can hope that developed countries will never again face such a savage and prolonged downturn as the Great Depression, one cannot be complacent. And emerging markets like Argentina have had, or are undergoing, near-Depression-like experiences even now. It is inevitable that future market downturns will generate demands for security and protection. It is also inevitable that in democracies such demands will be met. We need to prepare now so that these demands are met in ways that don't have the disruptive effects the Depression had on competition and markets.

Any safety net is best designed during a period of relative prosperity, when the pressure to help specific groups is lower and there is a better chance that the net will provide everyone reasonable security at low cost. In developed countries, some form of safety net exists but, as a legacy of the Great Depression, it is too focused on protecting firms and not individuals. It

¹See L. Guiso, Paola Sapienza, and Luigi Zingales, 2002, “Does Local Financial Development

makes sense to shift the net towards individuals. One example of such a shift is private social security accounts that protect individuals directly.

Perhaps more important, the net in many countries helps people overcome temporary business cycle downturns but not a permanent loss of careers. Handouts are not useful in the latter case. Instead, opportunities for continuing education, job training, and healthcare, are necessary to make people who lose their careers see hope in the market again. The best form of insurance may indeed be an early education that imparts flexibility to the mind. A sound school system is critical here.

For developing countries, which often have no safety net except the family, it is of paramount importance to build a formal one because family ties often fray as people become more mobile in the market economy. The advantage these countries have is that they need not repeat the mistakes made by developed countries.

There is no single proposal that will preserve the system of free enterprise from its enemies. This may not be a bad thing. Magic bullets, while certainly of much greater popular appeal than the incremental steps suggested here, often do more harm than good, even in the hands of the well meaning. Far better to have policies that, while individually moderate, can collectively check and balance each other.

While many in the developed world are now convinced of the superiority of the market democracy as a form of organization, far too few are

aware of how fragile its political foundations are. The all-conquering market is a myth, and the sooner the myth is put to rest, the easier it will be to buttress the markets we have and keep them free. Awareness is critical; for too long, politicians have played upon the ignorance of the public and catered to special interests.

By contrast, in the developing world, too few have really experienced either true democracy or true markets. One of the worst consequences of colonialism has been the creation of domestic elites intended to bolster the colonizer's position. Mahatma Gandhi's greatest fear was that the "brown sahib" would simply take over where the "white sahib" left off, making independence and democracy a sham. Unfortunately, his fear came true in all too many countries. By embracing competition, wider access, and truly free markets, developing countries will rid themselves of this terrible legacy.

The developed world needs markets to grow in the developing world, not just because unrest in the latter leads to swarms of economic refugees into the former, nor just because aging retired populations in developed countries will have to depend increasingly on productive young populations in developing countries, nor even because those markets will absorb developed country goods today. The developed world needs a more open, competitive developing world because that is the best guarantee that capitalism in the developed world will stay vibrant, with capitalists motivated more by the opportunities for growth than by the fear of competition. We have to break

the shackles holding back markets the world over. On that depends our own future.

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