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Hlavac, Marek

Georgetown University

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**Freedom as the Key to Prosperity:**

**Lessons from the World's Growth Miracles and Economic Disasters**

Marek Hlavac\*

Georgetown University

Georgetown Public Policy Institute

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\* Candidate, Master of Public Policy (MPP), Georgetown University, Expected 2011  
A.B. in Economics, summa cum laude, Princeton University, 2008

## **Freedom as the Key to Prosperity:**

### **Lessons from the World's Growth Miracles and Economic Disasters**

What do China, Estonia, Germany, India, Chile, South Korea and Slovakia all have in common?

At first glance, not a lot. All have their own cultures, traditions and politics. But one important aspect of their histories unites them: They have all enacted free-market reforms, and have seen their inhabitants' living standards soar as a result. This essay describes how free-market policies have improved economic performance in these "growth miracles." We will also draw contrasts with the policies adopted by governments in some "economic disasters" – countries that have failed to improve the economic well-being of their populations. The lessons we learn from these comparisons paint a clear picture: A country's economy performs best when its policies lead to greater economic freedom, limit the role of government, and promote respect for the rule of law.

#### **Economic Growth: What Is It? And Why Does It Matter?**

Economic growth represents the gradual increase in the amount of goods and services an economy produces. It is usually measured in terms of the per capita gross domestic product (GDP), the dollar value of all final goods produced in a country during a given year divided by the country's population. Sustained growth in the gross domestic product is the most important factor in improving a country's living standards (Baumol and Blinder, 2009).

High levels of the gross domestic product go hand in hand with other measures of the quality of life, such as high life expectancy or low infant mortality (World Bank, 1991). Over the long haul, furthermore, economic growth can reduce environmental pollution (Grossman and Krueger, 1992), as

industries can afford cleaner technology and as the population becomes more attuned to environmental concerns, especially in post-industrial societies (Andreoni and Levinson, 2002). In other words, GDP per capita can serve as a useful “summary statistic” of the level of a country’s economic development (Jones, 2002).

Over time, even modest increases in the economic growth rate can, furthermore, lead to vast improvements in the standard of living. If China sustains the eight percent annual GDP growth rate that it has achieved since its market-oriented reforms began in 1978, its inhabitants will double their living standards every nine years. By contrast, in the United States, which has grown at an average annual rate of about two percent, a doubling of living standards would require thirty-six years.

It is no wonder that, as he was contemplating the virtues of rapid economic growth, Robert Lucas, a Nobel Prize-winning economist at the University of Chicago, once famously remarked:

“I do not see how one can look at figures like these without seeing them representing possibilities. [...] The consequences for human welfare involved in questions like these are simply staggering: once one starts to think about them, it is hard to think about anything else.” (Lucas, 1988)

In this hopeful spirit, let us now embark on a whirlwind tour of growth miracles and disasters around the world, in search of policies that promote economic growth.

### **Cold War Contrasts: A Tale of Two Germanies and Two Koreas**

Some of the starkest contrasts come from countries that were, during the Cold War, split in half by the Iron Curtain: Germany and Korea. Capitalist countries, whose economies relied on market forces, achieved extraordinary increases in living standards. Communist countries in the Soviet bloc, on the other hand, grew much more slowly, stifled by central planning and command-and-control regulation.

The German economy and infrastructure was almost entirely destroyed during the Second World War. Burdened with large post-war reparations and restitutions (Cowen, 1985), West Germany had, some argued, little hope of making a swift recovery. Thankfully, it benefited from the leadership of Ludwig Erhard, who served as Minister of Economics from 1949 to 1963 (Henderson, 2008). A member of the free-market Mont Pèlerin Society (Mirowski and Plehwe, 2009), Erhard implemented a complex currency reform and removed numerous price controls, which had been responsible for widespread shortages of most goods, including food (Klopstock, 1949). As a result of these market-oriented changes, West Germany experienced a post-war *Wirtschaftswunder* (“the economic miracle”), and soon became Europe’s largest economy.

East Germany, by contrast, stagnated, and suffered frequent shortages even of basic foodstuffs. After the German reunification in 1990, the government poured massive amounts of money into former East Germany in an attempt to mitigate the inequality (Uhlig, 2006). Nevertheless, East German regions still exhibit much lower technological progress, suffer from a lack of entrepreneurship, and are home to fewer and less efficient businesses and industries (Kronthaler, 2005; Funke and Rahn, 2000).

After the Second World War, a similar split occurred on the Korean peninsula. Over the past fifty years, South Korea has been one of the world’s economic growth miracles. In 1960, South Korea was poorer than many countries in Sub-Saharan Africa (Rodrik, Grossman and Norman, 1995). It has since opened up to international trade, exposed itself to the powerful forces of international competition, as well as encouraged the inflow of foreign capital (Deme and Homaifar, 2001). Its government has, furthermore, systematically implemented growth-oriented economic policies (Kohli, 2004). Between 1960 and the end of the 20<sup>th</sup> century, South Korea achieved an average annual rate of economic growth of about six percent (Jones, 2002; Lucas, 1993). Today, the standards of living in South Korea are approaching those found in Western Europe (IMF, 2009).

North Korea, on the other hand, remains an economic basket case. It is one of the last remaining communist economies, and its per capita GDP is equal to only one fifteenth of that of its southern neighbor (CIA, 2008). Instead of pursuing trade liberalization and growth-oriented policies, the government has relied on the long-discredited methods of central planning, and decided – quite foolishly – to pursue complete self-sufficiency in production, rather than opening up to free trade. Because of its tragic economic mismanagement, North Korea suffered a famine in the 1990s that killed over one million people. It has been described as “the most backward, isolated country in the world.” (Powell, 2008).

The cases of Germany and Korea are particularly instructive, because they involve the division of countries that are quite homogeneous ethnically and culturally. This fact makes it difficult to argue that the peculiar characteristics of the country or of its inhabitants, rather than bad economic policies, account for the dismal growth record. The capitalist-communist chasm in living standards, however, was obvious in countries all across the Soviet bloc: Defectors and occasional visitors from communist countries were so unused to prosperity that they sometimes wondered whether the bounty of Western supermarkets was a kind of Potemkin’s village – a set-up designed to impress foreigners (Lowenthal, 2009).

The overarching lesson that emerges from the Cold War is quite clear: As an organizing principle for society, capitalism and free markets deliver much better economic performance than does central planning. The collapse of communism in 1989, spurred in part by the Soviet bloc inhabitants’ disillusionment with their relative poverty, gave final confirmation to Ludwig van Mises’s 1922 verdict on centrally planned economies: “If we were to regard the Soviet regime as an experiment, we would have to say that the experiment has clearly demonstrated the superiority of capitalism and the inferiority of socialism.” (van Mises, 1981). The intellectual climate has changed a great deal since the writing of *The Road to Serfdom*, Austrian economist Friedrich August von Hayek’s famous warning about the perils of central planning: Few serious economists today harbor any great doubts about von Mises’s conclusion.

## **Central and Eastern Europe: Growing Into Capitalism**

Having thrown off the shackles of communism, countries in Central and Eastern Europe embarked on a difficult, yet necessary, transition from centrally-planned to market economies. The process was difficult for many, as it led to a significant loss of job security, especially among blue-collar workers (Kramer, 1995): Businesses and, in fact, entire industries that had little incentive to innovate or improve their productivity during the communist era now had to adjust to the harsh reality of market competition. On the whole, however, the process was a beneficial one, as it made Central and Eastern European economies much more productive, and laid the foundations for future economic growth. At the same time, Central and Eastern Europeans, whose entrepreneurial spirit had been squashed by long decades of communist rule, gradually re-embraced pro-market ideas (Aligica and Evans, 2009). There really was no other option: The end of communism, in the words of Douglass North, an eminent economic historian, “reflected a collapse of the existing belief system and a consequent weakening of the supporting organizations.” (North, 2005)

Out of these tumultuous transitions have emerged a number of innovative pro-growth policies. Perhaps most revolutionary was the flat income tax that a number of Central and Eastern European countries have implemented. Under such a flat tax, all earnings, after some non-taxable amount, are taxed at a single rate. Estonia was the first country to introduce the tax in 1995, and was soon followed by several other countries that had formerly been part of the Soviet Union – most notably Russia in 2001. In 2004, Slovakia introduced a 19-percent flat income tax, and, in 2005, Romania adopted a 16-percent flat tax on personal income and business profits (Moore, 2005; Grecu, 2004).

Flat income taxes have stimulated economic growth across Central and Eastern Europe. They motivated the countries’ inhabitants to work harder: Their rates were usually set low, and workers could take home more of their earnings, rather than give them up to the government. The flat rate schedule, furthermore, no longer punished workers for their efforts, and thus gave them a strong incentive to put in

longer hours and more effort (Cassou and Lansing, 2004). In most Western European and Scandinavian countries, on the other hand, the welfare state was financed through high tax rates, which increased rapidly as workers' earnings rose. Edward Prescott, an economics Nobel laureate, has argued that high taxes were to blame for the high unemployment levels in some European nations (Prescott, 2004).

Another important advantage of the flat tax, especially in the context of post-communist Europe, is its power to dissuade businesses and households from evading taxes. When they contend with less tax evasion, governments can lower tax rates, and still raise the same amount of revenue (Gorodnichenko, Martinez-Vazquez and Sabirianova Peter, 2009). Furthermore, because a flat tax is easy to administer, it can help fight corruption: With fewer loopholes available, bureaucrats will find it more difficult to extract bribes (Mitchell, 2005). By reducing tax evasion and foreclosing opportunities for corruption, the flat tax can enhance a country's rule of law, and therefore help raise its standard of living: Studies have found rule of law to be associated with higher economic growth rates (Barro, 2001).

Two countries, in particular, stand out as paragons of successful market-oriented economic reform: Slovakia and Estonia. Both countries implemented audacious pro-market reforms, and achieved high rates of economic growth as a result. Sound economic policy allowed them to avoid the fate of Latvia, which recently suffered a severe financial crisis (Connaghan and Martin, 2009), or of Hungary, whose reluctance to pass much-needed reforms threw the country's public finances so far off balance that the government had to be rescued by the International Monetary Fund (Charter, 2008).

The splintering of the nationalist right, along with the surprising underperformance of the social democratic left, Slovakia's 2002 parliamentary election in Slovakia brought to power a center-right coalition (Krause, 2003). Soon enough, the Slovak government implemented a number of pro-growth measures: It privatized state enterprises which had been managed by politically appointed cronies, adopted a 19-percent flat income tax, and made the labor code more flexible to allow for easier hiring. Furthermore, it passed tax breaks to attract foreign investment, and supplemented the pay-as-you-go



pension system with personal accounts invested in private funds (Fisher, Gould and Haughton, 2007). These reforms soon bore fruit: During the first decade of the new century, Slovakia achieved an average economic growth rate of over six percent a year, one of the highest in the area. An influx of foreign investment, moreover, has made it the world's largest per capita car producer (SARIO, 2008).

Since it gained independence in 1991, Estonia has aggressively pursued market-oriented economic reforms. In 1995, it made history as the first Central or Eastern European country to adopt a flat income tax. Like Slovakia, Estonia privatized its state-owned enterprises, opened up to trade by slashing tariffs on imported goods, and courted foreign investment (Laar, 2007). The reforms were so deep that Estonia, a formerly communist country, is now the sixteenth most economically free country in the world, according to a well-respected ranking published by the Heritage Foundation, a conservative think-tank (Heritage Foundation, 2010). Predictably, the Estonian economy responded by growing at astounding rates, and significantly narrowed the gap that separated Estonians' living standards from those enjoyed in Western Europe.

What can we learn from the experience of post-communist Central and Eastern Europe? Political leaders of countries that grew the fastest were not afraid to pass sweeping market-oriented reforms. These included measures such as the privatization of state-owned industries, a liberalization of the labor code, supplementing pay-as-you-go pension systems with private accounts, as well as offering tax credits to foreign investors. A large number of Central and Eastern European countries have adopted the flat tax, which has further accelerated their economic growth: It motivated workers to earn more, and improved rule of law by reducing corruption and tax evasion. In light of recent calls to "harmonize" the European tax system (presumably at rates higher than those seen in post-communist Central and Eastern Europe), the importance of a pro-growth tax system deserves special emphasis (Rohac, 2005).

## **South America: The Miracle of Chile, and the Empty Revolution in Venezuela**

Countries in post-communist Europe, of course, are not the only ones from which we could have learned about the key role of pro-market policies in raising living standards. In Latin America, a region that has own sad experiences with political repression, the fastest growing economies were those that passed market-oriented reforms.

Chile stands out as perhaps the most notable example: After the country opened up to trade, modernized its pension system, and enacted a new labor code, Chile grew faster than any other country in Latin America (Hiscock and Hojman, 2002; Sachs and Warner, 1996). Unfortunately, these achievements have been tainted somewhat by the brutality of Chile's authoritarian military regime, which enacted the reforms (Lutz and Sikking, 2003).

Chile's economic success stands in sharp contrast with the economic disaster that is Venezuela. Terribly mismanaged by Hugo Chávez, a flamboyant leftist authoritarian, Venezuela has suffered ubiquitous shortages and runaway inflation. Chávez's nationalization of formerly private industries has undercut confidence in the rule of law, and frightened investors away.

Economists disagree about the merits of Chávez's large increases in redistribution and social spending: Some argue that his policies have improved the lives of the poor, while others worry about their negative long-run consequences (Alvarez and Hanson, 2009). Last year, Francisco Rodríguez, a Wesleyan University professor who had served as Chief Economist at the Venezuelan National Assembly, published a scathing piece on Chávez's "empty revolution" in *Foreign Affairs*, a respected international relations magazine. "Chávez's government has not done any more to fight poverty than past Venezuelan governments, and his much-heralded social programs have had little effect," he wrote. Rodríguez also argued that income inequality has actually increased, and that, in Chávez's Venezuela, the poor are suffering the most (Rodríguez, 2008).

## **A Richer World Is More Equal: The Extraordinary Growth of China and India**

Hong Kong has long been considered the world's freest economy, thanks to its success at maintaining low tax rates, securing property rights, enforcing contracts and encouraging international trade (Dorn, 2004). Since the 1970s, it has grown at a dizzying speed, and has become a major hub for international business. To the People's Republic of China, officially still a communist country, Hong Kong's prosperity has served as a reminder of what it could achieve, if only it gave capitalism a chance.

And it has. China had tried several rounds of collectivization, which only lead to economic distress and even famines (Lin and Yang, 2000). Since 1978, however, China has gradually begun to implement sweeping economic reforms. The pragmatists within the Chinese Communist Party, most notably Deng Xiaoping, argued that more reliance on markets could improve living standards across the country (Naughton, 1993). The Chinese government began to support the creation of rural enterprises and private businesses, relaxed price controls, liberalized trade, sought to attract foreign investors, and focused on improving its workers' education (Hu and Khan, 1997). This strategy has been a spectacular success: It has led to such high growth rates that the Chinese government now worries about public dissatisfaction if growth dips below its target of eight percent a year (Fan, 2008). In most other countries, policy-makers can entertain such growth rates only as a matter of wishful thinking. Today, Shanghai and Beijing are already two of the world's most important economic centers, and China has become an indispensable player in the global economy (Ikenberry, 2008).

Similarly, after many years of economic stagnation, India embarked on market-oriented economic reforms in the early 1990s. Advocated by the Oxford-educated Finance Minister Manmohan Singh (Ganapati, 2004), India underwent a massive reform in 1991 that involved slashing tariffs, and opening up various industries to foreign investment (Aghion, Burgess, Redding and Zilibotti, 2003). In Asia, India's strong growth during the rest of the 1990s and the 2000s was overshadowed only by China, which grew at an even faster rate (Bosworth and Collins, 2008).

Together, China and India are home to about 2.5 billion people – more than a third of the world’s population (CIA, 2010). The pro-market reforms that these two countries adopted have reduced poverty on a historically unprecedented scale. Not only are there now fewer poor people, the extraordinary growth in Chinese and Indian incomes has also reduced global income inequality (Sala-i-Martin, 2007), perhaps to the surprise of leftist critics who often believe that capitalism and globalization necessarily widen income disparities. In reality, the world is now both richer and more equal.

Market-oriented policies can make developing countries much richer, and policy-makers know it. In a recent *New York Times* article, Tyler Cowen, a professor of economics at George Mason University, summarized the prevailing sentiment about free-market economics in China and India very well:

“The raging economic growth rates of China and India are well known, though their rise is part of a broader trend in the economic development of poorer countries. Ideals of prosperity, freedom and the rule of law have probably never been more resonant globally than they’ve been over the last 10 years, even if practice often falls short. And for all of the anti-capitalistic rhetoric that has emerged from the financial crisis, national leaders around the world are embracing the commercialization of their economies.” (Cowen, 2010)

### **Conclusion: The Key Role of Economic Freedom**

So, where does our whirlwind tour leave us? What can we conclude about the effect of various policies on economic growth? What lessons can we learn from the growth miracles of recent years, and how can we avoid the sorry fate of the growth disasters?

The countries that have been most successful at increasing their economic growth rates, and therefore at raising the living standards of their population, have all shared a commitment to increasing economic freedom, limiting the role of government, stamping out corruption, and strengthening the rule of law. They relied on free markets, rather than on central planning. They lowered their tax rates, and some even adopted a flat income tax. They made their labor laws more flexible, and allowed their firms to hire new workers more easily. They privatized their inefficient state-owned enterprises. They lowered

tariffs, and opened up to trade and international competition. They courted foreign investors, and created a favorable business environment to lure them in.

In other words, growth miracles have occurred in countries whose governments have adopted policies that reflect the classical liberal ideals of economic freedom, limited government and rule of law. Our brief survey of economic successes around the world shows that this lesson is universal: Countries as diverse as China, Estonia, Germany, India, Chile, South Korea and Slovakia have benefited from applying a similar set of market-oriented policies.

In the 2009 edition of *Economic Freedom of the World*, published annually by the libertarian Fraser Institute, economists James Gwartney and Robert Lawson write:

“Economic growth is primarily the result of gains from trade, capital investment, and the discovery of improved products, lower-cost production methods, and better ways of doing things. [...] [C]ountries with more economic freedom grow more rapidly and achieve higher levels of per-capita income than those that are less free. [...] Given the sources of growth and prosperity, it is not surprising that increases in economic freedom and improvements in quality of life have gone hand in hand during the past quarter of a century.” (Gwartney and Lawson, 2009)

Exactly right.

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