Martin Wolf "Why Globalization" 2004

Chapter 4 The 'Magic' of the Market

Though my heart may be left of centre, I have always known that the only economic system that works is a market economy. This is the only natural economy, the only kind that makes sense, the only one that leads to prosperity, because it is the only one that reflects the nature of life itself. The essence of life is infinitely and mysteriously multiform, and therefore it cannot be contained or planned for, in its fullness and variability, by any central intelligence.

Vaclav Havel[1]

The enemies of globalization are opponents of the market economy. That is the heart of this debate. But what is such an economy? Where has it come from? How does it work, both within a country and across frontiers? It is impossible to assess the critique of globalization without trying to examine these fundamental questions. This chapter looks at the market itself. The next looks at the role and limits of government.

Rise of the market economy

'Trade and market-regulated behaviour, though present from very early times, remained marginal and subordinate in civilized societies' until about a thousand years ago.[2] Thus did the American historian William McNeill describe the gathering revolution of the past millennium. Prior to that period, he argued, command systems were the principal way of mobilizing resources in complex societies.[3] Civilization – by which I mean large-scale hierarchical societies, with a complex internal division of labour – was the fruit of the agrarian revolution, which seems to have begun in the fertile crescent of West

Asia some 10,000 years ago and arose not much later in the valleys of the Indus and the Yellow River.[4] The vast majority of people in these societies were tillers of the soil, feeding themselves and those in power over them, with their lives and livelihoods perennially vulnerable to the weather, disease and the stationary and roving bandits described by Mancur Olson.[5] Beyond the limits of complex civilizations were nomads of steppe and sand, mountain-dwellers and, remoter still, the hunter-gatherers. In the Americas a parallel evolution occurred, though some thousands of years later.[6]

Throughout the agrarian era of human history, commerce and trade, albeit significant, remained marginal activities.[7] The merchant and, still more, the moneylender were distrusted and despised. In many of the value systems of civilized society they came below the tillers of the soil, particularly in Confucian China.[8] Occupants of the highest social places were the ever-recurring figures of the warrior-ruler and the priest-scribe-bureaucrat. The power they held was also the most effective route to wealth. For the warrior-ruler, the two came naturally together. The highest position of all was held by those who combined the two aspects of authority in one – priest-kings, such as the Byzantine emperors, or, loftier still, god-kings, such as the pharaohs of ancient Egypt. The moral and mental machinery of contemporary revolutionaries harks back to those pre-modern times. The party-state of the communist era was a ruthless priest-kingdom. In contemporary North Korea, it even turns out to be a hereditary one.

Only when the commercial spirit – and its concomitant rationalistic approach to technological innovation and scientific inquiry – seized control of powerful states (as outlined in the previous chapter) did the market economy comprehensively transform ways of life. In the beginning its impact was fitful. In China, after a remarkable technological and commercial flowering under the Sung dynasty (960–1279), advance slowed sharply. It was on the western promontory of Eurasia that the commercial revolution broke through the crust of tradition and repression that lay over agrarian hierarchical societies. It gathered strength, albeit fitfully, over several centuries, before bursting into astonishing life in the nineteenth century.

From a technological view, the decisive shift was towards use of inanimate energy – wind, water and, most important, fossil fuels – from the old reliance on animate energy – human and animal power. What is called the industrial revolution is better named the energy revolution. Some economists refer to the growth of the past two centuries as 'Promethean', after the legendary titan who brought fire to man.[9] This distinguishes that form of growth from the

'Smithian', which works via the division of labour and economies of scale, as described in the *Wealth of Nations*, published in 1776. The arrival of Promethean growth was the most important event since the agrarian revolution. But adjusting to its onset has been painful. Never before have ways of life changed so much and so quickly. The agrarian revolution spread across the globe over thousands of years, not two centuries. In no more than six or seven generations, the Promethean revolution has brought in its train urbanization, industrialization, global economic integration, two world wars, the spread of democracy and a global commercial culture. The proportion of people working in British agriculture halved between 1780 and 1870. Not surprisingly, such upsetting changes have repeatedly brought a backlash by millenarians promising a perfect future and romantics longing for a more natural past.[10]

The liberating technological changes of Promethean growth did not emerge from nowhere. They reflected a new way of organizing the economic activities of society as a whole – a sophisticated market economy with secure protection of property rights. Unshackled from the constraints of tradition and driven by hope of gain, economic actors were tied by competition to the wheel of what the great Austrian economist Joseph Schumpeter called 'creative destruction'. To achieve success in their battles with their competitors, businesses have been driven to exploit and nurture the ever-burgeoning power of technology and science. Within a market economy the hope of gain and the fear of loss drive inventors and innovators to apply new ways of doing things or to produce new products.[11]

As Professor Mokyr notes:

> for a society to be technologically creative, three conditions have to be satisfied. First, there has to be a cadre of ingenious and resourceful innovators who are both willing and able to challenge their physical environment for their own improvement. . . . Second, economic and social institutions have to encourage potential innovators by presenting them with the right incentive structure. . . . Third, innovation requires diversity and tolerance.[12]

The second and third of these was as important as the first. Happily, the environment of eighteenth- and nineteenth-century enlightenment Europe, particularly of Britain, provided all three.

To describe what happened in the early nineteenth century as an 'industrial' or even as an 'energy' revolution is misleading. It would be more accurate to describe it as a culmination and acceleration of a market revolution that became far more powerful with the mass application of physical energy. The active force of profit-seeking business people exploited and drove the economic transformation, as it continues to do to this day. It is they who choose the investments and make the technological innovations. The market economy is, as a result, the only human institution that generates a 'permanent revolution'.

Growth during the market millennium

If the last thousand years have, as Professor McNeill argues, been the millennium of the market, what have been the consequences? The short answer is that the world has undergone an unprecedented transformation. According to the economic historian Angus Maddison, the population of the world rose twenty-two-fold over the last millennium, but world gross domestic product (at purchasing power parity) rose thirteen times as fast.[13]

This astonishing increase in population, output and incomes per head has no earlier parallels. The world's population barely increased in the first millennium, while the average standard of living in 1000 was also much the same as it had been a thousand years before, at a bare subsistence level. Today, however, very few countries have living standards close to the world average of a thousand years ago: Chad or Sierra Leone might be examples.

Moreover figures for economic growth in the second millennium understate the true increase in the standard of living. Life expectancy was twenty-four in England between 1300 and 1425. It had probably been much the same in the Roman Empire. By 1801–26, the English level had reached forty-one. By 1999 it had reached seventy-seven. Two centuries ago or more, nobody, however powerful and rich, had access to dentistry, medicine or sanitation worthy of the name. Nathan Rothschild, founder of the Rothschild dynasty in England, died in 1836 of an infected boil. Today, antibiotics would have cured him with ease. Anne, Queen of England, bore fifteen children, not one of whom survived to maturity. Even in 1900 one in ten children in the United States died before his or her first birthday. By the late 1990s the rate was down to seven in a thousand.

Growth accelerated enormously after 1820. But something important had already started to happen before then. World population rose nearly four-fold between 1000 and 1820. World GDP rose perhaps six-fold. This meant a 50 per cent rise in real incomes per head. This aggregate conceals very different performances by western Europe and the rest of the world. Between 1000 and 1820, European real incomes per head rose about three times. In the most successful market economies in Western Europe, the United Kingdom and the Netherlands, average incomes per head were about four times as high as they had been in 1000.[14] But, prior to the early nineteenth century, sustained rises in living standards were largely limited to western Europe and, from the seventeenth century onwards, the British colonies of North America.

In the period after 1820, the rate of global growth greatly accelerated. Between 1820 and 1998, world population rose almost six-fold, its GDP forty-nine-fold and its GDP per head almost nine-fold. Between 1820 and 1998, real GDP per head rose nineteen-fold in western Europe, the former British colonies of North America and Australasia. In Japan, which was relatively poor in 1820, standards of living had risen thirty-one-fold by 1998. In the rest of the world, real GDP per head rose only five-fold. Almost every economy is richer than it was two centuries ago, but some have done much better than others.

The historically unprecedented economic dynamism of the last two centuries and the divergence in performance across countries are the two most important features of the world we inhabit. The *dynamism* was the product of institutions, practices and attitudes that emerged in western Europe over an extended period. These cultural, social and political advantages combined with favourable resource endowments, particularly the proximity of coal and iron.[15]

The *divergence* was the result of the uneven spread of this form of rapid growth. In the course of the nineteenth century, rapid growth – what the Nobel-laureate Simon Kuznets called 'modern economic growth' – spread swiftly from Britain to the rest of western Europe and the former British colonies overseas. Incomes converged strongly among these countries.[16] Rapid growth also jumped from one end of Eurasia to the other once the United States forced Japan to open up its economy in the mid-nineteenth century. At the present stage in human history, all the successful economies are rooted in European or Sino-Japanese culture.[17]

In 1820, the richest country in the world had a real income per head about four and a half times as high as the poorest. The ratio was fifteen to one by 1913, twenty-six to one by 1950, forty-two to one by 1973, and seventy-one to one by 2000.[18] Not all is gloom. Africa's average real income per head is perhaps three times higher than it was a century or so ago. Asia's as a whole is up six-fold since 1820 and Latin America's nine-fold. In 1900 life expectancy was a mere twenty-six in today's developing world. It was sixty-four by 1999. This is much the same as the sixty-six achieved by today's advanced countries as recently as 1950.

Yet the overall picture of a world in which some countries have economies that grow more or less consistently while others do not is correct. A few countries have already caught up on the leaders of the nineteenth century, while some are growing very rapidly, including the world's biggest, China. India, the world's second biggest country, is also beginning to sustain reasonably rapid growth, at last. But many countries have been failing. As Lant Pritchett of the World Bank has noted, out of a sample of 108 developing countries for which data are available, 'sixteen developing countries had negative growth over the 1960–90 period. . . . Another 28 nations . . . had growth rates of per capita GDP less than 0.5 per cent per annum . . . and 40 developing nations . . . had growth rates less than 1 per cent per annum.'[19] So what explains successful economies? The answer is that they have dynamic market economies. But what does this mean? That is the question to which we now turn.

How an advanced market economy works

Think for a moment about what our economy achieves. We can buy food produced all over the world, which is then bought, processed, distributed and sold though a long chain of wholesalers and retailers to satisfy our varying tastes. The food will be extraordinarily safe.[20] One can buy clothing made by workers in China, India, Italy or Mexico, in a staggering number of different fabrics and styles. For personal transport, one can choose from many varieties of motor car; for entertainment, one can select a DVD player and flat-screen television; for work, leisure or personal bureaucracy, one can buy a personal computer. An army of competing inventors, designers, producers and distributors try to meet all these and many other demands. A host of intermediaries takes money from households and supplies it to those who persuade them they can use it productively. In the process, they create an endless array of financial instruments, including bank deposits, bonds, equities and assorted derivatives, and package and repackage risk, allowing savers and investors to diversify and hedge their portfolios.

We take all this for granted. Yet it is extraordinary. What makes it far more extraordinary – and to many quite scary – is that nobody is in charge. Adam Smith's metaphor of the invisible hand remains as illuminating as ever. Self-interest, co-ordinated through the market, motivates people to invent, produce and sell a vast array of goods, services and assets.

As a way of satisfying the material wants of mankind, self-interest exceeds the power of charity as the Amazon exceeds a rivulet. This is what Ronald Reagan called 'the magic of the market'. But 'the market process', as Friedrich Hayek called it, is not magic. It is far cleverer than that.

In his book *Reinventing the Bazaar*, John McMillan of the University of California, at Berkeley, indicates the nature of this institution by comparing an 'absolutely free market' to 'folk football'. But 'a real market is like American football, an ordered brawl'.[21] To a large extent, the rules governing markets evolve with markets themselves. The result today, in advanced economies, is a system of extraordinary complexity and efficiency.

Every society has some markets. Equally, in no society are markets ubiquitous. In contemporary advanced economies, three categories of transaction occur largely or entirely outside markets: those within households; those with the government and within it; and those inside corporations. Yet markets are significant institutions virtually everywhere. They emerge in prisons and concentration camps; they emerged in communist dictatorships even though the participants, condemned as 'speculators', were often shot out of hand; and in almost all developing countries they emerge as the informal sector where people trade outside the purview of foolish regulations and corrupt regulators.[22]

Yet many societies today and virtually all societies historically had only very limited markets. Those markets dealt only in immediately available goods and services. These transactions are self-enforcing: one buys a fruit or a carpet and pays for it. The constraint on development is the absence of markets for transactions that take a long time to reach fruition: borrowing, lending, investing and insuring. In such transactions trust and confidence matter a great deal. In many developing countries, these longer-term or complex transactions are limited to dealings with family or close friends, where misbehaviour carries credible sanctions.

If a sophisticated market economy is to work, it has to solve five problems: first, information must flow smoothly, giving people confidence in what they are buying; second, it must be reasonable to assume people will live up to their promises, even if these promises are to be executed decades into the future; third, competition must be fostered; fourth, property rights must be protected; and, finally, the worst side effects on third parties must be curtailed.[23]

The flow of reliable *information* and the ability to *trust* are the life-blood of markets. As James Q. Wilson, formerly professor at Harvard, puts it: 'trust must exist in a society for it to be a capitalist society because people who do

f mankind, self-interest exceeds
a rivulet. This is what Ronald
market process', as Friedrich
...an that.
McMillan of the University of
this institution by comparing an
'a real market is like American
it, the rules governing markets
lay, in advanced economies, is a
ency.
y, in no society are markets
mies, three categories of trans-
kets: those within households;
l those inside corporations. Yet
everywhere. They emerge in
ed in communist dictatorships
peculators, were often shot out
es they emerge as the informal
iew of foolish regulations and

cieties historically had only very
mmediately available goods and
one buys a fruit or a carpet and
he absence of markets for trans-
borrowing, lending, investing
onfidence matter a great deal. In
n or complex transactions are
ds, where misbehaviour carries

k, it has to solve five problems:
people confidence in what they
sume people will live up to their
ecuted decades into the future;
operty rights must be protected;
ties must be curtailed.[23]
bility to *trust* are the life-blood
fessor at Harvard, puts it: 'trust
society because people who do

not trust their neighbors, do not trust other groups, do not trust distant people, cannot trade with them; and, unable to trade with them, capitalism remains at the level of a bazaar economy'[24] Sometimes, obtaining information on what is available is too expensive to allow any market to emerge. To this the rise of the information economy is providing some answers. At other times, the difficulty is 'asymmetric information'. If one thinks that the person one is dealing with not only knows more about what is being sold than one does oneself, but has an incentive to deceive one as well, the transaction may well not occur. Happily, there are solutions. People in business can provide guarantees or create reputations for honest dealing; they can invest in a brand that associates the company with the quality of what it sells; and they can employ more or less credible professionals (such as accountants) to certify the truth of what they are saying. Regulators can help by certifying the quality of a company's processes or products, their financial soundness or whatever else may be relevant. The law and other forms of recourse provide penalties for deceit or the breaking of contracts. Finally and perhaps most important, the values of a society can support honesty: if cheating and stealing are regarded as normal, a society will possess no more than a shallow and undeveloped market economy. If high levels of personal probity and honest dealing are encouraged, the market economy will work well.

Competition is essential to good performance. A private monopoly may be more efficient than a public one, largely because it has clearer objectives, but it is likely to be more exploitative and less innovative than competitive businesses. In principle, sound competition policy can remedy anti-competitive behaviour. Some actions – making price-fixing and other forms of cartel behaviour illegal, for example – are self-evident. But imposing competition by administrative or legal fiat can be tricky. There is often a temptation to use competition policy as a way of protecting competitors instead of competition or consumers.

Protection of *property* is the necessary condition for a sophisticated market economy. Indeed, it is the most important single condition. People need to be able to own things. What does ownership mean? It means, first, that people have a right to the residual income, over and above that committed to other parties – suppliers, lenders, employees and so forth. This gives them an incentive to use the asset productively or, if they cannot do so, to sell it to someone who can. Second, the owner also possesses residual control rights. Not only does the owner have the incentive to use the asset productively. He or she has the right to do so as well. In a sophisticated modern economy, such rights of ownership are complex. They rest in mere pieces of paper and may be exercised through chains of agents.[25]

The protection of property links to what economists call *externalities*, the production of 'goods' or 'bads' whose positive or negative value is not included in the calculations of those making the transactions themselves. They are in some way or another outside the market, usually because there is an incomplete specification of property rights. Where externalities exist, property rights may well need to be qualified. The right to make use of a river passing through one's land may exclude the right to take more than a certain proportion of the water it contains, or to pollute it. Sometimes, as the Nobel-laureate Ronald Coase has argued, such externalities can be addressed through bargaining among those affected.[26] Often, however, the costs of reaching and policing such bargains will be excessive or the costs (and benefits) may be distributed too widely for those affected to have an adequate incentive to coalesce to 'internalize' the externality. A solution will then have to be imposed by a coercive power – usually the state.[27]

Central features of a modern market economy

A modern market economy is therefore about as far from Edouard Balladur's jungle as can readily be imagined. The market is a complex and sophisticated piece of institutional machinery that has evolved over centuries on the basis of the broad principles of freedom of contract, secure property rights and a service-providing state. Four interconnected features of the modern market economy are of decisive importance, especially for any discussion of global economic integration. These are: the corporation; innovation and growth; intellectual property; and the role and functioning of financial markets. All depend on institutional arrangements underpinned by the state as creator and enforcer of the law. All are focal points for the criticisms of protesters against globalization. Yet, without them, we would not have the economic dynamism we take for granted. They are at the heart of a modern market economy.

Corporations[28]

The Nobel-laureate Kenneth Arrow has remarked that 'truly among man's innovations, the use of organization to accomplish his ends is among both

ed modern economy, such
pieces of paper and may be

mists call *externalities*, the
gative value is not included
ns themselves. They are in
because there is an incom-
alities exist, property rights
e of a river passing through
a certain proportion of the
the Nobel-laureate Ronald
essed through bargaining
reaching and policing such
ts) may be distributed too
entive to coalesce to 'inter-
be imposed by a coercive

ny

far from Edouard Balladur's
complex and sophisticated
over centuries on the basis of
cure property rights and a
ures of the modern market
for any discussion of global
n; innovation and growth;
ng of financial markets. All
ed by the state as creator and
iticisms of protesters against
ave the economic dynamism
odern market economy.

ted that 'truly among man's
lish his ends is among both

his greatest and his earliest'.[29] The private corporation is the most extraordinary organizational innovation of the past two centuries. Today's economy would be unimaginable without its dynamism and flexibility. The corporation is a hybrid institution: it is hierarchical, but embedded in markets. Before the modern corporation, commerce was largely the province of individual merchants, while big hierarchical institutions, both civil and military, were the province of rulers.[30] Today, there exists an institution that combines the two. This required the merging of two distinct forms of social organization and value systems, that of the merchant and that of the administrator. Making such organizations entrepreneurial remains an abiding challenge.

The modern multi-unit business enterprise emerged in the 1840s, almost at the beginning of the era of Promethean growth. This was the point at which technological advance combined with an enlarging economy 'to make administrative co-ordination more productive and, therefore, more profitable than market co-ordination'.[31] The modern corporation also required the invention of limited liability, which occurred in 1856. Otherwise the immense capital needed would have remained unavailable.

Corporations are crucial to a modern economy. In the United States transactions in the market account for well under a third of total incomes.[32] Yet the corporation is not above or outside the market. Shifts in market conditions, including technology or trade, will alter the boundaries of corporations, force them to merge, impose fundamental changes in strategy or maybe bankrupt them. Companies are servants of market forces, not their overlords. If they do not meet the terms of market competition, they will disappear.

Why do companies exist? The simple reason, first proposed in a classic 1937 article by Ronald Coase, is that transaction costs can make hierarchical structures more efficient than market transactions.[33] For such an organization to work, it must be possible to form relationships of trust. As one might expect, therefore, large companies are far more prevalent in advanced countries with high levels of trust than in less developed ones: in the United States plants with fifty or more employees account for 80 per cent of manufacturing employment; in Indonesia, the proportion is only 15 per cent.[34]

The corporation is a wonderful institution. But it contains inherent drawbacks, the core of which are conflicts of interest. Control over the company's resources is vested in the hands of managers who may rationally pursue their interests at the expense of all others. Economists call this the 'principal-agent' problem. In the modern economy, where shares are held by fund managers, there is not just one set of principal-agent relations but a chain of them.[35] Asymmetric information and obstacles to collective action exacerbate the principal-agent problem. Corporate managers know more about what is going on in the business than anybody else and have an interest in keeping at least some of this information to themselves. It is hard to create incentives that ensure management acts in the interests of others. Equally, dispersed shareholders have a weak incentive to monitor management, because they would share the gains with others but bear much of the cost themselves.[36] The upshot is the vulnerability of the corporation to managerial incompetence, self-seeking, deceit or malfeasance.

In practice, there are six (interconnected) ways of reducing these risks. The first is market discipline: financial failure will ultimately find managers out, provided governments can be dissuaded from bailing failed companies out. The second is internal checks, with independent directors, requirements for voting by institutional shareholders and internal auditing. The third is private regulation, such as listing requirements of stock exchanges. The fourth is official regulation that covers the composition of boards, structure of businesses and reporting requirements. The fifth is transparency, including accounting standards and independent audits. The last is, once again, values of honest dealing.

Economists are very uncomfortable with the notion of morality. Yet it seems to have rather a clear meaning in the business context. It consists of acting honestly even when the opposite may be to one's advantage. Such morality is essential for all trustee relationships. Without it, costs of supervision and control become exorbitant. At the limit, a range of transactions and long-term relationships becomes impossible and society remains impoverished. Corporate managers are trustees. So are fund managers. The more they view themselves (and are viewed) as such, the less they are likely to exploit opportunities created by the conflicts of interest within the business.

Innovation[37]

Rising standards of living and their uneven spread have been, as noted above, the most remarkable features of a global market revolution. The source of this sustained growth has been technological innovation. Of that there is no doubt. In technological innovation modern market economies found the economist's free lunch. A brilliant book by William Baumol of New York University sheds light on this revolution.[38] He builds on the insights of the Austrian economist Joseph Schumpeter to expose the machine that drives capitalism. Professor

Baumol argues that innovation rather than price competition is the central feature of the market process. Competition forces companies to invest in innovation. Otherwise, they risk falling behind and, ultimately, being driven out of their markets.

In Schumpeter's model of the capitalist economy, the engine of innovation was the extraordinary profits offered to the lone entrepreneur. Yet, as Baumol makes clear, the bulk of the innovation that drives economies occurs within existing companies. It is a routine aspect of their behaviour. Overall, such innovative activity will not be particularly profitable: some companies will be lucky; others will not. But the motivation is no longer the hope of exceptional profit. It is the certainty of failure if one is not in the race. Innovation then does not come from outside the market. It is hard-wired into capitalism.

Intellectual property

Given the role of innovation, intellectual property is not a marginal feature of the property-rights regime of a modern market economy, but its core. It is the most important example of property that only a powerful state can protect. The reason such action is needed is that ideas are public goods. Put plainly, this means that a person can enjoy the fruits of an idea without depriving anyone else of its benefits. But also, once divulged, they are available to everybody. Yet if ideas are freely available, nobody can make money out of creating them.

The solution has been intellectual property – patents, copyright and trademarks. For innovation, patents are the most important. But they are also a legally sanctioned restraint of trade.

Intellectual property protection requires striking a delicate balance. It is essential, but can easily go too far. There will be strong pressure from powerful and self-interested producer lobbies to make intellectual property protection too tight. Protection must also not be granted too freely. In the United States, that now seems to be happening, with protection granted to genes with unknown use and trivial business methods – such as 'one-click' purchasing on the Internet.[39] Over-liberal granting of intellectual property rights is a restraint on trade and should be viewed as such.

Financial markets

Financial intermediation is as central a feature of a modern market economy as the corporation, innovation and intellectual property. It is its bloodstream, taking resources from people who do not need them or cannot use them and supplying them to people who do need them and can use them. Overwhelming evidence links the depth and sophistication of financial markets to levels of output per head. As a World Bank report on finance stated, 'there is now a solid body of research strongly suggesting that improvements in financial arrangements precede and contribute to economic performance. In other words, the widespread desire to see an effectively functioning financial system is warranted by its clear causal link to growth, macroeconomic stability, and poverty reduction.'[40] The Bank noted, for example, that developing countries with relatively deep financial markets in 1960 subsequently grew far faster than those with relatively shallow ones.

Financial systems perform four essential functions: they mobilize savings (for which outlets would otherwise be far more limited); they allocate capital (to finance productive investment and permit people to spend temporarily above their current incomes); they monitor managers (to ensure funds will be spent as promised); and they transform risk (by pooling risk and distributing it to those best able to bear it). These are vital functions. It is absolutely impossible to imagine a successful market economy without a dynamic, competitive and flexible financial system.

Yet market-driven financial arrangements, though irreplaceable, are liable to well-known difficulties.

First, financial markets suffer from inadequate supplies of information and obstacles to monitoring performance.

Second, financial markets are, partly for this reason, fragile. This is particularly true of banks. Their fragility comes from the fact that their liabilities are short term, in domestic or, occasionally, in foreign currency, usually payable at par and on demand, but their assets are long term, with values that are vulnerable to interest rate, credit and macroeconomic risks.

Third, financial markets are liable to wild swings in prices, both upwards and downwards, because of the instability of valuations of uncertain streams of income.

Fourth, financial markets tend towards herd behaviour. This is particularly true when ill-informed players believe they lack information available to others. When classes of assets are unfamiliar to a large number of investors, herding behaviour may be very powerful.

Fifth, financial markets may generate self-fulfilling expectations and so what economists call 'multiple equilibria'.

Financial markets are fragile because of the inherent challenge of orienting economic activity to an unknowable future. It would be quite wrong to conclude that the 'imperfections' underlying such fragility mean either that such markets should be abolished or that there exist some evident cures. Without financial intermediation, market economies would be unable to perform. As for eliminating market 'failures', one must remember that one can never do better than one's best. So-called imperfections are irrelevant, therefore, if the costs of eliminating them exceed the benefit of trying to do so.

Conclusion

The world of full information and perfect competition is an illusion. If it did exist, the dynamism of the modern market economy would not occur. Indeed, it would be ruled out, by assumption. The modern corporation, perpetual innovation, intellectual property and sophisticated financial markets imply a substantial degree of monopoly and instability. But they also are what make the modern market economy astoundingly successful.

Morality of market economies[41]

Intelligent critics are prepared to accept that a sophisticated market economy works far better than any other economic system. But they would proceed to complain that markets encourage immorality and have socially immoral consequences, not least gross inequality. These views, albeit common, are largely mistaken.

Inequality

All complex societies are unequal. In all societies people (generally men) seek power and authority over others. But, among sophisticated societies with an elaborate division of labour, societies with market economies have been the least unequal and the inequality they generate has been the least harmful. To many this may seem a shocking statement. It should not be.

Remember that in agrarian kingdoms or feudal societies, kings and lords had the power of life and death. The rich and powerful could seize the labour, the possessions and even the lives of subjects, serfs and slaves, at will. Perhaps the most unequal societies of all were the state-socialist and national-socialist regimes of the twentieth century. A Stalin or a Mao possessed absolute control over the resources of vast countries and their inhabitants. When, on a whim, Mao decided on the Great Leap Forward in the 1950s, 30 million people died.

The irony is that such tyranny was justified by the alleged horrors of capitalist inequality. To eliminate market-driven inequality, all power was concentrated in the hands of the state, which then promptly and inevitably generated non-market-driven inequalities for the benefit of those who controlled it.

In all that matters – in the ability to lead one's own life and the legal rights one possesses – the modern liberal democracy is unprecedentedly equal. Virtually all citizens have access to a range of goods and services unavailable even to the wealthiest a century or even half a century ago. Wealthy people have more influence over the life of a democracy than do the majority of its citizens. But, compared to the power and influence that accrued to the wealthy in traditional societies, the power of today's wealthy is highly circumscribed. Politicians have more power and intellectuals more influence than men with big cheque books. Who has made more difference to the way Americans live their lives today, Ronald Reagan, Milton Friedman or Warren Buffett?

No rich man or corporation can ignore the law, as a number of corporate scoundrels discovered in 2002. Even Bill Gates, the world's richest man, discovered he could not ignore the low-paid lawyers of the Department of Justice when it went after Microsoft's alleged monopolistic abuses. A few centuries ago, the richest man in a European country could create a private army capable of defying the state. Today, Gates would exhaust his fortune in less than three months in trying to rival the spending of his country's defence department. In a competitive market economy subject to the rule of law, Gates or Warren Buffett can tyrannize over their bank balances, not over people. They can support politicians, not coerce them.[42] They can cajole customers, not compel them. They can give money to charity, not create armies. They can order their businesses, not buy their workers. Gates and Buffett are citizens, entrepreneurs, investors and philanthropists. They are neither tyrants nor overlords. A competitive market economy neither ends inequality nor eliminates the desire for power and prestige. It tames them instead.

Freedom, democracy and the permanent opposition

A competitive market economy is a reflection – and a source – of freedom. It is also a necessary condition for democracy. In a society where political power determines the allocation of wealth, it is impossible to be independent without being powerful. But in a market society that combination is possible and this, in turn, provides a basis for competing political parties. As Vaclav Havel explained, 'a government that commands the economy will inevitably command the polity; given a commanding position it will distort or destroy the former and corrupt or oppress the latter'.[43]

Liberal democracies with market economies are, as Joseph Schumpeter argued in his classic book *Capitalism, Socialism and Democracy*, the only societies that create their own opposition. 'Capitalism created both a parvenu class of rich plutocrats and corporate climbers and a counter-culture of critical intellectuals and disaffected youth.'[44] It continues to do so today. Take a look at the campuses, the publications and the protesters in western democracies. Only in a market economy could books condemning society's rich and powerful be published and promoted with such success. Only in a market economy would the wealthy give large sums of money to universities that provide comfortable homes to those who despise the wealthy and the system that made them so. The market economy does not merely support its critics, it embraces them.

Yet lauded and successful critics indulge in paranoid fantasies about

> corporate space as a fascist state where we all salute the logo and have little opportunity for criticism because our newspapers, television stations, Internet servers, streets and retail spaces are all controlled by multinational corporate interests. And considering the speed with which these trends are developing, we clearly have good reason for alarm. But a word of caution: we may be able to see a not-so-brave new world on the horizon, but that doesn't mean we are already living in Huxley's nightmare.[45]

So even Naomi Klein has to admit the limits of corporate power. In fact, anti-corporate books and television programmes are being published and produced with great commercial success. Klein's *No Logo* has become a brand all of its own. Capitalism nurtures its enemies. It also tries to make money out of them. But then they make money too.

Morality

Markets also require, reward and reinforce valuable moral qualities: trustworthiness, reliability, effort, civility, self-reliance and self-restraint. These qualities are, critics argue, placed in the service of self-interest. Yet, since people are self-interested, this is neither surprising nor shocking. But people are not completely self-interested. Happily, a wealthy society allows people to be far less driven by material objectives than one in which the vast majority of people are on the threshold of subsistence. A prosperous market economy also generates a vast number of attractive activities for those who are not motivated by wealth alone. People can work for non-governmental organizations or charities. They can work in the public sector, as doctors, teachers or policemen. They can even live off the welfare state and devote their lives to campaigning against the iniquities of capitalism. It is only the wealth generated by successful market economies that has made a welfare state possible. Poor countries today and all societies historically lacked the means to provide economic security to their citizens. Moreover, if people do make a great deal of money, they can use it for any purpose they wish. They can give it all away – and some have.

Over the last two centuries in the advanced market economies, the value placed on eliminating pain and injustice and on human and, more recently, animal life and welfare has also hugely increased. This is partly because a liberal society places such heavy weight on individuals. It is partly because people, being richer and far more secure, can afford concern with deeper moral ends. It is partly because people are better informed about what goes on across the world. It is partly because premature death and pain have been so much reduced, making life seem far more precious. The savage punishments and casual injustices in the judicial systems, military services and educational institutions of two centuries ago are gone. It took militarists, extreme nationalists, communists and fascists – the anti-liberals – to bring these horrors back, indeed to glory in violence and cruelty. Now, with the passing of these creeds, advocacy of human and animal rights has gone global, ironically as part of the litany of anti-globalization.

Again, consider environmentalism. Business is supposedly indifferent to the environment. That, indeed, is one of the principal criticisms of a market economy. Yet we now know that the supposedly benevolent state-socialist economies were environmental catastrophes. The market economy has avoided these disasters for at least four reasons: first, it provides the means for independent critics of environmental abuses to flourish; second, it generates the prosperity that makes people concerned about the environment; third, it implies a separation between companies and the government that makes independent regulation possible; and, finally, companies are concerned about their reputations and will act to protect them, in response to campaigning against them. For these reasons, effective environmental pressure groups have emerged only in market democracies.

Conclusion

The liberal market economy is morally imperfect, because it reflects the tastes and desires of people, who are also imperfect. A market economy satisfies the desires of the majority more than the tastes of a refined minority. It rewards the hustler more than the sage. But it is also the basis of freedom and democracy. It encourages valuable moral virtues. It makes people richer and more concerned about environmental damage, pain and injustice. It makes the welfare state possible.

Those who condemn the immorality of liberal capitalism do so in comparison with a society of saints that has never existed – and never will. This, it appears, can be a literal truth. At the end of *Empire*, a tedious neo-Marxist tome on globalization, the authors compare the communist militant to St Francis of Assisi. 'Once again', conclude the authors, 'in postmodernity we find ourselves in Francis's situation, posing against the misery of power the joy of being. This is a revolution that no power will control – because biopower and communism, cooperation and revolution remain together, in love, simplicity, and also innocence. This is the irrepressible lightness and joy of being communist.' This is the absurdity one must embrace, in the wake of the collapse of state-socialism, if one is to envisage a society better than the liberal democracies.[46]

Markets matter

The arrival of an economy dominated by sophisticated markets with secure property rights, long-term investment and constant innovation has brought about a revolution in human life. These benefits have not been equally shared. But there is almost no part of the globe where standards of living are not significantly higher than they were two centuries ago. Most opponents of the market economy compare the worst of today with the best. That may seem fair enough. But it makes as much sense to compare the worst of today with the normal in the past. By those standards, we have already come a long way.

Yet if markets matter, so do governments. What are the role and limits of government in a liberal market democracy? This is the topic of the next chapter.

Martin Wolf "Why Globalization" 2004

Chapter 5 Physician, Heal Thyself

What this war has demonstrated is that private capitalism – that is an economic system in which land, factories, money and transport are owned privately and operated solely for profit – does not work.

George Orwell[1]

Not so very long ago, economic planning and public ownership of the means of production were the wave of the future. Even a man as wise as George Orwell believed in both these bad ideas. That faith did not end with the 1940s. When I worked at the World Bank during the 1970s every developing country, however limited its intellectual resources, was expected to produce a five-year economic plan in pale imitation of the Stalinist model. Sophisticated developing countries, such as India, produced sophisticated plans. Less sophisticated countries produced less sophisticated plans. All these plans had one thing in common, however: they were fictions. But they were not harmless fictions. They inflicted grave damage on the economies and people of these supposedly 'planned' societies.[2] Anti-capitalists of today talk as if these experiments with planning had never happened or, if they did, have no significance now that state-socialism has collapsed. They are wrong. The experience with national economic planning has important lessons. It helps us understand what a state can usefully do – and is obliged not do – if it is to see a rise in the living standards of the people for whom it has responsibility.

What the state cannot do: the death of central planning

In the twentieth-century heyday of the anti-liberal counter-revolution, an extraordinary belief grew up.[3] This faith held that the entire national economy not only could – but should – be brought under central control and direction. This was the faith that failed. It was an example of what the late Friedrich Hayek called the 'fatal conceit' – the belief in our ability to plan and control human destiny.

The belief that central planning was possible emerged partly from the success of the modern business corporation, partly from a realization that it would be easier to manage an industry with a few large players than one with many smaller ones, and partly from the experience of economic mobilization for war. People found it increasingly natural to think of a country as a large company. Even today, the notion lives on in metaphorical discussions of 'UK plc' or 'America Inc'. But for the better part of a century people who considered themselves progressive did not think of this as a metaphor. They considered the planned economy logical, necessary and desirable. They were wrong.

First, planners cannot find out what needs to be done to co-ordinate the production of a modern economy. As Professor McMillan points out, there are 20,000 different job categories in the United States. A central plan cannot begin to cope with such complexity.[4] Worse, the information planners need about the possibilities of production is locked away in their underlings' heads. The planned will want to tell planners not the truth, but what they find personally convenient. It is in the interests of factory managers to tell planners the levels of production that would be easy for them to achieve, since they are far more likely to be penalized for failure to achieve targets than for over-achieving them.

Second, even if a technically feasible plan could be drawn up, there is no reason to believe it will be implemented. It is in the interests of factory bosses to produce what they find personally beneficial and, wherever desirable and feasible, deceive their superiors. Maybe factory managers will meet the purely quantitative targets, but they can easily evade targets for quality, even where such targets can be specified. Planners can only inspect part of the production. Only users in markets automatically inspect all of the production.

Third, it is impossible for planners to know what hundreds of millions of different people desire. So the technically feasible plan, even if implemented, will bear no relation to what people actually want. Think, for a moment, of cosmetics. How could a central planner know better than the consumers what the individual woman wants? Planners can only provide users with what they believe they *should* want, which is quite another matter.[5]

Fourth, because prices bear no relation to costs, there is no way to calculate what production needs to increase and what production needs to be reduced.

A technically feasible plan can, quite easily, be wealth-destroying. Without prices generated in a market, rational calculation of what needs to be produced is impossible.

Fifth, the comparison with a war effort is completely misguided. The salient feature of war is that the state defines the goals. The salient feature of peace is that individual consumers define them. In peacetime, production's function is to satisfy consumers. The objectives of production in war and peace are opposites.

Sixth, even if all such problems can be resolved, planners do not know the possibilities for production of new things or of old things in new ways. Worse, they find such novelties – the fruits of innovation – inconvenient. Any innovation disrupts the plan automatically. It also brings additional uncertainties, since nobody can know with reasonable confidence how to produce completely new products or how successful a new technique may turn out to be. In practice, therefore, the planned economy is as innovation-resistant as the market economy is innovation-prone.

Finally, foreign trade cannot be integrated successfully into the plan since, by definition, foreigners cannot be planned, unless the planners control those foreigners. Planning is hierarchical by its nature, because it turns a country into a single company. It can be stretched across borders only if there is a clear hierarchy among countries. For this reason, independent planned countries pursue autarky, so far as they can. At the same time, they always need trade since there are some things they cannot make. But planners do not know what it makes sense for them to trade, since they do not know what anything costs.

The idea of comprehensive national planning is not just mistaken. It is ludicrous. It ignores everything we know about the role of incentives and information in economics. Output per worker in the Soviet Union and eastern Europe was about a third below that in the west even when they had the same equipment. The productivity of Chinese peasants doubled once the communes were abolished.[6] Planning would fail even if the planners were benevolent and competent. Alas, there is every reason to expect the people who reach the top of a bureaucratic hierarchy to possess neither of these virtues. Central planning could not have succeeded in a long-run race against market economies. Yet developing countries were cajoled into doing it. Sometimes they desperately wanted to. That was, if anything, more ludicrous, since these governments did not possess the powers of coercion over factory managers possessed by a Soviet planner.

What the state needs to do for the economy

If central planning is unworkable, the market is inescapable. There is no third way of running a complex modern economy based on an extensive division of labour. The alternative of customary behaviour is feasible only in simple economies where changes in economic conditions are rare. Some contemporary anti-market romantics imagine that it would be possible to escape from the market in this way. Often they add to this the idea that the economy should be fragmented into small 'local' pieces. They are dreaming. They should also remember that customary behaviour of this kind was usually enforced by oppressive social hierarchies.

So what role does the state have to play to make a market economy work? At the broadest level, it has three functions: first, to provide things – known as public goods – that the market cannot provide for itself; second, to internalize externalities or remedy market failures; and, third, to help people who, for a number of reasons, do worse from the market or are more vulnerable to what happens within it than society finds tolerable.

The discussion above of the link between the market and politics, in Chapter 3, and of the workings of a modern sophisticated economy, in Chapter 4, already indicates the public goods the government must provide. It starts with *security of property* from predators. This necessitates armies, police, judges and prisons. Drawing up and implementing legislation is a central function of the state. But these functions need to be separated. Independence of the judiciary from both the government and legislature is the most important single way to protect citizens from the predatory activities of the government.[7]

A fundamental requirement for the protection of property is, therefore, the impartial *rule of law*. The Nobel-laureate Amartya Sen has argued, that 'legal and judicial reform is important not only for legal development, but also for development in other spheres, such as economic development, political development, and so on, and these in turn are also constitutive parts of development as a whole'.[8] As one might expect, indicators of the quality of the rule of law are highest in members of the Organization for Economic Co-operation and Development, followed by east Asia. The lowest levels are in sub-Saharan Africa and the former Soviet Union – the last being a good indicator of the impact of central planning and the party-state regime over more than seventy years.[9]

A second public good the state needs, under present arrangements, to provide is *sound money*. Over the past three centuries, monetary systems have evolved dramatically. Initially, most money was still in metallic form;

subsequently, most money was in paper form, though still convertible into metal. Finally, in the twentieth century, money became purely government-created, or fiat money. At each stage new challenges have arisen.

A currency will be stable only if governments manage their debts sustainably or if the central bank is able to stand aside when the government is driven into default. Throughout history, sovereign defaults have been a leading cause of economic disruption, either because they undermine the currency, through some form of debasement or inflation, or because they destroy the solvency of financial institutions that lent to the government, or, more often, both.

This is both an old story and a new one. A recent example is the Argentine government's default at the end of 2001. Philip II of Spain brought a famous banking house, the Fuggers, to its knees by his debt repudiation of 1575.[10] William III created the Bank of England to manage the country's debts during its wars with France at the end of the seventeenth century. So successful was the English – later British – state in establishing sound finance that it was able to pay for long conflicts without defaulting, overtly or covertly (through debasement or inflation). Honest money, credit and public finance, together with taxes more or less honestly paid, were (along with the sea and the Royal Navy) the decisive advantages of Great Britain in a series of long wars against France in the eighteenth and early nineteenth centuries.[11] They were also central to the development of the British economy in the eighteenth and nineteenth centuries.

After the 1930s and the Great Depression, it was widely accepted that the government's responsibility for sound money and public finances came together in the obligation to fine-tune the macroeconomy. This was a development of the economics of John Maynard Keynes, in his *General Theory of Employment, Interest and Money*, published in 1936. After the stagflationary débâcle of the 1970s, this idea went out of fashion. Today, inflation-targeting and sustainable public finances are generally believed, among economists, to provide as much macroeconomic stability as is reasonably attainable. There is, however, a substantial debate over the responsibilities of central banks for reducing the amplitude of financial bubbles.

Other important examples of goods with public goods characteristics are *infrastructure* and *basic research*. Roads have, historically, been a salient example of infrastructure the state alone can provide. Road space is not a pure public good, since it is unquestionably rival in consumption: two cars cannot occupy the same space at the same time. But it has been hard to charge users

though still convertible into
became purely government-
ges have arisen.
ments manage their debts
d aside when the government
vereign defaults have been a
because they undermine the
or inflation, or because they
at lent to the government, or,

cent example is the Argentine
II of Spain brought a famous
is debt repudiation of 1575.[10]
age the country's debts during
nth century. So successful was
sound finance that it was able
overtly or covertly (through
it and public finance, together
ong with the sea and the Royal
in a series of long wars against
th centuries.[11] They were also
onomy in the eighteenth and

it was widely accepted that the
ey and public finances came
acroeconomy. This was a devel-
Keynes, in his *General Theory of*
in 1936. After the stagflationary
shion. Today, inflation-targeting
believed, among economists, to
is reasonably attainable. There is,
onsibilities of central banks for

public goods characteristics are
ave, historically, been a salient
provide. Road space is not a pure
in consumption: two cars cannot
t it has been hard to charge users

sensibly, though modern technology may make wider use of road charging possible. Fundamental research is close to being a pure public good. Governments are important financiers, therefore, though charitable donations and corporate support are also likely to be forthcoming in a free society.

When government acts to internalize *externalities*, it is also providing public goods. Every advanced society has some form of planning regulation, to preserve environmental amenities. Similarly, every society has some form of control over pollution. These are cases in which what is rational for the transactors can lead to sizeable costs for innocent bystanders. As population densities grow, economic output increases and the world population becomes more urbanized, neighbourhood effects of this kind become more significant. These environmental spillovers can be local, national or global. Where they are global, environmental externalities also have to be internalized at the global level.

In addition to providing public goods, governments directly finance or provide certain *merit goods*. Such goods are consumed individually. But society insists on a certain level or type of provision. This may be either because these goods have public goods characteristics (my good health or education benefits others, for example, and vice versa), because a certain level of consumption is deemed a necessary condition for participation as a citizen, because of insufficient information about the nature of the goods or services in question, because a market failure makes it impossible to secure an adequate supply, or maybe for all of these reasons.

Obvious examples of merit goods are health and education, which are financed by governments everywhere. In the case of health, for example, it is impossible for the ordinary consumer to know what he or she needs. There are also important public goods aspects to health: your infectious disease is a threat to me. Similarly, it is hard to finance education, particularly basic education, against income that will accrue decades hence without some government assistance. For fundamental reasons of both equity and efficiency, governments end up financing education and health in every advanced society. But such finance does not imply that government needs to supply the service in question. It could buy health and education services from competing private sector suppliers and would probably do better if it did.

Governments implement *regulatory policies* for private enterprise. One important example is *competition policy*. Sometimes, governments also feel the need to create specific regulatory regimes for industries with monopoly power, such as water, electricity or telecommunications, because general competition policy is insufficiently effective. Sometimes the creation of a market is so complex that governments find themselves engaged directly in its design or act through independent agencies to achieve the same result. This has applied, in recent decades, to markets in electric power and to sales and use of the radio spectrum. The débâcle with Californian electricity deregulation, where wholesale prices shot up after liberalization, shows what happens when such designs go wrong. Governments are also responsible for policy levers with powerful economic effects, such as the structure and level of *barriers to trade or investment*. In addition, governments raise taxes and spend money to achieve their goals. *Taxation* and the pattern of *public procurement* have powerful effects on the operation of the private sector, especially on incentives for economic activity and competition among providers of the goods and services that governments buy.

Where there is difficulty in organizing private sector monitoring, where contracts are too long term to be effectively monitored or where governments feel obliged to protect people from themselves, governments often directly regulate economic activities. For reasons discussed in the previous chapter, financial sectors are particularly heavily regulated. Governments also increasingly find themselves regulating the health and safety of processes and products.

Markets generate a certain distribution of rewards. In response, political processes are likely to try *redistribution*. All advanced democracies redistribute income to some extent. Much of that redistribution is associated with the provision of *security* to individuals deemed unlucky or deserving in some way: the old, single parents, families with children, the disabled or the unemployed. In addition, most governments interfere in market processes directly to achieve what they consider, for some reason or another, more desirable outcomes: minimum wages and anti-discrimination legislation fall into this category.

Making interventions effective

The role of the state in a modern market economy is, in short, pervasive. The difference between poor countries and richer ones is not that the latter do less, but that what they do is better directed (on the whole) and more competently executed (again, on the whole). States have some functions they must perform: above all, protection of property and management of the government's own finances. States also have functions they must at present perform, such as the provision of sound money (though one could conceive of worlds in which this would be unnecessary). They have functions they feel compelled to perform by virtue of potential or actual market failure: the provision of infrastructure,

basic research and
monopoly power;
mental externaliti
perform by pressu
security and actio
While some of
run liberal democ
far more than the
'do something' w
government will
bureaucrat benefi
the view that inte
have their own in
Yet even if ther
how they should
ments are under
tions are good.
mostly just comr
The first requ
under the headi
both over time a
desired way if tl
they have no al
credible. If impl
ways that makes
make the policy
A good examp
people know th
will adjust relati
all concerned: w
accordingly, seel
the policy chang
and workers no
fail to do what
costs of implen
the governmen
becomes self-fu
this area, but

basic research and merit goods; regulation of competition and of utilities with monopoly power; and internalization of externalities, particularly environmental externalities. Finally, they have functions they feel compelled to perform by pressure from their electorate: income redistribution, provision of security and action against discrimination.

While some of the state's activities are unquestionably essential, even well-run liberal democracies do far more than they can do well and almost certainly far more than they need to do.[12] There are strong pressures for governments to 'do something' where doing nothing might be far better. In any given area, government will hear only from those who want it to act. No politician or bureaucrat benefits from saying that he thinks it is better to leave ill alone, on the view that intervention is likely to make the position still worse. They also have their own interest in making concerned citizens dependent upon them.

Yet even if there is an agreement that states should act, this does not indicate how they should do so. For, as experience with state planning shows, governments are under big handicaps in designing interventions, even if their intentions are good. What then are the implications for good policy? They are mostly just common sense. Unfortunately, sense is far from common.

The first requirement of effective policy is a range of qualities that come under the headings of *credibility, predictability, transparency and consistency*, both over time and across activities. Private sector actors will not behave in the desired way if they do not know what is wanted. They must also know that they have no alternative. In other words, policy must be predictable and credible. If implementation is negotiable, the regulated industry will act in ways that makes persisting with the policy more difficult. In the process, it will make the policy more costly than it would otherwise be.

A good example of the value of credibility is trade liberalization. If business people know that a barrier to imports will disappear some years hence, they will adjust relatively smoothly. That will, in turn, reduce the economic costs for all concerned: workers will know that the industry is likely to contract and will, accordingly, seek other jobs; and investment will also go elsewhere. But suppose the policy change lacks credibility. Then it would be in the interest of businesses and workers not to make the adjustment, in the hope that the government will fail to do what it has promised. Because of the resistance to adjustment, the costs of implementing the policy become higher than they needed to be. So the government may, indeed, back off. In that case, the lack of credibility becomes self-fulfilling, with untoward consequences not just for credibility in this area, but more generally. Weak governments impose unnecessary costs.

This is one of the most important justifications for making binding international agreements to liberalize. By making policy more credible, they make adjustment more inescapable, and so reinforce credibility. Similar arguments apply to environmental policies.

The second set of requirements comes under the heading of *directness.* Assume that there is some identifiable market failure. Then the right policy is the one that is most directly targeted at that failure and does the minimal amount of collateral damage.

For this reason, as will be shown further below, a trade policy measure is unlikely to be the best way to deal with, for example, an environmental concern. Again, even if one accepts that agricultural policy should have economic, social, food quality and environmental objectives, it is inconceivable that a set of policies aimed at raising production through higher prices will be the best for meeting all these objectives. There is an excellent chance that one policy intended to hit three separate objectives will fail to hit any of them. The EU's common agricultural policy is a superb example of just this: it promotes economically costly production; it fails to preserve rural activities; it worsens food quality; and it inflicts damage on the environment.

Another example can be drawn from policies to reduce greenhouse-gas emissions. The least costly policy is one that makes the marginal cost of reducing greenhouse-gas emission the same in all economic activities. If that were not the situation, one could obtain more valuable output, with the same emissions, by increasing production (and emissions) where the marginal costs of reducing emissions are relatively high and vice versa. It follows that there should be no exemptions from a tax on emissions.

The third requirement is going with the *grain of incentives.* Policy should elicit the behaviour one wants, at least cost. This involves two layers of analysis. The first is that market incentives – ones that work through prices – are usually the most effective means. If one has the knowledge to decide on the right tax on an undesirable activity or right subsidy to a desirable one, such taxes or subsidies are almost always better policies than quantitative targets and commands. They are market-compatible measures.

The second and deeper level is to consider market failures the result of incomplete property rights. If that failure can be corrected, the market should generate the best possible response. Professor McMillan gives the example of tradable pollution licenses in the United States.[13] In the Clean Air Act of 1990, the Environmental Protection Agency created a market in tradable rights to pollute. It transpired that the degree of abatement desired was much less costly

ons for making binding interna-
policy more credible; they make
redibility. Similar arguments

nder the heading of *directness.*
t failure. Then the right policy is
at failure and does the minimal

below, a trade policy measure is
for example, an environmental
agricultural policy should have
nmental objectives, it is incon-
sing production through higher
objectives. There is an excellent
separate objectives will fail to hit
policy is a superb example of just
luction; it fails to preserve rural
icts damage on the environment.
olicies to reduce greenhouse-gas
that makes the marginal cost of
in all economic activities. If that
re valuable output, with the same
nissions) where the marginal costs
d vice versa. It follows that there
ns.
grain of incentives. Policy should
This involves two layers of analysis.
t work through prices – are usually
wledge to decide on the right tax
to a desirable one, such taxes or
es than quantitative targets and
easures.
ider market failures the result of
n be corrected, the market should
or McMillan gives the example of
tes.[13] In the Clean Air Act of 1990,
ted a market in tradable rights to
ement desired was much less costly

than people had expected. This was shown by the fact that the average market price for cleaning up a ton of sulphur dioxide turned out to be $150. The EPA had initially estimated that the cost would be five times as high.

Market failures need to be addressed if sufficiently serious. But this raises a fourth and final point: *remediability*. Remedies are costly. They need to be credibly better than the ailments. For government action to be justified, the world must be credibly better after the action than before it. In making that judgement, one must also take into account the inherent failures of government. As is argued further below, one must avoid what the economist Harold Demsetz once called 'the nirvana approach', a comparison between the actual market outcome and the ideal, but unattainable, alternative that might be produced by omniscient, benevolent and omnipotent government intervention.[14]

Why government fails

We know there are some things states cannot do – plan an entire economy. We know there are some things states must do – protect property rights. This is a 'must have' if there is to be a sophisticated market economy. There are also 'nice to haves'. Unfortunately, the mechanism of the state is at least as defective as that of the market. In fact, throughout most of history and in most countries today, it has been far more so. Governments do not only fail to provide 'nice to haves', they fail to provide 'must haves'. Often the most important violator of the conditions needed for markets to generate prosperity is government itself. It does not offer a remedy for market failures, but is a source of greater failures itself. This is not an accident. It is inherent in any political process, but it is truest, inevitably, in the poor countries that most need better government.

Flaws of good governments

Think of an advanced democracy, such as the United Kingdom or the United States. These have stable political regimes, entrenched civil and political rights, elections, a well-defined legal system, an independent judiciary and modest levels of corruption. States like these are, quite simply, the best in history. Some will say that Sweden, Switzerland or maybe France is even better. So they may be. But these distinctions are modest. The advanced economies of today have, as one might expect, the most sophisticated, responsive and law-abiding states ever.

For some observers, including critics of economic globalization, this is sufficient to establish the superiority of political processes over all others, above all the market. Professor Benjamin Barber has just such a romantic view of the democratic political process. '[T]he self-interested motives on the basis of which consumers spend their pennies have nothing to do with who runs anything, let alone with the kind of civil society these same consumers hope to live in or the civic objectives they forge together as citizens in democratic political arenas in order to control the public and political consequences of their private consumer choices.'[15] The first part of Barber's statement is nonsense. He should try to stay in business when nobody is prepared to buy what he wishes to sell. The statement about democracy is more serious. Indeed, it is fundamental to the debate on the global market economy. For Barber is unquestionably correct on his central point: governments are extremely important.

The difficulty lies in his description of the political process of a modern mass democracy as one in which citizens come together to forge common objectives. This is a naive account of how politics do – or can – work in a modern complex representative democracy. The United States of close to 300 million people with very divergent backgrounds, ways of life and experiences is not the world described by Aristotle in his discussion of the polis of Ancient Greece. Pericles' Athens is gone for ever (if, in fact, it ever existed).

What then are the problems? One is that modern governments are, like modern economies and societies themselves, enormously complicated. They rest, as today's world does, on an elaborate division of labour. The decisions they make are highly technical. It is impossible for an outside observer to observe, let alone sensibly judge, more than a tiny proportion of the decisions being made. This is a statement that I can make with some confidence, since doing precisely that has been my job since 1987 at the *Financial Times*.

Not only is it very difficult to know what is going on, but most citizens have no interest in doing so. They are 'rationally ignorant'.[16] What makes their ignorance rational is that the probability of their individually affecting a policy outcome is zero. So why would one expect them to invest prodigious efforts in analysing the options, even if it were in an area in which they have a chance of doing so? Consequently, the majority of voters also have no basis on which to form a rational view of genetically modified foods, to take one contemporary example.

Three (overlapping) classes of people are relatively well informed: first, people who are paid to be, such as newspaper columnists, academic experts in a relevant field, bureaucrats and politicians; second, people whose livelihood depends on specific political decisions, such as doctors on health policies, teachers on education policy, farmers on agricultural policy, steel workers on trade policy, corporations on policy towards intellectual property, and so forth; and, finally, people who find a specific area of policy of absorbing interest. The first group tends to the cynical, the second to the self-interested, and the last to the fanatical. There is no reason to expect what emerges from this process to be a reflection of anything one could reasonably call the common interest. Not only is influence on the process extremely unequal, but it is also vitiated by the very partial nature of the influences at work. One person, one vote looks more egalitarian than the widely divergent wealth that influences a market. Wealth always brings disproportionate political influence, not just greater purchasing power. But there are others who also wield disproportionate political influence, above all, people who specialize in being opinion formers.[17] It is not an accident that opinion formers are, in general, strongly in favour of more politics and fewer markets.

In elections, one votes for a candidate or party that makes some broad promises over a long list of issues. One does not expect many of these to be implemented even if one's candidate or party wins – and often one is not disappointed in these expectations. So far as most voters are concerned, that is the end of the matter. Then, in the period between elections, policy is made in a hugger-mugger of special-interest lobbies, self-proclaimed 'public-interest' groups, journalists, assorted experts, bureaucrats, politicians, particularly more influential ones, and anybody else with a big enough axe to grind.

Most people would accept that those with economic interests are far from objective pursuers of the common weal. But what about some of the other actors in this play? One might hope that Greenpeace, Oxfam and the rest are impartial and disinterested. But many non-governmental organizations are heavily dependent on public funding. Others depend for fund-raising on the more or less plausible manufacture of photogenic crises. Again, bureaucrats are supposed to represent a broad public interest. But they too have interests, most important of which are to stay in business. It is no surprise to discover that the direction of public spending in every advanced country has been consistently upwards as a share of GDP over the last century.[18] Only economic collapse is likely to reverse this trend.

Advanced democracies do at least a tolerable job of providing the things needed for such a society and economy to function. But much of the detail of policy is horrendously bad. Institutions capable of the farm policies of today cannot be defined in the terms that Barber attempts to employ. The same is true of most trade policy, much environmental policy, the treatment of risk across different activities, energy policy, labour market policy in much of continental Europe and so on and so forth. Government is essential. Of that there is no doubt. But to rely on it to do a sensible job of remedying so-called market failures when it busily introduces so many failures of its own is absurd.

Catastrophe of bad governments

Yet the advanced representative democracies are impressive governmental systems by both contemporary and historical standards. If one raises one's eyes and looks at the rest of the world or at the history of the last century, one sees corrupt, incompetent, brutal and, depressingly often, murderous governments everywhere. A big part of the history of the twentieth century is a story of the crimes inflicted by those in power upon innocent people.

Alas, this era of mal-government is not over. Consider Rwanda or Serbia in the early 1990s. Look at Russia's brutality in Chechnya, at Burma's soldier-thugs, at the Taliban's brutal and regressive Afghanistan, or at Saddam Hussein's Iraq. Look, too, at the kleptocrats: Mobutu Sese Seko in the former Zaire, the Suharto family in Indonesia or Robert Mugabe in Zimbabwe.[19] War, civil war, massacre, political instability, autocracy, state failure, public sector profligacy, constant interference in markets, default, inflation and corruption have been salient features of the developing world over the last half-century. The notion that one can rely on governments, particularly in the developing world, to make an honest and disinterested effort to protect property, provide other public and merit goods and so raise national economic welfare, is mostly laughable. In the 1990s, at last, even the World Bank admitted the seriousness of bad government as a constraint on development. Indeed, that is probably the most important development of the era of James Wolfensohn as the World Bank's president.

Consider, for a moment, just the more obvious policy failures. As William Easterly, formerly at the World Bank, points out, a recurrent feature of the developing world has been high black-market premia on exchange rates. These are a symptom of suppressed inflation. Governments have attempted to finance public spending through the monetary printing press (thus violating a fundamental public goods function of the state). This creates inflationary pressure, which is partially suppressed through an artificially fixed exchange rate. But the pressure emerges in rising domestic prices of non-tradable goods

attempts to employ. The same is
ntal policy, the treatment of risk
ur market policy in much of
Government is essential. Of that
nsible job of remedying so-called
many failures of its own is absurd.

ies are impressive governmental
l standards. If one raises one's eyes
iistory of the last century, one sees
gly often, murderous governments
twentieth century is a story of the
ocent people.
ver. Consider Rwanda or Serbia in
in Chechnya, at Burma's soldier-
ssive Afghanistan, or at Saddam
: Mobutu Sese Seko in the former
obert Mugabe in Zimbabwe.[19] War,
tocracy, state failure, public sector
s, default, inflation and corruption
g world over the last half-century,
nts, particularly in the developing
ort to protect property, provide
ational economic welfare, is mostly
orld Bank admitted the seriousness
elopment. Indeed, that is probably
of James Wolfensohn as the World

obvious policy failures. As William
nts out, a recurrent feature of the
ket premia on exchange rates. These
Governments have attempted to
tary printing press (thus violating a
he state). This creates inflationary
rough an artificially fixed exchange
mestic prices of non-tradable goods

and services and declining competitiveness of exports (which may well shrink). The balance of payments worsens and citizens desperately try to get their money out. Thus emerges the black market. But this black market is not merely economically damaging. It is corrupting. There is an overwhelming temptation to buy domestic currency at the black-market rate rather than the official one. As Easterly notes, premia can reach insane levels: 'Ghana had a world-record 4,264 per cent black market premium in 1982 and had consistently had the premium above 40 per cent for eighteen of the previous twenty years.'[20]

Take a look at Mexico: between 1970 and 1982, two bad presidents destroyed the country's proud record of macroeconomic stability in the name of helping the poor. In 1976, a crisis forced a devaluation and a sharp slowdown in growth. Then came oil. But President López Portillo managed to waste even this surge in wealth. The country devalued again in 1982 and defaulted, triggering the Latin American debt crisis. Then painful reforms began, but the government failed to regulate the banking sector (another fundamental government role in an insured banking system). This led to a third foreign exchange crisis in two decades, in 1994–5.[21]

Fiscal, monetary and financial policies have certainly not been the only areas of government failure. Government monopolies have repeatedly failed to provide reliable electricity, telephone services, water, education or health services. 'In Nigeria, the government has failed almost completely to provide basic services, despite $280 bn in government oil revenues since the discovery of reserves in the late 1950s. The government has preferred to spend its money instead on things like the $8 bn steel complex that has yet to produce a bar of steel and a new national capital built from scratch, not to mention the breath-taking amount of money stolen by the rulers.'[22] In many developing countries, it has been easy to find examples of negative value-added production – enterprises whose inputs were worth more than their outputs – because of the enormous protection given to final products in the name of self-sufficiency and infant-industry development. Then consider India's public spending. A meticulous analysis by the National Council for Applied Economic Research concluded that 10 per cent of GDP – roughly 40 per cent of all public spending – went on subsidies for power, water and food to relatively prosperous people. Meanwhile, the national average literacy rate was only 57 per cent in 2002.[23]

There is also pervasive corruption. Hernando De Soto, the Peruvian economist, once registered a small clothing factory in Lima as an experiment. It took ten months. In that time, he was asked for bribes ten times by government officials. On two occasions, he had to pay them, since the experiment would otherwise have ground to a halt.[24] Remember what corruption means: it is the abuse of a position of public trust for personal gain. How can a state rife with such corruption provide what the market needs to achieve prosperity? The answer, of course, is that it cannot do so.

Corruption exists everywhere. But it is far worse in poor countries than in rich ones. Transparency International has a well-known index with a scale of zero to ten that rates corruption by the perceptions of those affected. Among advanced countries, almost all were above seven in 2001, with Denmark top on 9.5. The lowest among the advanced liberal democracies were France (6.7), Belgium (6.6) and Italy (5.5). At or below two were Bangladesh (0.4), Nigeria (1.0), Uganda (1.9), Indonesia (1.9), Bolivia (2.0), Kenya (2.0) and Cameroon (2.0). Meanwhile, Russia and Pakistan were on 2.3, India on 2.7, China on 3.5, Brazil on 4.0.[25]

There is, as one might expect, strong evidence that corruption impairs economic growth. Nobody wants to invest or do the other growth-promoting things discussed in Chapters 2 and 3 in a highly corrupt country.[26] Yet all corruption is not equal in its effects. Analysts distinguish centralized from decentralized corruption. Under centralized corruption, one person determines the size of the take. Call this Suharto's Indonesia. Under decentralized corruption, officials and politicians compete for the take. Call this India.

Centralized corruption should be less damaging, provided the ruler is enlightened. It is against the ruler's interests to let the rate of 'taxation' imposed by corruption become too high. But, under competing decentralized corruption, it is a case of grab while you can. Such destructive competition for loot can create an economic implosion, as in Nigeria. Government is a natural monopoly for good reason. Competing bandits are bad news.

A significant subset of such corruption is state capture by private interests.[27] An important example of this was the role of the so-called 'oligarchs' in Boris Yeltsin's Russia. Where the economic élite is competing for favours, the impact will be to corrupt policy-makers and bureaucracy. Vladimir Putin told Russia's business leaders in 2000 that 'you have yourselves formed this very state, to a large extent through political and quasi-political structures under your control, so perhaps what one should do least of all is blame the mirror'.[28] The economic effects of such capture are powerfully negative, since this élite is interested in favours for itself and not in an impartial rule of law. Only a wide business community of competing producers has an interest in the rule of law. But such a community is difficult to organize politically.

iem, since the exper-
ber what corruption
rsonal gain. How can
ket needs to achieve

oor countries than in
index with a scale of
iose affected. Among
with Denmark top on
es were France (6.7),
gladesh (0.4), Nigeria
(2.0) and Cameroon
on 2.7, China on 3.5,

corruption impairs
the other growth-
ily corrupt country.[26]
stinguish centralized
ruption, one person
onesia. Under decen-
e for the take. Call

rovided the ruler is
he rate of 'taxation'.
npeting decentralized
ctive competition for
vernment is a natural
iews.
by private interests.[27]
ed 'oligarchs' in Boris
or favours, the impact
mir Putin told Russia's
ed this very state, to a
ructures under your
me the mirror'.[28] The
ive, since this élite is
le of law. Only a wide
rest in the rule of law.

A society in which it is deemed normal for judges, bureaucrats or politicians to accept bribes creates a trap for those trying to achieve reform. In a society in which everyone cheats and takes or pays bribes, there is little incentive not to join in. It is rational for each individual to participate in this destructive game and, given the prevalence of such misbehaviour, little incentive for anybody to cease doing so, since the chances of being caught and punished are small. In a society in which cheating and bribery are rare, however, there is far less incentive to act dishonestly, since there is a far greater chance of being caught and punished as well as of obtaining what one wants honestly. Moving from the first sort of society to the second is difficult, however.

Conclusion

Good markets need good governments. This is just as true of global as of purely domestic markets, if not more so. Indeed the former grow out of the latter, as will be shown in the next chapter. Unfortunately, good governments are not easy to find. Even in advanced liberal democracies, where governments work relatively well, political and bureaucratic processes are as flawed as markets, if not far more so. In general, it is a case of balancing defective markets against defective political processes. In developing countries, however, governments are generally still worse. Many governments are grossly incompetent, corrupt, or both. This is both a cause and a consequence of poor policy performance. Decentralized, competitive corruption, including state capture by corrupt private interests, is particularly damaging. Improvements will not occur unless and until these constraints are at least partially lifted. One important way of doing so, it happily turns out, is to open up economies to global competitive forces.

How to reform the state

Even good and relatively uncorrupt governments are highly imperfect, by their nature. But they are also absolutely essential. So a central question is how to obtain the best governments one can. The answer to this question can be divided into two parts: internal reform and regulatory competition.

Internal reform

Reforms in the governance of the advanced liberal democracies have been designed to make them more effective. An important element in those reforms has been the mirror image of the observation above that good markets need good governments. Good governments also need good markets. More precisely, the more the government focuses on its essential tasks and the less it is engaged in economic activity and regulation, the better it is likely to work and the better the economy itself is likely to run. Good markets protect governments, just as good governments protect markets. They have a symbiotic relationship.

This is an important part of the argument for privatization. In the case of ordinary productive enterprizes, nationalization tended to mean political interference and waste, but also a diversion of attention and effort by governments. In the case of utilities, privatization allowed the creation of a far more transparent and rule-governed regime than that in place beforehand. Again, this has important economic benefits. But it also improves the quality of regulation. It is almost impossible to be both a producer and a regulator at the same time. The two activities are inherently different.

All this is important and valuable everywhere. But in the developing world much more needs to be done. A start has to be made by reducing the opportunities for corruption. Critics of the market and of global economic integration seem to be entirely unaware that a control, regulation or restriction creates an opportunity for corruption. Wherever there is a gap between the market value of something and an official price or the price government is prepared to allow, there is an incentive to cheat and to bribe. If the black-market price of foreign currency is twice the official rate, people will bribe officials to let them sell on the black market. Similarly, if imports of certain much desired commodities are restricted or under a very high tariff, business people will bribe officials to let them take the commodities in or evade the tariff. Again, if one needs a large number of bureaucratic permissions to do something in business, the officials have an opportunity to demand bribes. But there is worse: once it is known that a government is prepared to create such exceptional opportunities, there will be lobbying to create them. Then there is not just the corruption of the government, but the waste of resources in such 'rent-seeking' or 'directly unproductive profit-seeking activities'.[29]

In the early 1970s I worked on Kenya when the import-control regime was coming into place. I watched it corrupt the civil service in front of my eyes. Then in the mid-1970s I worked for the World Bank on India. The corrupting import-control regime operated for so long by its government went back to the late years of the British Raj. But, unlike in Britain, the restrictions were never liberalized after the Second World War. On the contrary, a twisted

ɔd markets need
markets. More
ks and the less it
is likely to work
markets protect
s. They have a

ɔn. In the case of
ɔ mean political
effort by govern-
ion of a far more
forehand. Again,
es the quality of
a regulator at the

developing world
lucing the oppor-
global economic
tion or restriction
gap between the
ce government is
ribe. If the black
people will bribe
mports of certain
igh tariff, business
es in or evade the
permissions to do
lemand bribes. But
ired to create such
hem. Then there is
f resources in such
ities'.[29]
control regime was
n front of my eyes
dia. The corrupting
ment went back to
ie restrictions were
contrary, a twisted

ingenuity went into elaborating the regime. Progressively, these and similar regulations in other areas corrupted the public administration. If the control regime of 1945 had remained in place for a further forty-five years, how far would the British civil service have remained non-corrupt? Not that far, would be my guess.

Regulatory competition

Predation is lucrative and attractive. Historically, the most important constraint has been external regulatory competition as much as internal pressure. Too often it is only when states fall far behind their competitors, when every enterprising person tries to leave, when capital goes enthusiastically anywhere else, when default threatens and capital outflow becomes a flood that governments are driven to reform. Such competition for people, capital and the development and application of ideas was, as argued in Chapter 3, a crucial element in the explanation for the rise of Europe.

Governments are natural monopolies over a given territory. Competitive government over a given territory means civil war. But we know that monopolies tend to become exploitative, oppressive, slothful and indifferent.[30] So one of the strongest arguments for an open economy is that it puts a degree of competitive pressure on government. If one believes governments are always benevolent, wise and caring, one may well object to that pressure. But the great irony of the anti-globalization critics is that most of them believe in none of those things. They are then in the paradoxical situation of wanting governments to intervene more, which will create corruption, and to close off markets, which will relieve bad governments of competitive pressure, while expecting governments to become more devoted to the weal of the mass of the public. Yet both theory and experience show that the more interventionist the state and the more closed the economy, the more likely the government is to be captured by powerful interests. To be illiberal and opposed to state-capture by special interests, including corrupt politicians, is incoherent.

Conclusion – your humble public servant

Good government is essential. It is a good in itself and essential for the working of a sophisticated market economy, which is, in its turn, the cradle of prosperity and freedom. There is a symbiosis between the market and the state. But it is a subtle one. The role of government is to be a humble and honest servant. How many humble and honest governments can we find? Not enough, is the answer. That matters in all circumstances. But, as we shall see in subsequent chapters, this is even more important when markets cross borders. Bad governments are a huge obstacle to gaining the benefits of economic integration across borders. Indeed, they are the most important obstacle of all.