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—John Gray, *Observer* (UK)

23 THINGS THEY DON'T TELL YOU ABOUT CAPITALISM

WITH A NEW POSTSCRIPT BY THE AUTHOR

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Thing 7
Free-market policies rarely make poor countries rich

What they tell you

After their independence from colonial rule, developing countries tried to develop their economies through state intervention, sometimes even explicitly adopting socialism. They tried to develop industries such as steel and automobiles, which were beyond their capabilities, artificially by using measures such as trade protectionism, a ban on foreign direct investment, industrial subsidies, and even state ownership of banks and industrial enterprises. At an emotional level this was understandable, given that their former colonial masters were all capitalist countries pursuing free-market policies. However, this strategy produced at best stagnation and at worst disaster. Growth was anaemic (if not negative) and the protected industries failed to 'grow up'. Thankfully, most of these countries have come to their senses since the 1980s and come to adopt free-market policies. When you think about it, this was the right thing to do from the beginning. All of today's rich countries, with the exception of Japan (and possibly Korea, although there is debate on that), have become rich through free-market policies, especially through free trade with the rest of the world. And developing countries that have more fully embraced such policies have done better in the recent period.

What they don't tell you

Contrary to what is commonly believed, the performance of developing countries in the period of state-led development was superior to what they have achieved during the subsequent period of market-oriented reform. There were some spectacular failures of state intervention, but most of these countries grew much faster, with more equitable income distribution and far fewer financial crises, during the 'bad old days' than they have done in the period of market-oriented reforms. Moreover, it is also *not* true that almost all rich countries have become rich through free-market policies. The truth is more or less the opposite. With only a few exceptions, all of today's rich countries, including Britain and the US – the supposed homes of free trade and free market – have become rich through the combinations of protectionism, subsidies and other policies that today they advise the developing countries not to adopt. Free-market policies have made few countries rich so far and will make few rich in the future.

Two basket cases

Here are the profiles of two developing countries. You are an economic analyst trying to assess their development prospects. What would you say?

Country A: Until a decade ago, the country was highly protectionist, with an average industrial tariff rate well above 30 per cent. Despite the recent tariff reduction, important visible and invisible trade restrictions remain. The country has heavy restrictions on cross-border flows of capital, a state-owned and highly regulated banking sector, and numerous restrictions on foreign ownership

of financial assets. Foreign firms producing in the country complain that they are discriminated against through differential taxes and regulations by local governments. The country has no elections and is riddled with corruption. It has opaque and complicated property rights. In particular, its protection of intellectual property rights is weak, making it the pirate capital of the world. The country has a large number of state-owned enterprises, many of which make large losses but are propped up by subsidies and government-granted monopoly rights.

Country B: The country's trade policy has literally been the most protectionist in the world for the last few decades, with an average industrial tariff rate at 40–55 per cent. The majority of the population cannot vote, and vote-buying and electoral fraud are widespread. Corruption is rampant, with political parties selling government jobs to their financial backers. The country has never recruited a single civil servant through an open, competitive process. Its public finances are precarious, with records of government loan defaults that worry foreign investors. Despite this, it discriminates heavily against foreign investors. Especially in the banking sector, foreigners are prohibited from becoming directors while foreign shareholders cannot even exercise their voting rights unless they are resident in the country. It does not have a competition law, permitting cartels and other forms of monopoly to grow unchecked. Its protection of intellectual property rights is patchy, particularly marred by its refusal to protect foreigners' copyrights.

Both these countries are up to their necks in things that are supposed to hamper economic development – heavy protectionism, discrimination against foreign investors, weak protection of property rights, monopolies, lack of democracy, corruption, lack of meritocracy, and so on. You would think that they are both headed for developmental disasters. But think again.

Country A is China today – some readers may have guessed that. However, few readers would have guessed that *Country B* is the USA – that is, around 1880, when it was somewhat poorer than today's China.

Despite all the supposedly anti-developmental policies and institutions, China has been one of the world's most dynamic and successful economies over the last three decades, while the USA in the 1880s was one of the fastest-growing – and rapidly becoming one of the richest – countries in the world. So the economic superstars of the late nineteenth century (USA) and of today (China) have both followed policy recipes that go almost totally against today's neo-liberal free-market orthodoxy.

How is this possible? Hasn't the free-market doctrine been distilled out of two centuries of successful development experiences by today's two dozen rich countries? In order to answer these questions, we need to go back in history.

Dead presidents don't talk

Some Americans call their dollar bills 'dead presidents', or 'dead prez'. Not quite accurately. They are all dead all right, but not all the politicians whose portraits adorn the dollar bills are former presidents of the US.

Benjamin Franklin – who features on the best-known paper money in human history, the $100 bill – never was president. However, he could well have been. He was the oldest of the Founding Fathers and arguably the most revered politician of the new-born country. Although he was too old and George Washington's political stature too great for him to run for the first presidency in 1789, Franklin was the only person who could possibly have challenged Washington for the job.

The real surprise in the pantheon of presidents on the greenback

is Alexander Hamilton, who features on the $10 bill. Like Franklin, Hamilton was never a president of the US. But unlike Franklin, whose life story has become American legend, he was, well, not Franklin. Hamilton was a mere Treasury Secretary, even though he was the very first one. What is he doing among the presidents?

Hamilton is there because, unbeknown to most Americans today, he is the architect of the modern American economic system. Two years after becoming Treasury Secretary in 1789 at the outrageously young age of thirty-three, Hamilton submitted to the Congress the *Report on the Subject of Manufactures*, where he set out the economic development strategy for his young country. In the report, he argued that 'industries in their infancy', like the American ones, need to be protected and nurtured by government before they can stand on their own feet. Hamilton's report was not *just* about trade protectionism – he also argued for public investment in infrastructure (such as canals), development of the banking system, promotion of a government bond market – but protectionism was at the heart of his strategy. Given his views, were Hamilton finance minister of a developing country today, he would have been heavily criticized by the US Treasury Department for his heresy. His country might even have been refused a loan from the IMF and the World Bank.

The interesting thing, however, is that Hamilton was not alone in this. All the other 'dead presidents' would have met with the same disapproval from the US Treasury, the IMF, the World Bank and other defenders of the free-market faith today.

On the $1 bill is the first president, George Washington. At his inauguration ceremony, he insisted on wearing American clothes – specially woven in Connecticut for the occasion – rather than higher-quality British ones. Today, this would have been a violation of the proposed WTO rule on transparency in government procurement. And let's not forget that Washington was the

one who appointed Hamilton as Treasury Secretary, and in full knowledge of what his view on economic policy was – Hamilton was Washington's aide-de-camp during the American War of Independence and his closest political ally after that.

On the $5 bill, we have Abraham Lincoln, a well-known protectionist, who during the Civil War raised tariffs to their highest level ever.[1] On the $50 bill, we have Ulysses Grant, the Civil War hero-turned president. In defiance of the British pressure on the USA to adopt free trade, he once remarked that 'within 200 years, when America has gotten out of protection all that it can offer, it too will adopt free trade'.

Benjamin Franklin did not share Hamilton's infant industry doctrine, but he insisted on high tariff protection for another reason. At the time, the existence of almost-free land in the US made it necessary for American manufacturers to offer wages around four times higher than the European average, as otherwise the workers would have run away to set up farms (this was no idle threat, given that many of them were farmers in their previous lives) (*see Thing 10*). Therefore, Franklin argued, the American manufacturers could not survive unless they were protected from low-wage competition – or what is known as 'social dumping' today – from Europe. This is exactly the logic that Ross Perot, the billionaire-turned-politician, used in order to oppose the NAFTA (North American Free Trade Agreement) in the 1992 presidential election campaign – a logic that 18.9 per cent of the American voters were happy to endorse.

But surely, you may say, Thomas Jefferson (on the rarely seen $2 bill) and Andrew Jackson (on the $20 bill), the patron saints of American free-market capitalism, would have passed the 'US Treasury Test'?

Thomas Jefferson may have been against Hamilton's protectionism but, unlike Hamilton, who supported the patent system, he argued strongly against patents. Jefferson believed that ideas

are 'like air' and therefore should not be owned by anyone. Given the emphasis that most of today's free-market economists put on the protection of patents and other intellectual property rights, his views would have gone down like a lead balloon among them.

Then how about Andrew Jackson, that protector of the 'common man' and fiscal conservative (he paid off all federal government debts for the first time in US history)? Unfortunately for his fans, even he would not pass the test. Under Jackson, average industrial tariffs were in the region of 35–40 per cent. He was also notoriously anti-foreign. When in 1836 he cancelled the licence for the semi-public (second) Bank of the USA (it was 20 per cent owned by the US federal government), one of the main excuses was that it was 'too much' owned by foreign (mainly British) investors. And how much was too much? Only 30 per cent. If some developing country president today cancelled the licence for a bank because it was 30 per cent owned by the Americans, it would send the US Treasury into a fit.

So there we go. Every day, tens of millions of Americans go through the day paying for their taxis and buying their sandwiches with a Hamilton or a Lincoln, getting their change with Washingtons, not realizing that these revered politicians are nasty protectionists that most of their country's news media, conservative and liberal alike, love to lambast. New York bankers and Chicago university professors tut-tut through articles criticizing the anti-foreign antics of Hugo Chavez, the Venezuelan president, in copies of the *Wall Street Journal* bought with an Andrew Jackson, without realizing that he was far more anti-foreign than Chavez.

The dead presidents don't talk. But if they could, they would tell Americans and the rest of the world how the policies that their successors promote today are the exact opposite of what they used in order to transform a second-rate agrarian economy dependent on slave labour into the world's greatest industrial power.

Do as I say, not as I did

When reminded of the protectionist past of the US, free-market economists usually retort that the country succeeded despite, rather than because of, protectionism. They say that the country was destined to grow fast anyway, because it had been exceptionally well endowed with natural resources and received a lot of highly motivated and hard-working immigrants. It is also said that the country's large internal market somewhat mitigated the negative effects of protectionism, by allowing a degree of competition among domestic firms.

But the problem with this response is that, dramatic as it may be, the US is not the only country that has succeeded with policies that go against the free-market doctrine. In fact, as I shall elaborate below, most of today's rich countries have succeeded with such policies.[2] And, when they are countries with very different conditions, it is not possible to say that they all shared some special conditions that cancelled out the negative impacts of protectionism and other 'wrong' policies. The US may have benefited from a large domestic market, but then how about tiny Finland or Denmark? If you think the US benefited from abundance of natural resources, how do you explain the success of countries such as Korea and Switzerland that had virtually no natural resources to speak of? If immigration was a positive factor for the US, how about all those other countries – from Germany to Taiwan – that lost some of their best people to the US and other New World countries? The 'special conditions' argument simply does not work.

Britain, the country which many people think invented free trade, built its prosperity on the basis of policies similar to those that Hamilton promoted. This was not a coincidence. Although Hamilton was the first person to *theorize* the 'infant industry' argument, many of his policies were copied from Robert Walpole,

the so-called first British Prime Minister, who ran the country between 1721 and 1742.

During the mid eighteenth century, Britain moved into the woollen manufacturing industry, the high-tech industry of the time that had been dominated by the Low Countries (what are Belgium and the Netherlands today), with the help of tariff protection, subsidies, and other supports that Walpole and his successors provided to the domestic woollen manufacturers. The industry soon provided Britain's main source of export earnings, which enabled the country to import the food and raw materials that it needed to launch the Industrial Revolution in the late eighteenth and the early nineteenth centuries. Britain adopted free trade only in the 1860s, when its industrial dominance was absolute. In the same way in which the US was the most protectionist country in the world during most of its phase of ascendancy (from the 1830s to the 1940s), Britain was one of the world's most protectionist countries during much of its own economic rise (from the 1720s to the 1850s).

Virtually all of today's rich countries used protectionism and subsidies to promote their infant industries. Many of them (especially Japan, Finland and Korea) also severely restricted foreign investment. Between the 1930s and the 1980s, Finland used to classify all enterprises with more than 20 per cent foreign ownership officially as 'dangerous enterprises'. Several of them (especially France, Austria, Finland, Singapore and Taiwan) used state-owned enterprises to promote key industries. Singapore, which is famous for its free-trade policies and welcoming attitudes towards foreign investors, produces over 20 per cent of its output through state-owned enterprises, when the international average is around 10 per cent. Nor did today's rich countries protect foreigners' intellectual property rights very well, if at all – in many of them it was legal to patent someone else's invention as long as that someone else was a foreigner.

There were exceptions of course. The Netherlands, Switzerland (until the First World War) and Hong Kong used little protectionism, but even these countries did not follow today's orthodox doctrines. Arguing that patents are artificial monopolies that go against the principle of free trade (a point which is strangely lost on most of today's free-trade economists), the Netherlands and Switzerland refused to protect patents until the early twentieth century. Even though it did not do it on such principled grounds, Hong Kong was until recently even more notorious for its violation of intellectual property rights than the former countries. I bet you know someone – or at least have a friend who knows someone – who has bought pirated computer software, a fake Rolex watch or an 'unofficial' Calvin & Hobbes T-shirt from Hong Kong.

Most readers may find my historical account counter-intuitive. Having been repeatedly told that free-market policies are the best for economic development, they would find it mysterious how most of today's countries could use all those supposedly bad policies – such as protectionism, subsidies, regulation and state ownership of industry – and still become rich.

The answer lies in the fact that those bad policies were in fact good policies, given the stage of economic development in which those countries were at the time, for a number of reasons. First is Hamilton's infant industry argument, which I explain in greater detail in the chapter 'My six-year-old son should get a job' in my earlier book *Bad Samaritans*. For the same reason why we send our children to school rather than making them compete with adults in the labour market, developing countries need to protect and nurture their producers before they acquire the capabilities to compete in the world market unassisted. Second, in the earlier stages of development, markets do not function very well for various reasons – poor transport, poor flow of information, the small size of the market that makes manipulation by big actors

easier, and so on. This means that the government needs to regulate the market more actively and sometimes even deliberately create some markets. Third, in those stages, the government needs to do many things itself through state-owned enterprises because there are simply not enough capable private sector firms that can take up large-scale, high-risk projects (*see Thing 12*).

Despite their own history, the rich countries make developing countries open their borders and expose their economies to the full forces of global competition, using the conditions attached to their bilateral foreign aid and to the loans from international financial institutions that they control (such as the IMF and the World Bank) as well as the ideological influence that they exercise through intellectual dominance. In promoting policies that they did not use when they were developing countries themselves, they are saying to the developing countries, 'Do as I say, not as I did.'

A pro-growth doctrine that reduces growth

When the historical hypocrisy of the rich countries is pointed out, some defenders of the free market come back and say: 'Well, protectionism and other interventionist policies may have worked in nineteenth-century America or mid twentieth-century Japan, but haven't the developing countries monumentally screwed up when they tried such policies in the 1960s and 70s?' What may have worked in the past, they say, is not necessarily going to work today.

The truth is that developing countries did not do badly at all during the 'bad old days' of protectionism and state intervention in the 1960s and 70s. In fact, their economic growth performance during the period was far superior to that achieved since the 1980s under greater opening and deregulation.

Since the 1980s, in addition to rising inequality (which was to

be expected from the pro-rich nature of the reforms – *see Thing 13*), most developing countries have experienced a significant deceleration in economic growth. Per capita income growth in the developing world fell from 3 per cent per year in the 1960s and 70s to 1.7 per cent during the 1980–2000 period, when there was the greatest number of free-market reforms. During the 2000s, there was a pick-up in the growth of the developing world, bringing the growth rate up to 2.6 per cent for the 1980–2009 period, but this was largely due to the rapid growth of China and India – two giants that, while liberalizing, did *not* embrace neo-liberal policies.

Growth performances in regions that have faithfully followed the neo-liberal recipe – Latin America and Sub-Saharan Africa – have been much inferior to what they had in the 'bad old days'. In the 1960s and 70s, Latin America grew at 3.1 per cent in per capita terms. Between 1980 and 2009, it grew at a rate just above one-third that – 1.1 per cent. And even that rate was partly due to the rapid growth of countries in the region that had explicitly rejected neo-liberal policies sometime earlier in the 2000s – Argentina, Ecuador, Uruguay and Venezuela. Sub-Saharan Africa grew at 1.6 per cent in per capita terms during the 'bad old days', but its growth rate was only 0.2 per cent between 1980 and 2009 (*see Thing 11*).

To sum up, the free-trade, free-market policies are policies that have rarely, if ever, worked. Most of the rich countries did not use such policies when they were developing countries themselves, while these policies have slowed down growth and increased income inequality in the developing countries in the last three decades. Few countries have become rich through free-trade, free-market policies and few ever will.