Cultivating the Constitution of Capitalism

"Political power, then, I take to be a right of making laws with penalties of death, and consequently all less penalties, for the regulating and preserving of property, and employing the force of the community, in the execution of such laws, and in the defence of the common-wealth from foreign injury; and all this only for the public good"

John Locke, *Second Treatise on Civil Government (1690).*

"It is not the amount of physical resources that a country has within its borders that determines the wealth of its people. It is how the resources are employed, and the institutional environment within which they are employed that counts."

G.P. O'Driscoll, K.R. Holmes, Jr., M. A. O'Grady, *2002 Index of Economic Freedom (Heritage Foundation, 2002), p. 43*

Coming to Terms with Globalisation

Everywhere, both in rich and in poor countries, the tug of war continues between

a) a vision of simple, universal institutions that coordinate autonomous individual behaviour and facilitate spontaneous economic growth, job creation, social peace and confidence, in short a vision of economic freedom, and
b) the reality of interest-group politics, party finance and parliamentary, bureaucratic and judicial *ad hoc* interventionism.

Many aspire to live under simple institutions which they can understand. They hope to arrange their lives and businesses free from confusing, selfish political activism and unpredictable interventions. They want the institutional framework of their lives to remain predictable. They want public policy and political leadership to back a rule system, which inspires trust. When politicians, judges or bureaucrats initiate yet another convulsive change or the military seize power, citizens deeply resent it. Changes from above produce unforeseen side effects and yet more confusing corrections!

Ordinary citizens often seem to understand instinctively how little the masters of public policy really know and can know. When political changes annoy or confuse them, some may try to exercise the exit option, at least with some of their capital. When this is not feasible, they voice protests and show their disaffection. When that also fails, they withdraw their loyalty, as Albert Hirschman predicted in his well-known book *Exit, Voice and Loyalty* (Hirschman, 1980). In many states, the majority of citizens seems to have reached a state of mind where they feel little loyalty to collective action and the wider community. In many developing countries, very little sense of collective loyalty has developed, and politicians are not trusted because they do not protect the rights of the individual.

Citizens also want specific, government-guaranteed outcomes. Sometimes, people do not even see the contradiction between confidence, order and a spontaneously effective community on the one hand and demands for "outcome engineering" and government hand-outs on the other. The fundamental conflict between a competitive market economy, which opens fair chances for most and distributive political interventionism is not widely perceived as such. Pressure-group spokesmen in parliament, in the bureaucracy and in single-issue advocacy groups do little to clarify this contradiction. It is therefore not easy to obtain political support for reforms that simplify the rule system, restore stability, confidence and pave the way for self-responsibility.

Because citizens often harbour such contradictory attitudes, politicians, bureaucrats and judges are able to circumscribe private property rights and restrict individual liberties in the market. The agents of government—whatever their professed ideology—are loath to make themselves superfluous by ceding ground to more coordination by markets. A minimal state is simply not in their interest. It is the citizens who will have to fight for it, but the citizens remain "rationally ignorant". The fundamental conflict between private and collective action thus persists in many areas.

At the start of the new millennium, most developing countries have reached a critical crossroads in their political and economic development:

a) whether to embrace the cosmopolitan spirit whole-heartedly in order to complete the liberalisation agenda—still a major reform task for many nations—and to create the conditions that enable residents to compete freely, confidently and successfully for the rapidly growing number of jobs in the world; or
b) whether to fall back on the instincts bred in the long era of discretionary politics and protectionism, hoping that they do not need to rival all that hard with others and do not have to incur too many knowledge search costs in discovering modernity.

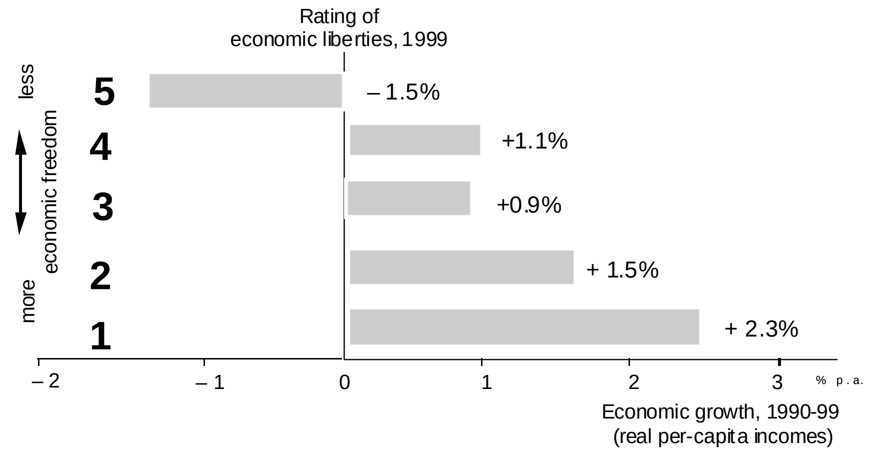
As of the beginning of the new millennium, policy makers and their advisors have certainly understood that openness and globalisation affect all nations in profound ways. Producers in developing countries, despite government-made handicaps, are now turning into spontaneous winners in global markets, most notably those in East Asia, but now also increasingly in India and Latin America. Among them are many service exporters. Globalisation also benefits those who win domestic market share using newly imported capital and knowhow, and also those who can benefit from better, cheaper imports. But of course there are also some losers, in particular people who believed in assurances of protection by previous, corrupt governments, and committed their capital, skills and careers to industries that were viable only with political protection. The losers from globalisation-driven reforms can also be found among politicians, military elites, unions, and community organisers. They are losing their customary grip on power as they are confronted with the "exit threat" of some of their constituents and are forced to abandon corrupt old ways, or are swept from power altogether. In countries where traditional tribal rules are still the dominant model of thinking about community life, the new challenges of equal liberty for all is in direct contradiction to the old hierarchical order. This 'clash of cultures' causes considerable frictions in everyday life. To overcome this clash of the modern and the traditional institutions requires time and a clear commitment to simple, universal institutions on the part of the ruling elites.

In many developing countries, pervasive interventionism since independence has created a *privilegentsia* of regulators, monitors, arbitrators, activists, industrialists and camp followers, who have a well-defined interest in perpetuating the interventionist culture (Chakravarti 2000). When the rules are simplified and streamlined, those used to organising individuals by command (such as military men who understand only command and control) naturally feel a sense of deprivation. Many who are still subjected to a government-made, top-down order feel a sense of comfort in this and may feel threatened by the uncertainties of a competitive, open world. Many have not yet discovered that continuing the government-provided certainties is an impossibility. The open society, with all its uncertainties, as well as its great promises, is here to stay for all citizens on earth.

Indians, too, have to realise that any modern rule system has to work with spontaneous self-organisation and competition. The rules and prescriptions must be simple and universal to allow individuals to cope constructively and expediently with the rapid and pervasive changes of modernisation. The insight that society and economy are complex evolving systems—where clumsy and frequent interventions are as perilous as in ecological systems or human medicine—must become part of the political culture. The know-all delusion of economic interventionism, which was able to develop in the closed economy of a simpler earlier era, will be overcome only when this fundamental fact is widely understood.

Much valuable and clear evidence has been accumulated in recent years which underpins the new institutional economics (see Insert below). The key message is that free markets and secure property rights, which are protected and administered without favoritism and under the rule of law, are more important than this or that government action programme or new development scheme. Graph 9 shows important and weighty evidence: It shows the economic freedom ratings, based on a thoroughly researched index of economic freedom for 123 countries, in relation to economic growth during the 1990s. Countries were grouped into five groups, ranging from economically most free to least free, and their average economic growth rate was calculated. It can be seen that economic freedom has a direct and powerful influence on economic growth. The "Economic Freedom of the World" reports also document that economic freedom goes along with high living standards, high job creation, low incidence of poverty and a long life for the average citizen (Gwartney-Lawson, 2001, chapter 1). We note in passing that India has always had a rather poor rating, being graded amongst the least free countries a notch wave "economically repressed".

Graph 9: Economic Freedom and Prosperity



Every year, the Fraser Institute, a Canadian think tank, surveys information for a systematic index of economic freedom in 123 countries. The Centre for Civil Society is a copublisher of this report. These countries are then grouped into quintiles, ranging from most free to unfree. The average economic growth rate for each quintile is depicted above. It can be seen that the countries with the most regulations and poorest protection of private property rights experienced economic decline, whereas the citizens in the freest economies managed an average annual growth of 2.3 per cent during the 1990s. The freest 20 per cent of economies enjoyed living standards of nearly US-$ 20, 000, on an average 18 times more than the 20 per cent of countries with the least free economies.

Source: Gwartney-Lawson, 2001, p. 9–12.

Tried and True Way to Economic Growth

The Heritage Foundation in Washington has just published its economic freedom ratings for 2002 [with India in a poor 125th position out of 155 countries, being rated as "mostly unfree"].

But the Heritage report, as well as work done by the Fraser Institute in Canada, does something much more important than publishing league tables on the quality of property rights and non-interventionism. It adds convincing evidence to a new theory of economic growth, namely that 'it is the traffic rules, the institutions, stupid, that make for poverty or prosperity!'

The same conclusion emerges from a weighty new empirical research by two American researchers, Richard Roll of the University of California and John Talbot. Their research has shown that 85 per cent of all differences between the poorest and richest societies—ranging from US-$ 440 in Sierra Leone to over $ 41 000 in Luxembourg—is explained by differences in the protection of private property, civil liberties, political and press freedom, as well as the absence of black markets, discriminatory regulations, inflation and barriers to free trade. This observation holds true between countries and over a period of time. Liberal economic reforms and the assertion of basic economic freedom have invariably boosted economic growth, as well as high employment, the reduction in poverty and improvements on many other social fronts.

Post-war economic reforms in Germany and Japan, subsequent improvements in economic freedom in East Asia, even the Peoples Republic of China, and more recent reforms in countries such as Australia have been rewarded by economic prosperity. Only analysts who disregard institutions could call these episodes 'economic miracles', i.e. outcomes that cannot be rationally explained. Interest groups which seek and extract political favours, parliaments and judges that grant them, and politicians that distribute opportunistic hand-outs have to be seen as the main enemies of broad-based and sustained prosperity.

The research confirms what common sense and some economic theories have asserted all along. Prosperity, and all its benefits, depend on the division of labour and the effectiveness of coordinating millions of specialised producers. If these are made to compete, time and again, and can do so with trust in simple, reliably enforced 'traffic rules', they will be a genuine knowledge nation and offer bountiful economic opportunity will growth and high employment for most.

The good news to emerge from these insights is that the institutions—the rules of human coordination—are man-made and therefore can be altered by us.

The new growth theory has powerful policy implications, which are now being absorbed in Washington and some other capitals, though not yet in the traditional policy establishments of industry departments, international organisations and many parts of the third world.

One policy consequence of the insight that poverty is the result of insecure institutions and discrimination, now contributes to the decline in foreign aid. Countries that have implemented competitive markets and protected private property cannot remain their mismanaged brothers' keepers forever. Aid is being concentrated on short-term emergencies after catastrophes and is channelled away from avid aid claimants, who keep violating the most basic economic and other liberties. With rampant cronyism, foreign trade restrictions, expropriation and wide-spread market distortions, even copious aid will have no effect on alleviating poverty and extending life spans. The implication for national policy makers and the World Bank is to make foreign aid conditional on institutional reform. With economic reforms that implement high standards of economic freedom, a good investment climate will be ensured and "the investment dollars will magically appear", as Roll and Talbot put it, so that most aid becomes superfluous.

Another policy implication of the new growth theory has to do with the fact that prosperity is not driven by what many economists have asserted, for example a high investment rate, high R&D spending or a big share of foreign trade. These are proximate causes of growth. They beg the immediate question: Why are investment, R&D or international trade high in some countries, but not in others? The real and deeper reasons lie with secure property rights, the freedom of contract and the equality of all before the law. Government policies that promote investment or research and development by artificial means, target superficial symptoms and induce a waste of resources on lousy projects. What is worse, they introduce favouritism and detract from the equality of all before the law. Over time, governments thus erode genuine economic freedom and weaken the economy's spontaneous growth potential.

The New Constitutional Economics

The dilemma in which we now find ourselves can be clarified and promising solutions can be found, if a new discipline of economic analysis—Constitutional Economics—is taken seriously. It is based on two premises, namely that institutions matter and that the institutional system can and needs to be enhanced by conscious reform. In particular, the simple rules of protected, respected private property rights and private autonomy require fostering. These rules do not only matter for the rich and big business, they determine everybody's opportunities in life: what work we can do, whether employment is a matter of free, private choice, what life opportunities there will be for the young, how we can employ our skills and whether we have opportunities to be creative and entrepreneurial and lastly how much of the proceeds we will be allowed to use for ourselves.

Constitutional economics is becoming popular around the world because institutional systems have come under scrutiny everywhere (Scobie-Lim, 1992). Growing numbers of economic analysts now recognise—again—that the dynamic efficiency of different national economies depends on their institutions (see, e.g. Buchanan, 1991; Scully, 1991; Porter-Scully, 1995; Kasper-Streit, 1998). The socialist rule system in the formerly centrally planned economies has imploded after causing so much pain. It is now realised, just how ineffectual the alternatives to the capitalist market economy were. This has given further impetus to the new approach which takes institutional economics, as outlined in previous chapters, one step further, namely to the insight that disappointing institutions can be redesigned, not only by piecemeal repairs after mishaps, but through comprehensive, forward-looking reforms (McKenzie, 1984; Brennan-Buchanan, 1985; Gwartney-Wagner, 1988; Voigt, 1996, 1997; Kasper-Streit, 1998)). Constitutional Economics—the analysis of the socio-economic performance of alternative rule systems—often deals with normative aspects, namely the desirability or otherwise of alternative institutional systems. But, more recently, overseas researchers have begun to measure and analyse the positive-economics aspect of Constitutional Economics:

- What are the objective outcomes of alternative rule systems? What, for example, are the effects of differing voting procedures?
- What can be said about the merits of openness to trade and finance and its effect on economic performance? (for an overview, see Voigt, 1997).

Once one adopts a Constitutional Economics frame of mind, one begins to ask important new political questions, for example:

- Do the higher economic growth rates in the United States and East Asia, as compared to india, have something to do with Indian rule systems, in particular lack of economic freedom, rampart discrimination and lean governance?
- Is the poor economic performance of India due to poor economic institutions, as suggested above, and whose fault is this? More importantly, what institutional reforms can be implemented to liberate Indian citizens and give them the life opportunities that people in freer economies are enjoying?
- What institutional deficiencies have evolved in the years since political independence? Need they be rectified? What rule changes will be needed to allow Indians to re-accelerate economic growth in a sustained way, so that they can, in 2030, live as well as East Asians now or Americans a hundred years ago? Such achievements are feasible.
- How can rules be devised to ensure a clean relationship between business and government? And how can a competitive economy contribute to racial and religious harmony?
- What features of India's present political constitution are harmful to the chances of Indians succeeding in the global competition? How can the unbridled political opportunism of leaders be constrained?
- How can one devise fundamental, high-order institutions that prevent governments from intervening on behalf of specific industries, groups or regions in economic processes, when this is likely to undermine private autonomy, property rights and equality before the law?
- How can the judicial system be used to cultivate binding rules that hinder rent-seekers from going against the interests of the electorate?

An explicit awareness of *Institutional Economics* (that effective institutions matter) and of *Constitutional Economics* (that the systematic, comprehensive reform of the rule system will enhance prosperity, freedom and confidence) can do much to promote prosperity and social harmony. To this end, existing arrangements and rules must not be taken for granted. One should ask how good rules can be developed and turned into productive social assets—and how bad rules can be effectively suppressed.

India's Institutions

Table 1 shows the quality of institutions from the standpoint of economic freedom and norms of good corporate governance for a range of developed and developing countries in Asia and the Pacific, so as to cast India's present institutions in an international comparative setting. It shows that India's institutions that influence the climate of doing business in the country are rated at best mediocre: equals 41st out of 59 countries. This index is compiled on the basis of numerous judgements by internationally experienced business leaders, which the respected World Economic Forum in Geneva, Switzerland, publisher annually. The same insight is offered by the renowned Index of Economic Freedom, which the Fraser Institute in Canada publishes annually and which assesses how well a nation's regime complies with the maxims of secure property rights, free contracts and equality before the law India is ranked a poor 74th out of 123 countries (Gwartney-Lawson, 2002), well short of truly successful competitors in global markets, such as Singapore and Hong Kong, which are of course trading cities where the commercial benefits of reliable rules are well understood. It is also worth noting that India is still a rather closed economy, still rated 80th out of 91 countries in 1999, and way behind the East Asian growth economies.

Producers in other South Asian countries have to cope with similar handicaps of restricted economic freedom (Table 1).

Table 1 gives an indication to those readers who have accepted the logic of the argument in this essay, just how much reform work needs to be done until one can be confident that the institutional underpinnings for sustained growth and success in the global division of labour are in place. The reform work will require not only energetic and inspired legal and economic reform on the part of the various levels of government, but also changes in social psychology and the internal institutions of Indian society. This will be neither easy nor fast, and the drive must come from Indian political entrepreneurs, not outsiders. Once the political will is there (as it now is in China), Table 1 can, in my view, point Indian reformers to countries that have been successful and that are now magnets for internationally mobile knowhow, capital and enterprise.

This essay has been an attempt to alert readers to the big gains that can be made by cultivating the right institutions and giving a competitive, capitalist market economy a simple and solid underpinning (Chakraverti, 2002). We

Table: 1
The Quality of Institutions in Asian and Pacific Countries

Country	Per-cap. inc. US-$, PPP 1999	Growth rate (% p.a.) 1990s	Institutional Quality (out of 10) [av. rank out of 59 countries]		Fraser Index of Ec. Freedom 2000 [rank*]		Fraser Index of Openness 1999 [rank**]	
USA	28 698	2.1	7.2	[17]	8.6	[2]	7.8	[10]
Australia	20 696	2.4	7.3	[16]	8.1	[10]	7.2	[19]
New Zealand	15 222	1.1	7.5	[15]	8.2	[6]	7.4	[15]
Singapore	23 582	5.8	8.6	[10]	8.6	[3]	9.8	[2]
Hong Kong	20 352	1.7	7.7	[14]	8.8	[1]	9.9	[1]
Japan	20 431	0.9	6.2	[=24]	7.5	[20]	6.5	[28]
Taiwan	15 720	3.6	6.2	[=24]	7.2	[33]	7.2	[19]
South Korea	13 317	4.8	4.6	[35]	7.0	[43]	6.6	[26]
Malaysia	7 328	4.0	5.1	[33]	6.6	[57]	7.8	[10]
Thailand	6 398	3.6	4.1	[38]	6.6	[56]	6.4	[30]
Philippines	2 291	2.0	3.3	[45]	7.0	[44]	6.3	[31]
China	3 259	6.4	3.8	[40]	5.3	[102]	5.2	[50]
India	1 818	3.4	3.8	[=41]	6.1	[74]	3.5	[80]
Indonesia	3 031	2.1	3.1	[46]	6.3	[69]	6.1	[36]
Vietnam	1 677	5.1	3.7	[=41]	n.a.	n.a.		
*Bangladesh****	*835*	*3.0*			*5.1*	*[107]*		
Burma (alias Myanmar)	*1 050*	*3.8*			*3.6*	*[122]*		
Fiji	*2 634*	*n a*			*6.1*	*[73]*		
Mauritius	*4120*	*n a*			*7.3*	*[30]*		
Nepal	*954*	*1.9*			*5.9*	*[81]*		
Pakistan	*1 952*	*2.3*			*5.1*	*[108]*		
Papua New Guinea	*n a*	*n a*			*5.7*	*[88]*		
Sri Lanka	*3 451*	*3.9*			*6.0*	*[78]*		

* Gwartney Lawson, 2002
– Ranks out of 123 countries.
** Gwartney-Lawson, 2001, 91-98. Ranks out of 91 countries.
*** Most of the countries below were graded by the Fraser team on the basis of a reduced number of indicators.

have tried to outline the underlying concepts and ideas that need to be grasped before a country's institutional handicaps are undone, and before the rules are made more business- and citizen-friendly.

Reformers in India will be assisted by the fact that the tide of opinion on these matters has begun to change in advanced and developing countries alike.

Far-sighted Indian reformers might be inspired by what James Buchanan, the 1986 winner of the Economics Nobel Prize, wrote a decade ago: "Without the glitter of romantic delusion and with a hard-nosed understanding of the limits and the potential of ordinary politics, we may be able for the first time in more than a century to reinterpret our Constitution and/or redesign and reform it to exploit the full potential of a free people" (Buchanan, 1988, pp. 262–63).