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The hardware and the software to overcome a middle-income trap

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The importance of the software of development is now more and more widely recognised in international organisations and policy circles of some emerging countries.

Executive summary

No economy has ever been able to sustain membership in the high-income, developed-country league without having first adopted the institutions of secure private property rights and their free, competitive use under the rule of law that treats *all* citizens equally. These institutions (or rules) can be called the 'software of free-market capitalism'.

These basic rules of conduct make it easier for people to incur the transaction costs of innovation and to interact productively with each other in an increasingly complex, dynamic economy. Interventionism, income redistribution and crony politics weaken or destroy these essential institutions. They are therefore likely to lock the economy into a 'middle-income trap', apart from creating political tensions and growing social instability.

To develop the 'software' of economic development, social scientists and policy analysts must go beyond technical analysis and engage in moral discussions. This is a challenge that only the young in the countries concerned can tackle, if they want to create a better, freer and more prosperous future for themselves.

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This is the edited version of a public lecture organised jointly by the Malaysian Economic Association and the Faculty of Economics and Administration, University of Malaya on 28 August 2013. The lecture draws heavily on a new book, of which I was the lead author: Kasper, Streit, Boettke (2013). I greatly appreciated both the helpful and the critical comments made in the discussion after the lecture and in private exchanges with Malaysian friends since. I am also obliged to Ms Tricia Yeoh of IDEAS, who not only chaperoned my draft to publication, but also queried an earlier version so that my paper is now clearer and more complete. All value judgements and errors of course remain, as usual, with the author.

1. Introduction

It is always gratifying to visit Malaysia and check on the impressive economic progress since 1971 to 1973, when I worked here as the Harvard University-sponsored Economic Advisor to Treasury.

Now, there is even ambitious talk of advancing to high-income, developed-country status within the foreseeable future. This is the reason why I chose the title of my address. The important point has to be made that no economy has ever moved sustainably beyond middle-income status without having first cultivated the right 'software of development'.

Let me explain: Everyone will be familiar with standard neoclassical growth theory. It says that real per-capita incomes and their growth depend on how much labour is mobilised, what skills are acquired, with how much capital and technology the workforce is equipped and how well the country's natural resources are utilised. One may call these tangible factors the 'hardware of development'.

Numerous nations have mobilised these production factors, but are not moving ahead economically – for example the Soviet Union, now Russia and most of the countries between Casablanca and Karachi. Most of Latin America has experienced economic take-offs, only to relapse time and again into a 'middle-income trap'. As of late, the once-acclaimed BRICS (Brazil, Russia, India, China and South Africa) are not looking so promising since US money printing has slowed down and is no longer fuelling demand for their exports. Those who touted 'Asian values' (more collective government involvement) seem to have fallen silent, too.

2.0 The software of development

The answer to the puzzle of why well-known tangible production factors fail to produce sustained growth is that essential factors are missing from the neoclassical growth equation. These are secure private property rights and their free use, with equality of all before the law. One may call these intangible factors the 'software of development'. They are institutions, i.e. rules of conduct, whose violation attracts credible sanctions.

The institutions create trust and coordinate the behaviour of economic decision makers in the dynamic, complex process of economic development.[1] Where these rules are not obeyed and enforced, we get 'traffic chaos', even standstill in economic development. Some, who have in recent years focussed on the role of institutions in development have labelled this school 'the new development economics' (Boettke *et al.,* 2008). In reality, the focus on the critical role of institutions in economic development goes back to the Scottish Enlightenment (thinkers such as David Hume and Adam Smith) and the old, as well as the contemporary Austrian School (e.g. Carl Menger, Joseph A. Schumpeter, Friedrich A. Hayek, Lord Peter Bauer, to name but a few).

The importance of the software of development is now more and more widely recognised in international organisations and policy circles of some emerging countries. In many others, reform efforts are stifled by entrenched political, bureaucratic and industry lobbies that are afraid of free competition and the equality of all citizens before the law.

3.0 Level of development and transaction costs

A major role of good institutions is to reduce the costs of doing business; in other words, the transaction costs. These are the frictions in the complex economic system, in which ignorant, imperfect, forgetful, opportunistic, selfish human beings interact. These costs have been assumed away 'for simplicity's sake' in standard neoclassical textbook economics, assuming 'perfect knowledge' instead. By this trick, the textbook model of economics assumes away *the* essential, constitutional condition of economic activity, because ignorance, and how to tackle it, are part and parcel of economic life. Indeed, the very essence of economic activity and business life in the real world is to discover and test new, useful knowledge; knowledge search is an open-ended, dynamic process (Hayek, 1978; Economics Nobel Prize 1974).

Every business practitioner knows that economic activity requires

1 The English usage of the term 'institution' is often confused and confusing. In the sense used here, banks, universities and insane asylums are not institutions, but organisations, i.e. more or less permanent arrangements of production factors to obtain a given set of objectives (for details see Kasper, Streit, Boettke, 2013, pp. 100-141).

effort and information search and that this can be costly. And bankers, lawyers and business consultants know that they are helping people to peer into the fogs of the future and to make profitable discoveries easier. They know that the assumption of 'perfect knowledge' is sheer nonsense and that transaction costs are real!

There are two types of transaction costs:

- The ***fixed costs of transaction*** come with a paradox (to which the Economics Nobel laureate of 1972, Kenneth Arrow, drew attention): You have to incur these costs before you even know whether they yield a return! You have to drill an expensive hole, before you know whether it yields an oil or gas bonanza… or has been another failure. You have to incur massive costs to design and construct a new airliner, before you can ever find out whether the market wants it badly enough, so that you make a profit. Often, this involves massive amounts of resources. In other walks of life, fixed transaction costs may be small in absolute terms, but still overwhelming for a small entrepreneur. Think of a boy from up-country Perak, who wants to start a small retail business. Once these fixed costs of knowledge search are expended, they are sunk costs. For big and small ventures, finding new knowledge and new business partners is risky; it requires entrepreneurial spirit. If market signals are confused by political interventionism and favouritism, little of the needed enterprise will be forthcoming.
- The ***recurrent costs of transacting business*** consist of negotiating contracts, monitoring their fulfilment, and resolving possible conflicts. The late Ronald Coase, Economics Nobel Prize 1981, made these types of costs famous when he wrote that they alone explain the existence of firms. Entire professions – managers, merchants, lawyers, finance experts, consultants, business communicators – are engaged in dealing with these recurrent costs. They account for much of the rapidly growing service sector in advanced economies. We know that not all institutional systems are of equal value in keeping these costs as low as possible. Indeed, some institutional systems drive these costs so high that numerous potential transactions are never even attempted.

The share of transaction costs in the total cost of producing and distributing a nation's product changes dramatically in the course of development (Graph 1). At low levels of per-capita income, the recurrent and fixed transactions costs account up for some 5-10% of all costs. These are more or less stationary economies with little innovation. In particular, those risky, discomforting fixed Arrowian costs of finding and testing new knowledge are rarely incurred. Poor people thus often have the comfort of certainty. As income levels rise towards what we define as middle income, transaction costs may rise a little, but much new knowledge can be imported and copied from more advanced economies. Moreover,

If market signals are confused by political interventionism and favouritism, little of the needed enterprise will be forthcoming.

multinationals often transfer new knowledge at little cost to the developing economy.

Some countries, Malaysia included, have tackled high local transaction costs by creating special export-oriented free-trade zones, where many cumbersome rules and regulations are suspended. Such institutional experiments can be very successful. Just look at Shenzhen north of Hong Kong, which has grown, within a mere thirty years, from a fishing village into a 10 million inhabitant city full of young people from backward areas elsewhere in China. This is testimony to what the right institutions can achieve.

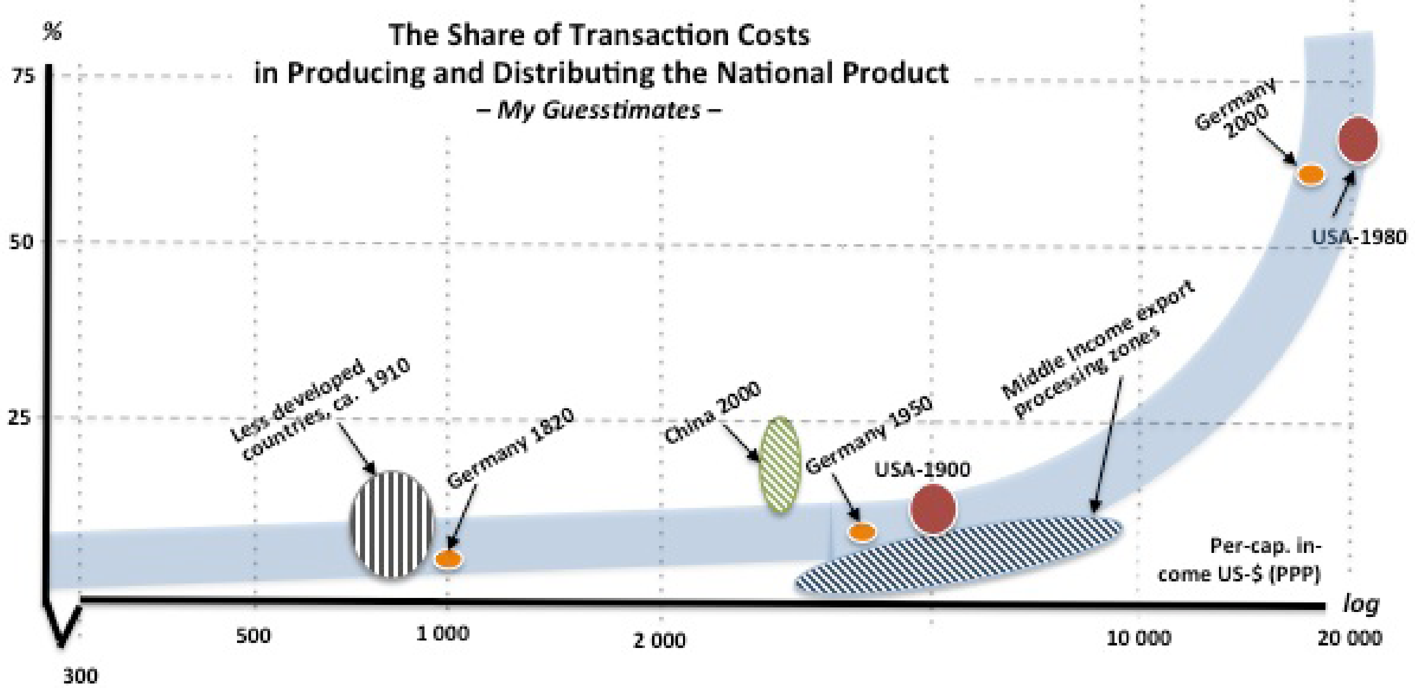
Beyond the middle income bracket, conditions change dramatically: The division of labour increases and many more transactions have to be carried out; inventions and innovations in particular become much more important to further growth. Dealing with the resulting transaction costs is skill-intensive, hence costly. Think only of those lawyers' bills! And with progressing economic growth, the structure of demand also shifts increasingly from food and manufactures to services, many of which have to be tailor-made and are very transaction-cost intensive.

In 1990, the Korean-American economist Walter Oi drew attention to the fact that only 11% of the American work effort in 1900 had dealt with transactions, but an amazing 61% did in 1980 (Oi, 1990). Similar dramatic increases have been identified in other developed economies. This is behind the explosive increase in the services sector in the rich countries, which now accounts for two-thirds to three-quarters of gross domestic product (Graph 1).

Observers and political operators, who have experienced the satisfaction of moving to middle-income level, are frequently unprepared for this fundamental shift in growth conditions. They may even have shaped economic institutions, which inflated transaction costs, and now find it hard to think about institutional reforms to modify the hitherto successful development strategy. And cultures, which are based on steady, uneventful ways of doing repetitive business, find it hard to adapt their traditional institutions to deal with frequent changes and the innovation necessary for advancing to high-income status.

It is frequently assumed that progressing to high-income, developed-country status is like climbing a mountain and then settling down for a well-deserved rest. Nothing could be more wrong! Operating in low income, steady-state economies is like paddling in a lake; advancing to middle income is like swimming up a slow-moving

Graph 1



Sources: Maddison, 2007; for USA: Oi, 1990; own estimates river; but being part of the affluent world requires the stamina, skills and effort – so to speak – of making it in the turbulent torrents of the headwaters. If your attitude is that the crocodiles laugh at you when you swim against the flow, you must either change your culture or forget about joining the competitive, harsh world of constant innovation, risk-taking and competing.

The competition for the top spots on the world income pyramid has indeed become fiercer. Let me just point to the fact that companies in the American S&P 500 share index had been in the index for an average of 61 years in 1960; today, the average is a mere 18 years. To succeed in this brave new world, producers must equip themselves with new mental and practical capabilities to work faster, cheaper and better. This means communities and jurisdictions must assist competitors by cultivating institutions that enable individuals and firms to succeed in competitive world markets. Above all, politicians and bureaucrats must understand that one of their functions is to act as support organisations for individuals and firms that compete globally by offering transaction-cost limiting institutions.

4.0 Institutions can constrain transaction costs

Institutions determine the level of both types of transaction costs. Let me therefore dwell a little on them. There are (i) informal, *internal institutions*, such as customs, *adat*, conventions and work habits, which have evolved in the light of experience and which are enforced spontaneously and informally, and (ii) *external institutions*, such as constitutions, legislation and regulations, which are made and enforced by political authorities. Both serve to order human interaction (for more on institutions in the East-Asian context, see Kasper, 1994, 1997, 1998, 1999).

A society's internal institutions are not made by anyone. They have evolved, are often culturally anchored and therefore hard to change. Violators of accepted rules are punished spontaneously: rude behaviour may attract tit-for-tat reactions. Those who cheat in trade will be criticised, lose their reputation, or even face exclusion (ostracism). The rules are enforced by the directly-affected, well-informed parties. They are enforced in cheap, decentralised ways.

The external institutions are made and imposed from above by some authority, through the courts, police and administrative penalties. Throughout history, priests, judges, rajahs and *qadis* have codified and clarified existing rules ('the law') and have created coercive mechanisms to enforce these laws. Often, such clarification of the rules has enhanced trust and reduced transaction costs. But there is also a fundamental problem, in that the authorities frequently do not know of rule violations. And if they do, they may be biased or disinclined to act.

The knowledge problem is universal; the motivations for political abuse endemic. Moreover, the visible hand needs ever so often to be greased. This is why even the traditional *protective function of government* is problematic, to say the least. In the final analysis, political power corrupts, and absolute power corrupts absolutely. This is also why rule by great leaders – the rule of men – has in practice almost always been inferior to the rule of law and why the control of governments by democratic elections and other devices is necessary (Kasper, Streit, Boettke, 2012 (pp. 365-372) discuss a wide array of measures to control political agents).

In addition, governments are often expanding their *productive function* beyond what is necessary, often creating monopolies to extract revenues. And they have also assumed a massive *redistributional function*, which is a huge problem in all electoral democracies. The literature demonstrates that this produces huge principal-agent problems in government (see Kasper, Streit, Boettke, 2012, pp. 69-72 and 361-364). This is why reformers postulate that government should be limited and constitutional.

However, we now observe throughout the Third World that elected governments, even if elected by slim majorities, promptly overturn fundamental constitutional rules, even if this violates the basic human rights of minorities. This happened in Germany after Hitler gained power in 1933 and promptly abrogated most constitutional protections to rule autocratically and persecute minorities. A similar process of discrimination and limitation of property and other inalienable rights was underway in Egypt earlier this year, before the military seized power from the elected (Morsi) government. It is always important for economic development to safeguard rights to life, limb and property, religious freedom and other fundamental human rights.

The temptations are always there that rulers with unconstrained power reshape the external institutions to suit themselves and their allies. Therefore, preference should be given – wherever possible – to the cultivation of good internal institutions and the streamlining and limitations of external institutions. It must be kept in mind that "good government springs from the hearts of the people" (Jefferson) and that reliance on internal institutions is ever so often cheaper and better, because it is based on on-the-ground information.

4.1 What are good institutions?

The question of course arises: What are good institutions – good in the sense that they facilitate the attainment of fundamental, universal aspirations, such as individual freedom, security, justice, equitable life opportunities and prosperity?

Institutional qualities that have been identified in the light of historic and international experience are:

- The rules must be *abstract*, i.e. not case-specific – no special laws and regulations for the car industry, but rules for all industries. In short, no discrimination.
- The rules must be *certain* to the minds of those whose behaviour they are to govern. This means that they must be simple, reliable and stable. Frequent rule changes and complex rule systems only confuse and are ineffectual. Even-handed enforcement of the rules is also essential. It is a truism that the internal and external institutions of a society must evolve, as technical and social conditions change. If they don't, prosperity, peace, security, justice and other fundamental aspirations suffer. However, the evolving rules must fit in with stable over-arching *meta* rules that make such adaptations understandable and predictable.
- The rules must be *open to the future*, i.e. existing rules must give guidance to future actions. After all, business opportunities do not wait for government inquiries and bureaucratic committees.
- *Rule systems* must be *inherently compatible*, so that the rules reinforce themselves. It is no good to have, for example, deregulated capital and product markets, but regulated labour markets, as Australia did in the 1980s – the result was unemployment.
- The historic experience in now affluent, stable nations points to a number of institutional devices likely to embody and uphold these qualities, among others: the division of powers between the legislative, the executive and an independent judiciary; free elections of the members of the legislature; a civil service that is staffed on the basis of merit and free of nepotism; a secular state that keeps religion out of politics; and a free press. It is also evident that a free economy, which fosters the rise of 'citizens of property' and an education system, which promotes factual knowledge and critical thinking, are important complements to these political institutions (Kasper, Streit, Boettke, 2012, pp. 365-378; also see below).

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5.0 The 'software of capitalism': secure property rights, freedom to compete under the law

Applying this logic to economic institutions yields the 'software of capitalism': secure individual property rights, their free use, as long as this does not harm others, under the rule of law, applying to everyone equally.

Let us define these concepts:

1.1 Individual property rights derive from the lawful ownership of a physical or intellectual asset, including one's own labour and skills (self-ownership). Yet, they do not amount to mere physical possession, but convey a bundle of rights. Owners can exclude others from use and access to their property (passive use), or they can single out property rights and use them, often in combination with the property of others (active use). Thus, a landowner may use his land for planting crops, but also rent it out for hunting and fishing, or lease it for mining exploration. The bundle of these rights is open-ended, as new uses may be discovered. Thus, a landowner may discover that some tourist business wants to buy access rights. The sum total of these discoveries amounts to economic growth. Of course, both passive and active uses of property rights are limited by transaction costs.

1.2 Owners who are free to use their property typically have to compete with other owners, which creates information and other transaction costs. Rivalling suppliers incur costs for product innovation, advertising and after-sales services to make themselves attractive to buyers on the other side of the market. And potential buyers rival with each other by incurring information costs — think of the search for the most suitable computer or the search for a house you want to buy! Only when such fixed transaction costs have been sunk will sellers and buyers be able to conclude a contract across the market, which then provides price and other valuable information (Kasper, 2008).

This understanding of dynamic competition is much more realistic than the static 'Marshallian cross' of supply and demand curves, so popular with lecturers in Economics 101. These are based on the assumption of perfect information about production possibilities and individual preferences (indifference curves), which in reality no one can have in a dynamic, complex society.

1.3 Property uses must not unduly harm others. In a free society, the law of the land defines what constitutes unacceptable harm and how harm can be compensated. It is upon those who claim being harmed to prove that harm has been done to them. The burden of proof in a free society rests always with the claimant – an important point. Alas, many political interventions turn the burden of proof around, for example when an economic activity has to be licensed. Then, it is a case of being guilty till proven innocent.

1.4 Private property rights are not only violated by the old-fashioned expropriation of entire assets, but also by government regulations that take individual property rights away. Thus, environmental concerns nowadays often motivate political actions that deprive owners of the right to develop and enhance what is rightfully theirs, and widespread industry licensing abridges the rights of people with skills and property to exploit their assets as best they can. A proliferation of licenses and permits weakens the property-rights system, apart from being a frequent source of injustice and discrimination, especially for the less-well-connected and economically weak, let alone corruption.

Another big threat to the private property rights system and a mighty 'growth blocker' is the political redistribution of income and wealth. Governments are simply not able to fulfil their traditional protective role – defined by classical liberal philosopher John Locke as "protecting life, liberty and the pursuit of property" – and at the same time confiscate income and wealth to subsidise politically favoured groups (which then only develop an entitlement culture and learn helplessness). Private property rights are of course also abridged by powerful private groups and organisations, for example when (often politically protected) cartels prevent new competitors from market access or when trade-union monopolies prevent individual workers from selling their labour and skills as they see fit.

1.5 The rule of law – and equality before the law– means that the same rules apply to all without fear or favour. The President's son has the same rights and duties as the poor peasant; government officials are subjected to the same rules as individual citizens. There are no group preferences on grounds of race or religion. After centuries of costly conflict, the West Europeans and North Americans have learnt to limit discrimination between 'insiders' and 'outsiders', because this has always been the cause of group think, politicisation, emotionalisation and social instability. Many other civilisations have yet to learn this lesson. Equality before the law is often violated when there is no separation between church and state. Centuries of painful civil wars have taught Westerners that there is merit and wisdom in a secular state.

These ground rules, which constitute the software of capitalism, have created the conditions for economic growth, even when applied imperfectly. Where this rule system is grossly violated or disregarded, growth has been elusive (Bauer, 2000; de Soto, 2001; Acemoglu-Robinson, 2012). It is possible that variations in the basic software of the capitalist order, which take cultural differences into account, can generate growth to high-income levels. We can already observe 'multiple modernities', e.g. in Taiwan and South Korea, where modernised local cultures blend successfully with fundamental Western approaches to business and public life.

However, crony capitalism – private enterprise under heavy and pervasive political discrimination, whether justified by populist, nationalist, socialist, racialist or pro-industry ideologies – has been a worldwide failure. Joseph Schumpeter identified this problem well over one-hundred years ago (Schumpeter, 1908/1961). Cronyism is typical of rule by 'great men'. It is inimical to the rule of law. Preferences may create an initial rush into modernisation, but it tends to falter in the face of contradictions and has never produced sustained high incomes for everyone (Holcombe–Castillo, 2013). What is needed is a policy design that is not pro-development or pro-business, but pro-market and pro-freedom.

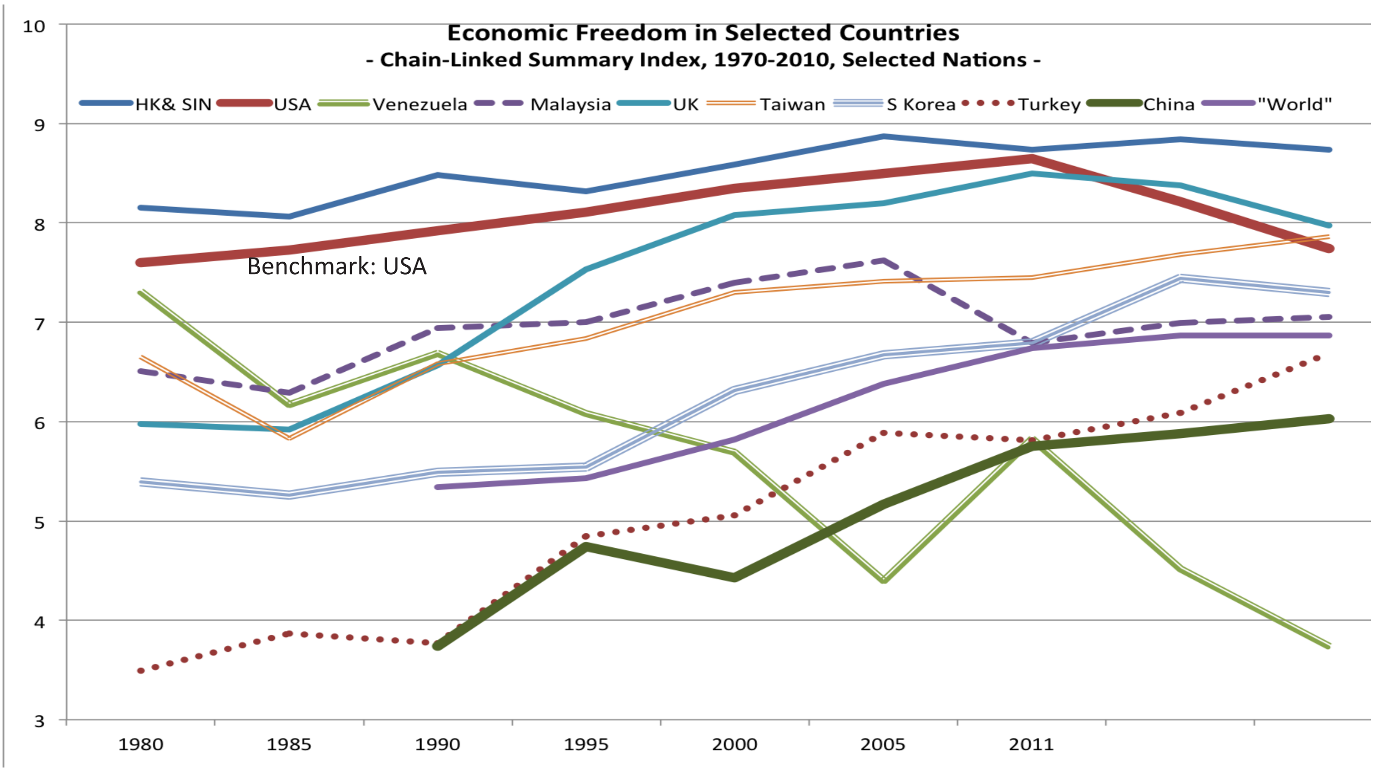
These two orientations of economic policy – pro-free market and pro-business – are often confused with each other. Both can easily be depicted as pro-economic growth, but the crucial difference is that a free-market order makes for equitable chances for all, whether connected with the ruling political establishment or not, hence for social harmony, as well as a more sustained economic growth over the long run. The critical point for societies that are ambitious to reach high-income status is that pro-business 'crony capitalism' leads into a dead end.

6.0 Measuring economic freedom

Because the software of capitalism is so important to economic development and prosperity, Milton Friedman (Economics Nobel laureate, 1976) argued that the quality of private property protection and the free use of property under the rule of law — in other words: economic freedom — should somehow be quantified. Only then could political lessons be drawn from what classical liberal economists had always been asserting. This triggered a major initiative by the Fraser Institute in Vancouver, Canada and the Cato Institute, Washington, DC to assess economic freedom in factor and product markets in many countries. An international network of think tanks began to collect data about (i) relevant objective measures (for example, the share of government consumption, rates of taxation and inflation, which amount to an expropriation of monetary assets), and (ii) subjective assessments of political and moral behaviour by internationally experienced business leaders (for example, assessing political and business corruption, discrimination, arbitrariness, administrative delays, and judicial bias).

By now, we have internationally comparable data for some 150 jurisdictions, compiled by a network of independent think tanks. IDEAS is the Malaysian partner of this international network. The resulting indexes of economic freedom have been published since the late 1980s,

Graph 2



Source: Gwartney, Lawson, Hall (2013), pp. 16-21
http://www.freetheworld.com/

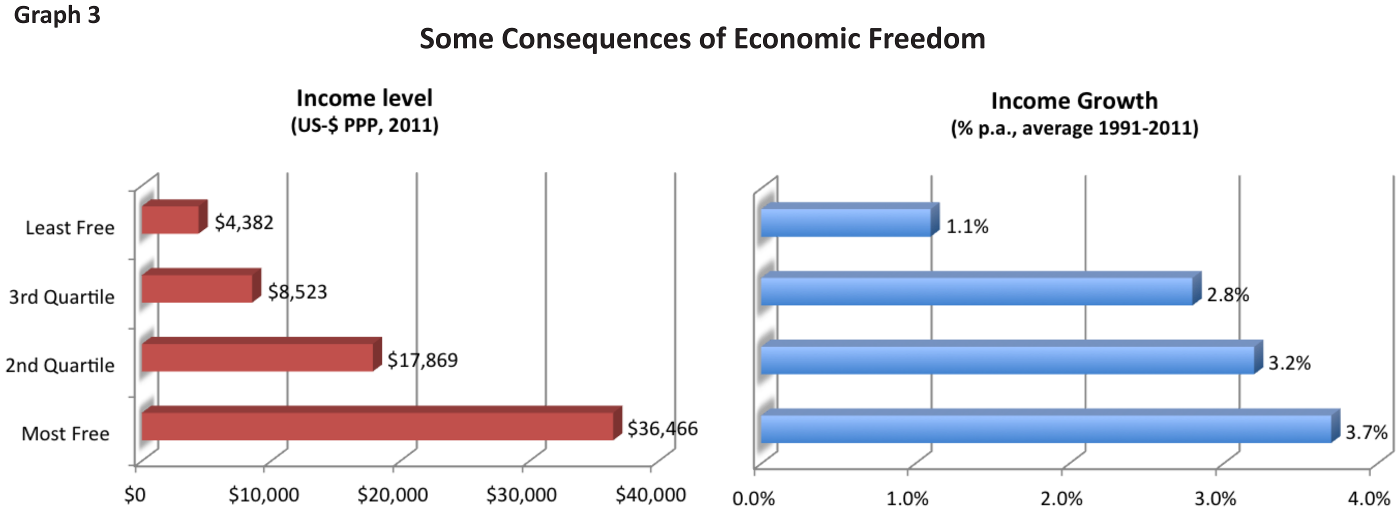
but go back in many cases to 1970. They are published annually and are readily accessible on http://www.freetheworld.com/ (Gwartney, Lawso, Hall, *passim*).[1]

Graph 2 shows indexes for selected economies. Although they are far from perfect measures, these estimates make for most instructive reading:

- The 'world average' of economic freedom has been improving since 1980, but since 2005 the average of economic freedom in the world has made no further progress (Graph 2).
- Economic freedom in the United States, which is normally the benchmark for world business leaders, improved after 1970 and in particular in the wake of the Reagan-era reforms, but has declined under the weight of President Bush's 'compassionate conservatism' and more so under President Obama's interventionist policies.
- The United Kingdom saw great improvements in economic freedom under the Thatcher government, but since 2000 there has been some backsliding.
- The leaders in economic freedom have been the two, by now highly-developed city states of Hong Kong and Singapore (in Graph 2 added together). Otherwise, the economic freedom in developed countries is still consistently ahead of the less-developed and emerging economies.
- Cases such as Taiwan and South Korea are remarkable for their steady, systematic climb up the economic freedom ladder. Government officials there have looked at the strengths and weaknesses revealed by the Economic Freedom indexes and have used this information to guide economic reforms. Their institutions now enable exporters of innovative products and profitable services to compete with the best and join the developed-country league. Real income levels in Taiwan are now higher than in Japan.
- China has made enormous progress, albeit from a very low level of economic freedom (Graph 2). Huge

1 There are other surveys of economic freedom, for example by the Washington-based Heritage Foundation and the *Wall Street Journal*. Although this research uses a different methodology, the results and conclusions are broadly the same. In recent years, even the World Bank – long wedded to neoclassical econometric modelling – has begun to pay attention to institutions, for example by monitoring how long it takes to set up a new business.

Graph 3



Source: Gwartney-Lawson-Hall (2013), p. 21-22

institutional differences exist between various provinces, but the resulting differences in economic performance are providing important lessons to policy makers. Whether the fundamental difference between a freer economic order and a repressive political order will create problems in the future must remain an open question, but one worth watching.

- I have included Turkey in the graph, because it is the Muslim country with the most impressive economic reform record — in distinct contrast to other countries in North Africa and the Middle East (not shown)
- Improving economic freedom requires political fortitude and effort. It is not automatic. To make this point, I have included Venezuela — a country blessed, or cursed, with great natural resource wealth, but one where 'a great leader' has wrecked individual rights with wrong-headed socialist redistribution policies.
- Malaysia ranks somewhere in the middle of the economies surveyed by the Economic Freedom project, somewhere between Zambia and Cambodia, a little ahead of Indonesia. This is not a disaster, but is far short of what it would take to reach developed-country status. Here is not the time and place to discuss details of strengths and weaknesses; I recommend interested observers and policymakers to look at the 'freetheworld' website.[1]

Does economic freedom really matter, as classical liberal economists like myself are saying? Graph 3 shows that both the level and growth rate of real per-capita incomes are indeed clearly associated with the degree of economic freedom, i.e. the quality of institutions. The graph shows that the quartile of most economically free nations (in a sample of 152 countries) earns on average a real per-capita income (US-$, PPP) more than eight (!) times the living standard in the least free quartile of nations. Besides, the income gaps are getting wider, because people in the least free economies have been able to attain less than one-third the economic growth of those in the freest quartile of countries covered by the Economic Freedom index.

This evidence shows that the Marxist slogan "the rich are getting richer and the poor are getting poorer" needs to be reformulated: "The free are getting richer, and the unfree are lagging behind." Of course, unfree economies have a priviligentsia of wealthy people, but the lack of economic freedom depresses the life opportunities and income potential of the poor and less-well-connected.

Analyses by the Economic Freedom Index project also show that people in the freest quartile of economies live on average nearly twenty years longer and are enjoying healthier lives. Child mortality is much lower than in the least free quartile (Gwartney, Lawson, Hall, *passim*). Moreover, the data show that economic freedom leads eventually to more political and civil liberty,

1 For a commentary of how the Economic Freedom Index applies to Malaysia, see www.ideas.org.my (under Publications)

as Milton Friedman asserted a generation ago (Friedman, 1962) and as both the history of Europe and America in the 19th century and the new democracies in East Asia over recent decades have demonstrated. Dictators, such as Park Chung-hee in Korea and Chiang Kai-shek in Taiwan, introduced economic liberties to make their economies flourish and their countries militarily strong, but the unintended consequence was that the people demanded and eventually got more civil and political liberties.

These are utilitarian reasons for economic freedom. It must, however, also be said that freedom – economic, civic, political – is a value in its own right. The German philosopher Immanuel Kant expressed it well when he wrote to a friend: "Freedom is special, because it brings out the best in us."

7.0 Growth and income distribution

The Economic Freedom data bank also throws light on the important, but controversial issue of growth and income distribution. A first and fundamental point to make is that, in a free market economy, production, buying and selling cannot be separated from distributing the incomes that these activities generate. Attempts to do so hinder overall economic growth. The notion that a cake is produced and then distributed by someone else, for example a well-meaning bureaucracy, is totally misleading.

Second, evidence is strong that the poorest people in free and hence wealthy economies are infinitely better off in absolute terms than the poor in unfree economies. In the free world, *absolute* poverty is much less harsh. The poorest 10 % of the population in unfree societies had less than one-tenth of the income enjoyed by the poorest 10% in the freest economies. There are of course always *relatively* poor people; for example, young school leavers are typically poorer and earn less than people close to retirement. Such differentials also serve to create incentives for competing and putting in an effort for material betterment.[1] The evidence shows that the share of national income that goes to the poorest 10% of the people is roughly the same, whether in free or unfree, rich or poor countries (Gwartney, Lawson, Hall, 2013, p. 22).

Theoretically, there are two ways of enhancing the living standards of the poor: (i) to seize income and wealth from the rich and redistribute it in the form of subsidies to the poor (*visible hand approach*) or (ii) to focus on economic growth by fostering a free institutional order, removing privileges and hindrances for everyone to get ahead, combined with fostering more equal starting opportunities for all through quality education, but then exposing everyone – rich and poor – to the discipline of competing (*open, free competition approach*). Under this second regime, everyone has to incur transaction costs of information search, and the relatively poor and inexperienced learn by doing.

Wherever in the world one is looking, the visible hand approach has worked poorly and has come with numerous deleterious, unintended side effects, such as political disharmony, disincentives to self-help and destruction of people's dignity of self-reliance. If, on the other hand, the poor are not featherbedded, but enjoy well-protected private property rights and free access to markets and credit, many will be able to experience the deep satisfaction of getting ahead by their own effort and risk taking. Even people who come from backward cultural backgrounds will eventually learn the game of participating in a thriving economy. The international and historic evidence is strong that, over the long run, the free-competition approach is by far the more promising way of lifting people out of dire poverty.

Applied to the Malaysian context, I would bet that many young Malays from *kampongs* will get ahead, even if they come from cultural backgrounds that have been less well-attuned to the modern, dynamic, urban civilisation that we now live in. The first generation may not match the income standards of affluent urban, cosmopolitan Chinese, but that dilemma will resolve itself over time. I base this assessment on the important insight that economic backwardness is neither the result of some sort of inherent racial shortcoming, nor of discrimination. Poor economic performance by a racial group is normally the result of historic accident. Children from poor rural backgrounds are of course less well prepared to succeed in business or science than the scions of well-educated, cosmopolitan merchant families. From early childhood, they

1 To my kind of thinking, when I judge the quality of economic policy in a country, the level and growth of income of the poorest 10% is an important and relevant indicator.

have learnt internal institutions and attitudes that make them more successful in the modern world.

However, if the peasant sons or daughters are exposed to modernity, economic freedom and competition, they have a good chance to learn and do better than their forebears (Sowell, 2012). What really matters to happiness and overall economic growth is that all, in their various personal circumstances, have the satisfaction of getting ahead materially and achieving something. Psychologists tell us that we are hard-wired to feel happy when we have tackled challenges. Government subsidies and featherbedding of certain social classes take such challenges away and infantilise people, who then feel that they are unfree wards of the state. Social harmony is endangered when people are caught up in politically-engineered class envy and group think. And let us not forget that free markets are great places in which to learn how to succeed and interact peacefully (Rabushka, 1974).

When I first came to work in the Malaysian government in 1971, I reluctantly favoured a degree of visible hand intervention to give the Malays more even starting opportunities and to overcome embedded racial discrimination, for example in how small businesses were hiring apprentices (Kasper, 1974). But I was aware then that there were serious dangers in the 'visible hand approach' to tackling poverty. Now, we can all look back at the evidence and be inspired by the insights of institutional economics and the international and historic evidence from around the world (Sowell, 1990; 2012) to reassess political strategies for the future and for moving beyond middle-income status.

Social-welfare policies in the affluent democracies have not worked; indeed, many observers have concluded that open-ended income subsidisation entrenches an underclass of dependents. Likewise, income redistribution in developing countries has weakened the incentives to learn and perform and has often contributed to corrupting political practice (Kasper, Streit, Boettke, 2012; pp. 330-341 and 352-372).

8.0 Be bold and engage in full-blooded political economy

With this worldview, we find ourselves of course in the midst of exciting, full-blooded political economy and social philosophy. One has to assess fundamental, universal human values, such as freedom, justice and prosperity. One has to investigate where pressure groups and rent-seekers hinder progress to freedom and economic development, and advocate a gale of creative destruction of cosy crony arrangements between politicians, bureaucrats and business leaders (Schumpeter, 1980/1961).

If one wants to include *all* in the venture of modernisation, one has to ask what the right institutions and regulations are to promote aspirations to attain high-income status and engage in deep economic reform, facing down entrenched lobbies and political and bureaucratic interests.

If, however, certain harmful institutions remain sacrosanct or powerful interests defend their existing socio-economic status by opposing reforms, then economic welfare and social harmony are bound to suffer. One should then be honest and open about it and abandon talk of progressing beyond middle-income status, for one cannot advance to high-income status while upholding the mental attitudes, habits and formal institutions of a static, bygone era. What was a virtue in a poor, stagnant, small-scale rural economy (for example sharing limited resources) may be a hindrance to competition and innovation in a modern macro-society and the dynamic contemporary age of globalisation.

Discussing these critical institutional aspects and the fundamental values of most in society is, to my mind, a more worthwhile undertaking for professional economists than constructing yet another econometric model. But it is also a more challenging task, because it requires a good understanding of sociology, the law, long-term history and other disciplines.

Outsiders, international organisations, and foreign friends like myself cannot do this work, nor can government committees. It is a challenge for the gifted and intelligent of the next generation who live in the country and want to forge a better, freer and more prosperous future.

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About the author

Wolfgang Kasper is an *emeritus* Professor of Economics and a well-known author. From 1971 to 1973, he was the Harvard Advisor to the Malaysian Ministry of Finance, helping – among other things – to launch the *Annual Reports,* which are part of the budget papers. Subsequently, he joined the Australian National University in Canberra and worked at the Reserve Bank of Australia, OECD in Paris and the Federal Reserve of San Francisco. He has first-hand experience as a lecturer and consultant for industry and government in most East Asian and Pacific countries. From 1977 to 1999, he was the foundation Professor of Economics at the University of New South Wales (ADFA). Since retiring from his chair in 1999, he has worked with various Australian think tanks and contributed occasional press commentary, for example in the *Wall Street Journal, Neue Zürcher Zeitung,* the *Australian, Australian Financial Review,* and *Quadrant*. He has been elected a member of the *Mont Pèlerin Society*, an international academy dedicated to the promotion of freedom. He is the lead author of the acclaimed textbook *Institutional Economics – Property, Competition, Policy* (co-authored with M.E. Streit/Germany and P.J. Boettke/US, published in the UK and the US by Edward Elgar in 2012 and 2013).

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