Hayekian Insights on Development

The world has never been richer—and yet a billion people still live on less than a dollar a day. How to rescue the world's poorest citizens from extreme poverty is perhaps the most vital question facing the field of economics. At a March 18 Cato Policy Forum, William Easterly, professor of economics at New York University and codirector of NYUs Development Research Institute, and Arvind Subramanian, senior fellow at the Peterson Institute for International Economics and the Center for Global Development and senior research professor at Johns Hopkins University, looked for new answers from an unexpected source: the insights of F. A. Hayek.

WILLIAM EASTERLY: In 2001, when I was employed by the World Bank, I wrote an article for the *Financial Times* called "The Failure of Development." The World Bank, for its part, was so swayed by my arguments that they promoted me to a position outside the World Bank. But an emerging consensus of economists agrees that we don't know how to achieve development. At the Barcelona Development Agenda in 2004, a veritable Who's Who of leading economists concluded that "there is no single set of policies that can be guaranteed to ignite sustained growth." In 2007, Nobel Laureate Robert Solow, the most famous development economist of them all, said that even when countries emerge from poverty, the "source [of that growth] can be a bit mysterious even after the fact." Meanwhile, my old employer the World Bank is currently wrapping up a multimillion-dollar Commission on Growth and Development whose conclusion is, "The forces behind sustained growth are not fully understood."

The state we are in today is one in which we really don't know how to achieve development. Indeed, we've had some traumatic experiences as development economists. There used to be this mainstream economic consensus called the "Washington Consensus." It was supposed to generate strong growth in Africa, Latin America, and the Middle East in the 1980s and 1990s. It didn't happen; today we term this period the "lost decades." There was the failure of shock therapy in the former Soviet Union, where the attempt to introduce top-down free market reforms overnight resulted in one of the worst economic depressions in history. Then there is the fact that while we've achieved rapid growth episodes in some countries, they are always brief in duration. Miracles don't last.

There's also the embarrassing fact that economists have been unable to predict the success or failure of developing nations. In 1962 World Bank economists could barely contain themselves at the unveiling of an ambitious development plan by the Republic of Korea. "There can be no doubt that this development program far exceeds the potential of the . . . economy. . . . It is inconceivable that exports will rise as much as projected," they wrote of the soon-to-be Asian Miracle. Meanwhile, population growth was among some "potentially explosive problems" in Singapore that would lead to "a mounting unemployment burden" according to Nobel Laureate Gunnar Myrdal in 1968. Needless to say, Singapore managed to handle population growth.

By the laws of probability alone, economists were bound to get one right. In 1958, the World Bank wrote about a country that had "made remarkable economic progress. . . . [its] long-run potential compares favorably with those of other countries in Southeast Asia." But this quotation comes from a 1958 World Bank forecast of the prospects of Burma.

Development economists have been just as surprised by success. The stars of the 1960s and 1970s were not China and India but Brazil and Côte d'Ivoire, which have done poorly since. Why did successfully developing nations all of a sudden veer off course? If economists knew the answer, Brazil would still be booming. Meanwhile, countless attempts by development economists have been made to replicate the success of the eight Asian Miracles elsewhere in the developing world, to little avail. What's more, the Asian Miracles themselves have been unable to replicate even their own success. Ironically, since 1993, when the World Bank issued a report on the success of the Asian Miracles, their growth has regressed back to the world average.

Why is it so hard to predict growth? One reason is that unpredictability happens at every level.

Who would have predicted that the big success story in India, which has a great scarcity of skilled labor, would be the skill-intensive IT sector? Or that integrated circuits exported by the Philippines would capture 71 percent of the world market? Or that cut flowers from Kenya would capture 40 percent of the European cut flower market? Or that 30 percent of Egypt's manufacturing export revenues would come from one product being exported to one country, specifically bathroom ceramics shipped to Italy?

The "big hits" phenomenon is a general one. The top 3 manufacturing goods (out of 3,000) account for a third of all manufacturing exports in the developing world.

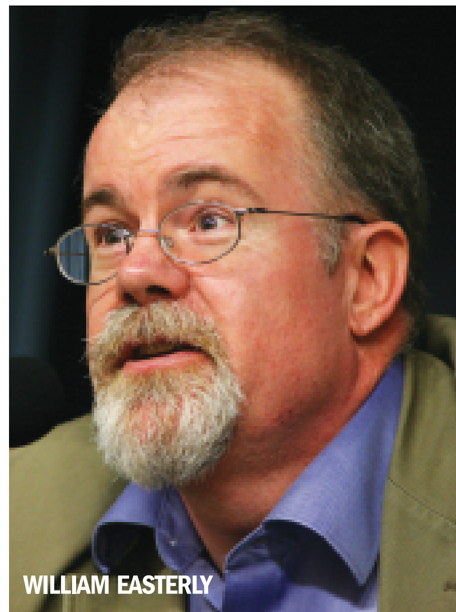
The top-ranked export on average produces 17 times more value than the 10th ranked export. Nobody can predict these "big hits"—certainly not governments or World Bank economists.

One economist who understood the unpredictable nature of growth was F. A. Hayek. Hayek, a favorite of mine since my days studying for a PhD at MIT, offered powerful insights on the role of information, the discovery process, subjective preferences, and dispersed knowledge—all making the case against planning and in favor of individual liberty and a great deal of humility. Hayek understood that the system best equipped to cope with the enormous unpredictability of growth is free market competition. "Competition is important primarily as a discovery procedure whereby entrepreneurs constantly search for unexploited opportunities that can also be taken advantage of by others," wrote Hayek. This is the system that leads to the decentralized search for "big hits" that lead to huge returns.

Despite our lack of knowledge about how to achieve development, development is happening anyway. Over the past 50 years, far from there being a poverty trap, there was parallel growth of rich and poor countries of about 2 percent per year. Now 2 percent is not the most impressive growth rate, but that the whole world for 50 years would be growing at that rate is unprecedented. That growth has been enough to fuel the greatest mass escape form poverty in human history. Fully 500 million people have been delivered from dollar-a-day poverty thanks to the economic ascent of China and India since 1970. That's one half-billion. And more are on their way.

The truth is there is no magic bullet to development. "To plan or organize progress is a contradiction in terms," as Hayek put it. Hayek's great insight was that freedom emerges from the bottom up. Some freedom leads to more freedom. Economic and political freedoms feed on one another. The success of individual business and technological entrepreneurs generate demand for more individual freedom to accommodate and exploit that success. And individual political and social entrepreneurs come up with novel incremental solutions to achieving still greater freedom. That is the path out of poverty that the developing world is taking. And that is the path they will continue to take—if only we do not get in their way.

ARVIND SUBRAMANIAN: F. A. Hayek had two major central insights. One was the "fatal conceit." The fatal conceit is the tendency among policymakers to think they can organize the complex inner workings of a modern-day economy. According to Hayek, the central planners, operating without the vast amount of knowledge dispersed among market actors, are steering blind.



WILLIAM EASTERLY

"To plan or organize progress is a contradiction in terms."

The second idea is the more general notion that liberalization and decentralization lead to prosperity. I agree with much of what Hayek said, but I have reservations about both of Hayek's central insights.

First, while the fatal conceit is an extremely important idea, we must remember that policymaking in the developing world doesn't come from Washington, D.C., and the World Bank. It often happens at the local level. Inside countries, inside capitals, policymakers must make decisions. The teachers in India are on strike—what should they do? In the real world, policymakers must address these questions. They can't throw their hands up and say "let the market decide."

In other words, I'm not so sure that the fatal conceit criticism applies to *insiders*. Domestic policymakers know a great deal about what's happening on the ground in their nations. On a more concrete level than abstract notions of individual liberty, those policymakers must make vital decisions about infrastructure and investment and things like policing.

Now I am in total agreement with Easterly on the fatal conceit of *outsiders*. Like Easterly, I've written on the failure of aid, most recently in "Aid and Growth: What Does the Cross-Section Evidence Really Show?" (2008). Aid has enormous problems, not the least of which is its tendency to prop up regimes and make them unresponsive to their citizens. As Robert Solow said, the job of economists is to consign bad ideas to the dustbin. Easterly has done tremendous work in helping to consign the idea of foreign aid as a savior of developing nations to the dustbin.

Now what about the other central insight of Hayek? That is, the importance of economic and political decentralization. Is decentralization the path to prosperity? That's certainly been the point of Easterly's presentation today.

I'm not so sure. I'm going to argue that the notion that decentralization leads to growth is only half right, or at least, still has questions surrounding it.

I think the notion that decentralization leads to better economic outcomes is broadly right because over the past 25 or 30 years we have indeed seen huge increases in economic growth and huge reductions in poverty worldwide. Surely a lot of that has to do with a global move toward economic decentralization. But there is a really deep puzzle lurking in the back of this development experience.

The slow reforming and least reformed nations, such as China, Vietnam, and India, have done better than the faster reforming and more reformed nations of Latin America and Africa. And all the while, we see a nation like India, with little privatiza-

tion, a public-sector-dominated banking system, an overregulated labor market, and a regime mostly closed to foreign trade and capital, soar economically. Over the past 25 years it has been one of the best performers in the world. And yet India is still very much a socialist system.

Were it the case that China, India, and Vietnam were doing worse than they are now, that would be a home run for the Hayekian view that more decentralization means more growth. But that's not what the data say.

Let me add that although I've been speaking about decentralization generally, if anything, this critique is truer of political decentralization. Now I believe democracy has intrinsic value, and certainly there is more to choosing a political regime than growth, poverty reductions, and the sorts of economic indicators I look at in my field. Nonetheless, you will find a very mixed picture when you look at the data on the connection between political decentralization and economic growth. When it comes to growth, democracy just doesn't help.

Here are two striking facts: the only two countries in Africa that have grown sustainably over the past 40 years are Botswana and Mauritius. What is common to them? They are the only two countries in Africa that have seen sustained and uninterrupted regimes for the past 40 years.

The overall trend in East Asia and elsewhere is that you see long periods of rapid economic growth followed by political decentralization playing "catch up." Of course, sometimes, as in the case of Singapore and China, that "catch up" never occurs.

How then do we understand this puzzle? Why do countries that have decentralized the least see the greatest growth? The way I think of it is that there is a black box out there that we don't fully understand. It's the interaction between that black box and opportunities created by markets and economic decentralization that delivers on economic development.

What is this black box? Here I am in complete agreement with Easterly and Hayek: We really don't know. Our experience has been very heterogeneous over the past 25 years. In the case of India the skills-based IT boom that everyone celebrates now was historically created by government. It is essentially a matter of luck that Indians turned out to have the skills to exploit the opportunities created by the IT revolution. In the case of China, many of its capabilities to create growth were the result of communism. I'm not saying that communism provides the recipe for economic growth—far from it. I'm simply making the point that decentralization alone does not deliver all the goodies we want from an economic system.

ARVIND SUBRAMANIAN

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Where does that leave us? I think it's clear that we have a robust understanding of the negative agenda. That is to say, as development economists, we know what *not* to do. Don't repeat the mistakes of a Zimbabwe or North Korea: Don't debase the currency, don't create hyperinflation, and don't expropriate wealth. But beyond some basic don'ts, I'm not sure we have a good sense of what to do.

We're not talking about planners from Washington, D.C., here—we're talking about the ministers and elected officials and policymakers within developing nations' governments, people who need to make choices. Do businesspeople emerge spontaneously from the fabric of those societies without the input of these officials? Or, does government create conditions for entrepreneurship? Can government do so? Should it? These questions represent an agenda for further research and reflection.

EASTERLY: Let me start with an allegory: A man quits his career as a successful, high-earning professional. Then he gives up everything he has. He becomes a homeless person, living on the streets. The next year, he returns to his job as a white collar professional. He returns to his old salary and standard of living.

Now this person has seen rapid, unparalleled year-over-year growth in his earnings. But does the return to his old income really represent a success?

This story is pretty close to the "China story" of growth. Put a megalomaniacal dictator in charge of a country. Have him bring the economy to a standstill through land "reform" and forced, failed attempts at industrialization. Have him kill tens of millions of people in the process and terrorize the remainder of the populace. Call him Mao, for purposes of illustration.

When Mao dies and a relatively less authoritarian ruler steps in, watch as business goes back to usual. Watch people go back to cultivating their private farms, return to work, invest in capital to create new businesses now that the regime is stable. China, of course, is a terrific success story. Its growth has lifted about 300 million people out of dollar-a-day, abject poverty since 1970. Still, I wouldn't recommend repeating its formula for rapid growth. Going from a disastrous situation to a less disastrous one is not the path to prosperity. And it certainly doesn't lend insights into what will work and what won't for other developing nations.

So when Subramanian and other "mainstream" development economists look at short-run GDP growth rates, they need to remember the larger, long-run perspective. Rapid GDP growth rates over short spans of time are welcome, but they do not necessarily represent real change. I think that's the

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Plus Wal-Mart's impact and Epstein on IP

Regulation Goes Tabloid: Sex Chats, Naked Shorting, and Bush at Midnight

Why would the operators of websites like hotlivesexchat.com and freecalls2theworld.com route phone calls to their services through rural towns like Riceville, Iowa? To take advantage of complicated telecommunications regulations and make a bundle of money from American consumers of long-distance telephone calls. Says Christopher Hixon in the Spring issue of *Regulation*, blame the FCC—it requires long-distance carriers such as Verizon to pay rural telephone carriers at inflated rates for calls originating from their network. Enter the phone sex chat lines, which reroute Verizon callers through the rural carriers, which in turn extract huge payments from Verizon thanks to the FCC rate at which they are billing. The ill-gotten earnings are then split between the sex chat line operators and the rural operators. The mechanism is a little tricky, but the bottom line is simple: carriers—and ultimately, consumers—are being fleeced because of an outmoded government regulation.

No one likes short sellers, who borrow a stock only to sell it, hoping that the price of the stock will go down and they can repurchase later at a lower price. By betting on and benefitting from instances where the stocks decrease, short sellers earn the enmity of the rest of the market, which is rooting for the prices of equities to rise. But if people don't like short sellers, they really don't like naked short sellers. Naked short sellers don't even bother to borrow stock before they sell it, leading to concerns, examined by John W. Welborn, economist with the Haverford Group (and former Cato research assistant), that these participants are artificially increasing the supply of stock. Small firms in particular can see their stock prices swing wildly as a result of the creation of what Welborn terms "phantom shares." Moreover, uncertainty is introduced as to who is a true shareholder and who isn't, leading to confusion in the corporate voting system. Welborn argues that naked shorting ought to be regulated, an opinion that finds many a sympathetic ear among investment firms, the public, and policymakers. By contrast, Christopher L. Culp, adjunct professor of finance at the University of Chicago, and consultant J. B. Heaton argue that naked short selling is financially equivalent to conventional short selling.

Other articles cover the phenomenon of "midnight regulation," whereby an outgoing presidential administration is said to issue an unusually large number of regulations in its final year or two in office—whether the entrance of Wal-Mart into local markets really does lead to a decline in mom-and-pop shops, whether auctions in takeoff- and-landing slots could aid airport congestion, and whether developed nations owe the world for their comparatively greater contribution of carbon to the environment. Also in this issue of *Regulation* Richard A. Epstein gets the *final* final word on intellectual property. ■

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case when Subramanian cites the fact—which I agree with, and have also written about—that some of the most reformed countries in terms of economic and political liberalization have seen some of the least impressive growth rates of late, and vice versa.

It's extremely difficult to determine what works and what doesn't in development. But one way to ensure misunderstanding is to look at short-run GDP growth rates and draw hasty conclusions. Even over 10 or 20 years, the relationship between policy changes and economic growth is not always clear.

The meaningful evidence is not in growth rates but in levels. The white collar professional is rich because he can afford a nice apartment and nice restaurants. He is not rich because he was penniless last year. Please note that, according to newly revised data, China's per capita income is $1,800 per year. That's about 1/20th of U.S. per capita income. Yes, China has seen impressive growth rates, but in terms of overall level of wealth, it has a way to go. The same applies to India. India's per capita income is about 1/20th that of the United States.

So we don't know whether or not China and India represent successes. Their stories are certainly promising so far. But we must be tempered by the examples of fast-growing nations before them that have fallen back in development—or regressed to the mean, at the least. Obsession with short-run GDP growth rates can make development economists lose sight of the big picture.

I also think Subramanian, like many development economists, is too quick to credit policymakers with creating economic growth. Just because a nation sees economic growth does not necessarily mean the policymaker at the helm is responsible. Economic growth is just as likely to come from the bottom up. Sometimes there is a technological breakthrough that the political process merely accommodates. Sometimes there is a "big hit" industry that takes the lead. You can have a winning team with a bad coach. And indeed, we have no very little direct empirical evidence that policymakers can spur growth within their tenures in office. We do, however, have direct empirical evidence that they can wreck growth. And, of course, we need only read Hayek to know that. ■