

APEE Essay Contest: What Causes Prosperity?
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Prosperity and the Freedom to Cooperate

It often seems strange to Westerners that some countries have remained poor. The real peculiarity, however, is that we have become rich. History has not been a steady march towards higher living standards, but a long period of stagnation punctuated by a brief burst of spectacular growth in some parts of the world. Most people, for most of human history have been extremely poor by our standards. Statistically speaking, poverty is the norm.

Prior to around 1750 or 1800, living conditions everywhere were poor and stagnant. The best estimates put the real income¹ of people in all societies at between US\$400 and \$800 per year – about the same as the world’s poorest, war-torn countries today. This had stayed roughly the same for at least 1500 years: on average, a person in 17th century England was about as wealthy as one in 2nd century Ghana. In the 18th century, living standards slowly began to rise by around one third of one percent per year. This growth rate has slowly improved, and has averaged around four percent annually since 1960.²

These growth rates sound rather underwhelming and it is easy to overlook their real significance. Even the most conservative estimates would put the wealth of the average American at more than fifty times that of virtually anyone living prior to the industrial revolution.³ This has happened through the power of moderate, compounding economic growth. As Robert Lucas has said, “the consequences for human welfare are simply staggering. Once one starts thinking about them, it is hard to think of anything else.”⁴ Indeed, concerns about inequality lose much of their significance when we reflect on how much living standards of the even the poorest have improved. The poor in developed countries today are exceptionally rich by historical standards. Things have steadily continued to improve in developed countries. Real income for the average American has more than doubled since 1970.⁵ Economic growth does not simply give us more stuff, but improves our lives along virtually every dimension. We are now much healthier and more educated. We are less likely to die in childhood, and live much longer.⁶

Only in recent centuries have a significant number of people been able to escape poverty and premature death. What is responsible for our unprecedented age of prosperity? In this essay, I will argue that prosperity is the result of voluntary cooperation between individuals. In a stable and predictable environment with institutions facilitating trade and specialization, people are able to unleash their creative potential for the benefit of all. Prosperity comes when economic freedom is

¹ Real income refers to what they actually produced, and could thus consume; even if they didn’t use money at all. The dollar value is simply a metric.

² Lucas 2003; Baumol 2002, pp. 1-6

³ CIA World Factbook: *Rank Order GDP per capita (PPP)*

⁴ Lucas 1988, p 5

⁵ EH.net: *What Was The GDP Then?*

⁶ Fogel 2004

maximised. Between anarchy and Leviathan⁷, this is achieved by *limited government*, which does just enough to foster cooperation and nothing more.

Economically free societies allow their citizens to engage in trade and other voluntary agreements. This requires not only the absence of government intervention, but also secure property rights, the rule of law, and sound money.⁸ Economic freedom is not simply the negative freedom from government constraint, but a positive capability.⁹ Limited government empowers citizens to do more than they otherwise could. The interference of Big Government reduces economic freedom through taxes and regulation, but so does the absence of effective government to protect property rights.

Just as the wheel allows people to move things more easily, limited government allows people to engage in socially productive behaviour more easily. Whatever a person wishes to do – whether start a company or join a commune – they can do it better under limited government.

These institutions allow Adam Smith's invisible hand to operate. People pursuing their personal goals produce outcomes as if they were altruistically pursuing the benefit of all.¹⁰ Resources are directed to where they are most useful. Goods are consumed by those who most desire them. When people must pay for one another's productive effort, both those wishing to buy and sell have the right incentives. People will only consume things if the benefit they get exceeds the cost of producing them, and so only those things which are worthwhile will be produced. This unplanned spontaneous order emerges through the price system, which provides both the incentives and information needed to maximise human welfare.¹¹

The institutions of voluntary exchange also allow specialization. Instead of each person producing everything they need to survive, trade allows people to specialize in activities they are good at. This gives us more goods to enjoy. Further, the simple act of breaking a task down into smaller pieces – the division of labor – can make people more productive. Smith famously pointed out that a lone pin-maker could scarcely hope to produce twenty pins per day, whereas a factory in which pin-making is broken down into various sub-tasks will be capable of producing thousands of pins with only a few people.¹²

Trade, specialization and the division of labor are acts of cooperation. By cooperating, people are able to do more than they could in isolation. This would not be possible without secure property rights and the rule of law. This sort of cooperation can take place only when people are free to make enforceable contracts and transfer. Limited government provides a transparent and predictable environment which is easier to navigate.

Well-defined and enforceable property rights enhance human capabilities in a number of other important ways. They help us avoid the 'tragedy of the commons' and reduce

⁷ Buchanan 1975

⁸ Berggren 2003, pp. 194-6

⁹ Sen 1999

¹⁰ Smith 1776, Book I, Ch. 2

¹¹ Hayek 1945

¹² Smith 1776, Book I, Ch. 1

costly efforts at protection, for example. Another crucial, and neglected, way in which property rights allow us to do more is through what Hernando de Soto calls *The Mystery of Capital*.¹³

De Soto argues that assets such as houses, cars and machines live a double life in market economies. These things are useful in themselves, but when property rights are well-defined they can also be used as collateral for loans. These objects have hidden potential: they enable people to make long-term agreements which could not otherwise be enforced. A major reason poor countries remain poor, according to de Soto, is that they lack the formal property rights which extract capital from assets. Even if customary property rights are well understood and respected within a community, assets cannot be used to attract finance from outsiders without standardized formal recognition.

The empirical relationship between property rights and prosperity is as unequivocal as the theoretical case. There is a tendency for countries without formally defined and enforced property rights remain poor, and those with them to grow richer.¹⁴

The definition and enforcement of property rights is an instance of government action increasing economic freedom. Failure through government inaction is common in poor countries, though so is an excess of government intervention. In richer countries, governments are universally hyperactive. The role of government should be to define and enforce the rules by which people play the social game. When governments go beyond this role of referee and become an active player, there is good reason to think they will produce poor outcomes.

While markets don't always work perfectly and it is tempting to say that government can improve outcomes, such arguments often assume that governments *do* work perfectly. Harold Demsetz has pointed out the folly of this *nirvana* approach. Comparing the performance of actual markets and ideal governments is not a good basis for policymaking, yet seems more common than the *comparative institutional* approach of comparing markets and governments on equal terms.¹⁵

Governments fail in countless ways. Hayek, Mises and other economists of the Austrian school have stressed that centralized governments do not have the information to put resources to their best use.¹⁶ Public Choice theory teaches us that even if governments had the right knowledge to maximise human welfare, they would nonetheless lack the right incentives.¹⁷

To earn money in markets, people must produce things that other people value. Voluntary trade makes both parties better off. Those who do not benefit from any given trade are free to refuse it. Franz Oppenheimer distinguishes between this cooperative 'economic means' of gaining wealth and the 'political means', involving forcible appropriation.¹⁸ Resources allocated by the market foster cooperation.

¹³ De Soto 2000.

¹⁴ Berggren 2003

¹⁵ Demsetz 1969

¹⁶ Mises 1920; Hayek 1937

¹⁷ Tullock 1976

¹⁸ Oppenheimer 1922 [1919], chapter 2

Resources allocated by government foster conflict. This is a simple and powerful insight.

The virtuous effects of free markets discussed above deal with what economists call ‘allocative efficiency’. If an existing stock of resources is used in the best way possible, allocative efficiency is achieved. Markets are uncannily effective at producing this sort of efficiency, but this is not their greatest virtue. Intuition and empirical evidence¹⁹ suggest that our prosperity is largely the result of technological innovation.

The standard of living we enjoy would not be possible without our technology, regardless of the level of economic freedom. The Industrial, Green and Information Revolutions have given us previously unimaginable products and ways of life. In addition to these radical improvements, we see a steady stream of minor improvements. Human creativity is the ultimate resource in improving material standards of living and expanding the frontiers of human experience.

Economic freedom is crucial in fostering technological innovation. Free markets have an unparalleled ability to produce the revolutionary and minor innovations which make life better. As William Baumol puts it, “[u]nder capitalism, innovative activity – which in other types of economy is fortuitous and optional – becomes mandatory, a life-and-death matter for the firm.”²⁰ This echoes the ideas of Joseph Schumpeter, who stressed the incentives markets create for innovation. Entrepreneurs seek new and better ways of doing things, leading to a vibrant economy characterized by ‘creative destruction’.²¹

This sort of innovation is impossible without the right institutions. Entrepreneurs have need the market mechanisms to allocate risk, make long-term contracts and secure their rights to intellectual property. People will innovate given the right environment: that which maximises real economic freedom.

Cross-sectional and historical evidence supports the idea that economic freedom leads to prosperity. Countries with more economic freedom grow faster.²² Further, it was not until limited government and secure property rights emerged in Great Britain that the modern era of unprecedented economic growth began.²³ There are also many examples of countries distinguished only by regime type with remarkably divergent levels of prosperity.

North and South Korea, for example, share a common culture and were one country until World War Two. Since then, the Communist North has remained poor, while the capitalist South has grown rich. South Koreans now enjoy a standard of living more than 13 times that of those in the North.²⁴ The only real difference between these countries seems to be their level of freedom, economic and otherwise.²⁵ A similar

¹⁹ Easterly and Levine 2001

²⁰ Baumol 2002, p 1

²¹ Schumpeter 1942

²² Berggren 2003

²³ Weingast 2006

²⁴ CIA World Factbook: *Rank Order GDP per capita (PPP)*

²⁵ Wikipedia: *Division of Korea*

situation existed in East as compared to West Germany prior to reunification 1990.²⁶ Zimbabwe and Botswana also present an important contrast between economic freedom and unfreedom.²⁷

We know in broad terms, then, what sort of policies will maximise human prosperity. Public policy, however, does not magically appear once well-considered conclusions have been reached. The government is a messy organization, not a rational individual. To get the right institutions, we need the right meta-institutions. To get limited government of the sort described above, we need constitutional limits on the power of government. This was the vision of James Madison's compound republic²⁸, and has been formalised by James Buchanan and Gordon Tullock in *The Calculus of Consent*.²⁹

While there are no perfect examples of truly limited government in the sense I have described here, we should be grateful for the freedom we have. Limited government is clearly preferable to anarchy, but has the tendency to grow into Leviathan. Rich countries have managed to restrict this growth. There is much work for classical liberals to do fighting the unmitigated harm of heavy-handed interventionism in rich countries and the last pockets of socialism and the Hobbesian anarchy in the third world. We must not lose sight of the fact that institutions fostering cooperation are not the default position of human existence. Improvement is possible, but so is descent into either anarchy or Leviathan.

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²⁶ Wikipedia: *Economy of East Germany*

²⁷ Halder 2005

²⁸ *The Federalist* No. 51

²⁹ Buchanan and Tullock 1962

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