Habits of Highly Effective Countries is an empirical analysis of how India compares with policies associated with success and failure internationally. It illustrates inter alia that the integrity of the legal system is one of the most important factors — perhaps the most important — associated with success.

This analysis has been done under the Law Review Project (LRP), a not-for-profit NGO established in 1984 to promote the Principles of Good Law with special emphasis on economic development and the reform of laws that impact negatively on small business. It provides advice and consultancy services to governments, businesses and individuals with a view to improving the quality of laws and administrative practices. The LRP promotes a climate of informed opinion regarding the integrity of the legal system, especially the philosophical and practical significance of constitutional provisions and values, such as the rule of law, due process, public participation in policy-formulation, the separation of powers and natural justice.

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LESSONS FOR INDIA

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CHAPTER 1

INTRODUCTION

The Policy Maker's Question

Policy makers need a simple question answered: which policies coincide with which consequences? They seldom get good answers. They are bombarded with biased advice from vested interest lobbies, self-serving bureaucrats, academic ideologues and sensation-mongering media. Policies are generally implemented without objective or reliable information on whether intended consequences are likely to materialize, what risk there is of perverse unintended consequences, and which policies have been tried successfully or otherwise elsewhere. Policy makers should have information that enables them to emulate proven successes, anticipate pitfalls and avoid failure. The exorbitant cost of re-inventing the regulatory wheel should not be imposed on them and, more importantly, their country.

Policy makers would like to know not only which policies coincide with which outcomes, but also which policies cause which outcomes. Careful analysis can

establish causality with high levels of probability, though seldom with certainty.

For successful policies to be adopted, policy makers and their advisors need the policy maker's question answered for every policy goal. They need to know, for example, why some countries are rich and others poor; what explains high and low levels of crime and corruption; which factors enable citizens to live longer healthier lives; why illiteracy is often rampant where education budgets are biggest; why Africa has been the only regressing continent for a generation; what makes some third world countries prosperous when they are surrounded by seas of destitution; how the policy mix must change for a country to coincide more with the world's winners and less with its losers; whether prosperity entails adverse or fortuitous trade-offs with equality, justice, resource-depletion and the environment; why some former colonies are amongst the world's richest countries whilst others stagnate for generations under the 'colonial legacy'; why poor people risk their lives getting into countries where governments do not want them and do less for them; which social policies coincide with rising living standards; whether development aid promotes development; if labour laws benefit people with jobs at the expense of the unemployed; and why some States in India do much better than others.

Many of these questions confronting Indian policy makers have to do with reforms, or their lack. Liberalization in India is often dated to 1991. That's not quite true. There was halting liberalization in the second half of the 1970s and this picked up a bit more speed during the second half of the 1980s. However, this first

cycle of reforms was somewhat ad hoc, fragmentary and piece-meal. It wasn't as systematic and comprehensive as reforms introduced since 1991, when an external sector balance of payments crisis drove India to reform. This first flush of reforms in 1991 is sometimes referred to as the first generation of reforms. Other than industrial de-licensing and some reforms in the financial sector, this liberalization mostly concerned reforms in the external sector (elimination of quantitative restrictions on imports, rationalization of export incentives, reduction in tariffs, transition from administered exchange rates and relatively more open policy on foreign direct and portfolio investments). Successes associated with India's reforms are also often attributed to the external sector (drop in debt-service ratio, growth in export of goods and services, net invisibles and capital inflows, size of foreign exchange reserves and FDI in and out of India).

In contrast, the second generation of reforms concerns the domestic economy, where political economy pressures are more and vested interests that oppose reforms are also stronger. It cannot be anyone's case that reforms are positive sum. There are losers from liberalization, those who benefit from the status quo. While liberalization brings net welfare gains to the country, there is no system that allows for gainers to compensate losers. Gainers also tend to be more diffused (small enterprises, small farmers, unorganized labour, consumers) and less vocal than losers (large and inefficient enterprises, large farmers, organized labour, bureaucracy). Consequently, many second generation reforms are still on the agenda. They are talked about, but haven't been implemented. Among major reforms pending are making government expenditure

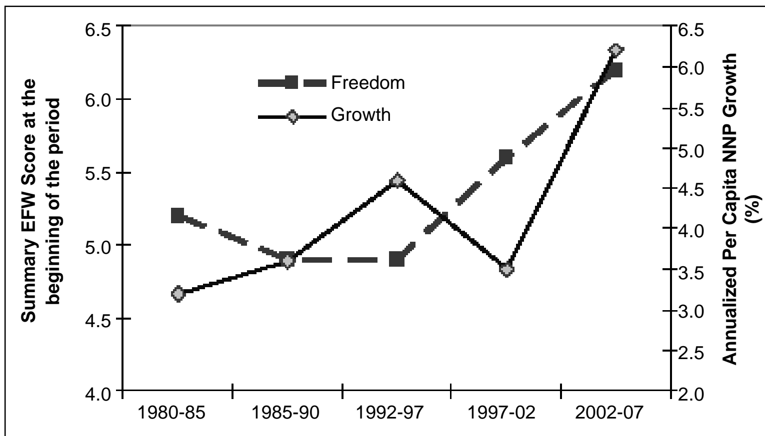
efficient, targeting subsidies, tax reforms, PSU (public sector unit) restructuring, infrastructure (including the issue of user charges), legal reform and reforms in the rural sector. All these reforms are based on the premise of injecting efficiency through competition and reducing government intervention that constrains such a right to choose. That is, they are based on the premise of increasing economic freedom.

The Economic Freedom of the World Index (EFW) now ranks 141 countries of the world. The scores are a better indicator than ranks, since the number of countries hasn't remained unchanged over time. These scores are out of 10. The higher the score, the better. Zero is un-free, ten is free. India's summary ratings have improved from 5.2 in 1980 to 6.6 in 2005. In 2005, India's rank was 69th out of 141 countries, showing that there is a long distance still to go. Though roughly half the countries in the world are less free than India, around half the countries in the world are more free.

However, when one begins with a low base of economic freedom, even a small increase in freedom increases income growth quite significantly. The graph shows India's EFW scores at five-yearly intervals and per capita net national product (NNP) growth. Since there are year-to-year fluctuations in income growth, it is better to consider the trend over a certain number of years, which is what is done for the Sixth Plan (1980-85), the Seventh Plan (1985-90), the Eighth Plan (1992-97), the Ninth Plan (1997-2002) and the Tenth Plan (2002-07). But the 2005 EFW is mapped with real per capita growth in 2005-06. These are per capita figures, so they also depend on the rate of population growth. The following conclusion is beyond

dispute. Since 1980, economic freedom in India has increased. And since 1980, per capita income growth in India has also increased. This hasn't benefited only the rich. The percentage of population below the poverty line has dropped from 51.3% in 1977-78 to 36.0% in 1993-94 and 27.5% in 2004-05. Human development indicators have shown improvements. India's Human Development Index (HDI) was 0.450 in 1980 and increased to 0.521 in 1990. In 2005, it went up to 0.619. During this period, India transited from a low (HDI less than 0.5) to a medium (HDI more than 0.5, but less than 0.8) human development category.

India: Economic System and Growth



There is an obvious correspondence between the economic system and the economy's performance. This is not only true of a country over time, but also true of cross-country comparisons. Countries with increasing levels of economic freedom (and this includes China), experience higher levels of growth. The evidence suggests

that the Indian economy will also continue growing at accelerating rates if the trend towards increasing economic freedom is persevered with.

Historically, India hasn't been particularly free. Beginning with the 1950s, there was extensive State intervention and presence of controls in the economy, a trend that got accentuated during the second half of the 1960s and early 1970s. This was what is often called the import-substituting phase and it didn't do much for the cause of poverty alleviation either. In the early 1950s, the percentage of India's population that was below the poverty line was around 50% and it continued to be around 50% in the late 1970s too, after three decades of planning. Till the mid- 1970s, the annual average real rate of GDP growth was only 3.5%. From the late 1970s, with some increase in economic freedom, the trend rate increased to around 5.5% and went up to 6.5% in the 1990s, after a further increase in economic freedom. Since around 2003, the trend rate seems to have gone up to more than 8%, with a temporary slowdown because of cyclical factors, higher interest rates and appreciation of the rupee.

Except a very brief period in 1996, India has had four governments since 1991—a Congress government (1991-96), a United Front government (1996-98), a NDA (National Democratic Alliance) government (1998-2004) and a UPA (United Progressive Alliance) government (since 2004). None of these governments have been able to contest the economic rationale behind increasing economic freedom. This is despite the Washington Consensus, LPG (liberalization, privatization, globalization) and neo-classical market fundamentalism sometimes being used as dirty expressions in India.

Indeed, there is recognition, particularly from the poor, that LPG also stands for life plundered by the government. However, there are vested interests that gain from the status quo and these oppose reforms. And more importantly, in a federal country, many reforms are State government subjects. This is a point we will return to. It is also not true that there has been no debate on increasing economic freedom in India. Ever since the late 1960s and early 1970s, some Indian economists have argued in favour of this and the rationale found an echo in a succession of government committee reports. The debate took place before 1991. But until the balance of payments crisis in 1991, no policy-maker was willing to listen.

This research was undertaken after presentations to politicians, government advisors and others on correlations between economic freedom and prosperity. People directly involved in policy making and implementation complained that an index of many variables—38 in the EFW index—is of limited practical value, because policy makers will not or cannot prioritize all of them. Individual variables are the responsibility of different ministries, and are subject to distinctive and complex exigencies in the world of 'political reality'. Plus, there is the federal angle. It was pointed out that only the most important few, perhaps five or six, are likely to be statistically significant individually and that some would be significant only in combination with others. Only if policy makers know which they are, can they prioritize them in a co-ordinated strategy. The research summarized here was a response to the request for a short list of policy priorities—what is truly important to do and avoid—as identified on the basis of the world's experience.

Policy makers are subjected to challenging realities: they serve disparate constituencies, deal with influential vested interests, make decisions under pressure, implement policies with unpredictable consequences, act as custodians for the country's biggest organization (its government), and promote party political interests. They are bombarded by a surfeit of facts, theories, ideologies, opinions and rival objectives competing for scarce resources. They have handicaps not found in business, such as the lack of profit incentives and financial statements from which the efficacy of their policies can be assessed accurately. One of the few helpful options is to make international comparisons. With rare exceptions, governments have no balance sheets—they have no accurate information on what they administer or its value—which makes it virtually impossible to manage government assets efficiently.

This research was designed to fill some of these gaps: to answer the policy makers' question. A short list is provided of critical changes for the government to consider if it wants to build on the characteristics of winning nations and avoid those of failed states. An elementary principle of analysis is that correlations are not necessarily causes, which means that establishing the characteristics of winners and losers needs to be accompanied by clarity about sequencing: what precedes and what follows. Although thorough analysis provides considerable certainty about probable causes and consequences, it is never prescriptive. Answering the policy makers' question is an aid, amongst others, to good government. The art of good government is converting the objectively desirable into the politically popular.

The next section describes methodology, and summarizes major considerations and findings, followed by a detailed analysis in which the findings are elaborated and the supporting data provided.

CHAPTER 2

THE BIG PICTURE

Methodology

Most research of this kind examines only factors that correlate positively with desired outcomes, such as capital formation or job creation. However, policies with negative correlations—those that coincide with unintended consequences—can be more instructive; for example, negative correlations between 'over-regulation' and economic growth. Bad policies can offset good ones; knowing what not to do can be more important than knowing what works. This may explain the under-performance of the Indian economy historically. For example, many of India's indicators were better than those in East Asia in the very early 1960s. But by the end of the 1970s, the picture was completely different. The 1960s and the 1970s were lost development decades for India.

In this exercise, success factors and characteristics of failure were identified. Standard assumptions were tested to see whether, for instance, increased spending on infrastructure and education precedes high growth and

job creation, or follows it; and whether poverty and unemployment coincide with more crime, as generally assumed, or whether criminals are merely profit-seekers for whom returns on crime surpass alternatives under conditions of inadequate deterrence. Such questions are important because they determine not only priorities in public expenditure, but justify the public expenditure itself.

A great deal of data was considered and researched, from which core findings were crystallized and are presented accessibly, with minimal technical detail, jargon and sources. This report covers only ‘highlights’ of the research. The researchers were able to draw on the formidable resources of an international network of think tanks and experts in over 70 countries.

Much can be learned from the large body of research that precedes this project and on which it draws heavily. However, what others have already done was not repeated. Thousands of studies analyze single policy objectives in complex ways and suggest single policies or packages of related policies to achieve those objectives, such as how to increase growth by creating ‘clusters’, how to create jobs by having ‘flexible’ labour policies, how to reduce crime through ‘zero tolerance’, and so on. Some studies examine individual policies and their effects, rather than starting with objectives and establishing which policies have been shown to achieve them. Our approach has been to ask a more open-ended question. For example, instead of establishing whether minimum wages increase unemployment, researchers asked which policies and other factors coincide with low unemployment. Instead of establishing whether protectionism supports wealth-

consuming industries, researchers enquired into the package of policies, including foreign exchange policy, which coincides with competitiveness. Instead of establishing whether public works programmes are an effective palliative for unemployment, they were concerned with which policies obviate the need for palliatives.

The approach in this project has been to establish the statistical significance of each of a wide range of policies and combinations of policies, with a view to eliminating those that do not appear to make a substantial contribution. This leaves a short list of those few that appear to be decisive. These may be thought of as the policy *sine qua non*s—the essentials without which policy makers are unlikely to achieve their objectives.

A consequence of eliminating statistically insignificant factors is that some favoured policies do not make the short list. Economic liberals, for instance, assume erroneously that there is a general positive correlation between lower taxes and superior economic performance. When published data for all countries has been analyzed, the correlation between higher taxes and lower growth that exists when considering only countries with more sophisticated data, such as OECD countries, is not found. On the other hand, interventionists are mistaken in their assumption that increased government spending, especially deficit spending, coincides with job creation and higher growth. (There is evidence that 'public works' and other methods of 'stimulation' can increase short-term growth, but that they do so at the expense of long-term growth, creating economic distortion because of the temporary diversion of resources.) One often forgets that

all resources have opportunity costs.

The policy maker's dilemma is not only the lack of hard evidence about intended and unintended consequences, but also that policies promoting one objective often undermine others. Perhaps the only non-contentious 'law' of economics is the celebrated axiom that 'there ain't no such thing as a free lunch' (TANSTAAFL). Stated more formally, all benefits have costs. Policies are often propagated by expecting or promising exaggerated benefits, and underestimating, ignoring or simply being unaware of costs that take many forms, from direct staffing costs to indirect, often remote, socio-economic effects. One of the most significant costs is that policy makers are often victims of goal-substitution by officials and vested interests advancing their own interests.

Our research confirmed what economists take for granted, that the attainment of every objective entails countervailing trade-offs. Policy makers need to know whether real world benefits are likely to exceed costs.

Published estimates of cost and benefit tradeoffs are available in specific contexts only, such as the costs and benefits of individual policies or laws, and then only for very few countries. Yet, being constantly vigilant about the unavoidable, often fatal, trade-offs between costs and benefits may be the single most important thing policy makers can do.

Information has been available for two decades indicating that freer markets are associated with higher growth, which means, as shown in this report, that most policy objectives are attainable. During recent years, simple techniques have developed for predicting probable effects of individual measures. It should therefore be easy

for all countries to prosper, yet very few do, which suggests that policy makers in most countries:

- Adopt sub-optimal or counter-productive policies unwittingly;
- Do not use readily available techniques to avoid, identify and correct mistakes, or
- Have higher priority anti-growth objectives.

Higher priority anti-growth objectives could be anything from promoting social, cultural and religious values to patronage, war and retaining power. A perverted form of Gresham's Law seems to operate. Bad policies drive good policies out of circulation.

Improving Efficacy—CBAs and RIAs

Apart from needing to know what effects policies are likely to have in general, policy makers need to know how best to predict the probable consequences of specific measures. One of the characteristics of advanced and high-growth countries is that they use increasingly sophisticated techniques for evaluating and improving the quality of laws and policies. Though they have common objectives, these techniques vary widely in name and methodology. They were studied in great detail and the key points are the following.

What the techniques have in common is cost-benefit or regulatory impact assessments (CBA/RIA). What they lack is that people undertaking CBAs/RIAs do not take information of the kind in this report into account sufficiently or at all. The lessons learned from the world's experience include:

- To avoid promoter-bias, CBAs or RIAs should never be done by or under the influence of a department or agency promoting a measure, but by a truly independent government agency or outsourced consultant, preferably answerable directly to the Presidency or Parliament.
- To be of real value to policy makers, and minimize their risk of being seduced into ill-advised policies, assessments must accord with a strictly prescribed and consistent formula.
- Provision should be made for efficacy monitoring.

The evidence points to a need for analysis of this kind to alert policy makers to TANSTAAFL trade-offs. Laws promoting improved working conditions, job security and high wages may, for instance, succeed for people who retain jobs, but do so at the expense of those who become unemployed. When things cost more, including labour, people buy less. Would-be employers may substitute technology for labour, or, more seriously, invest abroad, if at all, thus exacerbating unemployment and curtailing competitiveness. The Industrial Disputes Act is a case in point.

Consumer protection laws may achieve protection at the expense of a reduced range of choices (fewer products and services) and less innovation, both impacting disproportionately on the poor.

Increased powers granted to enforcement agencies to achieve such policy objectives as combating "organized crime" through asset forfeiture, entail discretionary power, which increases the prospect of real or suspected

corruption, injustice or abuse. Such measures may compromise one of the most important success factors, the rule of law.

Maintaining stable currency values may result in cheaper imports and a positive investment climate, but push exchange rates to levels that compromise export competitiveness. The cost of stability in financial markets might be depressed retail markets due to the diversion of disposable income from consumption to savings and capital formation, which, according to the data, are significant growth factors.

Uninformed pursuit of laudable objectives may generate perverse secondary effects that exceed benefits. There is, however, a conspicuous and fortunate exception (elaborated below), namely that the pursuit of economic growth appears to have such substantial benefits with such minimal costs (from the policy maker's perspective), that they can think of it as a virtually unique cost-free benefit. The data (below) suggest that supposed costs of growth, such as environmental harm, are more significant in the absence of growth.

To select best policies, policy makers need to know such things as whether high savings rates coincide with high growth, and whether high growth is likely to create more jobs than anti-growth 'job creation' schemes. Diligent policy makers want to be properly informed about these complex interactions.

An adequate analysis must identify and quantify all reasonably predictable costs and benefits. How many people will benefit, in what way, to what extent, at whose cost, and at what cost? Where feasible, there must be monetary values (for ease and accuracy of evaluation).

Where monetary values are inappropriate, quantification should be in defined units, such as how many fewer crimes of a specified nature there will be with increased budgets or powers, how much less litter, of what type, there will be after a new anti-litter measure, or how many more people will be literate/numerate after five years of adult education. Costs may be a combination of the education budget per beneficiary and how much learners' time will be diverted from alternatives, including jobs, perhaps with on-the-job training.

Improving Constitutionality

The other side of the CBA/RIA coin is the extent to which measures are consistent with the principles of good law, that is, the extent to which their probable costs and benefits have been assessed as well as the extent to which they comply with constitutional and jurisprudential requirements.

Ideally, a study of this kind would be comprehensive and 'value-free', subjecting all factors for which there are data to value-free analysis. It would produce a separate and definitive table of factors weighted according to their significance for every policy goal. But no single project could identify and process all available data in all possible combinations. What is achievable is to exclude factors that are obviously irrelevant. It can, for instance, be assumed that the ratio of vegetarians to primary dunes is not a determinant of exchange rates, whereas the ratio of money supply to foreign trade might be. Within broad parameters, serious research must entail some basic assumptions regarding probable relevance, especially in the context of preceding research. There are borderline

issues. Some might believe firmly that race or caste is obviously irrelevant—that it is clearly not a determinant of, say, productivity—whilst others might be equally convinced that it is probably a critical determinant. As many factors as resources permitted were examined, particularly statistically significant policy variables.

CHAPTER 3

AID AND POVERTY

Is Foreign Aid Foreign Harm?

Since 1991, there has been one fundamental change in managing the Indian economy. Ever since 1949, the foreign exchange constraint plagued India, leading to the Foreign Exchange Regulation Act (FERA) of 1957 and 1973. Foreign exchange is no longer scarce, it is plentiful. In the process, a country that relied on foreign aid for the greater part of its independent existence, has now finally said no to aid and usually, though not always, wants free trade instead. Indeed, India is now a net foreign aid giver to 23 countries, though none of this is classic foreign aid. However, the issue of foreign aid remains important to India for four different reasons. First, one is uncomfortable if 1 billion people are still mired in poverty in sub-Saharan Africa and this region is also wrongly cited as a failure story for liberalization and globalization. Second, there is some concern that unlike China, India's foreign aid policy hasn't yet been used in Africa to push India's strategic objectives, though the relative sums of money involved across the

two countries are quite different. Third, many of the issues about aid resurface when one thinks of attitudes towards India's backward States. And fourth, some of these issues resurface when one thinks of attitudes towards India's poor individuals.

To get back to foreign aid, in this study, besides policies, many other variables were considered, such as race, history, and natural resource endowment, to mention a few. The strongest correlations were usually, but not always, policy-related. Some, such as correlations between economic performance and demography were factors about which policy makers could do little or nothing. The absurdity of race as the explanation for the poor performance of sub- Saharan African countries is easily dismissed by virtue of the simple fact that countries with similar policies perform comparably regardless of race, natural resources, size, history and other factors. The data suggest that Africa's failure is fully explained by antigrowth policies adopted by African governments.

Strong correlations suggest that domestic policies are decisive determinants of prosperity, which is good news because it means prosperity is a matter of choice, not destiny. Developing countries, such as ours, have a simple choice: they decide whether to stay poor or become rich, and whether to do so slowly or fast.

There is no evidence that foreign 'aid' has the potential to 'make poverty history'. On the contrary, the evidence suggests that aid may be harmful. One of the scholars who has analyzed the data, William Easterly of New York University, has shown (see graph) that countries with less aid outperformed those with more. He cites compelling data for his thesis that Structural Adjustment Programme

finance (SAP) and aid have been a 'tragic' failure, and that attention should turn to adopting domestic policies and institutions in line with those of winning nations. He anguishes about the fact that the West 'spent $2.3 trillion on foreign aid over the last 5 decades and still had not managed to get 12-cent medicines to children to prevent half of all malaria deaths. The West spent $2.3 trillion and still had not managed to get $4 bed nets to poor families. The West spent $2.3 trillion and still had not managed to get $3 to each new mother to prevent 5 million child deaths. The West spent $2.3 trillion and Amaretch is still carrying firewood' (Cato: *Why Doesn't Aid Work?* http://www.catounbound.org/2006/ 04/03/william-easterly/why-doesnt-aid-work/).

Despite the apparent counter-productivity of aid and SAPs, 'the West tried harder than ever to save Africa' in 2005. At the World Economic Forum (WEF) meeting in Davos, Switzerland, Tony Blair called for 'a big, big push forward'. The G-8 agreed at its summit in Scotland to double African aid 'from $25 billion a year to $50 billion, and to forgive … debt incurred … to fund previous (unsuccessful) 'big pushes'. Rock stars Geldof and Bono were prominent in 'Live 8' concerts to urge G-8 leaders to 'Make Poverty History'. The evidence suggests that increased aid is more likely to perpetuate than ameliorate poverty. The Centre for Global Development (CGD) produces a 'development-friendliness index' that ranks rich countries according to how much they do for poor countries and the environment. The lack of evidence that aid is beneficial raises doubts about the utility of the index as a guide for rich country policy.

An obvious concern about aid is that it is government-

to-government, seldom going directly to impoverished people, which means that recipient governments have an incentive to maximize rather than minimize destitution. According to critics, foreign aid in its present form says to governments of poor countries 'The better you are at causing poverty, the more you'll be rewarded'. They fear, based on the evidence, that they'll be 'making poverty' instead of 'making poverty history'. To illustrate the concern, William Easterly compared foreign aid to developing countries with their growth rates during the past 40 years and found a distressing negative correlation—more aid, less growth.

Easterly's conclusion that 'development everywhere is homegrown' is consistent with the data. He observes, for instance, that 'as G-8 ministers and rock stars fussed about a few billion dollars here or there for African governments, the citizens of India and China (where foreign aid is a microscopic share of income) were busy increasing their own incomes by $715 billion in 2005 (http://www.washingtonpost.com/wpdyn/ content/article/2006/02/12/AR2006021201150.html).

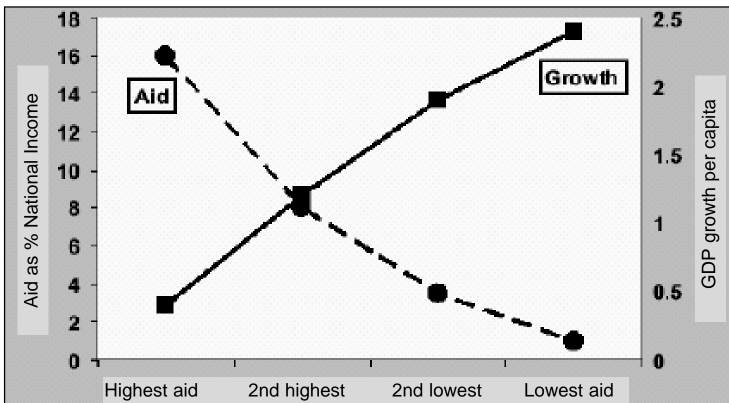
The aid paradox is that to be a positive incentive, aid would have to go to countries where it is not needed, that is, where governments adopt policies that result in high growth. The empirical evidence suggests that the prosperity of a country is determined by the policies its government implements. It is curious that in the prevailing aid dialogue, there is relative silence on why countries are poor at all—why they need aid. The implicit assumption seems to be that wealth and poverty are accidents of history and some countries are just lucky.

Concerns about counter-productive aid effects speak

primarily to aid providers. It is not clear what policy makers in poor countries can do about it. They are likely to continue wanting as much aid as they can get, with as few strings attached as possible. Specifically, they may overtly and covertly resist pressure from aid givers to adopt pro-growth reforms for two reasons, firstly, that growth reduces their chances of getting aid, and, secondly, that pro-growth policies undermine the objectives of anti-growth policies.

That past aid did not make poverty history appeared to explain 'donor fatigue' during the 1980s and 1990s. The new millennium coincides with renewed pro-aid fervour. There are relatively small changes in aid policy in that donors are encouraging recipients to adopt high growth policies. That *per se* is not, of course, new. It was the idea behind SAPs. One difference is that there is now more emphasis on 'governance' and, in some cases, micro-economic ('red tape') market liberalization. These new approaches are instead of rather than added to the macroeconomic reform of 'fundamentals' under SAPs. It

Aid and Growth 1960-2002



is not clear that the new approach will succeed because good governance is good only if applied to good policies, and the deluge of Western advisors accompanying aid might unwittingly be giving the worst possible advice, namely to adopt policies rich countries employ now rather than policies they adopted when they were poor. Perhaps poor countries need advice from economic historians rather than contemporary policy experts.

Whatever the case might be, our research suggests that rich countries wanting to help poor countries need to ensure that they do so in ways that promote the only apparent determinant of prosperity, namely the adoption by domestic governments of policies that correlate with prosperity worldwide. Rich countries would have to ensure that they do not 'help' poor countries by rewarding their governments more generously if they succeed in maximizing poverty.

The purpose of this report is to supply government policy makers (Ministers, senior officials, advisors etc) with evidence to their satisfaction that whether or not to prosper is a domestic policy choice, so that they have at their disposal accurate and objective evidence enabling them to implement policies that will result in prosperity for all if they decide that is their policy priority.

Poor Advice for Poor Countries

The idea informing this project is that policy makers, especially ones in relatively poor countries like India, should know what characterizes winners and losers, so that they can have policies that coincide more with those of winners. Is this not precisely what governments of poor countries, including India, do? They seek and get advice

from rich countries. They send costly fact-finding missions to find out from governments of rich countries what they do, and they import their policies, often verbatim.

However, there is a profound flaw in this myopic conception of the matter. What matters, as far as economic growth is concerned, is not the characteristics of rich countries, but of high-growth countries. The problem is that what one gets from countries that became successful long ago, is what they do now, instead of what they did to get there. Policy makers should have fact-finding missions only to less-developed high-growth countries. If they go to rich countries they should meet only with historians, especially economic historians, who are experts on what policies rich countries had when they were at the stage of development of the country seeking guidance.

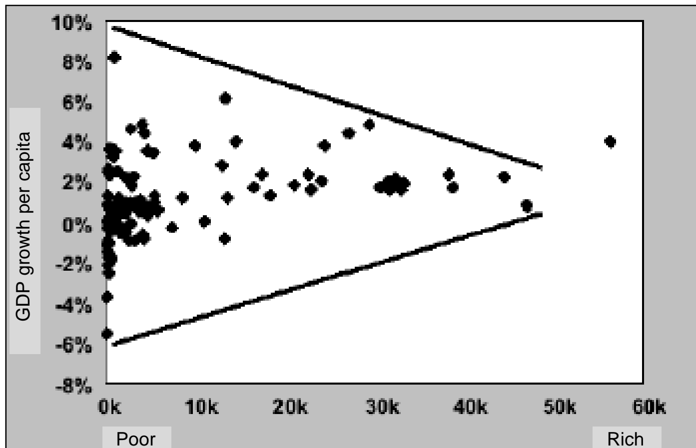
Yet some contemporaneous characteristics are relevant. What policy makers need to know is what probably caused present conditions and what sustains them. Regarding the single most important policy objective, economic growth, historical policies that characterized high growth leading to high GDPs in country A are likely, according to the evidence, to do so in country B.

Nobel Laureate, Friedrich Hayek, gave Indians sound advice during the 1960s and the 1970s, as their country receded from high-growth policies. Poor countries, he said, cannot afford the policies of rich ones. They make a grave mistake when they import what those countries do after prosperity. Rich countries can afford and survive costly impacts of sophisticated controls and high taxes, but poor countries have to follow a different path if they want to catch up.

Why Africa is Prospering

However, as the next chart shows, Africa as a continent (particularly a growing number of its individual countries) is reforming towards proven high-growth policies, which coincides with rising growth rates for the continent that are amongst the world's highest growth rates for reforming countries. Paradoxically, a few years hence few may recall or notice that Africa's rise from poverty followed its pro-market reforms and preceded G-8 initiatives. History may give credit where it is not due.

Anyone can Grow



Sub-Saharan Africa has the least economic freedom of any continent or region. However, economic freedom and democracy have been increasing and, with 5% growth for the region in 2005, Sub-Saharan Africa is now one of the fastest growing regions on earth. If such plans as The New Partnership for Africa's Development (NEPAD), especially the economic policy and rule of law components, are implemented purposefully, the evidence predicts that the

region will grow at even faster rates. What is necessary for Africa to rise from poverty is no longer a mystery. Africa distinguished itself as the only continent to get poorer for thirty years. The new millennium saw Africa's legacy of failure reverse dramatically, perhaps permanently. The end of the 1990s saw most African countries shift towards democracy and free markets. In 2000 eighteen of Sub-Sahara's forty-nine countries had growth at rates exceeding 4%. By 2004 there were twenty-five, giving the region more high growth countries (over 50%) than any other region or continent. Growth for the region averaged a respectable 3.7% for the first five years of the new millennium, and was 5% in 2005. Eleven countries sustained growth rates exceeding 5% between 2000 and 2004.

Since 1979 the World Economic Forum (WEF) has been ranking countries (currently 117) according to 'global competitiveness', defined as a 'comprehensive and authoritative assessment of the comparative strengths and weaknesses of national economies', based on selected third party indices and an Executive Opinion Survey of the opinions of more than 11,000 business leaders and entrepreneurs. Factors found in WEF research to coincide with 'growth competitiveness' include technology, public institutions and the macroeconomic environment. There is a strong correlation between 'competitiveness' and 'economic freedom'. The next chart shows that Sub-Saharan African countries have experienced increased economic freedom.

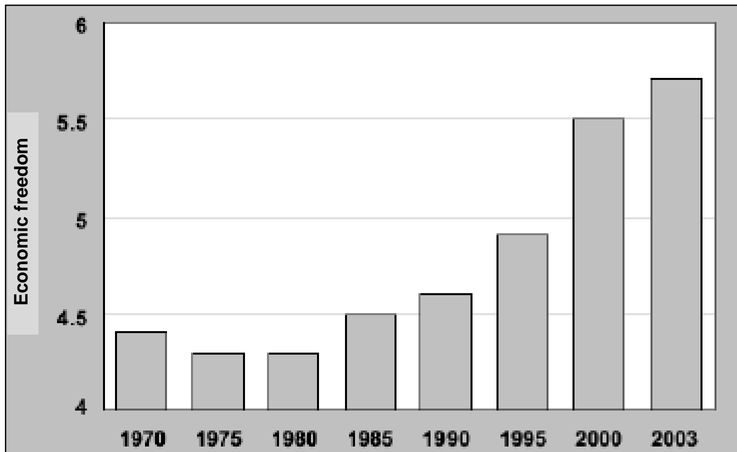
South Africa was 42nd out of 117 ranked countries in the latest index (2004), down from 41st in the previous year, and the following chart shows that it reformed least

towards competitiveness during the 1990s, with Mozambique having reformed most. There is a tenacious mantra to the effect that Africa is poor because of the 'colonial legacy' and that the West owes it aid because it exploited African colonies, a sentiment that used to find some resonance in India too, once upon a time. Obvious flaws in this view are well documented, so there is no need to do more here than remind readers that:

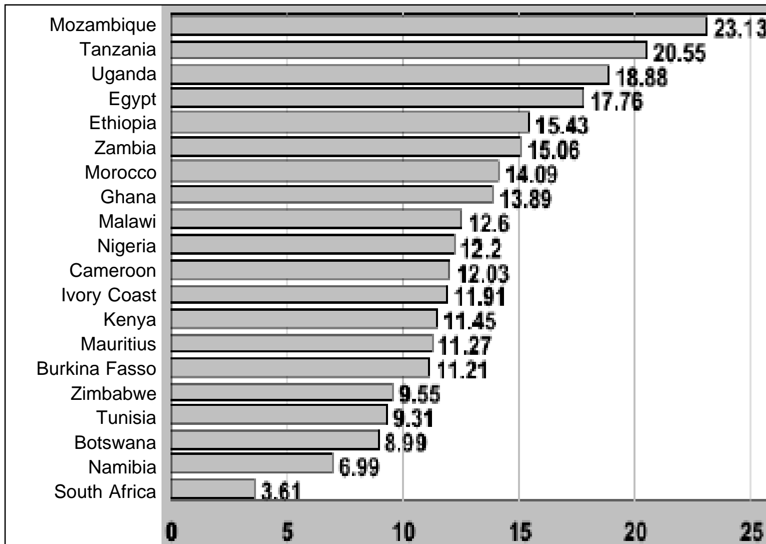
- Some of the world's most prosperous countries were colonies (USA, Canada, Australia, New Zealand, Norway, Iceland, Singapore, and Hong Kong—not yet independent).
- African countries grow, like other countries, at rates predicted by their economic policies—which means, increasingly, at very high rates, suggesting that having been colonized has no relevance, except to the extent that former colonies were left with crude democracies (stripped of necessary liberal democratic 'checks-and-balances').
- There are few countries that have never been colonized or occupied, and there is no statistically significant correlation between colonization, either as a colonizer or a colony, and prosperity.

When countries with similar economic freedom indices are compared, it becomes clear that whether or not they were colonized or colonizers is irrelevant. The evidence suggests that the extent to which there is a 'colonial legacy' is a self-inflicted matter of choice, and that former colonies can achieve very high living standards.

Sub-Saharan (black) Africa and Economic Freedom



Africa: Reform towards Competitiveness

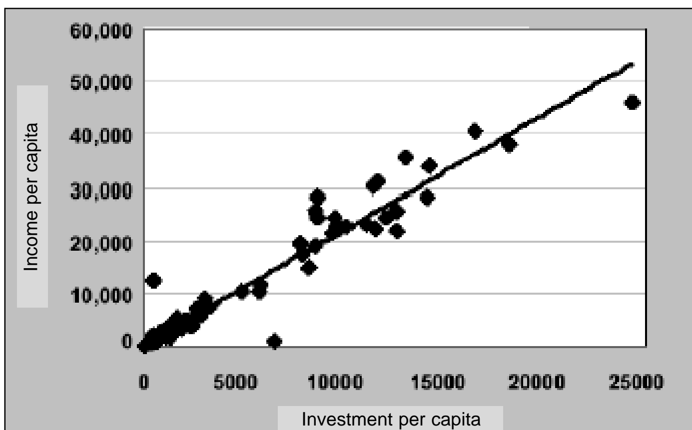


More specifically, the outlook for a country's economy is dependent on factors within its direct control, and not on such variables as natural resources, climate, size, race, culture or arable land, nor is it dependent on extraneous (exogenous) vicissitudes, like foreign aid or tariff-free access to foreign markets.

The lack of investment coincides with a lack of income. Amongst the most under-appreciated factors coinciding with prosperity are savings, capital formation and investment, which play a decisive role in high growth economies. Furthermore, there is a very strong correlation between investment per worker and income: for workers to be employed and earn more, there must be investment.

Inferior legal systems coincide with poverty. As explained elsewhere, improving the legal system, and especially reducing crime, may be the single most important factor for any country if it wants to have more in common with the world's winners.

Investment and Income per Worker



Africa in Context

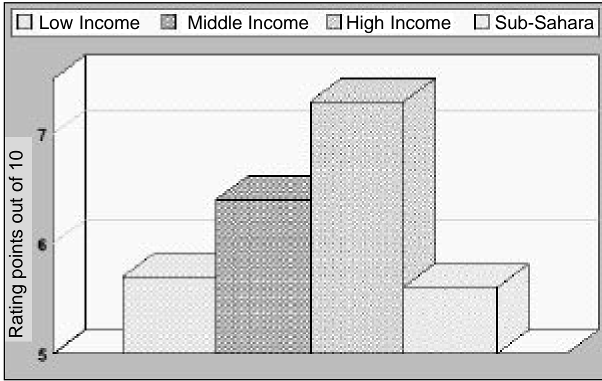
The myth that 'the rich get richer and the poor get poorer" is addressed below under the heading 'poverty and inequality'. There are two related myths to the effect that the same happens between countries, the first being that rich countries get richer and poor countries get poorer, and the second to the effect that poor countries are at a disadvantage because they lack capital, markets, technology, skills, institutions and so forth. They can therefore, supposedly, not catch up with rich countries that use their competitive advantage to move even further ahead.

The first idea is not, technically, a myth. It is true as can be seen below, that the least free fifth of countries, almost all of which are African, get poorer on average, and the top fifth get richer, but this is a function of economic policy rather than being rich or poor. In other words, the poor get poorer when they choose poor policies.

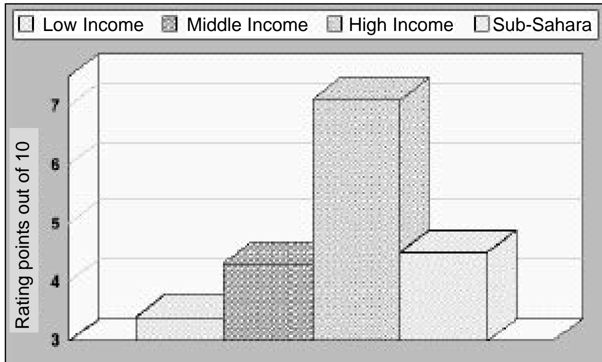
Are Poor Countries at a Disadvantage?— 'The Funnel'

Regarding the belief that rich countries can grow faster than poor ones because of superior endowments, the reality is what we call 'The Funnel', with some poor countries growing and some contracting at much faster rates than rich ones. Rich countries congregate in the narrow end of the funnel, neither growing nor contracting much. What matters is that there is nothing other than a lack of political will stopping poor countries from growing at spectacular rates. Conversely, the laws of economics are harsh. Whilst rewarding poor countries generously for doing 'the right thing', they are ruthlessly cruel when they don't.

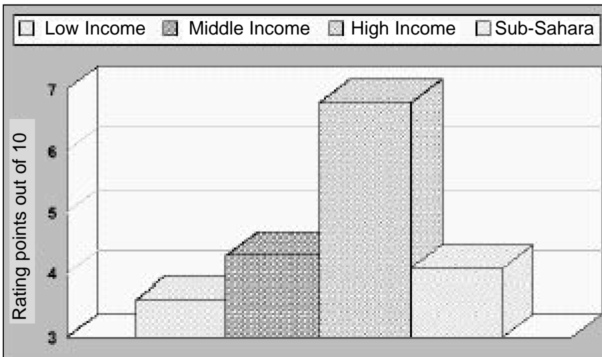
LMH and Sub-Saharan Africa Economic Freedom



LMH and Independent Judges



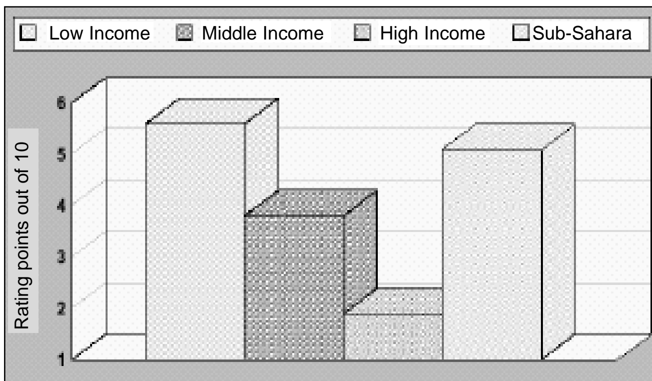
LMH and Imperial Courts



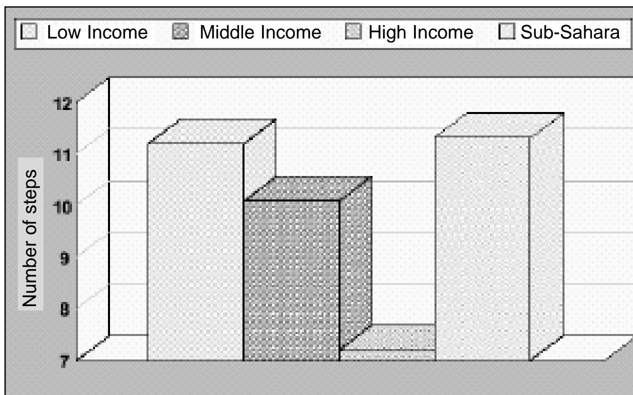
Why don't Poor Countries Choose Prosperity?

It is clear from the data what poor countries would have to change if they want to be more like winners, and it is clear from *The Funnel* that they are at no fundamental disadvantage. Since so few poor countries follow the example of the few that break from poverty to prosperity, it is necessary to see whether they are constrained in some way. There are many anecdotal and *a priori* views to the effect that poor countries do not have the sophistication

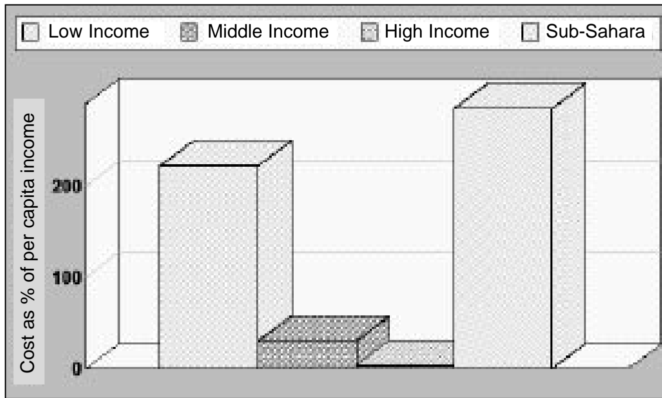
LMH and Regulations/Bribes



LMH and Regulations



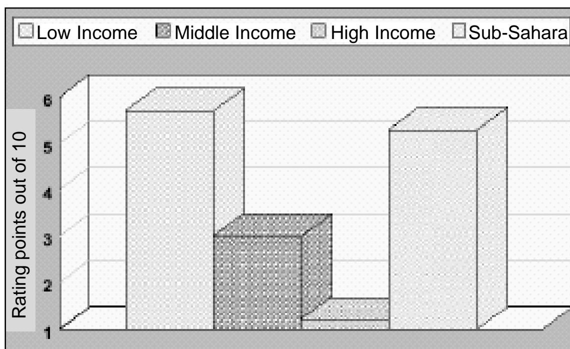
LMH and Telecoms Regulation/Internet Cost



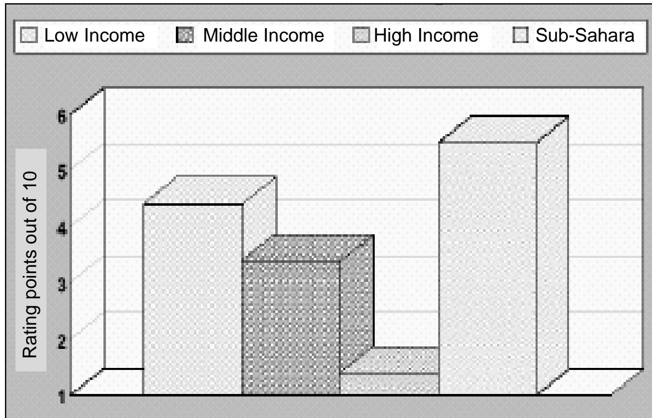
needed for a market democracy, that they should not or could not do without *dirigisme*, that aid from rich countries gives governments of poor ones irresistible incentives to cause poverty, that rich countries keep poor ones impoverished in mysterious ways for sinister 'globalization' reasons, and so on.

There seems to be no intellectually rigorous (testable) analysis behind such conjecture. Such hypotheses do not survive scrutiny. All suggestions that poor countries are at a disadvantage are refuted by a few basic facts.

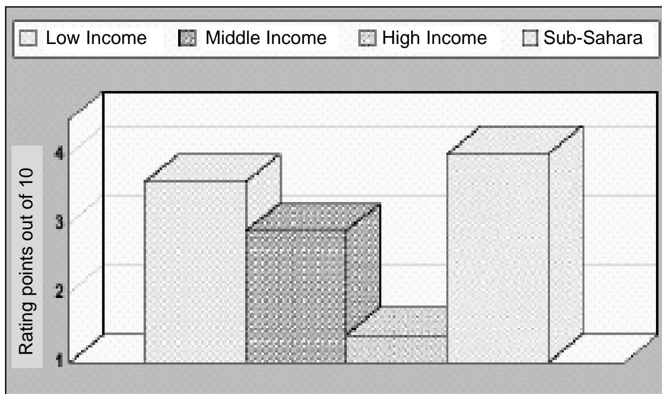
LMH and Military Interference in Courts



LMH and Restrictions on Foreign Accounts



LMH and Tariffs on International Trade

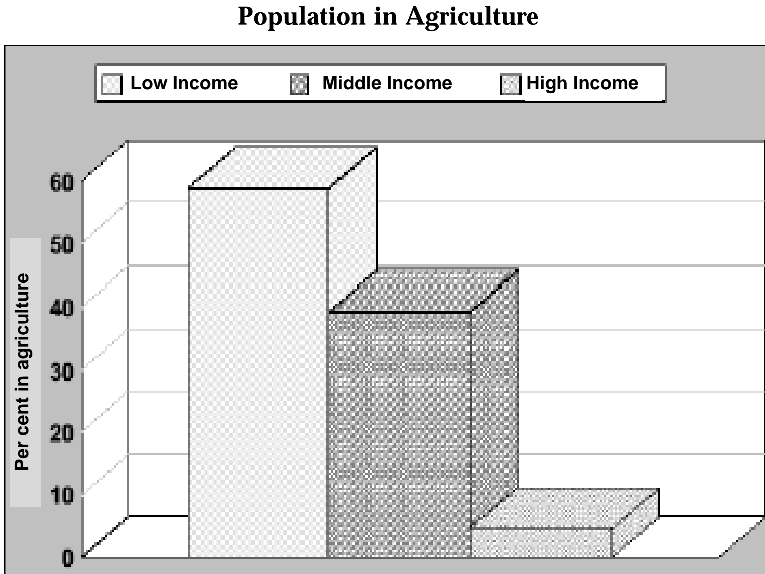


Many poor countries with diverse starting conditions (big or small areas or populations, hot or cold climates, resource-rich or resource-poor, previously colonized or independent, coastal or landlocked, mountainous or flat, white or black, religious or secular) became rich after their governments adopted policies that coincided with prosperity elsewhere. There is no reason to believe that, from a growth perspective, there is anything distinctive

about poor countries. That governments often say their country is a 'special case' may be an excuse for pursuing policies that failed elsewhere or for avoiding proven success factors in the interests of advancing hidden political agendas. There is disagreement among scholars on the significance of abnormal phenomena like conflict and disease. The evidence suggests that even such massive disasters as the incredible floods in Mozambique and the world's highest incidence of HIV/AIDS in Botswana do no more than slightly reduce high policy-induced growth rates.

- Some rich countries became poor after adopting policies that coincide with poverty internationally. Argentina was one of the world's richest countries. It regressed under Peronist policies of the type that usually coincide with stagnation and regression, and is now a poor country. China also regressed economically under Maoism, and Zimbabwe is doing so under Mugabe. The economic performance of these countries is predicted by the policies they followed.
- The idea that first world policies, or 'globalization', cause third world poverty, also appears to be mistaken. Many poor countries achieve high economic growth rates under conditions that are supposed to hold them down. They seem to grow in direct response to internal policies, almost as if global conditions are irrelevant. It may be that governments fail to achieve their policy goals because they mistakenly believe that their fate depends on

Population in Agriculture



external forces, to which end they may divert energy to try to create favourable international conditions rather than to get things right at home.

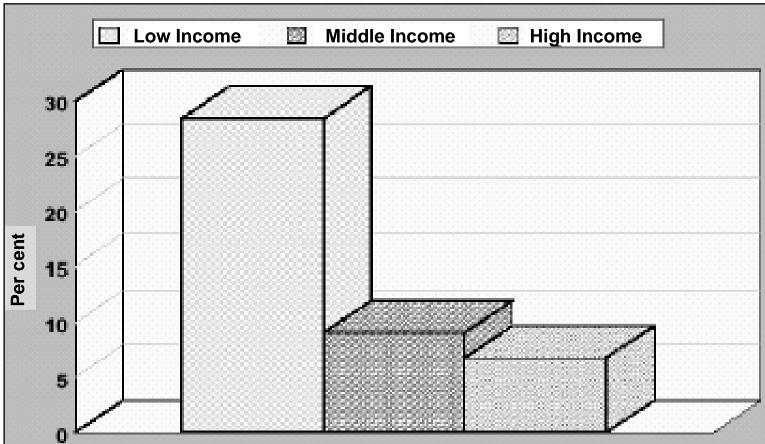
- The most conclusive refutation of third world poverty theories is that the world's highest growth countries—the ones getting richer fastest—are poor countries. As explained later in the discussion of the income gap, a much higher growth rate in a poor country might add less in nominal terms to its per capita wealth than the addition to a rich country's wealth where growth is much slower. In this sense the 'gap' between rich and poor countries may grow irrespective of how spectacularly poor countries perform. The essential point is that, whatever the current income level of a country, the best that can be achieved is for it to grow fast. Comparisons

between itself and other countries on the basis of relative wealth should be ignored.

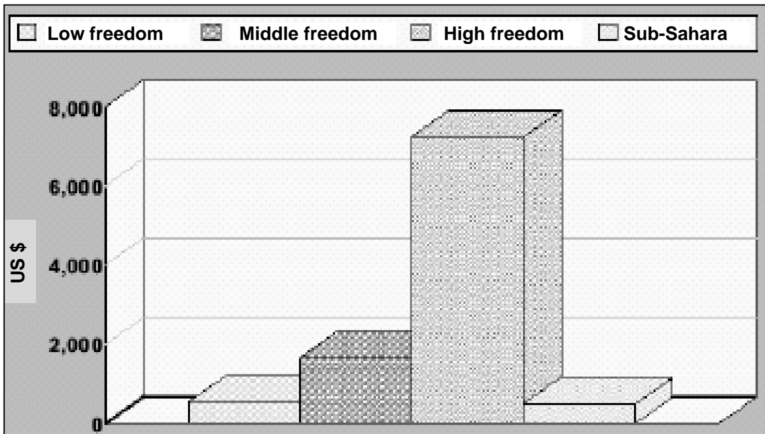
- This income gap anomaly is similar to the off-a-low-base phenomenon. When the observation is made that a poor country, say Mozambique, is achieving one of the world's highest growth rates, a typical retort is 'yes, but it's off a low base'. This is a virtually meaningless statement, yet it is exceedingly common. Is high growth meant to be easier to achieve off a low base? Perhaps this is so, but most poor countries stagnate or contract. What matters is the fact that poor countries appear to respond, as do rich countries, to whatever domestic policies their governments adopt. The only difference according to the data, as explained below, appears to be that the effects of comparable policies in rich and poor countries differ only in extent and not in substance.

The following graphics show characteristics of low, middle and high-income countries (LMH), and how these compare with sub-Saharan African countries. They appear fully to explain why Africa is poor, despite having been decolonized for many decades (starting with Ghana 50 years ago), despite being richly endowed with natural resources, and despite trillions of dollars in aid. They also show some of the critical factors African governments would have to change if they want to have more in common with winners and less in common with losers.

LMH and Undernourishment



LMH and Investment per Worker



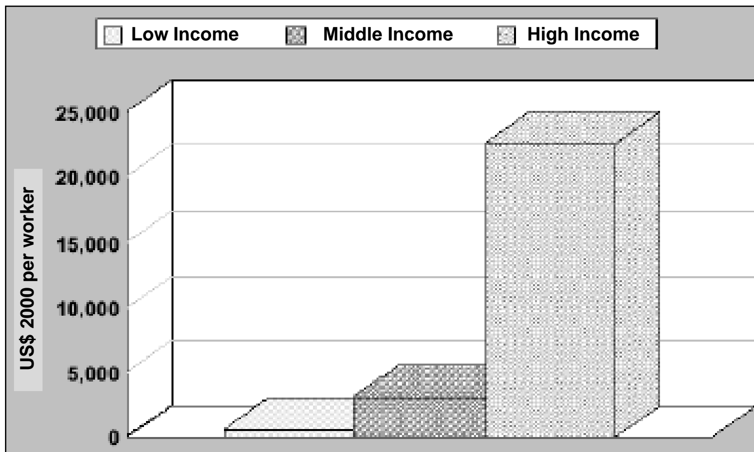
Poor Countries have Poor Policies

The following charts show aspects of the plight of poor countries, apparently due to poor policies.

Land and Agriculture

African countries, and especially Zimbabwe, are tormented by conflict over land, often called 'the land

Output per Agricultural Worker



question'. The underlying assumption is that people need land to prosper and that when the 'wrong' people hold too much land, 'landless masses' suffer as a result. The evidence does not support this view. Firstly there is no significant correlation between 'access to land' and prosperity. If anything, the reverse is true—where there are more people 'on the land', there is more poverty. Prosperity coincides with urbanization, and the conversion of rural and agricultural land to agribusiness, with farming being regarded as simply a form of enterprise.

Romanticisation of agriculture is virtually universal. Rhetoric about the need for countries to be food producers is common; yet there is apparently no evidence that people need to produce food to have it. Agriculture and land markets remain one of the last bastions of controls in India, all for the wrong reasons.

What markets do—all markets—is convert by a seemingly miraculous technology what people have into

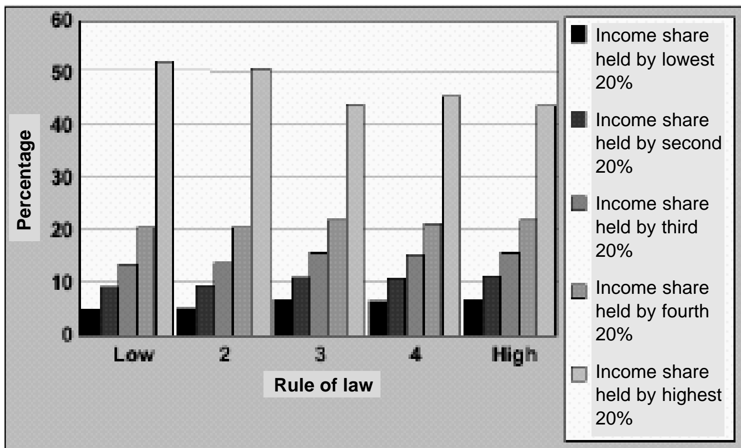
whatever they prefer. All one has to do to change platinum and gold into food or clothes is put it in ships and send them into the ocean. They return a few days later with clothes or computers. Wine farmers put surplus wine in ships and they return with books and radios. Prosperous countries, like individuals, concentrate on selling what they do or produce competitively and buying goods and services from whoever supplies them on the most favourable terms. This ability to trade is what distinguishes man from animals and birds.

The Indian government has been liberalizing foreign trade at a modest pace. This shifts the country towards free trade, which characterizes rich and high growth countries. But this logic also extends to domestic policies, including agriculture.

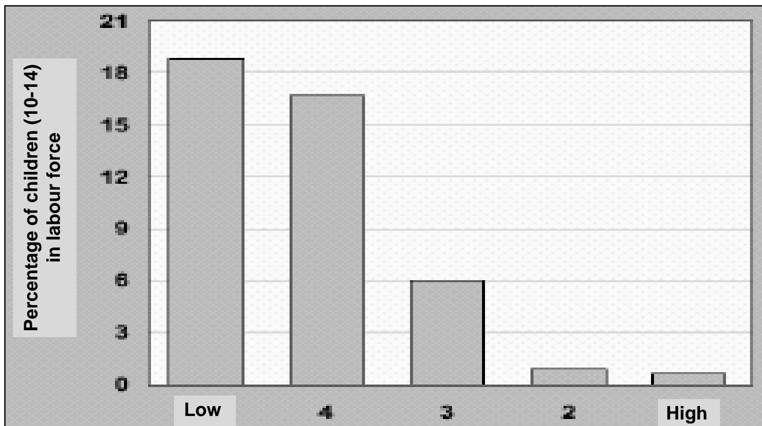
Not Policy Formulation

This document does not recommend policies. It provides information that can assist policy makers to formulate policies. What, if anything, policy-makers

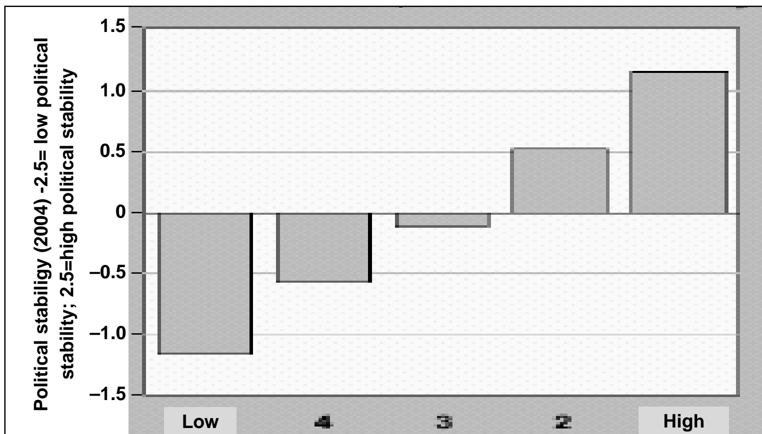
Rule of Law and Inequality



Rule of Law and Child Labour



Rule of Law and Political Stability



should do with this information is beyond the scope of the exercise, which does not consider or attempt to resolve complex political imperatives that make it difficult or impossible for governments to follow the example of the world's most successful countries. When it is clear that policy A is more likely than policy B to achieve objective

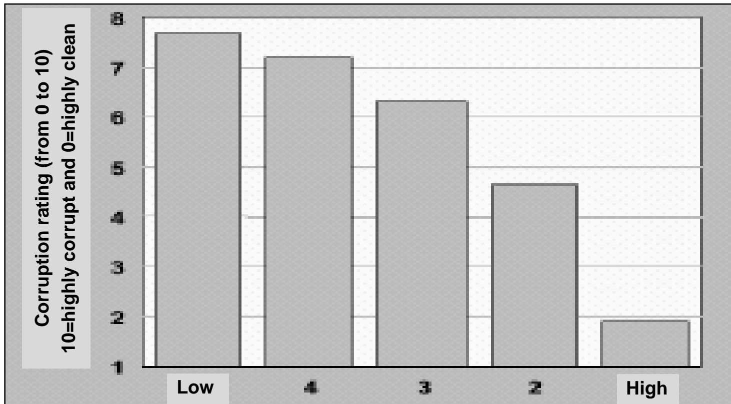
X, and that policy C is likely to be counter-productive, C might be chosen anyway. For instance, A, the policy most likely to succeed, may be unconstitutional or unconscionable. Even if forced labour is the best way to increase farm production, it should be rejected for constitutional and human rights reasons. B, though less effective, may be politically impossible, such as the conversion of all game reserves and wilderness areas to farms. C, which may reduce the likelihood of achieving the objective, may be chosen because it achieves other preferred objectives. It can be decided legitimately to reduce farm production because the arable land is more valuable for urbanization, eco-tourism or mining. One of the most obvious examples of this sort of trade-off is the retention of game reserves and wilderness areas for conservation purposes at the expense of agriculture. Agriculture is often not the best way to use rural land. Eco-tourism, for instance, often yields more revenue.

The Integrity of the Legal System is Crucial for Growth

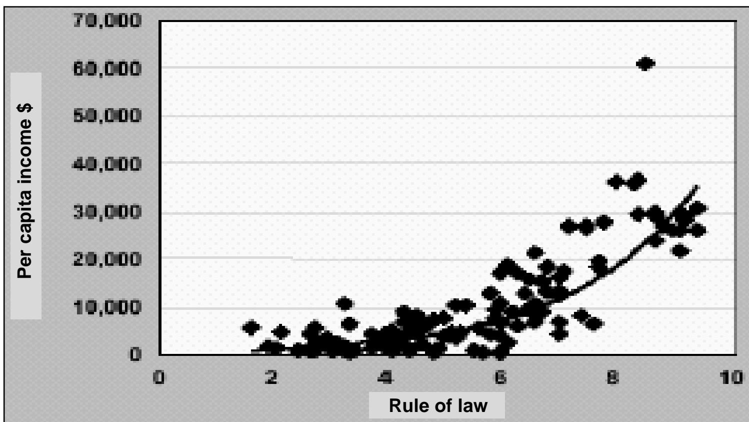
Perhaps our two most important findings are that certain common beliefs and axioms are unfounded, and that the single most important factor for India's major policy objectives is jurisprudential rather than economic, namely the integrity of the legal system. Almost all governments in the post-communist era pay lip service to "the rule of law". Everyone from George Bush to Robert Mugabe says they uphold the rule of law, yet they and most other leaders, perhaps unwittingly, violate it routinely. What matters, it seems, is the extent to which governments understand what it means in practice, that

they know spontaneously when things they are tempted to do to govern expeditiously and decisively are ill-advised because they violate aspects of the rule of law, some of which are elusive and subtle.

Rule of Law and Corruption



Rule of Law and Income



Once coinciding factors are identified, the logic of various disciplines can be applied to establish probable

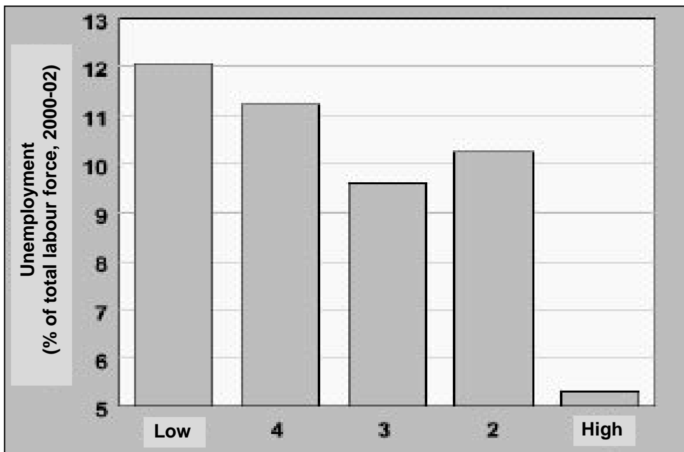
Rule of Law and Investment

causality and the feasibility of implementing policies that appear on paper to be ideal.

The evidence suggests that a conceptually simple way to reduce corruption is to subject public administration to extreme controls ('checks and balances' and 'red tape'). Even so, the government is likely to continue, probably justifiably, to reduce red tape within government, whilst increasing the imposition of red tape (regulation) in the private sector, and it is likely to try to find other, perhaps less effective, ways of combating corruption. It will do so in order to improve the efficiency with which its policies are implemented ('delivery').

Does this mean that corruption is an inevitable concomitant of 'lean and mean' administration? What countries with low levels of corruption have in common is a combination of the two most significant success factors for virtually all policy objectives. The first and most important of these is the degree to which the government understands and upholds the rule of law.

Rule of Law and Unemployment



The rule of law has various jurisprudential components, all of which reduce the likelihood of corruption and abuse of power. The most significant components are, however, substituting discretionary power with objective criteria and making the separation of powers a living reality. The separation of powers requires that lawmaking be returned to legislators and adjudication to the judiciary; that it be removed from the executive where legislative and judicial functions have been concentrated incrementally.

The natural propensity of governments is to transfer legislative and judicial functions to the executive. Everyone familiar with the tendency for so-called 'subordinate legislation' to be made within the executive branch of government, and for judicial 'activism' by the courts, will be aware of many anecdotal examples.

The second corruption-reducing factor is for the economy to be relatively free of controls (private sector red tape or 'regulation'). The corruption index correlates

strongly (inversely) with the rule of law index: a lower rule of law score coincides with more corruption. The converse is true of regulation: more regulation coincides with more corruption.

Growth-inducing Factors are not Necessarily Obvious

One of the most instructive aspects of this research relates to those factors that do not coincide with policy objectives. There are many beliefs that certain factors are conducive to prosperity; factors that seem so obviously correct that they tend to be accepted without evidence. There is a powerful notion, for instance, that natural resource endowment or substantial spending on education coincides with high economic growth. It is easy to assume that countries rich in natural resources outperform countries that lack resources and that the presence of natural resources may be a statistically significant non-policy factor in foreign exchange revenue, or that conducive climates ensure high agricultural yields. As already observed, the most important factors are government policies, which means that any country can achieve almost any policy goal by adopting the right policy mix.

Since every benefit comes at a cost, policy makers would benefit from cost-benefit analyses of whatever policy they consider. Regulatory Impact Assessments (RIAs), if done properly, will give them an idea of the expected costs and impacts of policies. RIAs, however, tend not to address the more complex and potentially more important question of how promoting objective A, for example consumer protection, will impact on B, C and

D, which may be availability of credit, product range and prices, or investment and innovation.

After analyzing many variables, it became clear that there are usually costly trade-offs. Laws promoting improved working conditions, job security and high wages often succeed for people with jobs, but coincide with high unemployment. Consumer protection laws often coincide with reduced service, innovation and choice, especially for the poor. There are many such examples. Indeed the isolated pursuit of a single objective usually has perverse secondary consequences, often doing more harm than whatever benefits are achieved—economic growth being the exception.

CHAPTER 4

THE GROWTH IMPERATIVE

Wealth Creation

Everything gets better with growth. Growth matters for two reasons. Firstly, there are many statistically significant concurrences, but by far the most significant, as already mentioned, is that almost all policy makers' objectives are achieved in rich countries. The evidence suggests that countries become richer faster if their governments implement high growth policies, that is, policies that characterize high growth countries. Secondly, few people realize how much faster countries become much wealthier if they achieve just slightly higher growth rates. This 'growth imperative' section addresses these two aspects in turn.

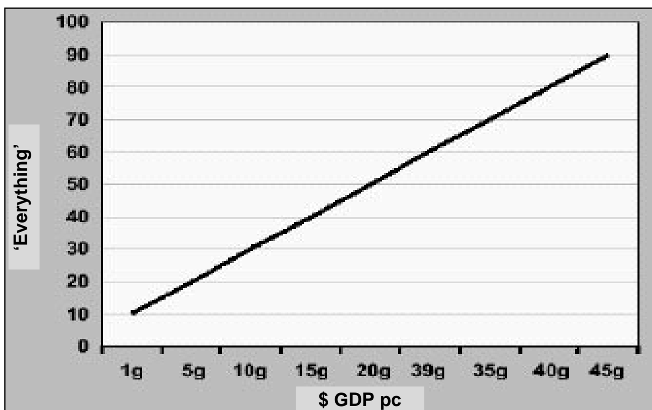
The overwhelming coincidence between growth and most policy objectives suggests that growth is both an effect and a cause. Factors that are good for growth are likely to be factors that are also good, for example, for savings, investment, job creation and competitiveness. Additionally, high growth means more wealth and coincides with more and better education, health care,

infrastructure, security, safe water and clean air.

High growth tends to follow the implementation of the specific policies identified in our research. Those policies also appear to be good for almost everything else that policy makers desire.

It is commonly assumed that 'society' and 'the planet' endure massive impacts as side-effects of economic growth, that growth promotes social tensions and class conflict, causes resource-depletion, destroys the environment, endangers species, pollutes rivers and oceans, and much more. The reality is much more satisfactory. Almost every indicator of human and environmental well-being is much better in rich than in poor countries and, instead of causing problems such as social or environmental damage, these indicators improve rapidly at high growth rates. In his book, *It's Getting Better All the Time: 100 Greatest Trends of the Last 100 Years*, the late Julian Simon (with Stephen Moore) summarizes most of the relevant data to show that, notwithstanding the propensity for catastrophism, most things are getting

Whether makes 'Everything' Better



better for most people in most countries most of the time. This is a popular version of more substantial books, such as his seminal *The Ultimate Resource II*.

By achieving the single objective of high economic growth, governments can get as close to 'free lunches' as reality permits. Economists tend to regard this as so obvious that they proceed without illustrating the point with hard data on the determinants of economic growth. This project is indebted to them for it. It means that it was possible to draw on what has been done, which does not yet include comprehensive value-free identification of all factors coinciding with high economic growth.

Although the facts no longer leave room for serious debate, most people, even experts, remain surprisingly uninformed. The relevant point here is that everything examined suggested that growth is the best way to achieve policy objectives. With prosperity, it makes surprisingly little difference what non-growth policies governments adopt. High growth appears to be very forgiving. Policy makers can make many mistakes and the consequences will be ameliorated if there is high growth. There is, of course, no index for 'everything'. The following chart is a stylized way of illustrating the point. Components of 'everything' include over 500 factors for which there are published data and indices.

The Good Society and its Friends

Thanks to Sir Karl Popper's seminal book, *The Open Society and its Enemies*, the concept of the 'open society' has passed into common usage. Social philosophers have used many terms to describe the ideal world. An open society is one of its components. Prosperity is a term that implies material well being in some countries, and

spiritual well being in others. Terms like emancipation, liberation, social justice, fulfillment, the ideal society, the good life (Socrates), or simply the good (Plato, Aristotle) are also used. The American Constitution uses general welfare. Religious believers speak of societies informed by faith or their religious values. Ideologues want socialism, liberalism, capitalism and the welfare state. The comprehensive concept, for which there are no unambiguous definitions or words, embraces all aspects of life and too many factors to be researched immediately but it does invite incremental research over time. Our approach permits us to identify what coincides with any desired state of affairs.

Objectively, almost everything is getting better almost all the time, for almost everyone, almost everywhere. While philosophers, scientists and policymakers debate the nature of the ideal society, millions of people are voting with their feet. They go from poor to rich countries. The poorest of the poor do not need this research to tell them that most things are better for most people, especially destitute people, in rich countries. They want to live in prosperous countries and they want to live in their own countries: they want their countries to prosper, and they want their policy-makers to know how to make that happen.

One way to imagine the good society is the degree to which people are happy. There are various attempts at measuring happiness. Quality of life indices do so, the most recent and sophisticated being that of the Economist Intelligence Unit. Measures of human misery amount to the same thing inversely. There is a World Database of Happiness (http://www2.eur.nl/fsw/research/happiness/).

The first government to measure its performance by the happiness of its subjects is Bhutan. In 1972, King Jigme Singye Wangchuck said he was more concerned with Gross National Happiness than with Gross Domestic Product. There is a lot to be said for this idea conceptually. A measure for happiness overcomes the concern that economists are too obsessed with monetary measures of well-being. This would be a legitimate concern were it not for the fortuitous fact that all measures of wellbeing tend to move in sympathy with each other: richer societies are happier societies. Perhaps ordinary people can be trusted to know better than intellectuals what is good for them, and they want to be in rich countries because, in their judgment, they have better security, welfare, justice, human rights and so on.

There are many possibilities, some general and some specific. There is even a Tax Misery Index (http://pdf.forbes.com/media/pdfs/TaxMisery.pdf). According to the Happiness Index, people are happier in freer societies, although they tend to believe that things are getting worse when, in fact, they are improving.

Examples of 'everything'

There are hundreds of published indicators of conditions generally regarded as preferable. Most refer to the human condition and a growing number are concerned with the environment. More wealth, democracy and press freedom; less crime, unemployment, discrimination and inflation; higher life expectancy and literacy rates; cleaner air, less endangered species and a stable climate; better respect for human rights, and so on, are generally regarded as preferable. Exceptions to the general rule that

everything is better in wealthier societies are hard to find.

There is a view that well-being should not be measured in material terms, the most fundamental question being: under what conditions are people happier? Various alternatives have been considered, such as indices for happiness, life satisfaction, quality of life, misery, and hardship. Bhutan has happiness as an official policy objective. There is no recognized index measuring simply how people feel. Surrogates are usually used for happiness, such as arbitrary presumptions about the supposed (de)merits of specific religious beliefs, cultural factors, 'sustainability' or participation in civil society. Some indices should be dismissed because they are ideologically contrived to avoid the fact that people enjoy and seek material wealth. The evidence suggests that, in most countries, wealthier people are happier. However, in the world's few rich countries, more wealth does not appear in all studies to coincide with more 'national happiness'. The Economist Intelligence Unit (EIU) ranked the 'quality of life' in 111 countries (*The World in 2005*), and found that the 'main factor' in 'life satisfaction' is income. When all nine factors in their index are considered (health, political stability, family and community life, climate, job security, political freedom, and gender equality) richer countries are not always happier, but richer countries are usually happier. There are, for instance, no poor countries in the top twenty, and no rich countries in the bottom twenty. India is ranked 73rd out of 111 countries and has a quality of life rank that is 23 ranks higher than its per capita (purchasing power parity) GDP rank. Zimbabwe is ranked last.

The EIU also produced a 'hardship' index, with similar

results. There are other indices, such as a 'human misery' index, which found less misery in rich countries, with Switzerland topping the list.

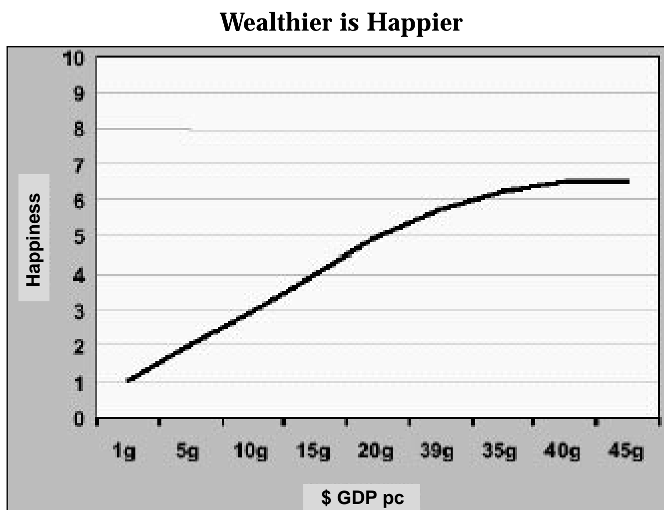
World Values Survey produces 'happiness' and 'life satisfaction' indices, which also reflect strong correlations between national happiness/satisfaction and wealth, as does the European Foundation's 'quality of life' survey, which 'reveals that levels of individual well-being reflect levels of national prosperity and the quality of society, with dissatisfaction, unhappiness and feelings of alienation being concentrated in Europe's poor regions'.

Taken together, diverse indices correlated with wealth can be represented, like 'everything' above in a stylized manner, plateauing off to reflect that within very rich countries, more national wealth may not produce more national happiness.

Health

Life expectancy (longevity) is recognized as an indicator

Wealthier is Happier

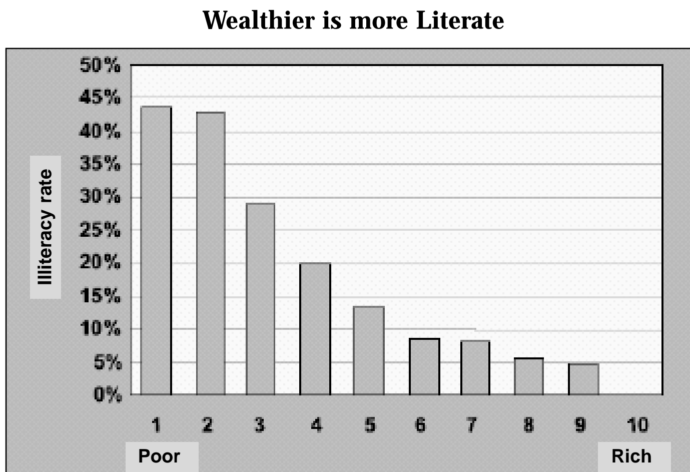


of health. There are many disease-specific health indicators, such as cancer and heart disease rates (adjusted for same-age people), and disease prevalence estimates, especially 'diseases of poverty', like AIDS, malaria and tuberculosis. It is clear from the evidence that wealthier is healthier.

Literacy

Adult literacy rises rapidly in sympathy with wealth. Most adults are illiterate in the world's poorest countries and there is virtually no illiteracy (<0.1%) in the world's richest countries.

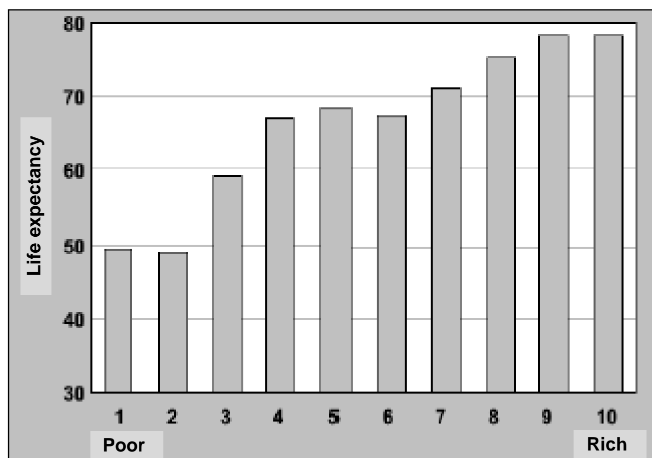
Wealthier is more Literate



Human Development

Economists used to dominate the definition and measurement of the human condition. They concentrated, and still do, on 'economic growth', measured with increasing sophistication, though with debatable accuracy, changes in the 'gross domestic (or national) product',

Health (longevity) and Wealth

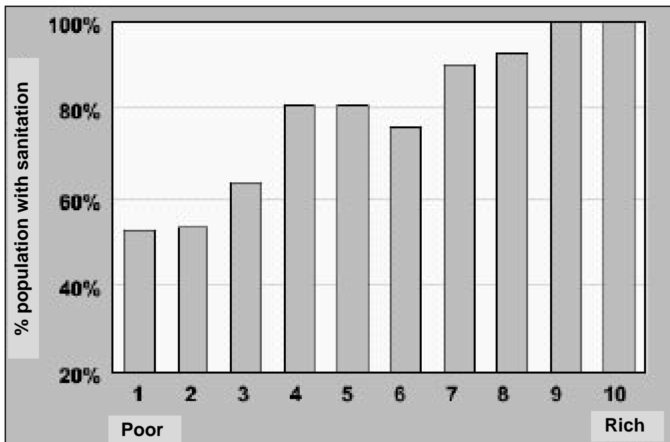


which is essentially the amount of economic wealth produced in a country. Other social scientists were concerned about other, perhaps more important, factors than material wealth, and have developed a range of alternative indicators. The best known of these is the Human Development Index (HDI), published by the United Nations Development Programme (UNDP). It turns out that most alternative indicators of human well-being, including the HDI, are better when there's more wealth.

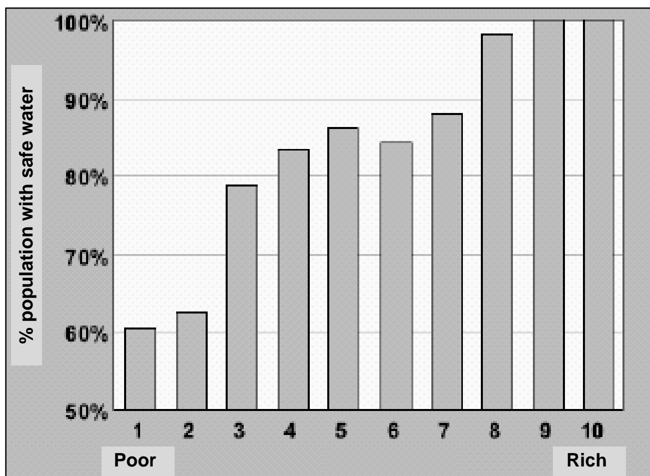
Sanitation

The proportion of people with 'improved sanitation' (effective disposal of domestic waste) is a recognized indicator of hygiene, health and pollution. Access to sanitation ranges from virtually none in the world's poorest rural communities to 100% in rich countries.

Sanitation and Wealth



Sanitation and Wealth



Water

Available indices for access to safe water and the literature on the subject indicate that access to safe water varies from virtually none in poor communities and countries to 100% in rich ones.

CHAPTER 5

POVERTY, INEQUALITY AND DESTITUTION

Should there be a ‘war on poverty’?

Most people in India will shudder at this question being asked. ‘Poverty and inequality’ are often referred to as if they are two sides of a coin. They are, but not in the sense usually assumed.

‘Poverty’ has two distinct meanings: destitution and inequality. The latter meaning refers to the omnipresent fact that some people have more wealth (or some other advantage) than others. Inequality is a relative concept. However, relatively poor people often enjoy high living standards, such as ‘poor’ people in rich countries, who are among the wealthiest people on earth. Curiously, this is the sense in which the term is usually used, despite the obvious fact that saying ‘poverty and inequality’, where poverty means inequality, is as nonsensical as saying ‘inequality and inequality’. Used in its proper sense, poverty is an absolute concept, such as, the percentage of population below a poverty line.

It makes sense to combine the terms only in the first

sense, destitution, not just for the reason given, but because there is less inequality in (a) rich countries and (b) in ones with high growth rates. Furthermore, compassionate people are more concerned about destitution than whether rich people by global standards have wealthier compatriots.

Both inequality and poverty raise blood pressures in India, especially if issues like gender, caste and religion are brought in. Inequality and the allied notion of poverty can take different forms. In the last resort, development and deprivation are about individuals, since specific individuals may be poor or earn low levels of income relative to others. Ascribing poverty or inequality to collective identification, be it based on geography (States, districts, rural versus urban areas) or caste (SCs, STs, OBCs, religious minorities) or even gender amounts to use of surrogate and simplified indicators. Collective identification can commit the double error of not including the deprived in the assumed "have" category or of including the developed in the assumed "have-not" category.

For a long time, the poverty/inequality debate in India was mired in methodological issues concerning the comparability of the large sample NSS (National Sample Survey) data of 1999-2000 with that of 1993-94. Thus, the debate on the effects of post-1991 liberalization on poverty and/or inequality took place in the complete absence of any reliable data, notwithstanding attempts to make NSS 1999-2000 comparable with NSS 1993-94. This changed with the availability of the NSS 2004-05 (61st round). The drop in poverty in 2004-05 has already been mentioned, at least at an all-India level. But the poverty ratio is high in Bihar, Chhattisgarh, Jharkhand, MP, Maharashtra,

Orissa, UP, Uttarakhand and Dadra & Nagar Haveli. NSS collects data on expenditure, not income and inequality based on expenditure distributions are bound to be lower than those based on income distributions and this raises problems in cross-country comparisons. But having said this, the Gini coefficient (a measure of inequality) was 0.305 in rural India and 0.375 in urban India in 2004-05. By international standards these are not high levels of inequality.

Let us now turn to the international story. Which policies coincide internationally with less poverty and more equality? Equality in this context does not refer to equal rights (equality in law), or equal freedom from discrimination (equal treatment), but to equal material circumstances (material equality—incomes and living standards). The most commonly published and recognized indicators of material equality are the Gini Coefficient, and upper and lower categories of income earners (the top and bottom five, ten, twenty or whatever per cent).

Fortuitously, policy makers do not have to promote one at the expense of the other because there is no trade-off—prosperity does not exacerbate inequality. They do not have to decide whether less destitution (decent living standards for people at 'the bottom of the pile') is more important than relative poverty (the 'income gap').

A common, tenacious and very dangerous misconception regarding inequality explains why many commentators, especially in social sciences, doubt whether economic growth is good for the poor. This misconception informs the notion that redistribution should take precedence over growth, whereas growth *per se* is

spontaneously redistributive and egalitarian.

The Income Gap Fallacy

On April 4 2006, BBC World ran a programme on China in which one of that country's biggest problems was reported as being that high growth was causing an increase in the income gap. This is a sentiment that will find resonance in post-1991 India. However, the poor appear to be getting poorer whenever there is growth, even if they get richer much faster than the rich. It is easy for policy makers to be misled by the 'income gap' anomaly into adopting 'income redistribution' policies. Simple arithmetic explains why poor people usually benefit more from growth than redistribution.

Person	Income	Growth	Result	Gap
Rich	$10,000	+ 10%	= $11,000	(Initial gap -$9,900)
Poor	$100	+ 10%	= $110	$11,000-$110= $10,890
Poor	$100	+ 20%	= $120	$11,000-$120= $10,880
Poor	$100	+ 100%	= $200	$11,000-$200 =$10,800
Poor	$100	+ 1000%	= $1,100	$11,000-$1,100 =$9,900

Poor people in rich countries are much better off in absolute terms than their counterparts in poor countries—and they know it, which explains the global propensity for poor people to migrate (lawfully or unlawfully) to rich countries, usually from countries where governments redistribute more to ones where they get fewer hand-outs, especially as immigrants. Inequality is similar in rich and poor countries (the 'income distribution' in poor and rich countries is similar). If the GDP of rich countries is ten times that of poor countries, the poorest people in rich countries tend to be ten times richer than poor people in

poor countries. The significance of this is that if, say, the poorest 20% of people in the richest country were to be regarded as a separate country, that country would be one of the world's richest. In other words, poor people in rich countries are poor only by comparison with the world's richest elites.

It was widely lamented by critics of economic growth that the white-black income gap grew during the USA's prolonged high growth period (from Reagan through Clinton). They created the impression that the rich were getting richer and the poor, poorer. In truth, although the gap was growing, the poor were also getting richer faster.

Year	Low income	Growth	Result	High income	Growth	Result	Gap
1	$100	+ 20%	= $120	$1,000	+ 10%	= $1,100	$ 980
2	$120	+ 20%	= $144	$1,100	+ 10%	= $1,210	$1,066
3	$144	+ 20%	= $173	$1,210	+ 10%	= $1,331	$1,158
4	$173	+ 20%	= $207	$1,331	+ 10%	= $1,464	$1,257
5	$207	+ 20%	= $249	$1,464	+ 10%	= $1,611	$1,362
6	$249	+ 20%	= $299	$1,611	+ 10%	= $1,772	$1,473
7	$299	+ 20%	= $358	$1,772	+ 10%	= $1,949	$1,591
8	$358	+ 20%	= $430	$1,949	+ 10%	= $2,144	$1,714
9	$430	+ 20%	= $516	$2,144	+ 10%	= $2,358	$1,842
10	$516	+ 20%	= $619	$2,358	+ 10%	= $2,594	$1,975
11	$619	+ 20%	= $743	$2,594	+ 10%	= $2,853	$2,110
12	$743	+ 20%	= $892	$2,853	+ 10%	= $3,138	$2,246
13	$892	+ 20%	= $1,070	$3,138	+ 10%	= $3,452	$2,382

The reason why concern about the income gap is misleading is clear from very simple arithmetic. If rich person A earns $10,000 and poor person B earns $100 the 'income gap' is $9,900. If they both get 10% richer thanks to an abnormally high 10% growth rate, A has $11,000 and B $110, and the new 'gap' is nearly $1,000 bigger (from $9,900 to $10,890).

If A gets 10% more whilst B gets a stupendous 100% increase, A gets, as before, $11,000 and B celebrates having twice as much (from $100 to $200) … until someone points out that even if B's income grows ten times faster than A's the 'gap' grows from $9,900 to $10,800, again by nearly $1,000. B's income would have to grow an impossible 1000% merely to maintain the initial $9,900 gap.

If, at the outer limits of what might be achieved in the real world, B's income rises twice as fast as A's (20% versus 10%) in a highly successful country exceeding 10% growth, it will take 13 years for B to reach A's initial income, but by then A will be earning $3,452 and the gap will have more than doubled from $980 to $2,382. At these rates, the relative gap does close, but very slowly, A's income declining from 1000% to 323% of B's over the 13-year period. It will take many years for the nominal gap to start closing. After many more years incomes will equalize.

The real-world gap between rich and poor is much more than the simple round numbers used for this illustration. 'Rich' people earn a few hundred times more than poor people. Reality for people who fantasize about a world with closing income gaps is that all increased prosperity—any growth at all—increases the income gap. The only way to prevent this is stagnation or depression ('negative growth') as in Zimbabwe.

The table shows what happens over time with a mere ten-fold difference between rich and poor, and that income gaps in the crude popular sense close only under conditions of extreme hardship, especially for the poor.

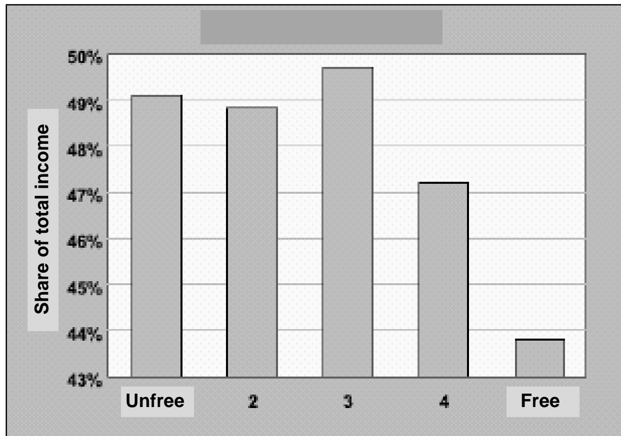
In Freer Economies 'the rich get richer and the poor get richer faster'

There is a widespread assumption that there is more inequality and poverty, however defined, in freer economies, where governments redistribute less wealth. Fortuitously and, perhaps, counter-intuitively, there is only a small difference in levels of equality of condition between free and unfree economies on average, and there is much less absolute poverty (destitution) in freer economies.

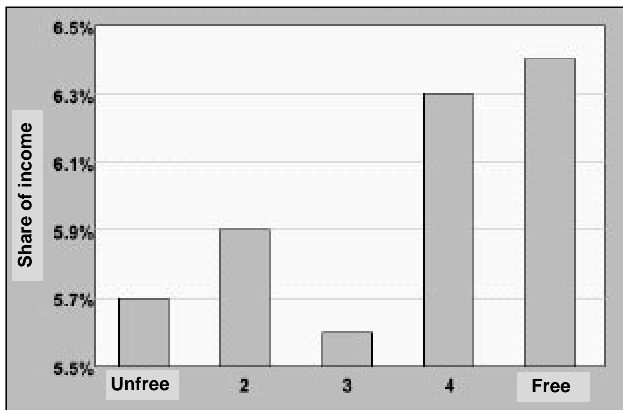
The following chart (2001) shows the Gini Coefficient (from zero to one hundred on the vertical axis, where higher scores mean less equality) and quintiles (five groupings) for unfree to free economies on the horizontal axis. There is virtually no difference in levels of inequality between free and unfree economies. To the minimal extent that there is a difference, free economies are characterized by more equality. Of greater significance according to the second perspective, is that the poor have much higher living standards in free economies, which may explain

Economic Freedom and Equality
(0 = equality; 100 = inequality)

Income of Top 20%



Economic Freedom and Income Share of Bottom 20%



why poor people tend to migrate from economies that are less free to those with more economic freedom where governments supposedly do less for them.

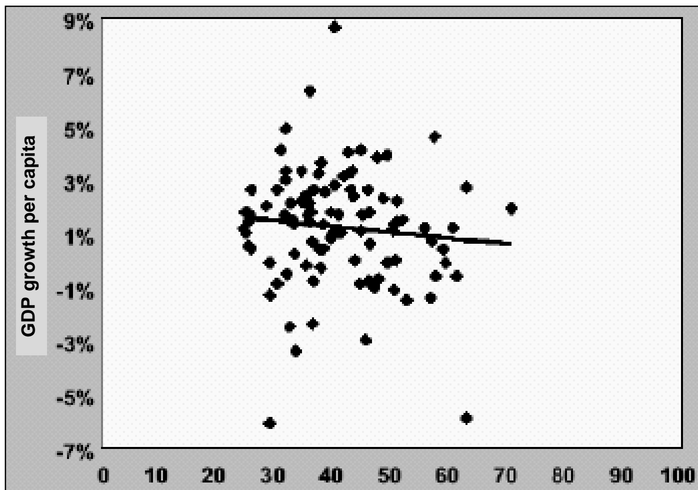
Having seen that during all growth periods the income 'gap' is likely to grow even if the poor get richer much faster than the rich, and the preceding chart shows there

tends to be more income equality with more economic freedom, what remains is to establish what happens during high growth. Since economic freedom coincides with higher growth, and with greater equality, it is to be expected that there is more equality during high rates of economic growth, and indeed there is. However, it is a weak correlation, which is apparent from the scatter distribution around the trend line.

The Miracle of Poverty

Countries are classified as low (<$825 pa), middle ($826-$10,066) and high (>$10,066) income. Numerically, most countries are middle (94), and roughly equal numbers are rich (55) and poor (59). Middle-income countries are sub-

Growth and Equality (Gini)



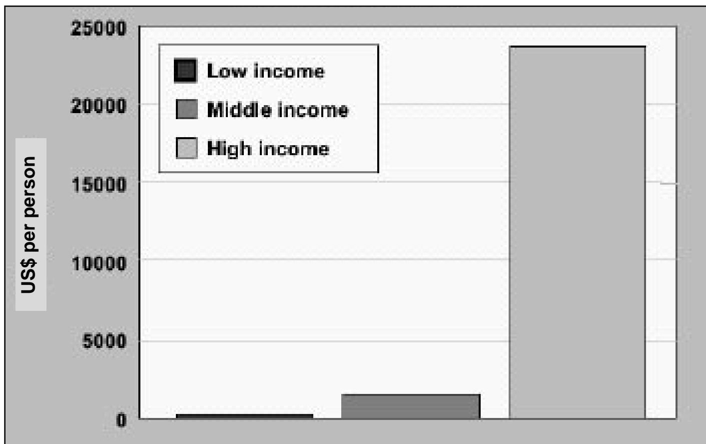
divided into 'upper' and 'lower' middle income countries. Middle-income countries, despite their classification as 'middle', are much closer to poor on average than to rich.

What this means is that three-quarters of the world's countries are relatively poor and a quarter are rich. There is no reason to doubt that all countries would be rich in less than a generation if they adopted the habits of highly effective (rich and high-growth poor) countries.

If the grouping of countries is reduced to these three categories, a simplified, but perhaps clearer, picture of the implications of being rich or poor presents itself.

If being rich is the policy maker's answer, how to become rich is the question.

Average Incomes in Low, Middle and High (LHM) Income Countries

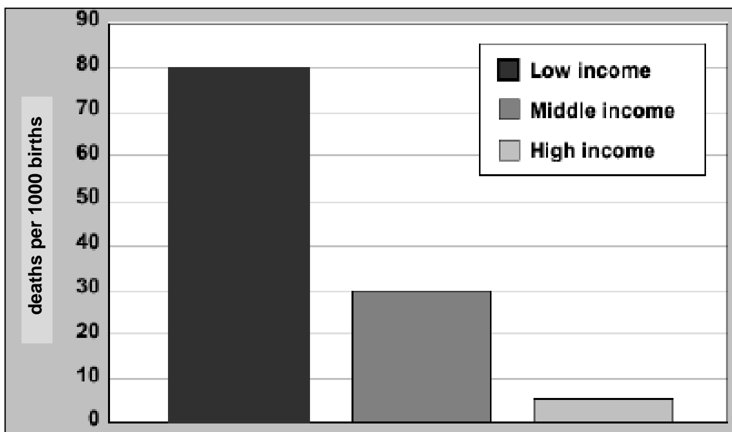


Analyses range from casual observation that capitalist economies appear to outperform alternatives, to complex mathematical modeling and econometric analyses, which generally reach the same conclusion. The evidence that freer economies tend to outgrow less free ones is now so overwhelming that it is no longer subject to legitimate informed debate. Given the degree to which governments now know how to achieve prosperity, the interesting

question is why don't they? Why are most countries poor? The answer may be that there are other policy goals, such as environmental, political, cultural, religious and social goals. Policy makers advance some of these other goals at the expense of prosperity. However, this report shows that almost all other goals are achieved more expeditiously and substantially when countries are rich, to which end they must grow—the faster it seems, the better. This report is a contribution to policy makers in the hope that they will be better informed and therefore better equipped to settle policy priorities optimally.

It has been customary to call the handful of countries that achieved very high rates of economic growth—catching up, and, in some cases, overtaking their colonizers, such as Hong Kong and Singapore overtaking Britain, 'economic miracles'. The evidence suggests that

LMH Income and Infant Mortality



there was really nothing miraculous about these splendid successes, that they may have been typical examples of the natural result of high levels of economic freedom

objectively measured. When not unduly constrained by taxes and controls, people in such countries appear to prosper naturally and automatically.

In a very real sense it is not wealth, but poverty that is an economic miracle. Left to their own devices, people appear to trade and manufacture, thus producing wealth spontaneously. That there are so many policies that curtail this natural propensity, and that governments, often equated with inefficiency, succeed in achieving poverty is a formidable accomplishment. That Mauritius, and now China and India, suddenly started growing at spectacular rates happened naturally when constraints were relaxed.

Growth, the Eighth Wonder of the World

Albert Einstein, Barney Baruch, Arthur C Clarke and other luminaries are credited with calling compound growth 'the eighth wonder of the world'. Whoever it was, the awesome power of compound interest is one of the most significant weapons in the policy maker's armoury. The compounding effect of sustained economic growth is experienced by a country's citizens much more rapidly and substantially than most people realise. Dividing 70 by a country's growth rate, according to the 'Rule of Seventy', is an easy way to calculate how many years it takes for wealth to double.

At 7% growth the average person is twice as wealthy in 10 years. At 1% it takes seventy years, thirty-five years at 2%, and just seven years at China's 10% growth rate. That's how important it is to accelerate India's growth from 8% to 10%.

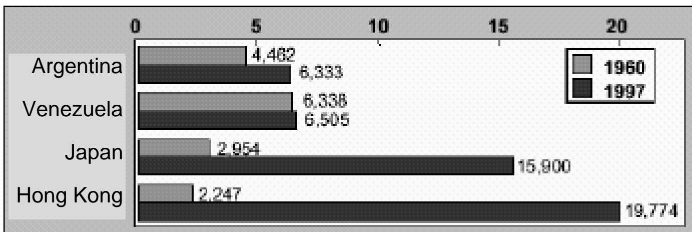
This chart contrasts the adverse impact on Argentina (1%) and Venezuela (0.1%) of slow growth, with Japan (4.7%) growing at rates recently achieved by South Africa

and Hong Kong (6%). In a generation Hong Kong and Japan went from half to three and four times South Africa's per capita GDP.

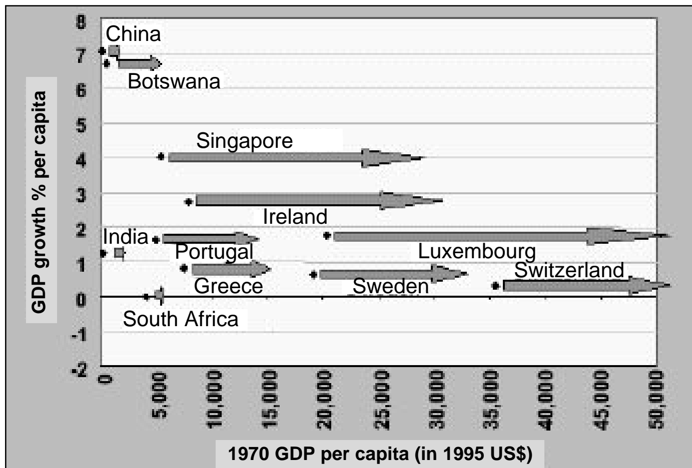
The next chart shows where India will be, 5, 10 and 20 years from now, if it grows at four alternative growth rates of 4%, 6%, 8% and 10%. The visual impact is dramatic and in the absence of a visual depiction, it is often difficult to appreciate the exponential impact of growth.

If growth is so critical for the achievement of almost all policy objectives, how do the world's winners perform? Many countries achieve high rates of growth for atypical

Per-capita Income (in 1000s of 1985 US$)

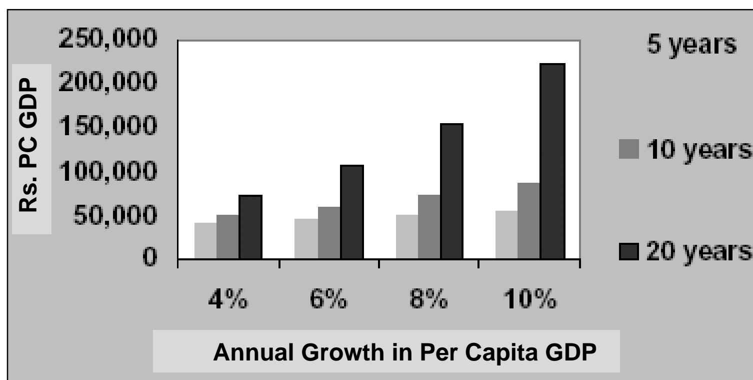


Growth and Resultant Wealth (1970-2001)



years. They can do so with relative ease by means of techniques often employed when governments need

PC GDP after 5, 10, 20 Years



short-term popularity, such as the run-up to an election, or when there is political instability. One of the most common and effective techniques is 'priming the pump', whereby governme nt spending (financed by increasing the money supply) is increased. The problem is that such growth is more apparent than real, and is unsustainable. If a country is to be transformed from poor to rich, it needs sustained growth for a few decades. Historically, India hasn't performed as well as the world's top performers. 1991 changed that and especially since 2003, there is greater optimism. If India achieves and sustains a growth rate of 10% or a per capita growth rate of (say) 8%, it will become a winning nation. This report identifies what the government would need to do for its policies to coincide with those of sustained high growth countries.

It is more difficult than generally recognized to know what the growth rate really is. The per capita growth rate is more significant than aggregate growth, because it

indicates the extent to which the average person has rising living standards. The problem is that there is great uncertainty about the country's population size and the population growth rate. The per capita economic growth rate is the aggregate nominal growth rate, adjusted for inflation, minus the population growth rate, in other words, the rate at which the average Indian is getting richer, bearing in mind that poor people tend to get richer faster than rich people.

Population estimates have been adjusted periodically, usually downwards. The matter is compounded greatly by uncertainty about mortality from new diseases. Notwithstanding these qualifications, the fact is that more economic freedom is associated with faster growth and more wealth.

The classification of economic systems is based on an index derived from a number of policy variables. Policy makers want to know which of them are particularly significant; they need components 'unpacked' with a view to establishing a short list of the most important. If components are removed one-by-one, most will not make a significant difference. Governments can probably 'get away with' compromising those aspects, but they have to know which are crucial. Some are addressed at different context-specific places in this report. Some components don't have to be the focus of special attention and having them in an index dilutes the degree to which the index predicts growth rates and other objectives.

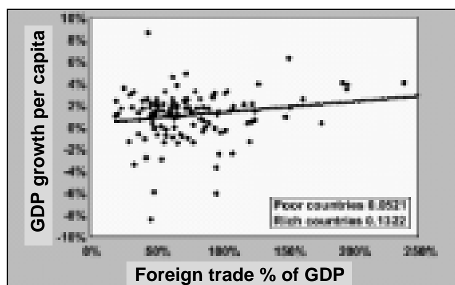
Capital—What it is and does

Lay people, and even some economists, seldom appreciate how important capital is. This may be because

it is equated with capitalism, and socialistically minded people are inclined to ignore or dismiss it. However, it is no coincidence that Marx's *magnum opus* was called *Das Kapital*, or simply 'Capital' in English. The serious debate is not whether there should be capital formation on a grand scale for a country to prosper—on that there is consensus—but who should win and control it.

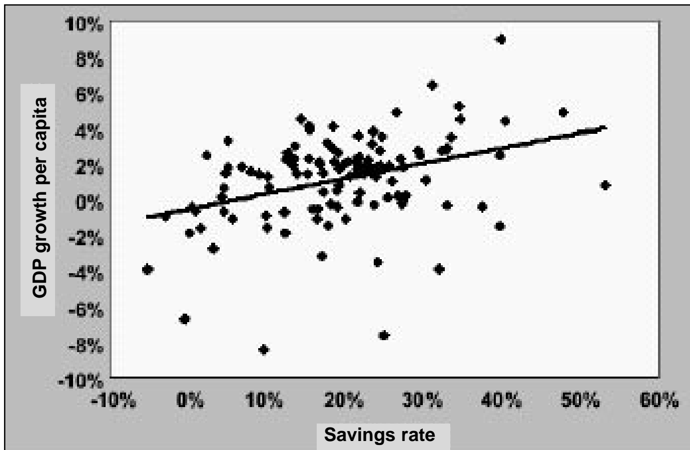
Without capital, labour does everything with bare hands. Everything used to supply goods and services, from a spade to an ocean liner, is capital. Anything such as tools, technology, equipment and facilities that enable workers to do more than they could with their bare hands and without skills, is capital, which enables individuals and society to prosper. Capital formation may be the single most important non-policy contributor to prosperity. It is therefore necessary to identify under what conditions there will be most capital formation. The evidence suggests that privately held capital is more productive and creates more and better paid jobs. More importantly, there are higher rates of capital formation with higher growth rates, which, in turn, are associated with more economic freedom. Let's not forget that in India, after 1991, the rate of capital formation has increased and so has the efficiency of capital usage (the inverse of the incremental capital/output ratio). In 2006-07, the rate of capital formation in India was 35.9%. In 1990-91, it was 26.0%.

Growth and Foreign Trade



For there to be capital there must be savings, so policy makers should know how to promote savings. Again, there is a strong positive correlation between growth (and freedom) and savings. In 2006-07, the savings rate in India was 34.8%. In 1990-91, it was 22.8%.

Growth and Savings

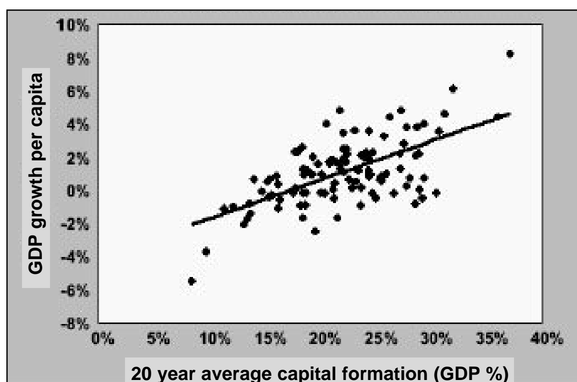


These correlations could work in either direction, and they may well be bidirectional, in that they feed on each other. Policy makers should promote growth to promote capital and savings, which in turn, probably promote growth in a fortuitous loop.

Another factor coinciding with high growth is free trade, meaning less import tariffs and no protectionism. That this is controversial is a political and social matter. This project is concerned with what policy makers need to know as they navigate their way through a quagmire of pragmatic trade-offs.

The stronger correlation between freedom to trade and growth than between foreign trade and growth may mean that the benefits of free trade exceed trade itself. It may have additional secondary benefits in the form, for instance, of improved machinery and technology. It goes beyond improved productive capacity. Easier and cheaper access to imported consumer goods and services may motivate increased domestic production and thus income with which to acquire imports.

Growth and Capital Formation



Things People Know that just ain't so

Mark Twain is reputed to have said, 'the trouble with people isn't their ignorance, it's the number of things they know that just ain't so'. Many examples of such false suppositions were encountered during this research. Methodology and provisional findings have been discussed with many experts locally and internationally, from whom constructive suggestions and criticisms were received.

Some experts insisted, often with passion, that this research had overlooked important and proven growth-generating factors. There is an inclination to assume that some determinants of growth are so obvious and predictable that they do not need research-based substantiation, or that the necessary research has been done. Examples are the axioms that economic growth involves the rich getting richer and the poor poorer, that natural resources make countries rich, that domestic food production is important, or that increased investment in education and lower taxes promote growth.

These and other factors that are supposed to be determinants of prosperity were tested. As a matter of statistics rather than theory or belief, they do not individually or together coincide with or precede high growth to a statistically significant degree.

Education for Growth?

At almost every meeting during which research findings were presented, there were people who felt strongly that more should be spent on education and training by government and philanthropic donors, and that 'skills development' is a crucial contributor to economic growth. Because of so much passionate conviction on the matter, considerable effort was devoted to investigating the findings on these issues.

The caution is repeated that this is an exercise in finding coincidences, which are not necessarily causes. Higher education budgets are not followed by higher growth, or by the attainment of other policy objectives (apart from education itself). Education may well be a growth determinant, but if so, there may be trade-offs of the kind

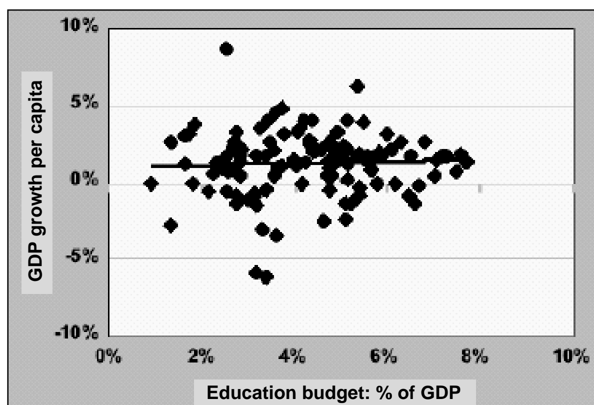
explained above which offset the contribution of education to growth. That apart, is education a public good, as is often assumed, or is it a private good?

That increased education spending does not appear to stimulate growth is not a case against improving education. On the contrary, education can be seen as a highly valued end in itself, as one of the substantial rewards for growth rather than one of its causes. Growth appears to provide the wealth with which to improve education as an end in itself.

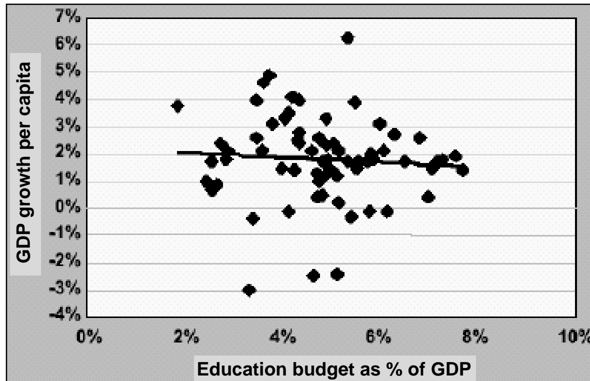
There is a single exception, namely that tertiary education spending on adult males is associated with higher growth. This may be an anomaly or pure coincidence. The matter was not pursued because discriminatory polices, even if empirically sound, would be politically untenable and probably unconstitutional. For the same reason literature suggesting that national IQ averages are a determinant of growth was not researched.

A recurrent proposal is that there should be a shift from general education to technical or vocational training. The assumption is that it would better equip people to get jobs,

Education Budgets and Growth (all countries)



Education Budgets and Growth
(rich countries: $2000+pa)



render them more productive, and increase the country's wealth. Anecdotal examples, such as Japan and Taiwan, are popular. There is, to our knowledge, no hard evidence to support this view.

Higher literacy rates coincide with prosperity; there is more illiteracy in poor countries. Higher literacy rates appear to follow rather than precede higher per capita incomes.

Increased education budgets and growth are highly correlated. Does this mean that growth provides resources for education or that education provides skills for growth, or are they both attributable to a third factor? That they are linked may be pure coincidence. What needs to be established is how consistent the correlation is. In how many countries does it occur? Are there differences between groups of countries, say rich and poor ones, or big and small ones? Does the correlation hold over long periods? Are there enough countries in the sample to be statistically significant?

There is an almost direct correlation between infrastructure and education spending. Protagonists of bigger education budgets or greater scope for private education commonly attribute growth and the sophisticated infrastructure associated with it to improved education. Conversely, protagonists of infrastructure development (whether government or private) attribute growth and the improved education that accompanies it to infrastructure. Sequencing analysis shows that both education and infrastructure improvements follow growth. In other words, they may be considered amongst the rewards countries enjoy because they achieve high growth rather than what they need to do in order to grow.

However, where more years of higher education have been completed by 25-year olds, especially men, there is significantly higher growth. There are weaker correlations between completed years of primary and female education.

These charts show that there is no statistically significant correlation between education budgets and economic performance. In rich countries higher education spending coincides with lower growth. To find out if more spending on education typically precedes or follows high growth the data were examined and they suggest that education follows growth. In other words, if countries want growth the data do not suggest that they will achieve it by spending more on education. If they want more to spend on education, they should first implement high-growth policies.

Non-factors

Many people have strong views on what governments

should or should not do to promote prosperity and other policy objectives. Bald assertions to the effect that what 'they' should do is so-and-so abound in casual conversation, popular articles, books, speeches and, less forgivably, intellectual publications. Sometimes there is empirical evidence supporting such views; more commonly there is not. This table lists some of the more common examples with observations.

It is often asserted, usually by lay people, and sometimes by experts who ought to know better, that what countries need in order to prosper are factors for which there is no rigorous measurement, or for which there has not been adequate analysis. Some factors not usually assessed do have indices: race, religion, caste and history, for example. The problem is that there are no objective measures of such factors, so it was not possible to assess their significance. Where there were measures, they were, within reasonable limits, tested. The following table lists factors that are popularly believed to be determinants of prosperity, but for which there does not appear to be hard evidence. Leading contenders in the un-testable, evidence-less league are amorphous concepts like 'leadership', 'commitment' and the 'work ethic'.

Factors Commonly, but Mistakenly, Presumed to be Determinants of Prosperity

Factor	Observations
Age	On the mailer of country age, commentators want to have it both ways. One view is that old countries are better off than new ones because of established institutions -having 'a head start'. Reverse logic has it that 'new brooms sweep clean', and young countries out-perform old ones by virtue of being more dynamic, not stuck in outmoded ways etc. In truth, there is no meaningful correlation between country age and prosperity, once like is compared with like (*ceterisparibus).*
Aid	To the limited degree that there is a correlation between aid and prosperity, aid is counter-productive. There are urban legends about post-war U.S. Aid supposedly explaining (West) German and Japanese prosperity. This is not the place lo elaborate, but every significant element of Marshall Aid mythology is mistaken (who was funded, by how much, when relative lo growth, etc). Calls for 'a Marshall Plan for Africa' reveal ignorance about it.
Colonialism (colony)	The view that colonialism explains poverty in post-colonial countries implies that countries which have been independent longer, should, on average, be wealthier. Two of the few countries that have existed for hundreds of years and never been colonised are at opposite ends of the wealth-development spectrum, Iceland (rich) and Ethiopia (poor). Conversely, one of the world's most spectacular success stories, Hong Kong, has at relevant limes been and, for practical purposes, remains colonised, whereas nearby Macau, with an almost identical set of variables (colonisation, size, race, etc), is poor. There are many such anecdotal examples at formal studies, which show that colonisation is not a significant determinant of a country's prospects.
Colonialism (coloniser)	There is no significant evidence to the effect that colonisers are better off than non-colonisers. Some of the world's poorest countries (China, Burma-Myanmar) colonised others, and some of its richest (Switzerland, Iceland) never had colonies. Obviously countries had colonies to benefit themselves, but colonising other countries is only one of many strategies, and not as effective as, say, US, Swiss and Japanese strategies. Most of the world's top 10 richest or highest growth countries never had colonies.
Democracy	Democracy does correlate with prosperity. Democracies without market economies are not prosperous, though they do seem

Factor	Observations
	to be somewhat more so than non-democracies with similar economic policies. Economic policies and the integrity of the legal system are much more significant.
Education	See text.
History	Current policies and institutions, rather than history, predict outcomes. History is obviously a significant determinant of a country's policies and institutions.
Infrastructure	Government spending on infrastructure as a proportion of GDP does not correlate significantly with prosperity. The evidence does suggest that spending on certain kinds of infrastructure, especially transport infrastructure, contributes to growth. *A priori,* since government infrastructure spending entails removing more wealth from the economy than spending on infrastructure (after administration, expenses, etc), it will constitute a net gain only if that spending produces more wealth than would have been generated had the resources been left in the private sector.
Leadership	It is commonly said that what a country needs is 'leadership'. There does not appear lo be any usable data with which the idea can be tested. Anecdotally, it should be remembered that many of the world's most significant, popular and charismatic leaders were people like Hitler, Stalin, Mao, Amin and Verwoerd, all of whom ruined their countries.
Natural resources	See text.
Political will	See 'Leadership' above.
Protectionism	This is a complex issue, on which there is scholarly literature.
Race	Is a factor - too sensitive lo address.
Religion	Every religion has adherents who are convinced that theirs is superior, that it will deliver more justice, wealth, happiness and redemption that any other. There is evidence that some religions are more conducive to material prosperity than other, well documented by Thomas Sowell especially. Economists might predict that Christianity and Hinduism are likely to outperform Islam because the latter forbids interest, which may prevent efficient allocation of capital. They might predict that Judaism is more consistent with economic theory than Catholicism, and therefore that Jews are likely to out-perform Catholics. What matters is that the evidence suggests that differences which may be significant within single economies, are minor compared to the impact of economic policy - the performance of followers

Factor	Observations
	of divergent belief systems is likely to differ less within a country than divergent fortunes of people of the same faith in different countries.
Resources	See text.
Size (area)	There are contradictory notions regarding country-size advantage. Sometimes *big* countries are presumed to be more likely to prosper because they have supposed advantages such as economies of scale, sufficiently large populations for an advanced division of labour and the like. The countervailing notion is that *small* countries are advantaged because small amounts of capital are sufficient to soak up unemployment and small increments in wealth amount to high rates of growth.
Size (population)	Protagonists of the view that population size is a significant determinant of prosperity are, as with country size and age, on opposite ends of the spectrum, some contending that small populations out-perform large ones, and others contending the reverse. The former refer to spectacularly prosperous mini slates (Monaco, Lichtenstein, Luxembourg, Singapore etc) and failed mega stales (USSR, communist China, Sudan, India, Indonesia, Nigeria). In the other corner disastrous mini stales are listed (Malawi, Lesotho, Rwanda, Burundi, Nauru, *et al*) and large winners (USA, Germany, Japan, France). There are, of course, only two truly large population countries, India and China, both of which are good examples of how immaterial population size is, because they shifted from being prosperous and advanced to being disastrous, and are now well on the road back to prosperity. In sum, population size *per se* is not a determinant of prosperity.
Trade	Some prosperous countries have 'closed' economies (USA) and some have 'open' economies (Singapore). Countries with lower trade barriers lend to outperform protectionist countries. Since some eminent economists (Alice Amsden, Jeffrey Sachs) espouse protectionism for developing countries, and refer to supposedly successful examples (South Korea, Japan), the profound flaw in their logic should be appreciated, namely that, if tariffs are a significant determinant of prosperity in those countries, there would be a positive cross-country correlation between protectionism and prosperity, whereas there is a negative correlation. The operative policy variables must be presumed to be other policies. What matters is what characterises winners and losers, and protectionism is a characteristic of losers, found in winners only where the majority of important policy variables are characteristic of winners.

Factor	Observations
Welfare	There is a curious argument to the effect that welfare statism promotes growth because it increases the buying power of the poor, which increases demand, promotes investment and so on. It overlooks the fact that welfare money given to A has lo be taken from B, and that people from whom lax is extracted are more likely lo spend (invest) money in ways that creale rather than consume wealth. It is not a surprise therefore that welfare stales under-perform on average, which could also be attributable to the fact that welfare statism lends lo coincide with other policies which compromise growth -Sweden being the conspicuous exception, where the market has been characterised by regulatory liberalism and privatisation.
Work ethic	There is apparently no leslable definition of the work ethic concept. Very compelling anecdotal evidence suggests that there is little or nothing lo the notion that some countries or cultures prosper because they are blessed with the 'work ethic'. The same German people in East and West Germany brought about disaster in the former GDR and the *wirtschaftswunder* in West Germany. Likewise North and South Korea, and Taiwan-Hong Kong *versus* China. However, Thomas Sowell, perhaps the leading authority on the economic significance of culture, has published at length on the subject, and concludes that culture is important and tenacious, but that the most significant factors are economic policy and the institutions of a free society. Culture, including such factors as the work ethic, and long-termism, are core determinants of inter-cultural differences within a country, Jews lend lo out-perform Catholics; Sothos lend lo out-perform Zulus; Hindus lend lo out-perform Muslims, and so on.

CHAPTER 6

THE MEANING AND SIGNIFICANCE OF 'FREEDOM'

Diverse meanings of 'freedom'

Since growth is the most significant precursor of the attainment of most policy objectives, and since the evidence suggests that freedom as defined by various organizations classifying economic, business and political systems is correlated with growth, the nature and significance of these classifications were examined. We are not concerned here with the innate virtues of freedom, or its divergent ideologically informed conceptions, but with the strong correlation between various freedom indices and prosperity, regardless of the philosophy that informs them.

As far as could be established, freedom indices are the only ones that coincide with prosperity to the impressive extent that they do. When countries become freer, they tend to start growing faster and many other things improve. This is what happened in India from the late 1970s, and even more so since 1991.

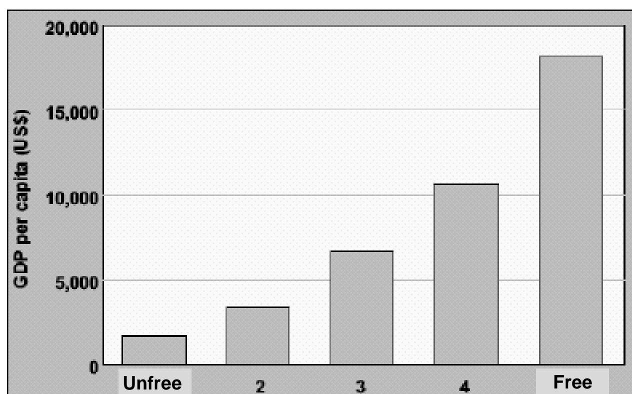
There is no simple or agreed definition of 'freedom' or

'economic freedom', even amongst people of the same philosophical persuasion. Fortunately, higher growth tends to coincide with more economic freedom regardless of how its protagonists define it.

There are only two recognized lists of countries ranked according to how free their economies are. These are the Economic Freedom of the World (EFW) report provided by the Economic Freedom Network (EFN) under the leadership of Canada's Fraser Institute, and the Heritage Foundation (HF) with the Wall Street Journal (WSJ). In addition, there are closely related classifications of economic and political systems, notably the Competitiveness Index (CI) by the World Economic Forum (WEF), and the Freedom House (FH) Index, which measures freedom generally, including economic freedom, but primarily political freedom.

Many studies compare regulatory environments, or labour and industrial policies, according to indices ranging from the least free to the freest, which may be called 'open', 'flexible' or 'accommodating'. These indices and studies

Economic Freedom (quintiles) and Wealth



were relied on heavily. FH scores for freedom, according to the FH definition (FH-freedom), correlate closely with economic freedom (E-freedom).

Economic Freedom and its Consequences

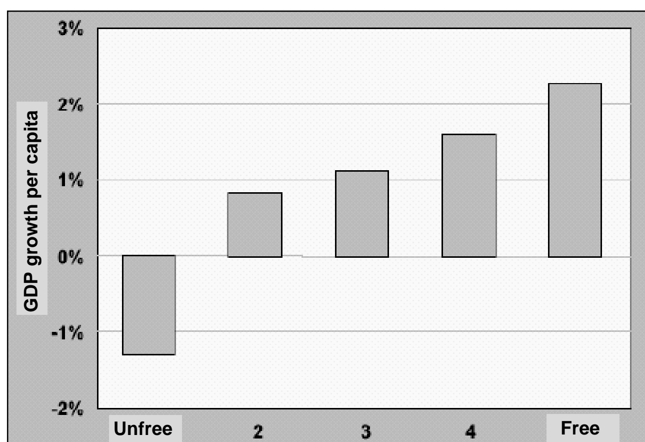
The EFW index shows a strong correlation between economic freedom and wealth (GDP). This correlation is usually interpreted as suggesting that wealth is a consequence of economic freedom, but the correlation by itself could equally suggest that once countries are rich they free their economies. It should also be remembered that, with a few exceptions called 'economic miracles', high-income countries got there over long periods, sometimes 100 years or more. This means that their wealth is the consequence of what they did many years ago, rather than now.

To establish whether economic freedom is the probable explanation of why some countries are rich, it is necessary to establish which policies characterized the periods of their growth. Economies may have stagnated or declined for many years along the way, such as those of post-war Britain and Spain. What has to be established is the sequencing of events—did wealth precede economic freedom or the other way around? Maybe they coincided as consequences of a third factor, such as democracy, and neither contributed to the other.

Analysis along these lines shows powerful evidence to the effect that economic freedom precedes growth and wealth, and that economic freedom coincides with democracy. In other words, economic and other freedoms (political, social, religious etc) tend to coincide as if they are aspects of a single paradigm. Aspects of freedom that

have the strongest correlations with growth and wealth are economic freedom and its legal-jurisprudential counterpart, the rule of law. The graph shows the GDP per capita in US$ of five groups of countries (quintiles), grouped together according to their levels of freedom, from 'unfree' to 'free'.

Economic Freedom and Growth



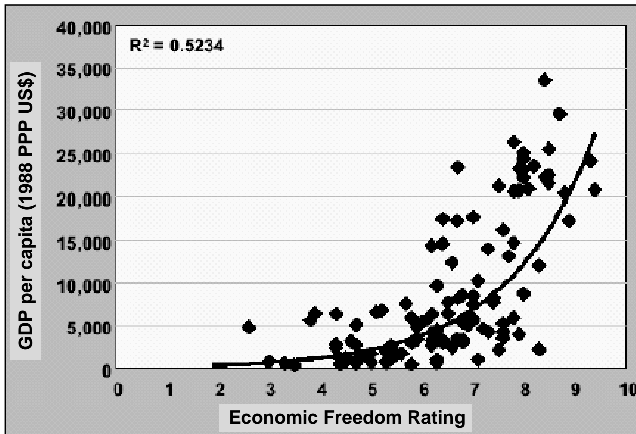
This, for more technically minded readers, is an economic freedom and wealth scatter-gram showing a R^2 correlation of 0.5234.

Since economic freedom coincides with growth and wealth, and almost all published indices show better scores in rich countries, it follows that economic freedom will correlate with those indices. There is, for instance, less poverty in freer economies.

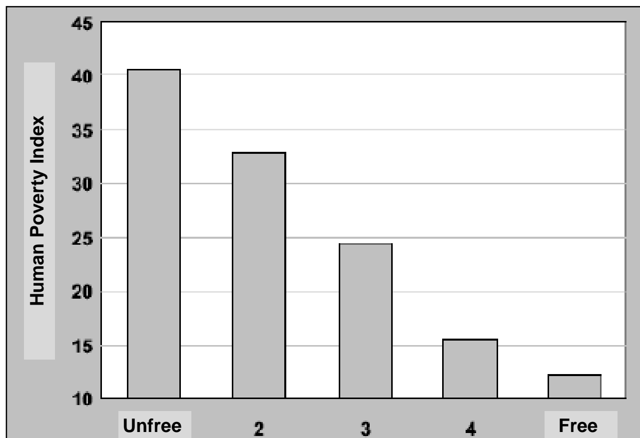
Political Freedom and Civil Liberties

It is no surprise therefore that FH-freedom also correlates positively with growth. FH compared FH-freedom with growth and prosperity and found more

Economic Freedom and Wealth (scatter)



Economic Freedom and Poverty



growth and prosperity coinciding with more FHfreedom (http://www.freedomhouse.org/research/freeworld/2001/essay1g.htm, and...1h.htm).

Remembering that causality cannot be assumed, this may mean that countries become free as a result of prosperity or prosperous because their people have freedom. To find out which was the case, the sequence of

occurrences was analyzed. Indeed dynamic analysis was a feature of the research, in contrast with most research, which examines static relationships.

Static analysis compares data at fixed points while dynamic analysis examines changing relationships. This might reveal that the current status of labour policy is not as significant as the direction of change, or that maximal impacts occur a few years after a policy is implemented. Policies in a given year may have consequences only three, five or even twenty years hence.

Most analyses of the influence of economic policies on economic performance compare economic policy at a specified moment with economic performance at that time, whereas the consequences of economic policies are likely to manifest themselves only a few years, perhaps decades, later. The Indian take-off didn't occur immediately, in 1991. There is always a time-lag and in the interim, it is incorrect to presume that policies have failed.

Researchers found that freedom (however defined) tends to precede prosperity, but there are instructive exceptions. Prosperity often occurs in countries with poor FH-freedom (China being a celebrated contemporary example; the Asian tigers are earlier examples), if they have high Efreedom. The world's experience appears to support the view that economic freedom may be a necessary and sufficient condition for prosperity. Conversely, FH-freedom sometimes, but not consistently, coincides with modest levels of prosperity in the relative absence of E-freedom. It seems as if countries, once developed, can sustain their prosperity with lower levels of economic freedom than those needed for poor countries

to prosper, and the best performance tends to occur when countries combine both forms of freedom. In any event, the cross-country experience doesn't suggest that there is a democracy tax and indeed, the case for a democracy tax becomes even weaker if one excludes the natural resource-rich economies.

All the well-known classifications of political, legal and economic systems include overlapping variables. These are a combination of some common factors and some that are index-specific. Policy 'variables' are simply government policies that vary from country to country and within countries at different times.

Some indices use many components (variables), some just a few. FH-freedom includes economic policy variables, on the assumption that more economic freedom is tantamount to more liberty. Equally, the Economic Freedom of the World (EFW) index, which combines 38 components, includes civil liberties on the assumption that there is more economic freedom when there is more respect for civil liberty.

Naturally, most variables in EFW are economic policies. Not only do different indices have some variables in common but they also often draw on each other. EFW, for instance, uses FH rankings to compile the 'economic freedom' index.

Not everyone agrees with Freedom House that more economic freedom is consistent with more liberty. Left wing intellectuals tend to regard less economic freedom as coinciding with more social freedom. Stated differently, the liberal conception of economic freedom is rejected in favour of the view that consumers and workers have more freedom when they are protected from 'exploitation by

market forces' through government intervention.

Freedom House Findings

In its annual survey, Freedom House analyzed economic growth in countries with populations of one million or more over a ten-year period and found an average annual GDP growth rate of 2.56% in countries classified as Free, 1.7% for Partly Free countries, and 1.46% for countries that are Not Free. This could mean that freedom is a consequence of prosperity and development as opposed to prosperity being a consequence of political and civil liberty.

In order to establish causation FH examined poor countries (less than US$5,000 annual per capita GDP) separately, and found that Free countries averaged 3.23% growth over ten years, which was more than double the average of 1.39% and 1.52% respectively for Partly Free and Not Free poor countries. FH concluded that, 'as a general principle, economic growth is accelerated in an environment of political freedom'.

Adrian Karatnycky of Toronto University found 'a high and statistically significant correlation between the level of political freedom as measured by Freedom House and economic freedom as measured by the Wall Street Journal/ Heritage Foundation survey' and that a 'primary factor' is the evidence that 'political freedom tends to reinforce economic freedom and a vibrant private sector based on property rights'.

Karatnycky and most commentators presume it to be 'the exception rather than the rule' that a few Not Free countries, such as China, have high growth, but this report shows below that China is not an exception to the rule. It shows that there is prosperity where there is economic

freedom. It seems to be true that 'economic growth is accelerated in an environment of political freedom', but it can and does exist without political freedom. Growth tends to be highest when political and economic freedom are combined in developing countries. The correlation between economic freedom and prosperity is stronger than between political freedom and growth, which is apparent from inter alia impressive gains in Africa which has not seen political freedom increase as much as economic freedom.

Nine of Africa's 53 countries are Free (17%), 25 are Partly Free (47%) and 19 are Not Free (36%). Freedom increased in eight and decreased in six. As such it is the world's least free continent, but not its least free region, which is the Middle East. Of Asia's 39 countries, 18 (46%) are Free, 10 (26%) Partly Free, and 11 (28%) Not Free. Although there is more freedom in Central and Eastern Europe than in Africa, 'progress toward the emergence of open societies has stalled or failed' in the less free European countries. Eleven of the region's countries are Free (41%), 10 are Partly Free (37%), and six are Not Free (22%). High growth in many countries in the Americas coincides with increased freedom there, with 23 (66%) of the 35 countries being Free, 11 (31%) Partly Free, and one (3%) (Cuba) Not Free. The Middle East has one (7%) free country, Israel, three (21%) Partly Free countries, and 10 (71%) Not Free.

'Pure' Statistics

The purely statistical approach in this report negates the need for taking sides on the debate about the meaning of freedom. It does not matter on which philosophical paradigm an index is based, such as the liberal democratic

approach of FH; whether more tax, labour regulation and one-channel agricultural marketing are regarded as constituting more freedom or less is therefore immaterial. As explained, this report is concerned simply with relationships between variables. This entire analysis could be written using terminology that characterizes the intellectual left or right without affecting the veracity or legitimacy of its findings. That its terminology is characteristic of classical liberalism is because that is the language most likely to be understood by readers and it is the paradigm within which most empirical growth analysis has been done.

In view of the positive relationship between liberty and prosperity, there is a possibility that it is a bad idea for poor countries to have economic or other freedoms; that they are appropriate or feasible only in developed countries. If that were so, poor countries with less freedom (as defined) would out-perform ones with more. Highest growth is found in poor countries especially when they have policies resembling those under which rich countries prosper, especially those which characterized rich countries when they were becoming rich. More significantly, such policies coincide with much higher growth rates when implemented in poor than in rich countries.

Even if poor countries adopt policies associated with rich countries after they became rich, they perform well, though not as well. In case the data merely reflected 'the dynamism of the advanced industrial countries', FH looked exclusively at poor ones and found the differences to be 'even more dramatic'. This coincides with our 'Funnel' showing that poor countries grow and contract faster than rich ones.

FH concludes that 'the survey's findings indicate that the promotion of political freedom is not exclusively a matter of values or morality… that political rights and civil liberties can reinforce economic development. And this in turn suggests that efforts to strengthen property rights, market systems, and the rule of law should be part of the effort by less developed countries to achieve growth'.

CHAPTER 7

IMPORTANT FINDINGS

The Acceleration Effect

Our research found that poor countries grow or contract faster than rich ones in accordance with the extent to which they have the policy characteristics of winners and losers. In other words, it is relatively easy for poor countries to catch up quickly with rich ones.

The Chinese government subscribes to the philosophy of another Nobel Laureate, Amartya Sen, whose view is that 'development is freedom'. Development improves social stability and serves as an internal economic engine for prosperity.

Our analysis went beyond policies *per se* to establish the significance of such variables as natural resource endowment, climate, stage of development, demography, geography and constitutional orders. Fortunately for governments, none of these variables correlated nearly as significantly with good society indicators as policy variables. This means that a country's fortunes are almost entirely within the power of government to determine.

There were interesting correlations that do not speak directly to the objectives of this project, such as the fact that there is less growth variability in rich countries than in poor ones. This suggests that it is harder for rich countries to achieve high growth rates than for poor ones, which is compensated for on the downside by evidence that suggests that the economies of rich countries will not contract rapidly even if they adopt policies that would be devastating in poor countries. However, the evidence also suggests that poor countries are particularly vulnerable to policy variations, which implies good news and bad news for developing countries, including our own. They crash if governments implement 'bad' policies and they boom in response to 'good' ones. Perhaps one should note that India's variability in growth rates has declined significantly since the early 1980s and in this, India stands out among developing economies.

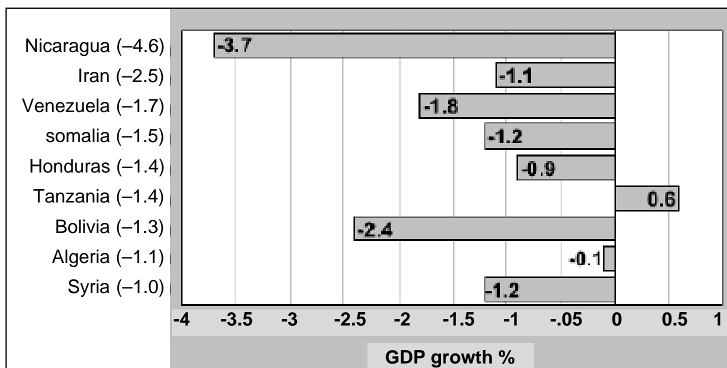
What is particularly encouraging for developing countries about the findings is the implication that they will be rapidly and generously rewarded merely for moving in the right direction, that is, away from policies that coincide with stagnation and contraction. We call this 'the acceleration effect'. On the other hand, because it works in both directions, developing countries with relatively high growth policy packages go into rapid and sharp decline if they move away from such 'good' policies. The best examples of this phenomenon are China and Zimbabwe. It is well known that China has enjoyed one of the world's highest rates of sustained economic growth. What is empirically curious is that it has done so despite having a relatively unfree economy at the start of its high-growth phase, which, in other countries, would have

coincided with impoverishment. By moving purposefully and convincingly towards policies that correlate with prosperity, China achieved sustained high growth rates well before its system had changed to the point where such growth might have been predicted on a static analysis of world economies. In the last couple of decades, a large number of people have been pulled out of poverty in China and India, depending on how one defines poverty and the time-line, close to 500 million people. When one thinks of the 1 billion still mired in poverty in sub-Saharan Africa, one shouldn't forget this 500 million.

The following charts show the acceleration effect for countries that had more than a one-point change in their economic freedom rating during the 1980s. Their economies grew (for increases in economic freedom) and contracted (for decreases in economic freedom) more than might have been expected.

It is critical when considering these findings to be mindful of the fact that these are not countries that are high or low on the EFW index, but ones that have moved

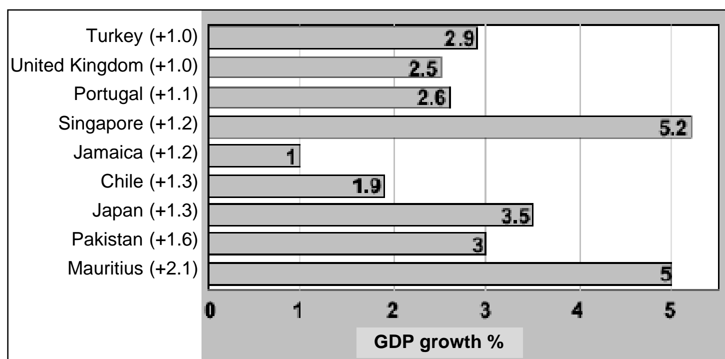
Acceleration Effect: Change in Economic Freedom and Growth (1980-90)



up or down. The data show that relatively unfree economies can achieve high rates of growth merely by becoming more free. On the other hand, countries that become less free experience economic contraction.

Since the direction of change turns out to be as significant as almost any other variable, it was examined in a diversity of ways, some of which are presented here. To be maximally instructive for India, which is still a poor country, less-developed countries that became more free were compared with ones that became less free.

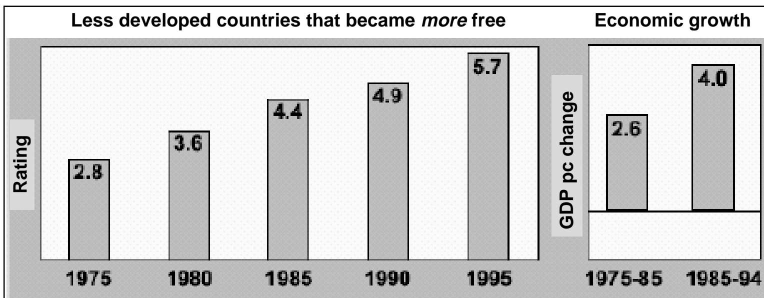
Acceleration Effect: Change in Economic Freedom and Growth (1980-90)



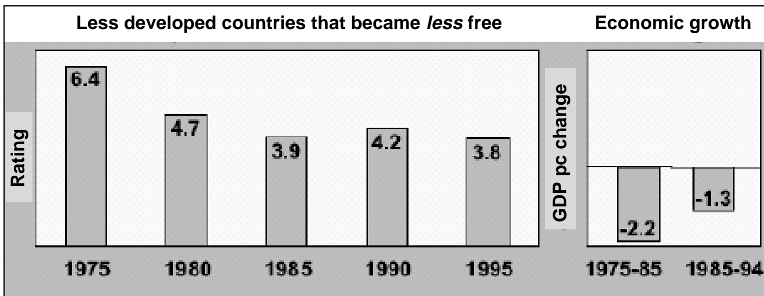
This last and most instructive chart shows that a free economy (bottom right), which is becoming less free (bottom left), is likely to contract. Conversely, one of the world's least free economies (at, say, 5 on the bottom right axis) will go into positive growth if it is becoming more free. Venezuela, for instance, has an economic freedom rating of 4 out a possible 10, making it one of the least free economies. Despite that fact, it could enjoy real growth if it moved up the index. In order to have sustained

growth, it would need to continue reforming until it has an index rating of about 6, which would place it a third of the way up, at around 80th out of 130 rated countries, at which point it should be sufficiently free to grow very slowly with no more reform. If it continues reforming, it could become one of the world's highest growth countries long before it is as free as the freest economies.

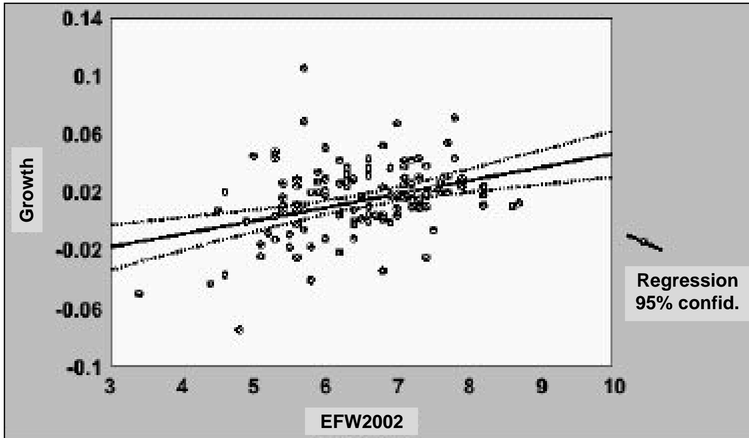
Acceleration Effect: Change in Economic Freedom and Growth (1980-90)



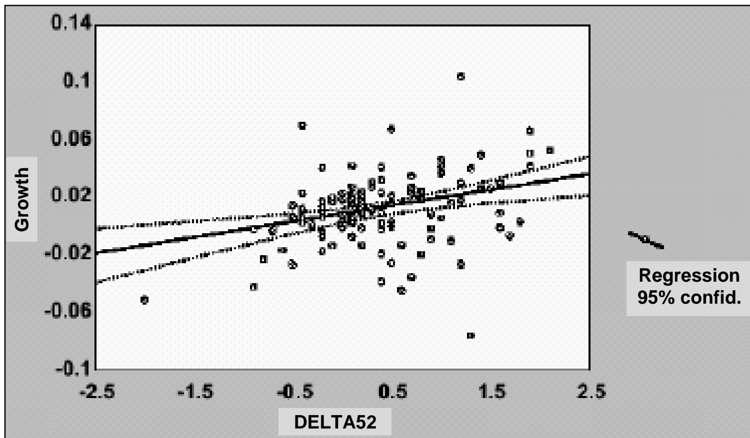
Acceleration Effect: Change in Economic Freedom and Growth (1980-90)



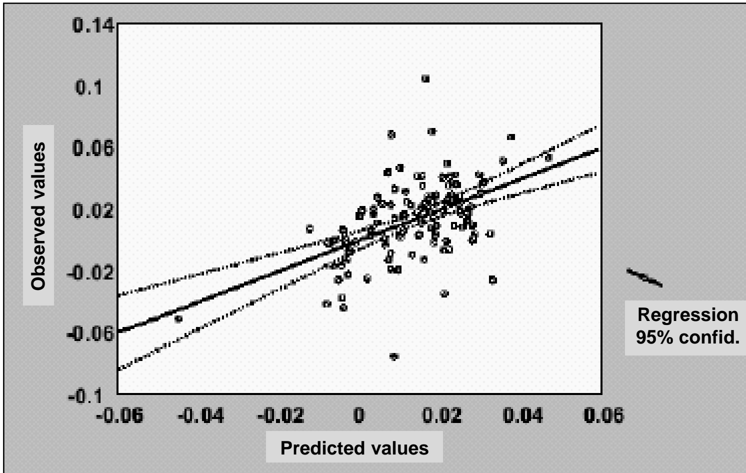
EFW2002 vs. Growth (Case-wise MD deletion)
Growth = .0455 + .00925 * EFW2002
Correlatio: r = .35738



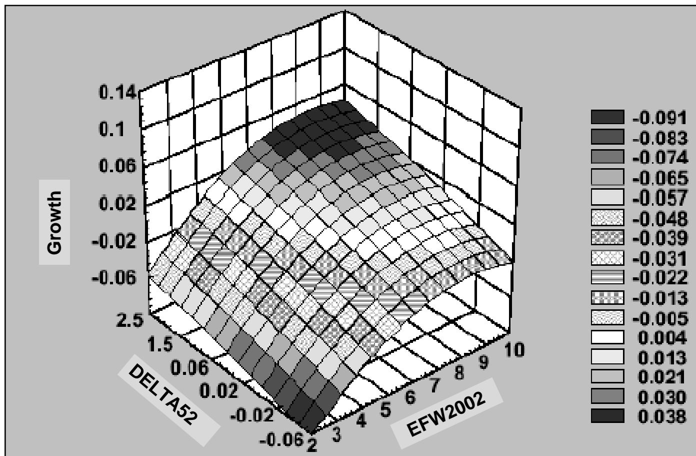
DELTA52 vs. Growth (Case-wise MD deletion)
Growth = .00956 + .01105 * DELTA52
Correlatio: r = .30804



Growth = –.0542 + 0.01 * efw 2002 + 0.012 * delta52 R = 0.49
Dependent Variable: Growth



3D Surface Plot (EFWDELTA.STA 3v * 140c
z = –0.149 + 0.041 * x + 0.009 * y – 0.002 * x * x + 0 * y – 0.001 * y * y



CHAPTER 8

CHINA AND INDIA

China

China has the world's most interesting and potentially most instructive economy. One in four of the world's population live there; it has the world's highest sustained growth rate—if official figures are to be believed—and, if it continues growing at present rates, it will soon be the world's biggest economy. Within a generation, it will account for half the planet's GDP. It seems destined to become the world's dominant 'super power', at least economically.

Discourse about China is reminiscent of debates during the 1970s, 1980s and 1990s about the 'Asian Tigers' (Japan, Taiwan, Hong Kong, Singapore and South Korea). They were the world's highest growth economies, and people of every persuasion claimed them as examples of their system outperforming alternatives. Initially, capitalists and socialists disagreed about which countries were succeeding, but the view that socialist economies were more successful, especially those with extreme forms of

socialism and communism, became unsustainable after the collapse of international socialism at the end of the 1980s.

Both sides now claim China as an example of their system succeeding. Many commentators predict that the Chinese 'bubble' will burst. Meanwhile every observer is dazzled, and no one seems to be sure what to make of the phenomenon.

Because of its unique significance, we wondered whether China really is a special case, and reached the surprising conclusion that, not only is there nothing conspicuously distinctive about China's success factors, but that it is perhaps the definitive exemplar of which policies coincide with which outcomes.

China's growth is consistent with and predicted by its economic freedom score, rather than its civil and political liberties score (FH). It does indeed grow faster than its nominal economic freedom score predicts, but that is typical of what happens when countries move 'in the right direction'. They often experience an 'acceleration effect'.

Conversely, countries that are relatively free but increasingly less so, tend to contract disproportionately. Zimbabwe is an obvious example. Its economy started deteriorating before it slipped from modest levels of economic freedom during its first decade of independence to now being one of the least free economies in the world.

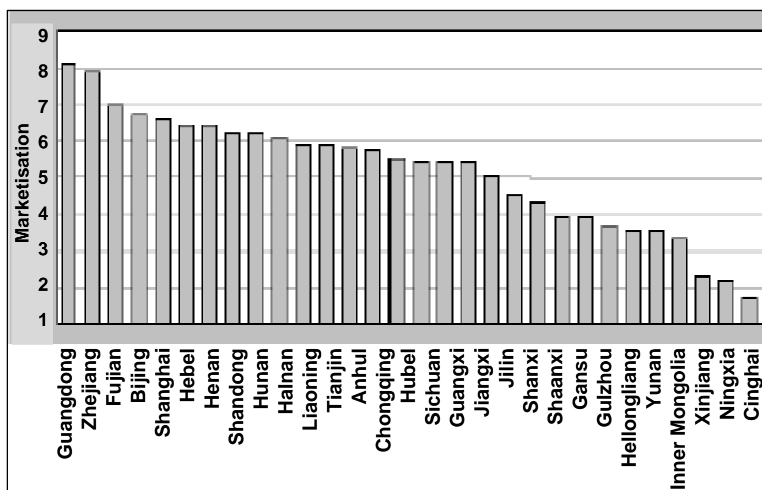
What we found is of considerable importance for policy makers. Firstly, China cannot be thought of as a single economy or even as a single country as far as its economy is concerned. The diversity of economic systems within China, from one province to another, is bigger than the diversity of economic systems internationally. Secondly, almost all its growth (industrialization, investment, etc)

is not only confined to provinces with high scores on the 'marketisation index', but to a few special zones. Thirdly, these zones have the freest economies on earth, if not the freest economies the world has ever known.

These are dramatic statements. We do not make them lightly, and took great care to check our facts. Given the extreme multiplicity of economic systems within China, it can be thought of as the world's most federal country, that is, as the country with most internal diversity and devolution of power.

Given these extreme differences, China is, for present purposes, close to a controlled experiment in social science. It is possible to see how diverse systems compare within a single country with most potentially confounding variables constant. Reliable data is notoriously difficult to obtain in China, but to the extent that it is available, economic performance varies as widely as and in sympathy with economic diversity.

Chinese Provinces: Marketisation Index



China's freest province (Guandong) is nearly as free as the world's freest economy, Hong Kong, and its least free province (Qinghai) is less free than the world's least free indexed country, Myanmar. In other words, China has a bigger range of economic systems internally than the world has internationally.

The great diversity of systems within provinces explains only half the story. Almost all China's prosperity, especially capital formation (investment,) is in a wide variety of special zones in the South and East. The most important of these are five *Special Economic Zones* (SEZs), followed by three *Key Economic Hubs* (KEHs), and thirteen *Economic and Technical Development Hubs* (ETDH). The SEZs are probably the freest economies on earth, and may be the freest economies that have ever existed.

They have extended tax-free holidays and, for practical purposes, no labour, competition, consumer, licensing or minimum standards laws. There are no trade barriers or foreign currency controls, not even reporting requirements. In the absence of accurate data, there is no needless anguishing about the "balance of payments" or "foreign debt".

Other special zones and special status attaching to individual enterprises include *Open Cities, Free Ports, Export Processing Zones* and *Special Economic Status*, each of which has distinctive characteristics.

Not surprisingly, variations in living standards, and in regional or geographic product (GGP), are extreme, ranging from areas with annual growth rates often exceeding 20% to backward areas in the hinterland and north-west where people live in primitive conditions. Encouraged by the fact that wealth has been doubling

every three to four years in the most successful areas (since the concept was introduced in 1979), the government has been increasing the number and diversity of zones throughout the country, to the point where practically all workers will be able to access new jobs with rapidly rising incomes and improving working conditions.

The evidence is compelling that China's extraordinary success is explained by its extreme internal diversity combined with the dramatic increase of economic freedom in selected areas (especially in the South-East). By virtue of localized increases in economic freedom, the country as a whole is, on average, more free, its marketisation index having increased from 4.87 in 1999 to 5,98 in 2002.

China's policy reforms predict its rapid progress towards modernization. China has moved towards greater trade openness, but much more so.

China: Special Economic Zones (SEZs)

There is a widespread belief that globalization harms African economies by way of cheap imports with which they supposedly cannot compete. Why African industry should not, with its abundant human and other resources, be competitive, is unclear. China is regarded as the most serious threat to Africa's indigenous industry but its imports from Africa have increased at roughly the same rate as its exports to the continent.

India

Many of the facts about China are also true of India. Close on China's heels, India is also arising from the ashes of a century of mass destitution at extraordinary growth rates. This has everything to do with reforms and making India a more free economy.

Most early reforms in India concerned the external sector—elimination of quantitative restrictions (QRs) on exports, rationalization and elimination of export subsidies and their replacement by a system of export incentives, reduction in import duties, a market-determined exchange rate with a convertible rupee, a liberal policy on foreign institutional investments and opening up to foreign direct investments (FDI). On each of these, reforms have already been introduced, or there is a timeframe for their further introduction, although external sector reforms are also linked to negotiations, multilateral, regional or bilateral.

There will be a reasonable degree of consensus about what the major pending reform areas are, the so-called agenda. At best, depending on one's perspective, there may be disagreement about the priorities. The following is a list of this core reform agenda.

- Reforms in the rural sector—There is an agricultural reform agenda and there is a rural reform agenda that goes beyond agriculture. Within the agriculture set, there are issues like allowing corporate sector involvement in agriculture, removal of government imposed restrictions on production, marketing and distribution, refocus of public expenditure away from input subsidies to infrastructure and extension services, disintermediation of distribution chains, forward markets, contract farming, revamping credit and insurance, and freeing up of land markets. All these are linked to encouraging commercialization and diversification. There is also an issue of encouraging off-farm employment and this is where rural sector reforms kick in, through provision of physical and social infrastructure.
- Taxation reforms—These have both a direct and an indirect tax component, and the latter includes import duties.
- Public expenditure reforms—This has a Centre, State and even local body aspect. In addition to borrowing and expenditure on the administrative machinery of the government, public expenditure also includes public services. These are not necessarily in areas where market failure exists, so that the classic public good argument has doubtful validity. Nor can a merit good argument be used, since subsidies are never targeted. That apart, expenditure is never linked to tangible improvement in outcomes and administrative costs of delivery are extremely high.

Yet, the present government has introduced or expanded several so-called public expenditure flagship programmes—National Rural Employment Guarantee, Sarva Shiksha Abhiyan, the Mid-Day Meal Scheme, National Rural Health Mission, Jawaharlal Nehru Urban Renewal Mission, Bharat Nirman and a Backward Regions Grant Fund. Had public expenditure alone been the answer, India would no longer have been poor and backward.

- Law reforms—This category subsumes several different elements—statutory law reform, faster speed of dispute resolution and reforms of administrative law, so that procedural costs are eased.

While there is no disagreement about these reform areas being important, why have the required reforms not been implemented? This is because of the political economy, not because these areas are unimportant, but because there is lack of consensus. And if one tracks the debate and distils out where there is lack of consensus, the debate boils down to one simple issue, regardless of the reform area. There is lack of consensus about the role of the government and core governance areas. The core governance areas for any State ought to be ensuring law and order, an efficient dispute resolution mechanism and intervention in some areas of physical and social infrastructure, sometimes through financing rather than through actual provisioning. It is because the Indian State is asked to do many more things that these four core reform agendas continually get stuck.

Notwithstanding this lackadaisical movement on most domestic reforms, barring the financial sector, there is no dearth of reports that are bullish about Indian growth prospects, some external, others internal or endogenous. We should note the following. First, the savings rate has increased. Second, the incremental capital/output ratio (ICOR) is now around 4, which suggests that real growth of 9% is eminently doable. There is yet another change that is sometimes ignored, at least in this context. The share of agriculture and allied activities in GDP is declining and that of services is increasing. What is pertinent is that the service sector tends to have a lower ICOR. That apart, if agriculture is growing relatively slowly and services is growing relatively fast, the sectoral shift from agriculture to services itself jacks up GDP growth as a statistical inevitability. Third, the effect of export growth on GDP growth is perhaps not always explicitly recognized. Fourth, while the demographic dividend and India's demographic transition is recognized, its impact on GDP growth is not always factored in. Fifth, the population is young, with a median age of 24. This does things to entrepreneurship that we imperfectly understand. One should not therefore be surprised if GDP growth turns out to be something like 9% between 2010 and 2015 and accelerates to 10% between 2015 and 2020, ignoring the effect of exchange rate changes.

But the point to note is that India, like China, is not homogeneous.

Economic Freedom for the States if India, 2007—Variables

Area 1: Size of government: expenditures, taxes and enterprises

- Government revenue expenditure as a share of Gross State Domestic Product (GSDP)
- Administrative Gross State Domestic Product as a ratio of total GSDP
- Share of government in organized employment
- State taxes on income as a ratio of GDP
- Ratio of taxes on property and capital transactions to state GDP
- Taxes on commodities and services to GDP
- Stamp duty rate

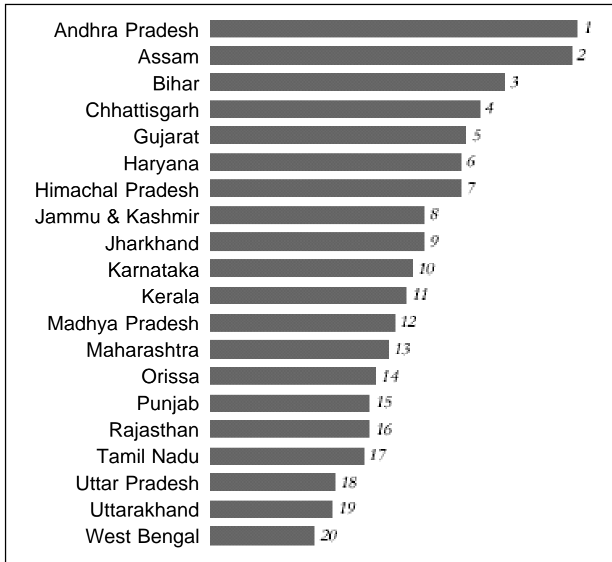
Area 2: Legal structure and security of property rights

- Ratio of total value of property recovered to total value of property stolen
- Violent crimes as a share of total crimes
- Cases under economic offences as a share of total cases registered
- Vacant posts of judges in the judiciary as a ratio of total sanctioned posts of judges
- Percentage cases where investigations were completed by police
- Percentage cases where trials were completed by courts

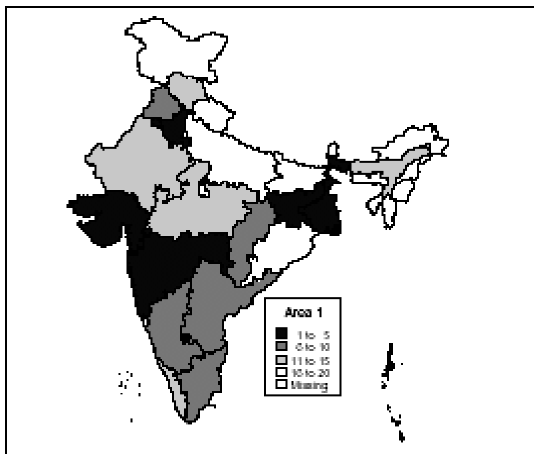
Area 3: Regulation of credit, labor, and business

- Ratio of average wage of unskilled workers (males) to minimum wages
- Ratio of average wage of unskilled workers (females) to minimum wages
- Man-days lost in strikes and lockouts/total number of industrial workers
- Unorganized labour force as a ratio of organized labour force in the manufacturing sector.
- Number of notified special economic zones (SEZs)
- Inverse of minimum license fee for traders
- Market fees charged by government run/regulated market boards on all commodities as a percentage of estimated value of commodities.
- Implementation rate of Industrial Entrepreneurs Memorandum (IEM)
- Inverse of power shortage as a percentage of total demand.
- Pendency rate of cases registered under prevention of corruption and related acts
- Persons arrested as a share of total cases being investigated under prevention of corruption and related acts.

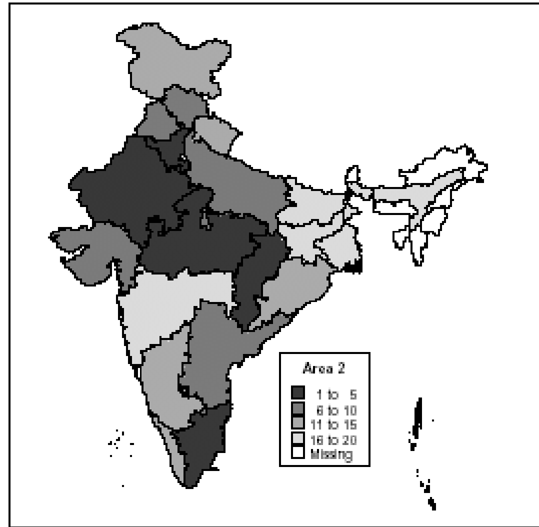
The Composite Economic Freedom Index for Indian States 2007—Ranks



Area 1: Size of Government: Expenditures, Taxes and Enterprises



Area 2: Legal Structure and Security of Property Rights



Area 3: Regulation of Credit, Labor, and Business

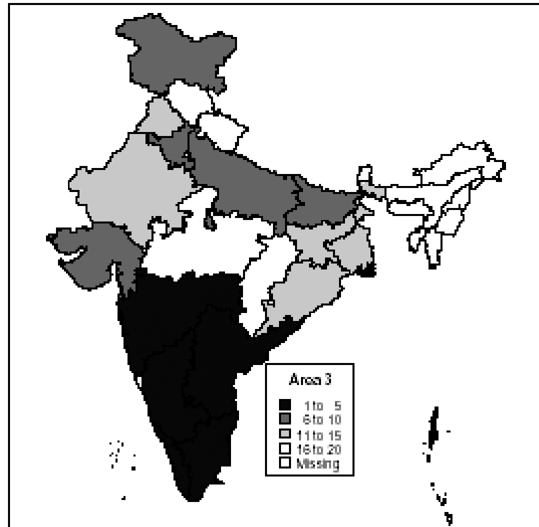


Figure 1: Per Capita GDP and Economic Freedom

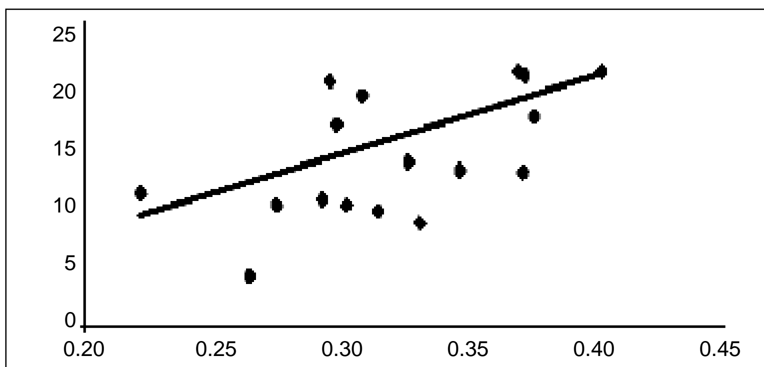
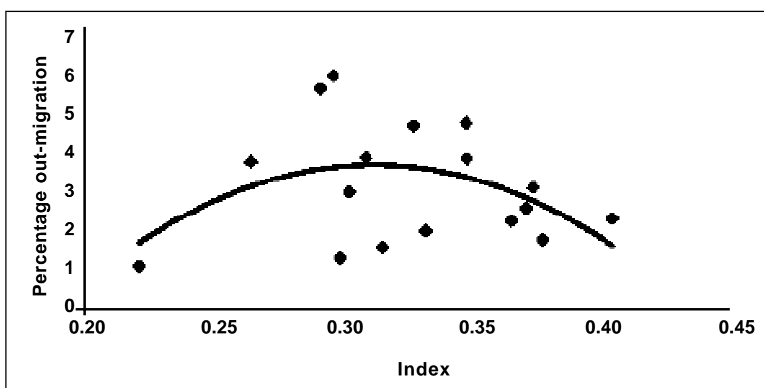


Figure 2: Out-migration and Economic Freedom



What about other Countries?

Maybe concerns about the sustainability of these two impressive growth rates in China and India is misplaced, given the enduring nature of spectacular growth over many decades in such so-called economic miracles as the Asian Tigers, Ireland and Mauritius.

The high-growth counterpart of China and India in Africa is South Africa's neighbour, Botswana. In some senses it is an even more impressive success story.

Botswana is achieving sustained high growth at rates in excess of those that coincide with its economic system. As with China, this appears to be a function of the acceleration effect described above. Botswana has been followed by Uganda, and, more recently, Tanzania and Mozambique.

The first African country to become an 'economic miracle' in recent times is Mauritius. Twenty-five years ago, it was one of the poorest countries on earth. It is a small, remote island in the Indian Ocean off the east coast of Africa, without resources. At the time, it was considered a hopeless case that would be in of need of foreign aid indefinitely. Its government implemented policies that we now know coincide with high growth, and it was rewarded accordingly. It became Africa's first 'economic miracle' and achieved high living standards with full employment.

Who says the world cannot changed and poverty cannot be banished?

CHAPTER 9

FACTORS AFFECTING GROWTH

Natural Resources—Blessing or Curse?

Mauritius, like many of the world's most celebrated success stories, including the Asian Tigers, provides compelling anecdotal evidence that natural resource endowment is not a determinant of prosperity. Equally conspicuous is the poor performance of resource-rich countries, especially resource-rich African countries, like Nigeria, Tanzania, Ghana, Zambia and Angola. Or for that matter, think of Chhattisgarh, Jharkhand and Orissa. That resource-rich countries tend to be losers and winners tend to be resource-poor is known as the 'the resource curse' or 'the paradox of plenty'.

There are interesting theories about why resource- rich countries seem to be 'cursed'. One of the most compelling is that 'resource-rich countries are subject to more extreme rent-seeking behaviour than resource-poor economies, which results in competing factions fighting for natural resource rents, which in turn ends up inefficiently exhausting the public good. In other words, governments of resource-rich countries are easily intoxicated by the

assumption that they or their citizens will prosper simply because of their resources. They assume that they can extract massive revenues from resources by exploiting them directly or sub-contracting to private companies subjected to heavy taxes. They do not appear to realize that natural resources contribute to prosperity only if accompanied by high-growth policies. Resource-rich countries are often characterized by internal conflict as rivals lock horns over who should control and be enriched by natural resource exploitation.

Just as there are impoverished resource-rich countries, there are also very successful ones. Obvious examples are the USA, oil-rich Gulf States, Norway, Holland and Australia.

Notwithstanding the widely held belief amongst experts that there is a resource curse, they are probably mistaken. Firstly, there is no accurate way to rank countries according to natural resource endowment. Most experts merely assume that countries are resource-rich or poor on the basis of popular perception, as if it is a matter of common knowledge. Some economists use objective cohorts for resource endowment, especially to determine whether or not countries have 'mining dominant' economies—whether minerals account for a significant part of national income or exports. There are two important problems with this definition: (a) 'natural resources' include much more than minerals—navigable rivers, natural harbours, arable land, moderate climate, etc are natural resources—and (b) natural resources are a source of revenue only if they are exploited successfully. The degree to which a country benefits from its minerals depends more on its policies than on being resource-rich.

Think of Orissa again. Recognizing this fact, economist Julian Simon concluded that people are 'the ultimate resource'.

Chamber of Mines economist, Roger Baxter, has shown that some eminent scholars have reached overhasty conclusions. According to Richard Auty, for instance, 'since the 1960s resource-rich developing countries have under-performed compared with resource-deficient economies'. One of the world's most celebrated economists, Jeffrey Sachs, and his coauthor, Andrew Warner, concluded in *Natural Resource Abundance and Economic Growth* that 'countries with abundant natural resources have tended to grow less rapidly than natural-resource-scarce economies'. Raul Prebish and Hans Singer, in discussing the 'Dutch Disease', which refers to a specific variant of the concept, argued that 'resource based growth would be ineffective because world prices of primary exports … show a deep tendency towards secular decline'.

It is true that many or most resource-rich countries are poor—some are amongst the world's poorest countries. Even so, resource-rich countries are usually slightly more prosperous than resource-poor ones. The problem is that they are not as prosperous as they should be. Baxter's research shows that growth rates in mining-dominant countries are above the average for their region, but well below growth rates in mineral-rich countries with high levels of economic freedom and good governance (as defined by the World Bank).

Does Size Matter—doing more by doing less?

World Bank (WB) and International Monetary Fund (IMF) economists have ranked countries in many ways.

One of the early classifications found that during the decade of the 1970s more tax—that is aggregate tax from all sources—coincided with less growth and less of everything else for which they had measures. The same was found for the 1990s in OECD (Organization for Economic Co-operation and Development) countries.

The reason for correlating growth with government size is that the size of the government is a proxy for what it does. More government, it is assumed, generally entails less economic freedom. We considered this and other proxies for the size and role of government, such as the number of people employed by it, capital formation in its hands, and tax as a proportion of GDP. Counter-intuitive though it is for economic liberals, aggregate tax does not correlate significantly with growth, except in rich countries, such as OECD countries. We examined this issue very carefully because of the importance attached to it, and concluded that the apparent lack of correlation is misleading, and incurs the risk of seducing governments into counter-productive tax-and-spend policies.

In India, tax revenue as a share of GDP was 11.7% in 2007-08. This is Central taxes alone. If one includes State-level and local taxes, the figure is probably around 17% of GDP. Various exemptions (on both direct and indirect taxes) amount to more than 5% of GDP. Even if some of these are eliminated, the overall tax/GDP ratio will approach 20%. The point is that these higher levels have not resulted from hikes in rates, but from reducing rates, standardizing and harmonizing and reducing compliance costs. That, and removal of exemptions, has led to a broader base.

Various economists, notably Arthur Laffer, have shown

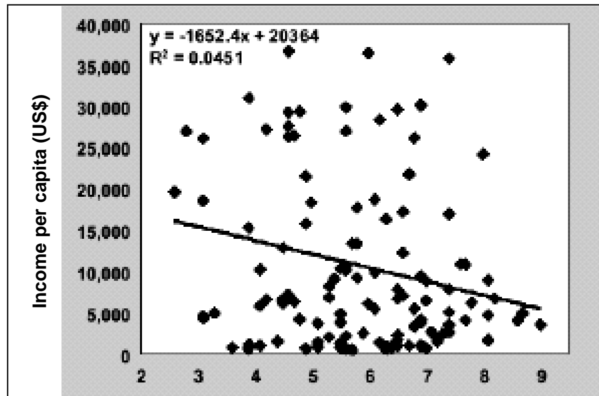
that modest tax rates generate most government revenue, especially over time. The 'Laffer Curve' shows that governments collect zero revenue at both extremes: zero and 100% tax rates. At higher levels, investors are encouraged to invest elsewhere and to manage their affairs in ways that reduce tax at the expense of productivity. Furthermore, there is a great deal of evidence to the effect that governments tend to use resources less efficiently than entrepreneurs. The most significant point is that what matters more than how much governments take in tax is what they do with it. The evidence suggests that governments are more likely to promote growth if they use their revenue primarily to:

- build infrastructure, especially transport infrastructure;
- provide services, rather than regulate economic activity;
- do things that don't duplicate what the private sector can do, specifically that they do not compete with it; and
- increase efficiency by outsourcing and privatizing.

Indian reforms have not yet successfully implemented the expenditure side of the story and that's one of the reasons Indian citizens suffer from tax fatigue. Despite accountability to Parliament, there is no obvious link between taxes paid and services rendered, since everything goes into the black hole known as the Consolidated Fund of India.

Though there is no significant correlation between aggregate tax and growth, the following graph shows a strong correlation between 'business tax friendliness' and

Per capita Income and Government Size



growth. Tax friendliness measures the impact of tax complexity and incidence on business, and shows more growth in countries with friendlier tax policies.

Common sense is a legitimate substitute for analysis regarding 'size-ism'. Whilst bigger governments, that is, ones that consume bigger proportions of a country's wealth, do not reduce prosperity if they keep their economies free and maintain good governance, according to the data they also do not seem to promote prosperity. The evidence suggests that there is not much governments can do to promote growth, but there is much they can do to curtail it. In other words, governments are best advised to do less rather than more because the downside risk of what they do is greater than the upside potential. People do not have more of what governments provide where governments are bigger and do more.

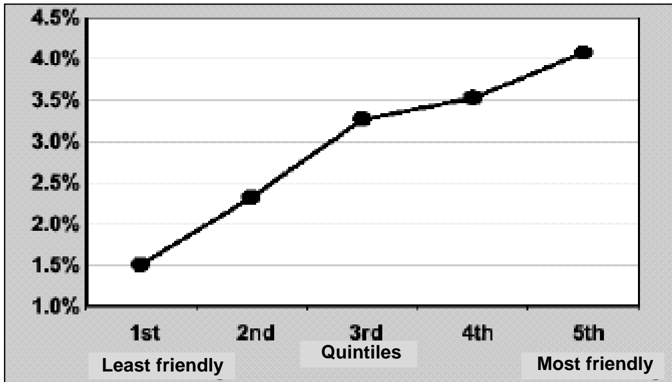
Whilst our 'funnel' analysis suggests that size *per se* does not matter, this is true only of conventional capitalist economies. The data do not include former and surviving communist countries concerning which data are

unavailable or unreliable. Cold war propaganda to the contrary, it is now clear that the biggest governments the world has known—communist governments that owned and controlled as much as they could—were economic disasters, the full extent of which is still becoming apparent. If we could include communist countries, there would be a clear correlation to the effect that bigger governments coincide with worse performance.

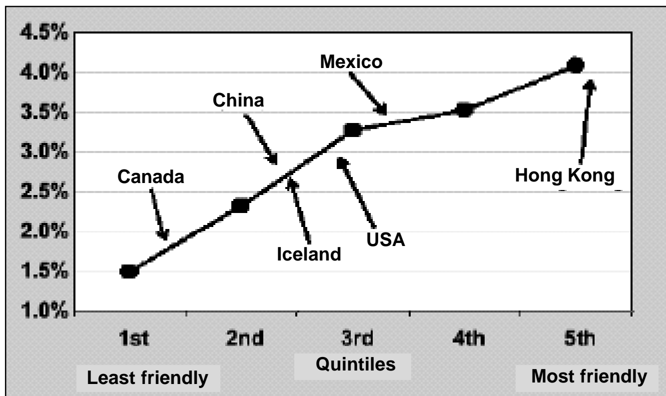
At the other extreme, countries with the world's smallest governments tend to be super-achievers, and we found no evidence that there may be a threshold below which things start getting worse. The lack of a correlation applies to mainstream countries between the extremes where most countries fall. Positive relationships emerge if one divides the world into bands according to income and population size. Within these bands, smaller governments tend to outperform bigger ones, and more populous countries with bigger governments are worse performers than those with smaller ones.

Common sense also requires us to conclude that the relative unimportance of size is due to what governments do being more important than how big they are. A small government of corrupt gun-toting warmongering despots, even dogmatic economic liberals must concede, will be worse than a big government using its size to protect liberty and property. The Indian work-force is around 400 million. Out of this, less than 20 million people work for the government, including employment in the public sector of around 6 million. Central government employees account for less than 3.5 million. The government doesn't account for a significant share of employment in India. The point is not how many people work for the

Tax Friendliness and Growth (Personal Rates and Brackets)



Tax Friendliness and Growth (examples)

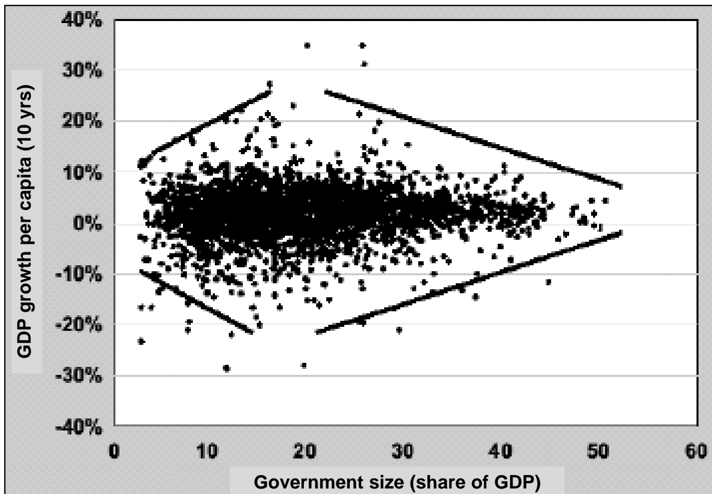


government, but what they do. They do the wrong things and impose efficiency costs on the private sector.

This research revealed what we call 'the funnel', a trumpet or funnel-shaped scatter-gram of countries with big governments at one end and small ones at the other. It turns out that big governments have the world's highest and lowest growth economies. Countries with small governments neither grow nor contract at high rates.

We did a considerable amount of research on this, since it is such a fundamental issue in economics. The evidence suggests that what matters more than nominal size is what governments do, or what we called the Q-factor, the quality of government.

Government Size and Growth



Hypothesis Testing

Research usually amounts to testing theories or hypotheses. Lest we be criticized for not following the scholarly convention of formulating and testing hypotheses, an explanatory note is necessary.

Firstly, legitimate research does not have to test hypotheses. Many of the greatest contributions to social and natural science did not involve hypothesis testing. Fact-finding 'fishing expeditions' are a legitimate research methodology (of which Darwinism is one of the celebrated examples).

Secondly, in any event, our methodology does amount to hypothesis testing. Whilst economic freedom may correlate positively with growth, most components of the definition of economic freedom are unlikely to do so on their own, and some may weaken the correlation.

Thirdly, even though components of the definition of economic and other liberties coincide with prosperity, this does not mean there are extraneous factors offering more statistically significant correlations with growth or other policy goals. We needed to establish whether other factors such as geography or history were more significant. Our hypothesis, if one was needed, could have been that there are. Our research has falsified that hypothesis to the extent that none were found—all strong correlations appear to be policy variables and all of them are included in prevailing definitions of freedom.

Fourthly, the scientific method (formulated by Sir Karl Popper, originator of the open society concept) requires the formulation of hypotheses so as to be falsifiable. This is counter-intuitive. It means that science does not prove things—it disproves them. None of the relationships we found were absolute; there are always exceptions. We discovered rather than formulated testable hypotheses, in accordance with the 'discovery process' formulated and described by Friedrich von Hayek. We tested all the relationships we describe here in the sense that we checked data accuracy and calculations. We also interrogated unusual relationships to see what could be learned by further analysis.

Notwithstanding a value-free approach, much of this report refers to indices of freedom defined in various ways (civil liberties, rule of law, economic freedom, political

freedom *et al*). This was not contrived; it is simply that the factors that correlate most with prosperity happen to be indicators of some form of freedom. We expected other factors to present high positive correlations, such as natural resources, climate, history, culture, religion and governance. Neil van Heerden, former head of the SA Foundation, suggested that these 'negative' findings might be more instructive than positive correlations. Identifying the extent to which people 'know things that just ain't so' is essentially the falsification of hypotheses.

A 'negative' finding that the absence of the rule of law coincides with high levels of corruption, due to excessive executive discretion (which it does, and about which there should be much more concern in India), is also a finding that corruption-free countries are those that uphold the rule of law.

Regulation and over-regulation

One of the challenges we faced was that there are no readily available or accurate indices for some important policy variables, such as the regulatory environment, the rule of law, or property rights, even though they are commonly cited as crucial issues. Important studies have been done on the impact of regulation on growth. These suggest that more regulation coincides with less growth. Celebrated Peruvian economist, Hernando de Soto, has done a great deal of pioneering research on the regulatory and property rights environment in selected countries. He did not produce global indices of the kind utilized in this analysis but his research is at least as instructive, showing that more regulation and a lack of secure property rights (property in all its forms), coincides with less growth (see

especially *The Other Path* and *The Mystery of Capital*).

The World Bank conducted extensive research into the regulatory environment and produced what became recognized immediately as the definitive regulation index (*Doing Business in 2005—Removing Obstacles to Growth*). The key finding is that the least regulated economies (top quartile) grow 2.2% faster than those that are most regulated (bottom quartile).

The report ranks 130 countries according to how regulation affects:

- starting a business;
- registration of companies;
- obtaining credit;
- hiring and firing workers;
- enforcing contracts;
- paying tax;
- getting licenses;
- registering property;
- protecting investors;
- trading across borders;
- closing a business.

It finds that efficient economies rely more on common-law than regulation, and that social democracies (like Denmark, Norway and Sweden) benefit from streamlined business regulation—they offset the burden of welfare by liberating productive market forces. The data suggest that excessive regulation stifles productivity in Africa, Latin America and the former Soviet Union. It is associated with inefficient public institutions, longer delays, higher costs, more unemployment, increased corruption, less productivity, lower levels of investment, and bigger illegal

('informal' and 'underground') sectors.

The world's twenty least regulated economies are all (except Taiwan) rich first world countries, including all G8 countries. The impact of heavier regulatory burdens in poor countries is compounded by the fact that their citizens have fewer resources with which to cope with the regulations. In addition, within poor countries, the poor pay disproportionately more in the form of bribes. For Delhi, Madhu Kishwar's work has documented this for rickshaw-pullers and street-side vendors.

The study is important, indeed pioneering and historic, but it does not tell the whole story. Much regulation impacting on society is not included. There are hundreds of measures in every country regulating the daily conduct of private and commercial activity, such as health and safety regulation, most of which has never been shown to have benefits exceeding costs, and all of which imposes enormous direct and indirect costs on people at the expense of prosperity. The study is limited because it is about 'doing business'. As every citizen knows, there are countless laws, regulations and administrative practices impacting on them. No one has, for instance, calculated the cost and benefits to the country of measures ranging from speed limits and road humps to building and safety regulations. Some detailed studies have been done, mostly in advanced countries, where petty regulation has been found to have extraordinary implications. A retreaded tyre regulation in the USA, for instance, was found to have cost a few million dollars for every sub-standard tyre identified by the measure, which led to it being scrapped. No one in India has assessed the cost to ordinary citizens and thus the economy of such matters as travel, waiting

time and related aspects of getting new identity documents, drivers' licenses and assorted other forms of identity. Administrative, enforcement and compliance costs might have amounted to so much that, had the government known in advance, the measures might have been abandoned or alternatives implemented. Perhaps the single biggest cost of regulation is its impact on the daily operation of business and private life, where the way things must be done, including minimum standards and red tape, impose unknown levels of cost on society.

An OECD study found that over-regulation is the major cause of the slower rate of growth of the European Union compared to that of the USA. But what are the benefits of regulation? The study found 'no quality benefits'. We all know that government is costly, but a 75-country study found that regulations usually cost a country twenty times more than they cost the government (see publications by Djankov, Laporta, Silanes and Shleifer). In the absence of a comprehensive index, researchers rely on surrogates for 'regulation' or estimates of a limited range of regulatory measures. Most studies find that less heavily regulated countries outperform more regulated countries. In the face of mounting anti-regulation evidence, the UK passed the Deregulation Act (now the Regulatory Impact Assessment Act), created the Better Regulation Task Force, and has a new Regulatory Reform Bill. The Bill will simplify unnecessarily complicated rules and allow partnerships of more than 20 people. A growing number of countries are simplifying company laws, which have become a nightmare of complex regulation in many countries. One effect of cumulative amendments over many years is that 'private' companies are no longer private in any

meaningful sense, and investors in 'public' companies are lulled into underestimating risk.

The *Economic Freedom of the World Index* (www.freetheworld.com) shows most economies getting freer on an average and India also mirrors this trend. However, this isn't true of the regulation of credit, labor and business index, which constitutes a sub-category. The value of this index was 5.7 in 1980 and 5.4 in 2005 (the higher the score, the better it is). Instead of improving, India has deteriorated according to this criterion. A further sub-category is the business regulations index, computed for India since 1995. In 1995, India scored 4.4 on this and by 2005, the value of the index improved to 5.3. But clearly, the improvement hasn't been enough. In the World Bank's *Doing Business Database* for 2008, starting a business costs 74.6% of per capita income in India, while the average for the region is 40.7% and the average for OECD countries is 5.1%. Similarly, a medium-sized company must make 60 annual tax-related payments. The average for the region is 30.6 and the average for OECD countries is 15.1. All of these are indicative of over-regulation, coupled with under-governance.

This spills over into an administrative law reform agenda, beyond the limited issue of civil service reform. Administrative law reform involves two kinds of relationships that can overlap—dealings between the citizen and the government and dealings between an enterprise and the government. The latter can again be divided into three phases of an enterprise's existence—entry, functioning and exit. The former involves birth certificates, death certificates, land titles, assorted requirements of establishing one's own identity and issues

connected with accessing public services. For both the citizen and the entrepreneur, the years since 1991 have witnessed the exertion of countervailing pressure, documenting corruption and inadequate delivery of services, even if this countervailing pressure tends to be located in certain geographical parts of the country. Partly as a result of such pressure, a Central *Right to Information Act* has now been passed. However, other than this, not much has happened on administrative law reform.

CHAPTER 10

CHARACTERISTICS OF WINNERS AND LOSERS

Reinventing the Wheel

Why not reinvent the wheel? Scientists at the CSIR in Pretoria entertained themselves by doing so, and their musings turned into a multi-million dollar impact roller, a square wheel that became the first breakthrough in decades for compacting soil. We are to some extent reinventing the research wheel. With the real world of policymakers in mind and at their request we needed to adopt new approaches. As a result of their request we have examined old research in new ways with a view to making it more practical and accessible for policy makers.

Experts know that the course of events is the consequence of an enormously complex concatenation of factors, perhaps too complex to analyze by way of pure empiricism. It is encouraging, however, that work done to date and for the purposes of this project enables the isolation of a few crucial factors which, when combined with the complex world beyond them, appear to be both

necessary and sufficient conditions for prosperity to be achieved in any country.

Whilst it is now possible for a government to know that it can achieve prosperity for its people by implementing a short list of decisive policies, common sense must never be forgotten. Obviously, a given country can have all these policies in place without prospering if there are intervening factors that nullify their potential. If a country's population is devastated by disease, civil or international war, natural catastrophe or dramatic shifts in international markets, the policy 'short list' may not rescue them. One of the extreme examples is Nauru. Nauru achieved one of the world's highest per capita incomes by exploiting its enormous guano deposits. When these ran out, the country's principal source of prosperity disappeared and it collapsed into destitution. Such a dramatic shock could have been ameliorated, though not avoided, had the government implemented appropriate policies.

Conversely, Botswana is reputed to have the world's most extreme AIDS pandemic. A shock of such extreme proportions would normally be sufficient for a country's economy to collapse and for it to descend into destitution. However, Botswana's government has not only achieved one of the highest prosperity scores of any African country according to almost every index, but has improved its score systematically and purposefully. Notwithstanding enduring the world's most severe health catastrophe, Botswana has maintained the world's highest economic growth rate for ten years. Perhaps most decisively, it maintained a particularly high score on the short list established, after the fact, in this research.

Nearby Mozambique experienced unimaginable devastation when much of the country was flooded so severely that it became unusable and the flooding was so substantial that significant volumes of water had not drained years later. At the time Mozambique was experiencing one of the world's highest growth rates. Not surprisingly, there was a general expectation that the country's economy would not be able to withstand the impact, especially since it is one of the world's poorest countries. In truth, its extraordinary high growth rates dropped slightly, but Mozambique has maintained one of the world's highest growth rates.

These and many other anecdotes coincide with what our research predicts, namely, that sound policies can withstand almost any shock, and produce prosperity under almost any conditions.

Reality Matters

One of the important revelations of our research is that many loudly proclaimed policies might be of little or no value. They often appear to make things worse. There is virtually no empirical evidence in favour of aid, subsidies, debt relief, technical assistance or protection of third world indigenous enterprise. Such factors are less characteristic of high growth than of low growth countries.

There are frequent anecdotal references to such abnormal phenomena as the Marshall Plan and the New Deal. It turns out that not only are they exceptions to the rule, but that there is more mythology than reality in the popular conception about the consequences of implementing these policies, even among scholars who should know better. The New Deal, for instance, was not

followed by high growth. America's recovery from the Great Depression came much later, and the New Deal, if anything, appears to have prolonged the depression.

Likewise the Marshall Plan: it entailed much less aid than widely assumed, and Germany's *wirtschaftswunder* ('economic miracle') followed in the wake of Ludwig Erhard's radical liberalization, after the Marshall Plan failed to generate prosperity. Furthermore, the UK received much more aid than Germany without achieving high growth. If anything, aid enabled it to perpetuate inappropriate policies.

Much can, and probably should be said about such supposed panaceas for poverty. What concerns us in this project is not to draw attention to work that has already been done, and not just to identify positive correlations, but also Popperian falsification of erroneous hypotheses. Most theories of what works are testable. We found when we checked to see if widely held beliefs are true in the real world that many are not.

One of the most celebrated supposed explanations for South Korea's high growth rates (Alice Amsden—*Asia's Next Giant: South Korea and Late Industrialization* (Oxford, 1989)) is that protectionism and fascist-type central planning caused them. Our research refutes such hypotheses by showing that nearly all other countries with comparable policies stagnated or declined. This suggests that the causality of Korea's success is simply that it had the right factors in place, especially that the government employed a smaller proportion of the workforce and spent a smaller proportion of the GDP than any other industrialized country.

Are 'The Fundamentals' in place—are they The Fundamentals?

Critics and critiques of India's reforms have said on many occasions that while an increase in economic freedom (more liberalization) may have improved growth rates, it has not resulted in sufficient poverty reduction or employment creation and has led to disparities and divides, across regions, caste and gender. This is contrary to what was promised. This research suggests that the answer to this poser is that while some of the reforms are 'in place', those that are not in place have denied India the prosperity it hoped for. Accordingly, the government should not abandon 'fundamental' policies it adopted, particularly since 1991, in accordance with the world's experience, as all four governments since 1991 have tended to do, but should supplement them with the missing pieces of the puzzle. It seems extremely probable that, if it does so, the country will become the world's next 'economic miracle'.

	20 Highest Growth Countries	Growth pc (5 year av.)
1.	Ireland	8.58%
2.	China	7.25%
3.	Latvia	6.62%
4.	Estonia	6.56%
5.	Georgia	6.19%
6.	Albania	5.94%
7.	Dominican Republic	5.84%
8.	Luxembourg	5.63%
9.	Mozambique	5.52%
10.	Vietnam	5.40%
11.	Poland	5.09%
12.	Lithuania	4.93%
13.	Croatia	4.74%
14.	Trinidad & Tobago	4.51%
15.	Finland	4.46%

20 Highest Growth Countries		Growth pc (5 year av.)
16.	Hungary	4.43%
17.	Tunisia	4.22%
18.	Slovenia	4.21%
19.	Mauritius	4.09%
20.	Iceland	4.06%
	Average	5.41%

20 Lowest Growth Countries		Growth pc (5 year av.)
1.	Sierra Leone	– 5.95%
2.	Congo, Democratic Republic	– 5.68%
3.	Kuwait	– 3.11%
4.	Burundi	– 3.08%
5.	Guinea-Bissau	– 2.92%
6.	Paraguay	– 1.57%
7.	Papua New Guinea	– 1.39%
8.	Romania	– 1.36%
9.	Venezuela	– 1.34%
10.	Ukraine	– 1.20%
11.	Colombia	– 0.95%
12.	Chad	– 0.88%
13.	Gabon	– 0.86%
14.	Jamaica	– 0.86%
15.	Congo, Republic of	– 0.79%
16.	Ecuador	– 0.77%
17.	Indonesia	– 0.66%
18.	Niger	– 0.66%
19.	Kenya	– 0.63%
20.	Thailand	– 0.26%
	Average	– 1.75%

20 Highest Growth Countries		Growth pc (10 year av.)
1.	China	7.71%
2.	South Korea	7.46%
3.	Botswana	7.15%
4	Thailand	5.99%
5.	Cyprus	5.09%
6.	Hong Kong	5.08%
7.	Singapore	4.90%

	20 Highest Growth Countries	Growth pc (10 year av.)
8.	Mauritius	4.89%
9.	Oman	4.75%
10.	Luxembourg	4.47%
11.	Indonesia	4.44%
12.	Malta	4.01%
13.	India	3.58%
14.	Pakistan	3.49%
15.	Japan	3.36%
16.	Ireland	3.31%
17.	Portugal	3.12%
18.	Sri Lanka	3.07%
19.	Malaysia	3.06%
20.	Egypt	2.87%
	Average	4.59%

	20 Lowest Growth Countries	Growth pc (10 year av.)
1.	United Arab Emirates	– 5.35%
2.	Nicaragua	– 3.98%
3.	Trinidad & Tobago	– 3.37%
4.	Niger	– 3.20%
5.	Guyana	– 2.99%
6.	Peru	– 2.95%
7.	Ivory Coast	– 2.89%
8.	Argentina	– 2.87%
9.	Bahrain	– 2.52%
10.	Haiti	– 2.29%
11.	Madagascar	– 2.16%
12.	Togo	– 2.09%
13.	Bolivia	– 2.05%
14.	Congo, Democratic Republic	– 2.02%
15.	Namibia	– 2.01%
16.	Zambia	– 1.99%
17.	Nigeria	– 1.94%
18.	Mali	– 1.89%
19.	Venezuela	– 1.86%
20.	Jordan	– 1.76%
	Average	– 2.61%

Needless to say, government operates under the constraints of political realities, and some of the policies indicated by this research are politically difficult or impossible for it to implement, especially regarding labour. Even so, policy makers are most likely to make good decisions if they are aware of what lessons can be learned from the world's experience.

20:20 Analysis

The biggest differences between India's policies, on the one hand, and those of the world's winners and losers, on the other, do not necessarily suggest the highest priorities for reform. Differences matter most only in areas where policies are associated with high or low growth.

Since, for instance, the relative size of education budgets does not correlate significantly with growth, a big difference in size between India's education budget and that of high or low growth countries is not serious for purposes of economic policy, though it might be for other purposes. This is the context against which one should consider proposals of increasing public expenditure on education to 6% of GDP. On the other hand, a big difference between India's rule of law index and that of winners and losers is important because of the association between the rule of law and economic growth. This analysis therefore concentrates on identifying the Indian policy characteristics that differ most from those of winners and losers, on the one hand, and high and low growth countries on the other.

Because abnormally high rates of growth, or contraction, often occur for short periods of one or two years, winners and losers were regarded in this analysis

as highest and lowest growth countries over extended periods of five and ten years respectively. There were no significant policy differences regardless of when the periods commenced, which increases the likelihood that policies associated with high growth in the past will be the same as those associated with it in future. The following tables show the twenty countries that averaged the highest and lowest growth rates respectively between 2000 and 2005.

It is particularly significant that the highest growth countries cover the full range of possibilities, from poor (Trinidad & Tobago) to rich (Iceland), small (Luxembourg) to big (China), formerly capitalist (Ireland) to formerly socialist (Vietnam), resource-rich (Mozambique) to resource-poor (Finland), countries that were colonized until recent decades (Tunisia) and ones that were not (Finland). There is also a wide range of cultural, religious, ethnic, historical and geographic diversity among high growth countries. Since Africa's colonization is popularly though mistakenly presumed to explain its poverty, it should be noted that former colonies, including African colonies, are well-represented amongst the world's highest and lowest growth countries, and that none of the world's major colonizers appear in either group. This reaffirms the evidence suggesting that any country is likely to prosper, regardless of its circumstances or history, if it implements policies that are associated elsewhere with prosperity.

The next two tables show the world's highest and lowest growth countries averaged over ten years (1990-2000). The characteristics of longer sustained growth or contraction are more instructive than for shorter periods

for two reasons. Firstly, economic performance is more likely to be explained by enduring policy variables, and, secondly, operative variables can be identified with greater confidence and conclusions will be more robust.

Only three countries are in the top or bottom twenty, respectively, for both periods. Rising and falling growth rates over extended periods vary for diverse country-specific reasons, but do so mainly in sympathy with changes in economic policy.

What India can learn from the experience of other countries is that it is likely to achieve and sustain high growth only if it resists the temptation faced by all governments to abandon a winning formula when sustained high growth is achieved. That complacency seems to have resulted in India after the high growth witnessed since 2003. As this report shows, markets tend to respond enthusiastically to promarket reforms, failing which they maintain modest growth indefinitely if there is certainty and stability (slow and slight change) of the kind which characterizes first world democracies. The tables show that average growth for winners during the first five years of the new millennium was higher than for the preceding decade, and the rate of contraction amongst losers was lower, both of which coincide with increased economic freedom in most countries, including India. One country, Trinidad & Tobago, shifted from one extreme to the other having elevated itself from the lowest to the highest growth rate group.

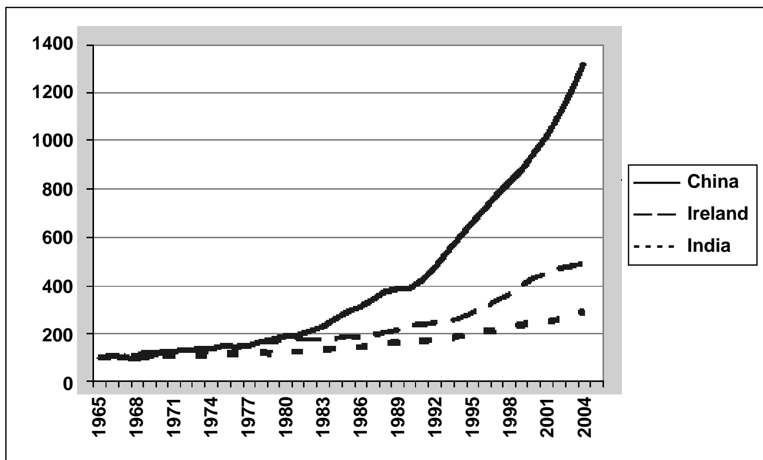
India versus the Top 20—Growth

The next five charts compare India's growth rates with those of the world's Top 20 growth countries for the first

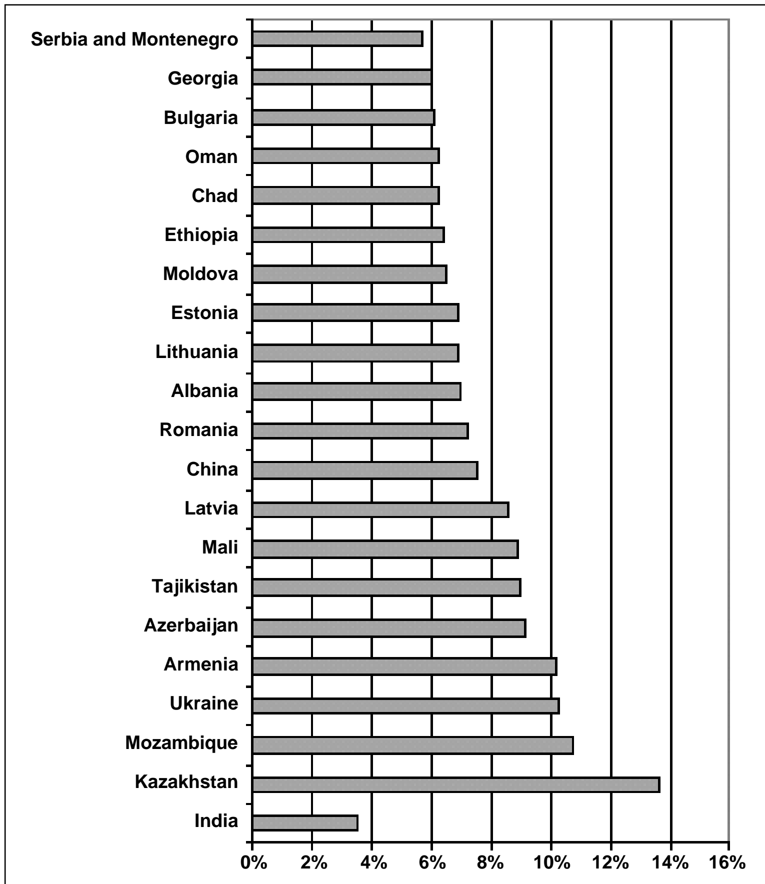
five years of the new millennium (2000 to 2004). They show that a few countries achieve growth rates of 6% and more but such results are unlikely without essential reforms. Also, the degree to which individual countries join the world's growth elites and then slide back into low growth or stagnation, suggests that sustained high growth requires continuing attention to core variables.

The next graph shows how India stagnated since 1970 whilst the Top 20 for the period started richer and increased their lead to the point where their average citizen now earns ten times more than the average Indian. The comparison with Ireland, one of the world's best performers, shows what's achievable in the real world. Ireland, which was one of Europe's poor relations, became one of the world's richest countries.

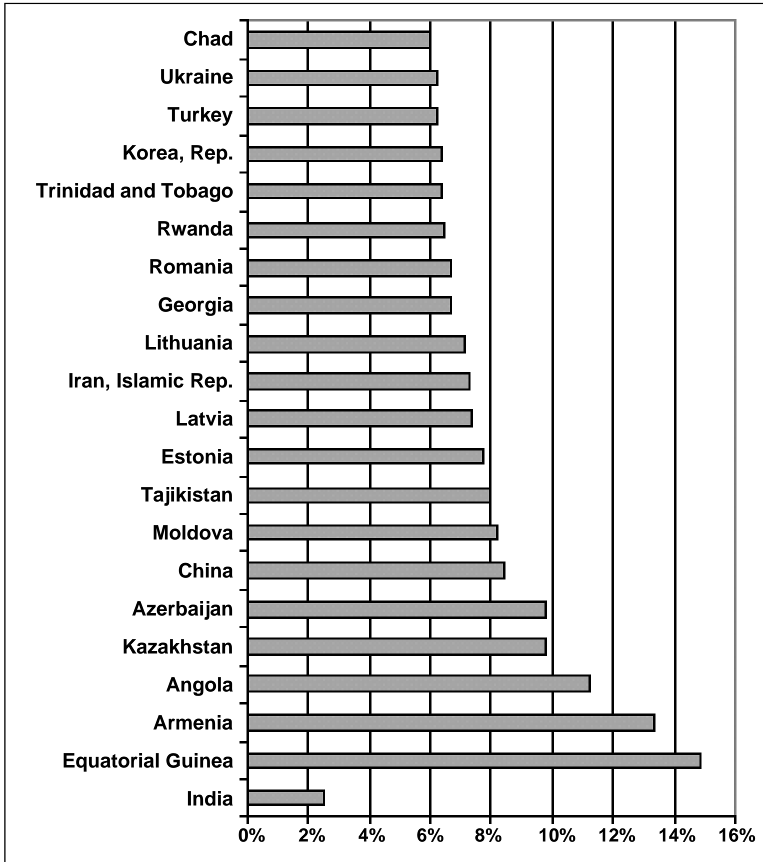
PC GDP Growth (1965 = 100)



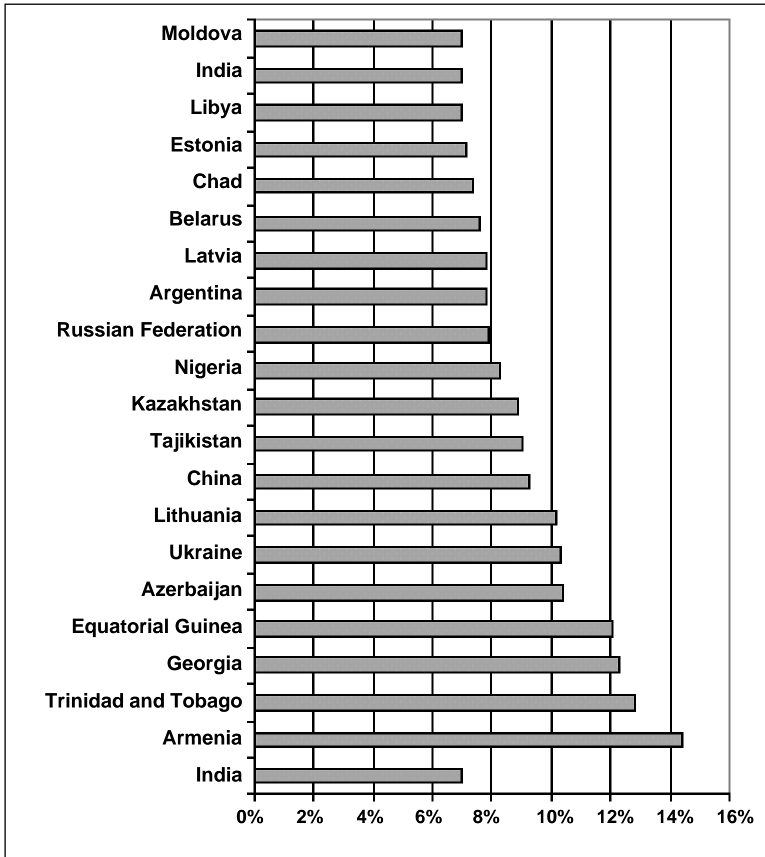
PC GDP Growth 2001—Top 20 Countries



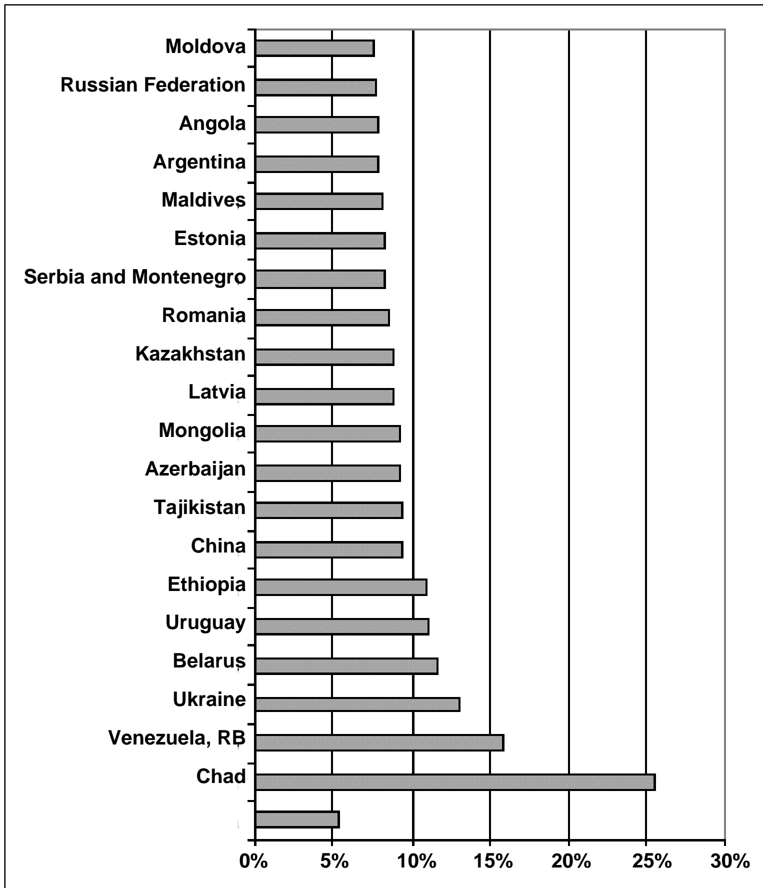
PC GDP Growth 2002—Top 20 Countries



PC GDP Growth 2003—Top 20 Countries



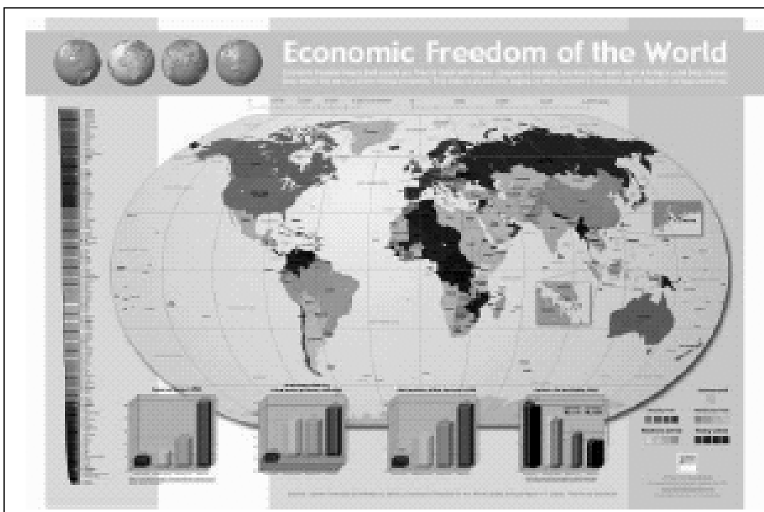
PC GDP Growth 2004—Top 20 Countries



CHAPTER 11

INDIA'S SHORT LIST OF 'WINNER' POLICIES

Differences between India on the one hand, and winners and losers on the other, are instructive only for policy areas with two coinciding characteristics, namely that they are characteristic of high growth and that they are areas in respect of which India differs significantly.



The world's EFW map for 2006 is shown above. India is just about in the middle. About half the countries in the world are better and about half the countries in the world are worse. As was mentioned earlier, ranks are misleading because the number of countries included often changes. However, in 2005, India had 69th rank out of 141 countries ranked. In 1970, India scored 5.0 on the summary rating. In 1980s, this improved only marginally to 5.2. By 1990, there was a slight regression to 4.9. By 2002, the score improved to a more respectable 6.2 and by 2005, it touched 6.6. 6.6 from 5.0 may seem like a big jump. As with Chile, China and Eastern Europe, India is a lot more free now. But India should do better than being stuck around the median.

The overall score of 6.6 in 2005 reveals, but it also hides. The break-up into the five separate EFW heads of (1) Size of government; (2) Legal Structure and Security of Property Rights; (3) Access to Sound Money; (4) Freedom to Trade Internationally; and (5) Regulation of Credit, Labour and Business is more illuminating. On size of government, India has a score of 7.7 and a rank of 17th. On legal structure and security of property rights, India has a score of 6.7 and a rank of 46th. On access to sound money, India has a score of 6.9 and a rank of 107th. On freedom to trade internationally, India has a score of 6.4 and a rank of 84th. And on regulation of credit, labour and business, India has a score of 5.4 and a rank of 123rd. At this level of aggregation, four trends are evident. First, India does relatively better than world averages on size of government and legal structure and security of property rights. Second, India performs better in areas where reforms have occurred and relatively worse in areas

(regulation of credit, labour and business) where reforms have not. Third, despite the scores being relatively high, compared to India's average score of 6.6, India performs relatively worse in areas like access to sound money and freedom to trade internationally. Fourth, India's performance sticks out in an area like regulation of credit, labour and business and to repeat what has been said earlier in the text, this is characteristic of areas where the second generation reforms are still awaited. EFW narrows down regulation of credit, labour and business further. On credit market regulations, India scores 5.9 with a rank of 126th. On labour market regulations, India scores 4.8, with a rank of 107th. On business regulations, India scores 5.3, with a rank of 77th.

It is possible to disentangle this even further. Within legal structure and security of property rights, what pulls India down is legal enforcement of contracts (category 2F) with a score of 4.6 and regulatory restrictions on sale of real property (category 2G) with a score of 6.1. Within access to sound money, what pulls India down is freedom to own foreign currency (category 3D) with a score of 0.0. Within freedom to trade internationally, what pulls India down is standard deviation of tariff rates (category 4A(iii)) with a score of 3.0, regulatory trade barriers (category 4B) with a score of 5.7 and international capital market controls (category 4E) with a score of 3.7. Within regulation of credit, labour and business, what pulls India down most is ownership of banks (category 5A(i)) with a score of 2.0, minimum wages (category 5B(i)) with a score of 3.4, hiring and firing regulations (category 5B(ii)) with a score of 3.3, mandated cost of worker dismissal (category 5B(v)) with a score of 2.7, administrative requirements (category

5C(ii)) with a score of 3.0 and bureaucracy costs (category 5C(iii)) with a score of 3.2. Beyond international trade and payments, this is thus about law, administrative law and controls in factor products.

Being a winning nation is associated with improving performance on vital indices. Countries' economies tend to grow when they improve their scores and those with good scores stagnate or contract if their scores stagnate or decline. The 20:20 analysis in this report is confined to indices used for the Economic Freedom of the World Report (EFW) because it contains all the policy variables that correlate significantly with high growth.

High growth also coincides with good scores on other indices, such as those of Freedom House, the World Bank and the World Economic Forum. This does not mean that there are alternative policies that can be adopted to get a country's policies in line with what characterizes high growth elsewhere. The reason for the coincidence is that various indices include the same or substantially similar data. Even so, there are differences between such indices. Some have variables not in EFW, but they are sufficiently similar to EFW indices that there is no need to consider them separately, such as the property rights index in the Heritage- WSJ index or components of the Freedom House index. In other words, no matter which index or sets of indices one uses, the results coincide substantially, which is in itself very instructive.

The proverbial "bottom line" is that the world's experience suggests that India is likely to prosper if, and only if, it:

1. Improves contract enforcement;

2. Removes regulatory restrictions on sale of property;
3. Liberalizes exchange controls;
4. Reduces dispersions on tariffs;
5. Removes regulatory barriers on trade;
6. Liberalizes ownership of banks;
7. Scraps minimum wage legislation;
8. Removes labour market controls that prevent flexibility in hiring and firing and implementation of retrenchment packages; and
9. Reduces bureaucratic intervention and compliance costs.

This report is an exercise in policy analysis, not political science. Its purpose is to establish which policy reforms would make India more like the world's winners and less like its losers, regardless of how politically popular or achievable they might be. Even so, it is probably uncontroversial to observe that the willingness of governments since 1991 to implement policies that were historically perceived to be unpopular suggests that the political will to reform should remain in the future. However, one cannot afford to slow down on reforms. If that does not happen, India is likely to be the world's next 'economic miracle' with high growth accompanied by less poverty, unemployment and inequality.

APPENDIX

Economic Freedom of the World Index Components

Policy Area 1: Size of Government (Expenditures, Taxes and Enterprises)

Area 1 has four components. Component (1A) measures government consumption as a share of total consumption and component (1B) assesses transfers and subsidies as a share of GDP, indicating the size of government. The third component (1C) measures the extent to which countries use private rather than government enterprises to produce goods and services. The fourth component (1D) is based on averages of (Di), the top marginal income tax rate, and (Dii), the top marginal income and payroll tax rate (and the income threshold at which the top marginal income tax rate applies). Taken together, the four components measure the degree of a country's reliance on personal choice rather than government intervention.

Area 2: Legal Structure and Security of Property Rights

Rule of law, security of property rights, an independent judiciary, and an impartial court system are components of area 2. They are drawn from two primary sources: International Country Risk Guide and Global Competitiveness Report.

Area 3: Access to Sound Money

Area 3 has four components, of which component (3D) measures the ease with which other currencies can be used via domestic and foreign bank accounts. A high rating applies if a country has institutions consistent with low and stable rates of inflation and avoids regulations that limit the free use of alternative currencies by its citizens.

Area 4: Freedom to Trade Internationally

The components in this area measure a wide variety of restraints that affect international exchange: tariffs, quotas,

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Habits of Highly Effective Countries is an empirical analysis of how India compares with policies associated with success and failure internationally. It illustrates inter alia that the integrity of the legal system is one of the most important factors – perhaps the most important – associated with success.

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