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Working Paper No. 343

Openness and Prosperity

by

Herbert Giersch

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Openness and Incentives*

1. Openness vis-à-vis the world and an improved incentive system at home are the key requirements for a lasting re-acceleration of economic growth in Europe, the U.S. and indeed most parts of the world. More specifically, the policy-oriented message to be propounded in this paper is essentially twofold: (i) Europe could already learn much from the U.S. to improve its incentive system and to make its internal markets more open. (ii) Openness vis-à-vis the world economy is a task to be pushed onto the policy agenda in the U.S. as well as in Europe and Japan. Such international openness involves more competition among governments and central banks, a competition that can support our hopes for limited government and sound money in future decades.

2. Forty years ago the outlook was much less bright; for many people in Europe it was almost desperate. My own country, Germany, although no longer on the road to serfdom, was still in a shambles. Millions lived as displaced persons lacking food and shelter in a centrally administered economy that left them no other room for self-help than the black market. But night changed into day almost suddenly when two measures were taken that had long before been advocated by liberal economists like Walter Eucken and Wilhelm Röpke: a currency reform and the quick removal of many controls. The currency reform was made by the Allied authorities, the removal of controls was the heroic decision of one man, Ludwig Erhard. Sound money and the restoration of incentives by reopening the market system produced a miracle that few had dared to expect. Without Erhard, who later succeeded Adenauer as Chancellor of the Federal Republic, the Marshall Plan, as useful as it actually was, might just have been another case of inefficient aid.

*This is a slightly modified version of the Presidential Address given at the 1987 Regional Meeting of the Mont Pèlerin Society in Indianapolis on September 6, 1987.

3. The lesson to be drawn is worth preserving. The controversy around the events was essentially about supply elasticities. Market pessimists and socialists stressed the existence of bottlenecks which would produce huge rents and unacceptable inequalities should controls be lifted. In contrast, MPS members and other economists of our persuasion argued that supply elasticities would turn out to be high after a short while provided individuals and firms were free to adjust. They were right. GNP growth rates in Germany averaged 8 per cent in the 1950s and 4.5 per cent in the 1960s. Mass unemployment, essentially due to a shortage of physical capital, disappeared in the 1950s. In the early 1960s the capital stock grew so fast that immigrant labor had to be pulled in. Surely there were unique factors at work: the economies of reconstruction and catching-up. But a comparative look at socialist East Germany demonstrates how much the Federal Republic owes to the opening of markets and the restoration of the incentive system.

4. This lesson is in danger of being forgotten as memories are short, and the miracle has been fading since the late 1960s. Fortunately, recent history has new examples to offer. European countries can learn from the miraculous employment performance of the U.S. economy in the difficult period after 1973, from the success stories of the small and open countries in the Far East, from the improved economic performance of Britain in recent years, and from experiments with free enterprise zones in several countries. We also see our case supported by the astounding effects of domestic market liberalization on agricultural production in less developed countries and by the hopes that millions of people attach to the promises of greater openness and better incentives in China and the Soviet block.

5. On the European continent we observe encouraging signs at the polls. They testify to sound instincts of the population in most countries. But economic policies and performances lag behind. The unemployment rates are far too high - 11 per cent on average in the European Community, 8 to 9 per cent in West Germany. In comparing unemployment figures in Europe and the U.S., we have to keep in mind that most European countries have lower female participation rates and much more disguised unemployment among formally enrolled students

than the U.S.. Europe's unemployment has hardly a Keynesian content. A mere demand boost would soon accelerate inflation. This is why such advice from the American East coast finds little response. Europe's deficiency is on the supply side. Just as the German currency reform of 1948 would not have produced a miracle by itself, but did so spectacularly in conjunction with a removal of controls, so does a better employment performance in Europe require a dismantling of those restrictions which make the labor market inflexible. It is this inflexibility which is meant by the term "Eurosclerosis", not any deficiency in high tech as some politicians and engineers believe. The focus is to be on the whole employment system, including barriers to entry for new entrepreneurs.¹

6. The inflexibilities blamed by the term "Eurosclerosis" are likely to develop everywhere, but they prevail less in the U.S. than in Europe, and they are more deeply rooted in European traditions. One root is the medieval guild system. It rested on the privilege of producers to organize themselves in cartels and to protect these cartels against outside competition by institutional barriers to entry. The apprenticeship system, as it still exists in Germany, is an essential part of it. This system is good for the formation of human capital, but separates insiders and outsiders. To be sure, the propensity to form cartels is always existent among producers of the same trade as Adam Smith's famous dictum underlines. This holds for services just as well as for goods markets as we know from professional organizations, craft unions, and labor unions. But without government protection the rents that keep these cartels together would be washed away. The mere threat of competition from cheaper sources of supply abroad or from the technological frontier may be sufficient to make participants behave "as if" there were actual competition. In the past, potential competition from abroad was strengthened by technical progress in international transportation; as to the future, we can anticipate great benefits for

¹Giersch, Herbert, Eurosclerosis, Kiel Diskussion Paper No. 112, Kiel 1985.

international competition from progress in telecommunication. No wonder that governments have been - and will be - under protectionist pressures most of the time.

7. Europe's guild and cartel heritage had and still has its protective belt, also in the world of ideas. Let me mention the ideas of nationalism and autarky, paternalism and solidarity, syndicalism and guild socialism, French planning and German codetermination, of industrial democracy and a third way between capitalism and socialism. They all contributed to a corporatist ideology as the Catholic Church did and still does with its socio-economic teachings and its influence on the Christian-democratic parties on the Continent. The common denominator is a deeply conservative longing for a specific and limited order which promises fair results to those who form part of it. This conservatism contrasts with such apparently horrible things as cosmopolitanism, Manchester liberalism, laissez faire capitalism or anarchy. Corporatist conservatism, in Europe and elsewhere, has on its side

- o the belief in old established professional ethics,
- o the plausibility of quality and skill requirements for the paternalistic protection of supposedly uninformed consumers, and
- o the emotional appeal of patriotism, xenophobia and other forms of separating insiders from outsiders, including anti-Semitism.

Outsiders are always suspected of practicing dumping or other forms of beggar-thy-neighbor policies. They are seen to disturb the solidity of the specific order, the functioning of corporatism as a system.

8. It is my conviction that corporatism in the labor market bears the main responsibility for Europe's rising unemployment after 1973. At that time a wage wave (against which labor had been warned in at least one country) culminated to collide with a cost push arising from energy prices and environmental concerns. It produced a squeeze of profits and investment and thus a capital shortage at the very time when the baby boom generation entered Europe's labor market. Corporatism is an inflexible system. Earlier on in the 1950s and 1960s, this system was slow to catch up with productivity advances when Europe's product markets developed surprisingly fast. The system

at that time permitted an excess demand for labor - without an excess demand for goods: classical overemployment. Now, in the 1970s, the same inflexibility produced the opposite result: excessive wages and, hence, classical unemployment. Full employment promises from governments made the wage negotiators insensitive to the negative employment effects they produced. And governments yielded when they were pressed to pay subsidies or to grant import protection wherever jobs came under the pressure of foreign competition. Corporatism gives birth to protectionism, domestic and international. This danger is great on both sides of the Atlantic.

9. Before making generalizations, there is a puzzle to be solved. Austria and Sweden, though often considered the most corporatist countries, used to have the lowest unemployment rates in Europe, together with Switzerland. To a large extent the explanation is openness. Being small countries they are almost bound - so to speak - by the force of nature to be open to international competition. And their neutrality prevented them from joining the European Community. Such natural and historic openness has two economic consequences. One is that outside competition is difficult to ignore or to shield off. Thus, the need to adjust is inevitable. The second positive effect is that openness due to smallness promotes consensus - as it does in the small group, in the club, in the family, in the corporation. Corporatism with consensus is more viable than corporatism without it or corporatism with class struggle. A corporatist consensus may even facilitate a necessary adjustment: in the Swedish case, real wages could be brought down by a currency devaluation in a social-democratic consensus. But in a longer perspective we see Austria and Sweden facing heavy adjustment problems. Their celebrated "active labor market policy", which mainly consists of artificially cutting the supply of labor by administrative schemes like government training programs, amounts to little more than a strategy of hiding the unemployment which results from excessive wages and wage rigidities. Clearly, this cannot be a viable long-run solution.

10. The cure for Europe's disease, in my opinion, is a comprehensive strategy of openness with a three-fold emphasis on privatization, deregulation and liberalization. As to the labor market, it

seems to me to be most urgent to establish - on a constitutional level - a "citizen's right to work". It is to be understood as the right to sell one's services at any wage an employer finds acceptable, independent of what is stipulated in collective bargaining agreements. Such a right, if it existed, would need public protection, given the prevailing corporatist mood in Europe. Otherwise, unemployed workers might be afraid of exercising it; and potential employers might resent the danger of being accused of exploitation.

11. A supplementary right to unrestricted market entry appears to be equally necessary in Europe. The public debate about such a right would already be helpful by revealing where such barriers have been erected to effectively exclude outsiders and thus to limit the supply of entrepreneurship. Once such an entrepreneurial right had been established, or were even only under serious discussion, a genuine process of discovery would soon gain momentum. It would make us aware of all the obstacles that have been erected over the years by legislative bodies and courts, but also by administrative acts, a myriad of obstacles that hardly anybody can be completely aware of now.

12. These citizen's rights are abstract rules similar to those advocated by MPS members against public debt, big government and increasing government interventions. Once established in statutes or only in people's minds, such abstract rules help to preserve the free society. But with regard to the right to work and the right of free entry into goods and service markets we are far behind, even in public discussion, at least in Europe. A new awareness seems to be required on the old continent, a kind of citizens' movement for openness. Why has such a movement not started long ago? One possible answer lies in the proposition that "exit" is an alternative to "voice" and that for centuries a migration movement across the Atlantic was enough of an outlet to calm down voice and protest in overregulated Europe. Those who built the free society under the American constitution can now conserve it. Europe is far behind in the process of liberalization, it still has a largely unfinished agenda of openness. Only consider that openness is merely another word for capitalism, and that capitalism in corporatist Europe is still a dirty word.

13. Openness also means competitiveness. In fact, there is hardly any better way of defining competitiveness in an economically meaningful sense. Nobody who charges an excessive price is competitive; and every country can be competitive in an overall sense if it allows the exchange rate to be freely determined in a competitive market. A truly competitive country excels in attracting mobile resources from the rest of the world: human capital and physical capital, knowledge and technology. By being open and hence competitive, North America attracted human resources from feudalistic and corporatist Europe. In recent years the U.S. has again attracted capital by running a current account deficit. In contrast to European politicians and many other observers, I do not mind these capital flows. Those who lend resources to the U.S. must know what they are doing since they have been warned by so many economists (and journalists) who tell them on the basis of macroeconomic data what precisely an imbalance is and how long it can last. What European politicians who worry have to realize is that capital flows across the Atlantic can surely be reduced and even reversed. But the condition is that Europe becomes more competitive on the world capital market. There is only one way to achieve this: Europe must offer better opportunities for entrepreneurship and investment by making its markets more open and its employment system more flexible. If capital imports are of great concern in the U.S., the answer to my mind is not protectionism in goods markets - that is a great danger to the free world - but a correction of those government distortions that depress the U.S. savings rate.

14. Europe's disease of high unemployment and slow growth is not only due to its corporatism. It must also be attributed to the excesses of the welfare state and the negative incentive effects they produce. What is primarily at stake in present-day Europe in this context is (i) the incentive to search for a regular job - instead of being unemployed or doing occasional work in the shadow economy, and (ii) the incentive to earn exceptional profits - instead of doing mere routine business.

15. There is no doubt that the welfare state in Europe has been greatly expanded over the last two decades. This is even more true if one includes government subsidies to agriculture and ailing

industries and other forms of domestic and external protection. The impairment of the incentive system which such a comprehensive welfare state is bound to entail did perhaps not become so obvious when the economy was rolling along at full speed on the straight road of quantitative growth as it did until the early 1970s. But when growth involves rapid structural change as it does nowadays in Europe under the impact of increasing competition from some newly industrializing countries, all this featherbedding is likely to be a severe brake on economic progress. Protection is a public bad because it destroys the public good of an enterprizing social atmosphere.

16. Most of those who feel this way welcomed the American sharp turn towards reducing taxes under the Reagan administration. But our hopes that Europe would feel inspired to quickly imitate the U.S. example were spoiled by the noise about the emerging budget deficit and by the Keynesian interpretation given to it in prominent circles. Nevertheless, some steps in the right direction have been taken in Europe, other steps are under consideration. But they will be far from sufficient to fully restore the enterprizing spirit in European countries. This is why we have to go on pleading not only for deregulation but also for the restoration of the incentive system through cuts in marginal tax rates.

17. Once a breakthrough has been made, success can be trusted to breed success in a virtuous circle similar to West Germany's postwar miracle. But even in a population that still keeps some memories of that successful experiment, it has proved impossible to arouse public emotions strongly enough to make politicians aware of a great opportunity for action on the tax front. Given this background, Erhard's 1948 reform under General Clay looks truly gigantic. Nothing remotely similar appears to be realistic for the time being. Even the simple and appealing rule that the government should let us have at our disposal at least half of the additional income we earn by rendering additional services to others was defeated in the German public debate about the modest tax reform scheduled for 1990. Thus, the principle of limited government will have to be continuously urged on the political agenda time and again, not only in the years but in the

decades to come. Competition among national governments for internationally mobile resources will help.

18. The third postulate of constitutional importance, apart from free entry and low marginal taxes, is sound money. Here again the best guarantee for citizens is openness. It involves free competition among central banks which amounts to a de-nationalization of money in practice. We are not as far from it as it may appear in abstract theory. One of its preconditions is free currency convertibility for capital transactions as well as for trade. As a citizen, I think that everybody who wants to protest against her or his government should have an inalienable right to emigrate and to transfer her or his claims and property rights to the new place of residence abroad. A second requirement is fully flexible exchange rates; they are necessary to avoid the high social cost of political misalignments and as indicators of good and bad behavior of central banks and governments.

19. In a regime of free international currency competition, national central banks have strong incentives to serve their customers loyally. Inflationary policies to artificially boost demand or to raise an inflation tax have quick boomerang effects. They induce a capital flight and thus increase the real rate of interest at the expense of all immobile domestic resources, notably labor, as Mitterand had to learn when he made his socialist experiment in 1981. Such boomerang effects are the reason why Keynesians are so eager to propose, and why some politicians are so fond of, international monetary cooperation or new gimmicks to tax the inflow and outflow of capital.

20. In contrast, sound money pays dividends in international currency competition. These dividends are not received by the central bank, but by the owners of domestic resources. Savers can feel safer and investors can trust in stable financial conditions with rather low real interest rates. The examples of Switzerland and - to some extent - Germany indicate the importance of this point. The case of Switzerland also proves that small countries can do as well under flexible exchange rates as large countries. Only when unsound policies are to be pursued is a small country's openness felt as a

constraint. Equally, large countries such as the U.S. can earn the premium of monetary stability. But their greater power is more likely to induce their authorities to adopt more permissive policies. This is the lesson of the late 1960s, when currencies tied to the dollar were effectively compelled to inflate as a contribution to financing the Vietnam war. Liberal economists who at that time effectively fought for flexible exchange rates, e.g. in Germany, have no reason to regret this.

21. In an open world economy, countries are bound to compete for internationally mobile resources. This should be an incentive for national governments to be more efficient and less populist, and to limit themselves to the supply of those goods and services for which they have a comparative advantage relative to private enterprise, relative to voluntary associations, and relative to local governments in their domain. This lesson of international competition among governments may not have come through yet. But it is imperative and impelling. Competition for lowering tax burdens will remain on the agenda in advanced countries competing with the U.S.. And deregulation is bound to spread from the U.S. to other countries, though it will take more time than we wish. Yet we also hear increasingly strong calls for international cooperation and coordination, in Europe also for harmonization. In fact, these calls amount to pleas for the formation of government cartels. Apart from the GATT, such cartels are cartels for intervention, cartels to reduce openness and incentives. The term cooperation just clouds the issue.

22. Behind the calls for coordination and harmonization, I believe I recognize the pretense of knowledge and the voice of constructivist rationalism. Economists specializing in matters of international economic policy feel tempted to offer their advice to policy makers who are eager to show that summit meetings are more than show business. These economists make politicians believe that the world economy will perform better if it is run by a visible hand. Targets are being suggested for various policy variables, not only for monetary expansion where they have some useful information content, but also for national GDP growth rates, for current account balances, and for fiscal deficits. The emphasis is, of course, by

necessity on the demand side where macro-economists have their domain, not on the supply side where the real work has to be done for faster spontaneous growth. In this sense, the demand bias and the coordination talk is potentially counterproductive, a red herring. Sufficient demand will come forth in the world economy - in the absence of a monetary contraction - if individuals and firms are free to increase their supplies and to learn how to adjust quickly to changing conditions on a worldwide market. But the freedom to adjust needs to be given to them, so that the required adjustment and the learning that has to go on all the time can take place in competition. The politicization of the world economy through coordination is not helpful in this respect. It can only have the consequence that the word "crisis" is heard and read disturbingly often in the news: balance of payments and foreign exchange crises, trade wars, breakdowns of commodity markets, beggar-thy-neighbor accusations. The politicization symptom most horrible to an international economist of the classical persuasion is the increasing tendency to focus on bilateral trade relations and to assert with strong moral overtones that they have to be balanced.

23. All this could be extensively developed into a lecture on methodological individualism in international economics. Let me merely say in conclusion that it helps greatly in the classroom to see the world as a catallactic system divided by national borders of diminishing importance - with competing national governments and monies, competing tax systems and business firms, internationally mobile and immobile owners of human capital and property rights. Such a view can prevent the student of economics from uncritically internalizing holistic concepts like economy and country or statistical constructs like GDP or bilateral trade flows which, unfortunately, feature prominently in the rhetoric of politicians and of economists close to the political scene.

24. An individualistic openness of the mind is perhaps the best protection against collectivism. In matters of economic policy, national and international, openness is intimately tied in with competition and incentives. The communication revolution that is going on was once thought to lead to an Orwellian nightmare. It may well turn

out to work for decentralization and individual responsibility instead. This supports the confidence that we have passed the watershed and that the way before us will lead to a truly open world economy.

Individual Freedom for Worldwide Prosperity*

1. In the past few years, it has become increasingly evident that needs and opportunities follow parallel trends in the East and in the West. While liberal Western economists speak out for more openness and better incentives, the Soviet Union strives for "glasnost" and "perestroika" which, in Russian, means little more than an improved incentive system. This is encouraging. To be sure, some of us in the West presently feel that we were too optimistic a few years ago about the development in the foreseeable future. Such setbacks are perhaps inevitable everywhere, notably in countries that are in the vanguard on the march towards an open world order. But we can derive hope from the fact that a loss of steampower at the front of the train does not necessarily lead to its slowing down if the brakes happen to be loosened elsewhere, for example at the end of the train. Socialism is in a deep crisis. This has an effect on social democrats all over the world. The Mitterands of today are far more open-minded than they were a decade ago. And so is the general public in many countries.

2. One may question whether the world is as interlocked - or interdependent - as to warrant the metaphor of a train. My answer is positive for the purpose at hand. The world's recent history shows that there are worldwide movements in thought and practice. Let me give some examples.

3. World War I brought an end to the liberal world order of the 19th century. It gave rise to economic centralization and comprehensive planning in many countries and led to Marxist and Fascist dictatorships in Eastern and Western Europe right through World War II. Lenin and Stalin, Mussolini and Hitler were cynical dictators

*This is a slightly modified version of the Presidential Address given at the Opening Session of the 1988 General Meeting of the Mont Pèlerin Society in Tokyo on September 5, 1988.

with a deep disrespect for the individual, urging the masses to sacrifice personal liberty and even life for the collective good of some class or party, nation or race that was claimed to be superior to others and to be destined for victory by some imagined laws of history. In the interwar period, the world was being closed in every respect: historical determinism reigned over openness, government planning over individual choice; autarchy and protectionism gained over 19th century multilateralism and free trade; exchange controls replaced the gold standard.

4. This closing of the world order continued after 1945 in those parts of the world that became known as the "South" (in the so-called North-South conflict) or the "Third World": Mao's China, Kim Il Sung's North Korea, the Indochina of Ho Chi Minh and Pol Pot, Ne Win's Burma, Sukarno's Indonesia, Nasser's Egypt, black Africa mostly under one-party dictatorships. The list can be lengthened by many more names, including Castro's Cuba and the countries suffering from "proxy" wars. At the end of the list we would have Khomeini's Iran and Soviet occupied Afghanistan.

5. The counterrevolution after World War II started in the defeated nations of Europe and Asia, notably in General Clay's Germany and MacArthur's Japan about four decades ago. While the Third World came under the influence of Harold Laski, Friedrich A. Hayek's socialist counterpart at the L.S.E., the intellectual battle in the advanced countries of Europe and Asia was won by Hayek. The idea of freedom for prosperity quickly spread in the West thanks to the German miracle which we owe to Ludwig Erhard and the advice and support he received from Wilhelm Röpke and from Walter Eucken.

6. Books such as Hayek's "Road to Serfdom" surely carry conviction, mostly among readers who have been conditioned by their experience to feel instinctively that the thought they absorb must in fact be true. But equally convincing is the experience from the successful experiment that invites imitation. The liberalization of trade in Europe, fostered by Marshall Aid, was one form of transmission, Germany's early move towards convertibility on capital account in 1958 was surely another. Countries lagging behind in the

liberalization process turned out to be laggards in income growth as well. The naive political assertion that government planning rather than economic freedom is required to overcome poverty was refuted by experience. In the late 1970s Britain closed a historical circle by losing faith in Fabianism and by rediscovering liberalization as the only appropriate cure for the British disease - about two centuries after one of her greatest sons had shown the way towards the "Wealth of Nations".

7. In Asia it was the example of Japan's outward orientation that invited imitation. The small Asian countries that could not afford the luxury of a closed economy followed the same track. Economic liberalism brought about spectacular growth in the Pacific Rim, though not always accompanied by a parallel process of political liberalization.

8. But there is hope for political pluralism in the future. It rests on the notion of politico-economic interdependence. This interdependence may be conceived as consisting of a vicious circle and a virtuous circle. Both can be illustrated by reference to recent history.

9. A vicious circle was at work in the interwar period when the rise of dictatorships and central planning reinforced the disintegration of the world economy and when this disintegration in turn made it easy and almost costless for dictators and planners to strengthen their power by closing the economy. The folly of the Smoot-Hawley tariff in the U.S. was surely a contributing factor in political practice, just as in the intellectual debate Keynes' writings on "the end of laissez faire" and on "national self-sufficiency" (Keynes, 1926, 1933) were perceived to support an inward-looking interventionism. Central planning and autarchy became, of course, less objectionable and even quite popular, given the mass unemployment in the wake of the Great Contraction and in the absence of appropriate measures to cure it quickly. There is a big question on which I have been pondering for more than fifty years: would Hitler have come to power without mass unemployment and the disintegration of the world economy? My answer is no. Had prosperity prevailed rather than distress,

my father's generation would have opted for freedom. But my judgement is perhaps biased by the striking experience during the last four decades when I was lucky to observe how individualism and worldwide prosperity provided a firm basis for democracy in the Western part of my country and in many parts of the free world.

10. The change from the vicious circle to the virtuous circle might have come about spontaneously, albeit with some delay, if it had not been for the war. In actual fact, the economic turnaround was prepared for the world by the Western Allies at their conference in Bretton Woods (1944) and could start only after the war had ended with the liberation of Western Europe in 1945. I do not think that Bretton Woods was decisive; but it formulated and expressed the political will to restore a more open world order, at least for trade in goods. The crushing of dictatorships, however, was decisive. It opened the door towards a free market in ideas as well as in goods. When Friedrich Hayek gave his Opening Address to the first MPS meeting at Mont Pèlerin on April 1, 1947, he observed,

"... the farther one moves to the West ... where liberal institutions are still comparatively firm, and people professing liberal convictions still comparatively numerous, the less are these people prepared really to reexamine their conviction and the more are they inclined to compromise I found on the other hand that in those countries which either had directly experienced a totalitarianism regime, or had closely approached it, a few men had from this experience gained a clearer conception of the conditions and value of a free society ... the actual decay of a civilization has taught some independent thinkers on the European Continent lessons which ... have yet to be learnt in England and America" (Hayek, 1967a, pp. 149-150).

11. Hayek's message can be compressed into a brief statement: bad experience gives rise to lasting lessons. But let me add: societies must be free in order to be able to transmit such lessons and to apply them in practical life. Eastern Europe lacked such freedom. When Western Europe became free, it learnt the lessons in almost no time. It learnt them lastingly from the prosperity which economic

liberalism was quick to produce in Europe's most devastated and impoverished parts. The transmission of experience was certainly facilitated by the relative cheapening of medium-range transportation and communication. This holds also for Eastern Europe. Without the decline of information costs, we would hardly have had the uprisings in East Germany in 1953, in Hungary and Poland in 1956, in Czechoslovakia in 1968. And in the Soviet Union, would there be perestroika without glasnost and hence more information, and would there be the loosening of Moscow's grip in the former Baltic states in the north and the Transcaucasian states in the south? My answer is no. Cheap communication and up-to-date information may often surpass our capacity to absorb, thus impairing e.g. our sense of history; but we have to be grateful that it has telescoped our geographic awareness with at least one important consequence: cheap communication is making freedom more contagious.

12. In his book "1984", George Orwell warned us of the danger that cheap communication would turn out to promote centralization and dictatorship. In this way he contributed to immunizing the world against this danger. But if my reading of recent history is correct, I have come to be sure that, in the present circumstances, cheap communication on balance works in favor of a decentralization rather than a centralization of decision-making. The opportunity exists in all dimensions of decision-making: within firms as well as in the worldwide division of labor. Cheap communication has a potential for serfdom as well as for freedom but, given the prosperity that freedom and capitalism have produced in recent history in large parts of the world, the net effect in the future is likely to be in favor of individual liberty.

13. Setbacks on the march towards an open world order should not discourage us. Looking back we can gain optimism from the fact that the revival of Marxism and the emergence of the New Left which we have observed - in the wake of the Baby Boom, the expansion of higher education, the Chinese Cultural Revolution and the Vietnam War - did subside in little more than a decade. This intellectual fashion stirred up the atavistic emotions of young people who had learnt to see the world through ideological glasses and were not

acquainted with the traditions and the lessons of social history; but it left few traces in the social fabric of today (putting aside left wing terrorism in parts of Europe). We can also derive comfort from the observation that the idea of a "New International Economic Order" did not survive the 1970s and quickly died when the international debt problem came to the fore. This debt issue showed that an international resource transfer is of no use when the recipient countries fail to make productive use of the imported capital or when they pursue policies that necessarily lead to a capital flight.

14. In the advanced countries, a new serious threat to the free market is arising from the ecological concerns. We know that the social costs of using the environment are not taken care of by the price mechanism because our system of property rights does not include public goods like fresh air and clean water. For us, this ecological gap highlights the importance of private property; for the other side, this gap is a failure of the market system inviting all sorts of government regulations and controls. No wonder that socialists and ecologists often join forces with bureaucrats and politicians eager to exercise controls and that they are supported by intellectuals in the media who address themselves to people's emotions. We know that bureaucratic solutions, apart from limiting freedom, are economically wasteful in this as in other fields. The adoption of direct controls for environmental purposes has certainly contributed to the slowdown in productivity advance which the industrial countries have experienced since the late 1960s. In many cases this negative effect was not understood and was, therefore, not anticipated in collective bargaining on the wage front. Therefore, environmental dirigism has contributed to the rise of unemployment at least in Europe. The lesson for the future is that environmental problems should better be dealt with in ways that are more compatible with the market. What Hayek wrote in 1960 about town planning equally applies to environmental policy:

"The issue is ... not whether one ought or ought not to be for ... (it) but whether the measures to be used are to supplement and assist the market or to suspend it and put central direction in its place" (Hayek, 1960, p. 350).

15. In the new field of environmental policy, economists can demonstrate in very specific terms that market-oriented solutions are least costly. One need only compare the direct emission controls (command and control measures) with the auctioning of emission permits. The auctioning method has the clear advantage that it leads to scarcity prices which give all polluters a general incentive to mobilize the available knowledge and to search for innovative solutions. In Hayek's terms, they ensure a better use of knowledge in society. Moreover, specific controls which impose state-of-the-art technology usually provide some period of grace for existing firms, while requiring full compliance by newcomers. This is why the business establishment likes them. Auctioning prices, on the other hand, do not discriminate against newcomers. By keeping the market open, they are not only efficient but also fair.

16. New technologies, one often hears, deserve the financial support of national governments if, as some economists add, the new ventures promise economies of scale that are large enough (relative to world markets) to be worth capturing for the domestic economy. This interventionist argument is similar to that for an optimum tariff designed to exploit the country's monopoly power. And it is also similar to some superficial version of the old infant-industry argument for protection. As government support takes the form of a subsidy - rather than a tariff - retaliation leads to competitive subsidization. For the world economy the outcome is likely to be an excessive pace of technological advance in one direction, at the expense of an alternative use of resources, including alternative paths of technological progress. I suspect this to involve a waste of resources in most cases. Technological mercantilists derive their enthusiasm from the notions of increasing returns or scale economies. In my view, their position is as unfounded as the old physiocratic myth that agriculture was the only really productive sector or as the subsequent enthusiasm for industry that assumed long-term economies of scale to be associated with manufacturing and its inherent

indivisibilities. In contrast, I maintain that we can have - or will happen to have - fast productivity advance in any line of production for which we can produce - and in which we can apply - new knowledge¹⁾.

17. It is true that the leading sector attracts human brains, but this is not to be confused with increasing returns. Moreover, the leading sector often enjoys government support for import substitution or export promotion. Entrepreneurial politicians in power can be quite quick in joining the bandwagon to promote a sector that is likely to show gains in the foreseeable future anyhow. This is technological mercantilism rather than increasing returns. As to the opportunity costs of government support for certain lines of applied research, we can only confess that nobody knows them. Hence, they will be neglected in the political market. This bias leads to a speeding up of certain technological developments with two serious consequences. One is the danger of running up against unforeseen bottlenecks, i.e. unbalanced growth with cycles in investment activity. The second danger is an increasing public animosity against technical progress as such. What the public seems to be afraid of is the great leap forward which is the exact opposite of those piecemeal improvements on a broad front that are brought about in the market by innovative competition on the supply side subject to continuous testing by consumers on the demand side. Big governments bring about bigger events, some of which may well be disasters such as the wars of the past, or future ecological catastrophes, as feared by so many. What is strange, then, is that ecopacifists, especially in Europe,

 1) And for the time being, I take the position that the notions of increasing returns, scale economies, synergy, unbalanced growth and so on either refer to indivisibilities that are partly man-made and short-run phenomena or are a myth based on the mechanistic assumption that growth means quantities rather than quality, size rather than satisfaction.

are often so close to collectivist ideas instead of becoming libertarians.

18. Whenever something is going wrong, a choice can be made between more government or less government. Most people still feel that more government is the natural solution. They even do so when big government was the problem to begin with. In the international field, many observers deplore that we have a world order without a world government. In the absence of a world government, they would say we need at least policy coordination to avoid chaos. These observers equate competition among governments with a beggar-thy-neighbor game or even an approximation to war in the extreme case. Coordination thus appears as a self-evident necessity requiring - like motherhood - no intellectual defense whatsoever. But there is an open question: coordination - what for? If it is to preserve the earth's ozone layer or for other genuine world public goods like peace, hardly anyone would fail to support it. But if, on the other hand, coordination is tantamount to an intergovernmental cartel, I would strongly object because I consider the emerging competition among governments for internationally mobile resources to be the best protection for the saver and the consumer, for the holder of money and financial assets, and for the taxpayer and the individual as a citizen. Government cartels to eliminate competition for internationally mobile resources would destroy the best hopes we can have for an emerging open world order.

19. Even in the more technical field of monetary policy the case for coordination is not very convincing. Proponents of coordination are full of praise about how coordination helped to avoid the severe consequences which the stock market crash of October 19, 1987, might have had on worldwide prosperity. Yes, the outcome could have been worse than it was. But why should we attribute the functioning of the capitalist system to policy coordination? Was it not in the enlightened interest of every large country and central bank anyhow to let the demand for money find an elastic supply when liquidity preference was expected to increase in the wake of the crash? Was this not the lesson we have learnt from Milton Friedman's research in monetary history? The answer is yes.

Moreover, there was and there always is a good reason to inform and perhaps also to consult each other, mainly to avoid intervention at cross purposes. Yet behind this, there is the awkward question whether the "Crash" itself was not the consequence of previous coordination efforts and their interpretation by the market. Martin Feldstein offers an answer:

"The expectation that (U.S.) monetary policy would tighten to defend artificial exchange rate levels can destabilize financial markets. The fear that the Fed would push rates even higher than they were in early October - to offset the downward pressure on the dollar that resulted from the unfavorable trade news of October 14th - was one of the key factors that triggered the stock market crash." (Feldstein, 1988, pp. 5-6).

The general lesson is clear: If in an open order some values or prices are made less flexible as a result of coordination, something else, be it prices or volumes, will suffer greater fluctuations. The normative conclusion is simply: governments and central banks should allow markets to operate freely and should themselves proceed in a fairly predictable way so that markets are not disturbed and can operate more smoothly. This would be coordination for nonintervention. Whether policy coordination for activism makes the economic universe more predictable is open to fundamental doubts.

20. Despite last year's stock market crash, the world economy is in a good cyclical position. The upswing that started in late 1982 has completed its sixth year. The figure for GNP growth has been around three percent in the industrial countries and in the world as a whole for more than a decade. A slowdown in the OPEC area was compensated by faster growth elsewhere; and shortfalls in Africa and the Middle East were outweighed by extraordinarily fast growth in Asia, notably in the Asian NICs.

21. Looking back at the whole period since World War II we may safely say that capitalism has shown an extraordinary vitality, giving us the fastest economic development the world has ever

experienced in its history. Compare this with the gloomy picture that was painted for us 140 years ago by Marx and Engels in their Communist Manifesto or by the Stagnationists around Keynes and Alvin Hansen 50 years ago.

22. To take only the Stagnationists, it is hard to avoid the conclusion that they were wrong on all accounts.

- (i) Did a saturation of consumer wants and oversaving become a limit to economic growth? It did not in the past, nor will it in the future, because people have unlimited desires, not limited wants. And if there is anything wrong with present savings it is that they are too low in large parts of the world.
- (ii) Was there - as the Stagnationists feared - a decline in investment opportunities because of American capitalism approaching geographic frontiers? The answer again is no. Instead, we observed the rise of international corporations operating on a worldwide scale. This rise was unforeseen by the Stagnationists and thus demonstrates how wrong one can be if one sticks to the traditional closed-economy assumptions.
- (iii) Was there - or will there be - a dearth of investment opportunities arising from a slowdown of invention and innovation activities as the Stagnationists thought? The answer again is no. More people than ever are living on this planet who are capable of doing research, of inventing, and of transmitting new knowledge at ever lower communication costs. The people who are ingenious may be limited as a percentage of total population, but the absolute numbers have been growing all the time due to overall population growth; and a larger part of the world's population has come or will come into closer contact with knowledge production due to declining communication costs.

23. Keynes in his growth pessimism once predicted that full employment policies would bring the long-term interest rate down to zero in one generation. Instead, we observe that the real interest rate (which is what he apparently meant) is at a historically high level. This is a signal for the world's population and for governments to save more so that more of the vast investment opportunities which the future seems to offer can be exploited in a shorter period of time. The high interest rate is also a signal to make better use of existing resources, to exploit fully the productivity potential that free trade offers through a worldwide division of labor, and to augment this productivity potential by letting capital, and capital-intensive human resources, flow freely across national borders.

24. This brings me to the agenda for accelerating the move towards an open world order. The productivity and growth potential that we could exploit by free trade is anything but small. It could even be enlarged by deregulation so that competition from outside sources could fully penetrate the sheltered domestic sector. In that case I would trust an estimate, derived from cross-section analyses of effective protection in the 1960s and 1970s (Heitger, 1987), that free trade would not only bring a once-and-for-all increase in the world's productive potential, but a permanent increase in output growth by about 2 percentage points. Thus a really open order could well reproduce the high growth rates the world had in the 1960s.

25. Resistance comes from organized interest groups. They lobby for protection against cheap imports that make the income prospects of domestic producers deteriorate. But such deterioration is necessary to push resources into alternative uses where they are more valuable at world market prices. The resulting protectionism has nothing to do with the theoretical arguments for import tariffs based on monopoly power or some presumed market failure. On the contrary, such defensive protectionism arises because markets are seen to work properly, though in a fashion that is regarded as cruel. Those negatively affected feel hurt, but what they want to have protected is usually nothing but the rent

element in their incomes. In their rhetoric they make us believe that they just need support to smooth the adjustment process. In a similar way they want protection against what they call dumping, a price-cutting by foreign suppliers that is often not more than one has to expect from new entrants into an open market. The protectionist rhetoric is designed to appeal to xenophobia or fairness. John Rawls is called in to help close the economy.

26. But such a closing amounts to a destruction of income opportunities elsewhere. Those hurt include not only people at home - i.e., consumers and producers in the domestic export sector. Those most severely affected are likely to be the much poorer people in the export sector of some less developed country, poorer people eager to catch up. Harming such poorer people is certainly not fair in the Rawlsian sense. The fact that insiders invoke the fairness principle immediately raises the question about outsiders: whose interests are (implicitly or deliberately) impaired by those who claim fairness for themselves? In international trade, the outsiders include foreigners; in the similar case of protection against new technologies, the outsiders include future generations. In this wider perspective the whole idea of fairness, including fair trade, becomes highly suspect as a violation of Kant's categorical imperative. It is free trade, not fair trade that meets Kant's norm.

27. Protection or subsidization, even if introduced on a temporary basis, becomes nearly always permanent in practice. Sunset provisions for phasing out such support may be a rational remedy; not, however, in permissive societies. Such societies show a tendency to being closed more permanently, often behind an ideological veil. This largely applies to Europe. In Europe, politics still has a more romantic or ideological flavor than Public Choice Theory would allow for. Without this romantic element in European thinking and politics, I could not possibly explain the public support which Europe's protectionist agricultural policy still has, although employment in agriculture is down to a small percentage of total employment, e.g. five percent in West Germany by 1986. In addition to the romantic notions of fairness and

permissiveness there is an important role being played by mere tradition. Even the very notion of fairness is - in a historical context - heavily determined by the past. In the absence of a specific criterion for fairness, people are inclined to take the relative income positions of the recent past to which they have become accustomed as a kind of benchmark for judging the fairness of relative incomes today. This tends to create implicit property rights, quasi-entitlements in income maintenance notions. They play a role in some European market economies which their proponents call "social". The outcome is defensive protectionism, international and domestic, i.e. the closing of markets for the preservation of previous relative positions of income and status.

28. Consider again agriculture. Numerous suggestions for liberal reform have been made in Europe without much appeal in practice. The radical solution I support and prefer would be to abolish all agricultural support systems at one stroke and to give farmers a once-and-for-all compensation for the loss in earnings (and land values) which would result from this move to world market prices. The compensation given to farmers would be interest-bearing government bonds. Nobody directly affected would lose, but those who have to foot the bill now and then - as consumers and taxpayers - are certain to gain. Surplus production would disappear, and all the wastes would go, including the ecological damages resulting from overfertilization. Farmers could reinvest the compensation they receive; and lower farmland prices would provide an incentive to reforestation and other forms of land use which would then become profitable. To be sure, there are technical difficulties as with every reform. But so far the idea as such has hardly caught any attention. Why is this so? One answer is that we may be up against atavistic irrationalities in moral judgements. The farmer is taken to provide us with the bread that used to be asked for in prayers; and it has to be the nearby farmer - as in previous times when high transportation costs and tribal wars prevented the emergence of an extended order. It is this extended order in which people do not yet instinctively trust. Agricultural protection is perhaps the extreme case of resistance against the

emerging open world order. In the current Uruguay Round of GATT negotiations it may turn out to be the major stumbling block.

29. As far as the E.C. is concerned, Europe has embarked on a program of completing the internal common market by 1992. This involves the removal of all border obstacles to the free movement of goods and services and of capital. The static gains have been estimated to lie between 4 and 7 percent of GDP. Additional dynamic gains can be expected from more intense competition if the move is accompanied by deregulation and privatization and by a parallel external liberalization that most free market economists would consider essential. We hope that the European label and the magic number that 1992 may become - half a millenium after the discovery of America - will accelerate the work for reforms which have been on the agenda of some countries for a long time but have so far been repressed by what we call "the tyranny of the status quo" (Friedman and Friedman, 1984).

30. A real breakthrough - at least in doctrine - was achieved by the E.C. Commission's 1985 White Paper. This document was largely written by the British Commissioner Lord Cockfield. In the same vein, there was a decision by the European Court establishing the principle of the country of origin in matters of regulation. This principle amounts to the rule: what is legal in a product's country of origin must not be an import impediment in the country of destination. This principle of the country of origin could also apply to value added taxes as has been suggested a long time ago (Giersch, 1962). These indirect taxes would then be treated like direct taxes - i.e. as a cost equivalent for the public goods consumed at the location of production. What the country of origin principle thus generally implies is free competition among different locations where taxes are locational factors like land prices and where rules and regulations are part of the locations' infrastructure. Such free interlocational competition, therefore, really is competition among governments; it is the competition of governments for internationally mobile resources such as capital and entrepreneurship and also labor with a high content of human capital. This competition, if not regulated by harmonization

agreements, would force governments to improve their price-performance ratios, i.e. to reduce their x-inefficiencies, in attempts to attract valuable resources. Such attraction, in the end, would also benefit local land and labor. A harmonization of regulations and taxes would come about as a result of such competition, but in a stepwise process leading to a much lower level of regulation. The outcome would be more to the taste of those mobile resources which are the object of competition. And they happen to be the resources which need openness as a condition for making their best contribution to future progress.

31. Such competitive harmonization - in a process similar to natural selection - of course goes against the grain of what Hayek called constructivist rationalism (Hayek, 1967,b). Such rationalism - or constructivism - has so far dominated postwar European thinking under the French influence from Jean Monnet to Jacques Delors. In this respect Lord Cockfield's White Book of 1985 was a revolution, a Waterloo for Descartes so to speak. But the struggle between constructivism and evolutionary selection goes on. It is not yet decided in practice, e.g. in the field of regulation; and it may be the constructivists who will win, at least in the area of European monetary unification.

32. Tendencies we observe on the world level - towards fixed exchange rates, target zones, monetary coordination - are even more clearly visible in the form of monetary constructivism in Europe. The Common Market is said to need a common currency which is to emerge from the present cooperation of central banks. What many politicians want is the emergence of a monetary monopoly from a central bank cartel. If the need for such a European currency were real, there would also be, to draw a parallel, an even greater need for a common European language, equally to be constructed, perhaps by an academy of linguists, as a compositum mixtum of ingredients from all national languages. But instead of Esperanto, English has turned out to be the winner in the linguistic market. In the monetary market, the ECU as a composite money so far has not won in intra-European transactions, neither against the dollar nor against the Swiss franc or the Deutsche mark. And it is open

to doubt whether any artificial money will ever win against a currency that, over a long history, has gained great credibility as a stable store of value - and more credibility than a composite money, with many less credible currencies as constituent elements, can immediately offer. The only solution, apart from natural selection by competition among existing currencies, would be to supply an index-linked ECU as a parallel currency. If governments and central banks failed to make such an innovation, private banks could do so, of course not only for asset holding and transactions in Europe but also worldwide.

33. Individual freedom would bring about such an innovation if freedom were specified to include, as a citizen's right, the free choice of currencies. Other citizen's rights are also essential for the move towards an open world order. They include

- . the right to low marginal income taxes,
- . the right to work - in the sense of being allowed to sell one's services at any wage an employer finds acceptable, and
- . the right to unrestricted market entry into goods and service markets.

The right to work is, of course, directed against syndicalism and the discrimination against outsiders that syndicalism often entails; whereas the right to free market entry is the leverage needed to mobilize citizens - as workers against domestic corporatism, as consumers and exporters against international protectionism.

34. The right to low marginal income tax rates - and in a sense the other rights too - would be less urgent points on the agenda if there were full freedom of capital movements and free migration, particularly for human capital. Governments would then feel much more constrained by the pressures of locational competition and would be forced, as already indicated, to offer more freedom to the suppliers of mobile resources.

35. Locational competition - or competition among governments - is perhaps the decisive criterion for the openness of the world order. Under competition and openness people have more and

greater opportunities for "exit" as an alternative to "voice" in expressing protest. This gives hope for a de-politicization of life. The constraint for government arises not only from actual competition; it may also arise from potential competition, i.e. from credible threats of emigration by future-oriented, and hence particularly valuable, resources. Will governments become more sensitive to such threats? I suppose the answer is yes, however, under the proviso that governments do not find it opportune to form cartels under such headings as cooperation, coordination, harmonization, or political integration. Without such cartel arrangements, individual freedom will also find allies among the owners of immobile resources - including labor. The latter are bound to realize sooner or later that their future earning prospects largely depend on the presence of mobile resources which are likely to be entrepreneurial, innovative or merely future-oriented like investment capital. While there may be antagonism between labor and old capital in a closed society, an open society which competes for mobile resources is bound to learn the medium-term lesson of positive complementarity between labor and new capital. My anti-Marxist hope is that declining communication costs, including border controls, will make old class conflicts more and more obsolete and strengthen the tendencies for productive cooperation within competing units.

36. In this perspective, the poor will increasingly realize that they have better income prospects in the neighborhood of the rich than in the neighborhood of the poor. In some parts of the world, like corporatist Latin America, much will depend upon whether public opinion, including the church, is prepared to learn this medium-run lesson of openness quickly enough. Otherwise, these countries - being uncompetitive in world capital markets - must face the danger of falling into the poverty trap - in a vicious circle of overpoliticization and overindebtedness, political unrest and economic decline, administrative corruption and hyperinflation, in sharp contrast to the open and competitive countries, as we find them in Asia, that have good opportunities to demonstrate the working of the virtuous circle of individual freedom and increasing prosperity.

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