

To: SOMC Members
From: Lee Hoskins
Subject: Property Rights and Wealth¹
Date: 15 October 2001

“A man has a property in his opinions and free communications of them. He has a property of peculiar value in his religious opinions and in his profession and practice dictated by them. He has a property very dear to him in the safety and liberty of his person. He has an equal property in the free use of his faculties, and free choice of the objects on which to employ them. In a word, as a man is said to have a right to his property he may be equally said to have a property in his rights.... Government is instituted to protect property of every sort; as well as that which lies in the various rights of individuals as that which the term particularly expresses. This being the end of government, that alone is a just government which impartially secures to ever man whatever is his own.”

James Madison

At the end of the day, democratic national governments have but one overriding objective: to protect the life and property of their citizens from foreign or domestic threats. Terrorism exacts a truly terrible toll on human beings around the world and it undermines and weakens the very foundations that have allowed societies around the globe to improve their standard of living. Coalition governments, working to eradicate terrorism, not only secure life but also secure property in the Madison sense of the word which helps lift millions from the misery of poverty.

The pursuit of self-interest and the desire to improve living standards are widespread and fundamental across societies. Yet some societies are much more effective than others in creating wealth and improving the human condition. All too often, a focus on the benefits of pursuing what is in our best interest overlooks the importance of the legal and institutional structure within which self-interest is pursued. That legal structure—the presence or absence of private property rights and their rightful enforcement—is a crucial determinant of the wealth of nations. Indeed, a casual look around the world today suggests that the progress of economies that ignore this fundamental aspect of economics has creaked to a halt, while the fortunes of those that prized it have soared.

¹ Remarks are based on a forthcoming paper by Ana Eiras and me to be published in the “2002 Index of Economic Freedom “, sponsored and produced by the Heritage Foundation and The Wall Street Journal

Economists, with few exceptions, recognize the ability of worldwide open markets to raise living standards and limit the scope of government intrusion into economic affairs. They have given less recognition, however, to the source of the power to raise living standards—privately owned and transferable rights to resources. This is an important oversight and one that should be corrected if we are to understand why some economies remain trapped in poverty and others create wealth.

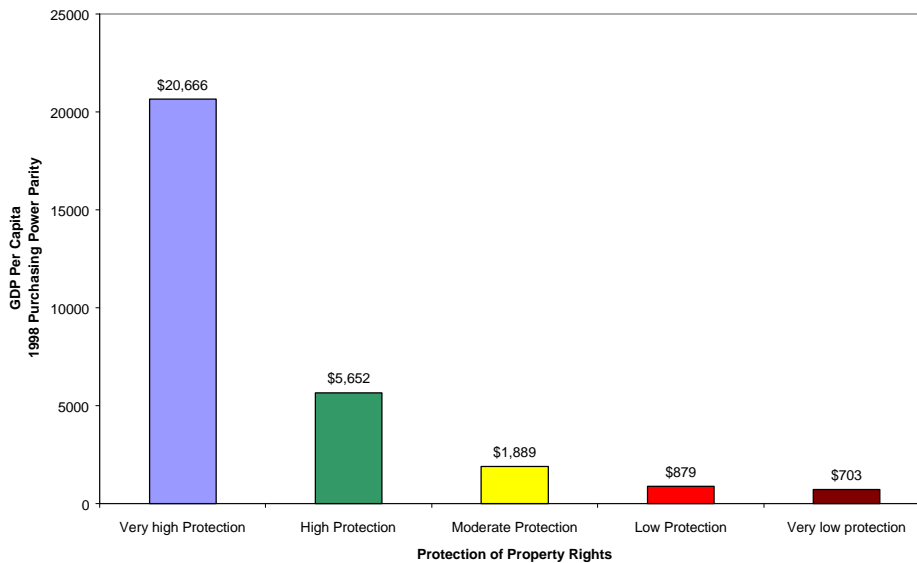
Government intrusion in the economy through policy has been and continues to be the main source of property rights infringement. Governments intrude not only through regulations, but through inflation and the consumption of scarce resources in economic activities that, most of the time, the private sector could carry out much more efficiently. A much more constructive role for governments would be defining and protecting private property and letting the market decide what is the best way to make use of resources.

For the past 20 years, many parts of the world have followed a trend to open markets. Part of the reason is a recognition of the benefits of freeing the economies. But this trend has also responded to technology. By lowering the cost of transferring information and allocating capital, technological advances have exposed and punished protectionist countries with sudden and massive flights of human and non-human capital. Even though there remain areas (like the environment and intellectual property) in which defining property rights is more challenging, the definition and protection of property is the single most powerful reason some countries grow while others remain trapped in poverty.

Most economists would agree that a free flow of economic activity guarantees the best use and maximum productivity of each resource. For that flow to be effective, however, countries need to define property rights and create a legal framework to enforce them. For example, a worker should be free to work 12-14 hours a day seven days a week if he or she chooses to do so; a business should be able to open or shut down without undue interference; individuals and firms should be able to sue and to have that lawsuit adjudicated justly and promptly.

Chart 1 depicts the relationship between protection of property –defined in terms of the transparency, independence and efficiency of the judicial system— and wealth, measured in GDP per capita for 150 countries around the world. On average, GDP per capita is 4 times higher in nations with strongest protection of property than in those nations providing a fairly good protection. Once the protection of property shows signs of deterioration, even without being in a totally corrupt judicial environment, GDP per capita drops to a tenth of that in those countries with strongest protection. Countries with a very corrupt system are also very poor.

Protection of Property Rights and Wealth



When governments make policies that interfere with the free flow of economic activity, however, their economies suffer and the living standards of their people decrease. Regulation, for example, affects market outcomes because it interferes with private property rights. It does so by attempting to modify, supplant, or replace market outcomes with outcomes mandated by government. Deregulation, as a result, responds to the realization that a strengthening of property rights ensures the best use of resources.

Consider, for example, the US banking system. By restricting products, geographic location, and price, banking regulation keeps investment and money from flowing to their most valuable use. Bank managers may be required to collect data for numerous government agencies and provide services to others without being compensated. These regulations represent a “taking” by government and erosion of private property rights. To the extent that the cost of these takings are significant, the market value of bank stocks will be lower than otherwise.

Minimum wage laws also represent a weakening of private property rights. These laws restrict an individual’s right to sell his property—labor services—to an employer for a mutually agreed price. The costs of such an erosion of property rights are explicit to the individual in the form of lost wages or lost jobs, and to society in the form of lost production. Efforts by unions in industrialized countries to impose a world labor standard on poor countries likewise represent an attempt to restrict the ability of the poor to sell their labor services at market prices.

Government ownership and use of scarce resources for its own purposes also infringes on private property rights and undermines economic performance. Privatization, as a result, is explicit recognition that privately owned resources produce more efficient outcomes than state-owned resources. A private business, for example, must respond to a loss in earnings by improving its use of resources. If it does not it will fail and its assets will be sold to someone else who will put those resources to higher valued uses. This is not the case for state-owned enterprises, which have little incentive to restructure in order to achieve higher profits for its owners. When the government owns businesses that could be run perfectly well by the private sector, the economy suffers a loss of efficiency.

Even inflation can be evaluated in terms of property rights. As John Maynard Keynes observed, “by a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens.”² Inflation, in this way, weakens property rights and steers resources toward less efficient use. Unanticipated inflation represents an involuntary redistribution on wealth. Holders of monetary assets and contracts suffer a loss of purchasing power with no offsetting compensation. Debtors arbitrarily gain rights to consume more than they otherwise would because they pay off with a currency that purchase less. Individuals will alter the way they use or hold resources in order to protect themselves against inflation. Because inflation is a tax on money people will economize on its use and in some cases resort to barter to avoid holding money. In countries with high and variable inflation long term fixed rate loans may disappear. The result is a less than efficient use of resources. Today, central banks of the major economies appear to be taking a much harder line with respect to inflation than they did 30 years ago.

Over the past two decades, more and more of the world’s countries have attempted to respond to popular dissatisfaction with their economies. Economists, politicians, and the general public seem increasingly to recognize that centrally planned, government-managed economies waste resources, concentrate wealth and power in the hands of the few, and fail to raise living standards for the majority. As a result, there is an intensified search for institutional arrangements that are conducive to progress.

To improve economic performance and (in some countries) greater personal freedom, governments are changing their public policies, priorities, and institutional arrangements. These changes respond, in part, to a growing recognition that open markets and private ownership allow for a free flow of economic activity and therefore are determinants of economic performance.

The move to rely on market forces will have far-reaching influence on political institutions as well. Mary O’Grady, editor of *The Wall Street Journal*

²John Maynard Keynes, *The Economic Consequences of the Peace* (London: Macmillan and Co. Ltd., 1919), pp. 102–103.

“Americas” column, has pointed out that Mexico’s economic opening to NAFTA was an important factor in ending single-party rule in Mexico. The European Union’s conditions for membership are shaping the politics and policies in countries aspiring to become members of the EU. China’s effort to replicate the efficiency of Hong Kong is affecting Chinese politics. Over time, opening markets will lead to both a stronger democracy and effective institutional arrangements to strengthen private property rights.