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The Institute over the past nine months had two major organizational changes. The first noted in the third issue of 2001 was the appointment of Dr. Gilbert HMO Morris as Managing Director. In late June of this year the Board of Directors and Dr. Morris mutually agreed to his separation. This is the first issue of The Review since that event.

This issue is dedicated to Dr. Milton Friedman who played the pivotal role in the development of the Chicago School of economics. In the 1950s and 60s this school of thought stood in opposition to the then more "politically correct" theories of John Maynard Keynes and it ultimately displace Keynesianism in the prescriptions of most economists.

The **Institute** remains an independent non-political non-profit institute that promotes economic growth, employment and entrepreneurial activity. It believes that this can best be achieved with a free market economy and a society that embraces the rule of law, the right of private property and the values of family, learning, honesty and hard work.

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A Tribute to Dr. Milton Friedman

The Nassau Institute dedicates this issue of The Review to Dr. Milton Friedman in honour of his 90th birthday and in appreciation of his remarkable contribution to our understanding of the principles for a free society.

Milton Friedman taught economics at the University of Chicago for thirty years starting in the late 1940's and was the leader of what is known as the "Chicago School" of economics.

That approach "proceeded from the assumption that modern price theory is a powerful weapon in the understanding of economic behavior, not simply a set of elegant theoretical exercises suitable for instruction and the demonstration of one's mental agility."[1] The examination of markets by him, his peers and students led to the advocacy of free market solutions to economic problems. At the end of 20th century these ideas had become a core element of economic development theory and practice world-wide.

Dr. Friedman recognized the danger to freedom and prosperity presented by the "growth of government, the triumph of the welfare state and Keynesian ideas"[2]. Fortunately he lives to see widespread acceptance of competitive capitalism, and an awakened recognition that governments are not the universal cure for all ills.

He is the quintessential libertarian of our time and one of the most important economists of the 20th century. His work is an inspiration to all who love liberty and forms the foundation for continued enlightenment in the 21st century.

Happy Birthday, Dr Friedman!

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[1] George Stigler, *Memoirs of an Unregulated Economist*, Basic Books, 1988 and Milton and Rose D. Friedman, *Memoirs*, The University of Chicago Press 1998.

[2] Milton Friedman, *Capitalism and Freedom* , The University of Chicago Press 1962.

Privatization – the Budget Cure

by **Anthony Ferguson & Larry Gibson**

In one of our recent articles, we promised that we would review the 2002/2003 Budget. We thought it best to wait until the politicians would have completed their contribution in both the House and Senate before commenting.

The present situation.

Like 1992, we find ourselves in a situation, where we have a new administration coming to office saddled with a large accumulated budget deficit, which presents a major challenge for any Government. To the extent that we have large budget deficits, we are in effect mortgaging our long-term economic future, to the detriment of future growth, certainly short-term economic growth.

James Smith, the minister of state for finance, in his National Address captured the dangers of running large deficits quite succinctly when he said: **"The really serious issue in relation to the public finances is that the 2001/02 level of fiscal deficit of 3% of GDP is not sustainable for a period of years for a number of reasons. One reason is that if it is not corrected within a reasonable time frame, more and more of Government's revenues would have to be set aside to pay the interest on the debt and repay the principal. This would starve other essential Government programmes of resources. Furthermore, a rapidly increasing level of Government debt sends the wrong signal to international banks and investors."**

In a nutshell, the 2002/2003 Budget is as follows:

Recurrent Revenues	$ 970.0 m	
Total Revenues		$970.0 m
Recurrent Expenditures	$1,035.0 m	
Capital Expenditures	155.0 m	
Total Expenditures		$1,190.0 m
Total Deficit		$220.0 m

It is important that we understand how we define Budget deficits. Under our system, the Recurrent Budget is separated from the Capital Budget. The theory behind this is that capital expenditures produce future recurrent revenue to offset that cost. This is fine in theory, but the reality is that they rarely offset each other so cleanly. In fact, it is argued that Governments rarely price capital investments correctly, whereby the 'future' recurrent revenue justifies the underlying investment in economic terms.

Recurrent budget.

The Recurrent Budget captures ongoing revenues and expenditures necessary to keep the economy going. Examples of Recurrent Revenues for example are derived from customs duties, stamp taxes, property taxes, business license fees, car license fees, hotel taxes and departure taxes. These are collected annually and represent the majority of all the money the government takes in (for 2002/2003 this is projected to be $970.0 million). Conversely, Recurrent Expenses would be wages, utilities, rents and such type expenses, which the Government has to pay to stay in business. In this respect the Government is no different from any other business. Current expenses are projected to be $1,035.0 million for the 2002/2003 fiscal year. Doing the quick math, we are going into the Budget $65 million in the hole.

Capital budget.

The Capital Budget consists of the Government's spending on non-recurring items. For the fiscal year 2002/2003 the Capital Budget is $155 million. Examples of Capital Budget items include infrastructure such as roads, docks, new schools, construction of government facilities, police and defense force equipment and so on. Capital items are typically items that are not duplicated each year. For example if you build a new road this year, you should not have to build it again or repair it for several years. The upkeep and maintenance will then be transferred to the Recurrent Budget.

When we add both the Recurrent Budget and the Capital Budget you will see that we still have a Total Deficit. The total funding requirements to support the 2002/2003 Budget is somewhere in the region of $220 million (as shown above) when projected Capital Expenditures are included. When adding in the estimated revenue shortfall of $100 million from the 2001/2002 Budget, this all adds up to a lot of Government borrowing within the next fiscal year. By contrast, when the United States talks about a Budget deficit/surplus they are referring to the sum of the Recurrent and Capital Budgets. They include the net result of both the Recurrent Budget and the Capital Budget.

The 1992 crisis.

The last time we found ourselves in a similar economic position (1992/1994), the Bahamian economy was rescued by massive foreign-led investments in the construction sector which resulted in significant inflows of foreign currency (mainly US$) as major investment were made in hotels, new office buildings and very high-end homes amounting to some $2.5 billion during the 1993-1999 period. It should be noted that the Gross Domestic Product (GDP) for The Bahamas last year was estimated at $5 billion. (GDP is the value of all goods and services produced in The Bahamas, and include all wages and salaries paid all the rents and utilities, all the construction projects carried out.)

In other words, during those 6 odd years, close to 50% of current GDP was invested in one sector alone. It can easily be another 20 years, if at all, before we can contemplate such significant foreign direct investment in the construction sector in such a concentrated timeframe. In simple terms, another construction boom of that magnitude is simply not likely within the medium term.

Another, significant feature of our economy is that Central Government now accounts for 25% of GDP. Expressed another way, $25 dollars of each $100 of economic activity generated in the country is generated by Government both directly and indirectly. It is indisputable that the percentage of Government's involvement in GDP is too large and care must be taken to restrict its growth.

Privatization, the only option.

This means that Government's divestment of hotels, airlines, telephone, electricity, and water companies will have, by necessity to be expedited. Unlike 10 years ago, the white knight for the recovery of the Bahamian economy will not be the Sol Kerzner's or Hutchinson Whampoa's of the world but rather a major privatization initiative. We recognize that the formula for the privatization of each will have to be determined based on their own merit and the overall national interest.

Those anti-privatization advocates can kick and scream all they like; the reality is that privatization is the only viable policy that we can effectively mobilize in the current global economic environment. The benefits of privatization will be numerous. Central Government gets a windfall on the actual sale; new owners will also inject much needed capital into these entities; and in some cases, new entrants will enter these markets, causing competition and additional investment.

The economic outlook we face today has many parallels to the situation Mrs. Margaret Thatcher met in Britain when she assumed office in the 1980's. In conclusion, we will not be reinventing the wheel but rather finally doing something that should have been done 10 years ago.

July 9, 2002

Devaluation Talk

by Ralph J Massey

The Bahamas is facing a fiscal crisis that has been the subject of discussion but whose exact dimensions may be known only by a few.

The U. S. Dollar slump.

For instance, in the *Tribune* of June 6th Mr. Raymond Winder, the President of the Chamber of Commerce, commented on the fall of the U.S. Dollar against other currencies. In the first six months of the year the dollar dropped 14% in value against the Euro. He said that this slump, a market induced devaluation, would raise the cost of some imports and diminish the wealth of U.S. citizens, and ultimately their tourist expenditures in the Bahamas.

Fortunately, this is not the whole story. The 14% drop in the value of the U.S. dollar also reduces the cost of both U.S. and Bahamian vacations to all tourists from non-dollar countries. The U.S. dollar slump creates an "opportunity" for increased tourist earnings.

That Bahamian vacations become more attractive to Europeans may help in some measure to allay some of the concerns over the competitive position of the Bahamas in the Caribbean. This concern is evident in various published articles that often cite the IMF August 2001 Consultative Report. That Report stated that "hotel operating costs in the Bahamas…are high by regional standards" and competitiveness needs to be enhanced.

The Cuban peso slump.

One competitive development appeared in the Tribune of June 14th. The Associated Press reported that the Cuban Government raised the prices in its "dollar stores" within Cuba. These stores sell a wide range of goods that include everything from beef and eggs to imported food, clothing, TV sets and other household goods. Sales are in U.S. dollars and not in Cuban pesos.

The AP story states that Cuba needs "to shore up its dwindling finances before the summer energy crunch, when Cubans turn on their fans and air conditioners". The situation is worse than usual because "tourism, the biggest currency earner, was down 14 per cent in the first quarter, oil prices are up and income from sugar, Cuba's biggest export, is down. Sugar will bring in $120 million less than its annual average of $500 million."

The Cuban financial crisis forced a devaluation that hurts every Cuban dependent on a peso income; and it increases its competitiveness in the international tourist market.

Opportunities.

Fortunately, the U.S. dollar slump and the Bahamian fiscal crisis are nowhere near as severe as that faced by Cuba. But…Mr. Winder does the country a service when he draws attention to the economics of changing exchange rates.

In addition the Hon. Perry Christie in the 2002/2003 Budget Communication stated that the rapid and continuing development of tourism was a major concern. He said "We will not hesitate to take whatever initiatives are deemed necessary to make it strong and vibrant."

Tourism is the Bahamas principal employer and the main source of its prosperity. Whether Bahamians like it or not the health of the nation is linked to the health of this industry that competes in the global tourist market. In his Budget Mr. Christie recognized this.

The electricity monopoly.

And…there are things that can be done. As a start the country could end the electricity monopoly. At present all consumers connected to the national power grid must purchase their electricity from BEC. Consumers can only use their stand-by power generators when BEC has a power failure even though they can generate power for their own requirements below the rates charged by BEC. This is so even though the economies of scale suggest that a large generator like BEC should operate at lower costs.

This means that electrical power users, such as the hotels, could reduce their utility bills immediately. This would make the Bahamas more competitive against everyone else including Orlando, Las Vegas and Havana. It would also put market pressure on BEC to become more efficient.

But this can be done easily only with public support and that support must be created. It is in the area of public relations and education that groups like the Chamber can help.

Of course, even greater efficiencies could be achieved by selling BEC and getting politics completely out of power generation. Once again the public must be aware of the benefits. It must be viewed by politicians and citizens alike as an opportunity and not as an assault on Bahamian pride or sovereignty.

Conclusion.

The devaluation of one's currency is always the last painful step to solve a financial crisis. It occurs when a country's cost structure makes it non-competitive in international trade and the country no longer has the financial reserves to defend the existing exchange rate. The prolonged failure to implement politically unpopular measures makes it necessary and subsequently often erodes its benefits thus creating a need for further devaluations.

There are things that can be done in the Bahamas to support continued stability and to avoid the chaos of devaluation and large economic adjustments. The more effective use of the total installed electrical generation capacity is just one of the many measures that can be taken to improve Bahamian competitiveness.

This is a time for thoughtful leadership and a public mindset that supports such measures. The Prime Minister needs help in building public support.

July 4, 2002

The Electricity Monopoly

by Ralph J Massey

The preceding article argued that the Bahamas is a high cost producer of tourist services. It pointed out that one thing that can be done to improve the situation without a devaluation of the Bahamian dollar is eliminating the laws and regulations that buttress the present electricity monopoly of the Bahamas Electricity Corporation.

A knowledgeable businessman responded to this article by e-mail. While conceding that it was a good article and free enterprise was desirable, he contended that the comments on ending the electricity monopoly were "grossly over simplified."

The electricity monopoly.

He stated that "It is not quick and easy to make the conversion from a backup electrical utility to an independent power producer. As an example, one major hotel is completely independent of BEC for power. They have grandfathered an agreement reached many years ago when the hotel was first built. Their equipment and systems are far different than most standby installations used by the other businesses. Another major resort has about 30 separate engine installations for standby and could not economically meet all their power needs on a continuous, long-term full time basis."

This criticism has its greatest validity in the short run.

If the electricity monopoly is ended, the number of power users who can reduce their electricity costs by immediately generating all or a portion of their power themselves is limited. But for them it could be an important cost savings.

In the longer run it is a different story.

Let's look at the facts first. Commercial users pay the Bahamas Electricity Corporation about 16-19 cents per kilowatt hour of electricity used. This compares with 6-8 cents in Florida for a

comparable user. Our knowledgeable businessman believes that a well managed private power producer in the Bahamas could produce power at 9-10 cents a kilowatt hour, approximately half that charged by BEC.

In a freer market, alternatives increase as sellers and buyers integrate new market facts into their operations.

For instance, a group of electricity users could band together to form an "electricity producers cooperative" to achieve the cost savings described above. Also there is at least one big continuous user of electricity who employs a higher cost technology simply to avoid the even higher costs of using and being dependent on BEC. In this case the options and/or choices available in a freer market could induce that user to change its technology and that could occur with the next expansion. But such developments could only occur if the Government adopts a free market orientated policy toward electrical power generation.

In addition, the ending of the electricity monopoly would be a clear signal to investors and international lending agencies that the Government is changing its policy direction from direct market intervention to one that harnesses free market forces to the advantage of key industries and Bahamians as a whole. This is a case of actions speaking louder than words.

Vaclav Havel's "natural economy".

Contrary to popular belief free markets can function efficiently only with an "activist" government that encourages competition in addition to protecting property rights, providing a low-cost judicial process to settle contract disputes and protecting the individual and his property against thievery. Essentially the government provides sellers and buyers with a positive environment for conducting business that both reduces the cost of transacting business and guarantees the freedom to transact it. (Refer to John McMillan, *Reinventing the Bazaar*, Norton, 2002)

The Government should take to heart the words of Vaclav Havel, the courageous Czech dissident, playwright and Prime Minister.

"Though my heart may be left of center, I have always known that the only economic system that works is a market economy. This is the only natural economy, the only kind that makes sense, the only one that leads to prosperity, because it is the only one that reflects the nature of life itself. The essence of life is infinitely and mysteriously multiform, and therefore it cannot be contained or planned for, in its fullness and variability, by any central intelligence." (*Summer Meditations*, New York, Knopf, 1992, p. 62)

July 18, 2002

Poverty, Trade & Growth

by **Ralph J. Massey**

At a seminar in 2001 Dr. Peter Maynard, president of the Bahamian Bar Association, commented on the dilemma facing small island countries in the proposed Free Trade Area of the Americas.

Dr. Maynard saw world poverty as a threat to mankind equal to that posed by terrorism and predicted that the island states under the FTAA will become "neo-colonies" by 2005.

Furthermore, he stated that --

1. Economic growth alone will not empower the people, insulate them against arbitrary crises and shocks nor end their "voicelessness, powerlessness and hopelessness."
2. Small island states lack sufficient economies of scale in transportation, markets, etc., and are prone to natural and ecological disasters.
3. Multinational corporations are a source of greed.
4. "Free trade was our colonial past." and that colonial past will return with the expanding economic empires of the future.
5. International development banks impose harmful conditions in making new loans and canceling and rescheduling old loans.

Yes…world poverty is a startling reality. About 900 million people in Western Europe, North America, and parts of the Pacific Rim find prosperity, while 5 billion people live in poor nations and 1.2 billion live in extreme poverty. Moreover, "the growth rate of Gross Domestic Product (GDP) per capita of the typical poor country was zero between 1980 and 1998."

The panaceas.

Fortunately, the world has a 50-year record of trying to create sustained economic growth in less developed countries. Mr. William Easterly, a Senior Advisor for the Development Research Group of the World Bank, analyzes this record in "The Elusive Quest for Growth" published in 2001 by MIT Press.

The starting point of the author is the exact opposite of Dr. Maynard. To Mr. Easterly improvement in hunger, mortality, and poverty is directly related to and not independent of economic growth. "Poverty is not just low GDP; it is dying babies, starving children, and oppression of women and the downtrodden. The well-being of the next generation in poor countries depends on whether our quest to make poor countries rich is successful."

The author then examines the failed development panaceas used in the past by the international development banks and wealthy donor countries. These include --

Capital fundamentalism. The development banks and donor countries financed major large-scale investments in dams, roads and factories in poor countries. These were believed to be the "necessary investments" that would trigger growth in both output and savings. They did not. They promoted consumption and not increased domestic saving and investment.

Education investment. Mr. Easterly concludes, "Education is worth little more than hula hoops to a society that wants to grow. Critical is determining what the educated people do with their skills. In an economy with extensive government intervention, the activity with the highest returns to skills might be lobbying the government for favors. The government creates profit opportunities by its interventions…"

Bad government.

Mr. Easterley identified Bad Government among the "villains" in his analysis of economic growth.

"Bad governments as well as bad luck can kill growth. Because becoming rich—that is, growth—is so sensitive to the incentive to lower present consumption in return for higher future income, anything that mucks up that incentive will affect growth. The prime suspect for mucking up incentives is government. Any government action that taxes future income implicitly or explicitly will lower the incentive to invest in the future. Things like high inflation, high black market premiums, negative real interest rates, high budget deficits, restrictions on free trade, and poor public services create poor incentives for growth. We have evidence that these government policies lower growth."

Corruption & stealing.

"The urge to steal everything not bolted to the floor is the most obvious growth-killing incentive that government officials face. Requiring private businesspeople to pay bribes is a direct tax on production, and so we would expect it to lower growth…

"The *International Credit Risk Guide* surveys businesspeople on their perception of corruption in countries around the world on a rating between 0 (most corrupt) and 6 (least corrupt). In 1990, the countries that distinguished themselves with a 0 for exceptional graft in the line of duty were the Bahamas, Bangladesh, Indonesia, Liberia, Paraguay, and Zaire.

"The data show that corruption and growth are inversely related…nobody wants to invest in a corrupt economy, and nobody wants to do all the other things that make for a growing economy"

Social polarization.

"The fundamental difference between redistributionist and development governments is social polarization. Societies divided into factions fight over division of the spoils; societies unified by a common culture and a strong middle class create a consensus for growth—growth that includes the poor."

Bahamian growth and free trade.

Mr. Easterly makes extensive reference to countries as Ghana, the Ivory Coast, India and Bangladesh but refers to the Bahamas only once. Among his poor countries of the world and the forty-two small countries in Dr. Maynard's list of African-Caribbean-Pacific states, the Bahamas is certainly one of the most prosperous.

Between 1993 and 2000 Bahamian GDP grew at an average of 1.6% when adjusted for both inflation and population growth and by 4% in the last two years. In addition, there was an important redistribution of income in favor of the "working classes." The lower 60% of then population got a bigger slice of the bigger economic pie. This good performance came after more than a decade of stagnation.

Bahamas
Distribution of Household Incomes

Percent of Households	Percent of Household Incomes 1973	1986	1999
0%-20%	4.6%	2.6%	4.1%
21%-40%	9.4%	7.5%	11.1%
41%-60%	16.1%	14.5%	17.3%
61%-80%	24.9%	26.7%	24.6%
81%-100%	45.9%	48.6%	42.9%

Source: Department of Statistics, Annual Surveys of Household Income

The reality is that the relative prosperity of the Bahamas has been based on a number of often-cited factors: its geographical location, tourism resources, a stable monetary environment and favorable incentives toward specific investments in the early years of the FNM administration (1992-1995).

An important factor often overlooked is free trade.

- Adam Smith in 1776 in his "Wealth of Nations" stated "in every nation it always is and must be the interest of the great body of people to buy whatever they want of those who sell it cheapest."

Bahamians are free to buy shirts manufactured in Bangladesh rather than South Carolina or Nassau; and they do.

- On the export side of the balance of payments ledger the Bahamas capitalized on the global travel boom. International tourists have been free to choose the Bahamas; and they do. But…the boom in the sale of international financial services, however, has come to a screeching halt because of the actions caused by the OECD to eliminate unfair tax competition from low tax countries and abolish Offshore Financial Centres.

The dilemma.

The real dilemma for the Bahamas appears to be –.

Will it pursue vigorously the positive incentives to economic growth?

or

Will it equate free trade with "Global Pillage", turn inward and stress infant industry protection and income redistribution?

Talk about empowerment, voicelessness, etc. may be politically correct; but…at best…it is not very helpful. Talk about the impediments to growth cited above is economically correct and relevant. These issues need to be addressed…whether the Bahamas does or does not join the FTAA.

November 20, 2001

The Globalisation Renaissance

By Rick Lowe

As the old cliché goes, history has a way of repeating itself, and Globalisation is no different.

Globalisation as it is known today is a renaissance of the mid 19th century movement. In the 1840s Richard Cobden and John Bright lead the "free trade" campaign when they fought Britain's Corn Laws that imposed high tariffs on imported grains. These two gentlemen espoused the view that free trade would help maintain peace through inter-dependence. And it did. The repeal of the "Corn Laws" ushered in a period of trade liberalization and goodwill. The resulting lower prices and expanding trade boosted incentives for English entrepreneurs and England, for a period, became the world leader in shipping, commerce, insurance and finance.

Of course the free trade or classical liberal revolution changed with the advent of the claims that Socialism would save the world. "People felt uncomfortable with the imperfect world and conventional wisdom was that countries could be self-sufficient and Governments could control everything to everyone's satisfaction."

As Brink Lindsey points out in his recent book *Against the Dead Hand* the Globalisation Renaissance "is the fitful haunted awakening from that dream."

Competition, capitalism and choice.

Human nature is such that we (individuals, businesses and governments) would prefer no competition. This leads to the acceptance of the centrally planned economy hoping for protection by government from loss of a business to new or more efficient operations.

Witness the US pushing the world toward free trade, while lobbying efforts by the steel companies and labour unions have forced increases in tariffs on steel imports there. The Republican Administration is apparently trying to improve its voter appeal in the industrial heartland of America before the upcoming Congressional elections and thus dumping, in this instance, their traditional free trade policy.

The vast majority of people want more material comforts and conveniences…this means economies must continue to grow to ensure more wealth is created. So, with the move toward Globalisation, more people, in more countries, will be better off if they become more competitive.

To prepare, the Bahamas needs to be informed of the details of Government's monthly treks to FTAA and WTO meetings. Yes citizens might get angry when some of the commitments that have been made are revealed, but people will eventually come to terms with Globalisation.

Because this is an imperfect world, there will be hardships along the way to Globalisation. Some businesses might not be as dominant in the future and Government, like business, will have to live within its means and become efficient. However, once Globalisation is implemented, studies have shown that more people will be better off.

Free trade works.

To quote Brink Lindsey again: "The political discovery process is leading us away from the waste and cruelty of error toward the greater opportunity and abundance that result from sound policies and institutions. The Promised Land may still be a distant dream, but at least we are heading in the right direction."

In a nutshell, free trade should be supported, but with less bureaucratic control. Buying and selling is really very simple. To complicate it with an excessive world wide bureaucracy will only impede the functioning of free markets, where the consumer is king. Further more, making trading difficult will not be enough for a secure future for those people willing to make the effort necessary to succeed.

The fact is that free trade and participation in the global markets for tourism and financial services is the very basis for Bahamian prosperity to date. These markets will force economic efficiency and competency if the Government allows and encourages such developments. There will be casualties along the way, because after all, this is an imperfect world. But it's a safe bet that The Bahamas will survive Globalisation.

June 28, 2002.


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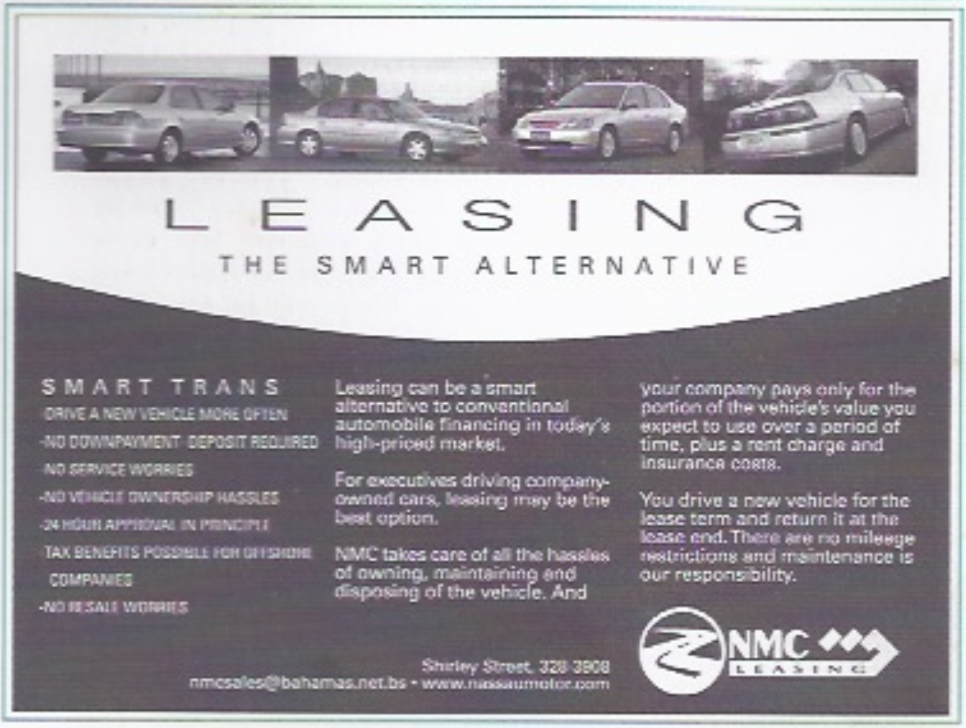
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