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Feature Articles

The Bahamas, Freedom and Growth

by Ralph J. Massey

Hong Kong: The Free Market Approach to Economic Growth

by Alvin Rabushka

The **Institute for Economic Freedom** is an independent non-political non-profit Bahamian institute that promotes economic growth, employment and entrepreneurial activity. It believes that this can best be achieved with a free market economy and a decent society...one that embraces the rule of law, the right of private property, the free exchange of property and services and the individual virtues of self-control, commitment and good will.

Past issues of **The Review** include -

Vol. 1/No. 1. The Caribbean Tiger: A Development Strategy for the Bahamas

Vol. 1/No. 2. Remarks by Nicholas F. Brady and Comments on the 1995 Bahamian Budget Debate

Vol. 2/No. 1. Fifty Years of Socialism

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ERRATA

The
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The text should read as follows:

Page 2, first word ***ideology.***

Page 4, third paragraph "(or as is ***often*** the case....)"

Page 7, second paragraph ***Venezuela***

Page 11, fifth paragraph ***ideology***

Page 11, Footnote "where ***he*** was a...."

Page 13, Third paragraph, last line ***self-rule***

Page 15, last paragraph "is to ***ensure*** that..."

Page 16, bold insert "How has the common worker ***fared*****....**"

With our apologies...

The Bahamas, Freedom and Growth

by

Ralph J. Massey

The Free National Movement in the Speech to the Throne and the 1996/97 Budget reviewed its accomplishments and its fiscal and legislative plans. Its efforts at "stabilization, restoration and reform" contrast sharply with the economic waste and neglect that were so prominent a part of Bahamian life. Gone is the visible physical deterioration of the country so long associated with the former Communist Bloc and third world countries. Refreshing is the euphoria associated with the good results of applying sound management techniques to government.

The FNM is an "activist" government with specific economic and social policy objectives. Unfortunately some of these are in direct conflict with others. The FNM proposes and implements incentives to encourage specific investments and creates for them a "fast track" through the bureaucratic maze. But it leaves the maze in place...the permits, licenses and regulations that discourage those new business ventures not selected for "fast track" treatment. There is an inherent conflict between the present system and the commitment to assure "upward mobility in an open society fuelled by a market-driven economy".[1]

It is difficult and even impossible for a government to embrace simultaneously both a vigorous direction and management of business and the economic freedom associated with a market-driven economy. The **Review** earlier this year covered the last "Fifty Years of Socialism" and "Politics and Business in the Bahamas". It dealt with the major flaws of socialist

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[1] Hubert A. Ingraham, "Manifesto Keynote", Manifesto '92, page 7.

idealogy and its overall record. This **Review** will deal solely with economic freedom and real growth.

The Study.

Milton Friedman in 1962 wrote "I know of no example in time or place of a society that has been marked by a large measure of political freedom, and that has not also used something comparable to a free market to organize the bulk of economic activity."[2]

In 1984 a Group of economists meeting in London discussed this quotation and began a twelve year project. It involved economic institutes in eleven countries under the egis of the Frazer Institute of Vancouver, Canada. The objective was to measure economic freedom and do it in a way that eliminated subjective judgements to the maximum extent possible.

This Group was not the first to tackle this type of problem. There were others evaluating the economic and political risks to private business investments; and, in fact, every large multi-national corporation had some way to adjust its minimum target rate of return in the home market to the realities of more risky foreign markets.

The objective of the Group was unique: construct an Index of Economic Freedom for 100 countries, produce a number not for investment purposes but to relate to measurable economic growth. The result of this effort is a book, **Economic Freedom of the World, 1975-1995**, published this year.[3]

To achieve objectivity the Study included concrete elements in the Index. The elements included specific data on money, inflation, freedom of currency and capital exchanges, trade

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[2] Milton Friedman, Capitalism and Freedom, The University of Chicago Press, Chicago 60637, copyright 1962 & 1982.

[3] James Gwartney, Robert Lawson & Walter Block, Economic Freedom of the World 1975-1995, Fraser Institute, Vancouver, B.C., Canada, 1996.

restrictions, government business regulations, equality in justice, government spending, taxation, income transfers, subsidies, etc..

The Elements

Money and Inflation. "The general ingredients of economic freedom in the monetary area are: (1) slow monetary expansion that maintains and protects the value of money, (2) price level (or inflation rate) stability; and (3) the absence of restrictions limiting the use of alternative currencies.

"...economic freedom is diminished when monetary disturbances and unexpected price changes alter the value of money and the terms of [long term contracts] involving money. Such actions involve, in effect, the taking of property. In many such cases, wealth is taken from one private party and given to another. In other cases, it is taken from individuals and transferred to the government.

"Money offered by other monetary authorities is a substitute for money issued by the government of a given country. When residents are allowed to maintain bank accounts in foreign currencies, it is easier for them to avoid the uncertainties accompanying an unstable domestic monetary regime. Thus, citizens have more economic freedom if they are allowed to maintain domestic bank accounts in other currencies.

"...When it is legal for citizens of a country to own a bank account abroad, the country is given a rating of 10 [for this component]. When ownership of these accounts is illegal, the country is given a rating of zero."

Government Operations. "There are two broad functions of government that are consistent with economic freedom: (1) protection of individuals against invasions by intruders, both domestic and foreign, and (2) provision of a few select goods - what economists call public goods...

"Government-Operated enterprises...involve the substitution of political coercion for market decision-making. Government enterprises are fundamentally different from private businesses. Their start-up capital is coercively obtained from taxpayers, whereas the initial funds of private firms are voluntarily obtained from investors willing to risk their own wealth. Subsequent investment decisions of public sector firms are made by political officials playing with funds that belong to taxpayers, rather than entrepreneurs capable of attracting financial capital voluntarily from investors. Subsidies, favorable tax treatment, and regulations are often used to protect state-operated firms from private competitors. If the government project fails to generate enough revenue to cover its costs, there is no bankruptcy mechanism to bring it to a halt."

Takings and Discriminatory Taxation. "When a government plays favorites - when it takes from one group in order to make transfers to others or when it imposes the costs of public services disproportionately on various groups - the government becomes an agent of plunder. Such actions conflict with economic freedom. This is equally true whether the policies are undertaken by a dictatorial political leader or a legislative majority."

Transfers and Subsidies "violate the freedom of individuals to keep the value of their productivity. When governments tax income from one person in order to transfer it to another, they are denying individuals the fruits of their labors. This is true whether funds are transferred from the rich to the poor (or as is soften the case, from the poor to the rich), from one racial group to another, or from the politically disorganized to the politically powerful. The taking of property (including labor services) without fully compensating the rightful owner is a `per se' violation of economic freedom."

Source: **Economic Freedom of the World 1975-1995**

The Results.

The Group graded the 100 countries from "A Plus " to "F Minus" based on where they stood on the Index. The highest graded country is Hong Kong which is "A Plus", all by itself; it is followed by New Zealand, Singapore and the United States that are graded "A".

At the other end of the scale graded "F" are 14 countries, the worst ranked from top to bottom -

Brazil	Iran	Uganda,
Haiti	Romania	and the three Zs
Nicaragua	Sierra Leone	Zaire
Venezuela	Tanzania	Zambia
Hungary	Togo	Zimbabwe

Now this ranking is interesting...but not very useful...until it is related to economic growth. When that occurs there are two main conclusions.

> **No country with a persistently high economic freedom rating failed to achieve a high level of income.** "A" rated countries averaged $15,834 of annual Real Gross Domestic Product per capita[4] and F" countries averaged $1,650.

A skeptic may say that "All that proves is that the rich start rich and end rich, and poor start poor and end poor." The Study shows how false this conclusion is.

> **Countries that had improved Economic Freedom ratings experienced economic growth; those with ratings that declined experienced economic decline.**

So who are the top ten Freedom and Growth achievers? The top ten with the largest increase in their Economic Freedom Index ratings were from top to bottom -

Chile	Pakistan	Singapore
Jamaica	Egypt	Mauritius
Iceland	and tied in eighth	New Zealand
Malaysia	Portugal,	
Turkey	Japan	

[4] Gross Domestic Product("GDP") is the present money value of the products and services produced by a country during a given period. "Real" GDP restates the present prices into those of a base period; the Study uses constant 1985 prices.

Like the Bahamas it is apparent that most of these are unique and special. Some are island nations. However, -

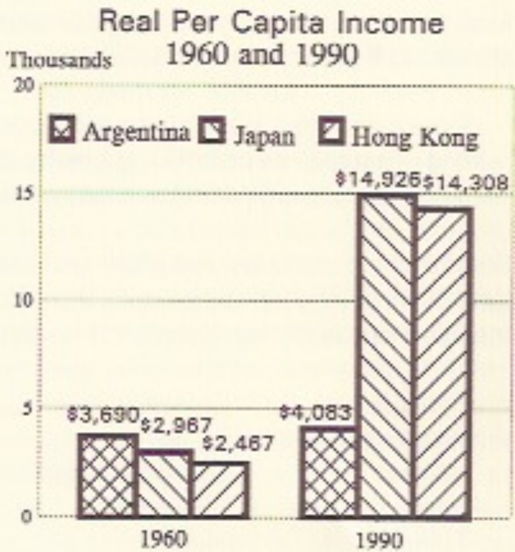
> **The Real Gross Domestic Product Per Capita of these top achievers grew an average of 2.7% per year for 20 years.**

Who are the worst? The ten countries with the largest decrease in their Economic Freedom Ratings were Panama and Morocco tied for first, and then

Venezuela	Zambia	Iran
Algeria	Congo	Somalia, and
Tanzania	Honduras	Nicaragua

> **Their Real GDP Per Capita declined at an average of about 1% per annum over a 20 year period.**

More Dramatic Evidence.



The results can be seen even more clearly when one compares three countries, Argentina, Hong Kong and Japan. Argentina has significant natural resources. Its Pampas is one of the five richest agricultural areas in the world; such geographic areas have topsoil at least 6 feet deep. In addition, it is self-sufficient in petroleum. Hong Kong has little or no mineral resources, very little agricultural land and has been subject to recurring, large and uncontrollable immigration. Japan imports all its energy requirements.

The economic growth for these three countries over thirty years can be seen in the graph.[5] The Japanese economy was 20% smaller than Argentina in 1960 but 3.6 times larger in 1990. Because of the implementation of new policies in Argentina in the late 1980s that favoured growth and lower growth rates in Japan, Japan was only 2.5 times larger in 1994.

Hong Kong "provides a vivid reminder of what an economically free people can accomplish in a relatively short period of time. In 1960, Hong Kong's per capita GDP was...less than the comparable figures for Israel, Mexico, and Argentina, for example. Its 1960 income figure was approximately one-third that of Venezuaela, Sweden, and Canada; and one-fourth that of Switzerland and United States. Three decades of sustained growth have changed all of this. In 1994, Hong Kong's per capita GDP...was the second highest in the world, following only the United States."[6] For the period 1980-94 the average growth rate of Real Per Capita GDP was roughly 5.5% per year. By the time that China assumes political control of Hong Kong its Real GDP per capita could equal that of the U.S., a truly amazing achievement.

Argentina in both 1975 and 1985 was "in the Bottom Ten among the more than 100 countries in the study." Argentine governments beginning with Juan and Evita Peron sought the forcible transfer of wealth from agriculture to the urban economy and population. In contrast, Hong Kong has been the freest nation in the world for several decades. Japan "has shown slow and steady improvement in the area of economic freedom over the last two decades."

Where does this leave the Bahamas?

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[5] Robert Summers and Alan Heston, "The Penn World Table (Mark 5): An Expanded Set of International Comparisons, 1950-1988." Quarterly Journal of Economics, May 1991.

[6] Economic Freedom of the World 1975-1995, page 155.

The good news.

Even though the Bahamas was not included in the study, we can look at what we know.

Since 1992 there is greater civil liberty. The government increased its operational efficiency in general and in the Customs and Treasury Departments in particular; and it appears committed to continuing this effort. The government's dominant position in the hotel industry was privatized to the benefit of the country.

Greater fiscal balance was achieved; the very large deficits of the last years of the PLP era, 1988 to 1991, were dramatically reduced.

Very visible and much needed investments were made in the economic infrastructure.

One very important recent move is the reduction of import duties on the tools of production and construction materials. Usually such taxes are not immediately recouped from the consumer, but become part of the capital cost of the enterprise and are recouped over time. But such taxes had been favored because they appeared as if they were paid by the tourist, the rich or business. In reality these high duties penalized the job creation that comes with capital investment. Every businessman paid dearly for tools that ranged from grass cutters to computers. The only tool not taxed was the machete.

The cost of housing was raised for every citizen in the country because of the high tax on construction materials. Until now and under the guise of compassion for the low income voter, the tax system favored consumption and penalized investment and job creation. In economic terms this is misguided compassion.

The Bad News.

	Growth Per Annum	
	1986-1991	1992-1996/97
Real GDP	**1.0%**	**0.2%**
Population	**1.8%**	**1.6%**

No Economic Growth. The economy has not been growing and, in fact, by one measure has declined over the past decade. This is seen if one compares the growth of Gross Domestic Product in Constant Prices in total(not per capita) with population. The GDP data comes from the address of the Minister of Finance and population data from the Inter - American Development Bank. **The lag of economic growth behind population growth clearly indicates that over the past 11 years the average Bahamian is worse off.**

Continued Government Growth. When the FNM came to power it was "firmly convinced that under proper management the current level of Government taxation and revenue [was] more than sufficient to meet the needs of the country."[7]

Since then the country has experienced "the fourth consecutive year [when] revenue collections exceeded projections for the budgeted period by some $15 million."[8] Between 1991 and projected 1996/97 Total Revenue is up 39%[9] while GDP in Current Prices (before the inflation adjustment) is up 19.1%.

[7] Manifesto '92, page 10, column 2, paragraph 3.

[8] "Budget Text", The Tribune, The Tribune Limited, Nassau, Bahamas, May 23, 1996, page 6.

[9] This calculation, +39.3%, uses $524 million for the 1991 and $730 for 1996/97 Revenue as contained in the Address to Parliament. If one uses $490.4 million for 1991, the Total Tax & Non-Tax Revenue published by the Central Bank, then the growth is 48.9%.

Better management techniques and higher taxes and fees are credited for the increase in revenue. For the same time period Total Expenditures grew 24.4%.[10]

The government is taking and spending an increasing share of the country's resources when economic growth is less than zero in real terms per capita.

Government Regulatory Growth. Of particular importance is the attitude of both political parties to the role of government in business.

The Speech from Throne cited the new Industrial Relations Act and outlined new or revitalized areas for regulation. It promised new unemployment insurance benefits and worker training measures that will be funded by payroll related taxes.

When questioned the Minister of Finance defends the long standing government regulations on the right to own foreign currency, transfer capital and maintain foreign bank accounts.

One PLP candidate promises to promote economic efficiency with greater government regulation. Both parties confirm in words and actions their intention and commitment to control employment decisions through work permits and licensing.

Both parties are committed to greater regulation of the private sector and a further reduction in economic freedom.

Conclusions.

If one objectively looks at the evidence that links economic freedom to economic growth and one considers the Bahamas

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[10] This calculation, +24.4%, uses $689 millions for 1991 and $857 million for 1996/96 for Expenditures as contained in the Address to Parliament. If one uses $652 million for 1991, Total Expenditures plus Net Lending to the Public Corporations, as published by the Central Bank, then the increase is +31.6%.

and its economic performance, one comes to several conclusions -

The policies followed by the Government...at least over the last eleven years...have produced a decline in the economic welfare.

Bahamian policy makers, present and future, should examine the Study, particularly the experience of the world's economic achievers.

The likely impact of continued economic stagnation on the political and social fabric of this country is disturbing ...to say the very least.

This brief discussion could produce extreme pessimism about the outlook for the Bahamas. Such pessimism, however, would be unfortunate. The wealth of the Bahamas is significant and the ability to grow is there. One has only to witness the effect of the investments of Sun International, Breezes, Sandals and Ruffin in tourism. Furthermore, the Study provides a strong basis for optimism since it shows that -

Other countries have not remained chained to the idealogy of the past, have changed and have gained from the "right" changes.

Ralph J. Massey is the Editor of **The Review** following a career in industry and banking. He earned a M.A. degree in Economics from the University of Chicago where was a Harry A. Millis Fellow and later a Research Associate.

Hong Kong: The Free Market Approach

to Economic Growth

by

Alvin Rabushka[11]

In the past few years, the results of [the state-directed and state-led strategy] have disappointed both its intellectual proponents and the inhabitants of the developing countries...

"In the postwar period, many new nations, often referred to as developing countries, have faced the task of transforming their poor, traditional economies into modern industrial societies. To this end, most of these newly independent developing countries have actively sought foreign aid from abroad.

"In addition, they have also disproportionately followed a strategy for economic development that is state-directed and state-led. The extent of government involvement in each country's economic development has ranged from that of a virtual command economy to one in which government does not try to manage all economic activity but does assume responsibility for all major capital investments and overall economic planning. This latter approach to development often consists of high taxation in the interest of government-directed capital formation and the prevention of inequitable distribution of wealth and income that supposedly occurs as a country develops. Governments adopting this developmental strategy typically impose on their economies foreign exchange controls, limitations

[11] Alvin Rabushka, "Hong Kong: The Free Market Approach to Economic Growth", The Journal of Economic Growth, First Quarter, 1986. This abridged text has been approved by the author.

on overseas investment or ownership, high tariffs, state control of businesses and other restrictions on the free exchange of goods and services. In the past few years, the results of this development strategy have disappointed both its intellectual proponents and the inhabitants of the developing countries, who are still mired in poverty with little hope for a better future..."

...the single best example of the market economy model of economic development is...Hong Kong...

"Perhaps the single best example of the market economy model of economic development is found in the incredibly successful record of the British Crown Colony of Hong Kong, a story of economic achievement from a starting point of almost zero.

"Hong Kong has had to overcome as many obstacles as any nation has ever faced, and has received almost no foreign aid in the process. Its land area is virtually resourceless and consists largely of unproductive granitic rock formations. It suffers a population density that ranks it among the world's most overpopulated areas; and it is dependent on imports for its food, raw materials and all capital equipment. Located thousands of miles away from its most important markets, Hong Kong has been unable to control population movements across its borders; and, to this day, it continues to be ruled by a colonial government (until the Chinese government in Beijing recovers sovereignty and administrative authority on July 1, 1997), that critics regard as obsolete, antiquated and inconsistent with the principles of independence, serf-rule and human dignity.

"Yet, despite these formidable obstacles, the rate of growth of the Hong Kong economy has been so rapid for so long that it has come to have an almost certain inevitability...A low top 17 percent tax rate on individual earnings and 18.5 percent on corporations, and the lack of any capital gains tax, encourage risk-taking and hardwork. The absence of tariffs and other restrictions on trade, including capital movements, make investment in Hong Kong very attractive. The result has been a rapidly improving standard of living for Hong Kong's largely Chinese population and the continued inflow of new immigrants seeking opportunity and betterment for themselves...

"Indeed, at 1985 exchange rates, per capita income in Hong Kong exceeded that in Great Britain, an astonishing turnaround: An impoverished, resourceless, densely populated territory surpassed, in one generation, the income of an advanced, industrial European nation..."

What factors have fueled Hong Kong's outstanding economic success? The answer can be found in the territory's liberal economic policies and its prudent, conservative fiscal policies.

"Economic affairs in Hong Kong are conducted in an environment of free enterprise. Since 1841, government policy has dictated a hands-off approach toward the private sector, one that is well suited to Hong Kong's exposed and dependent economic and political situation. Due to its small and open nature, the economy of Hong Kong is very vulnerable to external factors, and government action to offset unfavorable external factors is often of limited effectiveness. The government holds the view that the allocation of resources in the economy is most efficient if left to market forces. Nor has the government tried to dictate the structural development of the economy.

"Hong Kong's economy can be described as a free enterprise system. It enjoys a tax structure with low rates that provide incentives for workers to work and for entrepreneurs to invest. Both workers and entrepreneurs are highly motivated, given that all individuals have equal opportunity to get rich if they work hard or succeed. The primary role of the government is to provide the necessary infrastructure together with a stable legal and administrative framework conducive to economic growth and prosperity. The infrastructure includes a modern and efficient seaport in which is located the world's third largest container port, a centrally-located airport with a computerized cargo terminal, and excellent worldwide communications. There are no import tariffs, and revenue duties are levied only on tobacco, alcoholic liquors, methyl alcohol, some hydrocarbon oils, and the first registration of motor vehicles...

"The philosophy of government in Hong Kong can be summed up in a few short phrases: Law and order, minimum interference in private affairs, and creation of an environment conducive to profitable investment. Regulatory economic controls are held to a minimum, no restrictions are placed on the movement of capital, and the few direct economic services provided by government are operated on a commercial basis...

> Hong Kong is a completely free market in money...
>
> It is a general principle of...economic and tax policy not to discriminate between residents and nonresidents. On this principle, overseas investors may fully own local factories...
>
> Hong Kong is a duty-free port and allows the entry and exit of most raw materials, consumer goods and commodities, with only a registration charge...
>
> The government...does not impede the setting up of private business enterprise. Free entry is permitted and encouraged into almost every line of production. Legal formalities to set up business are few and inexpensive...
>
> Hong Kong does not impose a statutory minimum wage... most of [its] work force is fully employed and enjoys steadily rising wages...
>
> Government spending and public sector employment are closely monitored to guarantee that the rate of growth of the public sector does not outpace that of the private sector. This is to insure that the public sector, which has a natural tendency to grow over time, does not crowd out the private sector to the detriment of Hong Kong's external competitiveness. In recent years, government spending as a

share of GDP has ranged from 13 percent to 19 percent, but the financial authorities are watchful to prevent the share from surpassing the critical 20 percent threshold."

How has the common worker fated under this system?

"The evidence on postwar income distribution suggests that the 70 percent of the population in the third through the ninth decile [of income distribution] has gained the greatest share of the increase in national income. Low-paid unskilled workers have benefited most from the rapid increase in employment opportunities. The well-being of the poorest 20 percent has shown dramatic improvement...

"Thus, the free market system of economic organization appears to be effective in bringing about rapid economic growth and a more even distribution of income, without any need for redistribution schemes."

Alvin Rabushka is a senior fellow at the Hoover Institution, Stanford University and has a Ph.D. degree in Political Science. He has written extensively on the public policy issues of taxation, government spending and economic development. He is best known for two books, **The Flat Tax** and **Hong Kong - A Study in Economic Freedom.** The first was written with Robert Hall and the concepts have been featured by the Republican Congressional leadership and by Stephen Forbes during the recent Presidential Primary campaign. His work on Hong Kong has appeared in academic journals, a book and a TV documentary.

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