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The Institute for Economic Freedom

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Perspectives on ...

The Bahamas:

Unbalanced Budgeting

More Government

The Tale of Two Studies

Sir Lynden's Proposal

The Real Revolution:

The Crisis

More Market

From Milton to Deng

The Revolution Rolls On

The **Institute** is 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 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.

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Executive Summary:

The Bahamas

The Free National Movement in its 1998/99 Budget Communication clearly stated its objective…"to accommodate national priorities to the greatest extent possible while moving closer to eliminating the Recurrent Deficit in 2001." It further argued that "sound foreign investment policies ensured that capital inflows are for investment purposes and strengthen rather than weaken the balance of payments"; and it stated that the events in the Asian economies underline the importance of getting the "macroeconomic fundamentals correct."

This *Review* contends that the Budget, despite the statements to the contrary, is...in fact...an argument for increased government spending and taxation and for fiscal deficits through July 2002. The expenditures proposed for 1998/99 continue the sharply accelerated spending that began in 1996/97…a year that produced the biggest deficit in the history of the country and received adverse comment by the International Monetary Fund.

This commitment to the growth of government may be portrayed as an "accommodation to the national priorities"…but the economic experience of the world clearly indicates that such a policy diminishes long-term economic growth. "How this is so" is demonstrated in "The Tale of Two Studies" contained in this *Review*. The first study shows that the growth of government since 1960 in the United States and elsewhere did not improve economic performance. The second study is far more comprehensive in that it identifies the major factors that affected growth in 100 countries. It comes to the same conclusion on government spending as the first study but, in addition, deals with others determinants of economic growth such as male schooling, the rule of law, fertility and democracy. This analysis should be read carefully by all who want to find those policies that promote sustained economic growth.

Executive Summary:

The Budget Communication carefully uses a definition of "deficit" that gives the appearance of fiscal stability. This is more than semantics since this definition, as shown in this *Review*, provides for the continued growth in the national debt...even if the net balance under this definition is zero. This would be clearly evident if the more universally accepted deficit definition had been used. The Government is relying on investment and capital controls to avoid an Asian-type economic melt-down.

The Revolution

The second section of *The Review* deals with the Asian crisis and puts it in the context of "*The Revolution*" in government economic policy making. This revolution had its origins in the economic ferment of the 1930s but was propelled onto the world scene in the 1950s by Milton Friedman and the "Chicago School of Economics." The political leaders emerged 25 years later...first Ronald Reagan and Margaret Thatcher followed by Deng Xiaoping, Tony Blair and others.

Within this context the economic objectives of the 1998/99 Budget seem neither wise nor prudent. Specifically, the policies of spend and tax and deficit financing are outdated and old hat...these macroeconomic fundamentals are not correct.

The Bahamas:

Unbalanced Budgeting

1998/99 Budget Communication.

The May Budget Communication of the Minister of Finance did indeed contain much good news. It followed the now time honored pattern of reviewing the principles of governance, the world political and economic environment, the performance of the Bahamian economy and then the main features of the budget itself.

The Communication stressed the importance of –

- Prudent policies to safeguard confidence in the financial system and
- Sound foreign investment policies that ensure that capital inflows are for investment purposes and strengthen rather than weaken the balance of payments.

It further observed that **"the events in the Asian economies underline the importance of getting the macroeconomic fundamentals correct."**

And then it told about the good news of 1997 –

- The economy grew by an estimated 3% in real terms, the second consecutive year of real growth per capita after a long period of no growth.
- Robust foreign investment drove the construction industry to an all-time high as construction starts reached more than $450 million.
- Unemployment fell below 10% for the first time in more than a quarter of a century and employment was "without precedent".
- Inflation was less than 1%.
- Moody's reconfirmed the Bahamas' A3 Investment Rating .

The Bahamas:

- "Foreign exchange reserves increased by $56.5 million to $219.5 million…and currently exceed $300 million, an unprecedently high level…and without any precedent whatsoever except…the month of July 1997."

The Communication clearly stated the Government's Budget objective…

increased spending and continuing deficits. Total spending is to increase 6.1%, $52 million, "to accommodate national priorities to the greatest extent possible while moving closer to eliminating the Recurrent Deficit in 2001."

Deficit definitions.

Now the Budget used several definitions of "deficit"…which is confusing.

It is best to think of a government deficit in personal terms. You spend on essentials as food, medicine, gasoline and less essential items as entertainment. And then there are capital expenditures like housing. You pay for this with your salary…and…if it is insufficient, you borrow. If a loan falls due and you have not provided for it out of your income, then you have to borrow funds to roll that loan over.

The budget should be just as simple. The Government Financial Statistics("GFS"), an international standard for fiscal accounting, defines "Deficit" in the same way. The data for the Budget year 1998/99 is shown in Table I. This is the only definition used by the Central Bank in its analysis of Government Operations and Financing.

The GFS Deficit is

- the difference between total expenditures and revenues caused by government spending and taxing…
- the net increase or decrease in the national debt…

The Bahamas:

Table I

The GFS Deficit for the Budget Year 1998/99	
	Millions$
Current Expenditures	**$783**
Plus: Capital Expenditures	**117**
Total Expenditures	**900**
Less: Tax Revenues	**852**
GFS Deficit	**$48**

- the net result of Government Operations.

It does not include Debt Repayment, for instance. That is, in effect, grouped with other financing decisions.

In this case the GFS Deficit of $48 million is the additional amount the government plans to borrow or the amount of money that must be printed or the amount to be taken from the country's internal and external reserves to meet the Government's revenue shortfall. If the GFS Deficit were zero, then the budget would be balanced and in this case the national debt outstanding would not change.

But…the Budget Communication does not use the GFS definition when it states its objectives. It uses the "Recurrent Deficit". As can be seen in Table II this includes Current Expenditure, Revenue and Debt Repayment and excludes a very big item, Capital Expenditures. In 1998/99 a Recurrent Deficit of $16 million still means that the national debt will

The Bahamas:

Table II

The "Recurrent" Deficit
for the Budget Year 1998/99

	Recurrent	Memo: GFS
Current Expenditures	$783	$783
Plus: Debt Redemption	85	NA
Recurrent Expenditure	868	NA
Less: Recurrent Revenues	852	852
Recurrent Deficit	16	NA
Plus: Capital Expenditures	117	117
Total Deficit	133	NA
GFS Deficit		$48

NA = Not Applicable

increase $48 million.

The Budget Communication concludes that a Recurrent Deficit of $16 million "places us firmly on the path to our goal and objective of achieving a balanced recurrent budget by the year 2001."

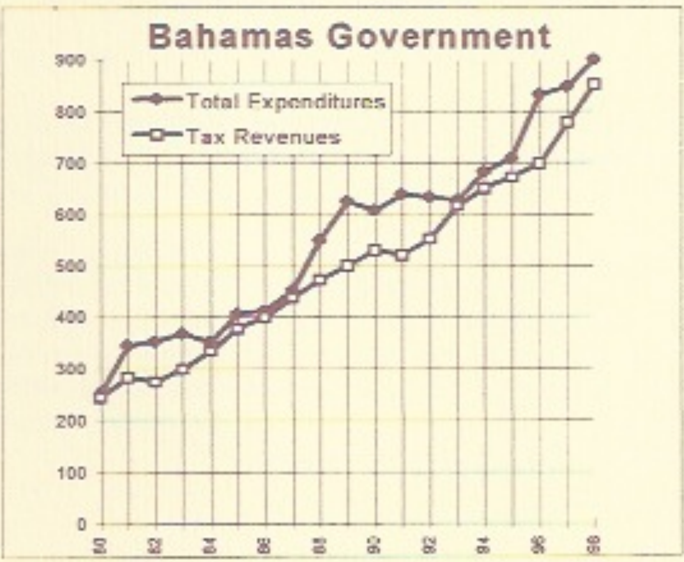
However, even the achievement of a balanced Recurrent Budget in 2001/02 would by definition produce a fiscal deficit in that year. This implies, in fact, a long-term Government commitment to fiscal deficits. This certainly is not a policy of " macroeconomic stability."

The Bahamas:

More Government

Another facet of this picture that needs attention is spending itself. The 1998 Report on the Bahamas of the International Monetary Fund also described the many accomplishments of the FNM…but… it criticized the FNM for its 1996/97 deficit. In that year a 17.3% year-over-year increase in spending…a $123 million increase …produced the largest deficit in the history of the country.

The graph of total expenditures(excluding loan repayments) and tax revenues from 1980 to budget 1998/99 clearly shows that spending



and taxes with few exceptions have followed a consistent upward trend. While the FNM appeared to show fiscal restraint in its first few years in office, the obvious acceleration of spending and taxing since then should be viewed with alarm.

The Bahamas:

Table III

Total Government Expenditures as a Percent of Gross Domestic Product

Actual			Budget
1980	1992	1996/97	1998/99
17.2%	20.4%	24.4%	23.0%

One of the consequences of the history of spend and tax (see the above table) is that the government's share of the economy has grown.

Total Government expenditures as a percent of the Gross Domestic Product("GDP") has grown steadily from 17.2% in 1980 to 24.4% in 1996/97 and a projected 23.0% in the 1998/99 Budget year. In the 1960s it is reported that Bahamian economic growth was among the most rapid in the world. Yet in the 10 year period 1985 to 1995 real GDP grew at a rate that was less than the annual increase in population...Real GDP per person declined.

Bahamas:

The Tale of Two Studies –

Study #1.

For an explanation of this one should look at experience elsewhere in the world. A Report (see Endnotes) made for the Joint Economic Committee of the U. S. Congress in April noted that —

> **government spending soared in the U. S. and elsewhere after 1960 "propelled by a confidence that politicians could solve problems." It found that this increased spending did not improve economic performance.**

"As the size of government has expanded in the U.S., growth of real gross domestic product has steadily fallen. Even though the U. S. economy is now moving into the eighth year of an expansion, the growth of real GDP during the 1990s is only about half what it was during the 1960s and well below even that of the turbulent 1970s.

"Likewise, as the size of government in other nations has increased, economic growth has declined. On average, government expenditures in the Organization of Economic Cooperation and Development's 23 long-standing members rose to 48% of GDP in 1996 from 27% in 1960. The average economic growth rate fell from 5.5% in the 1960s to 1.9% in the 1990s…there has been a striking relationship between the size of government and economic growth."

The study also describes the world's fastest growing economies where the size of government is small, and there is no trend toward bigger government …"bigger" being a larger share of the overall economy. On average, government expenditures in the top five countries consumed only 20% of GDP in 1995, virtually the same as in 1975.

The Bahamas:

Study #2.

Robert Barro, at the 1996 Lionel Robbins Lectures of the London School of Economics, presented his study on the determinants of economic growth(see Endnotes). This study is dramatically different from the Report to Congress. It covers more countries, 100 in all, and uses a multi-variable analysis in a mathematical model. The variables are as follows::

- Male schooling
- The Rule of Law
- The Terms of Trade
- Fertility
- Government consumption
- Inflation
- Democracy

These variables are related mathematically to the growth of real GDP per capita. The model and its mathematics are not simple...but…its principal findings are:

1. The **schooling of males** 25 years of age and older, as measured by the number of years of schooling at the secondary level and higher, shows the significant positive effect of male schooling on growth. An extra year is estimated to raise the growth rate of Real Gross National Product (GNP) per person by 1.2 percentage points per year. Over a 30 year period an incremental 1.2% per year means that Real GDP per capita is 43% higher.

2. The maintenance of **the rule of law** affects growth positively. The study used an Index that included measures of the quality of the bureaucracy, political corruption, likelihood of government repudiation of contracts, risk of government expropriation, and the efficiency of the legal system. An improvement of one ranking on the Index (the scale has a range of one to six)

raises the growth rate by 0.5%. Over a 30 year period 0.5% means that Real GDP per capita is 16% higher.

3. **Government consumption**, exclusive of spending on education and defence, shows a significant negative effect on growth. "The particular measure...is intended to approximate the outlays that do not improve productivity. Hence, the conclusion is that a greater volume of nonproductive government spending--and the associated taxation--reduces the growth rate."

4. A high rate of **population growth** has a negative effect on economic growth. "If the population is growing, then a portion of the economy's investment is used to provide capital for new workers rather than to raise capital per worker."

5. In countries that are heavily dependent on foreign trade any change in **the terms of trade**, the ratio of export to import prices, is important because export volume affects employment directly.

6. The relationship between **democracy** and growth appears to be non-linear...that is…democracy enhances growth at low levels of GDP per capita but reduces growth at higher levels. The reason is because at higher levels there is an "intensified concern with income redistribution."

The study discussed poor countries with low growth rates and potential and concluded that in these cases –

> **A higher rate of growth is possible "if the government improves the climate for business activity--say, by reducing burdens from regulation, corruption, and taxation" or "if people decide to have fewer children or...to save a larger fraction of their incomes."**

The Bahamas:

Sir Lynden's Proposal

To put these studies into a Bahamian context let us look at the proposal of Sir Lynden Pindling at the Colloquium on "Political Reform". He called for a healing, reconciliation and integration that would extend into the millenium. He did not say what acts or events created this need. However, it is not difficult...given the above economic analysis and some reflection on the events of the past 25 years...to identify the acts and events.

There is no doubt that one of the achievements of Independence is the infusion of pride and identity into the body politic. It was not forged in a military conflict with a foreign power that called for self-sacrifice and the mobilization of the country's resources for a single purpose.

This identity was forged in a civil war. The instruments of combat were citizenship, contracts, licenses and permits and the adversaries were selected businessmen and workers. The critical filters for all decisions were party and race and the objective was a forced redistribution of income. In Civil Wars the scars left in the minds and hearts of the victors and the vanquished are long lasting.

> **Unfortunately…this Civil War changed the economy from a dynamic one to a stagnant one. The reasons for this loss of national economic momentum are not hard to find...one need only re-read the above "Tale of Two Studies."**

Since 1992 the FNM has jump started the growth engine but is struggling hard to find the ingredients to make the recovery a lasting one.

> **Sustained economic growth comes from doing things that do not produce quick results. In this case, this means the end to the policy of spend and tax and fiscal deficits. It**

means productive investments in education, public safety and the justice system. It means limited government and a commitment to free markets and the harshness that these sometimes impose on the participants. It means a moral life for one and all. This need to look beyond the present and to inspire people to sacrifice for the future requires statesmen…not politicians.

Is this what that "old politico"…Sir Lynden…had in mind?

ENDNOTES

1. James Gwartney, Robert Lawson and Randall Holcombe, *The Size and Functions of Government and Economic Growth*, A Report to the Joint Economic Committee, Washington, DC, April 1998.
2. Robert J. Barro, *Determinants of Economic Growth: A Cross-County Empirical Study*, The MIT Press, Cambridge, Mass., 1997.

The Crisis

"The Real Revolution" by Daniel Yergin and Joseph Stanislaw, *Forbes Global Business & Finance*, May 4, 1998, pages 88 - 91.

When the Asian crisis finally ends, the remedy will be clear–"more market." Not more "more government" of the kind Asia has known. The crisis is one more step toward free market economics in the end-of-millennium world. For it was intertwined crony capitalism—plus speculative and poorly regulated financial sectors—that caused the near collapse of the Asian currencies.

India

Notwithstanding the area's current travails, the East Asian countries traveled far on recipes that were more market-oriented than what had been the standard Third World statist formula. India and the East Asian countries were all very poor nations in 1960, but India took a quasi-socialist path with its Permit Raj and central planning; countries like South Korea and Taiwan, more of a private enterprise path. By the 1990s those countries' per capita incomes were 10 to 15 times that of India. "Between the fall of the Berlin Wall in 1989 and the collapse of the Soviet Union in 1991," says Indian economic official G. V. Ramakrishna, "I felt as though I were awakening from a 35-year dream." During those years Ramakrishna was one of India's most prominent government planners. Now he says: "Everything I had believed about economic systems and had tried to implement was wrong." Ramakrishna is now in charge of India's "disinvestment" (privatization) program.

India, of course, was not alone in believing in government direction of the economy. Even in many of the industrial countries, the postwar consensus ascribed the leading role to government, if not through direct ownership, then through regulation. But the rigidities and inflation that resulted eventually forced the state to retreat from this role everywhere outside of the Soviet bloc—a process in which Ronald Reagan and Margaret Thatcher played leading roles.

Latin America

The Third World debt crisis of the 1980s—particularly the lost decade in Latin America—constituted an intellectual bankruptcy for the ideas of state control, whether clothed in Marxism, nationalism or the fashionable theory of *dependencia*. The bankruptcy was also financial. Governments could no longer borrow from abroad to keep money losing state-owned enterprises afloat. When Mexico began its selloff of state-owned companies in the 1980s, the government owned more than 1,100 firms, ranging from heavy industry to a blue jeans factory. "We even owned a nightclub in Mexico," said Jesus Silva Herzog, the former Mexican finance minister. "it was probably the only nightclub in the world losing money.

More Market

Changes in the way the global economy works are playing a big part in rendering government control ineffective. While global output increased at an annual rate of 1.4% between 1989 and 1997, international trade grew much more swiftly—at 15.8%. Foreign direct investment rose even faster, at an annual rate of 11.5%. As a consequence, it is no longer possible to run a national economic policy in isolation. Business now easily reaches across national boundaries, and governments no longer have the leverage over their own economies that they once did.

Thirty years ago there were not many more than half a dozen foreign stock markets deemed suitable for U. S. pension fund investment. The concept of emerging markets was invented only in the 1980s to promote investment in what was then still known as the Third World.

The Revolution:

Today there are upwards of 90 emerging-market stock markets. What this means is that whereas voters go to the polls only every two or four years, the global capital markets conduct a referendum every day on national economies. They reward market-friendly policies and penalize deficits and distortions. Governments can ignore this daily vote, but only at a very high cost.

> **That's the lesson driven home by the Asian disaster. While these countries were more market-orientated than may others, they had not gone far enough. And yet where they actually did need more government—to help regulate the financial sector and make it more transparent—they were deficient. Ultimately they forfeited the confidence of international capital markets. When that happened, their currencies collapsed.**

The rapid advance of technology is speeding this interdependency. When a country begins to lose the confidence of international investors, word travels fast. In 1976 a three-minute phone call from New York to London cost (in today's dollars) as much as $8. Today the computing power has reduced money from a physical thing to a blip on a computer screen, a blip that can move instantaneously in massive amounts—and with little respect for borders or distance.

Within companies, groups in North America, Europe and Asia can work together as single teams. In stock and bond markets, participants around the world have access to the same information at the same time and can act on it at the same moment. They are also able to use and manipulate vast amounts of information in a way that was inconceivable even a few years ago. As Thomas Hansberger, for 14 years the chief executive of Templeton Investment Counsel and now head of his own company, put it: "With computers, we can screen 20,000 companies for investment objectives before lunch."

Against these forces, government regulation, once so powerful, loses much of its power. For decades, MITI—the Japanese Ministry of

International Trade & Industry—controlled the economy through an intricate system of formal and informal controls. MITI now recognizes that the world has changed. It has turned into a promoter of deregulation in Japan, arguing that failure to deregulate will put Japan at a competitive disadvantage. Global markets have become too large, too fast and too complex for any government bureaucracy—no matter how well-intentioned—to second-guess them.

From Milton to Deng

Milton Friedman

As the balance of power has shifted away from ideas toward markets, ideas have moved, too. In the 1970s the prominent economist Arthur Okun, Chairman of Lyndon Johnson's Council of Economic Advisers, declared, "The market needs a place, and the market needs to be kept in its place." Contrast that with what Lawrence Summers, currently U. S. deputy treasury secretary, says about the relative roles of government and markets: "Milton Friedman", says Summers, "was the devil figure in my youth. With time have I come to have large amounts of grudging respect." Free market economist Milton Friedman hasn't changed his views much in these two decades, but whereas he once stood on the far right, he now stands much closer to the center.

This global change of mind represents a fundamental shift in the balance of confidence—toward increased reliance on markets as the more effective way to get things done. Yet the ascendency of markets will also mean a continuing testing of markets in terms of their ability to deliver the goods. When all is said and done, the public will judge markets by their results—growth, employment and standards of living—and by the public's perception of fairness, justice and opportunity.

Ronald and Margaret

Yet this transformation might not have come to pass in this form were it not for one vital ingredient—leadership. Conditions may cry out for change, but often it will not happen without individuals stepping forward. Ronald Reagan stepped forward and transformed the political vocabulary in the U.S.

In Britain it was Margaret Thatcher. She was willing and able to challenge the conventional wisdom that put government at the center of the economy. She never doubted that she was engaged in a battle of ideas, and she unabashedly projected her convictions. "I myself never had any sympathy for socialism," Thatcher says. "It was becoming obvious to people that the socialist way meant accepting decline. Can you imagine—people accepting decline?"

At the time, her many critics considered her the spearhead of the radical right. Now the program she promoted is embraced by the very politician who ousted her Tory party from power: Tony Blair—no doubt to the distress of many in his own party—has been consolidating most of Thatcher's economic revolution, not dismantling it. As Baroness Thatcher says, "New Labour has an understanding of what socialism was and how it doesn't work, that somehow you have to create wealth before resdistribution."

Chairman Deng

Deng Xiaoping, another market revolutionary of the late 20th century, came, of course, from much further to the left than Tony Blair. In Paris, just after World War I, Deng, still in his teens, became a fervent communist. (At the same time, he also opened and operated a very successful Chinese restaurant in Paris, the China Bean Curd Shop.) But many things changed in his lifetime, and he kept his eyes open. Deng, experienced first hand the disastrous consequences of Mao's policies. He paid a heavy price for his vision, including solitary confinement.

Fighting his way back after his third fall from power, Deng was determined to initiate a vast process of market reform. He once explained it very pungently. "I have two choices," he said. "I can distribute poverty, or I can distribute wealth." He chose the second—opening up China to the dynamism of the market.

The Revolution Rolls On

In Asia today we are seeing that it is not enough to go only part way toward free markets. South Korea thought it could reconcile a market economy with government direction. Because it was freer than other developing countries and more engaged with the world economy, South Korea prospered for a long time, but now it is paying a price for delaying adjustment to a more open market. Indonesia thought it could enjoy the benefits of a market economy without an appropriate legal foundation and the transparency required for efficient functioning of the market. That, too, ended up proving unworkable.

The market revolution rolls on. Countries may well take their own approach to it. But, ultimately, they either climb on board or get left behind. That's true whether the government is right—or left.

ENDNOTE: Daniel Yergin and Joseph Stanislaw are co-authors of *The Commanding Heights: The Battle Between Government and the Marketplace that is Remaking the Modern World*, Simon & Shuster, 1998. This material is used with the permission of Simon & Shuster.

"The only freedom which deserves the name, is that of pursuing our own good in our own way, so long as we do not attempt to deprive others of theirs, or impede their efforts to obtain it." John Stuart Mill (1806-1873)

"It is one thing to show a man that he is in error, and another to put him in possession of truth." John Locke (1632-1704)

The mission of the Institute for Economic Freedom is to improve public understanding of the foundations of a free and harmonious society by analyzing the role of markets in solving economic and social problems.

In pursuing this goal the Institute has prepared, published and distributed position papers on economic growth, labour law and fiscal policy. In the case of the Minimum Fair Labour Standards Bill we believe that its initiative promoted a fuller public discussion and greater understanding of the Bill and its implications.

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From this Review

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