Have Free Markets Failed Us?

BY STEPHEN SLIVINSKI

Is it merely a coincidence that living standards rose sharply and absolute poverty declined while the world embraced free market policies beginning in 1980? That's the question Harvard University economist Andrei Shleifer ponders in this essay.

He names the period between 1980 and 2005 as the "Age of Milton Friedman" to acknowledge the adoption — at least in modified form — of many of the late Nobel laureate's market-oriented proposals. The policies pursued in that spirit include capital market deregulation, the lowering of trade barriers, inflation-conscious monetary policy, the adoption of flexible exchange rates, and tax cuts.

It's hard to argue that these policies didn't at least have some positive effect. As Shleifer points out, they corresponded to substantial increases in the rate of growth in per-capita GDP worldwide and it's quite likely that they were the main drivers of the growth. The countries for which market liberalization policies provided the best relative return were those that were once the most heavily regulated, such as the countries of East and South Asia. (Aggregate growth trends mask a few key differences between regions. Rapid growth in Asia towers above slow growth in Latin America and stagnation in Africa.)

"The Age of Milton Friedman" by Andrei Shleifer. *Journal of Economic Literature*, March 2009, vol. 47, no. 1, pp. 123-135.

The triumph over runaway inflation and high punitive tax rates was evident during the Age of Friedman. The world median annual inflation rate declined from 14.3 percent in 1980 to 4.1 percent in 2005. Marginal income tax rates dropped from the population-weighted average of 65 percent in 1980 to 36.7 percent in 2005.

Markets became more international in scope due to a weakening of trade barriers too. Tariff rates fell from the population-weighted world average of 43 percent in 1980 to 13 percent in 2004. As formal goods markets become more free, black market activity declined.

The benefits of abandoning dirigistic policies have become clear to many in the developed world and this, in turn, has raised people's hopes and expectations. Shleifer recounts a trip he took to Chile a decade ago. At that time, the ambition of policymakers was to overtake Argentina. In 2007, policymakers wanted to match the growth of Australia and New Zealand.

Yet some scholars, most notably Columbia University economist and Nobel Prize winner Joseph Stiglitz, remain skeptical that free market policies are, in fact, good for the countries adopting them. For instance, these economists do not necessarily look askance at capital controls or see price stability as an important precondition to economic growth.

A recent book co-authored by Stiglitz, surveyed by Shleifer in this essay, seeks to make the case for significant state intervention in developing economies. Yet, Shleifer argues, the evidence offered is not persuasive. On inflation, for instance, their argument often amounts to a straw man, Shleifer maintains. Stiglitz and his co-authors see advocates of zero inflation as their main opposition when that point of view isn't held by most market-oriented economists, who argue that a certain level of inflation might need to be tolerated, at least in the short run. Meanwhile, Stiglitz and his co-authors are incautious when they "express little concern for the huge costs that high inflation has brought to countries that lost control of their fiscal policy, including many Latin American and transition economies."

Stiglitz and his co-authors also favor capital controls as a way to stem swings in speculative capital investment. As Shleifer notes, they lean heavily on the example of Malaysia as a country that imposed such controls and was able to escape the Asian financial crisis of the 1990s. Yet that example is still controversial as recent analysis has failed to find that these controls had macro-economic benefits. Instead, Shleifer suggests that such controls encouraged misallocation of capital and political corruption.

Shleifer reminds us that we must be careful to learn the right lessons from the experiences of developing economies. The transition to a more free market system "has taught us that economic and political disorganization, combined with obsolete human capital of both economic agents and politicians, can sharply slow down the economic turnaround." The other obvious problem facing the developing world now, he writes, is the lack of new business investment — a phenomenon that must be tied to the lack of institutional barriers to arbitrary political power which spawns predatory regulatory and fiscal policies.

"On strategy, economics got the right answer: free market policies, supported but not encumbered by the government, deliver growth and prosperity," Shleifer concludes. "And while a lot has been accomplished in the last quarter century, a lot remains to be done." In short, the principles to which Milton Friedman devoted his career can continue to provide a suitable policy guide in the future. **RF**