CHAPTER EIGHT

Liberty in Comparative Perspective

China, India, and the West

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Introduction

Until about 200 years ago, most of mankind was desperately poor. Then the great transformation happened. Global population increased sevenfold, global production more than 60-fold, and manufacturing industry at least 75-fold (Goklany, 2007: 19, 41). During the nineteenth and twentieth centuries, Europe and its North American and Australasian daughter societies overtook the great Asian civilizations and overcame mass poverty (Collins, 1986; Jones, 1981; Landes, 1998; Maddison, 2001; North, 1990; North, Wallis, and Weingast, 2009; Weber, 1923/1981; Weede, 1996, 2000). Ferguson illustrates Western dominance before World War I in these terms: "In 1500 the future imperial powers of Europe accounted for about 10 percent of the world's land surface and at most 16 percent of its population. By 1913, 11 Western empires controlled nearly three-fifths of all territory and population and more than three-quarters (a staggering 79 percent) of global economic output. Average life expectancy in England was nearly twice what it was in India" (2011: 5). Japan was the first Asian country to experience catch-up growth. Since the 1960s, Singapore, Hong Kong, Taiwan, and South Korea followed. Now,

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mainland Asia is catching up. According to Maddison, in 1950 the Asian share of world population was 54.7 percent, but the Asian share of world GDP was only 18.6 percent (2007: 378, 381). Until 2003, the Asian share of global population had increased to 59.4 percent, and the Asian share of world GDP had more than doubled and increased to 40.5 percent. In 2003, the West still commanded 43 percent of world GDP, but contained only 12 percent of global population (Maddison, 2007: 71).

In general, global growth has been good for the poor (Dollar and Kraay, 2002).[1] The rise of Asia is documented by the fact that China has become the world's biggest manufacturer over the USA (*Economist*, 2011, June 25: 3). Neither the so-called "great seven" nor the "great eight" of the global economy constitute what the names suggest. Including Canada or Italy but excluding China and India may have had historical or political reasons, but the decision certainly does not reflect the current and even less likely the future weight of these economies. According to data published by the World Bank, the rank order of gross national incomes *in purchasing power parity terms* is: first, the United States; second, China; third, Japan; fourth, India; fifth, Germany; sixth, Russia; seventh, Britain; and eighth, France (2011: 344-345). Three among the top five are Asian economies. Moreover, the Chinese economy might become equal to the American in size (but not, of course, in living standards) before 2020 (Maddison, 1998: 17, 96). *The Economist* once speculated that not only in purchasing power terms, but even in dollar terms, both economies might be equal in 2019 (2010, December 18: 129). According to Maddison's estimates, in 2030 China might control about 23 percent, the USA 17 percent, and India 10 percent of gross world product (2007: 343). Fogel (2010) dares to make an even more extreme prediction. In his view, China might control 40 percent and the West, i.e., the US and the EU together, about half as big a share of global GDP by 2040. Although Chinese per capita GDP will remain lower than America's income per head, income levels in China might become twice as high as European ones.

The purpose of this paper is to explain the divergent economic performance of Asia's giants and the West with special reference to economic

1 Although Anand and Segal (2008: 63-64) doubt whether we know how the global distribution of income is changing, six of the analyses in their compilation of studies that cover the last three decades of the twentieth century report a decrease, but only three report an increase in inequality. So, there is more, albeit inconclusive evidence, in favor of an equalizing trend than of a change for the worse. Nevertheless, 41.6 percent of all Indians had to survive on less than $1.25 a day, and 75.6 percent on less than $2.00 a day in 2005. By contrast, only 15.9 percent of Chinese live below the lower threshold and only 36.3 percent below the higher threshold (World Bank, 2011: 346).

freedom[2] and the roots of limited government in political fragmentation and interstate competition. In a subsequent section of the paper I will summarize why both China and India were overtaken by the West. In doing so, I shall introduce some factors that might explain why China could outperform India when both economies started to grow faster than the global economy and began their catch-up growth spurts. The third and fourth sections of the paper analyze Chinese and Indian growth in the latter half of the twentieth century. The final sections of the paper examine Western civilization's future prospects and summarize the theoretical approach elaborated in this paper.

Property rights, incentives and their consequences in Eurasia

Until the end of the twentieth century, neither China nor India had made much progress in overcoming mass poverty. Why did these great Asian civilizations stand still when the West grew rich? Although explanatory debates are by no means settled, I favor an approach focusing on institutions (Weede, 1996, 2000, 2011a). Alternative theories underline the importance of technological progress and innovation (Goldstone, 2008; Huff, 2011; Paldam and Grundlach, 2008). It is frequently claimed that technology accounts for about 50 percent of economic growth and 80 percent of productivity growth. Despite the plausibility of the link between technological progress and growth, Niskanen provides a useful warning against exaggerating the impact of technology: "'Technology' is one of economists'… favorite code words for what they do not understand…. All these estimates of technology are residuals, estimates of the percentage of economic growth that economists cannot explain by the measured increase in conventional inputs. Any underestimate of the increase in the quantity or quality of labor or capital, for example, increases the magnitude of the residual, attributed without any direct evidence to an increase in technology. Similarly, any condition that improves the allocation of resources, such as economies of scale or a reduction in the distortive effects of taxes, tariffs, regulation, and litigation, is also attributed to an increase in technology" (2008: 15).

2 Since the concepts "freedom" and "liberty" are frequently misunderstood, it is necessary to point out that my understanding of freedom requires "that the individual be allowed to pursue *his own* ends" (Hayek, 1988: 63). In philosophical discourse this type of freedom is frequently called "negative freedom." Although "open access" is related to liberty, the two concepts differ. North, Wallis, and Weingast's (2009) "open access societies" are not only characterized by equality and the rule of law, but also by big government and universal social insurance programs. Like Hayek, I regard big government as a threat to liberty. For a comprehensive review of concepts of liberty, see McMahon (2012).

Ultimately, institutions matter because they structure permissible actions and incentives. They affect technological progress as much as they have an impact on economic performance. Individual liberty to theorize and to experiment as well as decentralized instead of collective decision-making have been background conditions of progress. Rosenberg and Birdzell explain why even the requirement of consent is harmful: "A society which delayed innovations by the amount of time required to reach a political consensus would fall further and further behind a society which did not… It implies the substantive criterion that the benefits of the innovation are sufficiently understood and predictable that they can be persuasively verbalized in advance of its adoption—that is, that everything is too clear to need the test of experiment" (1986: 310). In research as elsewhere in the division of labor, individual liberty permits the exploitation of human diversity for the benefit of all (Hayek, 1988: 80).

The institutional account is as useful for the explanation of why China could overtake India in the second part of the twentieth century as it is for explaining the rise of the West. It focuses on the liberating benefits of institutional competition which are ultimately rooted in interstate rivalry and geopolitics.[3] One may contend that limited government and the rule of law are underwritten by balances of power within and, even more importantly, between states. In the West such power balances arose because of interstate rivalry (Jones, 1981; Weber, 1923/1981), because of the competition between church and state (Berman, 1983), and because of the tensions between cities and territorial rulers in the Middle Ages (Weber, 1922/1964, 1923/1981).[4]

In my account of the rise of the West, there is a causal chain running from institutional competition via safe property rights and individual liberty to economic growth. Whether the safety of property rights or the freedom to trade had been much better in Europe than, say, in Asia, or whether it had dramatically improved before the industrial revolution and the take-off of European economies has been strongly disputed (Angeles, 2011; Hobson, 2004; Pomeranz, 2000). In this paper I cannot even attempt to discuss alternative historical approaches in any detail. It

3 According to Vaubel (2008), eighteenth century thinkers, including Ferguson, Hume, Montesquieu, Kant and Smith, preempted most of the arguments applied by contemporary writers.

4 Sally has pointed to the fact that no single power controlled the ports surrounding the Indian Ocean before the arrival of the Portuguese, the Dutch, and the British (2011: 9). Although this lack of political centralization may have protected the property rights of traders there as it did in Europe, the littoral of the Indian Ocean was not the core area of the land-based empires in India, and even less in China, which gave up the exploration of the oceans and restricted overseas trade in the fifteenth century.

may suffice to admit that almost all the details about property rights and incentives, taxes, and commercialization are disputed. Although I elaborate on the mechanisms or reasons which I believe to be important for leading from political fragmentation via economic freedom to prosperity, I do not provide much historical evidence about the intervening variables in my account. This would require at least a book, if not multiple volumes.

Whether property rights dramatically improved during the eighteenth and nineteenth centuries partly depends on the indicators of property rights accepted. Like North or Weingast (1989), but in contrast to Angeles (2011), I would accept high interest rates on public debt as an indicator of insufficiently safe property rights. Nevertheless, the growth of taxation over centuries, including the period when European economies dramatically increased their growth rates, fits oddly with the argument that safe property rights for producers or traders are essential ingredients of the European miracle.[5] Sufficiently safe property rights and sufficient incentives might be enough. If the rewards of effort and work are sufficiently great (because of rising productivity), it might do ever less harm if the government taxes away a growing piece of the pie. Net returns and taxes may increase together. The necessity to defend the core of the research program about institutional competition and property rights by this kind of deliberation rather than by reference to unambiguously supporting historical data necessitates a look for other types of evidence in order to corroborate the theory. First, one should consider econometric evidence from the late twentieth century. Of course, this econometric evidence presupposes the availability of measures of economic freedom for cross-national studies. Thanks to the efforts of the Fraser Institute and its affiliates in lots of countries, such data are available for recent decades. Second, the contrast between both parts of divided nations after World War II (China, Germany, Korea) demonstrates that a strong rejection of capitalist institutions leads to impoverishment (Paldam and Grundlach, 2008: 80-82). Furthermore, the well-documented destruction of property rights and incentives during the great leap forward (1959-1962,

5 Of course, one should also consider what taxes pay for. Heavy taxation should be less harmful if invested in the procurement of public goods. Here, Goldstone, for example, admits that British taxes were spent in an economically useful way during the industrial revolution: "The big difference in Britain's economy was not the level of taxes or tariffs, but how they were spent … these high tax revenues were not squandered on palaces and playthings for the king and queen, but were instead directed to payment on state debts and funding for the Royal Navy. … The Royal Navy, swollen to become the largest and most formidable force in the world, was then able to protect British shipping and give British merchants secure passage around the world. The result was a virtuous circle ('virtuous' in the sense of self-reinforcing), in which taxes paid on trade were used for naval and military expenses that cleared the way for safer and more extensive trade" (2008, pp. 113-114).

to be analyzed below) in China delivers much starker evidence about the impact of insufficiently safe property rights and the corresponding destruction of incentives than European economic history. My claim is that no competing theory is compatible with (or even relevant for) all three types of evidence at the same time.[6]

Although econometric evidence on the impact of economic freedom is essentially cross-sectional rather than longitudinal, although it covers the most recent decades only, econometric studies do support the idea that economic freedom promotes economic growth and wealth (Chauffour, 2011; de Haan and Sturm, 2000, 2009; Doucouliagos and Ulubasoglu, 2006; Farr, Lord, and Wolfenbarger, 2003; Gwartney and Lawson, 2004; Gwartney, Holcombe, and Lawson, 2006; Liu, 2007; Norton and Gwartney, 2008; Vega-Gordillo and Alvarez-Arce, 2003; Weede, 2006).[7] The continuing debates among econometricians mostly concern three issues: whether the level of economic freedom or the rate of its improvement is more important; whether the relationship is approximately linear or whether the first steps toward economic freedom (or away from socialism) are much more important than later steps or approaching perfect economic freedom; and whether "size of government" should remain part of the economic freedom index or be treated separately.

One may raise the following objection against the claim that econometric evidence about the impact of economic freedom on growth and economic history support essentially the same argument about the institutional sources of growth: Although the effects of economic freedom or its growth are usually significant, they are dwarfed by the much stronger effects of the initial level of economic development or appropriate measures of human capital formation (Weede, 2006). But one must not conclude from these econometric findings that modest support for cross-sectional effects of economic freedom should lead one to expect only moderately strong freedom effects in the long run. What we observe as the most robust effect in cross-sectional growth regressions from recent decades, namely, the strong impact of the initial level of economic

6 Pomeranz's (2000) explanation of the great divergence between China and the West illustrates this perfectly. In his theory, the configuration of natural resource deposits (coal, iron) in China and Britain plays a major role. Even if this is true, such a proposition is not useful in understanding the misery produced by the great leap forward or econometric findings about the impact of economic freedom. The wider the applicability of a theory, the better its testability, and the more confidence we should place in it, if most test results support the theory.

7 The benefits of economic freedom are not limited to better growth rates. Economic freedom also reduces macroeconomic volatility (Dawson, 2010), unemployment (Feldmann, 2010) and even homicide rates (Stringham and Levendis, 2010).

development on growth rates or catch-up opportunities for poor countries, must have been fairly weak before modern economic growth in the nineteenth and early twentieth centuries made the West much richer than the rest of the world. As long as average incomes across the world were about equally close to the subsistence level, catch-up opportunities could hardly exist. Catch-up opportunities for the poor presuppose the existence of rich countries. That is why one may regard the current catch-up opportunities that Asian societies have exploited so skillfully as an external benefit of the *earlier* establishment of limited government, safe property rights, economic freedom, and the resulting prosperity in the West. In this account, institutions and incentives drive economic development. Technological progress is part of economic development. But the technological progress made possible by free institutions in the West also makes it possible for emergent economies to benefit from technologies invented elsewhere, i.e., in the West.

Since the fourteenth century, China was a unified empire for most of the time, first under the Ming, and then under the Manchu or Qing dynasties, which lasted for some centuries each. Imperial China succeeded in monopolizing authority to a much greater degree than did European states. As Jenner notes, "The success with which the Chinese state prevented any religion from becoming a rival source of authority across the empire was one of many factors preventing the emergence of a doctrine that the monarch's rights were limited by the rights of groups and individuals" (1998: 78). There were no autonomous cities in China. In Weber's (1922/1964) terms, the traditional Chinese empire was patrimonial. Under patrimonialism, the state does not need to respect the rights of its subjects. Chinese merchants suffered from arbitrary, high, and discriminatory taxation as well as from frequent confiscation. By harassing merchants, the imperial bureaucracy impeded the development of markets and commercialization and indirectly the division of labor and productivity growth (Yang, 1987).[8]

Whereas China suffered the consequences of political unity, Western Europe benefited from cultural unity and political fragmentation. Conflict between European kingdoms or principalities contributed to the limitation of governmental power over subjects. If political units are small, it is much easier to run away from arbitrary officialdom and confiscation than in huge empires. In medieval Europe, even peasants could run away and find refuge in autonomous cities. Rivalry between small political units and early trade in mass consumption goods forced European rulers to

8 Although de Bary, Chan, and Watson (1960) do not analyze the actual economic order in imperial China, they document that Chinese writers recommended promoting agriculture at the expense of commerce.

concede relatively safe property rights to merchants. If merchants were robbed by some European prince, they could avoid and circumvent his territory in future. Merchants preferred routes through safe territory over alternative routes. Income from protection fees or taxes strengthened less kleptocratic rulers over their more kleptocratic rivals. Successful strategies of taxation and rule provide an example for other rulers to imitate. That is why safe property rights could spread through time and space in Western Europe.

As underlined by Weber (1922/1964), Europe differed from the great Asian civilizations by having a large number of autonomous cities where individual liberty, economic freedom, and even political freedom were established earlier and for the benefit of a larger part of the population than elsewhere in traditional societies. European cities were fortresses of liberty. Schmidt und Dirlmeier make the following comment on southern German and northern Italian cities in the Middle Ages: "Towns attracted unskilled workers from the countryside and skilled workers from other towns with the guarantee of personal liberty, fiscal incentives and superior income chances" (1998: 158). Communities defended individual liberty in European cities. In Asia, inhabitants of big cities remained subservient to rulers. The existence of autonomous cities in Europe also improved the conditions of life for peasants. The possibility of exit limited abuse by rulers. According to Volkart, "Peasants simply did not have to go that far to find an authority which offered a different and possibly better set of rights, and rulers had to grant favourable conditions if they did not want to lose them. In my opinion it was therefore not by pure chance that in Renaissance Germany prosperity grew with political fragmentation, especially where this became greatest, that is, in the southwest. And it was not by chance either that it was just this area where peasants were sometimes represented at the local diets" (1998: 178).

Palmer also summarizes the importance of cities for the evolution of the West very well: "The cities of Europe were islands of freely organized production and exchange protected by walls that were built to exclude the practitioners of violence and theft. As a fortified place—a *Burg*—a city made possible the freedom of the Bürger. The new cities of Europe were generally places of trade and commerce, rather than administrative centers of vast empires, centers of religious cults, or centers of exploitative rule over subject peasant populations.... Serfs or vassals who could make it to a city and live there for a year and a day were freed of feudal obligations and would be defended by the city" (2009: 18). Jenner compares the situation in Europe with China: "The weakness of medieval European monarchies that allowed cities to select their own governments and to bargain with the king would have shocked a Song official's sense of a well-ordered world" (1998: 78).[9] As cities were scattered across the densely populated parts of central and west Europe, they provided exit opportunities for common people since the Middle Ages.

The Chinese state was not only strong enough to subordinate religious communities and cities. Simultaneously, it was strong enough to constrain the growth of knowledge, for example the exploration of the oceans. As Jones observed: "The record of Chinese exploration which was halted in 1430 and prevented by fiat from resuming in 1480 shows what could happen in a centralized empire that could not happen, or be enforced, in a decentralized system of states, like Europe…. Columbus did eventually find a sponsor. The other large societies in Eurasia that might potentially have developed as Europe did develop, tended to suffer from various disabilities including political centralism and whimsicality" (1981: 67).

As opportunities for exit and circumvention are so important for the establishment and protection of freedom, it can be added that exit opportunities were at least as good in the United States as in Europe. Until the Civil War, the United States was a decentralized federation where the states had to compete for people and capital. This was "market-preserving federalism" (Weingast, 1995). During the nineteenth century Americans enjoyed another option. Whoever felt some grievances in the increasingly crowded east of the country could go west and settle in sparsely populated lands. Given such exit opportunities, oppression simply was no option for ruling classes.[10] Moreover, the possibility of mass emigration from Europe to the United States or Canada or Australia also strengthened the common man against officialdom and employers. The exit option forced officials to treat subjects more respectfully than would have been necessary without it. Moreover, the emigration of about 60 million Europeans also contributed to the convergence of Western European and North American incomes (Hatton and Williamson, 2006: 3, 114, 121).[11] It might be more than a pure coincidence that North, Wallis, and Weingast (2009)

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9 The Song (or Sung) dynasty ruled China at the beginning of the second millennium, before the Mongol conquest and much before the Ming dynasty.

10 I do not claim that ruling classes in America ever tried to establish a repressive regime. But infeasibility of such a project provides a stronger protection of freedom than political attitudes ever can.

11 Since the gap in purchasing power terms was much smaller between North American and European incomes before World War I than it is today between North America or Europe on the one hand, and poor countries like India on the other, obstacles to international migration condemn millions of people to persistent poverty (Hatton and Williamson, 2006: 215, 372). Chauffour criticizes this disgrace from a human rights perspective (2009: 43-44, 75). Palmer points out that restrictions of migration are typical of welfare states (2009: 245).

date the transition to "open access societies" or the extension of safe property rights from the elites to the masses in Britain, France, and the United States to the mid-nineteenth century when lots of exit opportunities for Westerners existed.

Unless people enjoy fairly safe property rights in the fruits of their labor, there are insufficient incentives to work. This insight can be found in Adam Smith (1776/1976) who recognized that shirking becomes the rule and hard work becomes the exception without property rights. The most fundamental cause for the divergence between China and India on the one hand, and the West on the other, is safer property rights and thereby better incentives in the West than in Asia (see Jones, 1981; Landes, 1998; Weede, 1996, 2000; and Yang, 1987, for evidence).[12] By contrast to China, Indian empires tended to be short-lived and less successful in uniting the entire civilization. Even the Mughal Empire never ruled all of India. Many Indian states engaged in war against each other. If the absence of a unitary empire contributes to safe property rights and limited government and ultimately to economic growth, then India does not fit with the theory, as argued by Lal (2004). In my view, however, one should not exaggerate the misfit between the Indian case and the argument that limited government, safe property rights, and incentives are prerequisites of economic development. By contrast to fairly persistent political units in Europe, Indian principalities and kingdoms disappeared fairly frequently. Indian rulers could not expect their sons and grandsons to be rulers of the same territory. Therefore, they had less reason to respect the property rights of their subjects for the long-term benefit of the ruling dynasty as well as of the economy. As North, Wallis, and Weingast (2009) elaborate for the West, there is some connection between the longevity of organizations and states—"perpetually lived" organizations and states in their terms—and the safety of property rights or the rule of law.

India also lacked other background conditions of limited government. Indian artisans and merchants did not acquire political power within self-ruling cities as European artisans or merchants did. According to Weber (1921/1978), this can be explained by Hinduism and the caste system. For orthodox Hindus, war-making and defense were assigned to warrior castes. Since artisan or merchant castes were not permitted to bear arms and to fight, they could not acquire political power. During the first millennium CE many inhabitants of Indian cities, in particular merchants, were not Hindus, but Jains or Buddhists. These religions disarmed their adherents, too. They were prohibited by their faith even from killing animals and this extended to humans, too. In contrast to European princes,

12 Hayek has also endorsed the view that the "certainty of law" contributed significantly to Western prosperity (1960: 208).

Indian rulers were safe from urban challenges to their prerogatives. Whereas a strong Catholic church during the Middle Ages contributed to containing the secular power of rulers in medieval Europe (Berman, 1983; North, Wallis, and Weingast, 2009), no comparable counterweight to political power can be found in Indian history.

An analysis of Indian history has to consider the fact that huge parts of India have been ruled by Muslims for most of the second millennium. In Weber's (1922/1964) terms, Muslim rule in India qualifies as "sultanism." Sultanism is the most extreme subtype of patrimonialism. Rulers were assisted by foreigners and slaves who enjoyed no support in society. They absolutely depended on the ruler and his grace. The more dependent on his grace the staff of the ruler is, the more reliable an instrument of arbitrary rule it becomes. That is why sultanism provides the weakest protection of property rights for subjects. As elaborated by North, Wallis, and Weingast (2009) or Pipes (1999), the first step towards safe property rights and the rule of law in the West has been elite privileges and their legal protection. Neither patrimonialism in China, where the emperor claimed to be the ultimate owner of all land (Yang, 1987), nor sultanism in Muslim-ruled India, provided a good starting point for the evolution towards the rule of law.

Whereas by the late eighteenth century Smith had already recognized the importance of property in providing incentives for hard work,[13] the special incentive problems arising with team production and firms were recognized only about 200 years later (Alchian and Demsetz, 1972). Wherever it is difficult to say or to measure who contributes how much to the productivity of the team, someone has to become the team leader and to specialize in coordinating and monitoring the work of the team members. The responsibility of the team leader includes the prevention of shirking by ordinary team members. If everyone shared equally in the output or profit of the team irrespective of effort and productivity, then incentives to shirk rather than to work would be tremendous. But if the team leader becomes the residual claimant of the profit, i.e., if the leader can keep whatever is left after paying for all the inputs, including the labor of the other team members, then the leader has an incentive not to shirk in his duty to control the others. Thus, efficient team production requires something like a capitalist firm, i.e., the private appropriation of the residual income. The value of residual claims becomes more useful if enterprises can outlive their owners, if ownership shares can be transferred

13 Here I do not want to claim that Smith was the first one to recognize the importance of property rights, but being the founding father of economics he was more influential than others. In China, for example, by the 4th century BC, Mengzi had pointed to the need for clear property rights in land (Mencius, 2003: 109).

within and between generations. In North, Wallis, and Weingast's (2009) terms, a productive economy requires "perpetually lived organizations." According to Jenner, "neither the state nor custom allowed large and permanent private companies to emerge" in China (1998: 80). As documented by Kuran (2010), Muslim civilization also made the establishment of permanent private companies difficult or impossible. Only under Western influence did Muslim civilization develop the idea of a legal person, which is essential for large and durable corporations to do business.

Capitalism is characterized not only by the existence of residual claimants and "perpetually lived" enterprises, but also by private property in the means of production and scarcity prices. In the early twentieth century, Mises (1920, 1927/2005) argued that socialism is bound to end in economic failure because of a lack of scarcity prices for production inputs. Under socialism all factories or means of production are at the disposal of the political leadership. Since there is no competition for land, workers, raw materials, machines, or other production inputs between different owners of the means of production, there is no information about the demand for and scarcity of these inputs. Opportunity costs remain hidden. Without competition and scarcity prices, however, there can be no rational allocation of resources. In a later book about bureaucracy, Mises (1944) made another argument against administrative guidance of the economy. In his view, economic and technological progress never result from following laws, orders, rules, or traditions. Whatever the virtues of bureaucratic dominion may be, the results cannot include innovation and progress.

Under which conditions can free or scarcity prices, i.e., the prerequisites of a rational allocation of resources, ever arise? Almost all traditional or pre-capitalist societies generated the idea of "just" or "fair" prices. Since "just" or "fair" prices actually depended on habits or traditions, they had to lack flexibility. Overcoming inflexible prices which do not respond to changing patterns of demand and supply is a prerequisite of a rational allocation of resources. Traditional prices are most easily overcome in cross-border trade where nobody has the necessary authority to enforce the terms of trade on both sides of the border. After people get used to flexible or scarcity prices in cross-border trade, this type of pricing is likely to spill over into domestic trade. Given the political fragmentation of Europe, cross-border trade had to be much more important in Europe than in Asia with its huge empires. Political units with the geographical area and population of Spain, France, or England would have been a mere province within China or India.[14]

The final basic component of my theoretical account concerns the exploitability of knowledge. This concept can be traced back to Hayek

14 At different periods in history each of these nations was a contender for supremacy in Europe.

(1945, 1960). In his view, human knowledge refers not only to academic or book knowledge, which can be acquired at universities. It also consists of practical knowledge to be acquired by experience, whether in farming or in an artisan's workshop. It may refer to what grows best on a particular field or to where there is a lot of demand for a certain product. Some of this knowledge is necessarily local. Other knowledge might be tacit. Nobody ever tried to make it explicit. The bearers of knowledge, especially of tacit and local knowledge, include illiterate peasants. Hayek's main argument is that knowledge can never be centralized by some authority. In order to exploit the knowledge dispersed among thousands of heads, people need the freedom to make decisions for themselves and the incentive to arrive at beneficial decisions. If one accepts Hayek's views on knowledge and his requirements for using it, then it follows that Europe could outgrow China and India because of a greater degree of economic freedom due to its more decentralized economic decision-making.[15] Economic freedom implies independent decision-making arising out of the fact that property owners are free to invest their property as they see fit, within the constraints of the law.

It is also possible to reconcile the Hayekian focus on the productivity of economic freedom with a Weberian analysis of the Indian caste system (Weber, 1921/1978; Weede, 2000). Although Hayek did not specifically refer to Indian civilization in the following quotation, it seems to fit the case perfectly: "Religious prophets and ethical philosophers have of course at all times been mostly reactionaries, defending the old against new principles. Indeed in most parts of the world the development of an open market economy has long been prevented by those very morals preached by prophets and philosophers" (1979: 165). The caste system makes one's rights and duties dependent on the caste one is born into (Dumont, 1970; Weber, 1921/1972; Weede, 2000, 2010). Individual liberty and economic freedom have been severely restricted, as long or wherever caste norms have been enforced, whether by social pressure from below or by rulers from above. In principle, albeit not always in practice, the caste system prohibits innovation and vertical mobility.[16] Since

15 Such a summary statement fits much better with Yang's (1987) analysis of China than with Chan's (2010). Chan's views, however, defy a brief summary. On the one hand, Chan refers to laissez-faire attitudes of the officialdom and light taxes (2010: 472), on the other, he refers to bureaucratic domination, low esteem of merchants, and incentives to keep the business small in order to avoid confiscations (Chan, 2010: 475-482). In my view, neither bureaucratic domination nor confiscation is compatible with laissez-faire or economic freedom. Moreover, low esteem made merchants vulnerable, as discussed by Yang.

16 In India, vertical mobility is often group mobility rather than individual mobility. One may distinguish Westernization and Sanskritization (Srinivas, 1959). Whereas Westernization is typical of more privileged castes, Sanskritization refers to the attempt of lower castes to

deviation from traditional caste duties might magically hurt even the reincarnation prospects of fellow caste members, it has usually been punished. Lower castes have frequently resorted to excommunication. Certainly, the caste system has made upward mobility by economic success less likely in India than either in China or Europe. Religious constraints on economic freedom had to interfere with profit-maximization and economic growth. In particular, entrepreneurship was much more accessible to members of the traditional trading castes than to others. While their members enjoyed superior access to opportunity, most Indians did not.[17]

Economic backwardness in India and elsewhere is sometimes explained by colonial exploitation. There is no doubt that exploitation has happened, but exploitation does not usually lead to development in the exploiting countries. Iberian rule over Latin America illustrates this point. It helped neither Spain nor Portugal to develop. Moreover, ruling classes other than Western colonialists have exploited their subjects, too. Maddison provides a quantitative estimate of the exploitation of India by the Mughals and their British successors: "The income which the Mughal elite, native princes, and zamindars managed to squeeze from the rural population was proportionately quite large. It amounted to about 15 percent of national income … But, by the end of British rule, the successors of the old elite got only 3 percent" (2007: 123).

In sum, the rise of the West and the stagnation of China or India can be explained by divergent institutional developments. In the West, political fragmentation and competition forced even autocratic (or "absolutist") rulers to respect the private property rights of producers and traders much earlier and to a greater degree than Asian rulers did. Because of better exit opportunities for common people, there was more economic freedom in the West than in Asia. Without economic freedom, incentives for hard work suffer. Political fragmentation in the West also contributed to scarcity prices and a rational allocation of resources as well as to decentralized decision-making and the application of knowledge that is dispersed among millions of heads.

Socialism in Asia

Although Europeans invented socialism, i.e., a program to roll back economic freedom, the West suffered much less from it than did Asia. From the 1950s to 1980, per capita incomes in China and India were fairly

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improve their status by leading a "purer" form of life. If this implies giving up dirty work, Sanskritization may reinforce poverty.

17 According to the 1931 census in British India, trading castes, like the Baniya, had much higher literacy rates than even the higher-ranking Brahmins. Obviously, literacy is useful in business (Wolcott, 2010: 463).

similar to each other. Per capita incomes in both countries still grew more slowly than globally (Maddison, 1998: 40-41); both neglected comparative advantage and pursued "leap-forward strategies" that focused on heavy industries in spite of capital scarcity and labor abundance (Lin, Cai, and Li, 2003: ch. 2). China and India were afflicted with socialism and an emphasis on planning. The choice of planning and import substitution by many poor countries, including China and India, had two roots. One was the spirit of the 1950s and 1960s, or the tendency of development economists to exaggerate market failure and to overlook state failure. The second was the desire to achieve national security by heavy industrialization, autarky (a policy of national self-sufficiency), and, at least in the Chinese case, building a strong army. A comparative-advantage-defying development strategy would have been impossible in a market economy where private investors suffer the consequences of their misjudgments. Government's large scope makes big and persistent mistakes possible. Whereas China suffered from the repressive and radical variety of socialism, India tried the democratic variety. Both countries, even democratic India, more or less disengaged from the global economy. Between the early 1950s and the late 1970s, the ratio between trade and output in China fell from more than eight to less than six percent (Lin, Cai, and Li, 2003: 83). In the late 1940s, when India became independent, its share of global exports was 2.4 percent. In the early 1990s, it was only 0.4 percent (Bhagwati, 1993: 58).

Although China and India should have enjoyed the "advantages of backwardness" and should have benefited from "conditional convergence" (Barro and Sala-i-Martin, 1995; Levine and Renelt, 1992; Olson, 1996; Weede, 2006), both of them grew slowly from the 1950s to 1970s. It depends on other factors whether or not a backward economy develops. Without investment and human capital formation, it is unlikely that they can catch up. Insufficient amounts of investment cannot explain why neither India nor China succeeded in realizing the advantages of backwardness in the 1950s to 1970s. Instead, the productivity of investment left much to be desired (Bhagwati, 1993: 40ff.). Human capital formation is another candidate for explaining this. Here, China and India differ. Already by 1950, the Chinese had benefited from a little bit more schooling than Indians had received (Maddison, 1998: 63). By the late 1970s, about 90 percent of all Chinese in the 15-to-19-year age group knew how to read and to write. Even in 2008, China scored much better in adult literacy than India, i.e., 94 against 63 percent (World Bank, 2011: 344). What holds Indian education back is not inadequate pay, but teacher absenteeism (Panagariya, 2008: 365 and ch. 20).[18] So, human

18 Absenteeism is even worse in Indian public health services than in Indian schools (Panagariya, 2008: ch. 19).

capital formation and its difference between Asia's giants may help us to understand why China outperformed India in the late twentieth century. In the early twenty-first century the Chinese advantage persisted. According to the World Bank and the *Economist,* Chinese workers were 50 percent more productive than Indian workers, but cost only 25 percent more (*Economist*, 2005, March 5: 10). Complementing the cross-national comparison with a look a trends in Chinese labor costs again delivers good news about the Chinese economy. Although labor costs in big enterprises tripled between 1995 and 2004, productivity quintupled, thereby cutting unit labor costs by 43 percent (*Economist,* 2010, July 31: 47).

Compared to the global economy China *and* India did poorly in the 1950s to 1970s. Advantages of backwardness were not realized in spite of sufficient investment and, at least in China's case, sufficient human capital formation. This poor economic performance was to be expected, if the explanation of the great divergence between Europe and Asia provided above and inspired by Weber (1923/1981) and Jones (1981), by Smith (1776/1976), Alchian and Demsetz (1972), Mises (1920), and Hayek (1945, 1960) is true. Take the case of China first. Under communism and central planning, incentives were poor. Egalitarianism prevented special material rewards for those who worked hard, carefully, and effectively. Since the means of production were nationalized, too, there were neither residual claimants to a firm's profits nor scarcity prices, least of all in input markets for production. Finally, few people enjoyed the opportunity of exploiting their knowledge for the benefit of themselves, their families, and their exchange partners. Obeying commands from above killed private initiative. Since economic freedom is productive, its abolishment under central planning guaranteed slow growth rates and persistent poverty. It was possible to use valuable inputs for the production of shoddy goods.

After the Communists had acquired political power, they confiscated land from larger landlords, murdered many of them, but provided small farmers with full private property rights. Their "land to the tiller" reforms contributed to rising farm incomes; by 85 percent in the first few years (Zhu and Prosterman, 2007: 3). In the middle of the 1950s, however, collectivization began, at first slowly, but then ever more radically. Mao Zedong's "Great Leap Forward," from 1959-1962, is a perfect illustration of the suffering socialism causes (Dikötter, 2010). The previously small collectives were combined into huge people's communes that often encompassed a few villages and tens of thousands of people. Agricultural property rights were further diluted. Incentives to work hard without permanent supervision were eliminated and replaced by threats of violence against those who shirked or disobeyed orders. Since the leaders of people's communes were not residual claimants of the commune's income, after paying for all the inputs including labor, they faced few incentives to carefully monitor the effort and work of commune members. Shirking at the leadership level complimented shirking by the peasants. The local and tacit knowledge of peasants (for example, what grows best when and where) was no longer applied. Political indoctrination wasted a lot of time. Changing political priorities (for example, a temporary focus on dam building or establishing rural industries) interrupted harvests so that grain sometimes rotted in the fields. Cadre arrogance prevailed. Close cropping, deep plowing, and misapplication of fertilizer did not produce the intended abundance of crops. In order to impress superiors, many cadres inflated reported harvests. Thereafter the state took a rising share of the harvests leading to shortages and famine in the countryside. For a while the government seemed to believe the inflated reports of miracle harvests and signed agreements with other communist countries to export grain and to import machinery or military equipment. Grain exports continued as promised after the famine had begun, even after many top leaders suspected how desperate the situation in many provinces was.

Efforts at achieving the industrialization of the countryside were aimed at local autarky. From a geopolitical point of view, local or regional autarky would have made sense if the Soviet Union had ever invaded China.[19] It made less sense, however, to cut down trees or to confiscate household implements and farming tools in order to feed small and primitive rural furnaces which produced extremely poor iron or steel. Because of a lack of experience many work accidents happened. But cadres insisted on rising output irrespective of cost. The Great Leap Forward became a great disaster. Whereas older sources estimate that more than 30 million people starved to death (Fu, 1993: 235, 304; Lin, Cai, and Li, 2003: 58), more recent research based on local and provincial sources arrives at an estimates of at least 45 million out of about 650 million Chinese in those days (Dikötter, 2010: 324-334). Not all of these victims starved to death. Some of them took their own lives, and others were murdered by cadres and militias. Dikötter estimates that about 2.5 million were tortured or otherwise murdered, whereas between 1 and 3 million committed suicide (2010: xi and 304). China paid an extremely high price for running the economy on the foundations of Marxism and Maoism instead of being guided by the principles elaborated by Smith, Mises, and Hayek.

Although the immediate consequences of Mao's policies were often disastrous, some of his policies can be interpreted more positively. According to Bardhan, one may credit Mao's policies (except for the disasters of the Great Leap Forward and the Cultural Revolution) with the

19 As Soviet and Chinese troops clashed along the Ussuri border in the late 1960s, the Chinese had some reason to fear the Soviets.

provision of a "launching pad" for later economic growth: by establishing some minimum, but broad-based education and health standards; by rural electrification; by making a highly egalitarian land distribution possible; by regional decentralization; and by high female participation in education and work (2010: 8).

India became and remained a democracy after its independence. Although it never nationalized all the means of production, it was inspired by the Soviet model for a long time (Lal, 1998: 129). As Maddison pointed out, "Ghandian pressures in favor of self-sufficiency" had a similar impact (2007: 130). Slow growth and persistent poverty were the results of this inspiration. Bureaucratic controls and interventions weakened incentives, severely restricted entrepreneurial decisions on hiring and firing, and distorted prices. Import substitution and protectionism contributed to weak competition. Favored enterprises, cartels, and even monopolies enjoyed an easy and profitable life at the expense of consumers. The political economy of India was characterized by "license-permit raj" (FICCI, 1999: 165). Instead of unifying Indian markets by improving infrastructure, political interference reinforced their fragmentation by erecting internal barriers to trade. In doing this, the state limited the size of Indian markets and the potential productivity benefits of lager markets (Nilekani, 2009: 242-243, 250). Moreover, taxation cut incentives for hard work and entrepreneurship. For a long time, marginal income tax rates in India had been above 90 percent. Later they came down to about 30 percent (Panagariya, 2008: 336-342).

By contrast to the private sector, the public sector expanded. Its share in gross domestic product increased from eight to 26 percent between 1960 and 1991 (Yergin and Stanislaw, 1998: 216). In the late 1980s, the Indian public sector was responsible for about 70 percent of all workers employed by big enterprises (Bhagwati, 1993: 64). Except for the impoverished informal sector and agriculture, public enterprises were dominant in India. As in China, public enterprises in India tended to be less efficient than private enterprises (Majumdar, 1998; *Economist*, 2011, September 3). Labor market policy made little sense. Firing workers was next to impossible before the enterprise went bankrupt (Bhagwati, 1993: 65, 86; Joshi and Little, 1998: 211ff.). Strong job protection in the formal sector, however, came at a price. Employment in the formal sector was reduced by at least 18 percent (World Bank, 1995: 90). The size of the unorganized sector in India matters because it depresses productivity. According to Luce, "the average labor productivity of the worker in the private organized sector was six times that of his counterpart in the unorganized sector [in 1983, E.W.]. By 2000, that had risen to nine times. The disparity in earnings was similar" (2006: 49). Although Indian socialism benefited a minority of workers, the poorest stratum of society was denied all access to formal employment. Luce summarizes the effects of democratic socialism in India on the poor by reference to a state that is "never absent from your life, except when you actually need it" (2006: 64).

Creeping capitalism in Asia

After Deng Xiaoping's final rise to power as well as under his successors, the Chinese government switched from radical communism to creeping capitalism. Reforms began in the countryside. Incentives to work were reestablished. Peasant judgment replaced cadre decision-making again. As implied by the label of the new policy, "Household Responsibility System," those who made the decisions had to suffer the consequences again. Although the state retained ownership of the land, the communists returned rights to work the land to small groups, to families, and even to individuals.[20] Peasants had to pay rent and to sell part of the harvest to the government at fixed prices. Since surplus products could be sold in free markets, even scarcity prices got a toehold in the Chinese countryside. Chinese peasants responded forcefully to the reforms. From 1978 to 1984 agricultural output grew about 42 percent (Lin, Cai, and Li, 2003: 145). Within less than a decade, per capita incomes in the countryside doubled. Since the mid-1980s, however, the rural-urban income disparity has widened again. In 2006, urban per capita income was about 3.3 times the rural income (Zhu and Prosterman, 2007: 2). By and large, the urban-rural gap is wider in the western interior than in the coastal provinces. The wider it is, the more investment is discouraged and the more provincial growth rates suffer (Wan, Lu, and Chen, 2008). According to Bardhan, these early rural reforms have been even more important than urban reforms, exports, or globalization for China's economic development: "Much of the high growth in the first half of the 1980s and the associated dramatic decline in poverty happened largely because of internal factors, not globalization. These internal factors include an institutional change in the organization of agriculture, the sector where poverty was largely concentrated, and an egalitarian distribution of land-cultivation rights, which provided a floor on rural income-earning opportunities, and hence helped to alleviate poverty" (2010: 6).[21]

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20 Most rural households do not even now have certificates stating which land they farm and which residential property they occupy. A completed land registry might become the first step towards private property in farmland, which some day might permit the consolidation of tiny plots into more efficient farms. Although rural residents are discriminated against when they work in cities, as tens of millions of them do, rural registration also has some advantages, including access to cheaper medical insurance, a residence, and some farmland (*Economist*, 2010, May 8).

21 Huang makes the same point about the timing of significant poverty reduction (before) and foreign direct investment (later) in China (2008: 26).

In the 1980s, urban and industrial reforms complemented agricultural reforms. The comparative-advantage-defying strategy was replaced by a comparative-advantage-exploiting strategy (Lin, Cai, and Li, 2003: 101). The preferences for heavy industry and import substitution were overcome. Township and village enterprises (TVEs) were established. In the first two reform decades they enabled 120 million peasants to move from agricultural to industrial employment (Lin, Cai, and Li, 2003: 199). In the absence of the rule of law, or even legitimacy of private property ownership in the means of production, Western-style property rights would have been insecure (Rodrik, 2007: 24). Entrepreneurs could not yet become owners of the means of production. Instead they were forced into some kind of partnership with the local administration, i.e., with those who might be tempted to expropriate them and who had the power to do it. But local governments lost interest in expropriation because they could share TVE profits. Although the necessity to reward entrepreneurship was respected, private property in the means of production was legalized only after the reforms had already succeeded. At the beginning of the reform process TVEs were an efficient institution.

TVEs had to compete with each other. The reach of "their" local government was not long enough or strong enough to protect them. Even if the ownership was still public or collective, most TVEs had to compete, *as if* they were private enterprises. Although not protected by law, managers and local cadres became de facto residual claimants of profits and therefore had an incentive to monitor the workforce and to prevent shirking. Later, truly private enterprises were tolerated. Prices were permitted to reflect supply and demand. By the early 1990s, most prices were determined by scarcities rather than political fiat (Lin, Cai, and Li, 2003: 172). Only 6 percent of the Chinese farm produce was sold in open markets in 1978; that proportion rose to 80 percent in 1993 (Bardhan, 2010: 44).[22] By contrast to TVEs and the increasing number of truly private enterprises, state-owned enterprises (SOEs) incurred losses for a long period without suffering bankruptcy.

While making SOEs profitable has been difficult and elusive for a long time, China had succeeded in quickly reducing their weight and importance. In the late 1970s when the reform process began, they accounted for more than three-quarters of the industrial output. Two decades later, their share was down to about one-quarter of it (Lin, Cai, and Li, 2003: 187). Of course, the transition from a state-dominated economy to a more capitalist one was costly. During the late 1990s about 30 million workers lost their jobs in state-owned or collective-owned enterprises. Whereas

22 Agricultural productivity is better in China than in India, about twice as high per hectare for rice, and one-and-a- half times as high for wheat (Bardhan, 2010: 43).

SOEs controlled about two-thirds of fixed capital in Chinese industry in 1990, now it is down to about one-third. "The Chinese economy is primarily privately owned or controlled today" (Bardhan, 2010: 68, 80, and 98). According to the *Economist*, enterprises that are *not* majority-owned by the state contribute 70 percent to Chinese GDP, 67 percent to industrial output, but 75 to 80 percent of the profits of Chinese industry (2011, March 26: 72). Huang is more cautious. In his view, just above half of the Chinese economy is privately controlled, with more of it controlled by foreigners than by indigenous entrepreneurs (2008: 15). Whereas foreign investors frequently established joint ventures with the Chinese in the late 1980s and early 1990s, since the beginning of the twenty-first century, wholly foreign-owned enterprises dominate (Walter and Howie, 2011: 7). Foreign investment is an essential background condition of Chinese export successes. According to the *Economist*, the biggest exporters are foreign invested enterprises (2010, July 31: 46).

Small and medium enterprises in China get little help from the government. According to the *Economist*, there were a million of them by 1990, eight million by 2001, and around 60 million in 2009 (2009, September 12: 68). Ninety-five percent of them are privately owned. They account for more than half of China's tax revenues, about 60 percent of China's GDP, 66 percent of its patent applications, 68 percent of the country's exports, and 80 percent of China's new products. They find it hard to get formal loans. Worse still, pooling private funds outside of official channels may be treated as a crime and can even lead to the death penalty (*Economist*, 2011b, April 16: 63). If environmental regulations are enforced at all, then small and medium firms are much likelier targets than state-owned enterprises. In general, political connections still count in China. According to Du and Girma, such "connections enhance firms' growth and survival prospects, even if politically neutral start-ups enjoy faster efficiency improvements" (2010: 543). Since politically less well connected businesses demonstrate better productivity growth than "red hat" enterprises,[23] the impact of political connections on resource allocation and economic performance tends to be negative.

It is hard to understand how the Chinese economy could do so well since the late 1970s without a full commitment to private property rights rather than the ambivalence about the degree to which they might be tolerated that actually exists. One answer to this conundrum has been provided by the theory of "market-preserving federalism" (Montinola, Qian, and Weingast, 1995; Weingast, 1995). By delegating much economic decision-making authority to provincial and local governments,

23 If one factors in the low cost of borrowing for SOEs and their preferential access to land, the real return to equity for SOEs might even be negative (*Economist*, 2011, June 25: 12).

the Chinese have invented a partial and preliminary substitute for the rule of law. If regional governments arbitrarily interfere with business or impose more arbitrary taxation than other provinces do, if they are more corrupt than others, then they lose capital, business, and even qualified labor to other areas. "Federalism, Chinese-style" imposes effective constraints on politicians and thereby generates opportunities for growth. Competition among themselves forces local and regional governments to act *as if* they wanted to respect private property rights. Whoever succeeds in making his county or province grow faster than comparable political units is likely to be rewarded by markedly better promotion and career prospects within the Communist Party or governmental hierarchy. An indicator of the strength of local government in China (and its weakness in India) is the fact that more than half of all public expenditure is made at the sub-provincial levels in China, but only about five percent at those levels in India (Bardhan, 2010: 38). Local decision-making in China is reminiscent of the political fragmentation that propelled Western Europe toward modernity and helped it to overcome mass poverty.

Experimentation by regional and local governments complements entrepreneurial experimentation from below. Since the 1990s, about 150,000 businesses have been formed per year and about 100,000 have been closed down (Chan, 2010: 492). But the modernization of the Chinese economy is not only promoted by market-preserving federalism or competition between local and regional governments, but also by what Huang calls "access to efficient institutions outside of China" (2008: 6). This institutional access ranges from laws and regulations that copy Western models and tend to favor foreign-invested firms over domestic private enterprises, or registering some enterprises (for example: Lenovo) in the more liberal legal environment of Hong Kong, to importing education (by sending Chinese students abroad) or overseas Chinese entrepreneurship. Walter and Howie make a similar, but much more radical argument: In their view, American and other Western investment bankers deserve much of the credit for restructuring China's fragmented and moribund state-owned enterprises and turning them into national champions (2011: chs. 6 and 7). Although these enterprises dominate Chinese stock markets, Walter and Howie point to three persistent shortcomings: first, the state and the party still control these enterprises and appoint their managers; second, because of majority state ownership, most of the shares are not available for trade; third, therefore Chinese stock prices cannot reflect fundamentals as well as Western stock prices do.

Instead of pursuing autarky as China did under Mao, Deng and his successors proceeded to exploit the opportunities of export-led growth and globalization. Chinese exports in 2009 were nearly ten times as high as Indian exports, if one includes Hong Kong with China. Without

Hong Kong, they were nearly eight times as high. Moreover, 94 percent of Chinese exports resulted from manufacturing, compared with only 67 percent of Indian exports (World Bank, 2011: 352). China has become a magnet for foreign direct investment. In 2009, China (excluding Hong Kong) attracted more than twice as much foreign investment as India. Even Hong Kong alone attracted more than did India (World Bank, 2011: 352). In 2010, China still attracted more than four times as much FDI as India (*Economist*, 2011, March 26: 68). By as early as 2004, China had overtaken Japan to become the third largest trader in the global economy behind the US and Germany. In 2009, China overtook Germany to become the largest exporter in the world (*Economist,* 2010, February 13: 74). China's trade-to-GDP ratio has risen from 21 percent in 1982 to about 65 percent in recent years. By contrast, in recent years, India's ratio has risen from 16 percent in 1990-91 to 45 percent (Bardhan, 2010: 25).[24]

By the time China was the third most important exporter in the world, India's rank as an exporter was not even equal to that of Taiwan (*Economist*, 2005, April 23: 101). Of course, trade in manufactured goods is China's comparative advantage. India might have a comparative advantage in services, particularly in software exports.[25] Moreover, the approximately 3-million-strong affluent Indian-American community of doctors, engineers, businessmen, and software experts (Dhume, 2008: 27; Feigenbaum, 2010: 79) may link India at least as closely to the United States as Sino-American trade does China. Conceivably, Indian expatriates might contribute to India's future globalization as much as Chinese expatriates have already done for China through past direct foreign investment. Certainly, there is little reason to doubt that more trade openness and globalization will help India. Its per capita growth rate was 6.2 percent in 2008-2009, by contrast to China's 8.5 percent (World Bank, 2011: 344).

Although recent data suggest that previous analyses have underestimated China's poverty rate, new data show that the country's poverty rate has fallen even more dramatically than older data indicate (Chen and Ravallion, 2008). In 1981, 84 percent of Chinese had to survive on less than US$1.25 a day (in 2005 prices); by 2005, that proportion was cut to only 16 percent. By contrast, the proportion of India's population that was below the same poverty threshold was lower (60 percent) in 1981, but the country was much less successful in cutting the ratio down: it dropped to 42 percent by 2005 (*Economist,* 2009, November 28: 68). Although

24 There is some disagreement about these data. According to Panagariya, the Indian trade-to-GDP ratio increased from 25 to 43 percent between 1990 and 2006 (2008: 109).

25 According to Bardhan, information technology (IT) and IT-enabled services employ less than one-half of one percent of the Indian labor force. Two thirds of India's service output remains in traditional and "unorganized" activities (2010: 6).

China's income inequality seems to be greater than India's, it is worth noting, first, that "the bottom quintile in China experienced a significant 3.4 percent growth rate in mean per capita expenditure between 1993 and 2004; the corresponding figure for the bottom quintile group in India is only 0.85 percent" (Bardhan, 2010: 138); and second, that equality of opportunity is better in China than in India because of a more egalitarian distribution of land cultivation rights, better access to schooling in the countryside, and a lack of caste barriers (Bardhan, 2010: 12, 16).

For decades there has been a debate about the importance of export orientation in accounting for growth (Dollar, 1992; World Bank, 1993). Recently, Rajan examined the benefits of a focus on exports for emerging economies: "One way to both discipline inefficient firms and expand the market for goods is to encourage the country's largest firms to export. Not only are firms forced to make attractive cost-competitive products that can win market share internationally, but the larger international markets offer them the possibility of scale economies. Moreover, because they are no longer constrained by the size of the domestic market, they can pick the products for which they have the greatest comparative advantage" (2010: 58). As Rajan suggested, a focus on exports fits a number of economic miracles very well: Germany and Japan after World War II, Hong Kong, Singapore, South Korea, and Taiwan since the 1960s, or Mainland China since the 1980s. Bhalla (2010) agrees that its export orientation explains China's growth, but adds that undervaluation of the currency helps. In Bhalla's view, the yuan has been more than 60 percent undervalued (2010: 15). Exports and a surplus in the balance of trade may be useful for some countries, but too many successful exporters, or those that are too big may generate problems at the global level.

Whereas China reformed its economy ahead of the bankruptcy of the Soviet model, India was a late and slow convert to capitalism. As Panagariya (2008: 96) and Lal (2008: 15) point out, there is a link between earlier Chinese and later Indian reforms. It was much easier for Indians to deny the policy relevance of the South Korean or Taiwanese economic miracles than of the Chinese miracle. Since independent India's economy grew much better even under Nehru than in the colonial period before it, Indians did not expect much growth (Cohen, 2001: 95; Panagariya, 2008: ch. 2). As in China, economic growth rates and productivity picked up in India during the 1980s. Growth in the 1980s has sometimes been explained by growing aggregate demand driven by soaring government deficits and a build-up of external debt which led to the crisis of the early 1990s and thereafter to liberalizing reforms (Ahluwalia, 2002; Lal, 2008). It has also been explained by "the suspension of the government's hostility to the private sector" in the 1980s (Rodrik and Subramanian, 2004: 3), by the government's pro-business orientation, which resulted in fewer restrictions on capacity expansion for established industries, fewer price controls, and lower corporate taxes. In essence the reforms were "liberalization by stealth" (Panagariya, 2008: ch. 4) or creeping capitalism.

These early reforms and the favorable growth record in the 1980s were not sufficient to prevent the crisis in 1991. Public sector deficits rose. Foreign currency was in short supply and became ever more so. After the dissolution of the Soviet Union, the main source of foreign aid disappeared. The reforms abolished most of the industrial licensing system. The dream of autarky was given up. Foreign investment was reluctantly welcomed. The Indian currency was devalued. Tariffs were cut dramatically. The average tariff rate was reduced from 125 percent in 1990-91 to only 71 percent three years later. The peak rate fell from 355 percent in 1990-91 to only 12.5 percent in 2005-2006 (Joshi and Little, 1998: 70; Nilekani, 2009: 71). Although the Indian economy did not switch as vigorously from inward to outward orientation and export promotion as China did, it moved significantly in the right direction. Since growth rates improved in the early 1990s, especially in manufacturing, and since the current account deficit fell and foreign exchange reserves strongly recovered while the primary deficit of the central government fell, the liberalizing reforms paid off (Joshi and Little, 1998: 17, 35). Given the poor record of Indian administrations in large scale policy implementation, liberalization made sense because it implies some economizing on limited state capability (Pritchett, 2009: 33). As Olson (1987) had recognized long ago, an efficient administration is not the comparative advantage of most developing countries. Therefore, planning is least likely to work in poor countries like India.

But the Indian development pattern does not offer sufficient job opportunities to its labor force, which is dominated by low-skilled workers (Bosworth, Collins, and Virmani, 2006: 34). Most of India's labor force is not even employed in the formal economy or the so-called "organized sector." According to Bardhan, 94 percent of the Indian labor force works in the informal sector (2010: 79). Frequently, workers are self-employed. Enterprises are tiny. Work is quite unproductive. Indian firm structure is characterized by a "missing middle." Nearly half of all Chinese workers are employed by enterprises with between 10 and 500 workers, but very few Indians are. This is an important difference, because productivity in 500-plus worker enterprises in India has been about ten times as high as in tiny enterprises (Bardhan, 2010: 35-36). Whereas manufacturing employs more than a hundred million Chinese workers, it employs just seven million Indians (Luce, 2006: 48-49). According to the *Economist,* foreign-invested enterprises in China alone employ more Chinese in manufacturing than the seven million Indians similarly employed (2010, July 31: 46).

Whereas China's economic development started with agricultural reforms, then moved to low-cost manufacturing before climbing the value-added chain, India grows from the other end with a strong emphasis on capital- and human-capital-intensive products and services (Luce, 2006: 38). Nevertheless, even in the service sector, total factor productivity could grow faster in China than in India (Bardhan, 2010: 29). According to Panagariya, "the key barrier to the emergence of large-scale, unskilled-labor-intensive firms is the complex set of labor laws they face in India" (2008: 288). Indian labor laws privilege insiders, but deny opportunities to outsiders. Neither much higher pay in the formal part of the economy, nor perfect job security helps those who cannot find a formal job in rigid labor markets. Within the formal economy, pay for people with modest skills may be three times as high in the public sector as in the private sector (Bardhan, 2010: 133).

In contrast to China, India had never abolished private property in land and private farming.[26] Nevertheless, Chinese rice yield per hectare has always been higher than India's. It still is about twice as high (Bardhan, 2010: 42-43). For a long time, Indian agriculture suffered from serious distortions. According to Joshi and Little, "the prices of all major agricultural products have been largely determined by the central government's total control of foreign trade in them. The prices of cereals—rice, wheat, and coarse grains—and cotton have been held below world prices in most years by controlling exports" (1998: 89). Although this specific problem has been mitigated or even overcome, subsidies for food, fertilizer, electricity, or water are still more likely to assist well-to-do farmers than the poor. Moreover, half of the value of the subsidies supports inefficient fertilizer producers (Bardhan, 2010: 46). The money could be better spent in building up rural infrastructure. According to Panagariya's estimate, only between 4 and 18 percent of the food subsidies reach the poor (2008: 361). Since subsidies, like labor market rigidities, distort market signals and reduce growth rates, one should concur with Panagariya's conclusion that a focus on equity has had harmful effects on poverty alleviation in India (2008: 77).

Compared to China, India *seems* to possess some advantages. Because of the British legacy, India seems much closer to the rule of law than China. As Kohli (2004) points out, the British built a much more effective administrative service in India than they did in some of their African colonies, such as Nigeria. Unfortunately, however, "affirmative action" for the benefit of backward tribe, low-caste, and untouchable (or dalit) Indians must have undermined the quality and effectiveness of the bureaucracy.

26 Legal titles to land are poorly documented in India. Records are incomplete and fragile (Panagariya, 2008: 323). This is also true in China (*Economist*, 2010, May 8).

In 1990, 49 percent of central government positions were set aside for these groups (van Praagh, 2003: 201). According to Peerenboom "violations of physical integrity rights in India appear to be more severe" (2007: 166) than in China—quite in contrast to what one might expect concerning the differential human rights performance of democracies and autocracies. Unfortunately, the application of the law in India leaves much to be desired. Relations between some politicians and criminals are simply too good (Cohen, 2001: 115). Even in big cities, property conflicts may still be "settled" by gangs of bullies rather than by courts of law (Kakar, 1996). In 2006, 27 million legal cases waited for a judgment, murder cases included. About US$75 billion was tied up in these legal disputes (Luce, 2006: 94-95). Problems of law enforcement also reduce the impact of this presumed Indian advantage. Bardhan bemoans that "India's overpoliticized administration and decision-making process, its clogged courts and corrupt police and patronage politics frequently make mockery of the rule of law for common people" (2010: 159).

Since Indian states are on the way to becoming more assertive, enterprising, and powerful, it is conceivable that they may also become engaged in a "race to the top," where they will compete with each other in providing a good business environment. "Federalism, Indian-style" may provide some hope for the future. As Bihar, one of the bigger and poorer states of India, has recently demonstrated, catch-up growth of poorer regions is possible (*Economist,* 2010, January 30). So far, however, India benefits little from its putative advantage in the rule of law, but it still suffers from the legacy of 'license-permit raj' (FICCI, 1999: 165). According to the *Economist*, "Indian bureaucracy continues to slow things down... it takes 89 days to receive all the permits needed to start a business in India, compared with 41 in China. Insolvency procedures take ten years, compared with 2.4 in China" (2005, March 5: 14). Tardiness of administration and endemic corruption undermine the advantages of the rule of law (Quah, 2008). As Palmer reminds us: "There is also a strong connection between the scourge of governmental corruption and the extent of governmental intervention into the market. The more obstacles the state places in the way of willing buyers and sellers, for example, the more opportunities for bureaucrats to exact a toll"[27] (2009: 213). On the legal system and property rights part of the economic freedom scale, China received a somewhat better rating than India (for 2008) (Gwartney, Hall, and Lawson, 2010: 9).

Both Asian giants face severe problems and vulnerabilities, albeit not exactly the same ones. Chinese savings and investment ratios are very high. Whereas Chinese profits are rising, wages and private consumption

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27 For econometric evidence on economic freedom, corruption, and economic performance, see Graeff and Mehlkop (2003) and Blasius and Graeff (2009).

as shares of GDP have been falling since about 2000 (Hale and Hale, 2008: 65). But capital is frequently not used productively. State banks in China prefer to provide loans to state-owned enterprises (SOEs). Until some years ago, they were least likely to invest the money productively. By contrast, private entrepreneurs sometimes pay more than 200 percent interest per year on the black market (*Economist,* 2011, March 12: 74). Chinese banks fail to channel the savings toward productive investment. It has even been questioned whether the earlier problem of non-performing loans has been solved or merely been swept under the rug and transferred to the future. Moreover, there are reasons to fear that the stimulus spending in 2009 will generate new and additional non-performing loans in the near future (Walter and Howie, 2011). Nevertheless, Chinese total factor productivity growth has been excellent: "one-third of China's growth is coming from rising productivity" (Anderson, 2009: 20-21). Whereas the total factor productivity growth rate in the United States, Japan, or Germany was not much better than one percent per year in between 1990 and 2008, China achieved four percent (*Economist*, 2009, November 14: 88). But India did well, too. It achieved nearly 3 percent productivity growth.

India should raise its investment rate. Since household savings have strongly increased, the savings rate could support more investment (Bosworth, Collins, and Virmani, 2006). Actually, India seems to be well on the way towards raising investment. By contrast to China, there is little financial repression in India. But in infrastructure development, India might lag a full decade behind China (Lal, 2008: 28-29). Since the Indian public sector is already deeply in deficit, financing infrastructure will be difficult; 44 percent of recurrent public expenditures in India service the public debt (*Economist*, 2005, March 5: 14). So, the legacy of past profligacy undermines India's capability to improve its infrastructure. Chinese public debt *might* be as little as 17 percent of GDP.[28] But India's is as high as 75 percent (Bardhan, 2010: 127). Whereas China's government might have been

28 China's government accounts, its banks, and their debts are still opaque and leave room for radically divergent evaluations. Chang arrives at an estimate of public debt that is about seven times as high as that of the *Economist* by including bad bank debts in the public debt (2008: 34). Recently, the *Economist* reported estimates of Chinese public debt ranging from 20 to 50 percent of GDP (2010, January 16: 65). According to Walter and Howie, 75-77 percent is a good estimate for the 2009-2011 period (2011: 201). The higher estimate includes local public debt and asset management companies which took over non-performing bank loans which seem to be rising again. Even the highest estimates of Chinese public debt compare not unfavourably with public debt in rich Western countries, which averages close to 90 percent. Certainly, central government finances are much healthier than local government finances in China. Whereas local governments receive only 46 percent of tax receipts, they account for 77 percent of public spending.

in surplus in 2007, India's total government deficits might be close to seven percent of GDP (*Economist*, 2008, February 16: 72). In 2008-2009, the Indian deficit was about 10 percent of GDP (Bardhan, 2010: 70). Given India's scarcity of capital, the country should welcome foreign direct investment. In 2010, however, the country received only US$24 billion, about one third less than in the previous year (*Economist,* 2011a, April 16: 14).

Although Indian public spending is frequently rationalized by the need to serve the poor, in fact, the poor benefit little.[29] Subsidies on fuel or fertilizer are most useful for those who own vehicles or farm large plots of land. In Luce's evaluation, two thirds of the nominally "pro-poor" subsidies in India benefit better-off groups (2006: 89). Moreover, even a few years ago, India's government depended to a significant degree, i.e., for about one sixth of its revenue (*Economist,* 2005, March 5: 15), on customs duties, or barriers to trade and globalization. Poor infrastructure, poor productivity, and bigger barriers to trade make it unlikely that India can repeat China's success in attracting foreign capital in order to compensate for the weakness of domestic investment. Although difficult, China's problems with investing capital productively still look more amenable to a solution than India's problems. But attitudinal obstacles against capitalism, free markets, and globalization seem to be weak in both countries. According to a Pew survey (*Economist,* 2009, May 30: 26), in no major country did faith in free markets exceed the Indian level or increase as much between 2002 and 2007. Although faith in free markets increased less in China than in India, China still is number two out of 11.[30] Whether politicians translate this permissive opinion into pro-growth policies or prefer to service rent-seekers remains to be seen.

As China is graying rapidly, demography will become less benign than it was. One may argue that there still is sufficient underemployed rural labor for years to come (Anderson, 2009).[31] Anderson adds that some reduction in China's enormous capital exports might be sufficient to plug the gap which a lower savings rate might generate in future. So, neither demography, nor lower savings and investment rates should do too much harm to China's growth prospects. One should consider

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Local governments make up much of the shortfall up selling land to developers without adequately compensating previous users (Sender and Anderlini, 2011, June 2: 5).

29 A corresponding statement applies to China where transfers focus on the better-off urban population rather than on the rural poor (Wang, 2008).

30 Of course, survey findings depend on specific questions. If one asks about increasing profits and the responsibility of business, then Indians demonstrate much more faith in unadulterated capitalism than Americans or Chinese (*Economist,* 2011, January 29: 57).

31 According to the *Economist* (2010, July 31), another 70 million rural Chinese might be willing to migrate to urban factories.

another source of growth, i.e., conditional convergence or the potential advantages of backwardness.[32] Since China remains poor compared to the West or Japan, this potential source of growth will last for some more decades. Thus, the future economic development of China seems to be at the mercy of two factors: whether a global depression and a wave of protectionism can be avoided, and whether the government of China will continue market-enhancing reforms instead of relapsing into socialist dead ends. The more China restricts economic freedom, the poorer its prospects will become. In this context, it may be important to note that about one-third of Chinese entrepreneurs have become members of the ruling party (Bardhan, 2010: 80). On the one hand, this may reinforce corruption and crony capitalism. On the other hand, this reconciliation of economic and political elites in China may help to improve Chinese economic policy-making.

For the sake of growth, government concessions of freedom to the people should not be restricted to a narrowly defined economic sphere. Freedom of technological and scientific research is obviously important for innovation and progress. Moreover, tolerance for severe criticism of the economic order or political institutions might be important for overcoming institutional obstacles to growth and the correction of policy errors. One might argue that generalized liberty instead of narrowly defined economic freedom becomes more important once the advantages of backwardness have been exploited.[33]

India's demographic future looks much more benign than China's (Eberstadt, 2010). Although India will not suffer from a scarcity of young people and an abundance of older ones in the near future like China or the West, the Indian problem is that the economically more successful regions already suffer from below replacement fertility, whereas the less successful regions are still above replacement level fertility. Therefore, human capital development remains a challenge in India. If one adds poor infrastructure, the remnants of the caste system, still overregulated labor markets, and corruption undermining administrative efficiency and the rule of law, then it becomes hard to be optimistic about India's prospects. If, however, India could overcome the legacy of permit-license-quota raj, which

32 A superficial comparison of provincial growth rates in China seems to be incompatible with advantages of backwardness. By and large, the more prosperous coastal provinces benefit from better growth rates than the interior provinces. According to Lin and Liu (2008), this results from the interior suffering more than the coast from comparative-advantage-denying development strategies. If this factor is controlled, then advantages of backwardness can be demonstrated within China.

33 It is sometimes argued that Chinese tradition is hostile to criticism. As de Bary (1983) elaborates for Neo-Confucianism and the Sung dynasty, this is an exaggeration.

provided so fertile a ground for corruption, and if India could expand economic freedom, then it might benefit from the optimism typical of young and growing populations. Since India is much poorer than the West and even China, it enjoys much greater advantages of backwardness and therefore potentially faster growth prospects than the other big civilizations.

Creeping socialism in the West?

Whereas developing countries and emerging markets tend to score a little better on economic freedom scales than on personal freedom scales, the opposite is true for Western democracies (Vasquez and Stumberger, 2012). Although personal freedom and political freedom still look safe in the West, economic freedom is under attack. As will be argued below, Western Europe seems to be even more at risk than the United States. Even "post-materialists" who care little about growth or prosperity (because they already tend to be prosperous) should worry about the attack on economic freedom for the following reasons: The ultimate consequences of economic freedom are prosperity and political liberty. Economic freedom is a prerequisite of political liberty. In Western and Central Europe, economic freedom was established before political democracy, if you define the latter by a franchise covering the entire adult population. Applying such a definition of democracy, the statement is even true for the United Kingdom or Switzerland, the oldest and most stable accountable governments in Europe.

Without economic freedom or capitalism[34] and the prosperity it promotes, democracy or political freedom might not be viable.[35] This view is corroborated by econometric evidence (Burkhart and Lewis-Beck, 1994; Lipset, 1994; Inglehart and Welzel, 2009).[36] Acemoglu et al. (2008)

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34 In my view, "economic freedom" and "capitalism" are synonyms.

35 Although capitalism is essential for the preservation of democracy, democracy might undermine capitalism. Olson (1982) had suggested that older democracies grow more slowly than younger ones which, in the long run, must undermine their prosperity. There are some econometric studies to support this view (Bernholz, 1986; Weede, 1991). Unfortunately, contemporary researchers seem to have lost interest in Olson's proposition. One reason might be that Olson (2000) himself has become more optimistic about the impact of democracy on economic performance in his later work. Another reason might be that the Anglo-Saxon economies did better than the losers of World War II since the 1990s. The contrast between them had been the inspiration behind Olson's (1982) theorizing. Although North, Wallis, and Weingast (2009: 140ff.) do not persuade me that the older public choice literature on the pernicious impact of organized interest groups and their rent-seeking activities in democracies is misleading, there is a need to develop appropriate research designs to find out which point of view fits better with the data.

36 Przeworski et al. deny a causal link between prosperity and democracy and assert that "economic circumstances have little to do with the death of dictatorships" (2000: 117).

provide the most serious challenge to the idea that prosperity promotes democracy. Although the challenge itself has already been rebutted and the income democracy nexus has been reestablished (Benhabib, Corvalan, and Spiegel, 2011), the criticism itself implied only a minor modification of the relationship. Acemoglu et al. (2008) looked for factors that affect prosperity *and* democracy. They analyzed the long-run development paths where some countries have grown rich and become democracies, versus others that have remained poor and autocratic. Although they did not use my preferred labels for the common determinants of prosperity and democracy, I think that their analysis is compatible with calling them limited government, secure property rights, or economic freedom. North, Wallis, and Weingast would call it "open access order" (2009: 13). Under this interpretation, the causal link between prosperity and democracy becomes replaced by one linking free or capitalist institutions and democracy where prosperity still may *indicate* that the institutional prerequisites for democratization are in place. But capitalism contributes to democracy not only (or even primarily) because of prosperity. Private ownership of newspapers, radio, and TV stations provides sources of information for citizens that are not under the control of ruling politicians. Moreover, the private economy provides opportunities for defeated politicians to prosper, whereas in a socialist economy the loss of political power is likely to lead to impoverishment, too. For democracy to persist, electoral defeat should be tolerable for office-holders. Otherwise, defeated politicians might not quit their offices peacefully.

European economic success was rooted in political failure and disunity. Whereas military and political leaders in Asia succeeded in conquering huge territories and imposing imperial rule for centuries again and again, Europe remained politically fragmented. There was interstate rivalry between principalities and kingdoms, but cultural unity. In the Middle Ages, this unity resulted from Christianity; later from the enlightenment and science. As early as the seventeenth century, when Europeans invented the telescope and progressed from a geocentric to a heliocentric view of the universe, the Dutch, Italians, Germans, and English contributed to this evolution (Huff, 2011). Given the small size of most European principalities compared to Asian empires, there was more trade between politically independent territories in Europe than in Asia. Independent cities, the rivalry between church and state, later the reformation and competition between the Catholic and Protestant churches also contributed to the dilution of authority in the West. In a nutshell, political fragmentation in Europe and the West provided individuals with exit opportunities and some degree of liberty. Competition

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Boix and Stokes (2003), however, have rebutted this assertion and demonstrated that economic growth promotes transitions to democracy.

between governments for capital and trade, for talent and people forced European governments to respect private property rights and individual liberty much earlier and to a greater degree than in Russia or Asia. European success rests on providing less room for government error than elsewhere. That is why Europeans and Westerners, i.e., Europeans and Americans, had become undisputed masters of the world at the beginning of the twentieth century (Ferguson, 2011).

Political fragmentation within the West or European disunity was not only a prerequisite for the establishment of the institutional package of limited government or individual liberty, private property rights and capitalism, but also the background condition of the wars which devastated much of Europe during the first half of the twentieth century. Except for the radical shift of power *within the West*, from European nation-states like Britain, France, or Germany to the United States of America and transiently to the Soviet Union, the catastrophe of two world wars killing between 70 and 80 million people, most of them Europeans, did not suffice to finish Europe and even less Western civilization. By about 1970 Western Europe, at least, had risen like a phoenix from the ashes. Western nations still dominated the global economy (Maddison, 2007; Ferguson, 2011). Neither the Chinese nor the Indian economies had grown faster than the global economy. Although the Soviet bloc constituted a military challenge until about 1990, it never was remotely able to grow rich and to challenge the superior quality of Western consumer goods. For the roots of the contemporary Western malaise we have to look elsewhere.

At the beginning of the twentieth century limited government was still a reality in the West. Now it has become a romantic memory of a past golden age or a distant ideal.[37] Since the beginning of the twentieth century, government expenditures as a share of GDP grew from less than 10 percent in the most austere states to more than 50 percent in the most profligate ones during the 1980s (*Economist*, 2011, March 19; Tanzi, 2011; Tanzi and Schuknecht, 2000). The United States always lagged Western Europe in taxation and government expenditure. Although some of the older democracies, including the US, Switzerland, or the UK, are less affected by this than some younger democracies, such as Germany, or countries where German military occupation during World War II interrupted democratic government, like France or Belgium, one may still argue that democratization and the universal franchise has driven the expansion of the tax and welfare state (Tanzi, 2011: 66). At the end of the century, state shares in GDP were about one third in the US and close to one half in most of Western Europe. The lower government revenue as a percentage of GDP or

37 Whereas North, Wallis, and Weingast (2009) argue that limited government and big government (or welfare states) are compatible, I disagree with them.

the level of taxation is, the higher the growth rate of the economy is (Bergh and Karlsson, 2010; Bernholz, 1986; Romer and Romer, 2010; Vedder and Robe, 2009; Weede, 1991).[38] Not all taxes are equally harmful. Corporate taxes and progressive income taxes are worst; consumption and property taxes are less harmful (Arnold, 2008).[39] The only hope to limit the tax burden comes from globalization and tax competition (Tanzi, 2011: 140-145).

Limited government in the West suffers from erosion, in pacific Western Europe more than in the United States. Whereas democracy depends on the prior establishment of economic freedom and prosperity, democracy might nevertheless undermine its prerequisites. In Europe, transfer payments have become the dominant element of government budgets. The new focus of European governments on transfers and the provision of welfare must lead to unfortunate consequences. First, the tax and welfare state cannot avoid punishing hard work by taxing workers and rewarding the lack of economic success by transfers. Such reinforcements undermine incentives. Second, the welfare state looks self-destructive. It gets more costly, if more and more people are ready to claim benefits fraudulently. An empirical analysis of World Value Survey data supports the view that generous welfare states encourage illegitimate claims and deteriorating ethics (Heinemann, 2008). Third, the welfare state also undermines the willingness of parents to discipline and educate their children (Lindbeck and Nyberg, 2006). It hardly affects one's living standard whether one is an unskilled worker or lives on income support at the taxpayer's expense. So, why should parents of modestly gifted children teach them discipline and a willingness to work hard? Fourth, the welfare state stimulates the wrong kind of migration. Look at high tax and welfare states. There are incentives for high earners to migrate to lower tax states and incentives for would-be welfare recipients to immigrate. All of these developments undermine the long-run viability of European welfare states.

Worse still, most European welfare states have not been capable of financing their persistent expansion out of current taxation (Tanzi, 2011: 98, 232). Deficits and government debt have been growing for decades. With an explicit debt-to-GDP ratio close to 80 percent, Germany still counts as solid and attracts the envy of other states. Assuming that public debt continues to grow at the same speed as during the last decades, however, German public debt will be nearly three times as large as its gross domestic product in 2030 (Simon, 2011: 69). But the German welfare state, like other Western democracies, including the United States, has made lots of unfunded promises concerning health care as well as pensions (Peterson,

38 Unfortunately, this view is not unanimously accepted. For example, see Lindert (2004).

39 Although Arnold (2008) does not make much of it, his regressions are compatible with the view that high tax burdens as such also decrease economic growth rates.

2004). Since retired people are the main beneficiaries of Western welfare states, one may raise Hayek's question about when "the physically stronger will rebel and deprive the old of both their political rights and their legal claims to be maintained" (1960: 297). If one includes unfunded promises, then Germany's government debt is already about three times as large as its GDP. The worst estimates of government debts which I have seen have been published by the *Financial Times* (2010, February 16). These estimates of government liabilities (pension promises and health benefits included) are about four times GDP in Germany and the UK, about five times in France and the US, and more than eight times in Greece.

The two wings of the West seem to suffer from different afflictions. In Europe, especially on the continent, the tax and welfare state is the main threat. While many Europeans believe that the state is responsible for the provision of welfare and even for equalizing incomes, fewer Americans share such views. Whereas 78 percent of Americans ascribed American economic success to "American business," fewer Europeans would assign business and capitalism a similar degree of legitimacy (Lipset, 1996: 72, 146, 287). Nevertheless, the United States became a welfare state, too (Voegeli, 2010). In addition, the US made lax monetary policy and easy credit a means of pacifying those who had been left behind in the market economy (Eckert, 2010: 79-80; Rajan, 2010: 31). In the United States, Keynesianism and the demand for stimuli still dominate. The recent financial and economic crisis illustrates this. In essence, the cure to the crisis consisted of three components. The first component has been to rescue system-relevant banks and other major financial market participants, such as the American International Group (AIG). Since no one can know for sure what the consequences of a financial market meltdown would have been, politicians can argue that there was no reasonable alternative. Although Austrian economists and libertarians do not concur, many economists accept the argument. With the benefit of hindsight at least, one may argue that the taxpayer did not suffer too much from those governmental actions that targeted banks or big financial market players like AIG. Much of the taxpayer money that went to them has already been paid back. According to estimates by Deutsche Bank Research (2010), the American taxpayer will almost certainly suffer losses below two percent of GDP (which includes money diverted to saving the auto industry in Detroit, and Fannie Mae and Freddy Mac), and the German taxpayer no more than one percent of GDP. French and possibly even British taxpayers still can hope to avoid significant losses that will come from stabilizing their banks during the crisis.[40] Wherever the state rescued the

40 The *Economist's* evaluation is even more optimistic (2011, June 11: 69). The Troubled Assets Relief Program may even turn a profit. Fannie Mae and Freddie Mac are responsible

banks and other big players on financial markets, it suffered the consequences of its poor performance in regulation. Unfortunately, the financial crisis and the response to it has done nothing for mitigating the "too big to fail" problem, which got worse rather than better. Worse still, rescuing banks and AIG has reinforced moral hazard.

The second component has been the continuation of the cheap money policy which was a prerequisite of the crisis in the first place. Possibly, there was no better alternative to low interest rates and quantitative easing, i.e., central banks buying government bonds and financing public deficits by the equivalent of printing money.[41] But it should be emphasized that the extraordinary fear of deflation and its consequences that politicians, central bankers, and most economists demonstrated rests on a tenuous empirical basis (Atkenson and Kehoe, 2004). Given the high (and, because of the crisis, more rapidly growing than ever) indebtedness of most Western democracies, and given the resulting incentive for governments to lighten the debt burden by inflation, the long-run problem will be inflation rather than deflation (Bagus, 2011; Bernholz, 2003; Hayek, 1960).[42] The question is less whether central banks know when and how to tighten monetary policy than whether the politicians shall let them do what is necessary sooner or later. Here, I must admit deep pessimism. As Friedrich August von Hayek (1976/2008) recognized in the 1970s, money might be too important to leave it to the politicians. We might need to wrest control of monetary aggregates from politicians and politically appointed central bankers by either returning to some kind of commodity-based money or by the privatization of money. According to Hayek, the future of individual liberty and economic freedom might depend on it.[43]

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for the lion's share of the losses, but relief for the banks was quite profitable. Of course, the financial crisis also affected growth rates and government revenue and therefore public debts. According to Reinhart and Rogoff, the real stock of debt tends to come close to doubling within three years after financial crises (2009: 170).

41 Hummel argues that Bernanke's Federal Reserve (Fed) did not flood markets with liquidity in response to the financial crisis, but that it redirected it, thereby becoming something like a central planner of the American economy (2011: 509). In the summer of 2008, the Fed's lending to banks was sterilized by its selling of Treasury securities.

42 Not only politicians, but even some economists (for example, Rogoff, 2011, August 9: 9) favor a higher rate of inflation in order to lighten the debt burden of democratic governments. Assuming that such a policy is a lesser evil than any alternative, the advice to politicians to confiscate part of people's savings implies an indictment of politicians and a strong verdict about government failure.

43 The most detailed proposal has been made by Huerta de Soto (2009). In his view, the limited reserve requirements in banking or the creation of credit out of nothing by banks, which are supported by central banks, are the main culprits for recurrent crises. That is

The third component of the rescue package has been Keynesian deficit spending.[44] In contrast to most Austrian or libertarian economists (such as Huerta de Soto, 2009), I can at least imagine that insufficient demand exists and that some deficit spending is desirable under some exceptional circumstances. I shall sidestep important technical issues such as the size of the multiplier. The smaller the multiplier is, the less effective deficit spending becomes. Suffice to say that there is disagreement about its size as well as about which kind of deficit spending is most effective (Barro, 2009; Cogan and Taylor, 2011). I shall also sidestep the related issue of crowding out. Possibly deficit spending is more effective in replacing private demand and private investment than in increasing aggregate demand. What really worries me is a different and more fundamental issue. Most Western governments almost always perceive the need to stimulate demand, but almost never see the need to renew the war chest for coming crises by accumulating government savings or at least paying back most of the excessive public debt accumulated through boom and bust. Most politicians behave as if running deficits were a free lunch and *always* good for the economy. Keynesian economists are much better in explaining the need for running deficits given insufficient demand than in urging politicians to reduce public debt during booms. The politically effective part of Keynesianism is nothing but pandering to the unfortunate inclination of politicians to spend almost without limits.[45] According to Buchanan and Wagner, the political legacy of Keynesianism in Western democracies amounts to a denial of scarcity: "Scarcity is indeed a fact of life, and political institutions that do not confront this fact threaten the existence of a free and prosperous society" (1977: 184).

Politicians have generated a framework where private actors, ranging from the poor desiring to become homeowners to overpaid bankers, have committed lots of errors which ultimately brought Western economies close to a collapse (Sowell, 2010; Taylor, 2009; Woods, 2009). In

why he demands 100 percent reserves, free banking, and abolition of central banks as well as a return to gold.

44 See Krugman (2008) for a recent explanation and defense of it. Other endorsements of the American stimulus are provided by Posner (2009) or Roubini with Mihm (2010).

45 As Tanzi underlines, high public spending and increasing public debt are not objectives of Keynesian economics, but by-products of demand management and stabilization policies (2011: 126). By contrast to some of his disciples, Keynes was not in favour of tax burdens above 25 percent of GDP. Some academics call for "hard Keynesianism," i.e., the requirement that governments run budget surpluses in good years so that they have resources to spend on stimuli in bad years (Farrell and Quiggin, 2011: 100). In theory, this is a good idea. In practice, it cannot work. If public choice economics comes even remotely close to reality, then it will remain impossible to persuade politicians to implement such recommendations.

order to contain the crisis, politicians expanded the scope of the state, increased deficits even more rapidly than before, and continued loose monetary policies which were a prerequisite of the last crisis. They did nothing effective against the "too big to fail" problem. By bailing out big players on financial markets, they increased moral hazard and put the Federal Reserve on the road to become a central planning agency. They have not worried about bankruptcy or the next generation in greying welfare states. They have not worried about individual liberty and economic freedom, i.e., about the ultimate source of Western prosperity.

Currently, Europeans are on the road towards a continental version of the tax-and-transfer state. The original idea behind the European Union (EU) was commendable: No more fratricidal wars between Europeans. Since Franco-German rivalry had resulted in three wars between 1870 and 1945, the special focus of the European unification project was always the prevention of another Franco-German war that might escalate into a larger European conflagration. Of course, we should be grateful that the risk of war in Europe is extremely low. Adherents of European integration credit the EU, even the euro and a process of achieving ever greater integration with the peaceful state of European affairs. I partially agree with this view. A free market in goods, services, capital, and labor, i.e., economic integration, does contribute to the prevention of war. I label this effect "peace by trade" or "the capitalist peace." The EU undoubtedly contributed to it. Furthermore, capitalism and free trade made Western Europe prosperous enough in the decades following World War II to support democratic governments. Thus, the democratic peace can complement "peace by trade" (Gartzke, 2005; Weede, 2011b).

But obviously the capitalist peace, and even the democratic peace, rests on a capitalist foundation. As soon as the European integration project undermines capitalism and the prosperity that can only be provided by capitalism, it will no longer serve the cause of European peace. From the beginning some economists doubted whether Europe was sufficiently close to being an optimal currency area for introducing a common currency,[46] or whether the inclusion of comparatively weak economies, like Greece or even highly indebted Italy, made sense. The frequent devaluations of other European currencies against the Deutsche Mark during the 1980s as well as the critical pronouncements by German economists should have provided warnings (Bagus, 2011: 46; Eckert, 2010:

46 Feldstein predicted adverse effects of the euro on inflation and unemployment as well as tensions within Europe and between Europe and the US (1997: 60, 67-68). He also pointed out that more centralized decision-making in Europe would lessen the opportunity for European countries to find out which policies succeed and which ones fail. Therefore, Europe would become less competitive with the rest of the world.

154, 173). At least political leaders in the late 1990s still insisted on combining the common currency with a "no bailout" principle and the prohibition for the European Central Bank to contribute to the financing of government deficits. These two prohibitions served the purpose of preventing an expansion or deepening of the European transfer union.[47] Governments still had to face the consequences of their profligacy. Of course, a European transfer union cannot avoid resulting in negative consequences just as transfer payments within Western welfare states do. In a transfer union, responsible governments that avoid the debt and deficit trap will be punished by having to help others, whereas irresponsible governments with high and growing deficits will be rewarded by receiving assistance. Government irresponsibility within a transfer union will spread, and deficits and debts will grow. Sound money will become a victim. The higher debt and deficits become, the more attractive inflationary policies become. Furthermore, current attempts to save the euro are likely to undermine the respect for international treaties and the legitimacy of the European project (Issing, 2011, August 9: 9).

Europe is in peril. The welfare state has undermined incentives for more than a generation. Debt and deficits have been growing for more than a generation. Although a greying Europe might need skilled immigrants, Europe certainly does not need immigration that will add to its welfare support system. Although rich European countries cannot hope to match the growth rates of China or India which benefit from the advantages of backwardness, there is little excuse for European politicians to be satisfied with the poor growth record of the last two decades. Why shouldn't Germany or France be capable of American growth rates (before the financial crisis); why shouldn't Greece or Portugal be able to rival the South Korean performance? Now the Euro-zone, the core of the EU, has added another problem: an extension of the transfer union or a second tier to the welfare state. The European Central Bank has been buying Greek and Irish and Portuguese government bonds—and recently even Spanish and Italian bonds. German, French, Austrian, and even Slovak taxpayers are picking up some of the unpaid bills left behind by the weaker Euro-zone governments.[48] The ruling elites of Europe are determined to achieve

47 According to Willeke (2011), the EU has been a transfer union for a long time. Germans, Dutch, and Swedes are the biggest losers, whereas the Mediterranean periphery of the EU comprises the biggest winners.

48 Instead of burdening the taxpayers of still solvent European states, one might have imposed a haircut on the creditors of Greece, Ireland, and Portugal. This would have been the lesser evil than providing guarantees amounting to 923 billion euros until the beginning of November 2010. Germany's share has been 215 billion, France's share 165,3 billion (Sinn and Carstensen, 2011: 1). One has to ask whether rescuing weaker euro

Continental unity. The preservation of individual liberty and economic freedom against state interference is not as high on their agenda.

European politicians want to become more powerful and thereby capable of enforcing truly grand errors: first, a deepening of the transfer union, which might later result in the inflationary union. Of course, non-members of the European Union with rapidly growing public debts, like United States, run similar inflationary risks. According to Bernholz, "Inflation has been the higher the greater the influence of politicians on monetary policy" (2003, 2010: 3). Before World War I, the gold standard established a hard budget constraint. Later some independent central banks remained obstacles against inflation. But the gold standard has gone and the responses to the financial crisis as well as rescue packages for the European periphery have undermined central bank independence. Democratically elected politicians seem to dislike hard budget constraints as much as central planners did. They are on the way to liberating themselves from such chains. The higher the mountain of public debt grows, the greater the temptation for elected officials to overcome the debts by inflation.

The early Keynes understood well what inflation does to property rights and a free society: "By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate *arbitrarily*; and, while the process impoverishes many, it actually enriches some.... There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction..." (1919/1988: 235-236). Whereas Keynes' negative view of inflation[49] implies an awareness of how easily inflation might get out of control, Western governments seem to remember the postwar period when inflation, together with financial repression, forced savers to accept negative interest rates for long periods of time and thereby permitted governments to reduce their debts (*Economist*, 2011, June 18: 80). Even the slow confiscation of savings by moderate inflation, however, is a frontal attack on private property rights. The fruits of centuries of European disunity are

countries overburdens the seemingly strong states. It has been estimated that the euro rescue package might add 18 percent to German indebtedness (Blankart, 2011: 46). Since the rescue operation has a tendency to expand, no end is in sight. The final effect might be overburdening the strong so that all of us can collapse later, but together.

49 Since Hayek (1960) disagreed a lot with Keynes, it is noteworthy that he quoted Keynes' statement about inflation approvingly at the beginning of the twenty-first chapter of his book. By contrast to most economists, Hayek does *not* believe that deflation is a greater threat to prosperity than inflation. Exaggerated fear of deflation is not supported by empirical research (Atkenson and Kehoe, 2004).

at risk: limited government and individual liberty, private property rights and capitalism, and in the long-run, even prosperity and peace.

Conclusion: Geopolitics, evolution and the expansion of liberty

Three hundred years ago, most of mankind was poor. Chinese, Indian, and European shares of world product were about equal. Then the West overtook Asian societies. Three decades ago, China and India were about equally poor in purchase power parity terms. Since then, China has left India behind. Chinese per capita income in purchase power parity terms is about twice as high as Indian per capita income. This history of economic performance raises two explanatory challenges. Why did China and India fall behind Europe or the West? Why did China do better than India recently? Here, an explanatory sketch has been suggested for answering both questions. While stagnation is blamed on restrictions of economic freedom, conversely, growth and prosperity have been explained by the expansion of economic freedom. Asia's giants grew much more slowly than the West because of weaker property rights, lack of scarcity prices, and insufficient mobilization of dispersed knowledge or deficiencies in economic freedom. Europe and the West benefited from better institutions than Asia because of interstate rivalry resulting in limited government and comparatively free markets. China could outperform India and start its attempt to catch up with the West only after climbing out of the socialist trap by a de facto improvement of personal freedom and property rights and implementing some economic freedom, by "market-preserving federalism" and joining the capitalist global economy. The extraordinary growth of both Asian giants would have been inconceivable without the advantages of backwardness. These advantages result from the earlier Western establishment of economic freedom or capitalism and the prosperity coming out of it. China did better than India because it moved away from socialism earlier and more forcefully than India did.

This account of Western, Chinese, and Indian economic performance is driven by geopolitics. Rivalry between European kingdoms and principalities, between territorial rulers and autonomous cities produced the checks and balances, as well as the exit opportunities for ordinary people, which contributed to the establishment of safe property rights and the European miracle. European states had to concede limited instead of absolutist government and therefore initiated the commercial and industrial revolutions in the West. During the twentieth century, the United States overtook Western Europe and established a transient hegemony at the end of the century.[50] Nevertheless, international rivalries still

50 The libertarian element in American political culture (Lipset, 1996) made American hegemony less burdensome than other types of hegemony would have been (Mandelbaum, 2005).

implied checks and balances against political power. Rivalry between the People's Republic of China on the Mainland and the Republic of China on Taiwan, the hostile competition between Communist China and the Soviet Union, the historical conflict between China and Japan, and the geographical closeness of US military deployments to China forced the PRC leadership to consider the consequences of falling further and further behind the economies of the West, Japan, and Taiwan. The more privileged geopolitical location of India compared with China, and the fact that Indian relations with America and the Soviet Union were never as bad as Chinese relations with these powers sometimes were, may explain the lateness and half-hearted character of Indian economic reforms.

The rise of Asia, in particular of China, constitutes a challenge to Western ideals of individual liberty. The appeal of political freedom is likely to suffer. A rhetorical question by Kaplan explains why: "Is a chaotic democracy better than the rule of autocrats who have overseen GDP growth rates of 10 percent annually over the past three decades?" (2011: 55). But the Chinese challenge is deeper. It concerns not only the selection of rulers, but also their decision latitude. It might ultimately be rooted in the Confucian heritage of China. Jenner points to "the unfree nature of the Confucian gentleman's place in the political order… An official could no more switch his allegiance to another regime than a married woman could leave home… It is as unusual to come across challenges to the principle of authoritarian rule (as opposed to misrule) in Chinese written records as it is to find the institution of the family questioned" (1998: 69).[51] Although economic freedom is less severely restricted than personal freedom in China, the Chinese economic miracle remains an intellectual as well as a political challenge to the defenders of liberty. Is as little freedom as currently exists in China enough for prosperity and growth? Or will China face the choice between dramatically expanding liberty or renewed stagnation once the advantages of backwardness are exhausted?

In the theory suggested above, liberty is the fruit of evolution, not of human planning. Rulers and ruling classes never can be interested in expanding liberty. Liberty for ordinary people rests on limited government or constraints for rulers.[52] Under some circumstances, rulers had to concede limited government, but they never desired to establish it. Although freedom is desirable and productive, we know little about how to fortify and extend it. But we do know that extending the territorial scope or the duties of government undermine liberty.

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51 Bell (2006) has made an interesting suggestion about how to combine Confucianism and democracy. Members of the upper house might be selected according to academic merit.

52 In previous centuries, ordinary people were labelled "subjects."

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