

Betting on a Brighter Future: Millennium Villages or Free Cities?

Michael Strong, co-founder and CEO, FLOW, Inc.

Theodore Roosevelt Malloch, Founder & Chairman SEI

“When Western countries pledged to double African aid last year an interview with an angry Mr. [James] Shikwati filled two pages of Der Spiegel, the German magazine. "For God's sake, please stop the aid!" he told the magazine.

. . . Jeffrey D. Sachs, a Columbia University professor who is a leading aid advocate, calls Mr. Shikwati's criticisms of foreign assistance "shockingly misguided" and "amazingly wrong. . . . This happens to be a matter of life and death for millions of people, so getting it wrong has huge consequences," Mr. Sachs said.

The New York Times, November 18, 2006

Sachs is correct: This is a matter of life and death for millions of people, so getting it wrong has huge consequences. Unfortunately, there is actually reason to believe that Sachs himself is “shockingly misguided” and “amazingly wrong.”

Sachs’ misguided judgment is a cause of particular concern given his extraordinary influence. In October of 2006, the Gates Foundation donated \$15 million to Jeff Sachs’ Earth Institute at Columbia University. In June 2007, Gates promised \$30 million to an initiative led by rock star Bono that is designed to put global poverty alleviation at the top of the 2008 election agenda. Bono, of course, wrote the forward to Sachs’ book, *The End of Poverty*. It is no secret that the iconoclastic anti-capitalistic billionaire George Soros, has given Sachs in excess of \$50 million to jump start his global campaign. Thus we have the wealthiest individual, running the largest philanthropic foundation on earth, Gates, joining forces with the highest profile rock star campaigner for poverty alleviation, and the anti-capitalist Soros, all joining forces behind the vision of Jeffrey Sachs, the most influential celebrity economist on earth.

Through his prominence in the World Economic Forum (one of us, Malloch, served on their Executive board so we have personal knowledge) and his influence on the design of its programs, Sachs has positioned himself as the most influential economist among certain global business and political elites. In his role as Director of the United Nation’s Millennium Challenge Project, he has direct influence on U.N. policy and agenda-setting. Through his column in *Scientific American*, he is the sole economist heard by most scientifically and technically minded people. Through his best-selling book *The End of Poverty*, Sachs became a leading voice among the literate public. Moreover, his book is cited as the authority in many high school and college courses and is the assigned text in thousands of such courses. Through his association with rock star Bono, Sachs is the only economist whose message reaches pop culture worldwide. It is no wonder that he is the only economist listed among *Time Magazine’s* “100 Most Influential People.” Recently a group has arisen that is promoting “Sachs for President.” Sachs’ Earth Institute at Columbia University has tens of millions in funding to promote its perspective.

Despite Sachs' prestige, there are reasons to believe that there are more effective paths to poverty alleviation than those he proposes. Throughout this article we will propose **WAGERS** that allow Sachs to preserve his reputation by putting his money, and reputation, where his mouth is.¹ If he believes his words, he and his supporters ought to be willing to accept some of the wagers proposed below (or some variation thereon). In true confession we have to admit we have been following Dr. Sachs throughout his whole career and selling him short. That's right, on Wall Street we actually kept a record of where in the world is Jeff Sachs and which countries he was advising and we sold those countries and their debt-*short*. The strategy has long worked so we have confidence it will again when it comes to his cockamamie schemes to end poverty.

On the other hand, if there are sound approaches to alleviating poverty that Sachs has not advocated, and if the approaches to alleviating poverty that Sachs does advocate are not sound, then there are grounds for describing him as the leading cause of poverty in the year 2025. He was in a position after all given his fame to advise the world well, but advised the world poorly. Much as a doctor may be sued for malpractice, Sachs should be sued for malpractice. But we will settle for a wager much like the famous wager of the past decades between population controlist, Paul Ehrlich and resource economist Julian Simon. We all know who won that bet.

This claim will sound odd to the great majority of people who think of Sachs as a leading figure in ending global poverty. He has, to his credit, dramatically increased the world's focus on global poverty, especially in Africa. Insofar as he may have increased support for charitable giving to global charities, and insofar as he has called attention to the policies and attitudes of wealthy nations that exacerbate poverty in the developing world, and insofar as he has called attention to those policies and attitudes in the developing world that exacerbate poverty, he has done a service for the world's poor. The added attention however will not end in the desired result.

Richard Feynman in his autobiography tells a story about attending a conference on poverty reduction that he knew nothing about and after hearing all the bleeding hearts, he understood that these people wanted to ship dollars to poor countries to make themselves feel better, not to help them. He also said that he understood that the West was wealthy not because someone shipped them dollars, but because they knew how to create wealth.

Insofar as Sachs' advocacy is commonly understood to promote government-to-government foreign aid as the preferred solution to poverty, and insofar as he promotes the notion that high tax social welfare states are an ideal to be emulated (the theme of a Fall 2006 Sachs article in *Scientific American*) his influence is primarily pernicious. Insofar as he has ignored or slighted the evidence that increases in economic freedom result in proven increases in economic growth, he has betrayed the world's poor.

¹ Formal statements of WAGERS available upon request.

Millennium Villages and Public Choice Theory

Jeffrey Sachs is the leading advisor of the U.N. Millennium Project, of which the U.N. Millennium Villages project, also headed by Sachs, is the most prominent project proposed for achieving Millennium Project goals.

The Millennium Villages project, piloted at twelve villages across Africa, proposes “investing” \$110 per person to train the villagers in new agricultural practices, improved public health and education, community decision-making, and other techniques believed (by Sachs’ expert team) necessary to insure the villages’ escape from poverty. In their own words:

- The Millennium Village effort is explicitly linked to achieving the Millennium Development Goals and addresses an *integrated* and *scaled-up* set of interventions covering food production, nutrition, education, health services, roads, energy, communications, water, sanitation, enterprise diversification and environmental management. This has never been done before.
- It focuses on participatory community decision-making. . . .
- The initiative uses improved science-based technologies and techniques that have only recently become available, such as agro forestry, insecticide-treated malaria bed nets, antiretroviral drugs, the Internet, remote sensing, and geographic information systems.
- The Millennium Villages initiative is linked to national–level processes to ensure that the success can be scaled up by governments.²

The Millennium Villages project assumes that only \$50 out of each \$110 “investment” needs to come from the donor nations, and that the rest will be funded by NGOs and corporations (\$20), the poor nations themselves (\$30), and the poor villages themselves (\$10). On the basis of these funding assumptions, and on the assumption that the scientific and technical interventions listed above can be scaled from 12 villages to tens of thousands of villages, and on the assumption that these interventions will result in each village achieving economic independence and the other Millennium goals, Sachs, Bono, Soros and Gates are leading a campaign to encourage each of the developed nations to commit .7 percent of their GDP. At present, the U.S. spends .16 percent of GDP on foreign aid.

Let’s assume that Sachs never really meant to imply that government-to-government foreign aid in general would alleviate poverty, but only government-to-government aid that was invested in his Millennium Villages. Our claim is that we can predict, in advance, that the bulk of government-to-government foreign aid will not end up funding Millennium Villages in the manner required to replicate his model villages. We are not in any sense questioning the value of private philanthropy. If Gates and any others believe that Sachs’ Millennium Villages is the best

² <http://www.earth.columbia.edu/millenniumvillages/faq.php>

investment of their private philanthropic dollars that is up to them. Here we simply want to focus on Sachs' highly public campaign to increase government-to-government foreign aid.

Most economists today understand public choice theory.³ It is quite simple to apply the theory to the issue of foreign aid. The mental model of "poverty alleviation through foreign aid" implicit in the exertions of Sachs, Bono, and Gates is to promote the idea of increasing foreign aid to at least .7 percent of the U.S. federal budget (up from .16 percent). It is believed that simply by advocating for more foreign aid, global poverty reductions will follow. Calculations by Jeffrey Sachs, based on his cost estimates for expanding Millennium Villages, are often used as a basis for drawing these conclusions.

Suppose Sachs succeeds in increasing the percentage of the U.S. federal budget that goes to foreign aid. What fraction of that increase is likely to go towards effective poverty alleviation programs?

Remember how legislation is passed in the United States. One of us (Malloch) worked for a period at the U.S. Senate Foreign Relations Committee, so we know this in great detail. First, each of 435 individuals in the U.S. House of Representatives and 100 in the Senate has an opportunity to impact the hypothetical foreign aid bill. Each supporter has an interest in inserting clauses that will benefit their constituents. There are innumerable ways of doing so, ranging from blunt stipulations that certain commodities be provided as part of the aid package, commodities that just happen to come predominantly from a Congressman's district, to apparently irrelevant riders to the bill that happen to mention a special tax treatment for companies that provide services as part of the aid package, and so forth and so on. The number of ways to serve constituents by means of targeted and earmarked legislation is limited only by human creativity, and many of our country's brightest minds are devoted to the task (lobbying) to invisibly insert clauses into legislation that are only understood by the beneficiaries of those clauses. In addition to the legislators and their staffs, and associated lobbyists, any goodies desired by the administration or his (or her) political party are also likely to be included. And throughout this process, a seething process of log-rolling and horse-trading goes on, "I'll give you two tax deductions if you'll give me three contract guarantees or vote for my bridge to nowhere," and so forth and so on.

Once the aid bill is passed into law, then the U.S. executive branch will interpret how it is to be executed – and regardless of political party in power, that process will also be influenced by yet more political considerations. If the funds can be used to further the goals of the administration, in a manner consistent with the legislation, then the goals of the administration will over-ride whatever the presumed original intent of those who advocated for the aid to begin with was.

All of this is on the U.S. side. At some point, funds will be transferred to foreign governments. Each will have its own public choice process, typically involving greater corruption and spoils

³ See James Buchanan, *Politics Without Romance*, or Gordon Tullock, Gordon Brady, Arthur Seldon, *Government Failure: A Primer in Public Choice Theory* for contemporary non-technical statements of public choice theory.

than our system. While no doubt there are many honorable individuals in these governments who will aspire to do the right thing, the fact the probability of the funds reaching their ostensible final destination can be reduced by each decision-maker along the way. Thus if there are twenty people who are responsible for directing the spending of the funds, and fifteen are honest, that still leaves five to take their share. And in poor countries, in which bureaucrats do not make a significant salary, often it has become routine to take a cut of whatever passes through their hands. In reality, there might be dozens of individuals along the way who have an opportunity to take a cut of the “aid” as it is “directed” to the Millennium Villages. Indeed, there is evidence that government-to-government foreign aid increases corruption and degrades developing nation institutions.⁴

Finally, we should remember Ghanaian economist George Ayittey’s macro estimates of what African leaders have skimmed from foreign aid in the past:

- * General Sani Abacha of Nigeria: \$20 billion
- * President F_lix Houpho_et-Boigny of Ivory Coast: \$6 billion
- * General Ibrahim Babangida of Nigeria: \$5 billion
- * President Mobutu Sese Seko of Zaire: \$4 billion
- * President Mousa Traore of Mali: \$2 billion
- * President Henri Bedie of Ivory Coast: \$300 million
- * President Denis N'guessso of Congo: \$200 million
- * President Omar Bongo of Gabon: \$80 million
- * President Paul Biya of Cameroon: \$70 million
- * President Haile Mariam of Ethiopia: \$30 million

In total, Nigerian President Olusegun Obasanjo estimated, “corrupt African leaders have stolen at least \$140 billion from their people in the [four] decades since independence.”⁵

Sachs believes that public advocacy of increased foreign aid will result in poverty alleviation. What percentage of increased U.S. foreign aid budgets does he believe will actually be invested in poverty-alleviating projects? We would be willing to bet one tenth of our net worth that, over a 20 year period, less than 5% of increased U.S. federal government foreign aid budgets, starting in 2009, measured against 2008 foreign aid budgets as a baseline, will reach Millennium Villages in a manner remotely resembling that specified by Jeff Sachs. Is this the most effective approach to alleviating poverty?

Poverty Today is Caused by a Shortage of Economic Freedom

⁴ Stephen Knack, “Aid Dependence and the Quality of Governance: Cross-Country Empirical Tests,” Southern Economic Journal, Vol. 68, Issue 2 (Oct. 2002).

⁵ Both Ayittey’s and Obasanjo’s estimates are taken from Roger Bate, “The G-8 Summit and Africa’s Development,” Testimony for the Committee on International Relations’ Subcommittee on Africa, Global Human Rights, and International Operations, posted at AEI, http://www.aei.org/publications/filter.all,pubID.22786/pub_detail.asp.

Gurcharan Das, the poverty *guru* from India has estimated that at rates of economic growth in India under socialism, it would have taken until 2300 for India to reach a U.S. standard of living. In the capitalist growth rates experienced by India after the economic liberalizations of the early 1990s, India is now expected to reach a U.S. standard of living around 2050. Only economic freedom, by accelerating economic growth, has the power to bring more than a billion people out of poverty 250 years faster than would otherwise have occurred. It is in recognition of the unique ability of economic growth to alleviate, or eliminate, poverty that Nobel Laureate Robert Lucas has said “Once you start to think about economic growth, it is hard to think about anything else.”

“Economic development” efforts, such as Jeffrey Sachs’ Millennium Villages, which do not focus on creating the conditions for entrepreneurial capitalism may alleviate some immediate suffering but should not be regarded as improving living standards to any significant extent. Entrepreneurial capitalism is the only means of alleviating poverty as well as the only means for creating a lasting foundation for world peace. No country on earth has raised its peoples’ standard of living without entrepreneurial capitalism having played a significant role.

Sachs, in *The End of Poverty*, ridicules the notion that economic freedom alleviates poverty by pointing out that there is no correlation between *levels* of economic freedom, on the one hand, and economic growth, on the other.⁶ It is unfortunate that this is the extent to which he takes note of the literature on economic freedom, because there are two powerful correlations that he ignores altogether.

In the 1980s Michael Walker of the Fraser Institute gathered Milton Friedman, Gary Becker, and other prominent free market economists together to create a formal measure of economic freedom. The result was the Fraser Index of the Economic Freedom of the World which today uses 38 distinct third party, objective data sources to measure the economic freedom of most of the nations on earth (a few are not included due to lack of adequate data).⁷ Fraser measures economic freedom using publicly available data in five categories:⁸

1. Size of Government: Expenditures, Taxes, and Enterprises
2. Legal Structure and Security of Property Rights
3. Access to Sound Money
4. Freedom to Trade Internationally
5. Regulation of Credit, Labor, and Business

There are two key findings:

⁶ Jeffrey Sachs, *The End of Poverty*, pgs. 318-320.

⁷ See Gwartney and Lawson, *The Fraser Institute Economic Freedom of the World: 2006 Annual Report*.

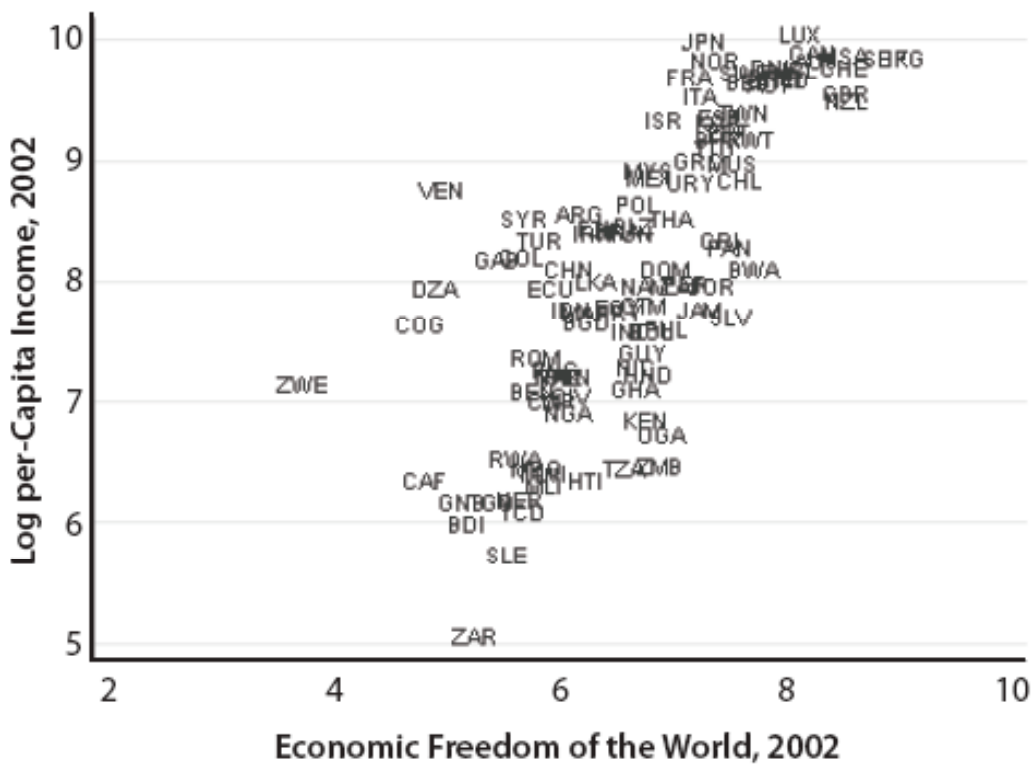
⁸ Because this index includes data going back to 1970 for some countries, and because it is based on publicly available data sources, the Fraser Index is more frequently used for scholarly research than is the better known Wall Street Journal/Heritage Economic Freedom Index (though the two are highly correlated). As a consequence, there is a large and growing set of empirical evidence of the consequences of economic freedom on economic growth.

1. Per capita GDP is highly correlated with economic freedom: rich countries are free, poor ones are not.
2. An increase in economic freedom correlates with increased rates of economic growth.⁹

The result: Any nation that continues to increase its Fraser ranking over a twenty year period will almost certainly experience increased economic growth. The surest way to achieve The End of Poverty is by means of increasing economic freedom around the world.

The following diagram, from William Easterly’s article “Freedom vs. Collectivism in Foreign Aid,” in the Fraser Institute *Economic Freedom of the World: 2006 Annual Report*, shows the correlation between per-capita income and economic freedom:

Figure 2.2: Economic Freedom in the World, 2002, and Log per-Capita Income



⁹ For a review of the literature on economic freedom from a skeptical European perspective that nonetheless concedes the evidence that economic freedom increases rates of economic growth, see Jakob de Haan, Susanna Lundstrom, and Jan-Egbert Sturm, “Market oriented institutions and policies and economic growth: A critical survey,” Thurgauer Wirtschaftsinstitut Research Paper Series No. 5, March 2005. See also See Gwartney, Holcombe, and Lawson, “Institutions and the Impact of Investment on Growth,” *Kyklos* Volume 59 Issue 2 pages 255-273, May 2006.

Few correlations in the social sciences are as clear-cut as is the correlation between economic freedom and prosperity.¹⁰

The other correlation that Sachs ignores is that increases in economic freedom are correlated with economic growth. According to several estimates, a one point increase in economic freedom, on the Fraser Institute rankings, results in 1% or greater increase in rates of economic growth.¹¹

While economic freedom rankings are often perceived as “political,” due to more than a century of leftist attacks on free market thinkers, if we look closely at empirical data, the controversy dissolves. The Fraser Institute Economic Freedom of the World Index reveals that the “socialist” economies of Scandinavia actually have more economic freedom than does any developing world nation. In short, if every poor country were as “free market” as Scandinavia, there would be no more poverty on earth. On this index, with Hong Kong in first place, Iceland is 9th, Finland is 12th, and Denmark is 17th (the U.S. ties for 3rd with New Zealand and Switzerland). Bangladesh is 95th.¹² To simplify exposition, we will continue to use Bangladesh for comparisons, but other poor nations share similar characteristics.

Sweden and Norway have somewhat lower rankings, 24th and 30th respectively, in large part due to their large governments. Relatively free market policies produced the wealth needed to finance these welfare states; between 1870 and 1950 Sweden had the highest per capita GNP growth in the world, with government spending relative to GDP per capita lower than that in the U.S. Only after Sweden became one of the wealthiest nations on earth did government spending increase.¹³ Moreover even in Scandinavia, growth in government peaked in the 1970s, and they have become increasingly free market ever since.¹⁴

Quite aside from the level of government spending, it is more helpful to regard Scandinavia as “free market welfare states” than socialist. Sweden regulates business less than almost all other nations on earth; it is ranked 6th in level of business regulation whereas the U.S. is ranked 16th. Bangladesh is 101st. (Iceland is first in the world; Finland is second, each with less business regulation than Hong Kong). With respect to credit market regulation, the U.S. is ranked 9th and Sweden 11th. Bangladesh is 116th.

Thus Sachs’ notion that “Hayek was wrong,” which he expressed in his *Scientific American* article, is absurd. Hayek’s case against socialism was explicitly focused on the socialist ideal of government control of the economic system. Indira Gandhi’s government controlled India’s

¹⁰ See James Gwartney and Robert Lawson, with William Easterly, *Economic Freedom of the World: 2006 Annual Report*, pg. 33.

¹¹ de Haan, Lundstrom, and Sturm, op. cit..

¹² This and all rankings are taken from See James Gwartney and Robert Lawson, with William Easterly, *Economic Freedom of the World: 2006 Annual Report*.

¹³ See Stefan Karlsson, “The Sweden Myth,” posted at The Mises Institute, 8/7/2006, and Johan Norberg, “Swede and Sour,” Tech Central Station, June 10, 2002.

¹⁴ See historical rankings from See James Gwartney and Robert Lawson, with William Easterly, *Economic Freedom of the World: 2006 Annual Report*.

economy in the 1970s and with a tyrannical result much as Hayek predicted. Meanwhile Scandinavian nations, far freer than most of the developing world to begin with, turned away from their modest dalliance with economic control in the 1970s and have become more free market ever since. Scandinavian nations have done well by liberating their economies more than most other nations on earth, despite their large welfare states. A reader of *Scientific American* who was unaware of these crucial distinctions might well assume that “socialist” Finland was really no different from “socialist” Cuba, whereas in reality free market Finland has one of the least regulated economies on earth.

These abstract economic freedom ratings have very concrete real world consequences. The Peruvian economist Hernando de Soto and his team have worked in dozens of poor countries estimating how long it takes to open up a legal business.¹⁵ They have discovered that in poor nations it takes between one and two years, working full-time going from government office to government office, in order to open up a legal business.

Only elites can afford to go through these labyrinthian procedures – or, more likely, to bribe officials so that they don’t have to submit to such nonsense. Indeed, over-regulation is a primary cause of developing world corruption. The consequence of such over-regulation is that when the poor do become entrepreneurs, they have no property rights, no secure contracts, and no insurance, none of the standard protections that every business person in the developed world takes for granted. Their opportunities as business people are severely constrained by the absence of an accessible legal system.¹⁶ One recent study estimates that moving from the lowest quartile of business regulations to the highest quartile implies a 2.3 percentage point increase in annual economic growth – depending on the size of the nation; this translates into millions, tens of millions, or hundreds of millions of additional people being brought out of poverty each year.¹⁷

Secure property rights have long been recognized as a cornerstone of free enterprise. De Soto has also documented how the poor throughout the world also do not have access to governmental protection of their property rights. Again, this is in sharp contrast to Scandinavia, where Denmark provides the most secure property rights in the world, and Finland ranks 6th. On this measure, Bangladesh ranks 116th. The wealthy nations all share secure property rights, rule of law, sound money, relatively unregulated economies and free trade. The poor nations, for the most part, do not have these economic freedoms.

Outcomes in the world represent reality rather than ideology; if Sachs chooses to dismiss these claims as “ideological,” then one would expect him to be more than willing to accept these

¹⁵ See Hernando De Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*.

¹⁶ The World Bank Private Sector Development website has an entire section devoted to papers researching various dimensions of this issue, <http://rru.worldbank.org/PapersLinks/Reducing-Administrative-Regulatory-Barriers/>. See also the World Bank “Doing Business” rankings and website, <http://www.doingbusiness.org/>.

¹⁷ Simeon Djankova, Caralee McLiesha, and Rita Maria, “Regulation and Growth,” World Bank, available online 24 July 2006.

wagers. Out of tribute to Sachs' two best-known policy positions we propose a series of reputational wagers.

WAGER: We compare three sets of twenty nations, twenty years from now:

Sachs 1: The twenty nations that have received the most government-to-government foreign aid as a percentage of per capita GDP.

Sachs 2: The twenty nations that have experienced the greatest percentage growth in government.

Easterly: The twenty nations that have experienced the greatest increases in economic freedom as measured by the Fraser Economic Freedom Index.¹⁸

We believe that the average GDP per capita increase will be greater among the countries in the Easterly proposal than among either Sachs 1 or Sachs 2. To avoid the ambiguity of outcome associated with a "battle of regressions," we will exclude nations that qualify for one of the Sachs' alternatives as well as Easterly: we will examine a mutually exclusive set of nations, one that exemplifies the characteristics required for economic growth as celebrated by Sachs, the other that exemplifies the characteristics required for economic growth as celebrated by Bill Easterly and others. To give Sachs unreasonably generous odds, we will call it a win for him if either Sachs 1 or Sachs 2 beats Easterly.

Is Sachs willing to put his money where his mouth is, and accept this bet?

He will not, because he knows as well as we do that Easterly will beat both Sachs 1 and Sachs 2. Sachs may avoid mentioning economic freedom, but he is not stupid. He will claim that, if one reads the fine print, he has never really or fully advocated for either Sachs 1 or Sachs 2. The millions of people who listen to Sachs need to hear him publicly renounce both Sachs 1 and Sachs 2, government-to-government foreign aid and high tax welfare states as a model. They also need to hear him communicate the value of economic freedom clearly and unequivocally.

Free Cities: A Constructive Alternative to Sachs' Millennium Villages

Milton Friedman was among the earliest and most persistent celebrators of Hong Kong as exemplar of economic freedom. As Friedman recognized many decades ago, Hong Kong provides a policy model for eliminating poverty worldwide – a far more effective policy model than Millennium Villages. And yet the global development community has scarcely noted the

¹⁸ There are reasons to believe, discussed later, that specific sub-categories of the EFW index are particularly important to development, especially "legal structure and security of property rights." We thus include as a requirement that the nations experience monotonically increasing scores on "legal structure and security of property rights" and that they each have achieved a minimum score of 5.0 ten years from now.. If Sachs claims that he accepts some modified version of EFW himself, then we have achieved our goal of getting him to acknowledge the real state of knowledge concerning economic development.

power of Free Cities to alleviate, or eliminate, poverty.¹⁹ Here we offer an *alternative approach* to poverty alleviation. Because we see Free Cities as a natural expansion of the best aspects of the Free Zone movement, we will cite evidence pertaining to Free Zones as well as Free Cities. The primary difference is that Free Cities include residential and social amenities rather than just factories.

Of the five elements of economic freedom,

1. Size of Government: Expenditures, Taxes, and Enterprises
2. Legal Structure and Security of Property Rights
3. Access to Sound Money
4. Freedom to Trade Internationally
5. Regulation of Credit, Labor, and Business

Three may be encouraged, or coerced, somewhat effectively through the efforts of international organizations such as the World Bank and IMF. The Washington Consensus, of which Sachs was a leading figure in policy implementation, coerced many poor nations to privatize industries and thereby reduce the size of their governments, to stabilize their money supplies, and to open borders to trade. The Washington Consensus has a mixed record because these initiatives alone are only of uncertain outcome in initiating economic growth.²⁰

But the two most important economic freedoms, secure property rights and streamlined regulatory environment, are most difficult to impose from the outside or to create from the inside.²¹ Although the Washington Consensus was able to force some deregulation, it was not able to cut through the choking regulations that are, in fact, responsible for the lack of enterprise in many developing nations. Washington Consensus policies were even less successful at ensuring property rights and rule of law, the most serious problem of all in the developing world.

Insofar as it has become clear that these “institutions” are critical for economic development, it has also become depressingly clear that it is difficult to create sound institutions within those countries in which they are lacking. Those legal institutions that have allowed Western nations to create extraordinary wealth took hundreds of years to evolve. The carrots and sticks of the World Bank and IMF are unsuited to support the growth of better legal systems in those nations in which they are most urgently needed. What to do?

¹⁹ See Ken Hagerty and Theodore Malloch, “Free Cities,” *Weekly Standard*, July 18, 2007 for a bold proposal, modeled on Hong Kong, for the U.S. to create free cities to alleviate illegal immigration.

²⁰ More recently, the U.S. State Department has created the Millennium Challenge Account as a carrot-based approach to encouraging positive reforms. It remains to be seen how effective this approach will be.

²¹ Mogens K. Justesen, “The Effect of Economic Freedom on Growth: Evidence on causality from a panel of countries 1970-2000” concludes that “Legal Structure and Security of Property Rights” and “Regulation of Credit, Labor, and Business” provide the most robust relationship to increasing rates of economic growth. Justesen’s conclusions from extensive analyses of data happen to reflect the independently derived conclusions of Hernando De Soto. See Hernando De Soto *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*.

In *The End of Poverty*, Sachs lists ten successful programs that were taken to scale as proof that poverty alleviation programs can succeed.²² Of the ten, seven are public health campaigns; it turns out that immunizations are an effective investment in public health. One is Norman Borlaug's green revolution. The ninth is Grameen Phone, a for-profit enterprise launched by Iqbal Qadir, a Bangladeshi who argues against foreign aid.²³ The tenth is described by Sachs as "Export Processing Zones in East Asia," which he cites as having been successful at bringing much of East Asia out of poverty.

The rise of the four Asian Tigers: Hong Kong, Singapore, Taiwan, and South Korea, each of which moved from poor to rich in the period from 1960-1990, was a key element in persuading many observers that entrepreneurial capitalism was more effective than socialism at alleviating poverty. Of the four, Taiwan and South Korea grew their economies by means of export processing zones offering tax holidays and removal of customs duties.^{24 25} Hong Kong and Singapore each were based on free port policies of removing tax and trade barriers. In the Fraser Institute's Economic Freedom of the World Index, Hong Kong and Singapore have been ranked as the most economically free nations in the world every year since the index was created. Hong Kong is now one of the wealthiest nations on earth and is the model for China's extraordinary growth through special economic zones.²⁶ Singapore is among the wealthiest, with a higher per capita income than Japan or Germany, and Singapore has now been hired by China as a free zone developer as well. Less well known is Mauritius, an island off the coast of Africa that experienced average real GDP (PPP) growth of 5.9% from 1973 to 1999 through the creation of economic processing zones, leading to average per capita incomes greater than \$12,000 per annum, higher than Chile, South Africa, or Russia.²⁷

²² Sachs, op. cit., pgs. 259-265.

²³ See Iqbal Qadir, "The Loan Ranger," one of the Harvard Business Review's "Breakthrough Ideas for 2004," in the Harvard Business Review, February, 2004 issue. Qadir argues that poverty would more effectively be reduced if the World Bank were to provide loans to the developed world to get them to reduce their trade barriers rather than loan funds to the developing world, where aid promotes statism and stagnation.

²⁴ See Jean-Paul Gauthier, "Free Zones: Performance, Lessons Learned, and Implications for Zone Development," paper prepared for the Foreign Investment Advisory Service (FIAS) conference "An Enabling Environment and Economic Zones for Private Sector Development in Bangladesh," 14-15 December 2004, for a comparison of the differential free zone impact on the economic development of South Korea vs. the Dominican Republic. Free zones are a neglected field within academic economic development studies.

²⁵ It is important to note that as of 1970, Taiwan had more economic freedom than all but four Sub-Saharan African nations today (Botswana, Mauritius, Zambia, and South Africa) and that today it has more economic freedom than any African nation. Although South Korea had relatively little economic freedom in 1970, today Botswana is the only sub-Saharan African nation with a higher rank.

²⁶ See William Overholt, *The Rise of China*, for Hong Kong's role in jump-starting China, leading with Shenzhen. Twenty-five years ago Shenzhen was a small fishing village; now Shenzhen alone has a GDP higher than any sub-Saharan nation except South Africa and Nigeria (most of which is due to oil).

²⁷ Eustace Davie, "Mauritius: Where They Don't Kill the Geese that Lay the Golden Eggs," originally published in Moneyweb South Africa, taken from the Mercatus Center website, May 6, 2007.

Dubai, which was a barren piece of desert soil fifteen years ago, has been among the most remarkable proofs of the free zone concept. In addition to offering tax-free trade zones at the Jebel Ali Free Zone and a series of similar areas for new media and internet companies to grow, Dubai has attracted millions of immigrants to live and work under one of the world's most liberal visa and work permit policies. By 2000, Dubai's economy was worth \$17 billion. By 2005, this had grown to \$37 billion, achieved by clocking growth rates on the order of 17% per year, by far the highest in the world. As of 2002 the UAE economy as a whole was thirty-six times larger than it was in 1971.²⁸ As of 2007, Dubai expects to triple its economy by 2015.²⁹ Sheikh Maktoum, the ruler of Dubai and major beneficiary of Dubai's explosion of wealth, recently announced a \$10 billion philanthropic gift, the second-largest philanthropic gift in history. While the development economists may be confused about how to achieve economic growth, the rulers of Dubai are not.

There is a growing body of significant, rarely acknowledged evidence that free zones, or special economic zones, or free cities are a proven means of economic liberalization and the creation of sound economic institutions. Such zones have played a key role in the economic liberalizations of Taiwan, South Korea, Mexico, Ireland, Mauritius, UAE and China. Hong Kong and Singapore, of course, are Free Cities that are essentially regime-wide free zones. Given this extraordinary track record in promoting economic growth, free zones should be receiving considerably more attention. They have recently been introduced as a means of increasing the liberalization of India, and diverse experiments with zones are taking place around the world. Although some zones are merely tax concessions, we are most interested in those zones whose design explicitly includes the creation of a world-class legal environment within zone boundaries, including a fast-track regulatory regime, secure property rights, and credible and transparent contract enforcement mechanisms.

There is reason to believe that zones provide a unique means of untying the Gordian knot of development states, as discussed in Douglas North's recent work. North states that the stability of most developing countries is dependent on elite groups having a vested interest in limiting the access of most citizens to the formal economy and the government, having an interest in maintaining the support of the powerful elite, and instituting obscure and exclusionary rules and regulations to protect the elite interests. General economic liberalization is seen as destabilizing by the government and the elite. Because a zone might be supported by a segment of the elite as a private business opportunity, and may not be seen by the rest of the elite as threatening their privileges, zones allow for small scale, incremental increases in economic freedom. If designed correctly, they cannot only encourage greater economic freedom in the zone, but also throughout the hosting nation-state. Eventually they can lead to an increase in political and personal freedoms we have seen in Taiwan, South Korea, and Mexico where authoritarian governments

²⁸ For one set of dazzling statistics on Dubai, see "Towards a Bright Future," <http://www.adcci.gov.ae/public/media/Magazines/Dec.2002/towards/html>. It is noteworthy that despite this dynamism within the free zones, outside the free zones, such as in agricultural sectors, there is a lack of economic freedom and consequent economic stagnation – yet another case study in the efficacy of economic freedom.

²⁹ Reuters and Rob Corder, "Dubai Economy set to treble by 2015," Arabian Business News.com, 3 February 2007.

were forced to yield control to political opposition through a relatively democratic and peaceful process.

Of course, in addition to the successful zones, there have been numerous failed zones. Professional zone consultants know that there are specific reasons why some zones have been successful and why others have failed. Yet development economists have almost completely ignored the study of zones and many international organizations, including the WTO, have been hostile to zones. We believe that the foregoing evidence regarding the importance of economic freedom for economic growth, together with the evidence that institutions, in particular, are most difficult to improve in many nations, suggests that zones in which world-class business climates are created within a specified jurisdiction should become a prominent research topic among development economists. In future articles we, and a handful of like-minded colleagues, will begin to specify what these research projects might look like and how free zones and free cities may be deployed as a deliberate strategy for global poverty alleviation.