



Human Betterment Through Globalization

By Dr. Vernon L. Smith
Nobel Prize in Economics 2002

The following is abridged from a speech delivered at "Evenings at FEE" in September 2005.

It's a great pleasure to join FEE for their "Saturday Night Live" and to be among both old friends and many new ones. Several years ago Candace and I taught one of the FEE student seminars here together. The experience was so wonderful that I married her!

My message today is an optimistic one. It is about exchange and markets, which allow us to engage in task and knowledge specialization. It is this specialization that is the secret of all wealth creation and the only source of sustainable human betterment. This is the essence of globalization.

The challenge is that we all function simultaneously in two overlapping worlds of exchange. First, we live in a world of personal, social exchange based on reciprocity and shared norms in small groups, families, and communities. The phrase "I owe you one" is a human universal across many languages in which people voluntarily acknowledge indebtedness for a favor. From primitive times, personal exchange allowed specialization of tasks (hunting, gathering, and tool making) and laid the basis for enhanced productivity and welfare. This division of labor made it possible for early men to migrate all over the world. Thus, specialization started globalization long before the emergence of formal markets.

Second, we live in a world of impersonal market

exchange where communication and cooperation gradually developed through long-distance trade between strangers. In acts of personal exchange we usually intend to do good for others. In the marketplace this perception is often lost as each of us tends to focus on our own personal gain. However, our controlled laboratory experiments demonstrate that the same individuals who go out of their way to cooperate in personal exchange strive to maximize their own gain in a larger market. Without intending to do so, in their market transactions they also maximize the joint benefit received by the group. Why? Because of property rights. In personal exchange the governing rules emerge by voluntary consent of the parties. In impersonal market exchange, the governing rules—such as property rights, which prohibit taking without giving in return—are encoded in the institutional framework. Hence the two worlds of exchange function in a similar way: you have to give in order to receive.

The Foundation of Prosperity

Commodity and service markets, which are the foundation of wealth creation, determine the extent of specialization. In organized markets, producers experience relatively predictable costs of production, and consumers rely on a relatively predictable supply of valued goods. These constantly repeated market activities are incredibly efficient, even in very complex market relationships with multiple commodities being traded.

We have also discovered through our market experiments that people generally deny that any kind of model can predict their final trading prices and the volume of goods they will buy and sell. In fact, market efficiency does not require a large number of participants, complete information, economic understanding, or any particular sophistication. After all, people were trading in markets long before there existed any economists to study the market process. All you have to know is when you are making more money or less money and whether you have a chance to modify your actions.

The hallmark of commodity and service markets is diversity—a diversity of tastes, human skills, knowledge, natural resources, soil, and climate. But diversity without



Dr. Vernon Smith, Professor of Economics and Law at George Mason University, grew up on a farm in Kansas, during the Great Depression. His dream always was to go to college. His diligence was rewarded, and he became a Caltech student majoring in electrical engineering. As a senior, he became intrigued by economics and stumbled upon his first free-market

book—Mises' *Human Action*. Economics became his calling, and he earned an economics Ph.D. at Harvard in 1955—and the rest is history. In 2002 Dr. Vernon L. Smith was awarded the Nobel Prize in Economics for laying "the foundation for the field of experimental economics."

freedom to exchange implies poverty. No human being, even if abundantly endowed with a single skill or a single resource, can prosper without trade. Through free markets we depend on others whom we do not know, recognize, or even understand. Without markets we would indeed be poor, miserable, brutish, and ignorant.

Markets require consensual enforcement of the rules of social interaction and economic exchange. No one has said it better than David Hume over 250 years ago—there are just three laws of nature: the right of possession, transference by consent, and the performance of promises. These are the ultimate foundations of order that make possible markets and prosperity.

Hume's laws of nature derive from the ancient commandments: thou shalt not steal, thou shalt not covet thy neighbor's possessions, and thou shalt not bear false witness. The "stealing" game consumes wealth and discourages its reproduction. Coveting the property of others invites a coercive state to redistribute wealth, thus endangering incentives to produce tomorrow's harvest. Bearing false witness undermines community, management credibility, investor trust, long-term profitability, and the personal exchanges that are most humanizing.

Only Markets Deliver the Goods

Economic development is linked with free economic and political systems nurtured by the rule of law and private property rights. Strong centrally planned regimes, wherever attempted, have failed to deliver the goods. There are, however, plenty of examples of both big and small countries (from China to New Zealand and Ireland) where governments have removed at least some barriers to economic freedom. These countries have witnessed remarkable economic growth by simply letting people pursue their own economic betterment.

China has moved considerably in the direction of economic freedom. Just over a year ago China revised its constitution to allow people to own, buy, and sell private property. Why? One of the problems the Chinese government encountered was that people were buying and selling property even though those transactions were not recognized by the government. This invited local officials to collect from those who were breaking the law by trading. By recognizing property rights, the central government is trying to undercut the source of power that supports local bureaucratic corruption, which is very hard to centrally monitor and control. This constitutional change, as I see it, is a practical means to limit rampant government corruption and political interference with economic development.

Though this change has not resulted from any political predisposition for liberty, it may very well pave

the way toward a freer society. The immediate benefits are already there: 276 of the Fortune 500 companies are currently investing in a huge R&D park near Beijing, based on very favorable 50-year lease terms from the Chinese government.

The case of Ireland illustrates the principle that you don't have to be a big country to grow wealthy through liberalizing government economic policy. In the past, Ireland was a major exporter of people. This worked to the advantage of the United States and Great Britain, who received many bright Irish immigrants fleeing the stultifying life of their homeland. Only two decades ago Ireland was mired in third-world poverty, but has now surpassed its former colonial master in income per capita, becoming a committed European player. According to World Bank statistics, Ireland's growth rate of Gross Domestic Product (GDP) jumped from 3.2% in the 1980s to 7.8% in the 1990s. Ireland recently was the eighth highest in GDP per capita in the world, while the United Kingdom was 15th. By fostering direct foreign investment (including venture capital) and promoting financial services and information technology, Ireland has experienced a formidable brain-drain reversal—young people are coming back home.

These young people are returning because of new opportunities made possible by expansion of economic freedom in their homeland. They are examples of "can-do" knowledge-based entrepreneurs who are creating wealth and human betterment not only for their native country, but also for the United States and all other countries around the world. These people's stories demonstrate how bad government policies can be changed to create new economic opportunities that can dramatically reverse a country's brain drain.

We Have Nothing to Fear

An essential part of the process of change, growth, and economic betterment is to allow yesterday's jobs to follow the path of yesterday's technology. Preventing domestic companies from outsourcing will not stop their foreign competitors from doing so. Through outsourcing, foreign competitors will be able to lower their costs, use the savings to lower prices and upgrade technology, and thus gain a big advantage in the market.

One of the best-known examples of outsourcing was the New England textile industry's move to the South after World War II in response to lower wages in the Southern states. (As was to be expected, this raised wages in the South, and the industry eventually had to move on to lower-cost sources in Asia.)

But the jobs did not vanish in New England. The textile business was replaced by high-tech industries: electronic information and biotechnology. This resulted in huge net gains to New England even though it lost

what had once been an important industry. In 1965 Warren Buffett gained control of Berkshire-Hathaway, one of those fading textile makers in Massachusetts. He used the company's large but declining cash flow as a launch pad for reinvesting the money in a host of undervalued business ventures. They became famously successful, and 40 years later Buffett's company has a market capitalization of \$113 billion. The same transition is occurring today with K-Mart and Sears Roebuck. Nothing is forever: as old businesses decline, their resources are diverted to new ones.

The National Bureau of Economic Research has just reported a new study of domestic and foreign investment by U.S. multinational corporations. The study demonstrated that for every dollar invested in a foreign country, they invest three and a half dollars in the United States. This proves that there is a complementary relationship between foreign and domestic investment: when one increases, the other increases as well. McKinsey and Company estimates that for every dollar U.S. companies outsource to India, \$1.14 accrues to benefit of the United States. About half of this benefit is returned to investors and customers and most of the remainder is spent on new jobs that have been created. By contrast, in Germany every Euro invested abroad only generates an 80% benefit to the domestic economy, mainly because the reemployment rate of displaced German workers is so much lower due to the vast number of government regulations.

I believe that as long as the United States remains number one on the world innovation index, we have nothing to fear from outsourcing and much to fear if our politicians succeed in opposing it. According to the Institute for International Economics, more than 115,000 higher-paying computer software jobs were created in 1999–2003, while 70,000 jobs were eliminated due to outsourcing. Similarly in the service sector 12 million new jobs were being created while 10 million old jobs were being replaced. This phenomenon of rapid technological change and the replacement of old jobs with new ones is what economic development is all about.

By outsourcing to foreign countries, American businesses save money that enables them to invest in new technologies and new jobs in order to remain competitive in the world market. Unfortunately we cannot enjoy the benefits without incurring the pain of transition. Change is certainly painful. It is painful for those who lose their jobs and must seek new careers. It is painful for those who risk investment in new technologies and lose. But the benefits captured by winners generate great new wealth for the economy as a whole. These benefits, in turn, are

consolidated across the market through the discovery process and competitive learning experience.

Globalization is not new. It is a modern word describing an ancient human movement, a word for mankind's search for betterment through exchange and the worldwide expansion of specialization. It is a peaceful word. In the wise pronouncement of the great French economist Frederic Bastiat, if goods don't cross borders, soldiers will.

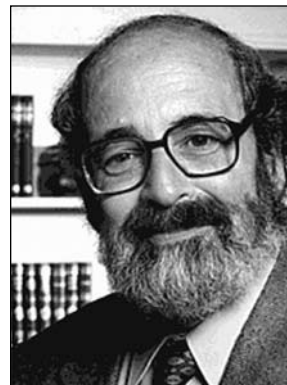
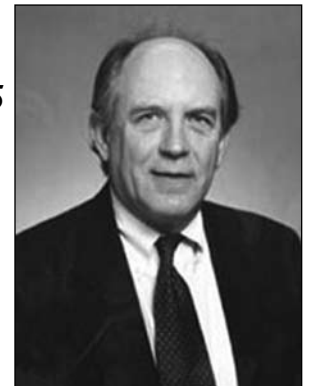
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Saturday, Dec. 10, 2005

**“Can a Free Society
Coexist with a Growing
Underclass?”**

Dr. Charles Murray
American Enterprise Institute



Saturday, Feb. 11, 2006

**“American Universities and
the Betrayal of Liberty”**

Dr. Alan Charles Kors
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