Integration or Assimilation: Whence the Private Sphere?

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I would like to begin by offering a moment of silence for a great man and a great leader who passed away last night: President Nelson Mandela.

Dobar don. First, let me thank Doctor Professor Safet Kozarevic, the University of Tuzla, and the Department of Economics for this opportunity to speak to you today.

Greetings from the United States, from the University of California, Berkeley, and from its Department of Economics, home of the next Chair of the US Federal Reserve, Professor Janet Yellen. First, the bad news. As some of you may have noticed, I am not Professor Yellen. But, second – and this is the good news – that means that nothing that I say to you here today will have any effect whatsoever on world markets. And for that we can all be grateful.

The problem I have decided to tackle this morning is a familiar one: why does capital not flow “downhill” from wealthier to poorer economies, which is what classical economics tells us it should. We may be inclined to fault government regulations and government programs. But the problem in Bosnia and Herzegovina is not that government is too large. Rather is the problem that the public sphere, the government, is insufficiently strong and independent to enact and enforce laws and regulations that aim at expanding wealth.

We can illustrate this problem by looking at a chart produced by one of neoliberalism’s leading architects, University of Chicago Economics Professor Robert Lucas. Lucas’s chart shows the fraction of economies growing from 1800 to 2000.

As you can see, in order to account for the modest rate of technological diffusion in the 19th century and a much higher rate in the 20th, Lucas plots technological diffusion, the hazard rate, variably beginning with *γm* = .01 and ending with *γM* = .03. Lucas sets the proportionality of income growth between any two economies at *β* = .025 and then sets *δ*, the parameter governing the *effect* of world income on the hazard rate at .5. The result is a remarkably accurate plotting of the fraction of economies undergoing economic growth with 1 signaling unity. Which is to say, by the year 2000, almost 90% of the world was experiencing economic growth. Good news for the 90%. Bosnia and Herzegovina should have been among these communites.

But, what if yours is an economy in which growth has proven sluggish? Ninety percent is great, *unless you are part of the ten percent*. The bad news, as I am sure you know, is that Bosnia and Herzegovina experienced negative growth (-.07) in 2012. So, unfortunately, did Croatia (‑2.0), Slovenia (-2.5), Macedonia (-0.3), and Serbia (-1.7). Only Montenegro fared better (0.5). The good news – if you can call this good news – is that this figure, -.07 GDP, beats overall EU rate of growth in 2012 by 0.33; which is important because the EU is Bosnia and Herzegovina’s leading trading partner, accounting for 65 percent of Bosnia and Herzegovina’s trade in 2012.

But economists, as you know, would not be doing their job if they did not begin with the bad news. And, let there be no doubts: the news is bad.

To give you an idea of just how bad the news is I did a little quick math. First, since I am used to working in the US, I am going to run the numbers in dollars. The average hourly wage in Bosnia and Herzegovina, is roughly $1.21 in 2012 dollars. The average hourly wage in the US in 2012 was $7.25. What this means, *caeteris paribus* – which, of course, it never is ­­– is that, based solely on the cost of labor, there should have been a nearly six-fold advantage in Bosnia and Herzegovina’s favor where international investors were deciding where to invest: in the US or Bosnia and Herzegovina. Instead what actually took place was that in the three-year period leading up to 2012, Bosnia and Herzegovina’s gross fixed capital formation declined from 5.4M to almost 4.6M BAM in 2011, before rebounding to 4.9M BAM in 2012. During this same period, US fixed capital formation also declined between 2009 and 2010, but then it began to rise from a low of $1997B in the Q1 of 2010 to $2429B in Q4 of 2012.

In layman’s terms capital should have flowed downhill from the relatively wealthy, but expensive United States, to the relatively poor Bosnia and Herzegovina during this period. It did not.

Now let’s work with the currency of Bosnia and Herzegovina’s largest trading partner, the EU. The average EU hourly wage in 2012: €23.40. That means that the average EU hourly wage in Bosnia and Herzegovina was €0.62. In other words, *caeteris paribus*, investors in Bosnia and Herzegovina’s largest trading partner, the EU, should have been pouring their investments into Bosnia and Herzegovina at a rate of almost 38 to 1.

As it is, capital formation in the Eurozone remained relatively constant, increasing from €384B in the fist quarter of 2009 to €401B in the fourth quarter of 2012, while, as we just noted, capital formation in Bosnia and Herzegovina declined from 5.4M to 4.6M BAM.

But what do these numbers tell us? At the very least, they tell us that capital formation and investment are responding to market forces other than the simple cost of labor. But what forces? Why isn’t capital flowing “downhill”? That’s the 1B BAM question.

I have titled my talk today “Integration or Assimilation: Whence the Private Sphere?” because there is a widespread misconception, particularly among American economists, that the public sphere – the government – accounts for most economic distortion. American economists hold this mistaken view because they feel that private economies are essentially self-regulating. They forget – or, in any case, they forgot – that, in order for economies to self-regulate, they first must enjoy a network of laws, rules, and regulations without which none of the benefits of free enterprise actually follow.

More recently, American economists have returned to the neoclassical foundations of their science, where economists from Carl Menger and Alfred Marshall to Milton Friedman and Paul Samuelson recognized that economies only flourish within the institutional and regulatory context of effectively and evenly enforced laws, rules and regulations. And this means that, if we really want to identify the reasons why capital is not flowing into Bosnia and Herzegovina from the EU 38 to 1, then we will find these reasons by looking not at the public sphere or at government, but at the private sphere or private enterprise itself.

The fear of an endangered or embattled private sphere is unfounded, based almost completely on the mistaken belief that the public sphere has grown too large and powerful. In fact, it is the interference of the private sphere in the public that accounts for most economic distortion in Bosnia and Herzegovina. Let me explain.

As every economist knows, the very word *economy* – *ekonomija* in Bosnian ­– comes from a Greek word *oikonomia* that means . . . well, “private sphere” or, if you prefer, “private enterprise.” Economics, in fact, is simply the study of the laws that govern private household management: *oikos* + *nomia*. But there are nearly as many ways to govern any private household as there are households to govern.

And were all of these households to trade with one another, without a sufficient regulatory framework, the transaction costs as you know would be prohibitive. Taking each household by itself – which is the business of microeconomics – the transaction costs do not so much disappear as much as they are ignored. The manager, or, as the Greeks called him – the *despotes,* is not concerned about how his household effects all other households. That, after all, is the business of macroeconomics. In ancient Greece, every functioning household was managed by a *despotes*. Simply remember, this scary word simply means “manager.”

The largest households in ancient Greece would have been managed by a team of mangers to whom all members of the household were responsible. In smaller households, there would be only one manager, one *despot*, to whom all members would report. And, as we all know, despotisms are never equal and never fair. Just ask my two sons.

The same, obviously, holds today. No matter how large or small the private enterprise, every functioning private enterprise is managed by one or more managers, one or more *despotes*. But what happens when all or most of these private enterprises want to do business with one another? Who will set the rules for how these different households will do business together?

We could, of course, say that the rules will change from one transaction to the next; or we could say that the largest households will dictate the rules by which all of the other households must be governed; or we could even say that the largest households will not allow the smaller households to engage in transactions. The smaller households will be excluded or compelled to sell off their holdings to the larger households.

Clearly these alternatives are anything but hypothetical. All of us are familiar with cartels, monopolies, and quasi-monopolies. And we know that wherever these kinds of entities prevail, they introduce distortions into the marketplace.

If I make my living off of producing a particular good domestically, then it makes sense not only that I would want to eliminate domestic competition, but also that I would want to make it as difficult as possible for foreign producers of that good to sell in my market. Or, if there are several equally powerful domestic producers of a good, it makes sense that collectively we would want to make it very difficult for any more domestic producers to enter the market. Or, if I produce or import a good that only sells to low-income consumers, it makes perfect sense that I would resist any attempt to improve the income of consumers.

There are, in short, countless reasons why I, as a private enterprise, might want to introduce, maintain, or even strengthen market distortions.

But, let us say that I was interested not only in maintaining or strengthening the market position of my own private enterprise, but that I was also interested in expanding the overall wealth of my community? What might this entail?

Well, according to neoclassical economic theory, if I want to expand the overall wealth of my community, my common wealth, my republic, then I will attempt to establish institutions, enact legislation, and enforce regulations that reduce or eliminate market distortions and that serve the interests of all private enterprises. Such laws would not favor any specific household or group of households, nor would they effectively eliminate any household or group of households.

Would a shared set of laws governing commerce benefit all private households? Would competitive hiring and competitive bidding on contracts yield higher efficiency? Would it help all of us to maintain and pay for a shared set of efficient transportation routes? How about truly independent courts of law to adjudicate our grievances? Would our employees perform more efficiently if they enjoyed a certain minimal level of numeracy and literacy? Would enterprises be able to communicate more effectively and efficiently did they have ready and equal access to reliable, independent sources of information and knowledge? Would we be able to innovate and solve shared problems more efficiently did our employees and managers enjoy cutting-edge training at independent, public institutions of higher learning where qualified instructors enjoyed true academic freedom? Would the costs of production at my private enterprise be dramatically lowered not only with a healthy and fit workforce, but could I lower my overall costs of production by joining with other private producers to offer public, universally available healthcare? Would the wealth of the nation benefit from effective laws to eliminate monopolies, cartels, and quasi-monopolies?

We all know the answers to these questions. And we also know who would be harmed by robust public institutions empowered to level the playing field by eliminating the advantages enjoyed by monopolies, cartels, and quasi-monopolies.

At least initially, we know that strong, effective, independent public institutions would harm those who currently benefit from membership in a cartel or from monopoly or quasi-monopoly conditions. Since their private households set the rules by which all other private households are governed, there can be no question but that, at least initially, in relative terms, they will suffer from laws, regulations, and institutions that favor free markets.

I said a moment ago that it is the public sphere that is suffering in Bosnia and Herzegovina. This may ring false to those of you who know the percentage of Bosnia and Herzegovina’s workforce employed by the government.

The allocation for wages of civil servants in Bosnia and Herzegovina is the highest in Europe compared to the GDP (12.8%). And for this reason, some economists have recommended not the strengthening of public institutions, but weakening them still further. But, how are we to understand this statistic?

Let us consider this question for a moment. Obviously, none of us would object to this percentage were these wages going to civil servants who had been awarded their positions after competitive job searches open only to candidates who had earned their degrees at institutions independent of political patronage and private intervention; or were the civil servants who occupied these positions responsible for fairly and evenly enforcing laws and regulations aimed at eliminating cartels, monopolies, and quasi-monopolies or fairly and evenly collecting necessary fees and taxes. But, take a look at university instructors and administrators for example. There is perhaps no more pressing need in Bosnia and Herzegovina than for qualified, independent instructors at its universities and technical schools. The same holds true throughout the Bosnian and Herzegovinian civil service. And, so, we all know why Bosnia and Herzegovina’s civil service enjoys such a large percentage of overall national wages.

We all know that this points to still one more way that the private sphere and private enterprise are intruding into and taking over public institutions; not the reverse. Far from indicating the strength of public institutions, this intrusion of private interests into the public sphere instead indicates the weakness of the federal government.

In closing, then, I would like to return to our original question. Why are European investors not pouring their investments 38-1 into Bosnia and Herzegovina? Is it because of Bosnia and Herzegovina’s bloated public sphere? No. It is not.

Rather is it because of a handful of private households, private enterprises, who are earning their wealth – and shipping it abroad – at the expense and to the exclusion of Bosnia and Herzegovina’s other private households. These few households – the ancient Greeks called them *oligarchoi* – have grown fat at the expense of the vast majority of their fellow countrymen. These oligarchs, as we know, do not favor free markets. They are doing all in their power to frustrate the emergence of free markets and so frustrate economic integration. Their success depends upon the weakness or complete elimination of truly free and independent, robust public institutions.

So, what role can economists play in this mess? Obviously our role at best is quite limited and modest. Let me close by offering three suggestions. First, if like me you are an advocate of the free market system, then we must also teach our students and our reading public about the close, intimate relationship between strong, independent public institutions – free of corruption and cronyism – and the vitality of private institutions. The two are not in competition. Each depends upon the other. Second, personally, we can demand that our political parties field slates of candidates who are as committed to the elimination of corruption, patronage, and cronyism in public institutions as they are to fighting cartels, monopoly, crime, and quasi-monopolies in the private sphere. Third, lastly, and closer to home, we need to fight within our own academic institutions and departments to ensure that all appointments – whether to administrative or to academic posts – are strictly based upon merit, without partiality for or against candidates because of their purely private and personal characteristics.

Returning briefly to the chart I showed at the beginning of this talk, it is really quite amazing how over the course of two hundred years, ninety percent of all nations are now experiencing economic growth. According to Professor Lucas, a leading authority on neoclassical and neoliberal economic theory, these communities have come to experience growth only when they shed their purely local, individual, traditional, and *private* qualities; *and* when they adopt and enforce the rules, institutions, laws and regulations governing the rest of the global economic community. Eventually, Bosnia and Herzegovina will become a full member of this community; and when they do, they will experience spectacular economic growth. But, so long as they continue to cultivate purely local, individual, traditional, and *private* enterprise, they will also continue to occupy that small and ever smaller sliver of communities who are failing to enjoy economic growth.

The solution to this problem is really up to us. Will we rein in the oligarchs now, or will we wait until they have further destroyed BiH? Will we strengthen our public institutions, or will we further weaken the only independent agent capable of standing up to the oligarchs? The choice is ours.