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Comment on Richard B. Freeman's "Labor markets and institutions in economic development"

Walter Block

College of the Holy Cross, Worcester, MA, USA

Freeman (1993) has a two-part thesis. The first, borrowed faithfully from Coase (1992), is that economic analysis cannot exist in a vacuum; rather, it must be embedded in, and appreciative of, the prevailing institutional arrangements. The second part, with which Coase may be expected to have somewhat less sympathy, is that when our analysis incorporates successfully the actual institutional setting in which economic activity takes place, a whole host and variety of conservative shibboleths, or pro free enterprise findings, can no longer be maintained. Among these are five fairly typical presumptions within the profession, he tells us. They are:

- (1) Bias towards urban elites in underdeveloped countries retards economic development (Freeman (1993) calls these nations "Developia", but the description used in the text describes more accurately what is actually going on in these countries, as opposed to what men of good will might wish were occurring there).
- (2) Pro union and minimum wage legislation are economically counter-productive.
- (3) Markets outperform central planning, or industrial policy, and that "clear property rules and privatization are necessary for rational economic behavior" (Freeman, 1993, p. 403).
- (4) Countries which feature military dictatorships and suppress labour organizations increase income inequality.
- (5) People are usually satisfied with economic progress.

Before considering each of these claims in turn we must begin by noting that Freeman adopts the usual debater's ploy of stating his opponent's views in a highly exaggerated manner. This "straw man" technique is seen, for example, in the dare "... if you think that military dictatorships that suppress labor necessarily produce high income inequality, the income distributions of Korea and Taiwan should give you pause" (emphasis added, Freeman, 1993, p. 403). The point is, no reputable economist, or anyone else for that matter, has ever asserted that there is any such necessary connection; the contention, on the contrary, is only that this seems to be a statistical or empirical reality. By

putting excessive claims in the mouths of his intellectual opponents, Freeman does indeed enhance his ability to "prove them wrong". But this is merely a Pyrrhic victory, as he only succeeds in undermining views they do not actually hold. Let us now turn to a consideration of each of his allegations in detail.

Richard I
Freeman
"Labor markets

Rural-urban differentials

Freeman states: "A principal tenet of the orthodox view of labor in development is that urban wages are excessively high relative to rural wages" (p. 403). Although Freeman does indeed cite one set of authors (Harris and Todaro, 1970) in support of this declaration, he realizes that this is only a proxy for an underlying causal explanation: the aggrandizement of the public sector at the expense of the private. And it is this, not some anti urban bias, that is the explanation of economic stagnation in the third world offered by a whole host of commentators (Ayittey, 1991, 1992; Bauer, 1981, 1984; Bauer and Yamey, 1957; Louw and Kendall, 1986; Williams, 1989).

Freeman points to a number of studies which show that urban/rural relative wages have been falling; but this is only an approximation of public-private compensation. Only two (Colclough, 1991; Lindauer *et al.*, 1988) address themselves directly to this issue, but leave open the question as to whether economic growth took place as a result. A reasonable expectation, *ceteris paribus* conditions holding, is that if public sector wages fell relative to those in the private, this would tend to boost the economy, given that - apart from a contestable[1] small but necessary "nightwatchman" function for the state - the main role of government bureaucrats is not to promote wealth creation, but rather to batten off it.

Of course, this change affects only relative wages. In absolute terms, even if real governmental wages declined, they could still be far in excess of those available in the rural sectors, and in excess of those needed for the growth enhancing minimal state.

Labour rigidities

Freeman's treatment of this subject is marred with a serious equivocation. In his first paragraph he starts off by characterizing the traditional view as one which sees "institutional interventions in the labor market (such as) minimum wages, unions", etc. as "major impediments to growth and employment" (Freeman, 1993, p. 404).

One would think that after such an introduction he would proceed to show that these interferences have not slowed down the rate of growth or job creation. Instead, and here is the equivocation, he tries to show that in the event, these policies have not actively been pursued by governments in the Third World. Here, he refers to the ILO study indicating that the "real value of minimum wages plummeted", or "were enforced weakly" (p. 404). Now surely this is a very different issue. It is one thing to assert that minimum wages, unions, etc., if enacted, retard the economy. It is an entirely different matter to show that they have not been pursued; that they have been, in effect, dead letter laws. The one

has no implication for the other. Surely, a strictly enforced law setting one cent per hour as the minimum wage, or even one for \$50 per hour with absolutely no penalty for violation, cannot be expected to have much of a negative effect on economic development[2].

Freeman (1993) avers that "the optimal policy may be to enforce minima in large (multinational) firms with low elasticity of demand for labor and where the supply of foreign capital is inelastic" (p. 404). But politicians who follow this advice risk discouraging the golden (multinational) goose from locating in their countries. Nor is it easy to rescind wage minima once they have been inaugurated. Has the recent French experience with minimum wages taught us nothing[3]? Then there is his claim that

Taiwan enacted a fairly high minimum in 1988 and increased it substantially in 1992. One interpretation of this pattern is that the minimum is an endogenous "luxury policy", imposed when it helps workers at little economic cost but dropped when it risks serious economic harm (Freeman, 1993, p. 404).

It would be hard to pack more economic fallacies into a shorter statement. One problem is the implication that the Taiwanese growth rate persisted during these years. If so, it accomplished this goal despite these enactments, not because of them. Freeman, who seems long on historical examples but short on economic theory, has no way to distinguish between these two very different states of affairs. Another problem concerns the notion of "luxury policy". Why is it that one and the same law – establishing wage minima – can help workers at times, and at other times "risks serious harm"? The straightforward answer is that this enactment can help workers only in the very short run, before the firm has had a chance to substitute other factors of production for the one which has suddenly increased in price[4]. But just as soon as this can be humanly accomplished, the employer moves along his isoquant to a new optimal point. And with this new allocation of resources, the unskilled labourer will find himself priced out of the market. The difficulty with this author is that he offers no alternative explanation; nor does he appear to accept this one, otherwise he would not speak of the "help" to be afforded by this law.

To conclude this section, Freeman's is indeed a strange defence of minimum wage laws: they are not so bad when not enforced. With friends like him, this law hardly needs enemies.

A similar analysis pertains to unions. Where once we might have expected a ringing endorsement of this curious institution (and probably would have received it, had this piece been written 30, 20, or even ten years ago) from this quarter, we are told instead that the defanged version is really not too harmful. It cannot be denied that non-aggressive unions, such as the Christian Labour Association of Canada, which specifically abjure violence, are vastly to be preferred to the ordinary garden variety labour organizations which have, as their main stock in trade, the legal ability to preclude entry of competing workers through threats of violence. But even this moderate version of the

union case is not, strictly speaking, correct. Just as a dead letter minimum wage law will still have some pernicious effects, even though far less than the virulent strain, so are moderate, "well behaved" unions still problematic, economically speaking. This is because unions are *per se* illegitimate organizations (Block, 1991a). Either they themselves threaten ("picket line") violence, or they struggle to enact "labour" legislation which mobilizes the state to act on their behalf in this regard. For example, laws which compel the employer to "bargain in good faith" with unionized employees, when he would just as soon fire and replace with "scabs", are an infringement on his rights of free association.

Needless to say, these laws have strong and negative impacts on economic development, *ceteris paribus*. Freeman (1993) holds, to the contrary, that "unions ... are associated with greater training, increased fringe benefits, and higher productivity" (p. 405). And in this, there is no gainsaying that he is correct. But he has hit on the truth accidentally, and for reasons he will not appreciate. First, he is correct in using the phrase "associated with", and not "caused by"; second, in maintaining that organized workers are among the cream of the crop. Labour organizations comprise the most highly skilled, but they do not create any of these benefits. Rather, the direction of causation is the other way around. These benefits enable them to be better organized than the "scabs" with lesser skills who are precluded from bidding for work slots with lower wage offers. If anything, however, the effect of unionism – apart from entry restrictions, which do indeed raise their wages – is to lower productivity; this is dissipated in work to rule, grievance procedures, jurisdictional disputes with other unions, featherbedding, etc.

Whether or not it is "justifiable ... to dismantle such institutions" (Freeman, 1993, p. 405) is of course a normative issue. It is justifiable if one believes in stamping out the initiation of violence; it is not if not. From a positive point of view this issue raises the question of whether unions enable poor countries to improve their lot. And from this perspective the answer is clear: both economic theory and history suggest the negative.

In the absence of unionism, rising profits typically mean greater investment, still more earnings and jobs and, hence, additional economic development. In their presence, the employer is diverted from this entrepreneurial task. His energy must be spent in protecting his profits from avid and unscrupulous unionists. Even when he succeeds in these defensive measures, he must pay the opportunity costs of these energies in terms of additional business, profits, etc. And when he fails, it is even worse: it is at the cost of potential bankruptcy.

Freeman (1993) concludes this section on a straw man note: "don't look to government or union labour-market interventions as prime causes of trouble" (p. 405). One need not look to minimum wages or unionism as the prime culprit explaining underdevelopment without seeing these phenomena as part of the problem, not part of the solution. "Government", of course, is entirely a different matter, one not addressed by Freeman in this section, and perhaps tacked on to

this sentence to make it less of a straw man argument than otherwise it would appear.

Ownership and government

Exhibit "A" in Freeman's case against the market is China. Here is a country, as communist as can be, and yet, in the teeth of massive governmental ownership and control it is one of the fastest growing in the entire world. "Take that!", advocates of capitalism, Freeman seems to be saying. Actually, he does say this, only in more scholarly language:

The message to the transition economies of Eastern Europe has been that the road to successful economic performance requires privatization of enterprises and a clear residual claimant. The failure of reform communism in Hungary, Poland, and other Eastern European countries seemed proof that only private ownership could create the incentives for an effective market economy (Freeman, 1993, p. 405).

And then along comes China, an utter refutation of all this pro market bias, in, his view.

Did China privatize its state firms or clearly define property rights for its various enterprises as part of its economics reforms? No. Chinese ownership rights (i.e., the particular residual income claimant) are complex at best (Freeman, 1993, p. 405).

There are several difficulties here, however. First of all, there is nothing in the Adam Smithian paradigm which requires a simple and clear residual claimant. A complex one, as occurs in China according to our author will do just fine. Second, it is not true that this country now functions completely in the absence of a marketplace. There are, after all, numerous privatizations and strings of free enterprise zones spread out all across this nation. After the passing of Mao, deregulation has hit the country like a storm[5]. In addition, China functions in a world economy, and as such enjoys the advantages of market prices generated elsewhere[6]. Third, there is the entrepreneurial spirit of the Chinese people (Sowell, 1983, 1994). Everywhere they go, wherever unfettered by Communism, they have made a vast economic success of their lives. Whether it is in the USA, or Malaysia, or Australia, people of Chinese extraction work hard, become highly educated, and wealthier on average than their "host" groups, even though often discriminated against by them[7]. It was only in China – under Communism – that the Chinese failed in their economic pursuits. Is it any wonder then, that when this country relaxed some of its economic regulations and restrictions – of which Freeman can find nothing negative to say – and set up privatization and free enterprise zones to a modest extent, that its economy would start to flower like parched grass too long kept away from water?

But is all this because of or in spite of the move towards economic freedom? Here, Freeman is at his absolute weakest. Unaccountably, he shows no evidence of being aware of any theory which attempts to account for economic success. In his intellectual arsenal is only the ability to look around the world, cite some countries that are developing and some that are not, and then argue

that anything (seemingly anything) that characterizes the former can account for their success. In fact, he goes so far as to consider the possibility that socialism, communism, central planning, government industrial policy, can actually lead to economic prosperity. This is neither the time nor the place to rehearse the reasons why this is not so (we can acknowledge, however, the raw coverage it takes to say these things in 1993, four years after the crumbling of the Marxist system), why this cannot be so. Suffice it to say that without markets, and market prices, economic calculation is impossible (Hoppe, 1989; Mises, 1966, 1981; Salerno, 1990, 1993); that be the economic planners ever so smart, and armed with all the modern computers beyond the dreams of avarice, the economy does not benefit from the automatic weeding out process[8] provided for by the profit and loss system (Hazlitt, 1979); that the market serves as a vast communication and informational providing network, without which central planning is like a chicken running around with its head cut off (Hayek, 1948).

This is why the presumption is always in favour of markets, not bureaucratic control, notwithstanding Freeman's contention that he has "shifted the burden of proof from those who see a positive role for a development-oriented government to those who argue that interventions are harmful" (Freeman, 1993, p. 406).

If China was Freeman's exhibit "A" in his search for a successful centrally planned economy, Singapore, clearly, is exhibit "B". Now this is more than passing curious, in view of the fact that numerous studies have shown the economy of this city state to be among the most free in the world (Block, 1991b; Easton and Walker, 1992; Walker, 1988). Talk about biting off more than you can chew. It is undoubtedly true, as Freeman points out, that Singapore deviates from the pure vision of the classical liberal nightwatchman state of *laissez-faire* capitalism (e.g. Nozick, 1974) with government owned enterprises, payroll taxes, state investment, wage dictations, etc. But by world standards, this does not at all deserve to be characterized as "massive state intervention". One must bring a sense of perspective to matters of this sort.

And it is the same with exhibits "C" and "D", Taiwan and Korea. Freeman (1993) reports gleefully that the central governments of these countries have "initiated new sectors, directed private investments into some areas, and regulated foreign trade in ways that are inconceivable in the United States or United Kingdom" (p. 406). Again, true enough. But Taiwan and Korea are still relatively free, from an economic perspective, at least when compared to most nations of the world.

By the way, Freeman is labouring under a geographical delusion: there is no such country on the entire planet named "Korea" as he seems to think. As it happens, there are only North Korea and South Korea. And this opens up an interesting comparison, for these two serve almost as a laboratory experiment. They have in them the same people, with the same genetic pool, the same ethnic stock, the same culture, the same just about anything anyone would ever care to mention – with the exception of one small detail. The North

functions under a system of which one would expect Freeman to give his enthusiastic support, while the South labours under a cloud of relative economic freedom[9]. Needless to say, we are not offered this as a case in point by our author.

Freeman (1993) concludes this section by tasking Hong Kong with "institutional intervention ... because the government owns the land, and the business elite may operate as a small directing cartel" (p. 406). Again, this is true enough, but there is a certain perspective missing. Hong Kong is usually rated the freest country on the globe (Block, 1991b; Easton and Walker, 1992; Walker, 1988), despite its admitted shortcoming on the land ownership front. One would think that Freeman would ignore this case, since it is a prime example of great economic growth for many decades, despite a continual influx of very poor people fleeing the People's Republic of China. As for allowing cartels, this is an example of economic freedom, not its absence (Armentano, 1972, 1982; Armstrong, 1982; Rothbard, 1962). It is compatible with the free enterprise system that co-operation between businessmen be legalized. Rather than a slur on the market credentials of Hong Kong, it is a diminution of that of those countries in the west with antitrust laws on their books.

Income inequality

The Freeman (1993) thesis in this section is that "it is widely believed that" (p. 406) under dictatorial regimes, particularly those headed by army officers, the poor suffer, both absolutely and relatively, whether or not growth occurs. The military dictatorships in South America particularly in Brazil and Colombia, seem to bear this out. However, and here comes his "refutation" of orthodox economics, this does not apply to Taiwan and Korea [*sic*], both of whose army high commands have suppressed independent unions and yet have "attained low levels of income inequality" (p. 406).

Again, an interesting hypothesis, but one which does not escape unscathed. First of all, it is pejorative to refer to "attaining" low levels of income inequality. There is nothing in all of value free economics which can serve as the basis for the claim that greater income inequality is "worse" than less[10]. One can make such normative proclamations if one wishes, but unless they are backed up by some sort of economic or philosophical justification, they cannot be allowed to stand uncontested[11].

Second, there is no consensus among economists (Block and Walker, 1988; Frey *et al.*, 1984) that military regimes necessarily reduce income equality. Certainly, there is no economic theory which holds this to be true. That it would describe practice in South America, but not Asia, should not be the occasion, then, of any intellectual embarrassment.

With regard to Freeman's contention to the effect that unions are instrumental in lowering income disparities, however, here there is a presumption on the part of economics – one which is at some variance with his views. Consider what we know of this relationship. The main business of

unions is to restrict entry; their *raison d'être* is to reduce the competition for jobs they want. But who are the people so restricted? They are typically lower skilled workers, labelled "scabs", who are almost always poorer than their better organized union counterparts. But if the main effect of unions is to raise their wages at the expense of those lower down in the income distribution, their effect on equality is precisely the opposite of that contemplated by Freeman. In order to see this, one need only consider the economic effect of unions on the lowest income decile, or quintile, where the "scabs" are likely to be over represented.

Progress and satisfaction

This section is also problematic. Here, Freeman (1993) seemingly turns on its head the usual expectation that, *ceteris paribus*, economic progress would lead to human satisfaction. He gives as an example economically expanding Korea[12], "where surveys of attitudes and revealed behavior portray an utterly disgruntled labor force ... with high levels of dissatisfaction". Naturally, this is a not so thinly disguised call for a greater role for unionism: "Growth without decent treatment of workers of the sort that free unions normally guarantee is evidently not the best path to a satisfied population" (p. 407).

It would be interesting to contemplate a study comparing the satisfaction of unemployed and underemployed "scab" labour in countries with "free unions" of the sort advocated by Freeman, with fully employed unskilled workers in those without this institution. The clear expectation is that those at the bottom of the labour skills pyramid would be far happier in the absence of unions than in their presence.

Even apart from Freeman's union advocacy, attitude surveys are notorious for their inaccuracy as a benchmark of satisfaction. Further, there is the well known "revolution of rising expectations". This refers to people who have been exploited for many years and now benefit from a slight improvement in living standards. Instead of being happy with their new lot in life they become more enraged; now, for the first time, they appreciate just how bad their condition was, how unjust, and have the ability to change things, and thus are determined to do something about their plight. We must take with a grain of salt, then, the surveys that Freeman cites. They need not at all indicate deterioration in condition; an improvement is a realistic alternative interpretation.

Conclusion

We have traced the Freeman exegesis through five separate but not unrelated topics. He sees his analysis as embodying Coase's call for sensitivity to institutional arrangements. A competing perspective views it instead as a cry for more socialism, more interventionism, more coercive unionism – not a very pretty picture, particularly as half the world is now involved in the difficult process of extricating itself from these very abuses.

Notes

1. For the limited government side of this debate see: Friedman, M. (1962, 1975, 1987); Friedman, M. and Friedman, R. (1980, 1983); Nozick (1974); Smith (1776/1965); for the alternative see: Friedman, D. (1979, 1989); Hoppe (1989, 1993); Rothbard (1970, 1973, 1982); Woolridge (1970).
2. They will have some effect, however, and this will be negative. Postulate two communities, otherwise equal in every way, except that one has enacted a "dead letter" minimum wage law, and the other has not. Is there any doubt that new investment will tend to concentrate in the latter? Nor is there any doubt about the reason: it is easier to raise the level of wages, or enforcement, of a law already on the books, than to attain this *de novo*.
3. There an attempt was made to introduce a lower teenage minimum wage, not even to discontinue the policy entirely. Even this moderate attempt at reform had to be withdrawn due to riots in the streets. It is therefore perhaps irresponsible to urge politicians to flirt with such dangerous legislation.
4. We should not lose sight of the fact that the worker is only helped in the short run at the expense of the firm which employs him. Apart from being akin to "killing the goose that lays the golden eggs", this state of affairs is problematic from the point of view that there is thus nothing in all of welfare economics which can support the view that this "help" is of benefit to society as a whole. All we know is that the worker is "helped", the employer hurt. Unless we are willing to utilize illicit interpersonal comparisons of utility, no such conclusion may be reached.
5. Horner (1994, p. 35) speaks of "decisions by China's government to allow capitalism an unprecedented sway throughout the country". He maintains that "there is little Maoism in today's China. Indeed, almost immediately upon Mao's death in 1976, his successors began to undo his work".
6. Why is it that the economy of the Soviet Union was able to function – after a fashion – for 70 years? One of the reasons was "The Sears Roebuck Catalogue", e.g. the fact that the USSR could avail itself of prices generated in true markets in the west.
7. In this they resemble the Jewish people, according to Sowell; they, too, do better than average, economically speaking, in every country in which they have settled – with the exception of Socialist Israel – even though they, too, have borne the brunt of discrimination, and worse.
8. It is undoubtedly true that central planners are far more sophisticated than businessmen, and have far better credentials. Neither Ray Kroc, Sam Walton, nor Bill Gates has earned a PhD. All were school dropouts. Nevertheless, the market singled out these three men, and hundreds more like them, and did not so distinguish their public sector counterparts.
9. A similar "laboratory experiment" was provided by East and West Germany, and is by Taiwan and China, neither considered – not too surprisingly – by Freeman in his world wide search for examples comparing markets and central planning.
10. For a refutation of the philosophical claim that this is true by Rawls (1971), see Nozick (1974).
11. A similar criticism applies to the oft heard phrase: "perverse income transfers", which denotes taking money from the poor and giving it to the rich. This, too, is unwarranted, because unless there is some proof of, or evidence on behalf of the notion that there is too much income inequality, such transfers need not be considered "perverse".
12. He presumably refers to South Korea, not the economic basket case to its north where, presumably, people are more happy with their lot in life, since they are immeasurably poorer.

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