The Wall Street Journal
February 15, 2007

Reprinted with permission of *The Wall Street Journal* c 2007
Dow Jones & Company, Inc. All rights reserved.

Competitive Cooperation

By Edward C. Prescott

Of all the thankless jobs that economists set for themselves when it comes to educating people about economics, the notion that society is better off if some industries are allowed to wither, their workers lose their jobs, and investors lose their capital — all in the name of the greater glory of globalization — surely ranks near the top. This is counterintuitive to many people (politicians among them), because they view it the government's economic responsibility to protect U.S. industry, employment and wealth against the forces of foreign competition. If the government has any economic role at all, surely this must be it.

Actually, no. Government has a higher calling in this country (and others like the United States), which is to provide the opportunity for people to seek their livelihood on their own terms, in open international markets, with as little interference from government as possible. That doesn't mean we shouldn't provide short-term social insurance policies to aid those displaced by foreign competition, but the purpose of that aid should be to prepare workers, not protect them.

Also, just because a country is open to international competition doesn't mean that it won't meddle in international markets. Complexities (and hypocrisies) abound when countries establish international trade agreements. In this regard, the U.S. and its free-trade friends are deserving of no small amount of shame. But broadly speaking — and these broad operating principles matter — those countries that open their borders to international competition are those countries with the highest per capita income.

This is more than mere correlation. Competitive openness is the key to bringing developing nations up to the standard of living enjoyed by citizens of wealthier countries. I am not speaking here of those countries faced with extreme poverty amid the ills of war, civil unrest, disease and famine. Those are countries with big problems and special needs, beyond the bounds of much economic theory. But I am talking about the majority of the world's population, who reside in countries with the opportunity for growth but who are stifled by protectionist policies and anti-competitive institutions.

Let's review some historical facts. With the signing of the Treaty of Rome in 1957, France, Italy, Belgium, West Germany, Luxembourg and the Netherlands formed what would eventually become the European Union. For six decades prior to the treaty, those countries were about 55% as productive as the U.S. But over the following 25 years, those countries essentially caught up to the U.S. in terms of productivity.

When that historic economic treaty was signed, three countries were roughly on par with those original six — Denmark, Ireland and the United Kingdom. However, a funny thing happened in subsequent years — those three countries started falling behind their former peers. So in 1973 they joined the original group and their economic fortunes improved. It took time, but the U.K. now is as productive as Germany.

The story continues in the 1980s, when Spain, Portugal and Greece joined the club. Spain has essentially caught up with the pack, and Portugal and Greece have narrowed the gap. By 1995, Austria, Sweden and Finland joined and have shown improvement relative to the group, after having fallen behind prior to signing. How about the 10 countries that joined in 2004? It's still early, but signs of positive movement are already apparent.

How to explain this phenomenon? The answer lies predominantly with competition — aided by an attendant drop in transportation costs — that industries had to face from their new member states. With regard to Europe, it is useful to consider the example of the U.S., which, from its early days, created wealth from the healthy competition among businesses and industries in its member states. This competitive cooperation was not a foregone conclusion during this country's formation, but its establishment has left an institutional legacy that has guaranteed the increasing standards of living that we all now enjoy.

This same competitive cooperation has been firing the economic engine of Europe for 50 years, when those first six countries took the historic step of uniting their economic fortunes. And there is other evidence throughout the world for the benefit of international openness. Like the U.S., Australia is also a tale of competition among member states; in addition, Australia had to reform once the U.K. joined the EU. The five wealthy countries of Eastern Asia — Taiwan, Singapore, Japan, South Korea and Hong Kong — were not so well off just a few decades ago, but their subsequent commitment to export markets and international competition put them on an upward trajectory that has improved the lives of millions of people.

And what of Latin America? Unfortunately, the region provides a case study in the perils of protectionism. Recent research by my Minneapolis Fed colleagues, Lee Ohanian and Jim Schmitz, and two co-authors, shows that from 1950 to 2001, per capita GDP for Europe increased 68% relative to the U.S.; Asia increased by 244%, while Latin America decreased by 21%. This is all the more striking when we realize that Latin America's per capita GDP actually exceeded Asia's by 75% in 1950.

The authors provide much evidence to support their claim that competitive barriers are to blame for Latin America's retarded growth. But there is hope. Microlevel examples of industries that have opened to foreign competition — the Chilean copper industry and Brazilian iron ore industry, for example — reveal that Latin American producers can match the high productivity levels of their Western counterparts.

Of course, many other factors account for marginal differences in productivity and wealth among countries that are already wealthy — tax rates being key among those factors — but they are comparative "frosting on the cake," and the cake in this case is the institutional commitment to international competition. The day when Latin American countries have joined the ranks of wealthy countries and are competing on the basis of marginal tax rates will be a happy day, indeed.

Protectionism is seductive, but countries that succumb to its allure will soon have their economic hearts broken. Conversely, countries that commit to competitive borders will ensure a brighter economic future for their citizens. This lesson should not be lost on the U.S., the paragon of competitive growth, where politicians and policy makers are contemplating whether to construct more protective barriers. It is openness that gives people the opportunity to use their entrepreneurial talents to create social surplus, rather than using those talents to protect what they already have (or to protect rents, as economists like to say). Social surplus begets a rising standard of living, which begets growth, which begets social surplus, and so on. Rent protection stops growth cold and keeps people poor.

People in all countries are motivated to improve their condition, and all countries have their share of talented risk-takers, but without the promise that a competitive system brings, that motivation and those talents will only lie dormant. The 50th anniversary of the Treaty of Rome is a good time to reflect on the benefits that competitive cooperation can bring to people. Here's hoping that more citizens of the world will reap similar benefits over the next 50 years and beyond. ■

Mr. Prescott is senior monetary adviser at the Federal Reserve Bank of Minneapolis and professor of economics at the W.P. Carey School of Business, Arizona State University. He is a winner of the 2004 Nobel Prize in Economics.