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The Undercover Economist

THE SUMMARY IN BRIEF

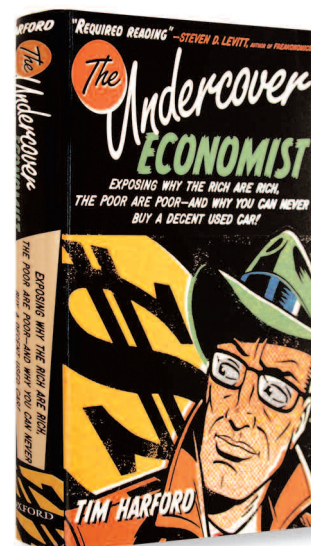
The Undercover Economist is an engaging guide to how economists view the world and the economic principles lurking behind daily events, explaining things from traffic jams to high coffee prices. Economist Tim Harford reveals the intricate economic games of negotiations, contests of strength and battles of wits that shape our day-to-day lives, often without our knowing it. He explores some of today's biggest controversies including, the gap between the rich and the poor, the high cost of health care and why some industries can have high profits for innocent reasons, while in other industries high profits are the result of sinister schemes.

Starting from a point familiar to us all, a \$2.55 cappuccino at Starbucks, the *Undercover Economist* uses detective work to discover the economic reasons behind Starbucks' prices. In the process, the principles of "strength from scarcity," perfect markets (and the World of Truth), globalization and the impact of immigration are all examined and explained.

In the end, economics is like engineering; it will tell you how things work and what is likely to happen if you change them. But dig deeper and it is about people and about the choices they make. Economic growth is about a better life for individuals — more choice, less fear, less toil and hardship. This is what makes understanding economic principles and concepts so important.

IN THIS SUMMARY, YOU WILL LEARN:

- Bargaining strength comes from scarcity.
- Strategies used to make us pay more.
- Why economic problems arise and how to patch them up.
- Economic decisions that have side effects on bystanders.
- The effect of missing information.
- Market failure vs. government failure.
- Using game theory to make decisions.



by Tim Harford

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THE COMPLETE SUMMARY: THE UNDERCOVER ECONOMIST

by Tim Harford

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Who Pays For Your Coffee?

The long commute on public transportation is a commonplace experience of life in major cities around the world, but whether in New York, Tokyo or Prague, it will look surprisingly familiar. Every morning, sleep-deprived travelers struggle to get through the human traffic and get to their desks just before their bosses. The one place many harried commuters will detour is a Starbucks, always conveniently located within yards of the exits of major subway stations around the world.

A Starbucks' coffee is hardly cheap at \$2.55 for a tall cappuccino but, like many people stopping at that café, no one cares to waste time trying to save a few pennies by searching out a cheaper coffee at 8:30 in the morning. There is a huge demand for the most convenient coffee possible and that makes the location of the coffee bar crucial.

The nice margin (the markup is estimated to be around 150 percent) that Starbucks makes is due neither to the quality of the coffee nor to its smiling staff: it's location, location, location. So why is nobody next door undercutting Starbucks? Other coffee bar chains are not eager to pay much for a space next to 10 other coffee bars, so the landlord gets the most advantage out of an exclusive agreement. There are an unlimited number of potential coffee bars and a limited number of attractive sites — and that means the landlords have the upper hand. The landlord who owns a single prime coffee-bar site should be able to dictate the terms and force one of them to pay rent which consumes almost all their expected profits. The successful company will expect some profit but not much.

Strength from Scarcity

The lessons of an economics book published in 1817 help explain not just the modern coffee bar, but much of the modern world itself. The author, David Ricardo, was an enthusiastic economist who longed to understand what had happened to Britain's economy during the then-recent Napoleonic wars. The price of wheat had rocketed and so had rents on agricultural land, and Ricardo wanted to know why.

The first lesson is that the person in possession of the desired resource — the landlord in this case — does not always have as much power as one would assume.

Bargaining strength comes through scarcity: When settlers are scarce and meadows are not, landlords have no bargaining power.

The second lesson that follows from that is if relative scarcity shifts from one person to another, bargaining shifts as well. If more farmers come to town and meadowland becomes scarce, suddenly the landlords have acquired real bargaining power. That means that the landlords will be able to raise their rents by an amount that allows the farmers to earn the same, farming on meadows and paying rent or farming on inferior scrubland rent free. If the difference in productivity of the two types of land is five bushels of grain a year, then the rent will also be five bushels a year. If the landlord charges more, the tenant farmer will leave to farm scrubland.

The simplicity of the coffee bar and farming stories emphasizes the underlying reality that sometimes relative scarcity and bargaining strength really do change quickly, and with profound effects on people's lives. We often complain about the symptoms — the high cost of buying a cup of coffee or a house; but the symptoms cannot



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be treated without understanding the patterns of scarcity that underlie them. It is the economist's job to shine a spotlight on the underlying process.

'Marginal' Land is of Central Importance

The shifts in bargaining power don't stop there. For example, if new farmers keep arriving, they will eventually cultivate not only the meadowland but also all the scrubland, and new farmers will settle for grassland, which is even less productive than scrubland. The rent on meadowland therefore, will always be equal to the difference in grain yield between meadowland and whatever land is available rent-free to new farmers. Economists call this other land "marginal" land because it is at the margin between being cultivated and not being cultivated (economists think about decisions at the margin a lot). It's important to note that there is no absolute value: everything is relative to that marginal land.

From Meadows Back to Coffee Kiosks

Ricardo's story illustrates that two things determine the rent on prime locations like meadowland: the difference in agricultural productivity between meadows and marginal land, and the importance of agricultural productivity itself. Meadows command high dollar rents only if the grain they help produce is also valuable. Applying this to coffee bar locations means landlords will command high rents only if customers will pay high prices for coffee. Rush-hour customers are so desperate for caffeine and in such a hurry that they are practically price-blind. For coffee bars, cheaper rent is no compensation for the loss of a flood of price-blind customers.

Portable Models

Nearly two hundred years ago, Ricardo produced insights that illuminate our understanding today. Economics is partly about modeling, about articulating basic principles and patterns that operate behind seemingly complex subjects like the rent on farms or coffee bars.

Ricardo's model is useful for discussing the relationship between scarcity and bargaining strength, which ultimately explains much of the world around us. If applied correctly, it shows that environmental legislation can dramatically affect income distribution. It explains why some industries naturally have high profits, while in other industries high profits are a sure sign of collusion. It even manages to explain why educated people object to immigration by other educated people, while the working classes complain about immigration by other unskilled workers.

Different Reasons for High Rent — Are We Being Ripped Off?

In Ricardo's terms there are two reasons why rents might be high: that good land is worth paying a high price because the grain it produces is valuable, and it's worth paying a lot for good land because the alternatives that should be available are not. Now the question becomes How can we tell the difference between things that are expensive because they are naturally scarce, and things that are expensive because of artificial means, such as legislation, regulation or foul play?

In the real world there are lots of reasons why potential new companies cannot enter a market and compete. Sometimes the consumers are to blame because they will deal only with established companies. More frequently, firms themselves lobby their governments asking to be protected from competition, and many governments grant monopoly licenses, or are highly restrictive of entry into "sensitive" industries like banking, farming or telecommunications. Whatever the reason, the effect is the same: Established companies, free of competition, enjoy high profits.

Landlords and executives are not the only people who like to avoid competition and who like to enjoy monopoly rents. Trade unions, lobby groups, people studying for a professional qualification and even national governments like them too. Economists call this type of behavior "creating rents" and "rent-seeking."

And Now for Something Controversial — Immigration

Immigration has always been an emotive issue for America. Well-educated workers with jobs requiring skill and training, along with businessmen in need of cheap labor, tend to welcome immigration as part of an enriching process. Poorly educated workers tend to reject any further immigration by unskilled immigrants on the grounds that "they steal our jobs." Who gets to enjoy the proceeds depends on whose abilities are scarce.

The facts support the application of Ricardo's theory to immigration. Skilled immigrants lower the wages of skilled natives and unskilled immigrants lower the wages of unskilled natives. In the UK, the salaries of nurses in the National Health Service have been kept low by the influx of 30,000 foreign nurses; immigrants in the UK are nearly 50 percent more likely than natives to have a university degree. In contrast, in the United States, which takes in a far higher percentage of low-skilled immigrants than the UK does, it is unskilled wages that have stayed low: The income of unskilled workers has not improved in 30 years. ●

What Supermarkets Don't Want You To Know

Any well-run business will seek to charge each customer the maximum price he'd be willing to pay — and they do. There is nothing Machiavellian about that. The problem for any company is to find ways to smoke out customers who are less sensitive about price. There are three common strategies for finding customers who are cavalier about price.

- “First degree price discrimination” or “unique target” is a strategy to evaluate each customer as an individual and charge according to how much he or she is willing to pay.
- “Group target” strategy offers different prices to members of distinct groups. It often seems reasonable because people in groups who pay more are usually people who can afford more.
- “Self-incrimination” strategy is to persuade some customers into confessing that they are not sensitive to price. To do this, a company has to sell products that are at least slightly different from each other, in different quantities, with different features or at different locations. Because the comparison is not exact, you never quite know whether the firm is using a price-targeting trick or merely passing on added costs.

Supermarkets have turned price-targeting into an art, using an automated process to “unique target” individual customers. For instance, supermarkets accumulate evidence of what you're willing to pay by giving you “discount cards,” which are needed to take advantage of sale prices. In return for getting a lower price, you allow the stores to keep records of what you buy, and then in turn offer you coupons for discounts on products.

When technology allows, firms with scarcity power may use highly sophisticated methods to target customers. It's no secret anymore that Internet retailers such as Amazon can identify each customer by putting a tracking device called a “cookie” on your computer. Each customer can have an identity tag, and price labels can change according to who was looking at them.

Of course, this “unique target” approach is unpopular. In Amazon's case, customers started to realize that if they deleted the cookies on their computers, they were offered different, often lower prices. There was an outcry against this and Amazon promised not to do it anymore.

When Price-Targeting is a Good Thing and When It is a Bad Thing

Whenever price-targeting fails to expand the number of sales and merely moves products from people who value them more to people who value them less, it will definitely be less efficient than a uniform price. An example would be HIV/AIDS drugs. If there is not an expansion in the number of sales, the drugs will be sold at a uniform high price to the people who value them the most (the rich), while the poor will not get the drug.

Whenever price-targeting opens up a new market without affecting the old market, it will definitely be more efficient than a uniform price. An example would be to expand HIV/AIDS drugs sales by supplying the drug to poor countries at a lesser price but continue sales at the higher price to the rich countries.

If the situation is such that a change could make at least one person better off, and nobody worse off, then the current situation is inefficient, or in everyday language, it could be better. If, on the other hand, the current situation is that every change that could make at least one person better off will also make somebody else worse off, then the current situation is efficient; it doesn't mean the situation can't be improved, it's just that there is no costless way to improve it. ●

Perfect Markets and the 'World of Truth'

There's a basic truth incorporated into any system of prices that comes from the fact that stores and consumers do not have to buy or sell at a given price — they can always opt out. In a free market, people don't buy things that are worth less to them than the asking price. The reason is simple: Nobody is forcing them to, which means that most transactions that happen in a free market improve efficiency, because they make both parties better off — or at least not worse off — and don't harm anyone else. This free choice produces information about a consumer's priorities and preferences, and when millions of consumers make choices, market prices aggregate the priorities and preferences of us all.

What is the result of a set of perfectly competitive markets interconnected like this?

- Companies are making things the right way.
- Companies are making the right things.
- Things are being made in the right proportions.
- Things are going to the right people.

Yet any modern democracy provides goods, like police

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service and schools, outside the market system. Nonmarket systems have their advantages (you wouldn't want to have to shop for a police force, for instance), but they also lose something important: information about wants, needs and desires, and about inconveniences and costs. Sometimes the loss of information is worthwhile because it is offset by gains in equality or stability. But sometimes the loss of information can leave an economy and a society floundering in waste and confusion. We need a way to make our economies both efficient and fair.

A young economist with a great desire for social justice named Kenneth Arrow came up with a Nobel Prize solution that proved that not only are all perfect markets efficient, all efficient outcomes can be achieved using a competitive market, by adjusting the starting position.

Arrow demonstrated that in a world of perfect markets, the only thing needed to ensure both fairness and efficiency is a "head start" strategy: a program of appropriate lump-sum taxes and subsidies that puts everyone on equal footing. The perfect markets then find every possible opportunity to make everybody better off from their revised starting points. The question is, can this be done in practice? ●

Crosstown Traffic

In any of the world's great cities, vehicles seriously damage the happiness of innocent bystanders. They cause severe air pollution and congestion. Because each driver who gets into his car is creating misery for other people, the free market cannot deliver a solution to the problem of traffic. Drivers do not offer compensation for the cost they inflict on other people.

What matters more for congestion is the price drivers pay at the margin; or, to put it another way, the price drivers pay to make one extra trip. Cars don't cause much pollution or congestion, after all: Car *trips* are the problem.

The idea of an externality charge (for inconvenience inflicted on bystanders) is not to discourage everyone from doing anything that might inconvenience anyone else; it is to get them to take into account the inconvenience they cause to others. It must reflect the cost of the externality — but no more.

Two Objections to Externality Charges

A charge for externalities is effectively a government tax, and thus controversial. The two objections are:

- The externality charge is an unfair tax aimed at a disadvantaged group.

- After the externality charge has been imposed, the rich will still be able to do whatever it was that was objectionable.

In answer to the charge that externality charges are unfairly redistributive: They are not aimed at poor people but at voluntary activities. If you decide to stop causing trouble for others, you don't have to pay. ●

The Inside Story

The United States system makes it voluntary to buy insurance, and premiums are linked to risk, not to income. These market-based principles are beloved by Americans. But a recent survey revealed that only 17 percent of respondents in the United States were content with their health-care system. The superficial reasons given were: The system is hugely expensive, very bureaucratic and extremely patchy. However, the same survey reports that only 25 percent of the British are happy with their system, a government-sponsored National Health Service, which offers health care to all citizens, and is almost completely free. This suggests that when market failure and government failure are both present, the choice is often between the lesser of two evils.

The overwhelming problem for the U.S. privatized, insurance-based system is that the insurance company tends to make a lot of choices, and it produces a "moral hazard" (compensation to people when bad things happen is apt to make them careless). It is a case where the markets work poorly because inside (imperfect) information eats away at the insurance by driving away low-risk customers and forcing premiums to rise. The overwhelming problem in a government provided system (British) is that the government makes the choices, and resources are rationed by political processes.

A better alternative is to have a market-based system without insurance where the patient makes the choices. Here the problem is that the patient also has to pay for unpredictable and potentially catastrophic health-care costs. What is needed is a solution that could fix health care without sacrificing the ability of patients to decide how much they value their own health.

Fixing Health Care with Keyhole Economics

Keyhole surgery techniques allow surgeons to operate without making large incisions. Economists often advocate a similar strategy when trying to fix a policy problem: Target the problem as closely as possible rather than attempting something more drastic.

Keyhole economics first identifies the specific market failures, which in this case fall into three categories, plus

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issues of fairness:

- Scarcity power
- Externalities
- Imperfect information.

The keyhole solutions would be:

- Some light-touch regulatory oversight to prevent the exploitation of scarcity power, coupled with focused subsidies to boost inoculation programs.
- Ensure widespread availability of information and give patients an opportunity to use this information (compel patients to pay for many of their costs, thus providing incentive to make informed choices, but leave the most severe costs to the government or insurance).
- Ensure fairness by tackling the general problem of poverty using redistributive taxes. ●

Rational Insanity

Economists work by studying rational behavior, but the more rational the behavior of stock-market investors, the more erratic the behavior of the stock market becomes. Here's why: Rational people would buy shares today if it was obvious that they would go up tomorrow, and sell them if it was obvious that they would fall. But that means that if investors really are rational, there won't be any predictable share movements at all. All the predictability would be sucked out of the stock market very quickly because all trends would be anticipated. The only thing that is left is unpredictable news. Mathematicians call the behavior "a random walk" — equally likely on any day to rise as to fall.

Shares are called shares because they give you a right to have a share in the profits of a real company. In the long run the share price has to reflect that. Economists can help work out what the fundamental value of the share is:

- If the price of the share is lower than the fundamental value, that tells you that the share is cheap and you should make money buying it.
- In the long run, share prices have to reflect the fundamental profits of companies.
- At the extreme, even if a good-value share stays undervalued forever, you should still make money holding it and pocketing the dividends.
- In the short-run, share prices should also reflect the fundamental prospects of the company.

Thinking Sensibly About Scarcity

Many Internet and technology fans argue that the

Internet is "transforming everything;" that we are in an economic revolution, and therefore shares should be very valuable. However, this premise is wrong. Share price should rise only if economic transformation increases the degree to which organizations control scarce resources.

For example, the gaggle of dot-com pretenders all had businesses that could have been duplicated at minimal cost in a matter of months, and it was that fact alone that should have made it clear that their shares were really worth next to nothing. It did not matter whether the economy was changing, because the economy will never change so much that companies with no scarcity power become highly profitable. ●

The Men Who Knew the Value of Nothing

Since the 1990s, governments across the world have been selling the rights (licenses) to use wavelengths of radio spectrum to telecom companies. With limited amounts of spectrum available (scarcity), there is money to be made. The problems the governments faced were:

- How to price the spectrum licenses to obtain the maximum amounts for the valuable public assets.
- How to ensure the licenses were sold to companies that would use them to deliver quality services at the lowest price.
- How to attract plenty of serious telecom bidders.
- How to accomplish the sale of licenses so as to maintain public confidence in the process (and not embarrass government officials).

Mathematician John von Neumann founded a system known as "game theory." A game, to a game theorist, is any activity in which your prediction of what another person will do affects what you decide to do. The game of poker could be analyzed using game theory, for example.

Using the mathematical model of game theory, economists argued that the allocation of public assets, from the right to drill oil to the right to use radio spectrum, ought to be determined by auction. The auction forces each bidder to tell the truth about his own estimate of the license's value. At the same time, the auction broadcasts the collective view to all the bidders, so they can update their own opinions accordingly.

In the early years, government auctions produced spectacular disasters like New Zealand's auction of radio spectrum in 1990, which was perceived to have sold public assets too cheaply. But with each auction, the process was improved. In the spring of 2000, the

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world watched as the United Kingdom's auction of five spectrum licenses resulted in a highly competitive and successful auction that raised £22.5 billion for the government, and became the biggest auction in modern history.

Critics of the auction argued that:

- Because the telecoms had paid so much for the licenses, they would charge consumers very high prices.
- The telecom industry was crippled by the government's charging such outrageous sums for the licenses.

In response to the first point, economists point out that any firm will charge customers more if their expenses are high; however, their ability to do this is limited by their scarcity power. Consumers do not have to purchase services from telecoms.

In response to the second criticism, it is noted that the most seriously afflicted telecom firms did not win a license — they are mostly U.S. firms who did not participate in the auction or troubled cable companies who withdrew from the auction without spending anything. The license winners, such as Vodafone, remain successful firms. ●

Why Poor Countries Are Poor

Economists used to think that the economic wealth of a country came from a combination of man-made resources, human resources and technological resources. Obviously, then, poor countries grew into rich countries by investing money in physical resources and by improving human and technological resources with education and technology transfer programs. Rich countries don't gain much from further investment: This is called "diminishing returns." For instance, a few roads in a poor country can open up whole new areas for trade; in a rich country, a few more roads just relieve a little congestion. So the theory was that the poorer countries, with investments in infrastructure and education should catch up quickly.

However, it became evident something was not right. Many poor countries are not growing faster than rich ones; in fact, they are growing more slowly or getting poorer.

Over the past 10 years or so, economists working on development issues have converged on the theory that "institutions matter." Government banditry, widespread waste and oppressive regulations designed to make it eas-

ier to extract bribes: All are elements of what are dysfunctional institutions that are a key explanation of poverty in developing countries.

Many poor countries with dysfunctional institutions create a topsy-turvy world in which it's in most people's interest to take action that directly or indirectly damages everyone else. The incentives to create wealth in any way at all are turned on their heads. The rot starts with government but it afflicts the entire society.

Is There a Chance for Development?

These problems cannot be fixed overnight. But there are some simple reforms, which — with a modicum of political will — would move poor countries in the right direction:

- Cut red tape by allowing small businesses to be legally established.
- Legal reforms are necessary; even a single minister with his head and heart in the right place can make a difference.
- Enlist the world economy for help — a small country cannot survive without the world economy. ●

Globalization

The most visible manifestation of the world's increasing economic interdependence is the availability of foreign products in familiar settings. It is both a blessing and a curse: A blessing because it becomes possible to enjoy a wider variety of treats in the place where you were born. It is a curse because you find that foreign places look a little too familiar.

However, economic and cultural integration will take a long time. Furthermore, new ideas and new technologies are always arriving.

Globalization will never homogenize what we have, not while new ideas are always appearing and adding fresh ingredients to the slowly turning blender of economic integration. Those who fear a terrible global sameness must remember that new ideas, welcome or unwelcome, will always arise faster than they can be mixed in.

Contrary to popular belief, it is simply not possible for trade to destroy all of our jobs and for us to import everything from abroad and export nothing. If we did, we would have nothing to buy the imports with. For there to be trade at all, somebody in America must be making something to sell to the outside world. The same is true for every country.

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Globalization is Green

The link between trade and environmental damage does not stand up to close scrutiny. The facts are:

- Foreign investment in rich countries is far more likely to go into polluting industries than foreign investment in poor countries.
- Foreign investment in polluting industries is the fastest growing segment of foreign investment coming into the United States while foreign investment in clean industries is the fastest growing segment of American investments abroad.
- An indicator of the environmental performance of foreign investment in poor countries, as measured in air pollution data, shows that as foreign investment improves the economy, urban air pollution is reduced. ●

How China Grew Rich

For most of the twentieth century, China was a poor country. In 1949, when the People's Republic of China came into being, the world's largest country was torn by civil war and ruled by a communist dictatorship. In the late 1950s, millions of people died in a famine induced by the failed policies of the government. In the 1960s, the university system was destroyed by the Cultural Revolution, when millions of educated citizens were forcibly relocated to work in the countryside. After all this, how did China become the greatest economic success story in history?

In 1976, after many crimes against his own people, Chairman Mao died. Just five years later, the change in China's economy was incredible. Agricultural output for example, had grown by 40 percent. Why? Because Mao's successor, Deng Xiaoping and his allies, brought the "world of truth" into Chinese agriculture.

Partly by accident, partly by benign neglect and partly by design, Deng introduced reforms that liberated agriculture. Those who had good ideas, good luck and who worked hard, prospered. Bad ideas were quickly abandoned. Good ones spread rapidly. Farmers grew more cash crops and devoted less effort to crops that were difficult to grow; all of this was the unsurprising result of introducing a price system. China had begun to travel along the so-called capitalist road.

Where successful agricultural reforms had paved the way, more complex and far-reaching reforms of the whole economy were to follow. Fifteen years after Deng

came to power, returns on investment had quadrupled. How was this achieved?

Growing Out of the Plan — Entry and Scarcity Power

The Chinese reformers needed to encourage entry and limit scarcity without resorting to a dangerously unpredictable strategy of rapid liberalization. They took steps to improve the performances of the state sector, introduce new public sector companies as competitors, gradually foster a private sector and slowly open up to international competition.

The Chinese economic miracle was not really about privatization. What mattered was not who owned the companies, but that the companies were forced to compete in a relatively free market, driving down scarcity power and bringing in the information and incentives of the world of truth.

The effect of all this was to reduce waste, give Chinese customers better return for their money and make China a potential player on world markets. Scarcity power disappeared.

China and the World

Foreign investment has been a major factor in keeping China's reforms on track. Not only did foreign firms bring capital, and expertise and connections to the world economy, they also continued the competitive process by competing with China's domestic firms, driving them toward improved efficiency.

Does the Economy Matter?

China is not rich — yet. But it is heading in that direction fast. With economic growth comes tremendous upheaval; it is not easy to be part of a revolution. Chinese people are confused; many are unemployed or dislocated from today's modern China, and migration has torn families apart.

Conditions in factories are terrible. Employees are badly paid and work long shifts under dubious safety conditions.

In spite of this, economists like Paul Krugman, Martin Wolf and Jagdish Bhagwati have repeatedly argued that Chinese sweatshops are better than the horrors that came before them, and a step on the road to something better.

In the end, economics is about people. And economic growth is about a better life for individuals — more choice, less fear, less toil and less hardship. ●