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Roots of Prosperity

by R. Glenn Hubbard and William Duggan

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The lessons of history suggest that if we want to reduce poverty in emerging markets, regulation reform and business success are prerequisites, not outcomes.

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In the history of economic success, no two countries have ever followed identical paths. But there is a universal pattern nonetheless: Nations rise out of poverty when elements of a thriving business sector replace the previous economic system.

The factors necessary for this transition are known. Since 2004, the World Bank has tracked them each year in countries around the world for its *Doing Business* report. (The most recent version is *Doing Business 2010: Reforming through Difficult Times,* by the World Bank and the International Finance Corporation [Palgrave Macmillan, 2010].) The report specifies 10 forms of government regulation that affect the various phases of a company's life cycle: starting a business, obtaining licenses (such as construction permits), employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business. The fewer impediments that government places before entrepreneurs in any of these areas, and the less time it takes (for example, to stand in line) and the less money is required (for fees or bribes), the more business-friendly the country is — and the more prosperous.

To be sure, as scientific measurements of the likelihood of economic growth, these elements are not perfect. Greece ranks only 109th, but its economy is helped by its membership in the European Union, its location (which makes it a hub of Mediterranean trade), and its huge informal sector of robust businesses operating outside regulation. As a whole, however, the *Doing Business* list offers a reliable scale for judging which countries have paved the way for their private sector to thrive.

Illustration by Guy Billout

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In 2009, Singapore ranked first out of 181 countries on the list. It was followed by New Zealand, Hong Kong (China), the U.S., and the United Kingdom. The Central African Republic ranked last, with the Democratic Republic of the Congo (Kinshasa), Guinea-Bissau, São Tomé and Principe, and the Republic of the Congo (Brazzaville) rounding out the bottom of the list.

But if the benefits of being friendly to business are so clear, why hasn't every country jumped on the bandwagon and adopted consistent and light regulations in these areas? The answer provides a critical insight into the struggles of poor economies today. Countries often have a competing system — either a powerful and arbitrary government or an entrenched oligarchy, or both — that resists the adoption of pro-business elements. And in countries that have remained poor, that competing system is still winning.

Friends, Romans, Businessmen

The same pattern is evident as far back as the dawn of recorded history. Starting around 2500 B.C. in Mesopotamia (where Iraq is today), archaeologists have found written evidence of private business: in records of loans between individuals, government advances to citizens for tax payments, and financing to merchants for trade. As the Phoenicians, Greeks, Persians, and Romans adopted these activities, thousands of trading cities and towns sprang up. Archaeologists have uncovered in these locations an abundance of pottery, metal implements, mosaics, and sculptures, and many workshops for the numerous craft shops that sold their goods near and far. These represent the first glimmers of mass prosperity; large numbers of people had enough income and wealth for a decent life.

These commercial centers held only a small fraction of the world's total population, however. For most of the world beyond them, life was hard and short. Literacy remained low, disease took a heavy toll, and war and pillage destroyed commerce again and again over the centuries. It was only in the first and second centuries A.D. that the Roman Empire managed to preserve peace long enough for prosperity to spread to a larger population, through the rapid growth of thousands of commercial centers with their nearby farmlands. Unfortunately, war disrupted this golden age of Roman business starting around 200 A.D. In the fifth century, the Roman Empire fell.

During its two peaceful centuries, the empire maintained a comparatively high level of business-friendly elements. For example, starting a business was apparently easy. Anyone, including women, non-Romans, and slaves, could open one without restriction. (In practice, of course, it was far easier for free Roman men to open a business than for anyone else; the mainstream leaders favored one another, just as they often do today.)

Licensing was also relatively business-friendly. Romans could make, buy, or sell anything without a license. There was only one major exception: government monopolies. The empire operated its own mines for salt, metal, and marble; bought and distributed grain; and produced uniforms, weapons, and other supplies for its army.

Finding workers was relatively easy, owing to the ancient evil of slavery (which long predated the Roman business system). Instead of paying wages, many businesses bought slaves, who came in a steady stream from regions that the Roman army conquered. As Roman businesses grew, however, they depended less on slaves

For its two most peaceful centuries, the legal and government systems of the Roman Empire helped ordinary business spread easily through the empire.

and more on hired employees. There were no restrictions against businesses hiring and firing ordinary wage workers, or against workers taking jobs and quitting them. We can even recognize a modern business manager in the Roman *institore,* who ran an enterprise for the absentee owner.

Registering property was also easy. Thanks to Rome's advanced legal system, written laws allowed individuals to own and sell property of all kinds, and protected those rights. Leaving aside the immorality of slavery, this was good for business.

Rome's legal system enabled credit, allowing loans with interest as a form of contract. The volume of loans stayed small, because the old Roman ruling class was made up of feudal lords and government officials whose wealth came from land, olive groves, cattle, slaves, and taxes. They looked down on business as a lowly occupation, and few of them invested their riches in banks. With no big banks to borrow from, the government paid for its expenses by raising taxes. As centuries of peace gave way to centuries of war, large armies led to higher taxes, crippling the business sector. This was one of the reasons Rome finally fell.

Although Rome had no corporate form that would protect investors by allowing them to pool money in common enterprises, one kind of business came close: a "society" that collected taxes for the government. This made for a predictable, stable investment. Romans bought and sold shares in the societies, and Roman law protected these sales as contracts.

Paying taxes was no special burden for business, except during wars. A business owner paid one annual tax of 1 to 3 percent on property and wealth. For comparison: In the Central African Republic in 2010, a company would have to make 54 payments each year, using 63 workdays for paperwork and waiting in line, to pay taxes that could be twice its profits.

From Britain to Syria, the Roman Empire had no borders, and thus no customs duties to pay. Importers and exporters paid duties of only about 5 percent, which is very low by any standard, ancient or modern. And paying the duty took a few hours at most. In many sub-Saharan African nations today, it takes 35 days or more to ship goods across a border, thanks to all the paperwork and fee paying.

Contracts were the pride of the Roman legal system. Whether written or oral, they were easy to create and enforce, with witnesses who could testify in court. Judicial corruption was an ongoing problem, but at least during the two most peaceful centuries, the courts aided rather than preyed on the ordinary flow of daily business. Unfortunately, the rules governing business closures were not as benign. They treated bankrupt businesses as unpaid debts under contract law. The court let creditors seize the property of debtors or force them into slavery if they failed to pay. These rules worked against business, because they did not allow entrepreneurs to recover from failure and try again.

Though the Roman Empire was far from perfect by modern standards, it would probably have achieved a fairly high score according to the World Bank's *Doing Business* criteria. The presence of slavery, the absence of true corporations, and the seizure of property would have brought the score down, but the legal and government systems helped ordinary business spread easily throughout the empire. And spread it did: Potters and glassmakers, grain and wine merchants, tailors, butchers, carpentry and metal workshop owners, bakers,

dealers in pressed oil, linen and wool weavers, sellers of hides and fish, lamp makers, jewelers, ivory and ebony traders, and dozens of other entrepreneurs helped businesses spring up in the thousands of trading cities and towns that thrived wherever the Roman army kept the peace. The greatest volume of trade took place within and between the Roman provinces, back and forth across the expanding empire. The government built roads and ports where needed, first for its conquering army and then for the commerce that followed.

The Feudal Backlash

After 500 A.D., as the Roman Empire fell to wave after wave of tribal armies, its business towns died out. Other empires rose: the Byzantine, Arab, and Holy Roman empires in the West, and the various dynasties of China in the East. All of these were either despotic (enforcing absolute rule through a central army funded with taxes and plunder) or feudal (organized like a confederacy, with regional leaders supplying armies and taxation). Business suffered greatly in these systems — partly because of constant warfare and partly because the feudal model, as developed by Charlemagne, was inherently bad for business (when judged by the *Doing Business* criteria). Goods and money flowed up through the pyramid as taxes from a peasant's field, to a lord, to a prince, to the king. At every level the Catholic Church oversaw the flow, took a cut, and enforced policies that helped suppress business activity. That church oversight, in fact, is what made the empire "holy."

The most important antibusiness policy of the western European feudal empires was a religious ban on lending money with interest. This effectively banned all Catholics from the business sector, which greatly reduced its overall size and crippled it to the core. Similarly, the despotic rulers of China, Egypt, and the Ottoman Empire supplemented military rule with paid officials who kept tight control over economic life. China became more pro-business under the Tang Dynasty, starting in the seventh century A.D., as the Silk Road to the Arab, Byzantine, and European empires brought business to its doorstep. But the Tang fell to another dynasty in 907 A.D., and the bureaucracy took over again.

Historian Angus Maddison has described the outcome of this latter shift in his book *Chinese Economic Performance in the Long Run* (OECD Development Center, 1998). In China, he wrote:

> larger undertakings were limited to the state or to publicly licensed monopolies. Potentially profitable activity in opening up world trade by exploiting China's sophisticated shipbuilding and navigational knowledge was simply forbidden. It was a similar story in India.… Europe's feudal bureaucracy tried just as hard as China's and India's to suppress the business sector. But they failed. So [Europe] was where the business sector took off, centuries after Rome fell.

Compared to business in China and India, business did flourish in Southeast Asia, where fertile river valleys combined with good ports and trade routes, beyond the direct control of the Chinese and Indian empires. Yet when kingdoms grew in these regions, they took those empires as models, including their antibusiness policies.

And it is the same story today in the impoverished countries of the world. In both tribal and feudal systems, there is an implicit assumption that the more government jobs exist, the better things are for people. In Mozambique, it takes 10 steps to start a business. That means an entrepreneur must go to 10 different government offices to fill out forms. This system provides jobs to 10 Mozambicans behind the desks. They get their small salary plus the bribes given to them in exchange for their stamps on a document. Only when entrepreneurs have these 10 stamps can they run a business without the police shutting them down.

Local corruption merges nicely with national socialism and despotism. In Bolivia, for example, the elected president, Evo Morales, installed socialism in 2006; he nationalized the main industries of natural gas and mineral processing. That created more government jobs, with much more money passing through the hands of

whoever got those jobs. But it was bad for business overall, and therefore bad for the country's prosperity. Equally bad for business has been the situation in Myanmar (Burma), where army despots keep business at bay with an iron fist. They know that as soon as they open up, Chinese traders will return. And who knows what balance of power will result from that?

History shows that the best check on despotism is a thriving business class. This often means democracy, but not always. As of 1890, the British cabinet still looked a lot like the House of Lords, and Queen Victoria was still the official head of government. Yet the business class had won enough freedom and rights to operate without harm or fear. No one knows if China will become a democracy, but already we see that the new business class is the only effective check on government power.

The Pro-business Long Wave

How, then, can the poorest countries of the world create a business class large enough to enable them to escape their problems? Here, too, we can look to the experience of Europe for answers. Europe's feudal bureaucracy may have tried hard to suppress the business sector, as Maddison suggests, but in the end it failed — in part because Europe's rivers and mountain borders made the whole continent more difficult to manage centrally.

The new European commercial system started in the 1100s in Venice, just beyond the borders of the Arab Empire to the south, the Byzantine Empire to the east, and the Holy Roman Empire to the north. Venice traded with all three. The merchants of this city-state essentially reconstructed the Roman business system, with improvements. Early Venice had innovated the "fraternity," in which brothers kept their family business together after the death of the father. In the 1100s this evolved into a "company," in which nonfamily could join in too. The company came together under contract to take on specific activities for a specific time, usually a trading voyage by a single ship, with a specific return for each member. The partners then renewed the contract for the next voyage, changing as needed the list of contributors, but keeping decision-making control, while outsiders just put in money. That outsider contribution was essentially an interest-bearing deposit, much like a modern bond.

The key to the new Venetian system was the dominant role that these companies played. The business owners elected a Great Assembly, a Senate, and a doge as chief official. There was no hereditary king, no role for the church, and no ban on Christians charging interest. Pawnbrokers, deposit banks, and merchant banks gave loans large and small to individuals and companies. Low taxes on a large volume of trade paid for a strong army and navy to protect the system from marauding pirates, tribes, kingdoms, and empires.

As the Venetian system spread up the fertile Po Valley and across northern Italy, it began to look like the business sector we know today. Large numbers of ordinary people prospered as never before. The cities and towns — from Venice in the east to Turin in the west — were centers of craft and commerce, and in the countryside between, feudal lords and independent farmers sold crops, livestock, and land. Those lords began to invest in banks and factories in the towns. By the end of the 15th century, the Venetian business system dominated all of northern Italy. Three features of the Venetian system were still thoroughly unmodern: slavery, the exclusion of women from business life, and religious discrimination. These would not end for several hundred more years. But for the first time in history, business centers and their surrounding farmland were no longer islands of prosperity in a sea of larger despotic empires.

The new merchants of northern Italy traded east along the Silk Road as far as China. Marco Polo was one of them. In the West, Italian merchants reached Greenland and traveled throughout Europe as far as the North Sea. Everywhere they went they brought their business practices. Northern Italy finally fell to the feudal empires of Spain and France around 1500, but the seeds of the Venetian system had already been spread.

The Rhine became the greatest European trading river, because it led from a vast fertile hinterland to a major free trading city on the sea, Amsterdam. All of Holland threw itself into some kind of business. In the countryside, the Dutch grew crops for sale. In the towns, they worked in crafts or commerce, shipping goods up and down the Rhine and everywhere else Dutch ships sailed. For example, the farmers around the town of Oudewater specialized in growing hemp, and the town made it into rope. Each sailing ship needed about 10 miles of rope. The town workshops also used hemp to make clothes, paint, oil, and soap. The hemp business alone employed thousands of Dutch farmers and workers. Leiden specialized in wool cloth, which employed even more workers than hemp. Delft made fine pottery. The countryside around Gouda and Edam produced cheeses. The financing, transport, local sale, and export of these products created more jobs. Add to

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those the imports from overseas trade, such as spices, tea, coffee, and Asian cotton. With no competing system such as feudalism, everyone in Holland worked in business, and its general population rose out of poverty.

In 1602, the Dutch East India Company thus became the world's first company financed completely by public shares. Seven years later it declared its shares nonrefundable. If a shareholder wanted out, those shares had to be sold to someone else. And so was born, in 1609, the first modern corporation. The buying and selling of shares made Amsterdam the first true stock exchange in the world.

The Dutch system spread quickly to England; London became a smaller version of Amsterdam. But the English stock exchange took another century to develop, because England's feudal system fought back far more fiercely than Holland's had. The business-friendly system continued to spread, most notably to the colonies of America — especially New York, founded by the Dutch in 1624 and taken by the English in 1674. These colonies eventually won their independence from the more feudal-minded English king. Their victory in 1781 helped inspire the French Revolution eight years later, and then the other monarchies of Europe fell one by one, first to Napoleon and then to what historians call the "bourgeois revolution," when the business class replaced feudal aristocrats across Europe. In the 19th century, this business culture became the source of the Industrial Revolution and the resulting increases in wealth and power in Europe and North America.

Fostering a Business-friendly Climate

Emerging nations that want to create economic growth have to do what others have done before them — put in place the elements on the *Doing Business* list, and deliberately create a more business-friendly climate. Some countries are doing just that. Most notably China and India, but also Rwanda, the Kyrgyz Republic, Macedonia, Belarus, the United Arab Emirates, Moldova, Colombia, Tajikistan, Egypt, Liberia, Georgia, and Mauritius, among others, are putting in place the necessary reforms. According to *Doing Business 2010,* initial studies indicate positive results: more registered businesses, increased employment, and falling prices, thanks to competition from new entrants.

Although the 10 criteria listed by *Doing Business* provide a road map for governments, governments alone cannot be effective in creating a healthy climate for business. In many cases, they will move slowly; other parties will naturally be impatient to act. For private citizens, there is a clear path. If you have enough education, wealth, skills, or opportunities to make a difference at home, look first toward joining or assisting your local business sector. Promote pro-business policies for your government. Go to your local business school; if your local business sector is so crippled that you find no opportunity there, work for a foreign business in your country or elsewhere. Do whatever you can to equip yourself to help your local business sector when the tide shifts.

If you are a private citizen who wants to help end poverty, find a pro-business project to help. Good places to start are the websites Businessfightspoverty.org and Businessactionforafrica.org. If you're interested especially in businesses that aim to help the poor in emerging countries, start with the online clearinghouse Nextbillion.net, a joint project of the World Resources Institute and the Acumen Fund.

As for leaders and managers of foreign companies, or donors seeking to improve conditions, the key is to make sure that charity money goes only for refugee, medical, or emergency relief. For economic development, support the business sector. For example, Barclays PLC boasts that it supports 700 community groups in 26 countries. Why not cut that figure in half, and support local business with the other half? Founded in 1690, Barclays was one of the earliest firms fostering a healthy business sector in the United Kingdom. It can help do the same in other countries.

Microfinance, training, and business loans are simple ways to start helping local business. The aim is for companies to contract to new local businesses what in more-developed countries they don't do themselves, such as transport, banking, supply, distribution, and other services. For example, if you are a manager, you might need to help develop and support a local construction or real estate business to help you build and maintain employee housing. It is especially valuable to promote local social enterprises, such as the recent partnership between the Grameen Bank and yogurt maker Danone to create a nonprofit in Bangladesh. (See "Not Just for Profit," by Marjorie Kelly, *s+b,* Spring 2009.)

We see a special role for business schools and their students in poor countries of the world. During the past two decades, the number of business schools in China has grown from zero to more than 100; India now has more than 1,000. All poor countries need competent business schools that support their local business sectors with dedicated research and trained graduates. Local alumni networks become pro-business associations. And local schools offer research and seminars that help a country reform and begin to move up the *Doing Business* list. These business schools can also profit from partnership projects with business schools in rich countries, as long as the project helps promote a strong relationship with the local business sector as well.

Business school students in rich countries can help. Social enterprise is booming among most major business schools; it's common to find that a quarter of all business students are members of social enterprise clubs. The international club Net Impact has hundreds of chapters; it sponsors field projects where business students travel to work for social enterprises. That alone is worthwhile, and it is not much of a stretch to expand to include small businesses in poor countries. If pro-business aid ever takes off, MBA graduates from rich countries will probably be such aid's foot soldiers, in the same way that an earlier generation went overseas on government and nongovernmental organization projects to help "save the world." And the local business school graduates in poor countries will lead the way in building their own thriving business sectors.

And as for domestic companies in poor countries, they're already doing what they need to do: staying in business. That is the single most important step in building the kind of climate that leads to prosperity. The easier it is for companies to stay in business, the more rapidly prosperity will appear. ✚

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Resources

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