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Personal Wealth Management

GHP Global Markets

The Law Deficit

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In 1990 the Nobel Prize winning economist Robert Lucas wrote a paper entitled “Why Doesn’t Capital Flow from Rich to Poor Countries?”. Lucas noted that investment returns are lower in developed countries with a large amount of capital per worker relative to poor countries where capital is scarce. Economic theory would suggest that, in this situation, capital should flow from wealthier countries to poorer countries with higher potential investment returns. Instead, Lucas observed, the opposite was true.

Studies continue to document this “Lucas Paradox.” A comprehensive study by Global Financial Integrity estimated that developing countries received $1.3 trillion in capital inflows in 2012 (the last year of their data) from investment, foreign income and aid, but $3.3 trillion flowed out, mostly due to capital flight. The study estimated developing countries lost a net $16.3 trillion from capital outflow between 1980 and 2012.

Although some of the capital outflow from developing countries was attributable to debt payments and global business expansion, the study estimates that $13.4 trillion was the result of capital flight. For example, when wealthy Chinese, Mexican, Brazilian, Russian or Egyptian businesspeople wonder whether their assets and families are completely secure in their native countries, they hedge their bets by purchasing homes in Vancouver or New York. They send some of their children to American universities, set up businesses in the United States, invest in U.S. shopping centers or office buildings, and apply for Green Cards. This is capital flight.

Poor Countries Subsidize Rich Countries

The capital inflow from developing countries is essentially a subsidy for developed countries like the United States. In effect, we rent our superior legal certainty and macroeconomic stability to people living in countries that lack these services. Capital in the United States is less expensive than it would be if the rest of the world implemented effective legal systems and macroeconomic policies. Unfortunately, the value of these services is not captured in global trade statistics. The flip side of large capital inflows into the United States is the deficit we record in our trade balance.

Since foreigners view the United States as a safe haven for investment, our ability to inexpensively finance imports far exceeds the ability of our developing country trading partners to do likewise. While many people believe our trade deficit is a sign of economic weakness, it is more likely a sign of our strength. By protecting property rights and equitably enforcing contracts, we provide considerable value to a world where these services are in short supply.

American companies face a host of barriers in foreign markets. Some trade barriers specifically impede imports from American and other non-domestic companies, but the most pernicious barriers often hinder domestic companies in equal measure. The rule of law is not the norm in most countries. Where the rule of law does not exist, or exists in attenuated form, free trade does not exist either. Our trade deficit is the mirror image of this global law deficit.

In many societies around the world, the legal system is biased, constrained, corrupt, inefficient or weak. Typically access to government enforcement powers is limited to narrow elites of privileged individuals or companies. Most citizens cannot rely on the courts to enforce their property rights or contracts. Therefore, the groups with privileged access to the legal system are better able to take advantage of business opportunities.

Trade Barriers Exist, but are Complicated

Selective legal enforcement is the primary trade barrier throughout the developing world. Even in the case where all citizens have formal legal rights, corruption or inefficiency often prevent de facto enforcement of their rights. Monopolies and oligopolies that stifle foreign and domestic business competition are pervasive in countries lacking effective legal systems. These monopolists are free to compete in the United States because our concept of equality under the law protect them. In contrast American companies, like most citizens in the developing world, go up against companies with privileged access to the law.

Take China as an example. American companies find it difficult to compete in China, but so do most Chinese companies. Success, particularly big success, requires political power and connections rather than superior goods or services. Chinese retailers can lean on their political networks to secure land rights from local governments or low-cost capital from state-owned banks. Foreign companies usually lack these connections, but so do most Chinese. If Chinese businesspeople who are not members of the Communist Party try to organize a bank, will the courts enforce their collateral rights? What if they are members but not senior leaders? American and other non-domestic financiers face the same dilemma.

Capital Flight Exists because Developing Countries have Weak Financial Systems

Ineffective rule of law impacts developing countries in a myriad of ways. Financial products such as insurance, credit cards, mortgages, automobile loans, accounts receivable, leasing, bonds and stocks are in chronic short supply. These products are merely legal contracts. If the legal system cannot be trusted or is only available to a fraction of well-connected companies, financial products will not proliferate. Without adequate life or disability insurance, for example, families must save money for potential emergencies. Without credit cards or other forms of consumer credit, families must hoard cash for large purchases. Without appropriate financial products, consumption is low and savings are high.

Using China as an example once again, pundits favorably comparing the high Chinese savings rate relative to our much lower rate are grievously missing the point. Savings are high because the financial system is weak. The financial system is weak because the legal system is weak. Finding ways to invest savings is a major problem in China. Beyond individuals and households, insurance companies, for example, cannot underwrite enough policies because the bond market is too small to invest the premiums collected. As a result, Chinese insurance companies buy companies, hotels and office buildings in the U.S. and other developed countries.

Without the Rule of Law China Will Never Become Rich

The capital flowing out of China and other developing countries is seeking a safe harbor. We use the capital they export to import their products, but also to inexpensively finance consumer credit, government debt and business expansion. Jobs directly competitive with imports are indeed lost, but the payoff from cheaper capital and products is much greater. Meanwhile China will never become as rich on a per capita basis as we are in the developed world so long as its legal system impedes business competition and financial development.

Tariffs are the Wrong Way to Go

Foreign companies can more freely compete in America than vice versa. Our laws protect their property rights and contracts as if they were American citizens. The same cannot be said for the laws in China, Brazil, Russia or a host of other countries around the world. The rule of law separates rich countries from poor countries. That is why monitoring changes in the rule of law is crucial to our international investment approach.

Although China’s economy started from nothing and grew quickly, it will most certainly hit a wall at some point if the Chinese do not transition toward the rule of law. While negotiations to reduce foreign trade barriers are certainly important, erecting our own trade barriers is counterproductive. Even with higher tariffs, our trade deficit will likely persist so long as the global law deficit persists.