Dr. Alan Greenspan – “Markets and the Judiciary”
Sandra Day O’Connor Project Conference, October 2, 2008

Thank you, President DeGioia. I am most delighted to participate in this Sandra Day O’Connor Project Conference. During a week like this, we realize just how much we miss someone with Justice O’Connor’s talents in public life—particularly her ability to work out compromises on difficult issues. It's also a time when we realize that the branch of government she once served seems to be the only one that's still functioning.

It's safe to say that Justice O'Connor's record of public service tells us who *she* is, and we commend her for the Western common sense she brought to her career at the Supreme Court. We wish only there was more of it.

This is especially the case since we are living through the type of wrenching financial crisis that comes along only once in a century. Financial markets freeze up, as an excess of fear displaces a protracted period of what some might call irrational exuberance. Eventually, the market freeze will thaw as frightened investors take tentative steps towards reengagement with risk. Broken market ties among banks, pension, and hedge funds and all types of nonfinancial businesses will become reestablished and our complex economy that has the capacity to produce a fifth of the world’s goods and services will reemerge.

When asked how the U.S. economy in little more than a century achieved the highest standard of living in the world, outpacing all others and then sustaining that lead for another century, my response has always been: it’s the Constitution of the United States.

Critical to economic growth is a rule of law, particularly protection of the rights of individuals and property. While it is true that over the decades the vast majority of investors have come to our shores to participate in a vibrant, open economy, a remarkably large number have simply viewed the United States as a safe haven for their savings that was not available in their home country. Our Constitution accords the rights of U.S. citizens to those who invest here under U.S. law. Short of a few ambiguous incidents, I can think of no circumstances where an expanded rule of law and enhanced property rights have failed to increase material prosperity.

It has been startling over the years to see what even a little private ownership will do. When three decades ago China granted highly diluted rights of ownership to the rural residents who tilled vast communal-owned agricultural plots, yield per acre and rural standards of living rose significantly. And it was an embarrassing stain on the Soviet Union’s central planning that a very substantial percentage of its crops came from “privately owned” plots that covered only a small fraction of tilled land.

As living requires physical property—food, clothing, homes—people need the legal protection to own and dispose of such property without the threat of arbitrary confiscation by the state or mobs in the street. To be sure, people have to, and do survive, in totalitarian, centrally planned societies where individual property rights are *de minimis*. But theirs is a lesser existence.

The ability to own and dispose of property under a rule of law a notion spawned by the 18th century’s Enlightenment spread through Europe and North America. It produced new ways to organize society’s pursuit of the industrial means required for people to survive and hopefully prosper. Prior to the Enlightenment, people could barely improve upon their short and miserable lives. Indeed for generation after generation, people tilled the same plots of land. Material progress was marginal at best. Global life expectancy was 25 years, unchanged for a millennium.

Since the early 18th century, however, the force of the rule of law has fostered standards of living that rose by 20 times in that part of the world that embraced competitive markets. Life expectancy more than doubled. And in the developing countries that have abandoned central planning for markets since the end of the Cold War, hundreds of millions of people have been elevated from subsistence poverty. Other hundreds of millions are now experiencing a level of affluence that people born in developed nations have experienced all their lives.

Regrettably, the notion of rights of ownership of capital and other income-earning assets remains conflicted, especially in societies that still believe that profit seeking is not quite moral. A key purpose of property rights, after all, is to protect assets in order to use them to profit or personally benefit. Such rights are not supportable in a society that holds any significant remnant of the view of property as "theft." That notion embraced by Karl Marx rests on the presumption that gained wide acceptance in the first half of the twentieth century that wealth created under a division of labor is produced jointly, and hence should be owned collectively. Any rights inhering in an individual, therefore, must be "stolen" from society as a whole. Classical economists led by Adam Smith, a prominent figure of the Enlightenment, in contrast, developed the notion of the marginal contribution of each individual to the production process as the basis of his or her incomes. Implicitly, Smith's followers argued that Marx's view was inconsistent with human nature and therefore could not explain economic development. Marx did recognize that acquisitive human nature was not compatible with a collectivized state. But he postulated a change of human nature fostered by communism. It took many generations to prove him wrong. With the exception of a few diehards, none of today's communist leaders hold to that orthodoxy.

In the West, the moral validity of property rights is accepted, or at least acquiesced in, by virtually the whole of the population. This is true even in societies which are disdainful of competition. Attitudes toward property ownership are passed from one generation to the next through family values and education. These attitudes derive from the deepest values governing social interaction that people hold.

Even in non-democratic societies where property rights are embraced, standards of living improve. But democracies with a free press and protection of minority rights have proved the most effective form to safeguard property rights, largely because democracies rarely allow discontent to rise to a point that leads to explosive changes in economic regimes. Capitalism under authoritarian rule, on the other hand, is inherently unstable because it forces aggrieved citizens to seek redress outside the law.

While the debate over property rights and democracy will doubtless persist, I was taken with an observation made by Amartya Sen, the Nobel Prize winner in economics: "In the terrible history of famines in the world, no substantial famine has ever occurred in any independent and democratic country with a relatively free press. We cannot find exceptions to this rule, no matter where we look." With the media in authoritarian regimes tending toward self-censorship, market-interventionist policies—the most prevalent cause of disrupted distribution of food—go unreported and uncorrected until too late.

Protection of property has always been a moving target as the law continually tries to keep up with the nature of economic change. It's not surprising that different cultures have different views as to whether and to what extent property should be protected. This issue is becoming pronounced as property is becoming increasingly intellectual.

How appropriate is our current system of intellectual property protection—developed for a world in which physical assets predominated—for an economy in which value increasingly is embodied in ideas rather than tangible capital? Arguably, one of the single most important economic decision our lawmakers and courts will face in the next twenty-five years is to clarify the rules of intellectual property. The coming difficulties were anticipated almost four decades ago by a young Stephen Breyer writing in the *Harvard Law Review.* In my favorite quote of a book I wrote last year, the future Supreme Court Justice noted "the case for copyright . . . rests not upon proven need, but rather upon uncertainty as to what would happen if protection were removed. One may suspect that the risk of harm is small, but the world without copyright is nonetheless [in the words of Hamlet] 'undiscover'd country' which 'puzzles the will, / And makes us rather bear those ills we have / Than fly to others that we know not of.'"

The demonstrable driver of economic progress is competition. I cannot improve on Adam Smith's identification in his *Wealth of Nations,* "[t]he natural effort of every individual to better his own condition, when suffered to exert itself with freedom and security is so powerful a principle, that it is alone, and without any assistance . . . capable of carrying on the society to wealth and prosperity." People generally do not exert the effort to accumulate the capital necessary for economic growth unless they can own it.

Clearly the increased concentrations of income that have emerged under technological advance and global competition, have rekindled the battle between the cultures of socialism and of capitalism—a battle some thought had ended once and for all with the disgrace of central planning. But over the past year, some of the critical pillars underlying market competition arguably have failed. A worldwide debate on the future of globalization and capitalism is being intensified by the current crisis. Its resolution will define the world marketplace and the way we live for decades to come.

As I have noted many times, competitive markets and, by extension, globalization and capitalism cannot be sustained without the support of a large proportion of society. The rule of law under which capitalist economic institutions function must be perceived as "fair" if these institutions are to continue to receive broad support. The only way to temper the animus against an economy that requires high labor turnover to prosper is to continue to support market incentives that create jobs and to find productive ways to ease the pain of job losers. That problem is not new. The recent growing inequality of income, however, *is* new, and requires insight into its roots, and policy action where appropriate.

Another important requirement for the proper functioning of market competition is also not often, if ever, covered in lists of factors contributing to economic growth and standards of living: trust in the word of others. Where the rule of law prevails, despite everyone's right to legal redress of a perceived grievance, if there is more than a small fraction of outstanding contracts that require adjudication, court systems would be overwhelmed, as would society's ability to be governed by the rule of law.

This implies that in a free society governed by the rights and responsibilities of its citizens, the vast majority of transactions must be voluntary, which, of necessity, presupposes trust in the word of those with whom we do business—in almost all cases, strangers. It is remarkable that large numbers of contracts, especially in financial markets, until recent advances in information technology, were initially oral, confirmed by a written document only at a later time, even after much price movement. It is remarkable how much trust we have in the pharmacist who fills the prescription ordered by our physician. Or the trust we grant to automakers that their motor vehicles will run as certified. We are not fools. We bank on the self-interest of our counterparties with whom we trade to foster and protect their reputation for producing quality goods and services. Just contemplate how little division of labor and wealth creation would be engendered if that were not the prevailing culture in which we lived.

Wealth creation requires people to take risks, and thus we cannot be sure our actions to enhance our material wellbeing will succeed. But the greater our ability to trust in the people with whom we trade, that is, the more enhanced their reputation, the greater the accumulation of wealth. In a market system based on trust, reputation has a significant economic value. I am therefore distressed at how far we have let concerns for reputation slip in recent years.

Reputation and the trust it fosters have always appeared to me to be the core attributes required of competitive markets. Laws at best can prescribe only a small fraction of the day-by-day activities in the marketplace. When trust is lost, a nation's ability to transact business is palpably undermined. In the marketplace, uncertainties created by not always truthful counterparties raise credit risk and thereby increase real interest rates and weaker economies.

During the past year, lack of trust in the validity of accounting records of banks and other financial institutions in the context of inadequate capital led to a massive hesitancy in lending to them. The result has been a freezing up of credit.

As I noted in my opening remarks, trust will eventually reemerge as investors dip hesitantly back into the marketplace. From that point, history tells us, financial and economic revival sets in. I suspect it will be sooner rather than later. In either event, human nature being what it is, revival will come. It always has in this society governed by that remarkable document we call the Constitution of the United States.