THE FREEMAN

IDEAS ON LIBERTY

CONTENTS
AUGUST
1994
VOL. 44
NO. 8

THE FREEMAN
IDEAS ON LIBERTY

Published by
The Foundation for Economic Education
Irvington-on-Hudson, NY 10533
Phone (914) 591-7230 FAX (914) 591-8910

The Freeman is the monthly publication of The Foundation for Economic Education, Inc., Irvington-on-Hudson, NY 10533. FEE, established in 1946 by Leonard E. Read, is a non-political, educational champion of private property, the free market, and limited government. FEE is classified as a 26 USC 501(c)(3) tax-exempt organization.

The costs of Foundation projects and services are met through donations, which are invited in any amount. Donors of $25.00 or more receive a subscription to *The Freeman*. Student subscriptions are $10.00 for the nine-month academic year; $5.00 per semester. Additional copies of single issues of *The Freeman* are $2.00. For foreign delivery, a donation of $40.00 a year is suggested to cover mailing costs.

Bound volumes of *The Freeman* are available from The Foundation for calendar years 1972 to date. *The Freeman* is available on microfilm and CD-ROM from University Microfilms, 300 North Zeeb Road, Ann Arbor, MI 48106.

PERSPECTIVE

Bunnie Rabbit, Winnie, and the Grand Plan

With their uncertainties and fears and aspirations, people do much fretting and flailing. It is a hard world, to be sure. So we work and save and plan. And in our striving and struggling, the veneer of civilization is often worn very thin. It is worn completely through at times and in places, exposing our greed and gaucherie and petty preoccupations.

A vastly more attractive and assuring aspect of being is provided by furry friends. I have been blessed with companionship of my rabbit, Bunnie, and my dog, Winnie. Bunnie had to leave me some while ago, and now Winnie, too, has gone.

Both little Bunnie—she of the dainty face and long ears and button tail and velvet coat—and dear Winnie—pretty and cute and sweet and fetching—like the lilies of the field, neither spun nor sowed. They directly contributed nothing to gross domestic product. They were consumers, not producers, absorbing a bit of the world's scarce resources and returning nothing—nothing but an example of poise and patience and grace and affection.

Presumably, we shall never fully comprehend the Grand Plan of the Universe. But much of what we can suspect and infer is to be gained—if we are willing to learn—from the humble likes of Bunnie and Winnie. While people meanly scheme and worriedly strive and struggle, the Bunnies and the Winnies seem instinctively to have found their role and purpose. They play their part with an innate dignity and beauty of nature which should humble us.

There are many ways in which we can do ourselves in, individually and collectively, and the human race has worked assiduously to discover and utilize them all. Occasionally, a Shakespeare, a Rembrandt, or a Beethoven reminds us of our angelic heritage. A few of the world's peoples have grudgingly permitted some experimentation in social arrangements of freedom and individualism which can ease the pains and constrictions of scarcity. It is not surprising that progress therein is, at best, slow and unsure, for it is perversely protested and opposed by most. Unlike the Bunnies and Winnies—the supposed lesser of God's creatures—people persist in rejecting their role and subverting their purpose.

Scarcity is not confined to iron ore and arable land. The most constricting scarcities are those of character and personality. All our cleverness and wit, all our tools and technology, all our constitutions and posturings will leave us poor, indeed, a disgrace in the eyes of the Deity, as long as we lack the goodness and grace and gentility of Bunnie Rabbit and Winnie.

—WILLIAM R. ALLEN

Why Medical Costs Are High

There is much consternation about the high cost of medicine in the United States. I have heard all sorts of explanations for this but none appealed to my common sense. Today I came up with one of my own, and I am sufficiently vain to think it makes very good sense. But first a bit of background.

I have medical insurance through my employer. Usually I get a checkup every year. I am now at the age when it makes sense to do this, although I have no unhealthy habits. My father died of a heart attack at 67, and I am 55, so why be complacent?

Recently my doctor prescribed a stress test to see if I might have heart disease. After I had spent eight minutes on a treadmill, technicians took pictures of my circulatory system.

As I lay there for about twenty minutes, I thought about high medical costs. And it dawned on me: Of course our medical costs are high. We have an intense desire to live!

I hypothesize that this actually explains why we spend so much money on medicine: We want to live as long as we can, and we want to be as healthy as the ingenuity of researchers and practitioners makes possible.

But it is a costly proposition. Add to this that many people also wish to strain their biological capacities with such indulgences as heavy drink, heavy smoke, and reckless driving, which can clearly put them at high risk of medical difficulties. For lack of a better catchphrase, let's say that the intense desire to live and to fill life with much enjoyment, pleasure, and adventure makes it likely that people in America will spend much more money on medical care than would people in cultures where the human life is not so highly prized.

I am not trying to justify any of this, although I will readily admit that I find none of it objectionable. I want to give a sensible answer to politicians, who worry that we pay too much for medicine. I suggest it may simply be that we want to live longer and with more intensity than people do elsewhere.

—TIBOR R. MACHAN

Income—Earned and Unearned

We often hear that some income—notably wages and salaries, the returns on labor—is earned, while other income—notably interest and dividends, the returns on capital—is unearned. This contrast usually arises in the context of discussion of what constitutes an equitable tax system, and has hence acquired a measure of importance. The distinction between earned and unearned income is rooted in the idea that it is labor that makes for value, and hence that it is the fruits of labor alone that are earned. This idea has a respectable pedigree: Both Locke and Marx held some version of it.

In truth, however, as the Austrian School has taught, income is earned by satisfying the wants and needs of others. This satisfaction can come from various sources: It can come from labor and it can come from capital, as well as from any other factor of production.

Labor by itself may be sterile. It must satisfy some need of others, some need for which they are willing to pay, for it to result in earnings. Likewise, the mere deployment of capital may be sterile. Capital must be deployed productively—i.e., so as to satisfy the wants and needs of others as those others see it—for it to result in income. And when it does, such income is most certainly earned, as consumers—not government officials—decide by their purchases.

—JOSEPH S. FULDA

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Reforming America's Medical System Through Deregulation

by Doug Bandow

Health care has moved to the forefront of American politics and almost everyone in Washington wants to do something. In the Clintons' view the medical system is in crisis and requires radical restructuring. A number of Republicans, too, seem to believe that more federal intervention is necessary, just not quite the sort envisioned by the administration. What virtually no one is talking about, alas, is implementing the one reform program with a proven track record, but one which most policymakers perceive to be far more extreme than even the President's plan: deregulation.

Government does need to act. While there really is no health care "crisis"—the sick are more likely to be treated successfully in America than in any other nation—the medical marketplace does suffer from some serious defects. Americans are paying more than necessary for their care and some people are receiving less and poorer care because prices have been inflated artificially.

It is these problems, rising costs and millions of people uninsured, that have caused the administration to advocate the *de facto* nationalization of health care. The basic objection to the current system appears to be that it is not centrally planned. This philosophy is epitomized by the comment of Wall Street analyst Kenneth Abramowitz, that "Right now, health care is purchased by 250 million morons called U.S. citizens." The answer, he explained, was to "move them out, reduce their influence and let smart professionals buy it" on their behalf. This philosophy, of course, motivated generations of apparatchiks and bureaucrats throughout Eastern Europe and the former Soviet Union, and reflects what Nobel laureate Friedrich Hayek called "the fatal conceit."

President Clinton seems to share this conceit, having forgotten who actually provides medical care. For instance, he told one audience that "Make no mistake about it, some of the people who are giving me hell in Washington [over Whitewater] are doing it so I can't give you health." But he would not be "giving health" to anyone under his proposal. Nor would any of the scores of bureaucracies that he wants to establish.

The basic problem is that medicine is a process, not a structure; rearranging boxes in a diagram cannot account for the intricacies of human behavior. The very complexity of the medical process requires decentralized decision-making. No National Health Board, no Health Alliance, no gaggle of lawmakers and bureaucrats can substitute for a complex system in which tens of millions of patients, doctors, hospitals, insurance companies, and other participants make more than 1.3 billion medical "trans-

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Mr. Bandow, a contributing editor to The Freeman, *is a Senior Fellow at the Cato Institute and the author of* The Politics of Envy: Statism as Theology, *forthcoming from Transaction Publishers.*

actions'' a year. Yet the administration would move in precisely the wrong direction, empowering political officials and health administrators instead of restoring to patients responsibility for their own medical destinies. Asks Tom Miller of the Competitive Enterprise Institute (CEI), ''Do we really want to vote collectively (or delegate decision-making to anonymous bureaucrats) on how life-saving technology is rationed, where boundary lines are set for mercy killing, when life gets to begin and end, the manner in which we die, how we manage risks to our health, and how much further we can push our own definitions of 'good health'?''

Moreover, advocates of increased government intervention in the medical market are confusing symptoms with causes. Costs do not rise in response to, say, sun spots. Rather, costs have been rising so quickly for several reasons, particularly due to government activity. For instance, more than three of every four dollars in the health care system is paid by someone else—much of it directly by the federal government, most of the rest by insurance companies. The latter is a result of a tax code that prefers fringe benefits, particularly health insurance, to wages. Because of this pervasive third-party payment, consumers have an incentive to consume and providers to provide more and more expensive medical services than if patients were directly responsible for the cost of their care and acquired health insurance to cover the risk of catastrophic illness, not effectively to prepay routine care.

Washington also directly boosts the costs of pharmaceuticals through its byzantine drug approval process. States inflate the cost of health insurance by requiring policies to cover many extraneous benefits and by interfering with the operation of insurance markets. State governments also hike labor costs by unnecessarily restricting, through occupational licensure, the work that nurses and other medical professionals can perform. Taken together, these many interventions in the marketplace are the primary cause of today's health care ''crisis.''

Real Solutions

Thus, the answer is not one or another scheme to restructure radically the American medical marketplace. Rather, the solution lies in building on the strengths of the existing system by enhancing the operation of market forces.

The fundamental problem with American medical care is that patients have become largely disengaged as decision-makers since most of every health care dollar is paid by someone else. As a result, patients and doctors freely spend someone else's money on ever-more expensive treatments; at the same time, that someone else is increasingly fighting to hold down costs through ''managed care'' and fixed fee schedules. Thus, medicine has simultaneously grown more expensive and bureaucratic. And that will not change unless patients recover more authority over their treatment.

The increase in third-party payment reflects both the creation of Medicare and Medicaid and the rise of employer-paid health insurance. The latter is largely the fault of Washington as well, since the failure to treat fringe benefits like wages encourages employees to demand ever more comprehensive health insurance. And until recently, at least, companies were happy to comply, because premiums are fully deductible and not, in contrast to wages, subject to Social Security levies. All that matters is that the employer buy the policy.

As a result, what is viewed as the most important fringe benefit is tailored to meet corporate rather than individual preferences. Many of the problems that exist today—such as lack of insurability and portability, particularly for those with preexisting conditions—are a result of the fact that insurance is written at the behest of employers rather than employees. Workers still foot the bill, since health insurance is merely one form of compensation, but most have very little control over the specific benefits that they receive. In contrast, if workers bought their own policies, individually or as part of group cooperatives, they would demand guaranteed long-term insurability and other provisions that employers have no incentive to offer.

That the proliferation of third-party payment, which affects doctors' recommendations as well as patients' requests, has had a profoundly negative impact on the medical system should come as no surprise. Imagine the result if some combination of government and private insurers paid three-fourths of the cost of buying and maintaining automobiles. Everyone would want luxury cars, few people would seriously question repair bills, garages would recommend every procedure imaginable, and total automobile outlays would soar.

Prices Matter

It has, of course, been argued that medicine will never respond to market forces in the same way as will, say, auto purchases and repair. However, while a patient may have little discretion in deciding how he wants to be treated after a serious accident or heart attack, he can easily decide not to see a doctor for a common cold or minor cut. This sort of choice is readily apparent in the market for cosmetic surgery, which involves very little third-party payment and significant price competition. In fact, if patients didn't exercise some restraint even in today's "cost-plus" system there would be permanent health care overload.

A Rand Corporation study provides dramatic evidence that moving towards catastrophic coverage promotes cost-consciousness: people with free care (a zero deductible) incurred 50 percent higher medical bills, visited physicians 50 percent more frequently, and were admitted to hospitals one-third more often than those with a deductible of $1,000 (worth about $2,500 today). Similarly, Medicare participants have been found to up their outlays as benefits rose and co-payments fell. In 1977 the elderly spent 3.3 times as much per capita as the nonelderly; by 1987 that figure had reached 4.1.

Reducing the generosity of medical insurance would also help cut the blizzard of paperwork. Much of the administrative burden is simply filing forms and cutting checks for even the smallest expenses; increasingly important in recent years is the role of insurers' "gate-keepers" who administer cost-containment procedures like utilization review and physicians' staffers who negotiate with the gate-keepers. Again, consider the effect on the cost of auto or home insurance if every repair required submission of a form, approval of the procedure by a company representative, and issuance of a check. One estimate is that administration consumes 19.3 percent to 24.1 percent of medical spending. That was as much as $202 billion in 1992 siphoned away from patient care.

What Can Be Done at the Federal Level?

End Lavish Tax Subsidies. Congress should end its tax preference for lavish insurance policies. Washington could implement this reform by taxing employer-provided health insurance (and other fringe) benefits. (Though such action should be paired with an equivalent reduction in tax rates, since rationalizing the health care system should not become yet another excuse for government to raid taxpayers' wallets.) Moving towards catastrophic insurance would benefit all concerned: hiking a deductible from $250 to $1,000 would lower an average policy's annual premium by nearly twice as much, $1,315, today.

Medi-Save Accounts. Better, however, would be a more far-reaching proposal for medical IRAs, or medi-save accounts (MSAs). Today employers in urban areas with an average cost of living spend about $4,500 per employee on health insurance. Rather than paying that $4,500 for a standard policy, a company could instead purchase a catastrophic policy for $1,500 and give the employee the extra $3,000 to cover his deductible of the same amount (94 percent of families have annual medical expenses under $3,000). The law could be structured to allow a pay-out of leftover funds at the end of each year, or to encourage the accumulation of extra money year-by-year to cover both traditional procedures, such as eyeglasses, and unconventional treatments, such as chiropractic services, not covered by the typical insurance policy. (Some cafeteria-style fringe benefit plans include flexible savings accounts, but any unused funds revert to the employer, the opposite of the result intended by MSAs.) MSAs are not an option today because the $3,000 would be treated as income and taxed; moreover, the self-employed are currently allowed to deduct only one-fourth of their health insurance premiums and medical expenses only when they exceed 7.5 percent of adjusted gross income.

The tax law could be changed in one of two ways. Most simple would be to make catastrophic policies, with large cash payments to cover patient deductibles, fully tax deductible, while ending the deductibility of comprehensive, first-dollar-payment policies. While that would eliminate the existing bias against catastrophic plans, it would leave employers in charge of the purchase of health insurance and would not help people who lacked employer-provided coverage.

Better, then, would be for the federal government to tax any employer-provided health care benefits, while providing a tax credit or deduction for individual purchase of insurance. This would place all types of insurance on an equal basis with one other, as well as on an equal basis with other forms of compensation; the self-employed and unemployed would have equal tax standing with the beneficiary of employer-provided health care benefits. In general, more people would choose insurance tailored to their own needs.

Turning insurance back over to workers would have two additional, important effects. First, it would give individuals more choice; today only a third of employees of even mid-to-large firms can choose between policies. Second, it would help guarantee portability and insurability. Today roughly 15 percent of workers either remain in their current jobs or change jobs largely due to health insurance. If they purchased their own insurance they, unlike their employers, would have an incentive to acquire insurance configured to meet their own needs.

To further reduce third-party payment problems, Congress could apply the MSA principle to both Medicare and Medicaid. That is, rather than have Washington (in conjunction with the states for Medicaid) run mammoth fee-for-service insurance plans for the poor and elderly, the government should provide either vouchers or refundable tax credits towards a participant's purchase of an approved policy. Such an approach might initially increase federal budget costs, but in the longer term should moderate overall medical expenses and improve participants' care.

States could also promote MSAs, although their ability to do so is much more limited than that of the federal government. States could, for instance, publicize the efforts of private firms that have developed programs that promote catastrophic health insurance coverage. States could also offer accounts for their own employees and, with federal approval, for Medicaid recipients. In the latter case states could provide vouchers to program participants for the purchase of private insurance plans with cost containment provisions.

Pharmaceutical Deregulation. Access to new prescription drugs must be improved. Federal regulatory policies have heightened the perception of a health care crisis both by raising the cost of pharmaceuticals and discouraging development of prescription drugs that would lower overall health care costs. Indeed, drugs, which account for just eight percent of U.S. health care expenses, offer real potential for helping to moderate future cost rises because new substances could forestall doctors' visits, hospitalizations, surgeries, and other expensive procedures. Until federal policy is changed, however, this promise is likely to go unfulfilled.

Complaints about high drug prices are legion, yet the industry is competitive—there are some 22 major drug firms, and no company has more than a 7.2 percent market share. Indeed, the industry was even more fragmented in 1962, before more stringent federal regulatory standards, passed in the aftermath of thalidomide-induced birth defects, drove smaller companies out of business. The new FDA "regulations created pronounced economies of scale for drug innovation, which steadily increased over time," reports author Terree Wasley.

But reducing the industry's competitiveness was not the only impact of the federal government's more restrictive regulations. In the name of safeguarding the public from harmful drugs, the FDA is protecting the public from useful drugs as well. The problem is two-fold. First, the federal regulatory process is unnecessarily cumbersome and expensive. Companies must file separate applications, which typically run 100,000 pages, for different treatments by the same drug, and the approval process averaged 12 years before the Bush administration made some modest reforms. The average cost of developing a drug runs $359 million, according to the Office of Technology Assessment, and estimates are that the FDA may be responsible for as much as half of this cost.

Second, the FDA's power is excessive by any measure: drugs cannot be released until the FDA certifies not only their safety, but also their efficacy. Yet the problem with thalidomide, which spurred Congress to give the FDA a stranglehold over the pharmaceutical market, was that it caused birth defects, not that it didn't work. Unfortunately, the requirement that firms demonstrate efficacy further lengthens the time necessary to win approval of new drugs. This problem is exacerbated by the natural bureaucratic tendency to be risk averse. To approve a drug that is either ineffective or harmful will hurt one's career far more than holding up approval of efficacious, helpful products.

As a result, families with a member suffering from Alzheimer's disease have been frustrated by the agency's refusal to authorize the use of the drug THA, available in other nations, despite evidence that it helps four of ten patients who take it. Delays in bringing propranolol, a beta-blocker for use in treating angina and hypertension, to the U.S. market may have cost 100,000 lives; nearly as many may have perished from the lack of availability of the anti-bacterial Depra. Thousands have also died waiting for misoprostol, a drug for gastric ulcers, and streptokinase and TPA, for heart conditions. Equally costly has been the delay in bringing anti-AIDS drugs, such as AZT, to the market. Only enormous pressure from AIDS activists and Vice President Dan Quayle's Competitiveness Council caused the FDA to speed up trials of potentially life-extending drugs.

But these delays are still too long: people continue to resort to "buyers' clubs" to obtain pharmaceuticals approved elsewhere in the world but banned by the FDA. Even FDA Commissioner David Kessler, a Bush appointee held over by President Clinton, acknowledges that "Back in the 1960s and 1970s, post-thalidomide, the agency's mission was to keep unsafe products off the market. But in dealing with AIDS, we have learned in no uncertain terms that our job is not only to keep unsafe drugs off the market but to get safe and effective drugs to the market."

Alas, supposedly learning this lesson has not prevented the FDA from attempting to extend its reach over such products as vitamins and herbs, as well as possibly cigarettes under the pretense that manufacturers add nicotine. The agency also regulates advertising: aspirin makers are not allowed, for instance, to tell consumers that use of their product may help prevent heart attacks. Yet advertising is a critical means of promoting an educated citizenry.

Because of this panoply of restrictions, the FDA, contends Michael Tanner of the Cato Institute, is "one of the most destructive of all federal government agencies," a bureaucracy that "is clearly an unnecessary burden to the American health care system." At the very least FDA decision-making should be decentralized and streamlined. Better would be to restrict the FDA to monitoring safety, leaving the question of effectiveness to pharmaceutical companies, doctors, and patients. After all, none of them are interested in promoting ineffective drugs. Best of all, the FDA should be turned into a certification agency even for safety, to compete with private entities, such as the Underwriters Laboratory, which tests electrical appliances. Unapproved drugs could be marketed as such, with doctors, pharmacists, hospitals, and insurers all operating as "gate-keepers" advising patients. The potential for product liability lawsuits, too, would remain a potent constraint on pharmaceutical practices. Overall, the danger of allowing the sale of a few ineffective drugs pales compared to the benefit of allowing patients access to additional effective ones.

State Opportunities for Reform

While states cannot reach such issues as the federal tax deductibility of health care insurance, there is still much they could do to help reduce health care costs. In fact, one of the virtues of federalism is that states can operate as laboratories for policy experimentation. Unfortunately, few have taken good advantage of this opportunity. Rather, most states have exhibited the same penchant to regulate as has the federal government.

End Expensive State Regulations: Certificate of Need Requirements and Benefit Mandates. Rising costs are a problem in and of themselves, but they also contribute to other problems. Nearly two-thirds of those who are employed but lack insurance labor for firms with fewer than 100 workers. For those companies cost tends to be the principal deterrent to offering insurance. Thus, it is critical for states to reduce regulatory burdens that unnecessarily hike medical expenses.

One problem is state control over the offering of medical services. Past federal subsidies led to an expansion of hospital capacity and extra beds; thus, during the 1970s states began to require a "certificate of need" (CON) for hospital construction and equipment purchases. These restrictions, in the name of consumer protection, limit competition and almost certainly push up prices, especially in rural areas, where medical services are scarcer. Moreover, the CON procedure itself is costly. The Federal Trade Commission has concluded that "hospital costs would decline by $1.3 billion per year if states would deregulate their CON programs."

Another concern is state control of benefits offered by insurance companies. State meddling in this area is pervasive, as governments force private insurers to cover specific conditions. There were just eight such requirements in 1965 and 48 in 1970; 20 years later there were nearly 1,000, involving "everything from life-prolonging surgery to purely cosmetic devices," write John Goodman and Gerald Musgrave of the National Center for Policy Analysis, including hairpieces, pastoral counseling, and sperm bank deposits. Luckily, federal pension law (ERISA) exempts companies that self-insure. Roughly half of companies that self-insure do so in order to avoid these restrictions.

States should eliminate (or Washington pre-empt) mandated benefits. Second best alternatives include exempting small business and, something implemented by roughly half the states, allowing insurers to offer a no-frills alternative policy. The cost of the mandated benefits vary widely, but some are quite expensive. For example, outpatient mental health care raises premium prices an average of 10 percent to 13 percent, while substance abuse benefits add six percent to eight percent to the cost. Maryland's Blue Cross/Blue Shield figures that mandated benefits are responsible for 13.3 percent of claims paid out.

By raising costs, state mandates make it more difficult for poorer workers to purchase insurance. Goodman and Musgrave estimate that the percentage of uninsured who lack coverage because mandated benefits have priced them or their firms out of the market ranges from 15 percent in Arkansas to 64 percent in Connecticut, and about 25 percent overall. Similarly, the Council of Economic Advisers complained in 1991, "These requirements raise the cost of health insurance and make it too expensive for many individuals and firms."

Insurance Law Reform. Hailed by some as compassionate social policy, courts have often ruled in favor of the most liberal interpretation of benefits due the insured. This phenomenon, in conjunction with other factors, such as the employers' enhanced role in choosing policies for workers, has badly skewed the health care market. Courts making such rulings view their decisions as being pro-patient, of course, and they are in the case before them. But overall, such rulings inflate expenses for all insurees. They also increase risks for insurers, the burden of which falls particularly heavily on smaller firms, and discourage aggressive cost containment efforts. Thus, negotiations over health insurance need to be taken out of not only the hands of legislators—who, as noted earlier, interfere through mandatory benefit laws—but also out of the hands of judges. State legislatures need to act to allow insurers and insurees to cut whatever bargain they prefer, and to have that agreement enforced in court. Only through true market competition are we likely to see the development of the variety of policies necessary to meet the differing needs of 250 million Americans. Among the possibilities, according to CEI's Miller:

> A few contractual devices might include incorporation of different medical practice guidelines, delegation of difficult decisions to an identified panel of medical experts, providing a specific process for resolving disputes over medical appropriateness, offering different levels of access to technology based on cost/benefit assessments, inserting clauses that expressly waive the insured's right to have a policy construed liberally against its drafter, varying standards for malpractice liability, and, most of all, adjusting premiums to reflect any of the above choices.

At the same time, states should reverse past interventions in the marketplace, such as forcing insurers to use community ratings. The temptation is great to attempt to manipulate the insurance market in this way to guarantee insurability for all. The result, alas, is unfairly to penalize those who are healthy and to prevent insurance rates from reflecting behaviors that affect the insured's health, such as smoking. In New York, for instance, legislation requiring community ratings and guaranteed issue has triggered staggering price increases for many citizens —a doubling and trebling, in some cases. Acknowledged one state official, "some people will not be able to afford these increases." The rise has fallen most heavily on the young, who tend to earn less than their elders. In short, the government is impoverishing some to assist others.

A far better approach would be directly to subsidize the roughly seven-tenths of one percent of people estimated to be uninsurable. This could be done with the government underwriting either medical expenses or the cost of insurance. Another option is to create assigned risk pools, a means used to ensure the availability of auto insurance for poorer drivers. In fact, roughly half of the states already offer such programs, though many of the existing systems are flawed. But states could redesign their assigned risk pools to offer the equivalent of MSAs to the uninsurable, with subsidies, best raised through taxes rather than special assessments on insurers, to make the plans affordable. As Mike Tanner of the Cato Institute argues: "If as a society we have made the decision that individuals should, for whatever reason, be subsidized in the purchase of insurance, the cost of that decision should be borne by society as a whole rather than a particular segment of society."

Occupational Licensure Reform. There is also a supply side to the medical equation, which is particularly important given the disproportionate role of labor in the cost and provision of health care. States, and the federal government, if it is willing to use its vast Commerce Clause power to pre-empt state rules, could increase the availability of medical providers and lower health care costs by reducing physicians' stranglehold over the provision of medical care. The problem is two-fold: doctors have successfully lobbied for laws that confine treatment to MDs and limit the number and activities of MDs.

First, most states unnecessarily restrict the activities of advanced practice nurses (APNs), who include nurse practitioners, nurse-midwives, clinical nurse specialists, nurse anesthetists; registered nurses (RNs); licensed practical nurses (LPNs); physicians' assistants (PAs); nurse's aides; and similar professionals. These providers dramatically outnumber doctors—there are 2.2 million RNs, three times the number of MDs, and nearly one million LPNs alone, while the number of APNs, well over 100,000, is about half of the number of physicians providing primary care.

Although APNs, RNs, and LPNs are capable of handling many simple and routine health care procedures, most states, at the behest of physicians, allow only MDs to perform "medical acts." The anomalies are many: "I can take care of a patient who has broken an arm, treat them from top to bottom, but I can't give them an adequate painkiller," complains Maddy Wiley, a Washington state nurse-practitioner. Instead, such treatment can only come through the government-created doctors' oligopoly, into which entry is restricted.

Even more virulent have been physicians' attacks on alternative professionals. Medical societies have worked to prevent chiropractors, for instance, from gaining privileges at local hospitals, and remain generally hostile today. (Doctors lost an antitrust case in 1990 for such practices.) MDs have similarly opposed osteopaths and podiatrists. Many states ban midwives from handling deliveries. Optometrists are usually barred from such simple acts as prescribing eye drops; the Federal Trade Commission and economic researchers have found that advertising restrictions on eyeglasses and contact lenses sharply raise prices. In half of the states only physicians can perform acupuncture. Over-regulation of pharmaceuticals, which prevents patients from self-medicating, also acts as a limit on health care competition. Allowing over-the-counter sales of penicillin, for instance, could save patients on the order of $1 billion.

The second manifestation of physicians' monopoly power is the panoply of anti-competitive restrictions on the profession itself. Doctors have helped drive proprietary medical schools out of business, reduced the inflow of new MDs, and for years prevented advertising and discouraged members of local medical associations from joining pre-paid plans. Up into the early 1980s the American Medical Association attempted to restrict walk-in clinics that advertised themselves as providing "emergency" or "urgent" care. Moreover, federal immigration law and state requirements limit foreign doctors from entering the country and often prevent them from finding work. None of these rules has anything to do with consumer protection.

Some states have begun moving slowly in the right direction. Mississippi, for one, does not regulate the practice of PAs. Nearly half of the states, among them New York, already allow nurse practitioners to write at least some prescriptions. Moreover, in this area, at least, the administration is moving in the right direction, pledging to "remove inappropriate barriers to practice." Specifically, the administration would break down state restrictions on the ability of APNs to offer primary care—prenatal services, immunizations, management of chronic but standard conditions like asthma, prescribing medication, and treating common health problems—and to receive insurance reimbursement for such services. This effort is not, of course, going unchallenged: The California Medical Association has attacked the Clintons' proposal as "dangerous to the public's health." A Georgia doctor said such an action would be a "catastrophe for the patient." An AMA report argued that expanding the role of nurses would cause unimaginable harm, including hurting patients, fragmenting care, and even *raising costs*.

There is, however, no evidence that the public health would be threatened by allowing non-MDs to do more. The most obvious method would be to let professionals perform work for which they are well-trained without direct supervision of a doctor. At the very least states should relax restrictions in areas, particularly rural, which have the greatest difficulty in attracting physicians, allowing those with the fewest options to seek treatment from professionals with less intensive training. PAs, for instance, receive two years of instruction to work directly for doctors and could perform, it has been estimated, roughly 80 percent of the primary care tasks conducted by doctors, such as taking medical histories, conducting physical exams, and ordering tests. Similarly, the Office of Technology Assessment estimates that nurses with advanced practices could provide 60 to 80 percent of the clinical services now reserved to doctors. Mary Mundinger, dean of Columbia University's School of Nursing, argues that nurse practitioners have been providing primary care for decades and no research, even that conducted by doctors, has ever found any problems. "There is not a single study that shows any lapses," she contends. In practice, nurses regularly perform many simple aspects of primary care far more often than do doctors and, as a result, are better qualified to handle it in the future, whether or not they work in the presence of a MD.

Patients should also be allowed greater use of alternative, unorthodox medical practitioners. In 1990 one-tenth of Americans—primarily well-educated and middle- to upper-income—went to chiropractors, herbal healers, massage therapists, and the like. Health insurance covered few of these treatments. Some of these procedures may seem spurious, but then, practices like acupuncture were once seen the same way but have gained credibility over the years. The most important principle is to allow patients freedom of choice in determining the medical treatments that they wish to receive. This requires relaxation of legal restrictions on unconventional practitioners and a more individual-oriented health insurance system, which would allow those inclined towards alternative treatments to acquire appropriate insurance policies.

Moreover, states should address the role of the MD, since even increased reliance on other health care professionals would not fully compensate for the artificial limit on physicians. Earlier this century, before the AMA's monopolistic activities had achieved their full effect, the U.S. had more doctors than other medical personnel, the reverse of today's situation. It is time for states to reconsider the entire regulatory system for which there is surprisingly little intellectual basis. Empirical evidence demonstrates that licensure reflects professional rather than consumer interests. Opines Andrew Dolan of the University of Washington, the proposition that occupational licensing is necessary "to protect patients against shoddy care" is "unproven by almost any standard."

At a minimum states should eliminate the most anti-competitive aspects of the existing licensing framework, particularly barriers that make it so difficult for people to become doctors and so hard for physicians to compete vigorously. These include doctors' power to control entry into their own profession and restrict competitive practices. But ending these practices should only be a start, for, as Goodman and Musgrave explain: "Virtually every law designed to restrict the practice of medicine was enacted not on the crest of widespread public demand but because of intense pressure from the political representatives of physicians."

More far-reaching reform proposals would establish a genuine free market in health care, backed by private certification and testing and continuing malpractice liability. Such an approach might seem shocking today, but only in the context of the vast regulatory structure that has been erected over the years. Full deregulation would also do much to achieve the administration's goal of encouraging both more minority and primary care physicians.

The potential benefits of attempting to deal with the supply side of health care are substantial, especially if the federal and state governments worked in tandem. For instance, in the late 1980s, New York City and Seattle allowed paramedics on the scene, rather than doctors in a hospital, to administer the drug TPA, approved by the FDA only after arduous delays. The result of more flexible government policy was better care for patients. Still, MDs criticize the prospect of increased competition from non-MDs. Complains Los Angeles physician Michael Stefan, "I spent 11 years in medical school, and you're telling me someone else could do it better and for less money with less education? That's ludicrous." That's not what anyone is saying, however. Not every patient needs to see someone with 11 years of education and even more expensive experience. Patients deserve a fuller range of options combined with the right to choose their preferred provider.

Conclusion

There are legitimate reasons to be concerned over the state of Americans' health care, but none of them justifies federal proposals for social engineering on a massive scale. The only genuine health care crisis today lies with the public sector that the President would entrust with control of the entire system. Thus, what the American medical marketplace really needs is a return to a free market in health care, built on the solid foundation that already exists.

To do so, the federal government should eliminate the tax bias in favor of third-party payment. Washington also should reform the drug approval process, as well as refashion Medicaid and Medicare. States, too, have an important role to play in reforming the health care system, since they can help address the third-party payment problem, deregulate the health insurance industry, and allow patients to choose who will treat them. The foregoing may seem prosaic to Washington policymakers, but unlike proposals to nationalize the health care system, these solutions actually could achieve the President's goal of providing better care to more people for less money. □

Is Canadian Health Care a Good Model for the U.S. to Follow?

by Michael Walker

As usual, I continue to have the most interesting job in the world. On February 9, it took me to Washington, D.C., where I had been invited by the Ways and Means Committee of the U.S. House of Representatives. The Committee is in the process of considering which one of the health care reform proposals it will back or how it will combine them to come up with its own proposal. It is a foregone conclusion that they will come up with a variant of reform which involves sweeping changes to the U.S. health care system. As becomes apparent when you listen to the evidence presented to the Committee and hear the

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questions they pose, it is far from clear what the real motivation is.

One thing which is crystal clear is that those who propose it as an alternative, have an entirely idealized vision of the Canadian health care system. They imagine that in our system access is equal, free, and unlimited. They are certain that merely adopting it will solve the problems of high infant mortality and shortened life expectancy amongst low-income members of their communities. And they think they will be able to accomplish all of this while saving money because the Canadian system is cheaper. No evidence presented to the Committee seemed to deter them in any way in their enthusiasm. But the evidence they heard should at least have made them think twice.

First, let me say that I think that the Canadian health care system has been one of the best in the world. We have been able to provide a very good quality of health care to the vast majority of Canadians. However, it is just as important to note that the quality of the system is changing and that there are definite signs of deterioration. The main point is that these signs of deterioration are traceable to structural characteristics of the Canadian system which also are embedded in the proposals for reform in the United States.

Premium Capping

The silver bullet in the plan proposed by President Clinton is premium capping—that is, the provision that the premium for the standard required health care package will be allowed to increase only by the rate of inflation and the rate of population growth. In other words, the plan freezes the quantity of health care resources at the present per-capita level in real terms. There will be no increase in the real cost per person from 1995.

The silver bullet that controls the costs of the (ten) Canadian health care system(s) is the fact that the provincial governments have acted gradually to cap the budget allocations for health care. The methods differ by province, but essentially the attempt has been made to cap the budgets of hospitals for operating expenses, for special surgical procedures such as by-pass surgeries and hip replacements, and for the acquisition of technology. Meanwhile province after province has adopted a form of cap for the incomes of physicians thus controlling the overall cost of health care. These controls have not prevented health care expenditures from escalating from 5.5 percent of GDP in 1960 to about 9.5 percent at the moment. In fact Canadian costs look good only by comparison with the United States, which is now spending 13.5 per cent of GDP—up from the same 5.5 percent as Canada in 1960.

In economics we say that there is no such thing as a free lunch. The question is: how has Canada been able to save the four percentage points of GDP? What have we done without? The Democrats on the House Ways and Means Committee believe, along with many Canadians, that we have sacrificed nothing, simply controlled the excesses of private enterprise medicine.

To cast it in sharp relief, it is interesting to restate what this belief implies. "The replacement of the dollar-focused, profit-driven judgment of the competitive market by the socially focused, well-meaning judgment of government bureaucrats has been successful in producing a better quality health service, for more people at a lower cost." The first clue that something may be awry is provided by substituting, the word "automobile," or "postal service," or "airline," or "gasoline," or "bubble gum," or "architecture," or "movies," or anything else for "health service," in the sentence. In fact, based on a tremendous amount of evidence and direct experience it is now possible to say the sentence would not be true for any other product or service. And there is evidence, which others and I provided to the U.S. Congress, that Canadian health care has not succeeded where all these other attempts at government coordination have failed.

The Fraser Institute survey of hospital waiting lists, which I presented to the Ways and Means Committee of the House of

Representatives, shows that nearly one percent of our population is waiting for surgery. That survey also shows that, unlike the myth, access is not uniform across the country but varies enormously by province. That is not surprising, of course, because health spending also varies by province. One would expect the more a province spends, the closer it would come to the U.S. experience of no or very short waiting lists. The shortest waiting times are measured in Ontario which spends $7,200 per family of four on health care, nearly double the amount spent in Prince Edward Island, which has the lowest cost care at $4,800 and the longest waiting times.

Technology Gap

A comparison of technologies shows that many Canadians do not have access to the latest diagnostic machinery and enough treatment facilities at their disposal. To pick a topical example, we have one-tenth the number of nuclear magnetic resonance imaging machines per capita as the United States. While there will always be the question (with no definitive answer) of how many is enough, the fact that private NMRI facilities are opening in Alberta and British Columbia, and that Canadians are going into the United States to get such diagnostic imaging done, suggests that we have not kept pace in this area.

The Congress learned from Dr. William Mackillop of the Kingston Regional Cancer Centre that cancer patients are now getting less radiation therapy for specific cancers than they were getting ten years ago, to their detriment. Less radiation therapy means more surgery, more disfigurement, and less longevity than otherwise would be achieved. Dr. Mackillop pointed out that there was a shortage of radiation therapy units, a shortage of people to operate them, and a shortage of people to train people to operate them. This, he noted, in spite of the fact that the current increasing demand for cancer therapy had been well forecast as early as 1975 because the incidence of cancer is age dependent and the average age of our population is increasing in a very predictable way. The bureaucrats had simply not reacted to the foreseeable need, he pointed out.

Perhaps the most important comment he made to the Congress, concerned a comparison he had made of waiting times for radiation therapy between Canada and the United States. The comparison he offered was based on a comprehensive survey of cancer centers in Canada and the United States. Dr. Mackillop asked the centers to provide the number of weeks that a patient could expect to wait for therapy for cancers of specific types. He found that in every case Canadian patients were waiting longer than American patients. In the case of some cancers, the median wait was three times as long in Canada as it was in the United States.

While Dr. Mackillop had many nice things to say about the Canadian system, about how unnecessary surgeries and treatment were kept to a minimum, he betrayed a concern about whether the system of bureaucracies in government was capable of anticipating and reacting to the health care needs of the population in the way that it should. He in particular thinks that cancer patients are not receiving the treatment they need and should be getting.

Our testimony was given some real-life impact by the testimony of Lisa Priest of the *Toronto Star* newspaper. Ms. Priest has been doing a series of articles on how waiting lists affect particular patients in Ontario. Her stories are both heart-wrenching and effective in pointing to the specific problems which beset our health care system. Ms. Priest surprised observers, however, by coming to the paradoxical conclusion that faults and all, she would choose the Canadian health care system over the American system, because, she noted, there are two things Canadians fear when they go to the United States: that they will get shot or get sick. Evidently those who go there to get the health care—including the cancer therapies about which Ms. Priest writes—are not included in this assessment. □

THE FREEMAN
IDEAS ON LIBERTY

If You Build It, They Will Come

by K. L. Billingsley

Critics of the government are not always right that taxpayers don't get what they pay for. Sometimes they get more. For example, the government of California has recently provided a lesson in the link between human behavior and economics that the best university would be hard-pressed to duplicate. But the lesson proved both expensive and difficult to learn.

In California, no government agency exists to provide health care for middle-class working people and their families. There is, however, a system for the poor called Medi-Cal, which the taxes of middle-class working people pay for, but which remains off-limits to them.

A number of press accounts have pointed out massive fraud in the Medi-Cal system, which is limited by law to California residents. But people from countries as far away as India have flown in, received operations costing hundreds of thousands of dollars—in one case $2.7 million—and quickly departed the country leaving the bill to California taxpayers who can't use the system themselves.

In some cases, Medi-Cal's own personnel helped people to commit this fraud and tried to cover up investigations. Here a bureaucratic principle was at work. More "clients" means bigger budgets, which means a bigger allocation from the state and increased job security. So the bureaucratic incentive, unlike the private sector, is to ignore fraud and bloat the budget.

Democracy is not simply the counting of heads but involves the rule of law. In 1986, the United States government granted blanket amnesty to millions of people who had flouted American immigration laws. Federal and California officials rewarded not only them but those whose status remained illegal.

In 1988 Medi-Cal began providing prenatal care to illegal immigrants residing in or even *intending* to reside in the state. California even launched an advertising campaign called "Baby-Cal," spending $78,000 for spots on Spanish-language radio and television stations transmitting from Mexico. The state quickly got what it paid for, and more.

"If you build it, they will come," was the phrase from the movie *Field of Dreams*. California not only built it but advertised it on television. And they came, in droves.

According to the most recent figures cited in a *San Diego Union-Tribune* study, undocumented aliens gave birth to nearly 96,000 babies in the state during 1992. This constituted a full 85 percent increase over the last three years and does not include those covered under amnesty who also used Medi-Cal. The costs for 1992 came to $230 million. That same year 40 percent of Cali-

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fornia's 237,000 publicly funded births were to undocumented immigrants. And 41 percent of those who used Medi-Cal for maternity care also used the welfare system after delivery.

There are several lessons here. First and foremost, as fiscal conservatives have often pointed out, you get what you subsidize. For example, if you subsidize single-parent families, you will get single-parent families. If you subsidize indigence, you will get indigence. If you subsidize the births of foreign nationals in the country illegally, you will get what you pay for. But state officials are just now learning that lesson.

Medi-Cal's John Rodriquez told the *Union-Tribune* that in his "wildest imagination" he never imagined the program growing so fast. "I think," he added, "we are seeing a magnet effect." Precisely.

America has been and always will be a country of immigrants. Historically, however, immigrants have traditionally come through legal channels in search of opportunities, not through illegal channels in search of handouts. The "Baby-Cal" fiasco shows how welfare state fraud has corrupted immigration. And as Cuban-American author George Borjas points out, most people now coming are unskilled and may wind up on welfare even if such programs were not their original attraction.

As the Medi-Cal episode also proves, good intentions can have disastrous consequences. And contrary to what one often hears, there is no "free" health care, something California's four-billion-dollar debt confirms. Federal politicians might see a warning here, but they seem to be missing the point.

On the contrary, they are now promising universal health care for every American and claim that a tax on cigarettes and changes in Medicare will pay for it all. The failed statist medical experiments of other countries provide some prospects as to its possibilities of success. And California's Medi-Cal program gives some clues as to what we can expect in the way of waste and fraud. American nationals will hold no monopoly in pillaging the system. If you build it, they will come. □

THE FREEMAN
IDEAS ON LIBERTY

Environmental Regulation: Just as Bad as Any Other

by Gregory B. Christainsen

Two sweeping studies of government regulation and deregulation, respectively, have been published in recent years. The findings of these studies deserve to be better known. The studies also merit attention for what they did *not* say about environmental regulation.

The first study, by Robert Hahn and John Hird, was published in the *Yale Journal on Regulation* in the winter of 1991. It surveyed all of the major benefit-cost studies on regulation that had appeared before the authors wrote their article. The authors concluded that in only two areas, the environment and highway safety, could one plausibly argue that the benefits of regulation had outweighed its costs. It should be emphasized that, with respect to the areas outside of the environment and highway safety, the authors were not claiming that regulation had had no benefits. They were claiming, however, that in light of its costs, people generally would have been better off if regulation had not occurred.

The second study, by Clifford Winston of the Brookings Institution (*Journal of Economic Literature*, September 1993), surveyed areas where significant deregulation has taken place, such as airlines and trucking. Environmental deregulation was not studied because little such deregulation has occurred. In every single case examined by the author, however, deregulation was found to have had net benefits.

It should be pointed out that the article in the *Yale Journal* was written before the Clean Air Act Amendments of 1990. Even before that legislation went into effect, Paul Portney of Resources for the Future estimated that the amendments would impose costs far in excess of their benefits. The annual costs were estimated to be on the order of one-half percent of the entire U.S. gross national product, a huge impact for one piece of regulatory legislation. When this legislation is considered in conjunction with other environmental measures (noted below) that were not considered in the *Yale* article, it seems very likely that environmental regulation has had the same overall impact as other regulation. In other words, it has been generally harmful.

The authors of the *Yale* article are well aware that benefit-cost estimation is a very imprecise science, especially so in the case of the environment. The likelihood that various measures will improve, or harm, human health simply is not known. There are also serious philosophical questions that can be raised about the relevance of benefit-cost estimates for public policy decisions. However, the research findings are in some cases so dramatic that basic conclusions can nevertheless be drawn about the efficacy of regulation.

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Any net benefits from environmental regulation prior to 1990 seem to have been due primarily to air pollution standards for factories. Estimates by Myrick Freeman of Bowdoin College indicate that emissions standards for new trucks and automobiles have probably had costs well in excess of their benefits. Virginia McConnell of the University of Maryland has found that the performance of vehicle inspection and maintenance programs—for example, smog tests for used cars—has been even more dismal. According to Freeman, it is likely that water pollution control efforts have also failed to pass a benefit-cost test.

Numerous other examples can be given of perverse environmental regulation. It now appears that the "Superfund" toxic-waste program will cost more than the government bailout of failed savings-and-loan associations. The activities of the California Coastal Commission, which regulates the use of one of the most valuable coastlines in the world, cannot pass a benefit-cost test. Notwithstanding some recent court decisions that have narrowed its scope, the Endangered Species Act has emerged as one of the most economically destructive pieces of regulatory legislation ever passed.

Even factory air pollution control has not been nearly so efficient as it could have been because firms are not always allowed to use the least-cost method of emissions abatement. It is still the case, for example, that firms must use abatement technologies dictated by the U.S. Environmental Protection Agency, regardless of their cost.

On the other hand, there has been limited progress in reforming the control of air pollution. A factory may now, for example, be able to pollute somewhat more than it formerly could if it can find, and pay, another factory to pollute somewhat less (so as to compensate for the increased pollution of the first factory).

Factories have incentives to enter into such arrangements insofar as one factory can abate pollution more cheaply than another. Suppose one factory could abate some pollution at a cost of $50,000. Suppose a second factory in the area could abate the same amount of pollution at a cost of $40,000. Under such circumstances, if the first factory paid the second factory $45,000 to undertake the abatement in question, both factories would be better off by $5,000. That is, the first factory would save $5,000 by paying the second factory instead of abating the pollution itself. The second factory would gain $5,000 by receiving a payment in excess of its (relatively low) abatement costs. The air quality in an area can thereby be maintained at lower overall cost than would have been the case under the old rules; in the past, factories were not allowed to make such agreements.

It would be a mistake, however, to conclude that, as a general principle, regulation can be successfully reformed or undone without fundamental changes in the structure of government itself. For every case of reform or of outright deregulation, several examples could be given of new regulation that is exceedingly harmful. The 1990 Amendments to the Clean Air Act, for example, require that a certain number of vehicles in cities with dirty air run on alternative fuels, whether or not improved air quality could be had in a cheaper way.

The problems go much deeper than calls for "regulatory reform" or "reinventing government" would suggest. After all, the negative impact of regulation under the existing form of government is simply a mild version of the ills of socialism. That is, when governments attempt to direct the use of resources, they are subject to two major difficulties: (1) they are subject to perverse political pressures (what economists call "the public choice problem"); and (2) even when government officials are well-intentioned, they cannot have all the information necessary to make efficient decisions. (This is what Austrian economists refer to as "the knowledge problem.")

Limiting Government

The structure of government itself must therefore be changed so that its power to direct resources is limited or eliminated. A modest proposal would involve restoring respect for property rights under the Fifth and Fourteenth Amendments to the U.S. Constitution. Prior to the Great Depression, the U.S. Supreme Court would consider the impact that regulation had on property owners and whether it was "essential" for a "legitimate public purpose." Under such "strict scrutiny," as the Court called it, regulation was often struck down as unconstitutional.

Such a stance limited regulation's excesses. Especially after 1937, however, the Court refused to interpret the Fifth and Fourteenth Amendments in the same way. Now, regulation can pass constitutional muster without the necessity of taking the interests of property owners into account, unless it involves the outright confiscation of land, or unless it drives the value of the property to zero.

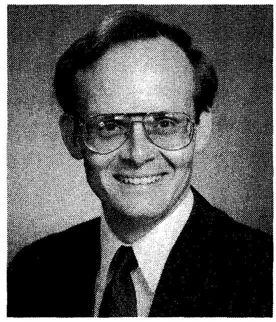
A more radical suggestion for constitutional change would be to deny government the power to regulate the use of property altogether. From this perspective, environmental problems could be addressed, not by restricting the rights of existing property owners, but by establishing *new* property rights to the natural resources in question. If groundwater basins were converted into private property, for example, the new property owners could sue anyone who polluted them.

In a similar vein, environmental organizations could be given title to members of various endangered species. For example, an ornithological society could own the bald eagles in an area. If a bald eagle were shot, the society would be owed compensation, which it might use for, say, a breeding program. On the other hand, the society would be liable if an eagle killed or maimed a lamb of a sheep ranch owner. To be sure, there would be enforcement problems, just as there are enforcement problems if a species is covered by the Endangered Species Act. The main point of such changes is to reduce conflict in society. People could not legally undertake actions that would directly harm the person or property of others unless they paid compensation.

As matters stand, opposing parties are encouraged to engage in political conflict to promote their interests. A political gain to one party constitutes a loss for the opposing party. For example, once bald eagles have been declared an endangered species, sheep ranch owners must stand idly by as birds maim their lambs. The ranch owners are not entitled to compensation.

Economists are just beginning to understand why governments habitually fail, and they have only begun to appreciate the importance of private property rights for the allocation of resources. Natural resources are no exception to Jefferson's maxim: The government is best that governs least. □

The Power of Positive Example



As an academician and former professor who taught at the college level for seven years, I feel that being with students again is much like coming home. There is much about the academic environment that shines as a beacon for the rest of society—not the least of which is the principle of genuine intellectual inquiry—a tolerance, an openness, and indeed, an encouragement of new ideas and a wide range of perspectives.

An institution of higher learning is a marketplace of ideas, where ideas are shared, discussed, debated, sometimes debunked, but always treated with respect, never dismissed without thought or reason, and never feared. In the spirit of true academia, truth is not advanced by stereotyping, by shallow epithets, by innuendo or insinuation, or by suggesting that those with different views should not be heard. Those who labor and study in our centers of learning must be made of stronger stuff than that. If they are not, the prospects for a free, virtuous, and compassionate society as a whole are slim. We should judge ideas as we should judge the people who bring them to the marketplace—on their merits. The thing I have always found refreshing about the traditional academic environment is the premium it places on thinking. True thinkers can disagree without being disagreeable. By nature, they reject the thought police.

Graduates, you are about to step into a world you will shape for years to come. I know it's customary, maybe even hackneyed, for commencement speakers to say at least a dozen times in their address: "You are the future." We all know that. What I would like to prompt you to think about is, *How* do you want to shape that future? *How* do you want your influence to be expressed?

I would like each of you to close your eyes for just a few seconds and think of one or two people who have motivated you, encouraged you, spurred you on. . . . Ask yourself, was it because of what they *said,* or what they *did*?; how they *talked,* or how they *behaved?*

My guess is that for most of you what those people did and how they behaved—in other words, the example they were (or are) for you—has had the more lasting and meaningful impact. Certainly, no one is inspired in a positive way by the hypocrite or by the unprincipled. Paraphrasing Emerson, "What you are speaks so loudly I cannot hear what you're saying."

If you reflect further, I believe you will agree with me that each of us is inspired far more by the power of positive example than by command or threats. This is not to say that those who have wielded great power at the point of a gun have not had profound impact. But doesn't it mean so much more to us to *earn the* respect of others as opposed to *commanding* it? How much have we really won, if others pay attention not because they want to but because they have to?

This month's column is an adaptation of the commencement address delivered on May 7, 1994, by Lawrence W. Reed to an audience of 6,000 at Central Michigan University (CMU) in Mount Pleasant, Michigan. Dr. Reed, a newly elected trustee of FEE, is an economist and author and President of the Mackinac Center for Public Policy in Midland, Michigan. CMU bestowed on him an honorary doctorate during the graduation ceremonies.

I can think of so many things I wish more people would do. I wish they would value education more highly and read to their children. I wish they would show more concern for those around them in need and do something about it. I wish they would work harder at being the very best at whatever they've chosen as their life's work. I wish they would take more seriously the responsibilities of being free citizens in a democratic society. I wish they would show more respect for the lives and property of others. I wish they would be better neighbors, more caring friends, more honest politicians, more responsible business associates.

I suppose we could devise all sorts of laws that would attempt to coerce more people in these directions and that would penalize them if they failed to comply. But that approach, frankly, leaves me with a feeling of hollowness. I don't want a society in which people do the right thing just because they have to, when they really don't want to. And I believe strongly that the most effective teaching method—and at the same time, sadly, the most underappreciated teaching method—is the power of positive example. It isn't a quick fix, it doesn't promise instant gratification, but in the long run, it makes all the difference in the world.

Forcing a person to go to church doesn't make him religious any more than forcing him to stand in a garage makes him a car. You don't make a person truly loyal by forbidding disagreement. You don't make a person charitable by robbing him at gunpoint and spending his money on good things.

The test of a true *leader,* it's often been noted, is not how many people you can coerce into submission or intimidate into silence, but how far others will go to follow you because they are attracted to your mission of their own free will. The attraction is the power of your example.

The late Leonard Read, founder of The Foundation for Economic Education, was fond of relating a story which I would like to paraphrase here and apply to myself: I'm terrible at golf, but I golf anyway. When I show up at the course, not surprisingly, no throngs appear. No one watches me to see how it's done. But let a Palmer or a Nicklaus or a Watson or a Trevino show up, and instantly the crowds gather, seeking his tutelage. The British statesman Edmund Burke once said, "Example is the school of mankind, and they will learn at no other." I especially like the way Mark Twain said it, "Few things are harder to put up with than the annoyance of a good example."

I am sure that no one here is entirely happy with the world the way it is. To some extent, all of us are would-be reformers of the world, whatever our personal philosophical inclinations may be. What we sometimes forget in our haste to reform the world is that we must first reform *ourselves*, one at a time, and none of us has yet done all we can in that regard. We chronically underestimate how much influence for good we can be by simply being better individuals—not *pontificating* about doing good, but actually *being* good—and doing it with our own resources, not someone else's—living it, serving as an inspiration for others. By underestimating our ability to shape the future of society by shaping ourselves first, we sometimes meddle in the lives of others while allowing our own to fall into disrepair.

In recent years, we have been treated to a great deal of public moralizing from some who have postured as our self-appointed moral authorities. But moralizing and morals are two different things and sometimes are not found in the same person. Individuals who preach about the morals of the rest of us while living their own lives to the very standards they prescribe do certainly exist, but I suspect that the greatest influence for good comes from those quiet folks who make morals, not moralizing, their vocation.

An item from a newspaper caught my eye some years ago because it made this very point. The story came from the little town of Conyers, Georgia. When school officials there discovered that one of their basketball players who had played 45 seconds in the first of the school's five post-season games had actually been scholastically ineligible, they returned the state championship trophy the school team had won a few weeks before. If they had simply kept quiet, probably no one else ever would have known about it and the school could have retained the trophy.

The really amazing thing was that the team and the town, dejected though they were, rallied behind the school's decision. The coach was quoted as saying, "We didn't know he was ineligible at the time . . . but you've got to do what's honest and right and what the rules say. I told my team that people forget the scores of the games; they don't ever forget what you're made of."

In the minds of most, it didn't matter that the championship title was forfeited. That coach, and that team, were still champions, and in more ways than one. We should ask ourselves, "Could I have mustered the courage to do the same?"

I suppose some of you might be thinking, "Okay, so he's telling us to be good. So did Mother. What else is new?"

What I'm saying is, keep your youthful zeal for doing good and for changing the world. Some may call you idealistic, but progress is never made without ideals, and those who champion them are the examples we most admire and remember.

Resolve that you will indeed make your mark and shape society for the better, but understand that it is not enough to preach to others, no matter how good it might make you feel inside. It is not enough, indeed it's almost always counterproductive, to try to shape the world by the use of force or political decree. You have it within your power to wield great influence. Just recognize that how great that influence will be, is in direct proportion to your ability as a shining example to attract others to your cause.

Graduates—with the degrees you've worked long and hard to achieve, you have a head start on success in life. Now it's up to you to rise to the duty of becoming the very best examples you can possibly be in every aspect of all that you do. □

At Home, But Hardly Alone

by Jim Christie

Any time the leaders and followers of certain causes—like, say, civil rights, gay rights, and abortion rights—descend on Washington, D.C., flexing their political muscle, those who may be opposed, indifferent, and just plain uninterested are lectured on the grandeur of direct democracy.

But when, let's say, a movement that is little known and completely uncovered by the media, like the homeschooling movement, does something similar—in this case with a recent massive telephone campaign to Capitol Hill—the press sounds all sorts of alarms that a clear and present danger is at hand.

After all, many homeschoolers are Christian activists. The telephone campaign was orchestrated by one Michael Farris, president of the Home School Legal Defense Association and a Christian conservative who unsuccessfully ran last fall for lieutenant governor of Virginia.

Liberals in the press can be mean enough to Christians. (Remember the flap last year after a *Washington Post* reporter in a story essentially called Christians a bunch of trailer trash?) But the coldest cuts are often

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the sectarian ones, like that delivered by a San Francisco columnist who most often writes from a conservative perspective.

In a column on Farris and the homeschoolers' telephone campaign, for instance, this right-of-center journalist called the homeschoolers "lemmings."

That's just plain mendacious and misses the point completely. There are *many* solid reasons why the homeschooling "lemmings" united to exercise direct democracy, albeit at the behest of a Christian activist, a member of the official strawman class for the 1990s.

In all too many public schools, reading, writing and arithmetic, are taking a backseat to backseat-of-the-car subjects. Some parents have come to the conclusion that there is an unstated effort in the public schools to promote promiscuity even though not much good has come from years and years of sex-ed as the country's teen pregnancy and sexually transmitted disease rates soar.

And let's face it, public schools are also on the skids academically. Certainly, bleak SAT scores and drop-out rates prove this. Just ask any employer or college-level instructor, and you will hear that young adults are not only lacking in basic skills but in basic manners.

Then there's the politically volatile issue of cultural curricula in politicized public schools. Now, for instance, instead of learning the broad themes of assimilation and cosmopolitan tolerance, children are subject to politicized multicultural sloganeering—while being used all too many times as cannon fodder in the continuous power grab of teachers unions.

To borrow from the title of one of the more celebrated special-interest texts, Heather may have two mommies, but can kindergartners appreciate lesbian studies? And must we subject small children to all the shrill self-esteem-based racial and ethnic cheerleading (and its distortions and frequent outright lies) in many new textbooks even as many American classics, like *The Adventures of Huckleberry Finn*, are denounced by the oversensitive?

Besides, children in public schools just aren't going to have enough time to bolster egos, sink into guilt trips, and absorb every "ism" if Ms. Marple is keeping them busy in class with letter-writing campaigns to governors and legislators any time education budget cuts or school reforms are in the news. For example, throughout California public schools last year, much class time was devoted to badmouthing the concept of school vouchers.

And let's not forget some basic and shocking truths about our public schools, like the fact that parent input into educational matters is kept to a minimum, by bureaucrats. Why else does busing still persist when in practically every public school district, whether white, black or other, parents want their children close to their own neighborhoods—and want funds for their neighborhood schools to be made top-notch instead of being used to subsidize social engineering?

Then there are purely selfish reasons for a family not to send their children to some public schools. Simply put, some public schools are no better and no safer than prisons, often featuring police-state details—metal detectors, drug-sniffing dogs, armed guards, barbwire—that leave the impression that education, when it's there, and even indoctrination, is of secondary concern to coercive efforts to maintain order.

Instead of depicting homeschoolers as tools of a nefarious Christian right plot, the media ought to look into why as many as 350,000 families want to keep government from getting its hands on truly *private* education.

The findings may not mesh with the welfare state advocacy of liberals within the press, nor sit well with conservative journalists who consider anyone on the right and outside the country club gates to be part of the dangerous rabble, but they would hold the hard truth of life in the public schools up for view.

Then it would become clear why a growing number of Americans aren't keeping their children from getting an education, but simply keeping them out of school. □

THE FREEMAN
IDEAS ON LIBERTY

The Natural Disaster Protection Act: A Disaster Waiting to Happen

by Gary Wolfram

The Natural Disaster Protection Act[1] provides an example of what the nineteenth-century French political economist Frederic Bastiat called "the seen and the unseen."[2] While it would appear to reduce the federal government bailout of those who have natural disasters befall them, it would instead create a substantial liability for the federal government, increase exposure to natural disaster, add to the regulatory burden of the economy, and increase the size and scope of government. Its actual effect would be to reduce our individual freedom and move us further down what F.A. Hayek termed "the road to serfdom."[3]

The legislation would amend the Robert T. Stafford Disaster Relief and Emergency Assistance Act[4] in order to, among other things: (1) require "disaster-prone" states to adopt a model building code and enforce this code on new construction, either directly or through their local governments and submit to the Federal Emergency Management Agency (FEMA) a disaster mitigation plan; (2) require any new federal building *or building which has been assisted by federal funds* to meet the new building code standards; (3) create two new federal insurance programs: (i) a primary insurance program and (ii) a reinsurance program whose rates would be set by FEMA; (4) create a new natural disaster mitigation and planning advisory panel to FEMA; and (5) require insurance companies to notify their policyholders of their nonparticipation in these new programs if the insurance company fails to participate and require insurance companies that participate in the current federal flood insurance program to notify FEMA of policyholders living in flood plains and required to have flood insurance who refuse to purchase the flood coverage.

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Can anyone look down this list and answer "no" to the question Albert Jay Nock suggests we put to any federal program: "Does this add to the power of the state?"[5] There is no question that this bill further extends the arm of government into the lives of everyone and will add to the cost of construction. But will it accomplish its purpose and at reasonable cost? In order to answer this we must go back to Bastiat:

> In the economic sphere an act, a habit, an institution, a law produces not only one effect, but a series of effects. Of these, the first alone is immediate; it appears simultaneously with its cause; it is seen. The other effects emerge only subsequently;

> they are not seen; we are fortunate if we foresee them.
>
> There is only one difference between a bad economist and a good one: the bad economist confines himself to the visible effect; the good economist takes into account both the effect that can be seen and those effects that must be foreseen.[6]

As the new Act adds ten new purposes to the Stafford Act (as well as 29 new definitions), we can be excused for summarizing them in order to simplify our answer. The Act itself is really a response to the large losses suffered in the United States in recent years due to natural disasters. In the past two years we have had hurricanes in Florida and Hawaii, floods in the Midwest, and earthquakes and fires in California. This has led to concern that insurance companies will become insolvent, reinsurance will be unavailable, and the federal government will be saddled with huge payments for disaster relief in the face of ongoing attempts to reduce the deficit. Let us, for now, take as given the fact that the Act will mean a large intrusion of the federal government into the building industry and the insurance industry. Will this result in improved solvency of insurers? Promote reinsurance? Reduce exposure to (or at least reduce the cost of) natural disasters? Reduce the taxpayer burden for natural disasters? Unfortunately the answer to each of these is "no."

Solvency of Insurers

Let us take these questions in order. Why would the Act not improve the solvency of insurers? The answer is to be found in acknowledging that the bill is really what Gordon Tullock identified as rent-seeking behavior,[7] in this case of the property casualty insurance companies. The insurance companies are seeking to get the government (taxpayers) to share the risk of insurance against natural disasters. How could the insurance industry be in danger of insolvency from natural disasters? There is only one answer: they have been selling insurance at too low a premium.

Premiums, in a freely operating industry, will cover losses after accounting for the investment earnings of the insurance company. If a company is selling insurance for a premium which does not cover the expected loss minus the investment earnings, it will eventually go out of business. This is the discipline of the market. As Ludwig von Mises pointed out, it is this market discipline which results in efficient use of resources, insuring that the value of the resources used in production at least equals the value to consumers of the service or good produced with these resources.[8]

What the Act will do is to allow insurance companies to sell insurance at below-market rates, with new federal programs acting, in effect, as the subsidizing agent. If the market is not providing reinsurance because the expected losses (the probability of the occurrence times the loss) are not calculable, then why should we expect that FEMA can figure out what the premiums should be? Since this is a government program, and thus rates will be set through the political process no matter what the statute says, we can expect the rates to be underpriced. The net result is that insurance companies which would not survive the market test will continue to survive, and thus improperly price resources, and all insurance companies will take on greater risk than they otherwise would. This must result in either increased paid losses from natural disasters, and thus create just as much danger of insolvency for insurance companies, as it will now be cheaper to locate in disaster-prone areas, or increased government regulation of the insurance and building industry in order to offset this incentive.

Reinsurance

The Act surely will not promote the strengthening of the reinsurance market. The fundamental problem, as has been pointed out in a recent article in the Federal Reserve Bank of Cleveland's "Economic Trends," is that natural disasters are low-frequency, high-impact events.[9] As such they create two problems for insurance. First, they are difficult to predict and thus price. Second, they are subject to "adverse selection": those most likely to purchase disaster insurance are the ones most likely to need it. Persons living in the San Fernando Valley of California are much more likely to purchase earthquake insurance than those living in Michigan or Ohio. The people who purchase insurance will be much more likely to suffer from a disaster than the average person.[10] This complicates the insurance market because insurers attempt to assemble a pool of uncorrelated risks.

There also is the problem of "moral hazard": once I am insured against an accident, I am less likely to take precautions to avoid the accident.[11] Is there any reason to believe that a federal government reinsurance program, managed by FEMA, and advised by a newly created, politically appointed board, is capable of solving these problems? Even if it could, what if the actuarially sound premiums for reinsurance were so high that no one would participate? Is it likely that FEMA would stick to these premiums? Isn't it more likely that there will be political pressure to set premiums sufficiently low to give the appearance that the problem has been solved?

Exposure to Natural Disasters

By reducing the cost of insurance, and by increasing the number of persons who purchase insurance, the Act will result in greater exposure to natural disasters. Suppose I have just had my house destroyed by an earthquake around Malibu. My insurance company says, "Fine, we will pay for this damage, but there is no way we are going to get stuck again and we are not willing to provide you with further insurance." I now find that I must bear the whole risk of building another $2 million home in an earthquake-prone area. Am I less likely to build my home in this area under these circumstances than if my insurance company says: "We now participate in the new Primary Insurance Fund and thus can now provide you with insurance for your home at reasonable cost"? To ask the question is to answer it. It is obvious that reducing the cost of locating in disaster-prone areas must do only one thing: increase the amount and value of buildings in such areas. When disaster does strike, as it inevitably will, then my house will now be standing there to be destroyed.

Burden on Taxpayers

Can the Act reduce taxpayer burden for natural disasters? It cannot reduce the value of buildings placed in disaster-prone areas by reducing the cost of insurance. The current government policy of providing de facto insurance to everyone in disaster-prone areas makes the point. In *The Constitution of Liberty*, Hayek warned that when the government undertakes ad hoc policies it will inadvertently be setting a principle.[12] By providing disaster relief on a regular basis, people come to expect government relief in the face of a disaster. The Act itself is a response to the fact that reducing the risk of locating in dangerous areas results in activity which creates greater exposure. It is an attempt to replace the de facto insurance program with an explicit program. However, at least there was some uncertainty under the old program. Congress might say "no" to relief, or provide minimal relief. With the Act, this modicum of uncertainty will be eliminated and there will be even greater reason for people to expose themselves and their property to risk. The government will now be under legal pressure to provide the relief which it now grants simply under political pressure.

Is the result likely to be more taxpayer exposure, or less? People who argue that it will be less will say that persons who didn't purchase insurance before will purchase insurance now, because it will be cheaper or more available. Thus, there will be less loss to taxpayers, since the premiums will go toward providing the relief. But with the increase in the number of persons with insurance, the adverse selection and moral hazard problems, combined with the fact that premiums must be set through the political process, the likely result will be greater taxpayer exposure in the long run. What happens when the federal reinsurance program comes up $25 billion short? It will, of course, borrow from the Treasury under the Act. And if several hundred thousand voters who own homes are now forced to pay much higher premiums in order to pay off this debt, will there be no political pressure simply to extend the length of the debt to the Treasury? Will this not especially be the case if the debt of the reinsurance fund is carried as an asset on the books of the federal government, and thus does not add to the perception of the federal debt? In the end, the debt of the reinsurance fund will never be repaid and it will result in the same loss to the taxpayer as if the taxpayer had directly provided relief.

Given that there is nothing inherent in FEMA to allow it to price disaster insurance and reinsurance more accurately and more cheaply than the market, what must happen as the exposure to disasters increases and the premiums rise for a large group of homeowners? The same thing that happened when the federal government provided insurance for deposits of savings and loans and banks: greater regulation. The insurance companies and homeowners will be faced with more and more government control. The types of insurance required, the premiums that may be charged, where buildings may be placed, how they may be built, what materials must go into building them, where they can be located—all this and more will be mandated by the federal government. The Act itself already sets up the mechanism for doing so and begins the process.

Karl Marx was certainly correct in pointing out the inevitability of the process.[13] Eventually, just as happened with Social Security, more and more persons will be required to purchase insurance, "in order to spread the risk," which really means in order to subsidize those who are located in the most risky areas. Required premiums, set by the federal government through FEMA, will be the way that the government indirectly taxes people to pay for the results of the massive program that will have started "because catastrophic natural disasters . . . pose particular problems in terms of substantial long-term consequences . . . and inadequate insurance and reinsurance coverage."[14]

Let us admit that Hayek was right, people must take responsibility for their own actions.[15] Harsh as it may seem, providing de facto insurance to persons who locate in disaster prone areas results in greater loss of life and property than would otherwise be the case. It took us decades to learn that our welfare policies have created a larger problem than they were meant to solve. Let us admit that we must simply reduce our proclivity to rush to every disaster with "federal dollars." Before we once again embark on a Promethean journey, let us simply admit that the problem of natural disasters is not too little insurance, but rather too much de facto insurance. □

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1. H.R. 2873, 103d Congress.
2. See his essay, *Ce qu'on voit et ce qu'on ne voit pas.*
3. This is the 50th anniversary of his *The Road to Serfdom*, University of Chicago Press.
4. 42 U.S.C. 5121 et seq.
5. See *Our Enemy, The State* (Delavan, Wisc.: Hallberg Publishing, 1935), 1983.
6. See note 2.
7. Professor Tullock provided the seminal treatment of the subject in his "The Welfare Costs of Tariffs, Monopolies, and Theft," *Western Economic Journal*, 5 (June 1967), pp. 224–232.
8. See, for example, his major work, *Human Action* (New Haven: Yale University Press, 1949).
9. "The Economy in Perspective," February 1994, p. 2.
10. Cf. George Akerloff, "The Market for Lemons: Qualitative Uncertainty and the Market Mechanism," *Quarterly Journal of Economics*, 84 (1970), pp. 488–500.
11. For a brief discussion of moral hazard, see Hal Varian, *Microeconomic Analysis* (New York: Norton, 1978), chapter 8.
12. The University of Chicago Press, 1960. See the Gateway Edition, Henry Regnery, 1972, p. 111 (chapter 8, Section 6).
13. See Karl Marx and Frederick Engels, *The Communist Manifesto*, Pathfinder Press, 1987 (originally published 1847), especially chapter I.
14. Sec 101.
15. *The Constitution of Liberty*, chapter 5.

THE FREEMAN
IDEAS ON LIBERTY

Free Markets and Externalities: The Symmetry of Unintended Effects

by James Rolph Edwards

Someone once said that the world is not only a stranger place than we know, it is a stranger place than we can know. Whether that is true or not, upon close examination it often turns out to be quite different in crucial respects than we had previously believed. Consider the theory of externalities, in which a distinction is made between the social costs and private costs of human actions and transactions. Normally, the voluntary trades that characterize production and exchange activities in market economies are mutually beneficial to the parties involved *a priori* because each exchanges something they want comparatively *less* for something they want comparatively more. Each bears the private costs of his actions generated by alternate uses forgone in the decision to use the resources employed in the way that they were. A meaningful difference between the social costs generated by these actions and the *private* costs exists, however, when *unintended* costs (often termed *external* costs) are imposed on third parties. In such cases, too many resources will be employed in the industry or activity involved, because only the private costs and benefits are being considered by the parties generating the externalities, and the private costs are by definition less than the true social costs.

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The quintessential examples are air and water pollution, which affect the environment adversely and often pose human health hazards. It has come to be accepted by many economists that in such cases the government is justified in imposing some sort of coercive regulatory policy to reduce the external costs generated and to obtain a more correct resource use. Other observers—including many leaders of the environmental movement—extend this logic to a more radical conclusion. They believe that pollution and waste are so pervasive and threatening that government must either socialize the economy, taking full control of industry to end pollution, or force an end to industrial/technological market society itself in order to save the human race.

A variety of arguments can be marshaled in opposition to these views. First, solutions more consistent with the maintenance of a free society, such as specification of private property rights (since externalities are a common-property problem) and tort law (in which those harmed sue for compensation) can often be applied to solve or reduce externality problems.

Second, industry and technology—in the

forms of such things as medicine and sewage, and water treatment—have often been intentionally employed to *improve* human health.[1] Indeed, as measured by mean life expectancy—the single best summary indicator of environmental risks faced by human beings—people face fewer such risks now than ever before in human history, and do so as a direct result of technical and economic progress in the market economy.

Third, the whole externality effects of industrial market society are being mischaracterized. As industry and technology develop, some forms of pollution are generated and others are *eliminated.* The electric stove largely ended the breathing of wood smoke in the home. The automobile ended the scourge of horse manure in cities, which would otherwise constitute a terrible source of pollution and a public health threat. As an inherent element of technological development, firms have progressively discovered and employed more and more efficient sources of fuel and power generation in order to reduce costs under competitive market pressures. This caused pollution per unit of output generated to decline steadily long before the EPA and the 1970 Clean Air Act were created. Indeed, according to economist Paul MacAvoy, there is no evidence that those regulatory mechanisms improved on that record.[2]

A closely related point constitutes the central argument of this paper. While it is true that market activities often generate externalities, and new technologies often have unintended side effects, *nobody has ever offered a convincing reason why such external effects should more frequently be detrimental than beneficial.* Creation of the automobile generated traffic and mobility problems that Henry Ford and other developers of the technology never foresaw, but it also eliminated local monopolies and monopsonies by integrating markets (as well as eliminating horse manure pollution), which was also no part of their intent. Environmental ideology, however, and the regulatory policy it drives, are biased toward finding the detrimental side effects of market industrial activity, and ignoring or mischaracterizing the beneficial effects. The example of industrial CO_2 emission is striking.

Carbon dioxide is quantitatively the largest single emission of free market industrial/technological society, and over time these emissions have begun to add substantially to atmospheric CO_2 concentration. Automobiles contribute heavily by emitting carbon monoxide, which is unstable and quickly mixes with atmospheric oxygen to form carbon dioxide. Most economists and all environmentalists treat CO_2 as an unqualified pollutant; that is, a substance which generates only external costs. As one of the primary greenhouse gases, industrial CO_2 emission is accused of being a primary factor generating global warming, that is, raising lower atmospheric temperatures over time. Such rising temperatures are asserted to be eventually capable of melting the ice caps and causing deserts to expand, threatening disastrous loss of land area and increasing famine. Consequently, the argument goes, massive government controls and interventions must be employed to reduce industrial CO_2 emission.

Actually, the evidence that global warming is even occurring, much less that human CO_2 emission is generating such warming, is very weak. Most ground station atmospheric temperature time series show no warming in the last forty or fifty years, though one data series does show a very slight temperature rise.[3] Tyros N satellites, in orbit since 1979, may eventually settle the matter. They use an extremely sensitive system of microwave radiometers to measure lower atmospheric temperature. The satellite observations cover a large area at a time (a circular "footprint" 110 km in diameter) and are not restricted to land, as are most surface based temperature recording systems. Over this period in which, by global warming theory, temperatures should have risen more rapidly than ever before in human history, since industrial CO_2 emission has been larger than ever before, the satellite data show *no* upward trend in global temperature *at all.*[4]

If the effect of industrial CO_2 emission on lower atmospheric temperature is obscure and debatable, however, certain other effects are not, or at least should not be. CO_2 is the primary nutrient that plants use in transforming sunlight into plant matter (carbohydrates) through photosynthesis. That is, plants *grow* by transforming CO_2, other nutrients, and sunlight into plant matter. For various natural reasons, many of which are unknown, atmospheric CO_2 concentration has varied widely over the earth's history. The last Ice Age seems to have reduced the CO_2 level far below concentrations existing in earlier historic periods. Indeed, it may have reached a level within 100 parts per million (PPM) of being too low to sustain life on earth.[5]

The significance of this is that industrial CO_2 emission is correcting what is, in terms of the Earth's geological and ecological history, an imbalance of atmospheric CO_2 on the low side. In particular, as Sylvan Wittwer, Professor Emeritus of Horticulture at Michigan State University explains, at current atmospheric concentrations (about 365 PPM), CO_2 is the *limiting* nutrient in plant growth, the one plants cannot obtain in adequate amounts. Increasing atmospheric CO_2 concentration *increases* plant growth. Wittwer explains that it also makes plants healthier and tends to benefit common food plants more than it does common weeds.[6] The beneficial effects of CO_2 are well established in the scientific literature, and the knowledge is so common in some circles that nursery owners have been deliberately enriching the CO_2 content of the atmospheres in greenhouses to as much as 1,000 PPM for decades.

In economic terminology, the point is that, at current atmospheric concentrations, industrial enrichment of atmospheric CO_2 has a positive marginal product for plant growth. Many hundreds of scientific experiments have been conducted to determine CO_2 productivity effects on particular plants, which often yield startling results. Recently, for example, Sherwood Idso, a well known soil physicist at the U.S. Water Conservation Laboratory in Phoenix, Arizona, planted two groups of orange trees in the ground in identical soil and climate conditions. In similar experiments the plants are usually grown in laboratory pots, so Idso's experiment more closely approximated real world conditions. Then he enriched the atmospheric CO_2 content around the second group of trees by 75 percent and observed the two groups over time. Trees in the CO_2 enriched group bore fruit a year earlier than the control group, and after three years were 2.8 times as large on average. Their fruit yields were enormously larger, and by every measure of plant vitality they exceeded the control group.[7]

A Greener World?

Evidence is accumulating that industrial CO_2 emission is increasing plant growth around the world. For example, scientists at the Finnish Research Institute, in a recent study of European forests, discovered that there had been a 25 to 30 percent increase in the growth and growing stock of those forests between 1971 and 1990, which they attribute at least partly to the increase in atmospheric CO_2 over the period.[8] They strongly hinted that this process is probably operating world wide. Other data indicate so. At Mauna Loa recording station in Hawaii, scientists measure the amplitude of the oscillation in atmospheric CO_2 concentration between summer, after spring plant growth has reduced the concentration, and winter, after much vegetation has died and returned CO_2 to the atmosphere. The scientists report that this oscillation, which is known as the "breath of the biosphere," has increased by 15 percent since 1959, indicating that plant sequestration of CO_2 has risen that much in the northern hemisphere over this period.[9] If so, this CO_2 "fertilization" effect must be *more* than offsetting deforestation in the tropics. Indeed, it may *automatically* compensate as rain forest trees are cut and stop sequestering atmospheric carbon through growth, leaving more in the atmosphere to generate and be removed by plant growth elsewhere.

The world is actually getting *greener*, then, due to the beneficial effects of industrial CO_2 emission, contrary to the dismal projections of the environmental apocalyptics. On the basis of the Mauna Loa data, Patrick Michaels computes that the probability that the world is *not* getting greener is only 3 percent. Consumers driving their automobiles, instead of feeling guilty for using depletable fossil fuels, as environmental apocalyptics so ardently wish them to, might justifiably take satisfaction in helping to feed the world's billions, since that is *exactly* what they are doing. It is safe to say that economic models which exclude such a systematic, beneficial externality, cannot generate accurate estimates of the costs or benefits of CO_2 emission abatement, and must systematically *overstate* the amounts of such emission abatement that is economically justified. They may even get the justified direction of change wrong.

Blinded by Ideology

How can economists studying environmental issues and other effects of technical change and industrial development miss all this? It seems odd that they would, since the theory of externalities makes specific reference not just to external costs but also to external benefits possibly resulting from human actions. Environmental ideology seems to blind most analysts to those benefits. In a recent paper on the issue of global warming policy, William Nordhouse makes the following amazing admission in a discussion of the costs and benefits of CO_2 emission abatement:

> In contrast to the cost function, we know little about the shape of the damage function . . . We suspect that higher levels of greenhouse gases will hurt the global economy, but because of the fertilization effect of CO_2 or the attractiveness of warm climates, the greenhouse effect might on balance actually be economically advantageous.[10]

Later in that paper, following a discussion of the various factors that must be considered in assessing the impacts of CO_2 emission and of emission abatement on the global economy, Nordhouse adds the following:

> These remarks lead to a surprising conclusion. Climate change is likely to produce a combination of gains and losses with no strong presumption of substantial net economic damages. This is not an argument in favor of climate change, or a laissez-faire attitude to the greenhouse effect. Rather, it suggests that a careful weighing of costs and damages will be necessary if a sensible strategy is to be devised.[11]

Unfortunately, though Nordhouse is among the fairest and most moderate of modern economic analysts dealing with such issues, these observations appear to be unrepresentative of his general philosophy. In an even more recent paper on the same subject, Nordhouse not only completely fails to mention the "fertilization effect" of CO_2, but expresses a highly pessimistic perspective on the risks associated with human industrial activity. That paper begins with a statement, phrased in the best apocalyptic style, that mankind is playing dice with the natural environment through a multitude of interventions. The usual bleak list follows, with none of the potential beneficial effects or side effects of scientific/industrial progress mentioned.

This attitude carries through to the last section of Nordhouse's paper, titled, symptomatically, *Uncertainties and Anxieties*. He remarks on the relatively small amount of coercive governmental controls for emission abatement his and other economic models justify, with some apparent disappointment, which becomes clear as he then writes the following:

> Yet, even for those who downplay the urgency of the most likely scenarios for climate change, a deeper anxiety remains about future uncertainties and surprises. Scientists raise the specter of shifting currents turning Europe into Alaska, of mid-continental drying transforming grain belts into deserts, of great rivers drying up as snow packs disappear, of severe storms wiping out whole populations of low-lying regions, of surging ice sheets raising ocean levels by 20 to 50 feet, of

northward migration of old or new tropical pests and diseases decimating the temperature (sic) regions, of environmentally induced migration overrunning borders in search of livable land. Given the potential for catastrophic surprises, perhaps we should conclude that the major concern lies in the uncertainties and imponderable impacts of climate change rather than in the smooth changes foreseen by the global models.[12]

Nordhouse clearly reads different scientists than I do. Most of the elements in this list of potential disasters seem highly unlikely. But notice his uniform concentration on *catastrophic* surprises, with *no* hint that *beneficial* surprises might be equally possible. Nordhouse goes on to point out that society often has to make decisions in the absence of complete information, and that a reasoned decision process lists events that may occur, assigns them probabilities, and weighs the expected values of costs and benefits under alternate courses of action in such a way as to maximize the expected value or utility of the outcome. This standard neoclassical economic argument is difficult to deny. But any society whose intellectual opinion makers and governmental decision makers—like Nordhouse—only presume *disasters* to be likely, and never beneficial surprises, would arrive at incorrect and harmful policy decisions with unnecessary frequency. Indeed, the progressive extension of controls such myopic disaster prevention policies entail would eventually end the very freedom that has been a precondition of modern human well-being. □

1. See Steven Gold, "The Rise of Markets and the Fall of Infectious Disease," *The Freeman*, November 1992, pp. 412–415.
2. Paul W. MacAvoy, *Industry Regulation and the Performance of the American Economy* (New York: W. W. Norton & Company, 1992), pp. 96–103.
3. The data and surrounding issues are discussed clearly and exhaustively in Patrick J. Michaels, *Sound and Fury: The Science and Politics of Global Warming* (Washington, D.C.: The Cato Institute, 1992). Michaels was Virginia State Climatologist for several years, and was President of the American Association of State Climatologists, 1987–1988.
4. See Roy W. Spencer and John R. Christy, "Precise Monitoring of Global Temperature Trends from Satellites," *Science* 247, March 30, 1990, pp. 1558–1562.
5. Michaels, *Sound and Fury*, p. 10.
6. Sylvan Wittwer, "Flower Power," *Policy Review*, Fall 1992, pp. 4–9.
7. Idso's experiment is reported both in Michaels, *Sound and Fury*, pp. 109–110, and Wittwer, "Flower Power," p. 7.
8. Pekka E. Kauppi, *et al.*, "Biomass and Carbon Budget of European Forests, 1971 to 1990," *Science* 256, April 3, 1992, pp. 70–74.
9. Michaels, *Sound and Fury*, p. 12.
10. William Nordhouse, "To Slow or Not to Slow: The Economics of the Greenhouse Effect," *The Economic Journal* 101, July 1991, pp. 920–937. The quotation is from page 933.
11. Nordhouse, "To Slow or Not to Slow," p. 933.
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THE FREEMAN
IDEAS ON LIBERTY

Labor Cartels, Competition, and Government

by Charles W. Baird

A cartel is a group of sellers of a product or service who, instead of competing with each other in an open market, band together and try to eliminate that competition. Some cartels are illegal, and some are legal. For example, if General Motors, Chrysler, and Ford conspired together to raise automobile prices and standardize market shares, government would prosecute them for violating the Sherman Antitrust Act. On the other hand, if the employees of General Motors, Chrysler, and Ford conspired together to raise wages and standardize working hours and conditions, government would applaud them for unionizing.

Economic theory tells us that all cartels are inherently unstable. If government doesn't do anything to force cartel members to refrain from competition and to keep interlopers from competing with a cartel, it soon disintegrates. As George Stigler put it, "Cartels are gentlemen's agreements, but they seldom are and never do."

In spite of the protection afforded unions by the National Labor Relations Act, only 11 percent of the American private sector labor force is unionized. According to Leo Troy, of Rutgers University, by the year 2000 that figure will be below seven percent. Unions are desperate for even more government protection. And the Clinton Administration seems eager to comply.

Much has been written about the pro-union appointments President Clinton has made to the National Labor Relations Board and his new National Commission on the Future of Worker-Management Relations (which one commentator calls FOU—Friends of Unions). The president's promises to sign such legislation as the bill to make it illegal for employers to hire permanent replacement workers during economic strikes and a bill to repeal all laws that protect workers from compulsory union membership are also well known. But far too little attention has been paid to the president's pro-union intervention in labor disputes.

A New Era?

Last Thanksgiving, with much fanfare and publicity, Clinton intervened on the side of the union in the flight attendants strike at American Airlines. Under political pressure, American capitulated to union demands. The Association of Professional Flight Attendants, which represents workers at other major airlines as well as American, immediately hailed Clinton's intervention as a victory that would "set the tone"

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for future negotiations in the industry. Clinton justified his action on the grounds that the Thanksgiving holiday was a peak travel time, and the public would be greatly distressed by continued interruption of flights. Labor Secretary Robert Reich said that this intervention was based on unique "extenuating circumstances" and that the Clinton administration did not plan to get involved in other labor disputes except in extreme circumstances. In contrast, the AFL-CIO lauded the president's action as the beginning of a new era in which management would no longer have the upper hand in labor disputes.

The president's pro-union intervention in the American Airlines strike was soon followed by a similar intervention in a labor dispute at United Airlines. While American flight attendants were on strike, machinists at United were "working to rule" to protest United's refusal to agree to a union plan to acquire majority ownership of United. The union proposed to pay for the buyout merely by accepting some wage and work rule concessions which would reduce United's labor costs. Clinton dispatched Reich and Transportation Secretary Federico Pena to pressure United into agreeing to reopen talks with the unions on the buyout. He also sent Felix Rohatyn, a member of his commission to study the national airlines, to "mediate" the talks. In March of this year United agreed to a buyout of at least 53 percent of its equity shares by its unionized pilots and mechanics in exchange for wage and work rule concessions that were not appreciably different from those United initially turned down. Even with the concessions, United's labor costs will still be much higher than, for example, those at rival, nonunion Southwest Airlines.

Coal Strikes

Then there were the coal strikes. Starting on May 10, 1993, the United Mine Workers of America (UMW) undertook an expanding program of "targeted" strikes against members of the Bituminous Coal Operators' Association (BCOA). More than 17,700, out of 30,000, unionized miners were pulled away from their jobs. The seven-month strike ended on December 7.

The UMW said its principal goal was "job security." Actually, the strikes were nothing more than a desperate attempt by the UMW to prove that it is still relevant in the coal industry. From the union's point of view its members are important only insofar as they serve the institutional interests of the UMW.

UMW mines have suffered a sustained decline of market share since 1970 when union coal amounted to 70 percent of total U.S. coal production. In 1980 the figure was 44 percent; in 1990, 30 percent; and in 1992, 28 percent. Union mines are losing market share to more efficient nonunion mines. Of the 2,800 active mines in the United States, only 800 are unionized. As more and more established union mines are shut down because of depletion or because the falling price of coal relative to union-driven costs makes their continued operation uneconomic, new, union-free mines are opened.

The reasons behind this declining market share have nothing to do with employers trying to rip off workers. For example, under the terms of the 1990 Clean Air Act, coal burning utilities are gradually being forced to switch from high sulfur, eastern coal to low sulfur, western coal. By 1995 many high sulfur mines, many of which are unionized, will be made obsolete by law.

Competition is the biggest part of the UMW's problem. In addition to the fact that 2,800 American mines compete with each other, foreign competition from such countries as Australia and Canada has been increasing. Expressed in 1987 dollars, the average price of coal in 1980 was $34.20 per ton. By 1991 the price had fallen to $18.24—a 48 percent decline. For a mine to stay open and continue to provide employment to miners, it must keep costs of production in line with these falling market prices.

Increased productivity is the single most important means to reduce cost. In union mines productivity is 27.9 tons per miner per day. In union-free mines the figure is

47.6—70 percent more. Even if hourly wages per worker were the same at non-union and union mines, the big productivity difference would give the nonunion mines a huge advantage in cost per unit of output.

The productivity difference is not the result of sweatshop conditions at union-free mines. Rather, it is because at such mines: employees are hired and assigned based on ability rather than seniority; work rule restrictions, such as requiring an electrician to plug in a power cord, are absent; scheduling is flexible; and contracting-out of repair and maintenance work is permitted. Interestingly, the UMW had already agreed to many of these productivity-enhancing practices at a few unionized mines that compete with BCOA mines; yet, the union refused to discuss the issue with the BCOA.

Average hourly wages and benefits received by nonunion miners ($24.21) exceed those received by union miners ($23.90). That doesn't include work incentive payments paid by many nonunion mines with which a nonunion miner can receive several thousand dollars more in wages and benefits per year than his unionized counterpart.

Nevertheless, unionized mines have higher overall hourly labor costs ($31.64) than union-free mines ($26.95). This is mainly due to spiraling health care costs. Unionized mines pay $3.14 per hour per existing employee for health policies with no deductibles and no coinsurance. Nonunion mines pay $1.83 for policies with deductibles and coinsurance. Moreover, the unionized mines are required by the 1992 Coal Mine Retirees Health Benefits Act to pay health benefits to retired unionized workers whose employers have gone out of business. That is unfair, but it is not the fault of the BCOA or the nonunion mines.

In the face of falling prices, higher overall labor costs, and much lower productivity, the UMW demanded that all existing union jobs be preserved and that all union miners receive full pay even if, for any reason, they are out of work. This is what it means by "job security."

Some BCOA mines are owned by parent companies that also own nonunion mines. As part of its plan for job security, the union demanded that the parent companies, which were not part of the bargaining, force workers in their nonunion mines to unionize. More and more miners are telling the UMW to get lost. Desperately afraid of losing dues payers, the union sought to take free choice away from workers in two ways.

First, the union demanded that management in nonunion mines *already* owned by parents of BCOA members remain silent when the UMW tries to organize their employees. In other words, it demanded that management give up its right of free speech during organizing campaigns in those mines. Second, the union demanded that management in *new* nonunion mines acquired or opened by parents of BCOA members automatically recognize the UMW on the basis of signatures on authorization cards. In other words, it demanded that management take away the employees' right to vote on whether to unionize.

Authorization card signatures are collected on a face-to-face basis, and workers are often intimidated by union organizers who are seeking their signatures. The only target unionists prefer to any employer is a worker who wishes to be union-free.

The UMW has a reputation for violence. For example, during the seven-month strike equipment was sabotaged; tires were punctured; truck and car windows were broken; rocks, steel balls, and bolts were launched from slingshots at guards and supervisors; at least one truck was burned by a Molotov cocktail; one supervisor was shot, and gunshots were fired at a mine office. The UMW is now fighting a $52 million fine imposed on it by a Virginia court for its violent activities during the 1989 ten-month Pittston strike.

The only way that BCOA mines can provide genuine job security to their employees is to cut costs to remain competitive. UMW demands are inconsistent with that goal. Yet, Clinton dispatched Reich and William Usery, a member of the National Commission on the Future of Worker-Management Relations (FOU), to "encourage" the BCOA to accept the UMW's job security demands. On December 7, 1993, the BCOA announced its capitulation.

Reich said the agreement was "a testament to the tenacity and conviction of Richard Trumka and the UMW." Trumka is the president of the UMW. In my judgment, the only conviction that Trumka had was that if he held on long enough, Bill Clinton would come to his rescue. When Reich was asked about the propriety of the administration's actions he lamely asserted that, like the American Airlines case, the coal strike involved "unusual circumstances." One wonders if there will be any major strikes that will not involve "unusual circumstances" which justify pro-union political intervention during the Clinton presidency.

Not since Franklin Roosevelt has the United States had a president so eager to subordinate the rights of employers, consumers, and union-free labor to the interests of cartelized labor. It won't work. Clinton may be able to slow down the rate of union decline, but he cannot reverse it. In an increasingly competitive world economy, unions will, like all cartels, eventually disintegrate. □

One Information Superhighway: Take It or Leave It?

by Eric-Charles Banfield

A key question about the "information superhighway" remains unanswered: Why only one? Americans have been led to expect the information revolution would bring us not one, but possibly hundreds of competing information networks. Now the future of telecommunications and cable will be dominated by a single system created under U.S. government jurisdiction and subject to U.S. government oversight.

Until just recently, the evidence suggested that the free market, without central government direction, would be allowed to establish information networks according to the needs of consumers. Technology, advancing rapidly, had been driving costs down at a rate that promised increased affordability of multimedia services over time. The sheer economics precluded any possible "need" for government assistance. The market process, without central direction, would develop not one "infrastructure" but instead many networks from which consumers could choose. In that free market, if a consumer disliked the level of performance or security offered on one service, he or she would be free to use a different one. Firms that did not satisfy consumers would have to adapt or fold, at their own expense.

But now the U.S. government asserts control over this evolution. It has worked out an arrangement with the large cable and telecommunications firms: The government will let these firms merge and will loosen a few other restrictions. In exchange, the firms will develop a single, centralized, fiber-optic cable information superhighway,

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called the "National Information Infrastructure" (NII), according to government standards. Presumably, most transmissions would have to use that one central highway.

The government wants to subsidize the building of that highway so that its price will be low enough to attract others from any market-based network that might offer a competing service. After using its power to price out market-based networks, the government would have de facto control over virtually all telecommunications. The government has also decided that in order to subsidize access to NII "for everyone," it must levy a tax on all phone, cable, and other information services. Of course, that means "everyone" would have to pay that tax, at least indirectly.

One irony of this intrusion is that, in the name of "promoting competition," the government claims it wants to "force competition." No one in the industry, it seems, has pointed out that competition cannot be "forced." Competition is only one element of sound markets, and it must evolve spontaneously. The monopolies the government officially wants to avoid are possible precisely because of the government's involvement. No monopoly could survive the modern telecommunications era without government protection or privilege. Under free markets, without government meddling, competition is guaranteed.

But apparently the big multimedia firms don't want competition. They prefer the easier life of government privilege and protection. They want the government to control and structure the market to their advantage. Cable and telephone firms, citing the large investments needed to begin laying cable, told the government they were reluctant to begin, unless officials would carve up the market in advance and let the corporate players know who their limited competitors would be in each region. Then they could proceed with "certainty." The government was all too happy to comply. That means free markets and competition in communications and entertainment have been sacrificed to power-hungry corporations, legislators, and bureaucrats.

The first casualty of that communications monopoly is consumer privacy. As the telephone, computer, and cable services merge, the Clinton administration is already pushing a bill to allow the Federal Bureau of Investigation, the National Security Council, and other law-enforcement agencies to tap into citizens' voice and data transmissions over the NII.

The second casualty, common in business-government arrangements, is the freedom of suppliers to select their customers. The regional phone companies (the seven "Baby Bells") will have to make the NII available on a "nondiscriminatory" basis. The government wants "universal service," meaning advanced telecommunications services "available to all." It also wants the system's developers to put schools, libraries, and hospitals "on-line" for free. If not, it will "re-regulate" the system. Declaring telecommunications a "necessity," Vice President Al Gore said, "Congress, the executive branch, the FCC, and the states will share responsibility for revising universal service [and] will share responsibility for meeting those obligations. . . ."

Citizens, including multimedia firms, should resist the idea of a single superhighway created under government fiat. Indeed, some personal computer makers have already expressed "disdain" for the government's single-superhighway idea. Competition and choice requires free markets, not rigged games benefiting those corporations with the most political weight. Consumers should not be satisfied with any centralized monopoly, especially in such an important area as communication of information. □

THE FREEMAN
IDEAS ON LIBERTY

Houston Says No to Zoning

by James D. Saltzman

"Zoning goes down for third time" read the morning headline of *The Houston Post* last November 3. As they had in 1948 and 1962, Houstonians voted once more to remain America's largest city without a zoning ordinance.

"We've got to stop the cancerous erosion of the quality of life in many of our neighborhoods. Those people are crying out for help. Zoning is the answer," said the president of the Houston Homeowner's Association last August.[1]

Yet, the vast majority of Houstonians were not crying out for zoning. Hispanics and low-income blacks voted overwhelmingly, 58 percent and 71 percent, against a measure touted as the way to "save" their neighborhoods.[2] In a low-turnout referendum, only 10 percent[3] of the city's registered voters gave their nod to zoning, disproving the pro-zoners' claim of widespread discontent among Houstonians with their "under-regulated" land market.

In fact, with 17 separate land-use ordinances covering things so specific as trailer parks, rendering plants, and commercial landscaping, property in Houston is not exactly "under-regulated." However, the evidence from this debate in Houston highlights the advantages of a large city that relies more than any other in America on the market to determine land use.

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Exaggerated Risks

With zoning, a city can regulate the location and design of all land uses, from houses to gas stations to bars. Its supporters said that homes unprotected by zoning risk a loss in property value if a business or apartment locates nearby.

Not necessarily. Drive around central Houston and you'll find plenty of expensive new houses built across the street from or adjacent to existing commercial or apartment buildings. The people who build and buy these homes are not dumb. There is obviously a strong market for homes in convenient urban settings.

This casts doubt on the need for zoning to protect or boost property values. Within Houston are two small, independent cities, Bellaire and West University, with zoning. Between 1970 and 1980 home prices in Bellaire and West University climbed more slowly than in many Houston communities, including those lacking private neighborhood restrictions against businesses and apartments.[4] In fact, between 1990 and 1993, average annual home sale prices actually fell in the two zoned cities while sprinting up in a number of Houston neighborhoods, restricted and unrestricted.[5] The financial risks to homes unshielded by zoning are, at best, greatly overstated.

Another exaggeration is that single-family neighborhoods without zoning are likely to be overrun by businesses and apartments. In the Houston Heights, a century-old neighborhood of 300 blocks, only about 5 percent of the residential blocks have private restrictions.[6] Also, a Prohibition-era law left over in the Heights bans liquor sales. Those are the only controls on property in the Heights for the last 100 years, apart from city codes.

Yet single-family homes occupy almost 86 percent of the lots on interior streets. Businesses take up 7 percent; industrial uses, less than 2 percent; apartments, less than 2 percent; churches and schools, 4 percent.[7] Similar distributions in land use have been documented for other unrestricted inner-city neighborhoods.[8] Why does this happen?

In Houston land uses tend to segregate themselves as investors respond to market incentives. Under the Houston system, heavy industry voluntarily locates on large tracts near rail lines or highways; apartments and stores seek thoroughfares; gas stations vie for busy intersections.[9]

With the market at work there's no need for government-imposed districting. Businesses that open inside quiet residential neighborhoods will compete poorly with establishments that enjoy the visibility and traffic count of a heavily traveled street. Businesses that thrive amidst homes often serve strong local demand.

"Shade-tree" mechanics appear in low-income neighborhoods to service old cars owners cannot afford to replace. "Mom and pop" grocery stores supply those who have no cars. In Houston's West End, an area with a large population of artists, stylish and expensive townhomes exist beside framing factories and studios. Around Houston, such mutually beneficial mixtures of commercial and residential uses reflect the market's sensitivity to consumer needs, a sensitivity unimpeded by the tastes of politicians and bureaucrats.

Pro-zoning fears ignore the self-regulating qualities of the market. In locations with stable demand for single-family homes, healthy real estate values are likely to prohibit many "noxious" uses—like junkyards and machine repair shops—that want cheap land. Without realizing it, the homeowners have "zoned out" such uses through their own free choices. As zoning expert Bernard Siegan says, "the most effective of restrictions [is] competition."[10]

Self-Buffering

Since the market creates predictability in land use, anyone can buffer himself according to his own standards from uses he dislikes. He can pursue his own notions about quality of life without the local government imposing its version on him.

People who like proximity to retail services can live on or near heavily traveled streets and assume the risk of facing more noise and traffic than individuals who seek the peace and quiet of an interior residential street. The need to keep bars away from residents is a frequent justification for zoning, but one Houstonian said he likes living near a bar because "patrons to establishments and pedestrian traffic are deterrents to crime."[11] In Houston, to each his own.

Even without zoning, home buyers wanting control over the development of land in their neighborhood have a choice called "deed restrictions." Usually, these deed restrictions are initiated by an original developer to cover all property purchased in a subdivision for 25 or 30 years. Restrictions are often renewable after that period, and most homes in Houston built since World War II have such renewable restrictions.[12] Enforceable by civic associations with help from the city, the document can prevent businesses or apartments from entering the neighborhood. It can even require residents to keep their lawns manicured or their homes painted only certain colors. However detailed, deed restrictions contain rules voluntarily accepted by home buyers, unlike the edicts issued to property owners by a zoning commission.

Predictably, zoning proponents criticize deed restrictions for not providing air-tight protection against mixed uses. Restrictions end at subdivision boundaries, leaving residents at the neighborhood's edge possibly unbuffered from an apartment or business. Zoning supporters want guarantees of protection that neither deed restrictions nor the market's natural separation of land uses can provide.

But are such guarantees possible, even under zoning? In Fort Worth and Dallas, two zoned cities, one can notice an eight-story office building overshadowing nearby homes, a high-density apartment complex and a shopping center across a narrow street from homes, and a junk dealer and a tire store next door to homes. Even in tightly zoned central Connecticut, one can find a factory right beside a home, a new supermarket being built next to homes, and a bar across the street from homes—all mixes routinely denounced as "incompatible" by zoning advocates in Houston.[13]

In land-use patterns and in the predictability of those patterns, Houston and zoned central cities are more similar than prozoners admit.[14] The difference is that Houstonians internalize risks (quite successfully) that zoning attempts to control elsewhere by managing the property rights of citizens.

The Houston Advantage

That's the Houston advantage: private property rights. True, Houston has many strict ordinances, but without zoning, citizens in Houston maintain over their property much of the control that other cities give to local government. Zoning dramatically increases the opportunity for public officials to manipulate private property for maximum political benefit and "impose costs on others at no cost to themselves,"[15] writes economist Thomas Sowell. Under zoning, local goods and services reflect regulatory costs Houstonians avoid.

One such good is housing. Without zoning, Houston ranks consistently as the leader among major American cities for housing affordability. "It's more affordable here than any other large city in the nation," said University of Houston economist Barton Smith.[16] According to Smith, one reason for this affordability is Houston's lack of zoning.[17] And a federal report in 1991 cited zoning as a leading cause for the shortage of affordable housing in America.[18] How does zoning push up the cost of housing?

The proposed Houston zoning plan showed how. It contained density controls that would have forced higher rents for many new apartments and higher prices for many new townhouses.[19] In one case, a planning commissioner effectively froze the renovation of a low-income apartment building by having it zoned into a district just for single family homes. In this way, the structure became a "non-conforming" use, discouraging lenders from risking money on the project.[20] In the long run, zoning increases the cost of housing by restricting its supply. Ironically, zoning makes such bad policy a predictable choice for municipal authorities because they are sensitive to the desire of politically influential homeowners to limit development near their neighborhoods.[21] In unzoned Houston, developers can adjust the number of dwelling units per lot to suit consumer demand, not the agendas of zoning insiders.

Zoning proponents say they just want bargaining power with a developer of land near homes. Ideally, they argue, a compromise on use or design could be struck that would create a "win-win" situation for everyone.

Well, not exactly everyone. Concessions to build fewer dwelling units in an apartment could raise rents there, pricing some individuals out of the complex. And the likelihood of construction delays fostered by zoning procedures and squabbles will price some builders out of their market as well. For example, according to one journalist, zoning and related land-use regulations have boosted the cost of development in Austin, Texas: "Problems—whether they involve neighborhood opposition, new ordinances, unclear policies or moratoriums—mean delays and delays cost money."[22] The interests of the most vulnerable consumers and producers are protected by secure private property rights, not by zoning.

Such rights also provide Houston with employment opportunities that zoning would have removed. One case involved Forged Vessel Connections, a manufacturer of special parts for pressure vessels. The company has been in its location in the largely black community of Acres Homes for the last 17 years and employs residents from the surrounding neighborhood. But the plant was zoned into a residential district, meaning the building could not expand, meaning the end of plans to add 35 new jobs by 1996.

In unzoned Houston home businesses are common and operate relatively freely wherever they are not prohibited by deed restrictions. But the zoning plan had a different approach:

No employees on site except residents. No signs. No parking spaces for customers. No external evidence of commercial activity.[23] For Houstonians, a taste of the regulation plaguing home businesses in 90 percent of American cities.[24] And the Houston Homeowner's Association, a leading pro-zoning interest, assured its members that there was no reason why home business "standards have to be limited to these prohibitions,"[25] suggesting that more rules could be added later.

Zoning would have created undue hardship for many entrepreneurs. For example, one single mother started a telephone answering service in her own home, hiring other women from the neighborhood for help. Zoning would have forced her to fire her employees or rent office space. She might have applied for an exemption and prayed that her aspirations suited her neighbors and city officials. This scenario offends the principle that the opportunity to use private property for employment is a right, not just a favor granted by local government.

The greatest beneficiaries of Houston's abstention from zoning are not the rich, greedy developers as zoning proponents would claim. Big developers in zoned areas enjoy the reduced competition brought by zoning and can afford the lawyers and other consultants needed to acquire variances from zoning rules. Those who have the most to gain from the free exercise of rights to private property are the unemployed and the poor, those who can least afford the costs of regulation.

Examples occurred during the 1980s when Houston lost 250,000 jobs[26] during the "oil crash." As one Houston reporter recalls: "Because there were a handful of neighborhoods where there were no significant barriers to home businesses, the bust became an opportunity instead of a devastation. Time and time again I saw the unemployed become entrepreneurs."[27] Time and time again in Houston's Hispanic neighborhoods entrepreneurs also emerge from homes.

Affordable housing near retail services, home businesses unhindered by excessive regulation—these are the blessings, not cancers, of a city in which the people determine the use of their property.

If anything, the presence of zoning, not the lack of it, can be cancerous to an old neighborhood. Real estate economist Jack Harris explains that, "zoning causes problems in transitional neighborhoods. Although the market may indicate the need for change in land use, zoning attempts to prohibit change."[28] Harris is saying that the market is smarter than bureaucrats and politicians. Unfettered by the realities of the marketplace, they may attempt to "improve" or "preserve" a neighborhood by zoning out most businesses and apartments, as if declining communities can be economically revived just by legislating non-existent demand for single-family homes.

A free market in land use does not guarantee neighborhood revitalization. But letting people decide what to do with their property can assist the recycling of land, especially when commercial or multi-family construction may capture the only viability a neighborhood has.

In the end, zoning restrictions only inspire their circumvention. A speculator will purchase tightly zoned properties for their artificially deflated price and then turn a hefty profit by negotiating with the proper officials for a less restrictive classification.[29] Such a scheme favors those with political clout. At least without zoning, larger benefits go to the original property owners, who can sell their land at its actual market price. Either way, market forces prevail. Zoning just slows them down and makes them costlier.

But zoning makes intolerance less costly. Some pro-zoners demanded the separation of houses from low-income apartments. "These ramshackle complexes contain hundreds of people of minimal educational and economic attainment, with value systems completely foreign to the majority of homeowners,"[30] complained the vice president of the Committee to Zone the City in August of 1990. In other words, it is not just the wrong kind of land uses that are "incompatible" with homes but the wrong kind of people as well. Such efforts to exclude the poor cannot prevail where the property rights of landlords and developers are secure.

Moral Costs

Zoning makes business activities and housing more expensive, but the greater cost of zoning is moral. In essence, zoning grants a cadre of public officials and favored private citizens the free exercise of state power to force their designs on the use of someone else's property. This process trivializes the individual's basic right to self-determination. By voting down zoning, Houstonians have strengthened their claim to that right. □

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THE FREEMAN
IDEAS ON LIBERTY

The Case Against Managed "Fair" Trade and Strategic Trade

by Shyam J. Kamath

The administration of President William Jefferson Clinton was voted into power in 1992 by a minority of the American electorate on the basis of its promise of "change." As a centerpiece of its platform of change, the new administration promised a "new economic paradigm," a major tenet of which was to create a liberal trading environment through strategic intervention in the process of international trade. Such strategic trade policy involved government intervention to open "closed" foreign markets (the example that was offered was Japan), government activism to serve the national interest in supporting "strategic" industries (e.g., commercial aircraft and semiconductors) and selective targeting of trading partners who were trading "unfairly" by subsidizing their exports or dumping them in the U.S. market.

In spite of the victories in Congress on the North American Free Trade Agreement (NAFTA) and the Uruguay Round of Negotiations of the General Agreement on Trade and Tariffs (GATT), neither of which was initiated by them, the Clinton administration remains wedded to a philosophy of managed and strategic "fair" trade as witnessed by recent confrontations with Japan, China, India, and a host of other nations on issues ranging from the opening of "closed" markets to human rights.

The slogan of "fair" trade has regularly inflamed the passions of the American people since the founding of the republic. Yet successive presidential administrations and the majority of the American people, have on balance been champions of free trade and have thereby made the U.S. the richest country in the world. As the champion of multilateral free trade through the active encouragement and sustained support of the GATT, the U.S. has also been instrumental in supporting world development and making people in other free-trading nations prosperous.

Yet, America in the eighties and early nineties has witnessed the rise of protectionism in the form of retaliatory tariffs and other forms of administered non-tariff barriers. Its "Japan problem" has given rise to a groundswell of popular support for "managed" trade and for punishing its partners for alleged "unfairness," even under the ostensibly free-trade administrations of Ronald Reagan and George Bush. The Clinton administration evidences an activist strain of the protectionist virus that has plagued the nation's movement toward freer trade, in spite of appearances to the contrary.

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Free Trade vs. "Fair" Trade

It is a commonplace of elementary economics that voluntary exchange creates benefits/wealth for all parties to the exchange. When it comes to trade between nations, the same principle applies since it is once again individuals who are involved in these exchanges. In fact, the classical theory of comparative advantage underlying the case for free trade argues that such trade is good for a country even if other countries do not return the favor.

Yet, the case for managed "fair" trade continues to be made on the grounds that free trade results in the loss of jobs, the deindustrialization of America, the loss of "strategic" industries to "unfair" foreign competitors, the loss of American economic leadership and, most recently, is alleged to be the cause of global environmental pollution and needs to be made contingent on the achievement of a common standard of human rights. Both the logic and experience of free trade convincingly refute each one of these claims.

The "They Took Our Jobs" Myth

Trade creates jobs as economic activity expands. The experience of the most free-trading nation on earth, Hong Kong, clearly illustrates this point. With no natural resources, except its people and one of the world's finest natural harbors, but with complete free trade, Hong Kong has witnessed an increase in its per capita income over twenty-five fold and an increase in employment of over twenty times within a short span of forty years. Today, its per capita income is greater than that of the United Kingdom, of which it is still a colony. This stellar economic performance has been achieved while the population of this largely barren island-peninsula colony increased from around 300,000 to six million over this period. The experience of the other "tigers," Singapore, Taiwan and South Korea, is similar. Lest these examples be considered atypical, the cases of western Europe, North America, and Japan have been similar both before and especially after the two World Wars.

The common argument that is advanced in favor of "fair" trade is that trade deficits (i.e., excesses of imports over exports) cause job losses. While this argument reveals a lack of understanding of what trade deficits imply in the standard system of balance of payments accounting, it is pertinent to note that over 21 million new jobs were added between 1980 and 1990 even as the U.S. ran up huge trade deficits with the rest of the world. And the majority of these jobs paid rather well, contrary to the "McJobs" myth. Job growth was mainly in those sectors that were largely unprotected against foreign competition such as computers and data-processing, telecommunications, petroleum and chemicals, pharmaceuticals and health-related products, scientific and photographic equipment, banking and finance, entertainment, leisure and recreation, hospitality and tourism, and the service professions.

Meanwhile, protectionist measures designed to "save" jobs in such industries as automobiles have not kept employment in them from shrinking drastically and, in fact, may have added to their troubles. The quotas (euphemistically called "voluntary" export restraints—VERs) against Japanese autos imposed by the Reagan administration in the early eighties did not prevent the net loss of over 200,000 jobs in the U.S. auto industry.

Robert Crandall of the Brookings Institution has estimated that the 27,000 direct jobs that were saved in the U.S. auto-manufacturing sector cost around $160,000 per job saved (in 1984 dollars) in terms of economic welfare losses in production and consumption. The VERs added about $2,000 to the price paid by consumers, reduced consumer choice, reduced the competitiveness and efficiency of American producers, and resulted in windfall profits for American and Japanese (and other foreign) automobile manufacturers, leading to the shift of Japanese auto production to luxury cars and further exacerbating Detroit's woes in this high-margin segment of the industry. Japanese transplant factories that were set up in the U.S. in order to avoid protectionist sentiment and restraints, reduced the magnitude of the job losses in the auto industry and the other pernicious effects of VERs.

The experience in steel, textiles, and a host of other industries such as dairy products, shipping, and meat-packing was similar. These industries continued to shrink while protective tariffs and subsidies were lavished on them to "save" jobs. For example, in the late eighties, consumers spent $27 billion on textile and apparel subsidies alone, and the cost per direct job saved was $42,000 in an industry with an average wage of $12,000. In the protected dairy products and shipping industries the cost per job saved was estimated as $220,000 and $270,000 respectively in 1987. In the carbon-steel industry for the 9,000 direct jobs saved, the cost was a phenomenal $750,000 per job. The impact of these high-cost "saved" jobs is the diversion of scarce resources from other, more market-oriented industries with perhaps a much larger number of jobs that never came into existence.

Restricting steel imports destroyed jobs. It is estimated that in the 1980s, steel restraints protected 17,000 jobs in the whole industry, while they cost 54,400 jobs in steel-related industries, for a net loss of over 35,000 jobs. Higher steel costs added to the burden of steel-using industries that were trying to compete against foreign manufacturers. Thus, for example, expensive steel raised the cost of building cars in Detroit and promoted Japanese auto imports.

The Deindustrialization Myth

The widespread belief that the U.S. has lost its manufacturing base in the face of foreign competition is simply wrong. Deindustrialization never happened. In terms of absolute output, America's manufacturing lead continues to increase, not fall. The U.S. share of total output of OECD countries (the 24-nation Organization for Economic Cooperation and Development, comprising the bulk of the market-oriented industrial economies of the world) increased from 36 percent in 1973 to 39 percent in 1986, and its share of the industrialized world's manufactured exports was estimated to be 18 percent, the same as in 1980, and ahead of Japan's current 17 percent share. Moreover, the absolute productivity level of U.S. labor in general, and manufacturing labor in particular, continues to be the highest in the world. American manufacturing productivity increased at the fastest pace among the OECD nations in the eighties. The U.S. share of OECD manufacturing employment also increased from 24 percent in 1962 to 28 percent in 1985, while the share of countries like France, Germany, and the United Kingdom fell.

If rising incomes and technological innovation raise the demand for services instead of manufactured goods, economic and social survival require that such services be supplied. The decline in the U.S. of the share of manufacturing in total output and employment has been the result of relatively fast productivity growth in manufacturing and an increase in the demand for services as compared to manufactured goods. The result has been very similar to what happened to the American agricultural sector in the early part of the century—unprecedented gains in agricultural productivity and a rising demand for manufactured goods led to a decline in the share of output and employment in agriculture. This "deagriculturalization" was not only desirable, given the shifts in demand and productivity, it also occurred amidst a period of rising trade surpluses in agricultural products. In any case, many of the countries with some of the highest standards of living in the world today specialize in the provision of services.

The Industrial Policy Myth

Another common complaint against free trade and argument for "fair" trade is that other countries, most especially Japan, are targeting and subsidizing "strategic" industries for takeover and ultimate market domination. The argument is that the U.S. government should create a "level playing field" with countervailing tariffs, or subsidies and industrial policy. Once again, the logic and evidence of actual trade belies this view.

The logic of "strategic" targeting and industrial policy requires that government officials possess vast amounts of information about the future and be able to outguess private entrepreneurs with money at stake. This is, as F.A. Hayek taught us, impossible because of the knowledge problem involved in collecting vast amounts of dispersed knowledge in order to predict successfully an unknowable future. Communist nations suffered from the fatal conceit that government planners could perform such impossible feats before their ill-constructed policies eventually collapsed.

Secondly, strategic targeting, even if possible, would lead to a cycle of retaliation and counter-retaliation which would ultimately make everyone worse off. The results of the infamous Smoot-Hawley tariff in the early thirties illustrate the point. Escalating subsidies and industrial policies will distort the price signals essential for the functioning of a dynamic economy, leading to unintended consequences that are worse than the original alleged disease.

The United Kingdom suffered from the disastrous consequences of its post-war protectionist and interventionist industrial and labor policies. It was the "sick man" of Europe until free-market policies in the eighties restored some of its economic dynamism.

Japan is presented as an example of successful strategic targeting and industrial policy. Yet the actual evidence seriously questions this alleged success. If Japanese strategic targeting had been successful, the original company that later became Sony would have never mass-produced the transistor radio and, in fact, the present-day Sony Corporation may have never come into existence. Similarly, Mr. Shoichiro Honda would have never manufactured Hondas if he had taken the Japanese government's advice.

While some Japanese industries clearly capitalized on the opportunities provided by government subsidies, low-interest loans, and import protection, a large number of targeted industries simply did not do well, or actually became inefficient and/or failed. These include the highly protected and inefficient agricultural industry; the heavily subsidized and low-interest loan-financed coal mining, petroleum refining, and petrochemical industries; the protected and politically mollycoddled wholesale and retail distribution industries; the largely unsuccessful and government-assisted aerospace and large commercial aircraft companies; and the government-supported shipbuilding industry which, after an initially successful period in the late sixties and early seventies, ran into heavy weather and had to downsize massively in the late seventies and early eighties. Japan's most successful and internationally competitive industries such as the automobile and consumer electronics industries have enjoyed practically no special government favors. The industrially targeted steel industry actually yielded below-market returns and has been judged by sophisticated analysts as an example of unsuccessful targeting.

What industrial policies and protection did do was to keep the Japanese standard of living lower than what it otherwise would have been. In 1988, the Japanese standard of living, adjusted by purchasing power exchange rates, was estimated to be around 72 percent of the American standard of living. Most of the improvement of its standard of living has occurred in the last fifteen years as it has dropped its tariff and non-tariff barriers.

The Japanese "Unfair" Trade Myth

Another common myth about "fair" trade is that Japan severely restricts imports. In fact, Japan's formal and informal trade barriers are lower than those in the U.S. and other industrial countries. For example, Japan's average tariff on industrial products was 2.9 percent in 1981 as compared to 4.3 percent in the U.S and 5.8 percent in the EC. Non-tariff barriers such as quotas, licenses, and VERs in Japan were found by a World Bank study to be no different than those in the United States, with the Japanese using more non-tariff barriers to protect agriculture, while the U.S. protects more of its manufactures in this fashion.

Japan was the world's third largest importer in 1990, taking in $235 billion worth of goods and services, imports that were almost as large as the GNP of India and larger than the GNP of Sweden. Japanese imports grew by almost 85 percent since 1985. In terms of imports per person, Japan imported $1,900 compared with $2,050 for the U.S. Yet, the typical Japanese person spent more on American products than vice versa—$372 in 1990 as against $357 for the United States. Over the 1986–91 period U.S. exports increased by 91 percent, while Japan's exports grew by around 17 percent and the average OECD growth was around 25 percent. U.S. exports to Japan during this period were especially strong, doubling to $46.1 billion by the end of 1990. The growth of U.S. exports was strongest in the manufacturing sector.

Sophisticated econometric analyses by a number of serious and scholarly analysts such as Gary Saxonhouse of the University of Michigan, Ed Leamer of UCLA, and T.N. Srinivasan of Yale and Koichi Hamada have shown that Japan does not "under-import" (as unmeasurable and illogical as that concept may seem) as a number of trade "revisionists" such as Clyde Prestowitz and James Fallows have contended. In fact, they have shown that Japan's total imports and imports of manufactures are well within the margins of what would be expected for a country with its natural resource endowments and demographic characteristics.

In fact, it can equally well be argued that it is the U.S. which is the unfair trader. In his book, *The Fair Trade Fraud*, James Bovard has documented that the U.S. has over 8,000 tariffs, 3,000 clothing and textile import quotas, and a variety of quotas and other non-tariff barriers for steel, autos, sugar, dairy, peanut, cotton, beef, machine tools, and other industrial products. Bovard estimates that these trade barriers cost U.S. consumers $80 billion on an annual basis, or more than $1,200 per family per year.

The Cleaner Environment Myth

A more recent argument for managing trade has been raised by environmentalists. According to them, free trade will lead to greater pollution as production expands in the trading countries. Therefore, only environmentally "safe" industries should be allowed in the newly industrializing countries, or trade policy should be linked to tough environmental pollution control laws in the developing countries.

The greatest cause of human misery in the underdeveloped nations is poverty. Free trade and free markets are the only viable way to achieve sustained growth and alleviation of this poverty. Restricting trade or slowing growth for environmental reasons will continue and perpetuate human misery in these nations. The existence of the knowledge problem implies planners cannot know enough to achieve "environmentally responsible" managed trade and economic growth.

In fact, if the economic development of the industrialized countries is any guide, free trade and free market policies will most likely lead to a cleaner environment. Julian Simon and others have shown how economic development in the context of a free market, private property rights economy has inevitably led to a cleaner environment while simultaneously alleviating poverty.

A recent report published by GATT shows that since the richer countries pollute less, and trade makes countries richer, protection or managed trade is likely to cause more, not less, pollution. For example, Princeton economists Gene Grossman and Alan Krueger have shown that air pollution in cities rises with national per capita income to around $5,000, but then falls as income increases further. Trade also helps cleaner technologies to spread.

The Strategic Trade Policy Myth

A major influence on the thrust toward managed trade is the presence of "strategic traders" in its ranks. Recent research in the field of international economics has given rise to what is called strategic trade theory where some of the world's leading trade theorists have shown that under certain stylized circumstances (for example, where a single national firm is in combat with a single other-country rival say, like Boeing and Airbus in the commercial aircraft industry), strategic support (for example, with a subsidy) of a domestic industry against its foreign competitor can be in the national interest and provide it with a "strategic advantage." Such arguments have been seized upon by the strategic traders, a group of public policy entrepreneurs and journalists, as evidence of a fatal weakness in the theory of comparative advantage and the case for free trade. Nothing could be further from the truth.

There are many good reasons for rejecting the temptation to implement strategic trade theory. The most important reason is that the knowledge problem makes it impossible to identify which industries to encourage. In any case, targeting one industry with a subsidy will draw away scarce resources from others so that strategic trade policy on behalf of one industry is simultaneously strategic trade policy against other industries. With the likelihood of government policy failure being very high due to the knowledge problem and a host of other problems (called problems of "public choice" by economists), strategic trade intervention is likely to prove most detrimental to the economy.

Secondly, real-life competition in most industries is unlike that depicted in stylized strategic trade models. Seldom is one national industry "champion" pitted against another solitary rival (even in the Boeing-Airbus case the analogy is seriously flawed), and when there are more than two rivals the outcomes are likely to be more varied and run counter to the desires of the strategic policy maker.

Thirdly, the basic premise of the strategic traders and the competitiveness advocates is patently false. Strategic traders portray nations as being like giant corporations with monopoly power pitted in mortal combat with each other. President Clinton himself has characterized nations as "big corporations competing in the global marketplace." This leads to ill-founded fretting about the "competitiveness" of a nation.

Not only is the concept of the competitiveness of a nation difficult to define, there is no equivalent counterpart to the one indicator of the competitiveness of a corporation—its bottom line in terms of profit or loss. When we say that a corporation is uncompetitive, we mean that it is making a loss and that, if it does not improve its market position in terms of profit (or cash flow), it will cease to exist. No such statement can be made about a nation's competitiveness since it does not have a definable bottom line and does not go out of business (the trade balance is clearly inadequate and inappropriate since countries running trade deficits often are attracting huge sums of foreign investment as did the U.S. in the last decades of the nineteenth and early decades of the twentieth century and as Mexico has done in recent years).

Countries also do not compete with each other like corporations since international trade is not a zero-sum game. While IBM and Hitachi tend to be successful at each other's expense in the same market as they wrestle for market share, countries normally comprise each others' export and import markets. This means that if China is successful in exporting a large amount of goods to the U.S., it simultaneously becomes a large market for U.S. goods. The gains from international trade and specialization accrue to both nations unlike the case of IBM and Hitachi competing for market share.

Human Rights

The most recent argument for managed "fair" trade has focused on the issue of human rights and workers' rights in developing countries. The Clinton Administration has threatened countries like China with the loss of most favored nation (MFN) status for its human rights record, and a host of other countries such as India, Indonesia, Brazil, and Thailand have been placed under "super 301" (named for Section 301 of the

U.S. Trade Act of 1974) sanctions for these and other reasons.

Free trade has been a powerful force for the establishment of human rights and workers' rights the world over. It is no accident that human rights and workers' rights have been and continue to be violated routinely in countries which do not participate in a major way in international trade. Even if international trade has not always resulted in the quick establishment of human rights, it is nevertheless a bad idea to use international trade as a political lever.

The argument for using trade as a weapon to enforce a uniform human rights standard can very quickly become the thin edge of a wedge to demand "fairness" in trade for favored domestic industries and pressure groups by the imposition of sanctions, embargoes and protectionist measures. This could very well degenerate into a name-calling "beggar-thy-partner" trade dispute. Looking for policy, institutional, and moral differences as sources of unfair trade is contrary to rule-based trade regimes such as GATT. It results in challenging every policy in the name of "fair" trade, making managed trade inevitable and putting bureaucrats and politicians in charge of a highly politicized trade regime.

It is very easy to see disputes about workers' rights degenerating into the prevention of trade on the basis of genuine comparative advantage such as lower wage labor. There are many who regard it as "unfair" for Mexican or Chinese workers to be paid a fraction of the wages of American workers and call for tariffs or trade barriers to redress the balance. Such arguments are very easily extended to "working conditions" and other labor costs. They are destructive to the aspirations of developing nations since they deny the basis for comparative advantage for these nations. Moreover, the call for workers' rights is often only a thinly disguised call for universal unionization of labor.

Globalization

The strongest argument against managed "fair" trade is the reality of the existence of globally integrated multinational corporations like IBM, AT&T, and Procter & Gamble, and the interdependence of the inhabitants of our "global village." It is estimated that over forty percent of world trade is carried out by over 2,000 multinational corporations that do not have a national identity and that produce and distribute through a globally-integrated operational network. Any attempt to impose "fair" trade on ostensibly "foreign" competitors through countervailing measures such as anti-dumping duties is more than likely to end up hurting ostensibly "domestic" corporations. This has been the experience with U.S. Section 301 sanctions against foreign countries and trade agreements such as the semiconductor agreement, which resulted in injury to "domestic" corporations like IBM, DEC, Apple, and so on.

The comedy of the recent "buy American" campaigns that preceded and followed the 1992 presidential election illustrates the futility of national policies and efforts to protect "us" from "them" in the face of this globally interlinked trade. Today, anyone wishing to "buy American" may have to purchase a car with a nameplate like Honda or Mazda rather than Chevrolet, Dodge, Ford, or Pontiac. Some of Lee Iacocca's much touted new line of American-built cars such as the Intrepid are not even built in the U.S.—they are built in Canada.

In Conclusion

Logic and hard evidence dictate that we resist the siren song of "fair" trade if we wish to maintain and enhance our standard of living in an interdependent world. Free trade is still the best option for promoting American prosperity in spite of our current problems and the exhortations of our politicians. Managed "fair" trade can only lead to costly mistakes and policy errors and an ever-escalating cycle of retaliation and counter-retaliation putting our world trading system and our futures at risk. Our economic and social future depends on keeping our borders open and the goods and services flowing! □

THE FREEMAN
IDEAS ON LIBERTY

Get a Grip, Garth!

by Reid Schlager

Garth Brooks has received considerable publicity in recent years, and deservedly so. The country music star has been one of the most popular celebrities in any field. His income over the last two years placed him ninth on *Forbes*' 1993 survey of the highest paid athletes and entertainers. However, he also made news for attempting to prohibit the sale of his latest compact disc recording at stores that sell both used compact discs and new ones. The reason, of course, is that selling used CDs would cheat him out of royalty income.

His position seems to be somewhat paradoxical for someone who:

- earned $47 million the last two years,
- has already retired once, and
- stated in previous interviews that he already had more money than his grandchildren's grandchildren could spend.

NBC's *Dateline* recently noted Mr. Brooks' business savvy, attributing it to his having received a college degree in marketing. However, judging by his stance on used CDs, he falls short in his knowledge of free markets. Basic economic laws explain why selling used CDs will not reduce his precious royalties. Economic principles tell us that the value of a capital good equals the present value of all future benefits the good provides. Future benefits are discounted by an interest rate, whose components are the pure rate of interest, the inflation premium, the tax premium, and the risk premium.

The pure rate of interest is the market price of credit in a world without risk, inflation, and taxes. It indicates the market's preference for spending today versus spending a year from now. Stated differently, it's the market-clearing price of credit that causes the supply of savings to equal the demand for borrowing.

Added to the pure rate are inflation, tax, and risk premiums. The market sets the inflation and tax premiums based primarily on government policies. The risk premium is the market's perception of uncertainty of future benefits.

Of these four components, only the risk premium is a function of the good itself. Thus, in discounting future benefits to establish current market values, the discount rate varies only as a result of uncertainty of the future benefits, not the nature of the asset. (The item itself is significant when there are different tax rates on capital gains and ordinary income. However, the tax rates and definitions of capital assets are arbitrarily set by government policy rather than the nature of the good in question.)

To illustrate, consider a bottle of wine, which will not be ready to drink for ten years. Assume that its value as a consumable good will be $100 a decade hence. Anyone purchasing the wine today will not pay $100, but will discount the value at the

Mr. Schlager is a financial and investment consultant in Norcross, Georgia. The inspiration for this article comes from Armen A. Alchian and William R. Allen, whose economics textbook, Exchange and Production, *he purchased used for $14.20.*

market rate of interest. If that rate is 10 percent, the bottle of wine would sell for $38.50, as that is amount of money invested today at 10 percent which would grow to $100 in ten years.

In others words, the bottle of wine is the same as a $100 zero coupon bond which yields a 10 percent rate of return. If the risk of owning the bond is perceived by the market to be the same as the risk of holding the wine, consumers would be indifferent to holding the bottle of wine or the $100 bond that matures in ten years. Since they are substitutes in terms of monetary value, both the bottle of wine and the bond would sell for $38.50 today, and be worth $100 ten years from now.

This principle applies to all goods. No matter what asset you consider, its capital value change plus its net service flow must be equal to the rate of interest, after adjusting for the risk involved. In short, all assets are valued at the present value of all future benefits. The value of any share of stock is the present value of all expected future dividends. The value of a bond is the expected value of all future interest payments plus the return of principal. The value of a college education is the expected increase in future income resulting from that education.

Of course, there may be some consumption value in addition to the investment value. College can be fun for a lot of people and provide psychic benefits (such as prestige), which cannot be measured in monetary terms. A college degree may also serve as an insurance policy—as something on which to fall back. This would be especially true for athletes and entertainers, such as Garth Brooks. Their market values, as measured by their incomes, generally have little to do with academic knowledge or intelligence. However, there is also a very high rate of failure in these professions, and the possibility of quickly fading into oblivion for those who do achieve success. As a result, it would not be irrational for athletes who expect to make millions of dollars to obtain a college degree as a kind of insurance against a career-ending injury.

The value of an asset may also include non-monetary personal services derived in the interim. For example, if a tree yields no personal service in the interim, its value must rise at the market rate of interest, just as the bottle of wine. But a tree may also yield personal service by providing shade and beauty, just as stocks pay dividends, houses give shelter, and works of art give aesthetic pleasure. (Unlike the wine, the tree may also increase in value through biological growth.) In these instances, the total return—the increase in value plus the value of the services provided—add up to the risk adjusted interest rate.

Why must all goods provide the same rate of return? Because investors (or speculators) will buy and sell various goods to take advantage of any mispricing. If they can earn 10 percent in a zero-coupon bond, but can purchase the bottle of wine for only $10, they will buy all the wine they can get their hands on, with the intention of selling it for $100 per bottle in ten years. Soon, the demand generated by these investors, combined with the limited supply of wine, will push the price up to the equilibrium price of $38.50, thereby generating the equilibrium rate of return of 10 percent on the purchases of wine.

Now, suppose you're the author of a book. You don't like used-book stores, because you think they cut into your book royalties. You collect royalties on the sale of new books, not on used ones. Based on economic logic, this simply is not true.

The initial sale price of a book includes the second person's usage. While some people undoubtedly will pay twenty dollars for a new book, a larger number would be willing to buy it if the price was only twelve dollars. Someone who pays twenty dollars for the book, and then sells it to a used-book store for eight dollars, has, in effect, purchased the book for a net cost of only twelve dollars.

Unless people are consistently irrational and thereby defy the laws of economics—as Mr. Brooks' theory of human behavior seems to assert—some people who pay the full price for the book would not have done so without the opportunity to resell it in the secondary market. Lacking this alternative, they would have three others, each of which reduces or eliminates the author's royalties:

1) Borrow the book from a library and pay nothing.
2) Wait for the paperback and pay perhaps six dollars instead of twelve dollars.
3) Decide to not read it at all.

Compact discs are no different from books and other goods. Just as some consumers factor in the resale value when choosing which new car to purchase, some consumers will purchase compact discs only if there is a secondary market for them. Certainly you would not pay as much for a car if the only choices were to store or destroy it when it was no longer useful to you.

The same is true with CDs. One reason CDs can command a higher price than phonograph records is their greater durability. This certainly increases their value in the secondary market. If royalties are calculated based on sales dollars rather than the number of units sold, the higher prices that result from greater durability would also increase the artist's income.

Trying to abolish used CD sales benefits neither musicians nor record companies. This fact, while apparently unknown to Garth Brooks, has been known to book publishers for many years. It should also be known to record companies.

If Mr. Brooks makes good on his recent promise to retire again, perhaps he will spend some of his free time and $47 million on a good economics textbook, and pass along the wisdom contained therein to his grandchildren's grandchildren. □

Why Old Proverbs Don't Apply Anymore

by Michael Bixby Dudley

Proverbs have served as common sense guidance for millennia. However, as every student of history knows, there are times when logic flees in the face of hysteria, and the world seems topsy-turvy. The '90s are such a time.

A man's home is his castle. Aside from the fact the word "man" is sexist, this used to be true. Not anymore. The Comprehensive Crime Act of 1984 (a good year for its enactment, don't you think?) has put this old-fashioned notion behind us. The Act allows your house to be seized and confiscated based on "probable cause" you may have engaged in an "illegal activity." No conviction is necessary for this confiscation. Since modern law is so comprehensive and complex, many Americans unknowingly undertake "illegal activities" every day. Remember, ignorance of the law is no excuse. In order to get your castle back, you must hire a lawyer and file suit to prove it was never the scene of (or "used to facilitate") any "illegal activity," whatever that means.

Sticks and stones may break my bones, but names will never hurt me. This outdated adage is no longer applicable, because, as

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one New Age "philosopher" has decreed, "words are the same as bullets." Therefore, speaking ill of people is now the moral equivalent of shooting them. So-called "speech codes," such as that being considered by the American Bar Association, provide for severe punishment for prohibited speech.

Two wrongs don't make a right. Modern jurisprudence and legal practice have shown it to be an anachronism. Affirmative action, which mandates present discrimination against one racial (or other) group as a "just remedy" for past discrimination by a different racial (or other) group, is now the law of the land. The fact that the alleged discriminator is long deceased does not enter into the equation. Clearly, under the law, past discrimination is the "fault" of the living.

Don't cry over spilt milk. This ancient proverb does not apply if you are a modern dairy farmer. Much milk has been spilt lately because it is "contaminated" with an artificial hormone which is the exact chemical equivalent of the natural hormone which makes cows produce milk for their offspring. Groups with names like "Save Our Children" have poured out (for the TV cameras) hundreds of gallons of milk that don't contain bovine growth hormone, and dairy farmers, are, indeed, crying over it.

An ounce of prevention is worth a pound of cure. Zealous reformers have obviously discarded this shopworn homily. Several billion pounds of cure are seemingly required to ensure "health care security" for all Americans. Forget the ounce of prevention —it is no longer sufficient.

A stitch in time saves nine. Similar to "an ounce of prevention," and outdated as well.

Charity begins at home. Clearly archaic, as much of the support for "charitable" organizations comes from taxpayer dollars. According to the Urban Institute, "federal support to the nonprofit sector alone amounted to $40.4 billion in 1980." Charities now have huge budgets. In the Atlanta area, for example, nonprofit budgets are "four times larger than the city budget," according to *Foundation News*. These days, charity begins in walnut-paneled offices with deep plush carpeting and matching social agendas.

It's an ill wind that blows nobody good. There are no such ill winds anymore. Look at Hurricane Andrew. First, the residents of Florida got clobbered by the winds themselves. On top of that, the residents of Oshkosh and Peoria got clobbered with higher taxes to pay for the damages caused by those same ill winds. Indeed.

You can't cheat an honest man. Of course you can. Just make each and every law, rule, and regulation so obscure that even those who draft and interpret them haven't the faintest idea what they mean. That way everyone can be cheated at the same time, and no one will be the wiser.

Take care of the pennies and the pounds will take care of themselves. While you were watching your pennies, some folks in Washington started looking over your shoulder. They imposed a new retroactive tax, which relieved your hard-earned pounds of several "windfall" pence.

Do unto others as you would have them do unto you. Not true if you are Congress. If you are in government, it is your duty to exempt yourself from all laws which affect everyone else. Feel free to remove yourself from the encircling tentacles of OSHA, CERCLA, Equal Opportunity Laws, Fair Employment Acts, Social Security, and so forth. If you actually write laws, be sure to include the phrase, "This law shall not apply to the state or any political subdivision thereof." This way, you don't have to worry about what others would do unto you—you are exempt by law.

If at first you don't succeed, try, try again. This prescription for success was obviously written in the Dark Ages. Modern times demand a totally different strategy. First, see above: have a law passed to exempt yourself from even having to try in the first place. If that doesn't work, proclaim yourself a "victim" and demand compensation for your lack of success.

A rolling stone gathers no moss. No one has ever been able to figure out what this one means, so let's pass a law against its use! □

THE FREEMAN
IDEAS ON LIBERTY

Some International Neglect Would Be Good for Africa

by James C.W. Ahiakpor

Many African governments and leaders of thought fear increased marginalization and neglect of their continent in the so-called New World Order following the collapse of Communist regimes in Eastern and Central Europe and the former Soviet Union. This fear has been triggered by the enthusiasm of governments in the industrialized West to help financially the former Communist countries develop into democratic and private-enterprise economies.

Africans believe that the countries of Europe and the former Soviet Union receive far more sympathy in attracting funds from governments of the industrialized countries than their own. After all, it has been suggested frequently in the West that helping the former Communist countries financially is in the West's own security interest. Such help, it has been argued, is far cheaper than spending on armaments to protect against renewed Communist threats, should these countries revert to their bad old regimes. This is why President Yeltsin, for example, receives billions of U.S. aid money while little by way of serious economic or political reform takes place in Russia.

Africans also have heard or read such comments as "It would be far easier to absorb people from Europe into American society than, say, a thousand Zulus from South Africa." In sum, many African governments and their Western sympathizers believe that given the closer ethnic affinity between peoples of the former Communist countries and the industrialized West, help to Africa is liable to receive little consideration on the international agenda. The recent withdrawal of U.S. troops from Somalia adds to this fear.

But the anticipated neglect of Africa has potential benefits for Africans that are seldom discussed. The benefits include (a) a much better functioning of their economies, (b) escaping from further international indebtedness at the governmental level, and (c) relief from their countries being used as proxies to fight East-West ideological wars. Consider these points in turn.

Deteriorating Economies

Most African economies took a turn for the worse during the 1970s, and many continued on that path throughout the 1980s. Today many are characterized by inadequate production of food and other basic necessities, high rates of inflation, low interest rates that penalize saving (nominal returns are wiped out by inflation), official currency exchange rates that bear little relation to the demands for their currencies in international exchange, severely underutilized capacity in public sector manufac-

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turing industries (less than 50 percent), large and persistent government budget deficits, and bloated government bureaucracies. These features are, of course, the creations of African governments, although Marxists and neo-Marxists may claim otherwise. But the conditions also have been exacerbated by governments of the industrialized West as well as international agencies, even if unintentionally.

Inadequate production of food and other necessities, which is really part of a general decline in production, has arisen mainly from African governments' misguided attempts to make food available cheaply to urban populations by dictating low, unrewarding prices to their rural food producers. (Many Western governments do the opposite, subsidizing their farmers and storing up excess produce, later to be used as foreign aid.) Farmers have reacted predictably by cutting back their production, some turning to subsistence cultivation.

Enter Western governments and other international "donors" with food aid (e.g., the World Food Program) and loans to alleviate the shortages created by the price controls. This international "good will" also attempts to alleviate the shortage of savings by granting loans at below-market rates of interest and on easy repayment terms. The loans are also meant to fill the so-called foreign-exchange gap incorrectly believed to be responsible for the countries' inability to import enough raw materials to increase capacity utilization in industrial production.

Indeed, some of those responsible for these unwise international "assistance" programs truly believe that market forces do not work well in the less developed countries. They are unable to make good meaning of trading on black markets in food, foreign currencies, gasoline, or spare parts in Africa. Others correctly understand that the black market reflects the economic rationality of its participants, but nevertheless feel constrained by their relations with African governments, or the dictates of their agencies, not to focus on removing the injurious policies themselves. When pressed on the ineffectiveness of their actions for the overall good of the economies, international "helpers" plead the necessity of going slow or employing palliatives lest the host governments are overthrown by their own people. Thus one now reads excuses from the International Monetary Fund (IMF) and the World Bank about not insisting on the quick removal of bad economic policies as a condition for granting "Structural Adjustment Program" loans in the Third World.

Facing Up to Reality

But suppose these governments do not receive any "food aid" or concessionary term loans to deal with their economic hardship. A few may stick with their unwise policies if they are strong enough to contain their citizens' anger, as countries such as North Korea and Myanmar (Burma) have done. But most would finally face up to reality and take the necessary painful steps toward an efficient economic system.

Take the case of Ghana, for example. While the country's economy tumbled during the mid-1970s in response to several unwise and inward-looking government policies, external aid increased (from $40 million in 1970 to $82 million in 1978, and to $129 million in 1980). But there was a sharp drop in 1982 (to $94 million) when Marxist rhetoric-reciting radicals took over the government. Failure of the government to acquire as much aid as they demanded from the World Bank and the IMF, and the sharp contraction in the economy that year (negative 7 percent in real terms), finally forced some dramatic changes in economic policy in 1983, particularly with respect to rigid price controls. Although international financial assistance later increased, those reforms culminated in the removal of practically all price controls by 1988. Today open markets in foreign currencies (a phenomenon abolished by law in 1961) flourish in Ghana and more private funds flow in than out.

Some of the international aid money has gone to finance government budget deficits in Africa. In some cases, such foreign financing amounts to more than 75 percent of the budget deficit, e.g., in Burundi, Cameroon, Chad, Congo, Gambia, Madagascar, Mali, Mauritania, Nigeria, Senegal, Togo, and Zaire during the 1980s.[1]

Now anyone who runs the family budget on such a principle must soon be burdened with unmanageable debt and go bankrupt. Indeed, some of these countries in 1990 had debt greater than 100 percent of their national income, including Mali (101 percent), Nigeria (101 percent), Madagascar (134 percent), Congo (204 percent), Mauritania (227 percent), and Somalia (277 percent).[2] Others with equally disturbing amounts of debt as a percentage of income in 1990 include Zaire (141 percent), Zambia (261 percent), Tanzania (282 percent), and Mozambique (385 percent). And who bears the burden of repayments? Not the governing elite, but the poor producers of export crops such as cocoa, coffee, peanuts, palm oil, and in some cases local labor employed in oil and other mineral extracting industries. This is why General Olusegun Obasanjo, a former military ruler of Nigeria, believes that the "most humiliating index of [Africa's] decline is the increase in infant and child mortality resulting directly from our debt problem."[3]

Although the peace dividend from the end of the Cold War may have evaded the people of the United States, for example, Africans stand to gain a great deal from the New World Order, if they could be left alone. Several of the civil wars in Africa, including those of Angola, Ethiopia, Mozambique, Somalia, and Zaire, really have been proxy ideological wars between the United States and its allies and the former Soviet bloc. Indeed, it was to contain "Marxist" Ethiopia that the United States sustained the Somalian dictator, Siyad Barre, in power with military and financial support until the end of the 1980s. Thus, "Operation Restore Hope" may justifiably be considered an atonement to the people of Somalia for past collaboration in their repression and economic ruin, rather than mainly altruism.

A Soviet academic put it best when he suggested, at a Soviet-Canadian African Studies conference held in Moscow in 1990, that debts owed by their African clients, especially Angola and Ethiopia, be canceled since they took the form of armaments with which those countries destroyed their own economies. The same can be said for Somalia and Zaire with respect to their governments' debt to the United States.

Bad Advice

What about foreign economic advisers as part of foreign aid to Africa? Would African economies still benefit if Western governments and international financial institutions such as the IMF and the World Bank did not send them technical advisers? In the first place, these advisers must be paid for by the recipient countries, and thus are part of their international indebtedness. Second, they may offer good advice but cannot force their implementation. Third, many of them offer bad advice. And in the case of Africa, as Mahbub ul Haq of the United Nations Development Program (UNDP) was recently quoted in *The Economist* to have observed, the continent "has perhaps received more bad advice per capita than any other."

A recent autobiographical account of foreign advising by Benjamin Higgins tells it all.[4] His client states included Lebanon, Haiti, Sri Lanka, Brazil, Indonesia, (pre-oil) Libya, Malaysia, Mauritania, Morocco, and the Philippines, mainly during the 1950s, 1960s, and 1970s. Other international development experts have focused on Bangladesh, India, Pakistan, Mexico, Kenya, and Tanzania. But when one looks for success stories in economic development, one finds Hong Kong, Singapore, Taiwan, and South Korea—countries that largely escaped the attention of development experts during the 1950s through the 1970s.

The experience of Eastern and Central European countries that followed advice from Western economic experts during the 1990s is not encouraging either. This is why it is most instructive that Higgins rates the success of the "international development


LIZ GILBERT/FOR SYGMA

Customers in an electronics store in Ghana.

effort" not in terms of how countries most affected have fared, but by the establishment of a "genuine 'international civil service,' of which the top members are of very high quality and thoroughly committed, . . . and who have achieved a certain unity of ideas . . ." and against whose policies and proclamations, "governments the world over are reluctant to be in open opposition."[5]

Besides some specific details of implementation, the kinds of economic policy that encourage economic growth and development in a country have been outlined in Adam Smith's *Wealth of Nations*. These have been restated time and again by the likes of Milton and Rose Friedman and Peter Bauer. Governments around the world have resisted heeding such policy prescriptions because they do not suit their interventionist tastes or political ends. This is why foreign economic experts frequently are of little help in the Third World.

Of course, the flow of aid money to African governments will not cease in the New World Order. Donor countries still want to retain their spheres of international influence. But the adoption of efficient economic policies that would likely follow the curtailment of Western aid would be good for the continent. □

1. World Bank, *African Economic and Financial Data*, 1989.
2. World Bank, *World Development Report*, 1992.
3. O. Obasanjo and H. d'Orville, eds., *Challenges of Leadership in African Development* (New York: Crane Russak, 1990), p. 28.
4. Benjamin Higgins, *All The Difference: A Development Economist's Quest* (Montreal & Kingston: McGill-Queen's, 1992).
5. *Ibid.*, p. 267.

THE FREEMAN
IDEAS ON LIBERTY

Eating the Seed Corn

by Raphael G. Kazmann

One of the most telling and widely used arguments made by politicians seeking office is that, if elected, their policy will create jobs. The implication is that governmental actions can create jobs in the private tax-paying sector, not tax-eating jobs in the public sector.

Bitter experience has taught us that production must come before consumption—you can't consume something that has not been produced. Equally painful experience has shown us that nothing can be produced without the expenditure of capital. To produce something new, or to increase the production of a commodity already on the market, you must invest capital. That is, you must have enough saved out of current consumption to support you while you build the new facility and enough to support the employees while the commodity goes to the market and is sold in sufficient quantities to make the enterprise viable.

This is the situation that faces the farmer as he puts aside edible seed corn for use during the next year. It is the situation that faces the miner, as he explores for economic quantities of metallic ore, of the wildcatter, looking for natural gas, and the writer of software as he works on a new, improved computer program. All enterprises require the investment of capital. Without capital investment there can be no new jobs, and even jobs in existing enterprises may be lost for want of capital for modernization.

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It should be evident that the larger the physical plant and the greater the investment of capital, the greater the potential for production and income of the population. More jobs, from a politician's viewpoint, mean a greater tax base and a reservoir of potentially larger taxes.

What Actually Happens

Yet despite these truths two major confiscatory policies conspire to consume capital (eat the seed corn) before it can be invested (planted): the inheritance tax and the capital gains tax. After a relatively small exemption of $600,000 for a single person ($1,200,000 for a married couple), the inheritance tax climbs to 28 percent and then to 55 percent. At a time when a modest house in the suburbs sells for from $125,000 to $250,000, a $600,000 exemption protects very little investment capital. And the value of the exemption is eroded every year by the inflation.

Proponents of the inheritance tax argue that the rich will gain a stranglehold on the economy unless part of their capital holdings are taxed away by the federal (and state) government. This is based on the assumption that rich people are organized and wish to dominate the gigantic array of competing interests in the marketplace. Of course, there is no way that this can be done without governmental coercion.

In an economy whose gross domestic product is estimated to be $6 trillion, the whole idea is ludicrous. Moreover, since the economy is not static, unless capital is deployed in accordance with market conditions, it is likely to be lost. Where are such industrial giants as Gulf Oil Company, Pan American Airways, and U.S. Steel—all dominant companies in the U.S. economy in the 1960s? They have either gotten much smaller or have been incorporated into competing firms because they couldn't meet the test of the market. So the inheritance tax, which tends to cripple the economy by reducing the supply of investment capital, is based more on the politician's desire for more money to hand out than on a rational examination of the facts.

The second major program to consume capital is found in the "capital gains" tax, which recently was increased from 20 percent to 28 percent. This rate applies to investments that have been held for more than one year. A capital gain earned in less than a year is taxed at the ordinary income tax rates—a maximum of about 40 percent. The value of the capital is not indexed for inflation. So if, during the course of holding a $10,000 investment for a period of three years, an inflation totaling 30 percent occurred, and the investment is sold for $13,000 a paper profit of $3,000 would be noted and of this "profit" $840 would be due in taxes. Actually since the investment did not grow but would actually buy the same basket of goods and services for $13,000 that it could have bought originally for $10,000, there was no real growth in the investment and the taxman simply confiscated the investment capital of the owner and the productive potential that had existed.

In effect the government first devalues money by running the printing presses and reduces the value of all bonds and corporate debt, then it confiscates capital because of the change in the dollar value that resulted from running the printing presses! It is a prescription for economic disaster.

But if we set aside the inflation factor, a person cannot readily channel funds from one profitable investment to another, potentially more profitable one without allowing for a 28 percent loss in any capital gain that the first investment had achieved. Suppose you had invested $10,000 and its value after 3 years (ignoring inflation) was $13,000, an average of increase of 10 percent a year. Now suppose that you have found an investment that, potentially, might grow during the next three years by an average rate of 12 percent (it might also be a loser). If you sell your original investment, you will have $12,160 to invest, after taxes. After three more years your investment will be worth $16,538. If you keep your original investment and the average rate of return remains at 10 percent, the value of the untouched investment will be $16,900. So switching your money to a more profitable investment (12 percent rather than 10 percent), which is risky, gives you less capital than if you did not switch. Because of this chilling effect on the movement of capital, rational beings will be reluctant to undertake new ventures—even when an increase in the return might change from an average of 10 percent a year to 12 percent a year.

Taxation and Confiscation

In a dynamic economy, where new ventures are constantly being proposed, the tax on capital gains is an important factor influencing the investment of capital. In any rational system of taxation, an increase in productive capacity (which necessarily involves investment of capital) would be welcomed and all irrelevant issues, like capital gains taxes, would be removed. And since a dynamic economy, which moves capital based on economic considerations alone, will create products and employment more rapidly than one laboring under the handicap of capital confiscation, rational government should be the first to remove the handicap and widen the economic base.

It is of interest to note that President Alberto Fujimori of Peru (an economist by training) has eliminated inheritance taxes and has a established a zero tax on capital gains and dividends. According to James Davidson in the *Strategic Investment Bulletin* of February 23, 1994, tax collections have doubled as a percentage of GDP as compared to the receipts before Fujimori superseded the parliament.

Our own situation is less optimistic. A dictum of Robert Heinlein, slightly modified, comes to mind: *"Anyone who cannot cope with elementary economics and mathematics is not fully human. At best he is a tolerable subhuman who has learned to wear shoes, bathe, and not make messes in the house."* This would seem to describe many elected politicians and government policy advisers, who claim they can create jobs. Economic ignorance is disastrous for the economy and society. □

THE FREEMAN
IDEAS ON LIBERTY

Pensiongate: The Emerging Crisis of Church Investments

by Charles Dickson

The average pastor, spending some 30 to 40 years shepherding the flock while contributing to a church-operated pension fund, hopes to find a golden egg at the end of the journey. In an increasing number of cases, it's not happening and hopes for a comfortable retirement vanish in the light of reality.

What's happened? That's the question being asked by clergy of many denominations, but the situation appears to be most acute in the Evangelical Lutheran Church in America (ELCA). The ELCA and its constituent Board of Pensions have been involved in litigation in Minnesota courts over the past four years and prospects appear strong for this situation to continue. At stake is the management of the funds generated from the pension contributions of its more than 17,000 pastors, who are discovering their golden egg has become both shriveled and tarnished.

Why should the returns on the portfolio of ELCA clergy be so much less than the money earned by similar programs operated for corporate and government employees? Are ELCA pastors being short-changed by the investment philosophy of a Church Council which divests itself of many companies with a history of high yield performance in favor of lesser ones with whom it may be in philosophical agreement? Recent lawsuits brought against the ELCA and its Board of Pensions by a group called the Pension Defense Fund allege that this practice, termed "social investing," is precisely what is happening and they are asking to withdraw their funds. Their requests have been summarily rejected by church authorities, thus precipitating the lawsuits.

Under the leadership of Pastors Tom and Matthew Basich of St. Paul, Minnesota, and Judith Boal of Beaver, Pennsylvania, the growing roll of plaintiffs now includes clergy and layworkers from 17 states acting as one voice, to ask that not only they as plaintiffs, but that all pension plan members, be given the right to withdraw their pension accumulations upon demand. Such a right is already guaranteed to corporate and other employees who participate in plans which operate under a 1974 federal law called ERISA (Employee Retirement Income Security Act) but from which church pension plans are exempt.

This exemption from regulations allows such plans considerable flexibility to "run their own show" without having to justify their decisions to any outside governing board or agencies including the body of contributing members whose money is being spent. In the ELCA situation this translates into a 35-member Church Council, under the direction of Bishop Herbert

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Chilstrom, who have the final say in regard to both policies and investments.

This absence of regulations has also meant that this governing board is under no obligation to divulge either the names of corporations in which the pension monies are invested or the amounts invested. All attempts to secure such documentation by various contributing members have met with failure.

Despite maintenance of a closed-door policy there has been some leakage of information that has served further to fuel the controversy. The fundamental dispute going on in the ELCA appears to involve those who, as Pastor Basich points out, "believe that the conventions, pulpits, and money of the church should not be used in support of any political agenda, left, center, or right." The plaintiffs in the litigation allege this is precisely the case. They point to the investment blacklists (screens) drawn up by the Lutheran Office for Corporate Social Responsibility in cooperation with the Interfaith Center on Corporate Responsibility which are forwarded to the ELCA Commission for Church in Society. Blacklisted corporations approved by this commission are then forwarded to the ELCA Church Council which imposes its divestment decisions on the Board of Pensions. One ELCA clergyman in learning of this process, commented, "It really upsets me greatly to think that my pension contributions may still be at risk of being used for somebody else's political agenda."

In the divestment process ELCA officials have dropped some of America's most economically sound corporations in favor of much less profitable ones, but who are more philosophically acceptable to the Council. Some "blue-chip" companies which have felt the ax include Borden, Colgate-Palmolive, Goodyear, 3-M, Bristol-Myers, John Deere, and Mobil. As one official of the Board of Pensions lamented, "We had to sell off the cream of the crop." This selloff, members of the Pension Defense Fund maintain, is resulting in significantly diminished returns to members of the plan.

In a report by Judith Boal, a clergywoman with experience in life insurance products and securities, eight generic plans offered in the secular market were compared to the church plan. The report demonstrated that a member could start with the same lump sum, plan to take 10 percent a year off the previous year-end balance, and in each of the secular plans, end up with a total figure that far outstrips the ELCA plan, plus leaving a sum to heirs as well.

These findings appear to be supported by other independent studies such as that reported by analyst Marcia Berss in a June 24, 1991, issue of *Forbes*. Berss wrote, "There is evidence socially-conscious investors underperform the market. Five mutual funds with socially responsible portfolios have been around at least five years and not a one has done as well as the Standard & Poor's 500."

Signals to Investors

Rates of return in financial markets are like prices in other markets. They are signals to investors of the relative values, in the judgment of the general public, of alternative uses of investment funds. Church officials who ignore those signals substitute their subjective value judgments of the merits of competing investments for the collective judgment of millions of ordinary people. That is not morality, it is hubris.

Church officials responsible for such social investing justify their actions by stating they are producing a "Christian witness" by selling the stock of companies with whose policies they disagree. This was particularly true with companies who either operated in or did business with South Africa. Church officials felt that divestment of stock in such companies was a means of punishing them. In reality, opponents of this approach have discovered that those who are ultimately being punished are the thousands of clergy and lay people whose contributions no longer benefit from the once-solid investments of the many "blue chip" companies which have been deleted from the portfolio.

Those who oppose what they believe are high-handed policies on the part of church leaders do so not only because they feel such policies have proven to be economically unsound, but also in the belief they are ethically and morally indefensible. While they rejoice with the church hierarchy that South African apartheid has ended, they do not feel divestment of high-yield stocks was an appropriate way to go. For them punishment by divestment is a way of dealing with a human problem that is, as H.L. Mencken put it, "an answer that is clear, simple, and wrong."

They point to a Gallup Poll in 1989, which revealed that 95 percent of the white population and 82 percent of the blacks in South Africa opposed sanctions, and to a survey by *Harper's* magazine which found that since 1980, three and a half million South African blacks lost their jobs as a result of divestment.

Members of the Pension Defense Fund recently received a shot in the arm for their case in the battle with ELCA hierarchy. On February 7 a Minnesota District Court judge denied motions for a summary judgment which would dismiss the lawsuit filed by the pastors and lay members, thus opening the door for further litigation. Their attorney noted that by denying the defendant's motions for summary judgment the district court judge was signifying that he agreed with the plaintiffs that in this pension dispute there are issues of fact which can only be determined at a trial on the merits of the case.

Meanwhile both sides recognize the long-range consequences of the outcome. "The forthcoming trial," reports Basich, "should produce sober thoughts in other denominational executives who may be toying with the temptation to use pension funds to achieve social and political goals." □

Do English Cathedrals Need Government Help?

by James L. Payne

One assumes that a great cathedral, having stood for centuries, will go on standing forever, but the truth is it is always falling down. If someone doesn't shore up the shifting foundation and replace the eroded stone facing, it will become a ruin. Stepping in to save dozens of glorious English cathedrals from this plight is a remarkable tribe of volunteers and philanthropists. In their quiet way, they show how voluntary action can perform the kind of public service we often leave to government.

In our visit to Britain last year, my wife, Judy, and I came across many volunteer efforts in the cathedrals. We were especially impressed by the range of activities at the cathedral in Wells, a small city in Southwest England. We spotted our first volunteer in the gardens behind the cathedral, a woman clipping roses. She was one of the "flower ladies" who decorate the cathedral (since the group now has a male member, they're

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looking for a new way to identify their group!). At the door, we were met by one of the welcomers, volunteers who greet visitors and hand out the guide pamphlet.

Our leader for the free guided tour was Daphne Shillingford, one of a team of some sixty volunteer guides. These guides are probably more professional, and certainly more enthusiastic, than paid staff would likely be. They have to prepare themselves by studying cathedral history and following the tours of other guides. Then they face a final exam: the chairman of the guides follows their trial tour around, lurking behind pillars, to evaluate their performance. "You see grown men, retired bankers and solicitors, quaking in their boots," reports Daphne.

The cathedral has a famous ancient clock in the north transept that, on striking the hour, sets mechanical horses galloping round and round. Naturally, tourists flock to watch. The bishop has wisely decided to make this an opportunity to introduce a religious point in what is, after all, a house of worship. After the clock has struck, a priest says a brief prayer, and then visits with the tourists. These prayers are conducted by voluntary chaplains.

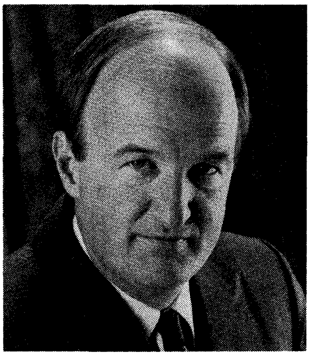
Other supporters include voluntary vergers who keep the cathedral open late in the summer for tourists, voluntary bell ringers, voluntary stewards in the library, voluntary stewards at concerts, and a voluntary choir when the regular choirboys are on vacation. All these volunteers give a great sense of warmth to the cathedral. "You don't get this feeling of voluntary care in cathedrals on the Continent," said Daphne. Having visited the gloomy cathedrals of Spain, Judy and I can confirm her point.

Another key group is a fund-raising branch called The Friends of Wells Cathedral. Founded in 1933, it has some 3,700 members, including a number of Americans. The Friends raise money to pay for stonework and structural restoration, as well as work on the organ, the bells, and woodwork, and to purchase new equipment. Their achievement has been funding the restoration of the Chapter House—which has cost about $1 million.

There is a worrisome note, however. Last year, the Dean of the Cathedral made history by accepting the first government grant. The amount (£15,000 to help clean some stonework) is insignificant financially, but the negative symbolic effect of the government connection could be harmful. If the government is going to fund the cathedral with tax money, prospective donors and volunteers will start asking, why should we exert ourselves to nurture it? The Dean failed to understand that when a voluntary group starts taking funds raised involuntarily, it compromises the spirit of idealism on which it depends.

For an example of how government funding can transform a voluntary group, consider what has happened to Britain's Poetry Society. Founded in 1908, the organization was getting along fine until it started accepting government money. The first grant, a mere $7,500, came in the 1970s. As the funding grew, high-salaried professional managers took over, sold the beloved old headquarters building, moved into a new office building that was closed to the public, and spent $14,000 on new, custom-designed desks. Membership fell, and the audience at poetry readings shrank to a handful of insiders. In 1993—shall we call it poetic justice?—the government put the Society on probation, threatening to cut off its $222,000 annual support on the grounds that it had become ineffective.

Government has a way of embracing noble causes and then disabling them with its largesse. Let's hope English cathedral volunteers realize the danger in time. □



What's Missing From This Picture?

The New York Times

BUSINESS Digest

The Markets Last Week

DOW 30 Industrials	DOLLAR vs. Japanese Yen	OIL Nymex Spot	BONDS 30-Year Treasuries
3,773.45 +1.23	103.60 Yen -1.75 Yen	$18.48 +$0.36	7.31% +0.04

The New York Times, that bastion of conventional wisdom, is missing a key element in its digest of financial markets. It leaves out the single most significant asset that each day reflects accurately the level of economic, political, and military stability around the world.

The commodity? Gold!

Instead, *The Times* uses oil, a crude and misleading substitute commodity, to measure inflation. Apparently the Midas metal doesn't "fit" the *Times'* definition of headline news.

The New York Times isn't the only establishment publication to fundamentally misread how the world works. *The Wall Street Journal*'s front-page summary of the markets highlights stocks, bonds, currencies, and commodities, including oil. There's plenty of room to list the yellow metal, yet gold is omitted—deliberately.

The reason is simple: The establishment prefers fiat money over the gold standard. It wants government rather than the market to maintain authority over money. It doesn't want to legitimatize a "non-performing" asset that might be warning of trouble down the road. The establishment is quite happy that the "barbarous relic" has been relegated to the commodity trading pits. "Gold is just another commodity," they say.

Oil—A Misleading Substitute

The majority view is that gold is an impractical monetary metal unrelated to real economic activity. Oil is a much better choice, they say, because energy is a critical determinant of the ups and downs of the economy. After all, didn't the energy shocks precipitate the recessions of 1973–75, 1979–82, and 1991–92?

Well, not exactly. All major industrial nations suffered sharp economic downturns in 1973–75, the time of the first energy crisis, but since then the relationship between the price of oil and economic performance has been cloudy. For example, Japan, which imports virtually all its oil, avoided the 1979–82 recession even though crude prices more than doubled. Germany, also a heavy

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oil importer, escaped relatively unscathed, while the United Kingdom, a net oil exporter, suffered the worst recession among industrial nations in 1979–82.

In 1986, crude prices fell by half, from $28 a barrel to $14. According to the establishment view, lower oil prices should have boosted economic growth. "If energy were an important ingredient in business cycles, you should have had a worldwide boom," declares energy economist Douglas Bohi. "There wasn't one." (*Forbes*, January 31, 1994, p. 66)

Bohi, director of the energy and natural resource division of Resources for the Future in Washington, D.C., is one of the few economists who have studied carefully the impact of energy costs on economic growth. After examining the evidence in the United States, Japan, Germany, and the UK, he concludes that oil prices did not have the impact on economic activity that most economists believed.[1] Bohi discovered that energy accounts for only 3–4 percent of the total cost of producing goods and services in the United States. Oil itself accounts for only 2 percent. The cost of energy is simply too small to have a significant impact on economic growth. Also if the oil price goes from $18 a barrel to $14 a barrel, that's a 22 percent drop for oil—but the reduction in costs for the economy as a whole is less than one-half of 1 percent. By the same token, Bohi does not expect the current increase in oil prices to reduce economic growth.

The Tie Between Money and Gold

If oil isn't the driving force behind economic boom and bust, what is? Bohi is convinced that monetary policy has a much broader influence on economic activity. Higher energy prices often reflect a general inflation, forcing most central banks to tighten money and bring about a recession. But not always. In 1979–82, when most world economies were suffering a recession, Japan did not impose a tight money policy and therefore escaped recession.

What better monitor of monetary inflation exists than the price of gold? There has been a strong correlation over the years between monetary policy and the price of gold. When central banks adopt easy-money policies, gold tends to rise. When they impose tight money, gold tends to decline.

The Midas metal is an ideal compass for monetary policy. Gold has certain unique features that make it the most sensitive measure of inflationary fears. It is not just another commodity. Unlike oil, soybeans, or pork bellies, gold is indestructible and is never consumed. Thus annual production is only a tiny fraction of the world's total stock. Annual production seldom exceeds 2 percent of the outstanding gold supplies. The fiat money supply may rise rapidly or fall sharply, depending on the whims of central bankers (usually more the former than the latter). But gold supplies never decline and seldom increase significantly. Even during the gold rushes in California, Alaska, Australia, and South Africa, world gold supplies never increased by more than 5 percent per year.[2]

In his exhaustive historical and statistical study of the purchasing power of gold, Berkeley economist Roy W. Jastram concludes, "Gold does maintain its purchasing power over long periods of time. . . . Its purchasing power in the middle of the twentieth century was very nearly the same as in the midst of the seventh century."[3] A $20 St. Gaudens gold coin would buy a tailor-made suit in the 1920s. That same coin, worth over $500 today, can still buy a tailor-made suit.

In short, gold is as steady as a rock, a standardbearer by which all currencies can be accurately measured. If the price of gold is volatile, it is not because gold itself is volatile, but because government policy is reckless and unstable.

Sharply rising gold prices are a sign of trouble ahead, whether it be inflation, war, or some other man-made crisis. Lower prices mean a return to normalcy and the avoidance of chaos or war. Stable gold prices suggest genuine prosperity and stability. Skyrocketing gold prices in the 1970s reflected a high level of inflation and financial crisis. The decline in gold in the 1980s suggested a disinflationary environment. The recent rise of gold in the 1990s implies a growing fear of more inflation. It is not surprising that Alan Greenspan and other central bankers are using the price of gold as an important gauge of inflationary expectations. Take heed, Wall Street! □

1. Douglas R. Bohi, "On the macroeconomic effects of energy price shocks," *Resources and Energy* 13 (1991), pp. 146–62.

2. See chapter 11, "The Gold Standard," in my book, *Economics on Trial* (Irwin Professional Publishing, 1991, 1993), pp. 128-44. In this chapter, I outline all the arguments for and against the gold standard, and expose several common myths about the yellow metal.

3. Roy W. Jastram, *The Golden Constant: The English and American Experience, 1560-1976* (John Wiley & Sons, 1977), p. 189.

BOOKS

Bargaining with the State

by Richard Epstein

Princeton University Press, 1993 • 322 pages • $35.00

Reviewed by Jonathan H. Adler

In *Takings: Private Property and the Power of Eminent Domain* (Harvard University Press, 1985), University of Chicago law professor Richard Epstein challenged the constitutional legitimacy of nearly every federal government action since 1937. He could scarcely do it again: "Once the New Deal has been declared unconstitutional (as only an academic can do), it is hard to do it a second time." Therefore, with his newest book he has moved to a more limited but intricately related project to ensure "that useful projects go forward in a sensible fashion." Where *Takings* focused on constitutional limits to the power of government to regulate and "take" private property without giving compensation, *Bargaining with the State* assesses the lesser known doctrine of unconstitutional conditions which limits the government's power to "give."

This doctrine holds that the state should not be permitted to condition the conferring of benefits "upon the individual waiver of constitutional rights." To protect freedom of speech, government must restrain privileging certain forms of speech, through subsidies and the like, just as it must refrain from censorship. As Epstein notes, "The power to contract and to grant, when lodged in the hands of government, may well prove to be as dangerous as the power to take and to regulate." For instance, by controlling access to highways and selectively granting incorporation privileges the state can wield an inordinate amount of influence over the lives of individuals. Because of the potential for abuse, this doctrine "is the necessary counterweight to the federal government's exercise of monopoly power." When state power is increased through a Byzantine array of tax codes and regulatory strictures, the dangers posed by its improper use increase exponentially. If the size of the state itself cannot be controlled, the doctrine of unconstitutional conditions can at least rein in its destructive power. Epstein describes this approach as "a 'second-best' approach to controlling government discretion."

To illustrate the doctrine of unconstitutional conditions, consider the recent Supreme Court case *Nollan* v. *California Coastal Commission*. The Nollans owned beachfront property in Ventura County, California, upon which they wished to build a home. The California Coastal Commission, however, refused to issue a building permit unless the Nollans were willing to allow public access to a path along their property. The Nollans rightfully objected, claiming that the only grounds for attaching such a condition to a construction permit would be if the state could prove that the proposed house "would have a direct adverse impact on public access to the [public] beach."

In his majority opinion, Justice Antonin Scalia ruled that if the California Coastal Commission (CCC) needed land for a public pathway, it could use the power of eminent domain to take a portion of the Nollans' property and compensate them for their loss. However, the CCC was in no way entitled to hold hostage the Nollans' right to build a house on their own land to achieve its objective. Scalia ruled that "unless the permit condition serves the same governmental purpose as the development ban, the building restriction is not a valid regulation of land use but 'an out-and-out plan of extortion.'" The Court ruled that the only means that the CCC could use to obtain the desired path was to pay the Nollans for it. Only then would the CCC be abiding by the Fifth Amendment dictum "nor shall private property be taken for public use without just compensation."

The *Nollan* decision was not nearly as sweeping as one might like, but it illustrates the general principles behind the doctrine of unconstitutional conditions. The court did not challenge the state's power to regulate land-use decisions, but it did proscribe how the state could exercise that power. This doctrine holds that even if the state is granted a particular power, that does not imbue the state with unlimited discretion in how that power is used. If the state is empowered to build and manage roads, for example, there are still limits to what conditions the state can impose on those who use the roads. Reasonable limitations might include prohibitions against drunk driving, speed limits, and include generic guidelines, such as driving on the right side of the road. However, the state is in no position to condition access to a "public" road on anything that does not promote the state's interest in maintaining a usable road. Constitutional conditions require some "nexus" between the benefit provided or right protected and the condition imposed. "Some 'related' conditions may be improper," writes Epstein, "but the nexus requirement weeds out many 'unrelated' conditions that are manifestly improper."

Even when the state owns, manages, or doles out a good, service, or privilege, it cannot act as would a private owner in attaching strings to various operations. This is because "unlike a private monopolist, its power cannot be eroded by the entry of new firms, but is perpetuated by a legal prohibition against entry by new rivals." As in the *Nollan* case, if the state is the only entity empowered to issue building permits, landowners cannot take their business elsewhere, so to speak, if the state attaches unreasonable conditions to the permit. If such permitting powers are to exist (hardly a forgone conclusion) the doctrine of unconstitutional conditions is necessary to limit their use.

While the argument put forward in *Bargaining* is highly persuasive, some may be uncomfortable with its reliance on utilitarian analysis. Epstein wants to carve out as much space for the competitive marketplace as is possible in today's constrained political climate. His justification is that infringing upon the market "leads to suboptimal social results." In his view, "The goal of constitutional law should be to maximize overall surplus by the maintenance of competitive markets." Epstein's conclusion is sound, though some may question how he got there.

Nonetheless, Richard Epstein has provided us with another immensely important work. Epstein's thought is a refreshing departure from the mainstream of legal thought that preaches an extension of state power at the expense of the individual. Voices such as his should be heard more often. □

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Public Education: An Autopsy

by Myron Lieberman

Harvard University Press • 1993 • 400 pages • $27.95

Reviewed by George C. Leef

As chance would have it, I was reading Myron Lieberman's book *Public Education: An Autopsy* at the same time the Michigan legislature was struggling with the issues of educational finance and quality reform. Juxtaposing the two, the ultimate futility of the legislature's endeavors was obvious. If Lieberman's powerful analysis is correct—and I am convinced that it is—changing the tax mix which funds public education and instituting marginal quality adjustments in the schools is the equivalent of rearranging the deck chairs on the *Titanic*. This ship is sinking and nobody can do anything about it.

At the outset, it is important to specify exactly what it is that Lieberman says has died, necessitating an autopsy. Notwithstanding his title, he is not claiming that public education is dead. As any taxpayer can tell you, it is still alive and kicking. Rather, Lieberman maintains, the *rationale* for public education is dead. The intellectual case that public provision of educational services is optimal or at least preferable to the market alternative has sustained such devastating rebuttals that it is, in the author's words, "beyond life-sustaining measures."

Standing alone, Lieberman's book goes far toward proving his point. He examines the standard defenses for public education (the public goods argument, the contention that it is necessary to instill democratic values, and so on) and exposes their logical and factual defects. Of course, he is not the first to perform this task, and if read in conjunction with other hard-hitting critiques of public education which have been published recently (books by Thomas Sowell, John Chubb and Terry Moe, Chester Finn, Charles Sykes, to name some of the more prominent), Lieberman's contention is, I believe, indisputably true. The notion that public education serves the nation well now stands on a par with the geocentric theory of the universe.

Not only does Lieberman argue that the rationale for public education is dead, he also contends that demographic changes in the United States will so undermine its base of support that it will eventually give way to a market-oriented system. Low birth rates, the aging of the population, stronger international economic competition, rising juvenile crime, and a host of other factors will create an increasingly hostile environment for public education. He predicts that in the future, we will return to the three-sector educational industry we had during the nineteenth century: public schools, denominational and other non-profit private schools, and schools for profit. (The inclusion of schools for profit is, in Lieberman's thinking, crucial. Competition from them is essential if non-profit schools, public and private, are to function optimally.)

On this point, I wish I could be as optimistic as the author. The public education establishment has proven itself adept at using public relations and political muscle to expand over the last twenty years, despite the presence of undermining factors. As the Post Office demonstrates, governmental monopolies are very tough breeds, capable of surviving demographic and economic factors which would kill or cause major changes in any ordinary business. I hope that Lieberman is right, but I am skeptical.

The theme which recurs throughout the book is that public education is dominated by the producers—the teachers and administrators. Their funding comes directly from government rather than from satisfied customers and when it comes to influencing the government, well-organized interest groups (such as the National Educational Association and its state chapters) have an enormous advantage over unorganized parents. They employ full-time staffs to lobby for the enactment of new laws that will make their position more secure and comfortable and they spend lavishly on political action. Against that, the consumers have about as much chance as a glider against an F-15.

The fact that public education is so dominated by the producers enshrines an unsatisfactory status quo. Lieberman writes, "[T]he largest cost of producer domination is the impossibility of fundamental improvement. The past few decades have witnessed significant improvements in health care, transportation, financial services, telecommunications—virtually every major service except education." What has led to improvements in those fields? Competition. Competition is the great force which brings about progress, but competition is anathema to the education establishment. Any policy proposal which would bring about even a modicum of real competition will be opposed to the fullest by the forces of the NEA and its allies.

How different would things be if we had a market system of education? On a host of educational issues, Lieberman shows how the competitive process of the market would give us far more satisfactory results than we get from the monopolistic status quo. For example, he argues that report cards do a poor job of communicating student performance since there are so many disincentives to candor in the present system. But under competition, "effective schools would have strong incentives to expose the deficiencies of ineffective schools. Under these circumstances, schools would not be able to deceive parents over a long period of time." Thus, competition would minimize if not eliminate the problem of grade inflation.

Indeed, perhaps the greatest of the book's virtues is that it shows non-economists how incredibly much better they are served by markets than by politics. After reading *Autopsy,* it would be nearly impossible for anyone to take the benefits of market competition for granted or to remain oblivious to the inevitable waste and inefficiency which result from politicization. Lieberman is not an economist, but he has produced an excellent proof of what public-choice economists have been saying for years, namely that the incentives built into governmentally controlled systems are such that the results are certain to be poor—except for the producers.

Every book has its omissions. An omission in Lieberman's is the matter of teacher strikes. Strikes and the threat thereof, although illegal, give teacher unions powerful leverage to obtain the terms and conditions they want. In a market system, strikes would be far more risky to the strikers, since customers driven away might never come back. In a market educational system, there still could be strikes, but they certainly would be less frequent and less devastating than are teacher strikes in a public education monopoly. Discussion of this issue would have made a strong book even stronger.

Public Education: An Autopsy is a carefully reasoned book by a man who has spent a lifetime in education. If you are really concerned about the future of American education, read this book. □

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The Endangered American Dream

by Edward N. Luttwak

New York: Simon & Schuster • 1993 • 365 pages • $24.00

Reviewed by Jeffrey Tucker

Edward Luttwak, of the Center for Strategic and International Studies, is obviously a brilliant man. His prose is concrete. It packs a punch. He marshals enough facts and anecdotes to his side of the debate to provide the appearance of an infallible case. It is easy to see how his previous book, *Pentagon and the Art of War*, became a bestseller.

But at the heart of *The Endangered American Dream* lies a deception. For all Luttwak's attacks on free trade, his frenzied warnings of Japanese "economic power," his aggressive call for centralized industrial planning, his desire for a global war for American economic supremacy, what he really seems to fear is a return to normalcy after the Cold War.

In a very revealing passage, Luttwak writes that America "has only two modes: internal strife over ideas . . . or a marvelous cohesion in the presence of a threatening external enemy. The Soviet Union performed that function very well for more than forty years," but now that threat is gone. A "basic instinct of American society is to search for an external enemy that can assure its cohesion—and Japan is the only possible candidate."

This passage has marvelous explanatory power. If it were written to demonstrate what's really behind Japan-bashing—culminating in the Clinton administration's walking out of trade talks in February 1994—he makes a compelling point. But, instead the passage is troubling, since the author's protectionism is designed to unite the citizenry in loyalty to the central state.

He is far from the only one in Washington to fear our present lack of some grand international mission. The entire industry of big government would find itself in mortal danger in the absence of an ominous foreign threat. Rather than fret about foreigners, the public would be likely to ask some interesting questions. The foremost is: What do we get in return for sending $1.5 trillion to Washington each year besides pork barreling, a permanent welfare class, and bureaucratic trouble? Frenetic fears of foreigners are powerful enough to drive such fundamental questions out of public debate.

According to Luttwak, we are supposed to fear Japan's "investment" in high technology, its state-subsidized industries, its high levels of education, its long work hours, and its tribal loyalties. If the United States doesn't match them trick for trick, Luttwak warns, especially by jettisoning whatever free trade principles we have, we are going to be economically sunk.

In Luttwak's world, there is no peace or mutually beneficial trade. All economics is war. When foreign corporations invest in new technologies, they are not attempting to make a buck or satisfy consumers; they are trying to drive our companies into the ground, humiliate us, and rob us of our national pride. When American companies invest in foreign countries, they are not boosting profits, but invading the enemy territory and striking where they are most vulnerable.

Luttwak views every trade slight as a bomb lobbed at American shores. Hidden trade barriers are the "geo-economic equivalents of the ambush," circumventing GATT rules amounts to "customs-house conspiracies," subsidized technology is "the equivalent of weapons innovations," and state-guided capital investment is "firepower." This is Cold War thinking gone mad: he has yet to make the psychological transition from war to peace, or the mental switch from geopolitics to plain economics.

There is no reason to fear Japan's Ministry of International Trade and Industry, or MITI, the way the CIA fears the KGB. It is a government bureaucracy, much like the Commerce Department, with the usual share of calculation errors. Government agencies are going to win sometimes and lose other times. Recall that MITI recommended that Honda should stick to making motorcycles, a point which does not receive prominent notice in Luttwak's book. History demonstrates that in the long run, it's the "unpicked" industries that have done well in the marketplace.

During economic decline, there's always a temptation to emulate any economy with a faster rising Gross Domestic Product. In the thirties, for example, the New Deal brain trust tried to copy the Soviet system under the mistaken impression that the Russian GNP was zooming. During the 1990 U.S. recession, moreover, hatred and envy of Japan was at its height. So was the Japanese stock market. Nowadays, the economic fortunes of the two nations have crisscrossed.

Mixed economies like the United States and Japan ebb and flow, depending on a whole variety of factors, including the rate at which the central bank expands money and credit, and the degree to which tax and regulatory police successfully interfere with economic decision-makers. It's best to stick to economic principles rather than hastily lunge from one central-planning fashion to another.

Nonetheless, Luttwak is a compelling prophet of doom. If you're looking for bad news, this is the place to find it. As he points out, our savings rate is at historic lows, and this is causing harm to long-term prosperity. But Luttwak concludes from this that we need a new consumption tax to skew the benefits and penalties the other way. Like Clinton, he wants more "investment" in the private sector by the public sector (based again on the alleged Japanese model), though there is no evidence that this would help at all.

A more sustained attack on the present state of American public education hasn't been published anywhere. That is to be appreciated. But in the end, Luttwak spoils even this by his call for federal government standards and testing, two "solutions" that are somehow never connected to the problem.

Throughout *The Endangered American Dream*, we are treated to masterful polemics, stunning pieces of information, and a sweeping understanding of national trends and economic troubles. Missing is any coherent theory as to why the American dream is indeed endangered. The real reason has to do with the cost of government, but Luttwak is not interested in discussing this. His supposed solutions actually present a greater danger than the status quo itself.

If we adopt his prescriptions—and we seem to be doing so under the current administration—we'll never return to that normalcy Luttwak so fears. That's unfortunate. A nation stuck in the mire of the mixed economy needs internal strife over ideas most of all. Only this kind of battle—not that kind that Luttwak longs for—will bring back liberty, which is the core of the American dream. □

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