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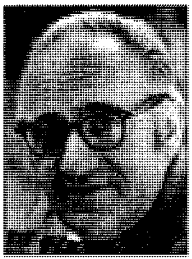
FEATURES



COLUMNS

DEPARTMENTS

THE FREEMAN
Ideas On Liberty

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PERSPECTIVE

Ever Striving

It is not "mere theory" to say that entrepreneurs, lured by the prospect of pure profit, constantly strive to make our lives better. It happens somewhere every moment of the day, usually out of sight. It is so ubiquitous we take it for granted.

One of the most fascinating lectures I ever heard was about how the Coca-Cola Company works assiduously to make cans and bottles with fewer materials and less energy. A few decades ago, only an arrogant he-man could crush a can against his head. Today, a 90-pound weakling can do it. As a result of Coca-Cola's efforts, we have lighter containers and more resources for other things that enhance our lives. (Why environmentalists think business has an interest in using more resources than necessary continues to mystify me. Are businessmen "greedy" or not?)

Now comes news that Hewlett-Packard is developing computer parts the size of—hold on—molecules. According to researchers, we could someday have computers 100 billion (that's not a typo) times faster than the best personal computers available today. (Prediction: We'll still be impatient.) Not only that, these computers will be cheap. John Markoff of the *New York Times* writes that the researchers "envision a world in which super-computing power is so pervasive and inexpensive that it literally becomes an integral part of every man-made object."

Markoff explains that today's computer technology is limited by the wavelength of light, which is used to create integrated circuits on silicon chips. But the research team "has found a way to build circuits using chemical processes rather than light, making the switches as small as a molecule," Markoff writes. "As a result, the researchers believe that they can make components for future computers several orders of magnitude tinier than today's smallest transistors."

The smaller integrated circuits will work much faster and use less electricity. The marginal cost of production will approach zero. Researchers say such tiny computers will permit vast increases in the storage of data. But it gets more exciting than that. Markoff reports that they "could create a new class of 'Fantastic Voyage'-style machines, like sensors traveling within a person's bloodstream, issuing alerts if health problems are encountered." Who can predict what other valuable services they will render?

Scientific problems remain to be solved, and it will be several years before the tiny computers become consumer products, but we'll be hearing more about this. Watch for the term "moletronics" (molecular electronics).

Isn't capitalism wonderful?

* * *

It seemed liked a good idea. At a small, isolated private college, students were invited to use any of 20 collectively owned bicycles to get around campus. What could go wrong? Plenty, write Daniel Alban and E. Frank Stephenson in their story of the relationship between private property and responsibility.

The Clinton administration wants to make sure it can unscramble your encrypted e-mail and computer files. That requires controls on security programs that the government can't crack. Claude Morgan has a status report on this latest power grab.

The "war on drugs" has eroded property rights and a host of what are called civil liberties. Now it even jeopardizes freedom of the press. Paul Armentano demonstrates that in the name of keeping young people from using drugs, the federal government is undermining the integrity of the news media.

Wilhelm Röpke, an important German classical liberal during the darkest days of the twentieth century, would have been 100 years old this month. Richard Ebeling's appreciation of Röpke's life and work brings to our attention one of the intellectual heroes of our time.

At the center of capitalism is the entrepreneur. While big entrepreneurs like Microsoft's Bill Gates and Wendy's Dave Thomas get lots of attention, little ones, like the barber on the corner, are usually taken for granted. Joseph Fulda pays proper tribute.

Did the Federal Reserve expand or restrain the supply of money in the fateful 1920s before the stock market crash and Great Depression? In recent months, Richard Timberlake argued in these pages that the Fed practiced restraint to a fault. In a rebuttal this month, Joseph Salerno argues that the Fed was the engine of inflation that wrecked the American economy and paved the way for the New Deal.

Understanding the Fed and the depression requires an understanding of the nature of money. Bettina Bien Greaves offers a primer in the tradition of Ludwig von Mises.

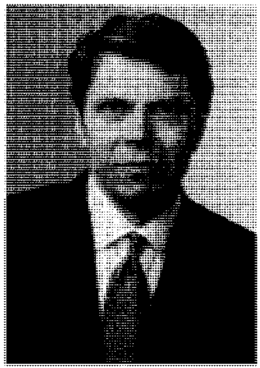
In our columns this month Donald Boudreaux discusses government, markets, and the real source of "inefficient lock-in"; Lawrence Reed asks where the omelets are; Doug Bandow documents the Medicare nightmare; Dwight Lee takes up the law of comparative advantage; Mark Skousen aims at gun control; and Walter Williams identifies a conflict of visions. Thomas DiLorenzo, contemplating the alleged need for the government to give away other people's money, declares: "It Just Ain't So!"

In the book section, reviewers evaluate works on philanthropic foundations gone astray, George Soros's lament about global capitalism, Nixon's economic record, criminal justice, the conduct of states, attempts to impede scientific progress, and the literature of the decline of Western civilization.

—SHELDON RICHMAN

Thoughts on Freedom

by Donald J. Boudreaux



Who's "Locked In" to What?

Politicians and bureaucrats are prone to overemphasize problems with the world and to propose command-and-control "solutions." Economists, sad to say, have aided and abetted that mindset with a series of suspect theories of how markets are doomed to perform inadequately.

Thankfully, not all economists have played this game. Many of the better ones have done outstanding research showing that free markets consistently deliver maximum value.

For example, while most economists 50 years ago were convinced that only vigorous antitrust enforcement could keep industries from becoming monopolized, far fewer economists today hold such a belief. One reason for this change is that a handful of researchers during the mid-century wisely re-examined the theoretical grounds supporting antitrust. (Aaron Director, Milton Friedman's brother-in-law, deserves special recognition for conveying to countless law students a deep understanding of how free markets keep unregulated industries from becoming monopolized.) But another reason is that—guided by these better theories—other researchers found persuasive evidence that the market doggedly resists monopolization. Faced with solid evidence of the robustness of unregulated markets, most economists grew appropriately skeptical of claims that markets are prone to monopolization. The perceived need for antitrust enforcement declined.

Donald J. Boudreaux is president of FEE.

New Justification for Government Activism

But government's thirst for power is unquenchable, as is the willingness of some economists to provide intellectual cover for regulatory activism. Evidence of how such activism is bolstered by new theories is the current antitrust case against Microsoft. Critical to this case is the government's charge that consumers continue to purchase Microsoft software *only* because they are "locked in" to these products.

The allegation is that most consumers want to purchase software from other suppliers, but Microsoft's very dominance locks these consumers into its products, now and forever. After all, the story goes, because a great majority of other computers currently use Microsoft's Windows operating system, it doesn't pay for you to buy another software-maker's less-expensive or technically superior operating system. If you did, your computer couldn't communicate with all those many others that use Windows.

The market, therefore, locks consumers into products and suppliers that by right ought to lose their market shares to firms offering superior deals. Naturally, the story concludes with the assertion that such inefficient "lock-in" is a widespread threat in markets and that only government can spring consumers from these traps.

This "lock-in" theory is dead wrong.

Anyone who cares to look will discover the incredible entrepreneurial dynamism that has long characterized our market economy. If the "inefficient lock-in" tale were true, we would all still be listening to AM radio, for no one would have built an FM transmitter when virtually no one owned an FM receiver. And no one would have bought an FM receiver when virtually no one broadcast FM signals. Likewise for color televisions. And for CD players. (I recall a conversation during the early 1980s with a fellow graduate student who insisted that compact-disc recordings would never catch on because too many people owned vinyl LPs. I hope he isn't now an investment adviser.) In each of these cases, the market smoothly performed the complex task of coordinating the switch by millions of people from a less desirable to a more desirable product standard.

Not surprisingly, there's no evidence that the market dynamism that assured substantial progress for consumers in the past isn't working now in the computer industry. In a thoroughly researched new book, economists Stan Liebowitz and Stephen Margolis document not only how the market has never been inefficiently locked into old technologies or products, but also that Microsoft owes its current success to its consistency in offering quality deals to consumers.[1]

Stuck with Government

Ironically, those who demand that government police against inefficient lock-in are oblivious to the fact that it is government, not the market, that locks people into bad situations. Once created, government power seldom disappears. Statutes, regulations, and bureaucracies remain cemented in place long after their original justifications have evaporated. In short, government—not the market—is the principal source of inefficient lock-in.

Consider, for example, one of America's most regrettable government programs: Social Security. Aside from those with naked political or material stakes in this deluxe boondoggle, no one today argues that it works. That argument would be ludicrous—as was shown recently by Professors Richard McKenzie and Dwight Lee, who calculated that a 38-year-old worker today, earning no more than $40,000 annually, must live to be 143 years old before getting as good a return as he would by investing. And a worker of the same age earning at least $68,400 per year has to pray for true earthly immortality, for only if he or she lives forever will Social Security pay off.[2]

Social Security has long been known to be disastrous for young people. No sensible person would today voluntarily join this system. But join they must. The reason is that Social Security—by its very existence, by the fact that it transfers wealth from the many to the few—has created its own hardcore constituency who benefits directly from its forced continuation. Because of the gargantuan political clout of today's Social Security recipients, Americans are locked into this nefarious scheme.

Of course, there are good people working now to help liberate Americans from the Social Security trap. (For two excellent efforts, see www.socialsecurity.org and www.praonline.org.) These efforts, though, ultimately require politicians to release citizens from Social Security. Perhaps it will happen. I'm hopeful.

But no significant scale-back in government power can occur until large numbers of people are educated and mobilized to support the change. In contrast, inferior products and programs supplied by the market are assuredly and quickly doomed. No political consensus is necessary to free consumers from unresponsive suppliers. All it takes in the market is a creative idea, entrepreneurial gumption, and consumers who recognize superior bargains.

If government is to launch a campaign against programs, products, and institutions that are protected from competition—"locked in"—it had best look in the mirror. □

1. Stan J. Liebowitz and Stephen E. Margolis, *Winners, Losers, and Microsoft* (Oakland, Calif.: The Independent Institute, 1999).

2. Richard B. McKenzie and Dwight R. Lee, "Security in Old Age—and We Mean Old Age," *Wall Street Journal*, June 17, 1998, p. A16.

Legalized Theft Is Good for the Poor?

It Just Ain't So!

Former U.S. Secretary of Labor Robert Reich spent the 1980s at Harvard's Kennedy School of Government spreading lies in the service of socialism. Not socialism as government ownership of the means of production but rather, as F. A. Hayek defined it in *The Road to Serfdom*, "chiefly the extensive redistribution of incomes through taxation and the institutions of the welfare state." He's at it again now that he's back in academe as a professor of social and economic policy at Brandeis University.

Reich began the decade of the '80s writing books and articles with the Marxist economist Barry Bluestone about the "deindustrialization of America," which, in their view, could only be stopped by the introduction of central planning, euphemistically called "industrial policy." But America wasn't deindustrializing. In a 1984 study published by the Heritage Foundation, I showed that the U.S. Commerce Department's Index of Manufacturing was at an all-time high, and that manufacturing as a percentage of GDP was about the same in 1980 as it was in 1950. American industry was evolving, as it always has, but it wasn't disappearing.

Then came the myth of the "great U-turn" in wages, with the average worker allegedly suffering a decline in wages and living standards. This myth was debunked by Richard McKenzie, who showed that if one considers total employee compensation, and not just wages, there is no "U-turn."

Reich and Ira Magaziner also championed the view that the Japanese system of crony capitalism was the key to that country's economic success and should be imitated by the United States. Now that the Japanese system has collapsed in a sea of corruption and bankruptcy, Reich is silent on the issue.

The late Murray Rothbard once asked Ludwig von Mises if he thought there was one single thing that designated an economy as primarily capitalist. Mises's response was yes, a vigorous private capital market. For it is capital markets that facilitate the constant reallocation of capital, guided by consumer sovereignty, in a capitalist economy. So, naturally, Reich next wrote a book and a series of magazine articles criticizing private capital markets as essentially useless, part of a "paper economy" that supposedly adds nothing to production.

The Latest Crusade

In a May 16, 1999, *Washington Post* article titled "To Lift All Boats," Reich is back to his old tricks. This time he endorses the Clinton administration's scheme to use tax dollars to set up "Universal Savings Accounts" worth up to $2,000 for citizens with incomes under $40,000 per year. Another variant of this scheme that Reich writes approvingly of is Senator Bob Kerrey's plan to give each newborn child $1,000 in tax money, along with $500 per year every year until age 21, to be deposited in a government-operated "savings account." Then there's Yale Law School's Bruce Ackerman, who favors giving every 21-year-old $80,000 of someone else's hard-earned income, no questions asked. This latter proposal really gets Reich excited. It can be funded, he says, with a mere "2 percent wealth tax on the wealthiest 40 percent of Americans." That's any family with an annual income of more than $40,000 per year, hardly what one would consider to be "wealthy." (For those who believe the tax rate under such a scheme would remain at 2 percent, I've got some oceanfront property in Arizona I'd like to sell you.)

All these socialistic share-the-wealth plans are based on profound economic ignorance. The most fundamental problem is a problem of socialism generally, as Mises pointed out in his 1922 classic, *Socialism*: "The socialist community is characterized by the fact that in it there is no connection between production and distribution. The magnitude of the share [of income] which is assigned for the use of each citizen is quite independent of the value of the service he renders."

Reich's share-the-wealth plans are just another "entitlement" (to other people's money) that will continue to destroy the work ethic by paying people for not working. Since economic reward is divorced from one's service to consumers, the principle is the antithesis of how a market economy works. Reich, however, absurdly claims that it would *expand* "the benefits of a market economy."

It would induce people to save less on their own, just as Social Security does. But once again, Reich gets everything backwards, arguing that it would "encourage saving." In reality, the reduced savings rate would diminish the rate of capital accumulation and reduce economic growth. The annual cost of the programs, which would run in the tens of billions of dollars, would in itself depress the private sector because the opportunity cost of such programs is returning those tax dollars to their rightful owners, the people who earned them.

Static View

Reich's case is based on a static view of the economy and the old socialist canard that there is a "lump" of wealth out there: if one person has more, others must have less. But the economy is dynamic; there is great mobility in a capitalist economy, and that mobility is driven by people's desire to better themselves financially and materially. Giving some of them something for nothing, as Reich's proposal does, can only diminish that incentive.

In their book, *Myths of Rich and Poor*, Michael Cox and Richard Alm examine a sample of more than 50,000 Americans from all socioeconomic backgrounds whose incomes have been tracked for more than 20 years. They found that those who started out in the bottom fifth of income earners in 1975 gained more than four times the income by 1991 than did the top fifth in 1975. In a dynamic, capitalist economy the "rich" may get richer, but the "poor" do even better.

Reich argues that the enormous flow of funds into the stock market in recent years doesn't seem to have benefited "the bottom 30 percent" very much. But those funds have financed the capital expansion and job creation that have made the U.S. economy the envy of the world. The "bottom 30 percent" has benefited as much as anyone, if not more.

Reich's share-the-wealth plan is nothing but another Ponzi scheme, not unlike Social Security, that is designed to help politicians buy the votes of a majority (the "bottom 60 percent") by taxing a minority. As Rothbard wrote in *The Ethics of Liberty*, "the State is a coercive criminal organization that subsists by a regularized large-scale system of taxation-theft, and which gets away with it by engineering the support of a majority . . . through securing an alliance with a group of opinion-moulding intellectuals whom it rewards with a share in its power and pelf." Professor Reich, take a bow.

—THOMAS J. DILORENZO
Professor of Economics
Loyola College, Maryland

The "Berry Bikes": A Lesson in Private Property

by Daniel L. Alban and E. Frank Stephenson

Berry College is a private college located on a large campus adjacent to Rome, Georgia. In March 1998, the Berry College Student Government Association (SGA) used student activity funds to purchase 20 bicycles for student use on campus.

The bright red bicycles, each with an identifying plate reading "Berry Bike," were available to all students on a "first-come, first-served" basis, making them a common property resource. In spite of the relatively favorable environment for common-property bicycles at Berry, it took less than two months for many of the bikes to be lost, stolen, or abused. This story illustrates the importance of private property rights and the folly of common property.

The SGA purchased 20 Schwinn Cruiser bicycles for $190 each. The rationale for spending student fees was that the distance between some buildings on campus made getting to classes on time difficult. Several factors would seem to favor the plan. The campus is relatively self-contained; it is unlikely that townspeople would enter college property to use the bikes or that students would ride them off campus where they could be abandoned, lost, or stolen. Berry students probably have a more cooperative ethic than students at many other colleges. For example, there is relatively high participation in student organizations, many of which are campus religious groups. Observers report a tendency for students there to split the difference during in-class market simulation exercises, rather than compete to maximize personal gain, suggesting that Berry students are not unusually self-centered.

Moreover, the student body is relatively small. Anyone who abused a bicycle could be readily identified, and the students harmed by having bicycles mistreated would not be strangers. These factors would presumably deter would-be vandals. Finally, and directly pertinent, privately owned bicycles were not being lost or abused.

Dismal Results

Unfortunately, the results of the Berry bike project were dismal. It took little time for the misuse of the bicycles to become evident. Writing in the April 2, 1998, *Campus Carrier*, student Liz Hill reported that "Chains have been broken, tires punctured, handlebars bent, and seats torn" after "only a couple of weeks." Recognizing the underlying cause of the mistreatment, Hill implored students to "treat the bikes as if they were your own property." Evidently, her column spurred little change.

On April 21, SGA President M. Lynsey Morris e-mailed all students that "It has come to our attention here in the SGA office that many students are failing to take care of the Berry Bikes. . . . These bicycles are top quality and should not be bending and breaking

Daniel Alban is a senior with an interdisciplinary major at Berry College, in Mount Berry, Georgia. Frank Stephenson is an assistant professor of economics in Berry College's Campbell School of Business.

COURTESY: BERRY COLLEGE

the way they are. The [SGA] officers and other students have seen many people riding the bikes at absurd speeds, doing tricks, and just abusing the bicycles in general." She too requested that students "treat [the bikes] as you would your personal property." Morris's appeal apparently met with little success; a survey at the end of the semester revealed that four of the 20 bikes were lost or stolen and 11 were in a state of disrepair—a 75 percent casualty rate in a mere two months.

Undeterred, the SGA had the bicycles repaired over the summer recess and resumed the program in the fall. It soon became apparent that the abuse would continue. The September 10 *Campus Carrier* editorialized about "mangled corpses of twisted red metal that lie about campus" and concluded that "Perhaps SGA put too much trust in human nature and Berry students' respect for property." Was that the problem? Or was it that the SGA did not understand the role of incentives? Only a month into the new semester, the SGA suspended the program with the intention of leasing the remaining bicycles to students on a semester-by-semester basis, thereby alleviating the problems associated with common-property resources.

Although it may seem cynical or impolitic to point out the failure of the project, we think just the opposite. A primary goal of college is for students to learn, both in and out of the classroom. At a cost of about $2 out of each student's activity fees, the failed Berry bike experiment provides an inexpensive example of the "tragedy of the commons" that students can remember vividly for the rest of their lives. □

THE FREEMAN (Ideas On Liberty)

The Encryption Scramble

by Claude V. Z. Morgan

When law professor Peter Junger penned a small computer program for his computer-law class at Case Western Reserve University School of Law, he never dreamed he'd be battling the U.S. Commerce Department for the right to post it on his Web site.

In 1997 the Commerce Department informed Junger that he would need a special munitions export license to publish "Fiddle"—a small encryption program that scrambles computer files into gibberish—over the Internet. "When I realized that I could not publish my little program, or any other encryption program, without asking for permission from the bureaucrats," he says, "I was shocked and angry."

Junger sued the Commerce Department for violating his First Amendment rights—the fifth freedom-of-speech case filed against the department in as many years. As he argues that "Fiddle" is protected speech, U.S. software makers gather at the sidelines to await the outcome of his case. They say that the very same export regulations that prevent Junger from posting "Fiddle" on the Net could cost their industry as much as $60 billion and 200,000 high-end jobs by next year.

Domestic software makers currently command 70 percent of the world's software market, with sales that topped $135 billion at home and abroad in 1997 alone. In fact, U.S. software makers are so adroit at capturing the world market that they are currently growing at two-and-a-half times the rate of other U.S. industrial sectors. But hampered by the current regulations, they have so far managed to win only a meager portion of the world's booming encryption software market.

Critics of the Clinton administration's communications and technology policies charge that backward export regulations are blocking the industry from competing in the world market. Furthermore, they say, lagging behind in encryption sales isn't just about losing profits, it's about undermining national security.

Protecting Data

"Encryption really is the backbone of effective privacy on the Internet," says Linda Bloss-Baum, manager of public policy at the Business Software Alliance (BSA), a public-policy group representing 17 leading U.S. software makers. By converting data in files to gibberish and requiring mathematical "keys" to unlock them, encryption products have protected sensitive data from unauthorized users since the earliest days of computing, says Bloss-Baum.

Encryption guards flight-control data, telephone networks, and power grids from mishaps and sabotage. It cloaks online financial transactions, trade secrets, and sensitive business and military data. It can also be used to scramble telephone calls and e-mail. In fact, Bloss-Baum says, "without strong encryp-

Claude Morgan writes on culture and technology from his home in Portland, Maine.

tion, anyone would be able to break into your files and gain access to your identity."

But if encryption software protects sensitive data from saboteurs and high-tech mischief-makers, it can also be used to conceal that information from law-enforcement agencies, the Clinton administration argues. Citing national security and endorsements from the National Security Agency (NSA) and FBI director Louis Freeh, the administration in 1996 banned the export of all "strong" encryption software and technology to U.S. subsidiaries, trading partners, and all foreign markets. The administration defined "strong" encryption as any software with key lengths of 40 bits or more. (Each bit represents an order of magnitude in the complexity of the decoding key.)

Domestic sales and the domestic use of strong encryption remain exempt from Commerce Department regulations. Banks and other financial institutions have been given special dispensations to glide the Internet safely with strong encryption.

The administration only briefly considered raising the export bar to 56 bits when a graduate student cracked the 40-bit code in three-and-a-half hours using simple desktop computers. After similar demonstrations and pressure from high-tech industry, the administration presented software makers with this proposal: Software stronger than 56 bits can be exported to friendly nations only after a Commerce Department review and only if the code-breaking key can be held in "escrow" by a government-authorized third party. This so-called "key recovery," or "key escrow," plan would allow law-enforcement agencies to obtain keys from escrow agents in much the same way that police currently obtain evidence through search warrants or wiretaps.

So far, the plan has won few friends among industry, public-interest groups, or private citizens. The key recovery plan is riddled with administrative and ethical flaws, says David Banisar, policy director at the Electronic Privacy Information Center. It calls for centralized databases—places to store keys—that would make appealing targets. Key recovery is therefore a bad strategy that jeopardizes national as well as corporate security, says Banisar, who recently gained national notoriety spearheading a boycott against the Intel Corporation for loading its new chip, the Pentium III, with trail-blazing serial numbers. "From a social and ethical standpoint," he says, "the concept that your communication should never be private, but subject to the whims of government, turns the basic principles of free speech and privacy on their heads."

Impeding the Market

That's not the only principle turned upside down, Bloss-Baum says. Current regulations prohibit American companies from competing against foreign firms. "There are a lot of 128-bit products already out there in the marketplace," she says. "Products are being manufactured by foreign providers in countries that have no export controls on how long the bit-strength is on their encryption." Because that technology is already widely available, she says, American companies should be allowed to compete with the same types of products.

More than 900 software makers in nearly 70 countries currently produce and market strong encryption software. Foreign competitors also produce "patches" and "plug-ins" to boost weak encryption exports from the United States.

Bloss-Baum, who has been lobbying Congress to lift the ban on encryption exports for three years, says that most U.S. intelligence agencies support industry's position that encryption software can be widely and safely distributed. She, Banisar, and others point fingers at Louis Freeh for driving the administration's policy into its current regulatory waters.

"The law enforcement argument has been wagging the Administration's whole Internet policy," says Alan Davidson, counsel for the Center for Democracy and Technology (CDT), a nonprofit public-research group promoting constitutional liberties on the Internet. Davidson argues that a lack of security and privacy actually slows economic growth on the Net, leaving consumers distrustful and U.S. technology and infrastructure vulnerable.

"There are serious inconsistencies between the administration's free-market version of the Internet and the administration's law enforcement version," says Davidson. "Encryption is only the most glaring example."

Davidson believes that the export controls are destined to fail because ideas cannot be stopped at the border. "People have good encryption outside of the U.S. and they're going to keep having that," he says. "Key recovery is a real problem because it builds a backdoor that people don't like, and that jeopardizes their privacy. As a whole, the policy really leaves people without the tools they need to protect themselves on the Internet."

Vulnerability has never appealed to the pioneers of the Internet. As early as 1990, Netsurfers began inventing their own tools to shield themselves from observation.

In 1990, Phillip Zimmermann, a Denver-based software engineer, wrote a small but powerful encryption program called Pretty Good Privacy (PGP) and distributed it to friends. The program found its way onto the World Wide Web in 1991, and the Commerce Department found its way to Zimmermann in 1993.

He became the focus of a two-and-a-half-year Justice Department investigation during which he gained cyber-folk-hero status, as well as a $35 million offer from a leading software maker to purchase and distribute PGP. Zimmerman fought the Justice Department's charges, which were dropped unexpectedly in 1996.

In 1995, university professor Daniel Bernstein filed suit against the government for prohibiting him from publishing "Snuffle," another homemade encryption program. A federal judge ruled in favor of his First Amendment suit in 1997. The government promptly appealed, but in May the Ninth Circuit Court of Appeals upheld the decision. There are currently three constitutional cases challenging the export regulations in court, says Banisar. The Supreme Court is likely to hear all three.

"The government has never demonstrated, and can never demonstrate," says Junger, "any threat to security interests that would arise from my publishing my little programs. As to more serious programs, they are all available on Web sites outside the United States anyway, so allowing their publication on Web sites within the United States could not possibly endanger any United States security interest."

Government Waffling

Since April 1996 the administration has waffled on its export policy at least four times, amending, changing, updating, even reversing the Commerce Department's complicated application process. Loopholes in the regulations make it possible to export strong encryption software, says Banisar. But that process can be expensive. Software makers must document that they are trying to comply with the key recovery plan before export licenses are granted.

Loopholes have led to skirting the law. Network Associates, the current distributor of PGP and popular software like the McAfee anti-virus programs, exports PGP's 6,000 pages of raw binary code to a Swiss subsidiary, which then compiles, packages, and sells it to foreign markets. That's legal. Yet U.S. regulations forbid the California-based company from e-mailing the small compiled program abroad.

But using loopholes and complying with regulations are too expensive, software makers say. The regulations are opaque, and the review process often runs late. Foreign manufacturers are not bound by similar restraints.

It's not just encryption software like PGP that gets snared by the regulations, says Bloss-Baum. Mass-market software like Lotus Notes and Microsoft Word have encryption capabilities built into them for the domestic market. "So those parts of these programs would also be subject to the export regulations," she says.

That means that when U.S. companies submit operating systems or Internet browsers for export, says Banisar, "they either have to find an overseas partner who can provide the encryption part of the system, or they forgo the whole contract altogether."

Who currently outside the United States buys American encryption software and technology? The answer is no one. Foreign buyers show little or no interest in the bit-strength of American exports or in the prospects of handing over their keys to a U.S.-based escrow agent. CDT says not one major key recovery product is being widely used by consumers today.

The cost of buying American can be prohibitive, as well, says the BSA. U.S. industry can plan on shelling out $4.2 billion annually for the first five years to set up and maintain the key recovery system. Start-up costs for small businesses will average $2,500. Large corporations may have to cough up as much as $25,000.

Consumers will chip in $1.8 billion annually for the first five years. Escrow agents will earn $6 billion a year for keeping the consumer and business keys available to law-enforcement agencies.

Who exactly is a key recovery agent? While details of the plan remain sketchy, many analysts believe that contracts will be awarded to banks, post offices, or private mail handlers like Mail Boxes Etc., according to a security spokesman for a leading software maker. Large corporations may be allowed to "post their own centers" provided investigations and warrants can be conducted discreetly—that is, without alerting the bosses upstairs.

Freedom of Speech

Despite the business concerns, free-speech arguments will likely play a decisive role in overturning the regulations. But the law is not clear on high-tech definitions of "speech" in the information age, says Davidson. "We think that there are free-expression issues implicated by the export controls," he says. "But we're treading on new legal ground here. Its difficult getting courts to understand why there's an expressive quality to Professor Junger's little programs."

If the legal issues surrounding encryption software aren't complicated enough, says Davidson, philosophical issues about privacy in the information age are about to muddy the waters further. "This is really about some very different views of how we protect privacy online," he says. "There are two different visions: one is where individuals have the tools to be able to protect themselves; another is where we build backdoors to the system, where we rely on government to be the protector. One minute I'm e-mailing somebody down the street, but the next minute that message is going across ten different countries. And each of those countries has different laws."

Getting the lawmakers to understand that has been difficult enough, says Bloss-Baum. But for the time being, she and her colleagues plan to focus the argument on free-market principles. In 1997, she says, a handful of lawmakers endorsed federal legislation to lift the ban on encryption strengths already available on the world market. That bill failed with 205 supporters.

This year a similar bill was introduced with 210 endorsements. The Safety and Freedom through Encryption Act of 1999 (SAFE), which in March passed the House Judiciary Committee, would prohibit the government from requiring keys to be held in escrow, but the secretary of commerce would still have the power to review encryption products and control exports. On the Senate side, the PROTECT Act of 1999 (Promote Reliable On Line Transactions To Encourage Commerce and Trade) would immediately raise the bar to 64 bits and open the floodgates for exports of *any* strength by 2002. Bloss-Baum says she's optimistic that the ban will be lifted this year.

"People are already moving their lives online," says Davidson. "There has to be a very broad discussion about how we're going to protect what's seen of us online. Encryption is just one small piece of it. I think this is the first skirmish in a very long campaign." ☐

THE FREEMAN
Ideas On Liberty

Bought and Sold: Drug Warriors and the Media

by Paul Armentano

Americans pride themselves on their independent press. Yet some media outlets and networks are compromising their autonomy and objectivity by welcoming the federal government as a major paying advertiser. This alarming union is the latest outgrowth of the "war on drugs," and the launch of a new $775 million White House campaign to promote its objectives through television, radio, and print advertising.

The message to media moguls is simple: Promote the continuation of the drug war in advertisements, editorial content, and features, and we, as federal officials, will reimburse you by spending millions of taxpayer dollars for ads. The better government mouthpiece you are, the more advertising space we will buy.

Not surprisingly, America's print and television media hierarchy are lining up for a slice of the pie.

Last fall, the board of directors of the Magazine Publishers of America announced their participation in the federal crusade, dubbed the "National Youth Anti-Drug Media Campaign," by agreeing to run "compelling ads in their magazines and providing editorial support for their audiences." Their decision came immediately after a meeting with White House drug czar Barry McCaffrey, who urged the industry to begin a "nationwide antidrug publishing strategy."

McCaffrey found the MPA more than willing. "[We] accept the challenge presented to the magazine industry by the General [Barry McCaffrey] to join with the Ad Council, the Partnership for a Drug-Free America, and the Office of National Drug Control Policy [ONDCP]," a spokesperson for the MPA board of directors announced following the drug czar's visit. "The MPA will use its best efforts to coordinate member participation in a national magazine 'roadblock' . . . to raise the level of awareness of the campaign among parents and kids."

Disturbing Implications

The implications of the publishing industry's new alliance with the federal government are disturbing. Michael Hoyt, senior editor for the *Columbia Journalism Review*, warns that the industry's involvement sacrifices credibility and journalistic integrity. "I don't think that the MPA should be urging members to provide editorial support for anything at all," he says. "And it doesn't matter how worthy they think the cause is. That's particularly true where there can be a perceived conflict of interest, such as urging that support in return for tax dollars."

Indeed, federal officials made it clear that the MPA's portion of the White House's war chest hinged on its willingness to espouse the government's party line. "We want . . . the magazine industry to be a critical player in

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this effort," McCaffrey told the publishing heads. "However, . . . we have yet to determine exactly how much of the roughly $775 million ad dollars will go to magazines. . . . That proportion depends on your response. If you deliver the commitment of your industry, we will provide the [financial] resources necessary to deliver the message on your pages."

As expected, the drug czar's bribe achieved the desired union. Unfortunately, this is not the first time the media have enlisted in this governmental campaign. Previously, the National Association of Broadcasters announced that it would cooperate with the U.S. Department of Health and Human Services and the advertising conglomerate Partnership for a Drug-Free America to launch a nationwide television campaign demonizing marijuana's alleged dangers. The ABC television network also broadcast a month-long federally backed antidrug media blitz two years ago that raised eyebrows among many media critics.

"All of us can benefit from an honest message about the risks of substance abuse, but it must be credible," wrote national columnist Robert Scheer, who called the earlier ABC/Partnership for a Drug-Free America effort a "propaganda campaign." "The government-sanctioned anti-drug message, inserted by corporate fiat into all [ABC] programming, including news, criticizes only those vices that are not legally profitable, while the network's advertising continues to glorify those that are. Surely, those sales people at ABC know that a warning that is transparently dishonest is worse than useless."

Apparently not. Today, the White House drug-control office is one of ABC's best-paying clients. ABC accepted over $14 million in paid ads from the ONDCP in the first five months of the federal advertising campaign, more than twice as much as any other network.

ABC also combined efforts with Disney Online to establish the drug propaganda Web site, Freevibe.com, which targets visitors with baseless drug "facts" like: "Pot turns people into potheads." This statement, like most others appearing on this and other government-influenced sites, conveniently ignores the science exonerating marijuana of such "reefer madness" inspired allegations. For example, visitors will find no mention of a May 1999 John Hopkins University cognition study, the first ever to investigate the long-term effects of marijuana on mental function in a large epidemiological sample, that found "no significant differences in cognitive decline between heavy users, light users, and nonusers of cannabis."

The White House drug control office spent an additional $5.5 million on Fox, $1.8 million on NBC, $600,000 on CBS, and $800,000 on the WB Network, according to *USA Today* columnist Melanie Wells. In return, the major networks "donated" $24.4 million of free air time to promote the feds' political antidrug agenda. This public-private partnership makes the White House campaign one of the top 15 single-brand campaigns in the nation, even outspending (in unadjusted dollars) the public service campaign run during World War II in support of the war effort.

Tom Haines, chairman of the drug-policy alternatives group Partnership for Responsible Drug Information, denounces the emerging alliance among the government and media as a threat to America's free press. "We are seeing the unification of the business end of the media community and the government for an advocacy campaign where only one point of view is coming across," he says. "If this were happening in any other country, it would be denounced as propaganda."

Shifting Roles

Also critical is *New York Times* writer Frank Rich, one of the few columnists to question the shifting roles of the government and the media. This new ad campaign "may introduce a new economic model to the long and tortured history of the drug war," he wrote in a syndicated column. "Where we once had companies that laundered drug money, we now have corporations synergizing anti-drug money."

One thing is for certain, as long as there are dollars to go around, expect the networks and much of the Fourth Estate to keep buying. "One of the most surprising results we've seen has been the tremendous response by the media and entertainment industry," Alan

Levitt, who oversees advertising for the ONDCP, said in a recent interview. "They're willing to listen to what we're saying . . . and they [are] willing to change storylines."

Such may have been the case last spring when the NBC show "Hang Time" aired an ONDCP-friendly episode regarding marijuana. "When kids and teens across the nation tuned into the popular TV show, they saw a group of high schoolers catch their friends smoking marijuana, witnessed the negative consequences of drug use, and saw some real friends convince their pal to get help," the drug czar's office bragged after NBC aired the show, declaring the network had "adopted" the prevention theme in their broadcasts. Other NBC shows followed suit, including "One World," "City Guys," and "Saved by the Bell: The New Class," each emphasizing the "negative consequences" of drug use. The network and the White House also combined efforts to produce and distribute "study guide" pamphlets to public high-school students. Teachers were encouraged to use the materials as a basis for initiating drug "education" classroom discussions. "The programming and surrounding activities were made possible by a unique collaboration among the ONDCP [and] NBC television . . . , arising from the powerful messages of the National Youth Anti-Drug Media Campaign," the White House summarized.

Is the campaign really propaganda rather than good science? The federal government's marijuana policy has long been based on propaganda. Government witnesses advocated passage of America's first prohibitive federal marijuana law in 1937 by telling Congress that marijuana consumption inevitably causes violence, insanity, and death among users.

In different eras, various other myths have gained prominence (marijuana kills brain cells, marijuana causes amotivational syndrome, marijuana harms sexual maturation and reproduction, and so on), but few have been abandoned. Indeed, many of the "reefer madness" tales that were used today to generate support for early anti-marijuana laws continue to appear in the government's media campaign and bureaucratic reports today, despite scientific studies demonstrating the contrary. For example, just one month after the May 1999 National Academy of Sciences Institute of Medicine report concluded that marijuana withdrawal symptoms evidenced in humans are "mild and subtle," the federal National Institute on Drug Abuse said that marijuana smokers who abstain from the drug become aggressive. Assertions like those form the backbone of the federal antidrug campaign, while nongovernment studies that fail to find deleterious or toxic effects from marijuana and other drugs are ignored.

The unholy taxpayer-financed alliance arising among federal drug warriors and the media threatens to usher an unparalleled campaign of government propaganda into our homes, lives, and public schools. In addition, by waving taxpayer dollars, federal officials are presenting many within the Fourth Estate with a conflict of interest that threatens not only their credibility and objectivity, but also their ability to maintain a proper role as a watchdog over big government and its policies. How likely is the media to question the drug-war party line when the warriors are some of their biggest advertisers? The feds are spending $775 million of your hard-earned dollars to find out. □

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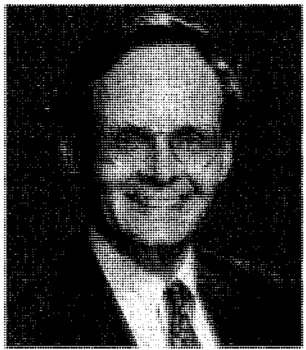
Government



Where Are the Omelets?

"*On ne saurait faire une omelette sans casser des oeufs.*" Translation: "One can't expect to make an omelet without breaking eggs."

With those words in 1790, Maximilian Robespierre welcomed the horrific French Revolution that had begun the year before. A consummate statist who worked tirelessly to plan the lives of others, he would become the architect of the Revolution's bloodiest phase—the Reign of Terror of 1793–94. Robespierre and his guillotine broke eggs by the thousands in a vain effort to impose a utopian society based on the seductive slogan *"liberté, égalité, fraternité."*

But, alas, Robespierre never made a single omelet. Nor did any of the other thugs who held power in the decade after 1789. They left France in moral, political, and economic ruin, and ripe for the dictatorship of Napoleon Bonaparte.

As with Robespierre, no omelets came from the egg-breaking efforts of Lenin, Mao, Pol Pot, Adolf Hitler, and Benito Mussolini either.

The French experience is one example in a disturbingly familiar pattern. Call them what you will—leftists, utopian socialists, radical interventionists, collectivists, or statists—history is littered with their presumptuous plans for rearranging society to fit their vision of "the common good," plans that always fail as they kill or impoverish other people in the process. If socialism ever earns a final epitaph, it will be this: "Here lies a contrivance engineered by know-it-alls and busybodies who broke eggs with abandon but never, ever created an omelet."

Every collectivist experiment of the twentieth century was heralded as the Promised Land by statist philosophers. "I have seen the future and it works," the intellectual Lincoln Steffens said after a visit to Uncle Joe Stalin's Soviet Union. In *The New Yorker* in 1984, John Kenneth Galbraith argued that the Soviet Union was making great economic progress in part because the socialist system made "full use" of its manpower, in contrast to the less efficient capitalist West. But an 846-page authoritative study published in 1997, *The Black Book of Communism*, estimated that the communist ideology claimed 20 million lives in the "workers' paradise." Similarly, *The Black Book* documented the death tolls in other communist lands: 45 to 72 million in China, between 1.3 million and 2.3 million in Cambodia, 2 million in North Korea, 1.7 million in Africa, 1.5 million in Afghanistan, 1 million in Vietnam, 1 million in Eastern Europe, and 150,000 in Latin America.

Additionally, all of those murderous regimes were economic basket cases; they squandered resources on the police and military, built vast and incompetent bureaucracies, and produced almost nothing for which there was a market beyond their borders. They didn't make "full use" of anything except

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police power. In every single communist country the world over, the story has been the same: lots of broken eggs, no omelets. No exceptions.

F. A. Hayek explained this inevitable outcome in his seminal work, *The Road to Serfdom,* in 1944. All efforts to displace individual plans with central planning, he warned us, must end in disaster and dictatorship. No lofty vision can vindicate the use of the brute force necessary to attain it. "The principle that the end justifies the means," wrote Hayek, "is in individualist ethics regarded as the denial of all morals. In collectivist ethics it becomes necessarily the supreme rule."

The worst crimes of the worst statists are often minimized or dismissed by their less radical intellectual brethren as the "excesses" of men and women who otherwise had good intentions. These apologists reject the iron fist and claim that the State can achieve their egalitarian and collectivist goals with a velvet glove.

But whether it is the Swedish "middle way," Yugoslavian "worker socialism," or British Fabianism, the result has been the same: broken eggs, but no omelets.

Have you ever noticed how statists are constantly "reforming" their own handiwork? Education reform. Health-care reform. Welfare reform. Tax reform. The very fact that they're always busy "reforming" is an implicit admission that they didn't get it right the first 50 times.

The list is endless: Canadian health care, European welfarism, Argentine Peronism, African postcolonial socialism, Cuban communism, on and on ad infinitum. Nowhere in the world has the statist impulse produced an omelet. Everywhere—it yields the same: eggs beaten, fried, and scrambled. People worse off than before, impoverished and looking elsewhere for answers and escape. Economies ruined. Freedoms extinguished.

It is a telling conclusion that statists have no successful model to point to, no omelet they can hold up as the pièce de résistance of their cuisine. Not so for those of us who believe in freedom. Indeed, economists James Gwartney, Robert Lawson, and Walter Block in their survey, *Economic Freedom of the World: 1975–1995*, conclude that "No country with a persistently high economic freedom rating during the two decades failed to achieve a high level of income. In contrast, no country with a persistently low rating was able to achieve even middle income status. . . . The countries with the largest increases in economic freedom during the period achieved impressive growth rates."

Perhaps no one explained the lesson of all this better than the French economist and statesman Frederic Bastiat more than 150 years ago:

"And now that the legislators and do-gooders have so futilely inflicted so many systems upon society, may they finally end where they should have begun: May they reject all systems, and try liberty; for liberty is an acknowledgment of faith in God and His works." □

THE FREEMAN
Ideas On Liberty

Wilhelm Röpke: A Centenary Appreciation

by Richard M. Ebeling

On January 30, 1933, German president Paul von Hindenburg appointed Adolf Hitler chancellor of Germany. One week later, on February 8, Wilhelm Röpke, a 32-year-old professor of economics at the University of Marburg, delivered a lecture in Frankfurt am Main with the title "End of an Era?"

Röpke told his audience that Germany was in the grip of a "revolt against reason, freedom and humanity." The National Socialists under Hitler were now the dominant force in an attack against the fundamental principles of liberalism and Western civilization. Liberalism, correctly understood, represented a 2,000-year-old intellectual heritage of political, civil, and economic liberty. Liberty required the rule of reason, resting on "truthfulness instead of obscurantism, clarity instead of hysteria, the advancement of knowledge instead of sensationalism for the masses, logic instead of wallowing in moods and emotion.... It is only the liberal ideal of the use of Reason in the service of truth that has engendered science... that alone has liberated Europe from the stupor and wretchedness of barbarism."

An additional element in the philosophy of liberalism, rightly understood, Röpke explained, was the idea of humanity. "The idea of humanity is seen in all its full significance when conceived as the rejection of the principle of violence in favor of the principle of reason. Violence is relegated to the very bottom of the scale of value; its use is admitted only as a last resort and with the utmost reluctance. This, ultimately, is the essence of civilization."

But Nazism was the culmination of Germany's sinking into "illiberal barbarism," Röpke said, the elements of which were based on: (1) "servilism," a "longing for state slavery," with the state becoming the "subject of unparalleled idolatry"; (2) "irrationalism," in which "voices" in the air called for the German people to be guided by "blood," "soil," and a "storm of destructive and unruly emotions"; and (3) "brutalism," in which "The beast of prey in man is extolled with unexampled cynicism, and with equal cynicism every immoral and brutal act is justified by the sanctity of the political end." Röpke warned that, "a nation that yields to brutalism thereby excludes itself from the community of Western civilization." He hoped Germany would step back from this abyss before its people had to learn their mistake in the fire of war.[1]

Röpke also spoke out against the Nazi dismissal of Jewish professors and students from German universities, which began in April 1933. The Nazis denounced him as an "enemy of the people" and removed him from his professorship at the University of Marburg. After an angry exchange with two SS men sent to "reason" with him, Röpke decided to leave Germany and accept exile rather than live under National Socialism.[2]

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Leading Figure

Wilhelm Röpke was a leading intellectual figure of twentieth-century Europe. He combined conservatism with classical liberalism to develop a political philosophy he called a market-oriented "middle way" between nineteenth-century capitalism and twentieth-century totalitarian collectivism. He also became a spiritual guide and political-economic architect of Germany's "social market economy" in the post-World War II era. As Ludwig von Mises wrote when Röpke died in 1966 at the age of 66,

> For most of what is reasonable and beneficial in present-day Germany's monetary and commercial policy credit is to be attributed to Röpke's influence. He—and the late Walter Eucken—are rightly thought of as the intellectual authors of Germany's economic resurrection. . . . [T]he future historians of our age will have to say that he was not only a great scholar, a successful teacher and a faithful friend, but first of all a fearless man who was never afraid to profess what he considered to be true and right. In the midst of moral and intellectual decay, he was an inflexible harbinger of the return to reason, honesty and sound political practice.[3]

Röpke was born October 10, 100 years ago in Hanover, Germany. He grew up in a rural community of independent farmers and cottage industry craftsmen. His father was a country doctor. That upbringing can be seen in his later belief that a healthy, balanced, small community is most fit for human life.

The event, however, that shaped his chosen purpose in life was his experience in the German army in the First World War. War was "the expression of a brutal and stupid national pride that fostered the craving for domination and set its approval on collective immorality," Röpke explained. The experience of war made him decide to become an economist and a sociologist when the cannons fell silent. He entered the University of Marburg, from which he earned his doctoral degree in 1921. At first, Röpke thought that socialism was the answer to the world's problems. But he soon discovered that the only realistic solutions were to be found in classical liberalism and the market economy.[4] Among the most important influences in that discovery were the writings of Austrian economist Ludwig von Mises. "It was his book, *Nation, State and Economy* (1919) . . . which was in many ways the redeeming answer to the questions tormenting a young man who had just come back from the trenches," Röpke wrote. And it was Mises who "rendered me immune, at a very early date, against the virus of socialism with which most of us came back from the First World War."[5]

In 1922, Röpke became an adviser to the German government on the problems of reparation payments resulting from the Treaty of Versailles. From 1924 to 1928 he was a professor at the University of Jena, spending part of the time, in 1927–1928, in the United States studying American agrarian problems under the auspices of the Rockefeller Foundation. After returning to Europe he was a professor of economics at the University of Graz, Austria, in 1928–1929. In 1929 he was appointed professor of economics at the University of Marburg, a position he held until his expulsion by the Nazi regime in 1933. He also served as a member of the German National Commission on Unemployment in 1930 and 1931, and as an adviser to the German government in 1932.

After leaving Germany in 1933 he accepted a position at the University of Istanbul, Turkey, which he held until 1937, and during which he undertook the reorganization of its department of economics. He also founded and was the first director of the Turkish Institute of the Social Sciences.

Teaching Career in Geneva

In 1937 he was invited to become a professor of international economic relations at the Graduate Institute of International Studies in Geneva, Switzerland, a position he retained until his untimely death on February 12, 1966. The Graduate Institute had been founded in 1927 by the famous economic historian Paul Mantoux and the internationally respected economist, political scientist, and leading classical liberal William E. Rappard. In the Graduate Institute's comfortable building overlooking Lake Geneva, Röpke took up his teaching duties. He was in the company of such colleagues as Mises, the eminent Italian historian Guglielmo Ferrero (an exile from the fascist regime in Italy), the Polish free-market economist Michael Heilperin, and the Austrian legal philosopher Hans Kelsen.

After the German occupation of France, Röpke was three times offered a teaching position at the New School for Social Research in New York (in 1940, 1941, and 1943) as a means of escape from Nazi-occupied Europe. But each time he turned down the invitation to leave neutral Switzerland, having decided to continue to be a voice for freedom and reason in a totalitarian-dominated Europe. In the immediate aftermath of the Second World War, Röpke circulated a memorandum offering a "plan for an international periodical" that would be devoted to the restatement and defense of classical liberalism and the free-market economy against all forms of political and economic collectivism. The journal was never established, but the ideas conveyed in the memorandum served as support for F. A. Hayek's successful founding of the Mont Pelerin Society in 1947, an international association of scholars and opinion makers dedicated to the philosophy of freedom. Röpke served as the society's president from 1960 to 1962.

In the 1950s, he was an economic adviser to the government of West Germany. He also was one of the leading figures of a group of market-oriented German economists who in the postwar period became known as the Ordo-liberals; their purpose and goal was the construction of a "social market economy" that assured both an open, competitive order and minimal social guarantees.[6]

Business-Cycle Theory

In the 1920s and for part of the 1930s, a primary focus of Röpke's writings was business-cycle theory and policy. His most significant work in this field was his 1936 volume *Crises and Cycles*, which summarized and elaborated on his earlier writings, mostly in German, on the subject.[7] Röpke argued that a complex division of labor with a developed structure of roundabout methods of production, held together by the delicate network of market prices for finished goods and the factors of production, had the potential to occasionally suffer from the cyclical waves of booms and depressions. The cause of such cycles was periodic imbalances between savings and investment in the economy. While not completely following the "Austrian" theory of the business cycle, Röpke's approach moved along similar lines, arguing that a monetary expansion that kept the market rate of interest below the level that could maintain a balance between savings and investment would feed investment projects and cause misdirections of labor and resources into production processes in excess of the savings available to sustain them in the long run.

Röpke's particular contribution to the analysis of the business cycle was his theory of what he called the "secondary depression." When the boom ended, an economic downturn was inevitable, with the investment excesses of the upturn having to contract and be readjusted to the realities of available savings and the market-based patterns of supply and demand. But while serving on the German National Commission on Unemployment in 1930–1931, he came to the conclusion that there were negative forces at work at that time far beyond any normal type of post-boom adjustment. The failure of cost prices to promptly adjust downward with the decline of finished-goods prices was causing a dramatic collapse of production and employment. Rising unemployment resulted in declining incomes that then created a new round of falling demands for goods in the economy, that in turn brought about another decrease in production and employment. At the same time, growing unprofitability of industry made businessmen reluctant to undertake new investments, resulting in the accumulation of idle savings in the financial markets. Such a sequence of events generated a cumulative contraction in the economy that kept feeding on itself.

Röpke concluded that this secondary depression served no healthy purpose, and the downward spiral of a cumulative contraction in production and employment could only be broken by government-induced credit expansion and public-works projects. Once the government introduced a spending floor below which the economy would no longer go, the market would naturally begin a normal and healthy upturn that would bring the economy back toward a proper balance.[8]

In 1933, when Röpke published in English an article explaining the findings of the German Commission on Unemployment, John Maynard Keynes expressed to Röpke his "great satisfaction" that German economists were reaching the same conclusions as he had, namely, that government needed to take an active role in steering the economy. But Röpke had no sympathy for Keynes's belief that the market was inherently unstable and permanently in need of government management of "aggregate demand." In Röpke's view the Great Depression represented a "rare occurrence" of an "exceptional combination of circumstances" that required "a deliberate policy of additional 'effective demand' into the economic system." But, Röpke continued, Keynes's construction of a "general theory of employment" based on the exceptional circumstances of the early 1930s was a "counsel of despair" and an extremely dangerous one, because it created a rationale for continuous government tinkering and a strong inflationary bias harmful to the stability of the market economy in the long run.[9] Indeed, Röpke became a leading critic of Keynesian economics after World War II.[10]

The Crisis of Western Civilization

But the central issue that absorbed almost all of Röpke's intellectual and literary efforts in the 1930s and 1940s was what he considered the crisis of Western civilization, the most stark and terrible symptom of which was the rise of totalitarian collectivism as represented by Soviet communism, Italian fascism, and German National Socialism. He devoted all his efforts to opposing and challenging this horrible trend in a series of important and highly influential books. In 1937 he published *Economics of the Free Society*, a treatise on economic principles that not only explained and defended the market economy, but also strongly criticized the ideas of socialism and interventionism.[11] This was followed in 1942 by *International Economic Disintegration*, in which he detailed the disastrous consequences that collectivist economics produced by destroying the international division of labor through trade restrictions, exchange controls, government planning, domestic interventions, and policies of national self-sufficiency.[12]

But the heart of Röpke's critique of the decay of Western civilization and the path for its renewal was in a trilogy published during the war: *The Social Crisis of Our Time*, *Civitas Humana* (later re-issued as *The Moral Foundations of Civil Society*), and *International Order*.[13] This was followed at the end of the war by *The Solution of the German Problem* (1945).[14] And a further reformulation of his conception of a properly ordered and balanced society was offered in *A Humane Economy: The Social Framework of the Free Market* (1958).[15]

The achievements of the eighteenth century, in Röpke's view, were the use of reason for a balanced understanding of both the natural and social world; the awakening of an insight into the possibilities of a free, spontaneous order of market relationships; a conception of man that looked at him in proportionate human terms; and a sense of humanity in appreciating and wanting to improve the human condition. Out of these insights came the physical and biological achievements of modern science and medicine; a free-market order that both liberated man from the status and caste society of the past and dramatically improved his standard of living; and the liberal, democratic ideal in which the individual possessed rights to life, liberty, and property, and in which peace and tolerant political pluralism replaced imperial violence and political absolutism.

But as Röpke saw it, many of these achievements and successes had been twisted in the nineteenth century. The use of reason had become "unreasonable," as there emerged a hyper-rationalism that claimed to have the power to discover the secrets for social engineering. The triumphs of the natural sciences in mastering the physical world had fostered a "cult of the colossal," in which there was a worship of the things of the material world and the desire for the creation of objects bigger than human life. The grand accomplishments of the market economy had not only freed man from his previous social restraints, but cut him loose from all the societal moorings of family, community, and the harmonies of local life, and in its place reduced man to a proletarianized "mass" in an anonymous, impersonal urban existence. And the ideal of democratic pluralism had been undermined and reduced, increasingly, into an arena of special-interest political plunder.

"Termite State"

The loss of traditional human connections, the dehumanization of man in mass society, and the corruption of the political and economic marketplaces, Röpke argued, had created the sociological and psychological conditions for the emergence of and receptivity to the collectivist idea and its promise of a new community of man, a transformation of the human condition, and a better society designed according to a central plan. All these were false promises and hopes. Collectivism, whether of the fascist or communist sort, meant the end of a rational economic order, threatened the loss of freedom and the end to human dignity, and required the reduction of man to the status of an insect in what Röpke often referred to as the socialist "termite state."

Röpke was uncompromising in his insistence that only the market economy was consistent with both freedom and prosperity. Only the market, with its system of private property rights, provided the framework to harness individual incentives and creativeness for the benefit of society. Only the market could generate the competitive process necessary for the formation of prices that could successfully coordinate supply and demand. Only the market gave each individual the freedom to be an end in himself while also serving as a voluntary means to the ends of others through the mechanism of exchange.[16]

Yet in Röpke's view the market by itself was not enough. The humane society required going "beyond supply and demand," to the construction of an institutional order that incorporated the market in a wider social setting. It was in this context that Röpke proposed the distinction between "conformable" and "nonconformable" interventions in the market. Nonconformable interventions went against the natural workings of the market through the introduction of price and production controls, which disrupted the normal coordinative processes of market competition. Conformable interventions influenced the underlying supply and demand conditions, and the institutional arrangements on which those conditions are based, for the purpose of modifying the results that competitive process would generate.

Röpke, for example, believed that: antitrust laws were necessary and desirable as a method of limiting some private industrial concentration; urban development restrictions were needed to limit the growth of city size and foster a retention of rural life; income redistribution was legitimate to narrow significant income inequalities; and moderate and limited welfare "safety net" programs were consistent with a humane society that remained essentially market-oriented. In fairness to Röpke it should be pointed out that in the wake of the Great Depression and the growing appeal of socialist planning, a large number of market-oriented economists at the time accepted a greater degree of interventionism and welfare-statist programs than many free-market economists would consider legitimate nowadays.[17]

But by the 1950s, Röpke began to have serious second thoughts about the welfare state and its tendency to grow beyond the narrow bounds that he considered reasonable.[18] Röpke agreed with his German liberal colleague Alexander Rustow, who in a paper delivered at a Mont Pelerin Society meeting in the 1950s referred to the welfare state as "the other road to serfdom." Röpke feared that the welfare state, in a democratic system open to the pressures of special-interest groups, threatened to grow to monstrous proportions and create an increasing dependency on the paternalistic state. Furthermore, the costs of funding the welfare state and Keynesian "full employment" policies acted as an engine for worsening inflation as government resorted to the printing press to pay its bills.[19]

Finally, Röpke argued that the growing politicization of economic and social life through an expanding interventionist-welfare state undermined the possibility for a successful international order based on peace, mutual prosperity, and a rational allocation and use of the resources of the world. International order required countries to practice sound policies at home: respect for private property, enforcement of contracts, protection for foreign investments, limited government intervention, and non-inflationary monetary policies. Networks of international trade and investment would then naturally and spontaneously connect the world through private market relationships.[20] For this reason, Röpke was doubtful that European economic and monetary integration could be successfully imposed as long as the member states were unwilling to follow the necessary domestic policies of limited government and open, competitive market capitalism. Tensions and conflicts were inevitable in an age dominated by collectivist and interventionist ideas.[21]

Wilhelm Röpke was more than just an economist. During some of the darkest decades of the twentieth century, he sounded more like an Old Testament prophet warning of the dangers from a loss of our moral compass. Collectivism had few opponents in our century with as much of a sense of ethical purpose. Precisely because he was an economist by training, Röpke understood the indivisibility of personal, political, and economic freedom in a way that many other critics of socialism in its various forms could never articulate. The appreciation of history and the historical context in his analyses only enriched the persuasiveness of his message. The rebirth of the market economy in Germany and in other parts of Europe after 1945 owes a great deal to his intellectual efforts and legacy. □

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17. Among American market-oriented economists in the 1930s and 1940s who shared some of Röpke 's views on these policy issues were Henry Simon and Jacob Viner at the University of Chicago, and Frank Graham at Princeton University; in Europe the group included F. A. Hayek and Lionel Robbins at the London School of Economics, Walter Eucken and many other market economists in Germany, and Eli Heckscher in Sweden.

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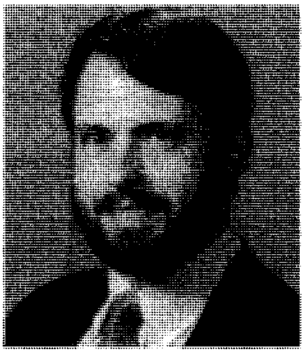

Health Care: Over the Canadian Cliff?

Everyone in Washington recognizes that Medicare is headed over a financial cliff. The growth in spending continues to outpace that of revenues; America's aging population will increase the gap as we enter the next century. Obviously serious reform is a must.

So what does President Bill Clinton propose? A massive taxpayer bailout combined with tighter price controls on existing providers, subsidies for employers who cover retirees, and expanded benefits for program recipients. The GOP Congress, lacking both philosophical principle and political courage, has done little more than mumble that it too desires to reform Medicare. It is the sort of irresponsible behavior that we've come to expect from Washington.

The Clinton package would be dubious enough if the administration's cost estimates could be taken seriously. Alas, federal health-care programs always end up more expensive than predicted. Medicare, Medicaid, renal dialysis coverage, and the short-lived catastrophic health-care initiative all suffered from soaring costs almost immediately.

For instance, within eight years after Medicare's creation, that program's tax rate was running at twice the initial projections; Medicare now spends well over 75 times what it did in its first full year. In fact, at Medicare's inception the House Ways and Means Committee predicted that the hospital insurance (HI) portion would cost $9 billion in 1990, a staggering $58 billion underestimate. HI outlays first exceeded $9 billion in 1974.

The initial costs of Medicare's kidney dialysis program, passed in 1972, were more than twice projected levels. And just eight months after passage of the 1988 Medicare Catastrophic Coverage Act, quickly repealed in response to a firestorm of popular protest, the Congressional Budget Office hiked its five-year cost estimates by upwards of 100 percent. The problem is endemic to third-party payment programs, which naturally inflate demand and thus expenditures.

There's no reason to believe that the administration's proposed pharmaceuticals coverage would be any different. On average, people with insurance use as much as 60 percent more physicians' services and three times as much hospital care as uninsured people. America's staggering health-care cost increases in recent years largely stem from what is essentially cost-plus medicine predicated on third-party payment of most medical expenses.

The inevitable response of future Congresses and presidents to soaring costs would be to impose price controls on prescription drugs, just as on other treatments. However, such past efforts have achieved little.

Congress has steadily tightened its reimbursement policy over the last couple of decades, yet federal outlays for Medicare still jumped from $32 billion in 1980 to an astounding $205 billion this year. The succeeding waves of price controls did, however, reduce services for Medicare recipients. Lim-

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its on drug prices would hinder the development of new pharmaceuticals, as well as restrict patient access to drugs.

Unfortunately, the United States seems to be slowly slipping into the sort of collectivist health care that dots the globe. Whatever the actual intent of a succession of presidents and legislators, their endless interventions—provider payments, business subsidies, polyglot regulations, and price controls—are turning the health market into a government-run system.

That we don't want to go there should be evident from the experience of the highly touted Canadian system. Once promoted by a significant segment of the Democratic party as the answer to America's health-care crisis, it is now suffering rising costs and declining quality.

The most important benefit of single-payer medicine theoretically is its thrift. Yet the only way Canada has been able to constrain spending while offering "free" care has been to explicitly ration medical services. The Vancouver-based Fraser Institute last year estimated that 187,416 people were on surgical waiting lists, up from 172,766 the previous year. Waiting times, too, were up—11.9 weeks to see a specialist after referral by a general practitioner, for instance. It takes another 6.8 weeks to actually receive treatment.

In Toronto "emergency" heart patients are operated on within 48 hours. "Urgent" cases have to wait up to six weeks. Elective patients can sit for four months or more, and year-plus waits are common elsewhere in Canada. One Canadian doctor wrote the *New York Times* to complain that "the risk of dying on the waiting list for cardiac surgery is greater than the actual operative risk."

Equipment that Americans take for granted is rare: Tennessee has more magnetic resonance imagers than does all of Canada. As a result, Canadians with brain tumors have to wait up to a year for an MRI scan. It typically takes three months to receive a CAT scan (though pets with paying owners can be tested within a day!). The United States has three times as many lithotriptors, which smash gall and kidney stones with sound waves, per patient as does Canada. On average, cancer patients wait three times as long as Americans for treatment; they are routinely denied cancer treatment for longer than what their doctors consider to be clinically reasonable.

The problem involves more than high-tech procedures. In Montreal an obstetrician was suspended for exceeding his hospital-imposed quota of deliveries. Delays of months for operations on hands, hernias, cataracts, hip transplants, varicose veins, and tonsils are typical. Patients have to wait even if they are in pain and have limited physical mobility. Yet the Fraser Institute reports that the delays only get worse year after year.

In fact, Canada's arbitrary budget controls caused the province of Ontario to shut entire hospitals during Christmas 1993. Explained Theodore Freedman, president of Toronto's Mount Sinai, which was shuttered for two weeks, "This is not about health care. This is about the deficit." Hospitals have also temporarily dropped specific practices, such as neurosurgery, to save money, and have refused to reopen even for emergency cases.

Ironically, despite these draconian efforts to contain costs, health care isn't really cheaper in Canada. After accounting for differences in population—America has a larger proportion of elderly, poor urban dwellers, and war veterans, all of whom use more health care—and including costs of tax collection, Canada spends roughly the same share of its GDP on health care as the United States. Indeed, in recent years Canada's spending has been rising faster than America's.

The United States faces a stark choice regarding health care: government control or a free market. Medicare's impending collapse should concentrate legislators' minds. Instead of approving the President's counterproductive package of greater government spending and regulation, Congress should emphasize individual responsibility and private choice. □

THE FREEMAN (Ideas On Liberty)

My Barbers

by Joseph S. Fulda

When Alex, my Greek barber, retired, I tried several haircutters before settling on a barbershop on West 180th Street on the corner of Broadway, up a bit toward Fort Washington Avenue, in New York. Although Spanish-speaking like all the neighborhood's barbers, the three barbers working at this shop were able to understand my instructions. They did a really fine job, too.

Some years passed, and they grew increasingly disenchanted with the new owner of the store, who wanted them to pay for their own tools of the trade and wouldn't allow them common decencies. So what did they do? Sue? No. File a complaint with a city, state, or federal agency? No. In the best American individualist tradition, they quit to go into business for themselves. To this day the owner of that barbershop has not found success in his replacements. But our heroes pooled their money, bought equipment, and a mere month or two later were in business again—as the competition, located on West 180th Street on the corner of Broadway diagonally across from their old place, a bit down toward Wadsworth Avenue.

They did well in that location, and one of the three eventually retired. The barbershop was located in the first chamber within the building. Through the outer door, one could bypass the barbershop and go behind it. I never knew what went on in that part, as there was neither an exit from the barbershop toward the back nor a window. I was eventually to find out when one day, needing a haircut, I came across the store padlocked with a prominent sign: Closed by order of the New York State Supreme Court—Illegal Gambling site. (In New York, the Supreme Court is the court of first resort for serious cases.)

Of course, I had all the libertarian reactions—but of more immediate interest, I still wanted my hair cut! I went next door to the travel agency to ask what had happened. There in the waiting room's corner was a barber chair with equipment and supplies and one of the two barbers. This resourceful man had persuaded the travel agency to rent him enough work space to do his job. Meanwhile, I learned, the other barber was working at home on Pinehurst Avenue just north of West 180th Street.

Sensing a story, I began to ask questions. The barbers had not known what was going on in the back—and did not care—and hoped the store would soon be allowed to reopen. The authorities did allow them to take possession of their property, after all. (Remember, the state, not the federal government, shut the place down.) The travel agent told me that business was slow and she was more than happy to have the barber defray some of her expenses. The neighborhood, you see, is comprised of numerous immigrants who return frequently to their native countries; travel

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agencies flourish, but there is stiff competition among them for the large market.

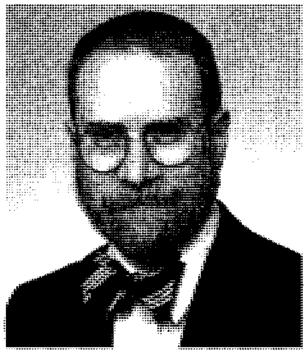
Still Partners

I continued to use my barbers, going sometimes to one, sometimes to the other. As a libertarian, I felt a special need not to help the state destroy these men's living—and I recalled that when Alex retired and I started looking for a replacement, I got some fairly unwelcome haircuts in the interim! I learned in discussions with them that my barbers remained partners, splitting their expenses and proceeds. The small space was not designed for comfort, but the haircuts were still up to par. Unfortunately, their hope to reopen their store was not to be realized, as a restraining order was eventually posted on their old place of work.

Undaunted, the two barbers showed their resourcefulness yet again and somehow managed to obtain a store on Broadway between West 180th Street and West 179th Street. The reader can visit them there and attest to the truth of this tale while having his hair cut.

The qualities these barbers showed in the face of market adversity (the change of owners in their original place and the bad working conditions) and government obstacles are not just resourcefulness, ingenuity, and determination. They also benefited from their ability to cooperate—none would have been able to open their second store without the other two and neither of the remaining barbers would have been able to open the third store without the other. I suspect most people would have severed the partnership or acted in a way that would have made maintaining it an insuperable obstacle—and that would have proved their undoing.

These three entrepreneurs and countless others like them across this land are the real, if unsung, heroes of American capitalism. Their stories do not make for captivating biography; they are not the stuff of heroic novels; they are neither titans of industry, nor great innovators, inventors, or investors. But they epitomize the Franklinesque virtues that made America great, and they and others like them are the reason why not everything in this fair land is sold in chains and franchises, as marvelous as those bulwarks of capitalism have admittedly proven themselves. They're the sort of entrepreneurs who provide much more than labor and capital in a felicitous combination; they give the word "independent" a strong, favorable cast. □



The Love of Economics

I attended a lecture recently on romantic relationships, and some in the audience became agitated when the speaker invoked economics in his analysis. Beyond the obvious financial issues, many people just did not understand what economics has to do with dating and marriage. This points to an unfortunate feature of many people's understanding of economics.

Economics is not primarily about money and stock markets. Those are topics within economics. Economics is the study of certain implications and consequences of human action; hence the title—*Human Action*—of Ludwig von Mises's magnum opus.

"Human action is purposeful behavior," Mises writes at the start of his treatise. We can identify a long series of facts about human action without doing "research." This is what distinguishes economics from physics. In economics the unit of analysis is the individual, which we know from the inside, so to speak. As human beings we can observe introspectively the features of action. In contrast, when we observe stars or molecules, we are outsiders. We can make repeated observations and experiments to discover the principles and relationships of entities, but we cannot have the same intimate knowledge that we can have about human action.

We can all readily see that when we act, certain things must be true. An action consists in the pursuit of an objective, or end, using means perceived as appropriate to its accomplishment. This has many implications. Acting is choosing. To pursue an end is to choose it from an array of alternatives, including the option of "doing nothing." To embark on a course of action intended to obtain an end is a form of exchange. The actor opts for the intended state of affairs over the future circumstances envisioned in the absence of the action. Implicit in the necessity of choice is the idea of scarcity. All means, beginning with time, are scarce. You can't choose A and non-A at the same time and in the same respect. You can't "have it all."

Opportunity Cost

If action entails choosing one thing rather than another, all action requires giving something up, namely, the most highly valued alternative not pursued. The alternative forgone is the cost of the action, more precisely, the opportunity cost. We can say with certainty that when we act, we value the satisfaction from achievement of the end sought more highly than the satisfaction expected from the highest value forgone. (Anticipated satisfaction can't be measured or subjected to mathematical operations; nor can it be compared person to person.)

Some have criticized this Misesian approach as mere tautology, true by definition. But clearly it is more than that. One's action demonstrates a preference for the chosen objective over anything else one could have aimed at. Hence, Murray Rothbard's term "demonstrated preference." This is not

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an empty tautology; it is a truth that underlies and makes sense of our observations of the human world. An attempt to refute it is a self-contradiction: the attempt requires action. Thus, these principles of human action has the status of an axiom.

The focus on the individual's selection of goals does not presume egoism or any other ethical category. Nor does it presume that the goal must be money or any other material good. These principles held true for Mother Teresa as well as for John D. Rockefeller. Each chose objectives and suitable (in their judgment) means. Mother Teresa wished to be efficient in ministering to the poor in India, just as Rockefeller wished to be efficient in producing kerosene from crude oil. Their particular ends dictated what "efficiency" meant, but the framework was conceptually the same. Economics is concerned with neither why people choose as they do or nor what they ought to choose. Those matters are left to psychology and ethics.

Marginal Utility

A further implication of human action is the law of diminishing marginal utility. We act to attain values, in effect, according to a scale of descending importance. As we obtain successive units of a good, we devote them to lower priorities. Any one unit is only as important as the lowest priority. For example, I have three cups of water and plan to devote them to these three objectives ranked in descending importance: quenching my thirst, quenching my dog's thirst, watering my rhododendron. If as I begin to drink I accidentally drop the cup, I do not forgo quenching my thirst and devote the remaining cups to the other objectives. Rather, I move the remaining cups up the scale, leaving the least important objective unfulfilled. (Sorry, rhododendron.) In other words, the value to me of any one unit of a good is determined by the value to me of the least important end that good can serve. The utility of the marginal unit (the last one or next one obtained) diminishes as I acquire more.

This all applies to the individual acting in isolation, what Mises calls "autistic exchange." But the principles apply to exchange between individuals too, which preoccupies most of economics. Things get more complicated—money eventually evolves from barter, long structures of production emerge—but the broad outline is the same. Exchange between two people entails some necessary truths. Each party intends to achieve a value through the exchange. Each ranks what he is willing to give up lower than what he will receive. Why exchange otherwise? Each therefore comes out ahead. There's a "surplus" on each side. The same amount of stuff is there; it's only changed hands. Yet each has "more" than he started with. (Either party, being fallible, can err and regret the exchange. But each enters the relationship anticipating gain.)

This is a good time to raise the idea of subjectivism, a concept much misunderstood. The economic meaning of subjectivism differs from its meaning in ethics. In ethics subjectivism means that human beings can arbitrarily determine what is good for them. In economics it means that to understand market phenomena such as prices, the focus must be on subjects—acting beings—not objects. (Thus, there is no conflict on this count between Mises and Ayn Rand.) What we observe in markets grows out of the choices people make about things based on their beliefs and intentions, not out of anything intrinsic to those things. The price of a slow-acting lethal poison might rise as people erroneously come to believe it is nutritious. But the poison will still kill them.

Once economics is seen as focused on human choice, it is no great leap to grasp its relevance to other areas of life not usually thought of in economic terms, such as dating and marriage. This is not to say that economics is all that is relevant, only that the laws of human action apply. □

THE FREEMAN (Ideas On Liberty)

Money and Gold in the 1920s and 1930s: An Austrian View

by Joseph T. Salerno

In consecutive issues of *The Freeman*, Richard Timberlake has contributed an interesting trilogy of articles advancing a monetarist critique of the conduct of U.S. monetary policy during the 1920s and 1930s.[1] In the first of these articles, Timberlake disputes the late Murray Rothbard's "Austrian" account of the boom-bust cycle of the 1920s and 1930s. Timberlake contends that Rothbard proceeds on the basis of a "new and unacceptable meaning" for the term "inflation" and a contrived definition of the money supply to "invent" a Fed-orchestrated inflation of the 1920s that, in fact, never occurred. Moreover, Timberlake alleges, Rothbard's account was marred by a "mismeasurement of the central bank's monetary data" as well as by a misunderstanding of the nature and operation of the Fed-controlled pseudo-gold standard by which U.S. dollars were created during this period.

In the two subsequent articles, Timberlake also takes issue, respectively, with the U.S. Treasury's policy of neutralizing gold inflows and the Fed's policy of sharply raising reserve requirements in the mid-1930s, arguing that these complementary policies aborted an incipient economic recovery and brought on the recession of 1937–38. In what follows I will address the weighty charges brought against Rothbard and, in the process, offer an evaluation of the Federal Reserve System's culpability for the economic events of these tragic years that diverges radically from Timberlake's.

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The Meaning of "Inflation"

Let me begin with Timberlake's contention that Rothbard imputes a meaning to the word "inflation" that is both new and unacceptable. In fact Rothbard's definition of inflation as "the increase in money supply not *consisting in*, i.e., not covered by, an increase in gold," is an old and venerable one. It was the definition that was forged in the theoretical debate between the hard-money British Currency School and the inflationist British Banking School in the mid-nineteenth century. According to the proto-Austrian Currency School, which triumphed in the debate, the gold standard was not sufficient to prevent the booms and busts of the business cycle, which had continued to plague Great Britain despite its restoration of the gold standard in 1821.[2]

Briefly, according to the Currency School, if commercial banks were permitted to issue bank notes via lending or investment operations in excess of the gold deposited with them this would increase the money supply and precipitate an inflationary boom. The resulting increase in domestic money prices and incomes would eventually cause a balance-of-payments deficit financed by an outflow of gold. This external drain of their gold reserves and the impending threat of internal drains due to domestic bank runs would then induce the banks to sharply restrict their loans and investments, resulting in a severe contraction of their uncovered notes or "fiduciary media" and a decline in the domestic money supply accompanied by economy-wide depression.

To avoid the recurrence of this cycle, the Currency School recommended that all further issues of fiduciary media be rigorously suppressed and that, henceforth, the money supply change strictly in accordance with the inflows and outflows of gold through the nation's balance of payments. The latter provided a natural, noncycle-generating mechanism for distributing the world's money supply strictly in accordance with the international pattern of monetary demands.

Following the triumph of the Currency School doctrine and the implementation of its policy prescription by the Bank of England, its definition of inflation became accepted in the English-speaking world, especially in the United States, where there existed a much more radical and analytically insightful American branch of the School. The term "inflation" was now used strictly to denote an increase in the supply of money that consisted in the creation of currency and bank deposits unbacked by gold. Thus for example, the American financial writer Charles Holt Carroll wrote in 1868 that "The source of inflation, and of the commercial crisis, is in the nature of the system which pretends to lend money, but creates currency by discounting such bills when there is no such money in existence."[3] Even earlier, in 1858, Carroll had written, "Instead of using gold and silver for currency they are merely used as the basis of the greatest possible inflation by the banks," and that "we should prevent any artificial increase of currency to prevent a future . . . catastrophe."[4] So it was the "artificial increase of currency" only—through the creation of unbacked bank notes and deposits—that constituted inflation.

The leading monetary theorist in the United States in the last quarter of the nineteenth century was Francis A. Walker. According to Walker, writing in 1888, "A permanent excess of the circulating money of a country, over that country's distributive share of the money of the commercial world is called inflation."[5]

Francis Amasa Walker (1840–1897)

While this version of the definition is applicable to inconvertible paper fiat currency, Walker also believed that inflation was an inherent feature of the issuance of convertible bank notes and deposits that lacked gold backing. In Walker's words, "there resides in bank money, even under the most stringent provisions for convertibility, the capability of local and temporary inflation."[6]

Unfortunately, however, because the writers of the British Currency School, unlike their American cousins, neglected to consider bank deposits as part of the money supply, their policies as adopted in Great Britain failed to prevent inflation and the business cycle. Consequently, and tragically, the School's doctrines and policies fell into profound disrepute by the late nineteenth century, and its definition of inflation was replaced by that of the opposing Banking School, which saw inflation as a state in which the money supply exceeds the needs of trade.

Early American quantity theorists following the proto-monetarist Irving Fisher, in particular, seized upon and adapted this definition to their peculiar analytical perspective. Thus, Edwin Kemmerer wrote in 1920 that, "Although the term inflation in current discussion is used in a variety of meanings, there is one idea common to most uses of the word, namely, the idea of a supply of circulating media in excess of trade needs."[7] Kemmerer went on to define inflation as a state in which, "at a given price level, a country's circulating media—money and deposit currency—increase relatively to trade needs." From here it was a short step to the currently prevailing definition of inflation as an increase in the price level.[8]

So Rothbard's theory is surely not new and to say that it is "unacceptable" is simply to express one's agreement with the long-entrenched preference among orthodox quantity theorists, including contemporary monetarists, for the Banking School over the Currency School.


COURTESY: YALE UNIVERSITY

Irving Fisher (1867–1947)

Defining Money

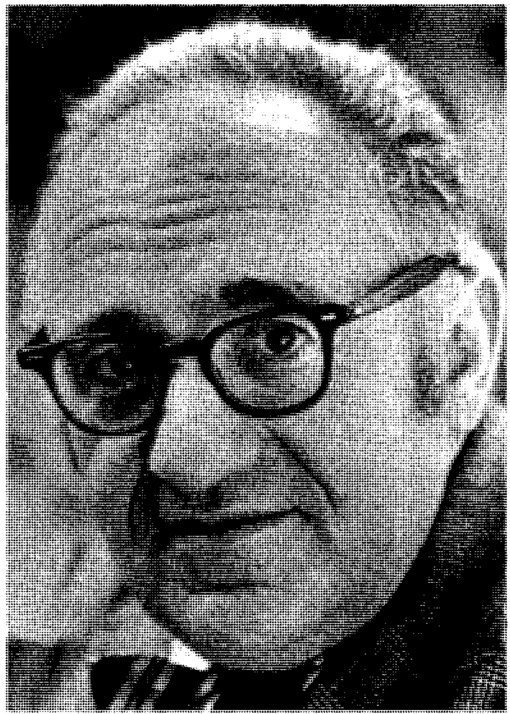
Timberlake also challenges Rothbard's statistical definition of the money supply for including savings and loan share capital and life insurance net policy reserves, alleging that Rothbard contrived this definition in order to make the rate of monetary growth appear larger than it actually was during the 1920s. Timberlake argues that the two items in question are not money because "they cannot be spent on ordinary goods and services. To spend them, one needs to cash them in for other money—currency or bank drafts."[9] Let us take these items one at time.

In the case of savings and loan share capital, there are two responses to Timberlake. First, the "share accounts" offered by savings and loan associations are and always have been economically indistinguishable from the savings deposits offered by commercial banks, included in the older (pre-1980) definition of M2 that Timberlake apparently upholds as the appropriate definition of the money supply.[10] In practice depositors could withdraw their savings deposits from commercial banks on demand, because the law that permitted the banks to insist on a waiting period was rarely if ever invoked. Similarly, while savings and loan associations were contractually obligated to "repurchase" their "shares" at par on request of the shareholder, they could legally delay such repurchase for shorter or longer periods depending on their individual bylaws. Nonetheless such delays rarely occurred and "for many years savings and loan associations have made the proud boast 'every withdrawal paid upon demand' or some similar statement."[11]

Moreover, while Timberlake is right that "shareholders" had to trade their share accounts in for currency or bank drafts (at par and on demand) before they could spend them on goods and services, this was equally true of savings depositors at commercial banks. Thus the public has always considered dollars held in savings and loan share accounts or savings accounts as readily spendable as dollars held in commercial bank savings deposits.

Second, Timberlake curiously does not object to Rothbard's inclusion of the savings deposits of mutual savings banks in the money supply, although they also are not included in the M2 definition he favors.[12] What makes Timberlake's position even more puzzling is that mutual savings banks were practically identical in economic function to savings and loan associations and were also technically "mutually" owned by their depositors.[13] So why, then, does Timberlake insist so vehemently on treating the liabilities of these two institutions differently?

A resolution of this mystery can perhaps be found in the work of Milton Friedman and Anna Schwartz, who excluded the share accounts of savings and loans (and of credit unions) from their definition of the money supply on the grounds that these institutions are technically not banks as defined "in accordance with the definition of banks agreed upon by federal bank supervisory agencies" since "holders of funds in these institutions are for the most part technically shareholders, not depositors." Despite this legal technicality, however, even Friedman and Schwartz were forced to admit that those who place funds with these institutions "clearly . . . may regard such funds as close substitutes for bank deposits, as we define them."[14]



Murray Rothbard (1926–1995)

Life Insurance Reserves

This brings us to the issue of the net policy reserves of life insurance companies. Rothbard claimed that the cash surrender values of life insurance companies, that is, the immediately cashable claims possessed by policyholders against life insurance companies, statistically approximated by the companies' net policy reserves, represent a source of currently spendable dollars and should be included in the money supply. Once again the question is not whether insurance companies superficially resemble banks or can be technically classified as such according to some arbitrary regulatory definition. It is whether they essentially function like depository institutions, receiving funds from the public with which to make loans and investments, while contractually promising that such funds are available for withdrawal on demand by the policyholder. In Rothbard's view, the policyholder is economically in precisely the same position as a bank depositor (and thrift institution shareholder) in holding an immediately cashable par-value claim to dollars.

Now admittedly, Rothbard's inclusion of this item in the money supply is controversial, much more so than his inclusion of savings and loan share accounts. However, he was hardly alone in maintaining this position. A number of mainstream writers of money and banking textbooks in the 1960s and 1970s recognized that cashable life insurance reserves possessed some of the characteristics of money. For example, Walter W. Haines characterized insurance companies as "savings institutions" and noted that these savings "can be withdrawn at any time" simply by allowing the policy to lapse, a feature that marks them as a "near-money" on a par with savings accounts.[15] M.L. Burstein maintained that the cash value of a life insurance policy offered "ready convertibility" into cash, was "almost as liquid as a mattressful of currency," and satisfied the "precautionary motive" for holding liquid assets no less than savings and loan accounts and savings bonds.[16] Albert Hart and Peter Kenen included the "net cash values of life insurance" in the broadest class of financial assets possessing the attribute of "moneyness," while Thomas F. Cargill ranked them on a liquidity spectrum immediately below large certificates of deposit, which are included in the current M3 definition of the money supply.[17]

More important, however, even if we grant for the sake of argument that net life insurance reserves should be excluded from the money supply, we find that it makes very little difference to Rothbard's characterization of the 1920s as an inflationary decade. With this item included, the increase in Rothbard's M between mid-1921 and the end of 1928 totaled about 61 percent, yielding an annual rate of monetary inflation of 8.1 percent a year; with this item left out (but savings and loan share accounts included), the money supply increased by about 55 percent over the period or at an annual rate of 7.3 percent.[18] *Mirabile dictu*, by using a definition of the money stock that arbitrarily excludes savings and loan share accounts while including mutual savings bank deposits on the basis of an inexplicable adherence to a legalistic regulatory definition of banks, it turns out that it is Timberlake (and Friedman and Schwartz) who have mismeasured money supply growth during the 1920s.

Flawed Institutions

Timberlake also criticizes Rothbard for "ignorance of the flawed institutional framework within which the gold standard and the central bank generated money" and also of "mismeasurement of the central bank's monetary data."[19] But this is surely a curious charge to level against Rothbard, steeped as he was in Currency School doctrine. In fact, Rothbard was quite cognizant that the U.S. monetary regime of the 1920s and 1930s was not a genuine gold standard in which the supply of money was determined exclusively by market forces, that is, by the balance of payments and the mining of gold, but a hybrid system in which the Fed possessed substantial power to manipulate the money supply by pyramiding paper bank reserves atop its stock of gold reserves. Indeed, Rothbard went much further than Timberlake in rigorously and completely separating those factors affecting the money supply that were subject to Fed control from those that the Fed had no control over.[20]

In analyzing the central bank monetary data, Timberlake starts with the monetary base or "Total Fed," which is equal to currency in circulation plus member bank reserves. From this aggregate he properly subtracts the Fed's legal-tender reserves, mainly the gold stock, whose size depends on balance-of-payments flows and is not under the immediate control of the Fed. What remains is the "net monetary obligations" of the Fed or "Net Fed," which, according to Timberlake, "faithfully indicates the *intent* of Fed policy."[21] From 1921 to 1929, this aggregate declined by 8 percent per year, leading Timberlake to conclude that the intent of Fed policy was decidedly deflationary during this period. The motive for this deflationary policy bias was, Timberlake suggests, to aid Great Britain in re-establishing and maintaining gold convertibility for the pound sterling.

However, as important as it is, the gold stock is not the only factor that lay beyond the Fed's control. For as Rothbard points out, currency in circulation, which improperly remains in Timberlake's Net Fed aggregate, is not controlled by the Fed at all but by the banking public. Any time a depositor withdraws cash from a bank, currency in circulation increases and bank reserves decline, dollar for dollar. Under a fractional-reserve banking system, this loss of reserves causes a multiple contraction of bank deposits that far exceeds the original increase in currency in circulation that induced it and therefore results in a net deflation of the money supply. Conversely, a decline in the amount of currency held by the public causes an overall increase in bank reserves and an overall inflation of the money supply.

This is not all, however—Timberlake also ignores the fact that under the prevailing policy regime the banks themselves could autonomously reduce the amount of bank reserves and thus the quantity of money in existence by deliberately reducing their indebtedness to the Fed. During this period, it was the chosen policy of the Fed to lend liberally and continuously to all banks at an interest, or "discount," rate below the market rate. While the Fed was legally authorized to make such loans to its member banks, it was not mandated to do so. Furthermore, it also retained complete power to set the "discount rate" it charged on these loans. Hence, if it had chosen to, the Fed could have restricted its lending to emergency situations and charged a penalty rate substantially above the market rate, so as to discourage all but the most seriously troubled banks from applying for loans. In short, it could have almost completely neutralized the inflationary impact of its discounting operations. This "emergency lending" policy had been urged by some prominent officials within the Fed establishment itself.[22]

The fact that the Fed chose instead to pursue a "continuous lending" policy meant that the increase in bank reserves that resulted from the origination of new Fed loans to member banks via the rediscounting of business bills or advances on collateralized bank promissory notes was under the exclusive control of the Fed. But it also meant that the reduction in bank reserves entailed by the net repayment of discounted bills was uncontrolled by the Fed, because it depended solely on the decisions of the banks. Given the Fed's indiscriminate, below-market rate discount policy, the banks were always in a position to maintain or augment their debts to the Fed if they so desired simply by discounting additional bills with the Fed. Thus, as Rothbard concluded, when "Bills Repaid" exceeded "New Bills Discounted," banks were deliberately and autonomously diminishing their level of indebtedness to the Fed and this must be counted as an uncontrolled deflationary influence on bank reserves.

Real Fed Intent

If we follow Rothbard, then, in identifying currency in circulation and the reduction of bank indebtedness to the Fed along with the gold stock as the main "uncontrolled" factors affecting bank reserves, we get a picture of the Fed's intent during the 1920s and early 1930s that is poles apart from the one suggested by Timberlake. Indeed, we find that from the inception of the monetary inflation in mid-1921 to its termination at the end of 1928, "uncontrolled reserves" *decreased* by \$1.430 billion while controlled reserves *increased* by \$2.217 billion. Since member bank reserves totaled \$1.604 billion at the beginning of this period, this means that controlled reserves shot up by 138 percent or 18.4 percent per year during this seven-and-one-half year period, while uncontrolled reserves fell by 89 percent or 11.9 percent per year. Thus Rothbard correctly concluded that the 1920s were an inflationary decade and that it was indeed the intention of the Federal Reserve System that it be so.[23]

The Fed's inflationary intent is perfectly consistent, moreover, with its motive of helping Great Britain re-establish and maintain the pre-war parity between gold and the British pound. While Timberlake properly recognizes this motive underlying Fed policy, he is incorrect in suggesting that it necessitates a deflationary policy on the part of the Fed. In fact, the precise opposite is required. The British pound in the mid-1920s was overvalued vis-à-vis gold and the U.S. dollar, causing British products to appear relatively overpriced in world markets. As a result, Great Britain experienced imports chronically in excess of exports accompanied by persistent balance-of-payments deficits and outflows of gold reserves. Had the Fed deflated the U.S. money supply, thus lowering U.S. prices even more relative to British prices as Timberlake claims was its intention, it would have exacerbated, and not resolved, Great Britain's gold drain. Clearly, then, the Fed's desire to aid Britain in reversing its balance-of-payments deficits and rebuilding its gold stocks called for an inflationary policy intended to pump up U.S. prices, thereby rendering British products relatively cheap and enhancing the demand for them on world markets.[24]

This point about the motive for the Fed's easy-money policy in the 1920s was not only advanced by Rothbard, but by other economists, including monetarists such as Kenneth Weiher. According to Weiher:

> Great Britain was calling for help [in 1924] and Benjamin Strong [president of the New York Fed] heard the call. Expansionary monetary policy in the U. S. would drive prices up and interest rates down in this country, which would tend to send gold flowing toward Great Britain, where prices were lower and interest rates higher. These changes would help America's ally build up its stock of gold. . . . [T]here can

> be no question that the Fed would not have moved when it did were it not for concern over the gold standard and the plight of Great Britain. . . . By 1927, the stagnant British economy needed help from the United States and the rest of Europe. . . . Just as had been the case in 1924, monetary policy was shifted to an expansionary program in an effort to aid Great Britain's struggles to return to the gold standard.[25]

Rothbard's reinterpretation of the monetary data also cuts against Timberlake's claim that the Fed "monetarily starved the country into the worst economic crisis it has ever experienced."[26] On the contrary, the factors controlled by the Fed continued to exercise a highly inflationary impact on bank reserves and the money supply from late 1929 through 1932, as the Fed attempted desperately to ward off the depression precipitated by the termination of the bank credit inflation that it had orchestrated in the 1920s.

The deflation of the money supply, therefore, was caused wholly by factors beyond the control of the Fed. First, there was a loss of confidence in the Fed-dominated phony gold standard among the domestic public and foreign investors. As a result there occurred an increase in currency in circulation and a decline in the Fed's gold stock, both of which caused bank reserves to decline. Second, U.S. banks prudently attempted to save themselves and their depositors by restricting their loans to overcapitalized and failing businesses and instead using these funds to pay down their indebtedness to the Fed, which gave further impetus to the "uncontrolled" reduction of bank reserves. Third, in the second quarter of 1932, the banks also began to increase their liquid reserves beyond the legal minimum. The accumulation of "excess reserves," as they were called, constituted a separate uncontrolled factor that reinforced the deflationary influence of the uncontrolled decline in bank reserves on the money supply.

From the end of December 1929 to the end of December 1931, bank reserves fell from \$2.36 billion to \$1.96 billion causing RM (for Rothbard's money supply) to drop from \$73.52 billion to \$68.25 billion or at an annual rate of 3.6 percent. But this monetary deflation was not caused by the Fed, which pumped up controlled reserves by \$672 million or at an annual rate of 17 percent during the period, while uncontrolled reserves declined by \$1,063 million or by 27 percent per year. During 1932, RM continued to decline, falling to \$64.72 billion or by 5.2 percent. But bank reserves increased sharply during the year from \$1.96 billion to \$2.51 billion, as the Fed furiously inflated controlled reserves. In the last ten months of the year, controlled reserves rose by a staggering \$1,165 million, or at an annual rate of 76 percent. Fortunately, this attempted massive inflation of the money supply was undone by the domestic public, foreign investors, and the banks as uncontrolled reserves dwindled by \$495 million and banks began to accumulate substantial excess reserves.

The story was much the same in 1933 as a determined inflationary campaign conducted by the Fed in the early part of the year—controlled reserves rose by \$785 million in February alone—was defeated by the public and the banks, and RM declined by over \$3 billion, or by almost 5 percent.[27]

So once the data have been properly arranged and interpreted, it becomes clear that the Fed does not deserve praise for the bank credit deflation of 1930–1933. This honor goes to private dollar-holders, domestic and foreign, who attempted to reclaim their rightful property from a central bank-manipulated and inflationary financial system masquerading as a gold standard that had repeatedly betrayed their trust.

"Sterilizing" Gold

In two follow-up articles, Timberlake extends his attack on what he considers to be the "deflationary" monetary policies pursued by the Treasury and Fed in the mid-1930s. In particular, he criticizes the Treasury's policy of "neutralizing," or "sterilizing," the effect of the inflow of gold on bank reserves from late 1936 to early 1938 and the Fed's policy of increasing reserve requirements in 1936 and 1937. But neither of these policies caused a contraction of the money supply. They merely temporarily interrupted a massive monetary inflation caused by the abolition of the gold standard and subsequent devaluation of the dollar engineered by the Roosevelt administration.

It is important to recognize that this influx of gold was not a result of the "uncontrolled" operation of the gold standard, which had been abolished in 1933. Rather, it was the result of the deliberate and steady increase in the price at which gold was purchased by the U.S. Treasury and the Reconstruction Finance Corporation. By January 1934, the price of gold had risen from \$20.67 to \$35.00 per ounce, or by almost 70 percent, where it was officially pegged by the Gold Reserve Act of 1934. The Treasury was now legally mandated to maintain this devalued exchange rate between gold and the dollar by freely purchasing all the gold offered to it at this price. In effect, then, Treasury gold purchases were now economically identical to inflationary Fed open market purchases, substituting demonetized gold for government securities. Consequently, in response to this unilateral increase in the price of gold above its world price, there occurred a prodigious influx of gold into the United States—a "golden avalanche" it was called at the time—which vastly increased bank reserves. The result was an unprecedented inflation of the money supply (M2) during 1934, 1935, and 1936 at annual rates of 14 percent, 14.8 percent, and 11.4 percent, respectively.[28]

With respect to its influence on the supplies of bank reserves and money, the demonetized gold stock thus had been transformed into a factor "controlled" by monetary—in this case Treasury—policy. Given that the use and ownership of gold money by the public had been legally suppressed, gold was effectively demonetized and its continued purchase by the Treasury was purely a matter of discretionary monetary policy. Accordingly—and contrary to Timberlake's assertion—when during 1937 the Treasury began to finance its purchases of gold in a manner that neutralized their effect on bank reserves, it was not engaging in deflation. The simultaneous sales of government securities to finance these purchases were simply and properly eliminating any extraneous effects of a demonetized asset on the money supply.

Even if gold were permitted to continue in its monetary function, however, Timberlake would still be wrong in criticizing the policy of neutralizing its effect on bank reserves. For under a genuine, Currency School-type gold standard, a country's money supply would increase by exactly the amount of the gold inflow from abroad. This is not inflationary and represents precisely the proper amount by which the money supply should expand, because it is the outcome of the deliberate actions of the country's residents who are decreasing their purchases of foreign imports and increasing their sales of exports in order to satisfy their desires for greater money holdings. This balance-of-payments mechanism is a natural part of the market economy and works continually on all levels—including the region, state, town, and even household—to efficiently adapt money supply to relative changes in money demand.

A problem arises, however, when these benign, money demand-driven gold inflows are used, as they were in the 1920s and early 1930s, as bank reserves to create unbacked notes and deposits. In this case, as F. A. Hayek has so aptly described, international gold flows will regularly cause a serious distortion of the free-market interest rate and investment pattern in the affected countries, leading to a business cycle.[29] The reason is that the needed adjustment in national money supplies upward or downward now entails creating or destroying fiduciary media by expanding or contracting bank loans in defiance of the preferences of the economy's consumers and savers. Thus, a policy of neutralizing the effect of gold flows on bank reserves in the context of a fractional-reserve banking system dominated by a central bank does not constitute a gross violation of the rules of the gold standard; to the contrary, it tends to facilitate the operation of the natural money-supply mechanism that prevails under a genuine gold standard.

Not surprisingly, in the third article of the trilogy, Timberlake also objects to the Fed's policy of raising reserve requirements in 1936 and 1937, which was undertaken to mop up the massive amounts of excess reserves held by the banking system. Timberlake advances two criticisms against this policy. First, the policy was unnecessary because, even if all the excess reserves that existed on the eve of its implementation were subsequently fully loaned out by the banks, the inflationary potential was relatively minor. Appealing to the Banking School definition of inflation, Timberlake pronounces the 52 percent increase in the money supply that would have resulted as only mildly inflationary because the larger money supply would have exceeded the needs of trade of a fully employed economy by 5.6 percent at 1929 prices, which were about 25 percent higher than prices prevailing in June 1936.[30] In plain language, Timberlake is literally defining away a potential money and price inflation of gargantuan proportions because of its perceived expedience in expanding employment and output and extricating the economy from a depression. But as Timberlake himself admits in a footnote—and as Rothbard and other Austrians have never ceased to argue—what impeded the economy's natural and noninflationary recovery from the depression was the existence of "government programs [that] had actively worked against money price declines for ten years."[31]

Growing Money Supply

In his second criticism, Timberlake contends that the increase in reserve requirements went beyond closing off a potential avenue of recovery for the economy and "turned what had been an ongoing recovery into another cyclical disaster." But if we once again turn to Timberlake's data we find that the money supply (M2) continued to grow, from $43.3 to $45.2 billion or by 4.4 percent, between June 30, 1936, and June 30, 1937, the year in which this policy was implemented. Even if we focus on the last six months of the period, there was hardly a wrenching deflation, as the money supply *increased* at an annual rate of 0.8 percent.[32] Even from Timberlake's monetarist standpoint, then, it is difficult to blame the "recession within a depression" of 1937–1938 on deflationary Fed policy.

Unfortunately Timberlake's strained and narrow emphasis on Fed deflationism as the cause of all the woes of the 1930s causes him to ignore a plausible "Austrian" explanation of the relapse of 1937. As a result of a spurt of union activity due to the Supreme Court's upholding of the National Labor Relations Act of 1935, money wages jumped 13.7 percent in the first three quarters of 1937. This sudden jump in the price of labor far outstripped the rise in output prices and, with labor productivity substantially unchanged, brought about a sharp decline in employment beginning in late 1937.[33] The large upward spurt in excess reserves and the accompanying decrease in the money supply that we observe in Timberlake's data between June 30, 1937, and June 30, 1938, therefore, can be explained as the result, and not the cause, of the recession.[34] As business profits were squeezed by the run-up of labor costs and the economy slipped into recession, banks prudently began to contract their loans and pile up liquid reserves to protect themselves against prospective loan defaults and bank runs. To offset this uncontrolled decline of the money supply, beginning in mid-1938 the Fed (and the Treasury) once again resorted to an inflationary policy, reversing the reserve requirement increase and allowing gold inflows to once again pump up bank reserves. As a result, M2 increased by 5.9 percent, 10.1 percent, and 12.5 percent in 1938, 1939, and 1940, respectively.[35]

Our conclusion, then, is that the Fed's monetary policy, except for very brief periods in 1929 and 1936–1937 when it turned mildly disinflationist, was consistently and unremittingly inflationist in the 1920s and 1930s. This inflationism was the cause of the Great Depression and one of the reasons why it was so protracted. □

1. Richard H. Timberlake, "Money in the 1920s and 1930s," *The Freeman*, April 1999, pp. 37–42; "Gold Policy in the 1930s," *The Freeman*, May 1999, pp. 36–41; and "The Reserve Requirement Debacle of 1935–1938," *The Freeman*, June 1999, pp. 23–29.

2. For a review of this debate, see Murray N. Rothbard, *Classical Economics: An Austrian Perspective on the History of Economic Thought*, Volume II (Brookfield, Vt.: Edward Elgar Publishing Company, 1995), pp. 225–74.

3. Charles Holt Carroll, *Organization of Debt into Currency and Other Papers*, ed. Edward C. Simmons (Princeton: D. Van Nostrand Company, Inc., 1964), p. 333.

4. Ibid., p. 91.

5. Francis A. Walker, *Political Economy* (New York: Henry Holt and Company, 1888), p. 151.

6. Ibid., p. 171.

7. Edwin Walter Kemmerer, *High Prices and Deflation* (Princeton: Princeton University Press, 1920), p. 3.

8. Ibid., p. 4.

9. Timberlake, "Money in the 1920s and 1930s," p. 38. For Rothbard's explanation and defense of his broader definition of the money supply, see Murray N. Rothbard, *America's Great Depression* (Los Angeles: Nash Publishing Corporation, 1972 [1963]), pp. 83–86.

10. I say "apparently," because he states that "No basis exists for a more inclusive money stock than M2" (ibid., p. 42, n. 3). It should be pointed out that, since February 1980, savings accounts of savings and loan associations and credit unions have been included, along with savings deposits of commercial and mutual savings banks in the new M2, an official Fed statistic that is today considered to be the most reliable indicator of movements in the money supply by many economists.

11. John G. Ranlett, *Money and Banking: An Introduction to Analysis and Policy* (New York: John Wiley & Sons, Inc., 1969), p. 251.

12. Paul A. Meyer, *Monetary Economics and Financial Markets* (Homewood, Ill.: Richard D. Irwin, Inc., 1982), pp. 31–32.

13. Walter A. Haines, *Money, Prices, and Policy* (New York: McGraw-Hill Book Company, Inc., 1961), pp. 249–50.

14. Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton: Princeton University Press, 1963), p. 4, fn. 4. The essential economic—as opposed to the technical legal—identity between commercial bank deposits and all kinds of instantaneously cashable savings accounts held at the various nondepository or thrift institutions was established many years before Friedman and Schwartz wrote, in 1937, in a brilliant but neglected article by Lin Lin ("Are Time Deposits Money?" *American Economic Review*, March 1937, pp. 76–86). This article was not cited by Friedman and Schwartz but greatly influenced Rothbard.

15. Haines, pp. 253–54, 31–32.

16. M. L. Burstein, *Money* (Cambridge, Mass.: Schenkman Publishing Company, Inc., 1963), p. 111.

17. Albert Gaylord Hart and Peter B. Kenen, *Money, Debt, and Economic Activity* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1961), pp. 4–6; Thomas F. Cargill, *Money, the Financial System and Monetary Policy* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1979), p. 11.

18. I have based this calculation on Rothbard's data. See Rothbard, *America's Great Depression*, p. 88.

19. Timberlake, "Money in the 1920s and 1930s," p. 38.

20. Rothbard, *America's Great Depression*, pp. 94–100.

21. Timberlake, "Money in the 1920s and 1930s," p. 40.

22. On the Fed's discount policy in the 1920s, see Rothbard, *America's Great Depression*, pp. 111–16.

23. For an analysis of the factors involved in the development of the monetary inflation of the 1920s, see ibid., pp. 101–25.

24. On the desire to help Great Britain restore the gold standard at an overvalued gold parity without having to endure the consequences of deflating its economy as an important motive driving the Fed's inflationary monetary policy in the 1920s, see ibid., pp. 131–45.

25. Kenneth Weiher, *America's Search for Economic Stability: Monetary and Fiscal Policy Since 1913* (New York: Twayne Publishers, 1992), pp. 48–49.

26. Timberlake, "Gold Policy in the 1930s," p. 36.

27. On the factors responsible for the monetary deflation of the early 1930s, see Rothbard, *America's Great Depression*, pp. 186–295 passim.

28. Weiher, pp. 75, 79–82.

29. F. A. Hayek, *Monetary Nationalism and International Stability* (New York: Augustus M. Kelley Publishers, 1971 [1937]), pp. 25–32.

30. These figures are calculated from Timberlake's data. See Timberlake, "The Reserve Requirement Debacle," p. 27.

31. Ibid., p. 29, n. 11.

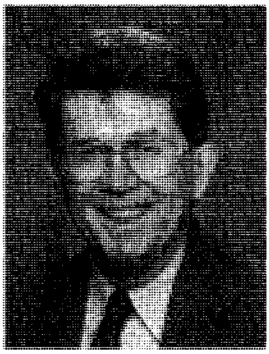
32. Ibid., p. 27.

33. Richard K. Vedder and Lowell E. Gallaway, *Out of Work: Unemployment and Government in Twentieth-Century America* (New York: Holmes and Meier, Publishers, Inc., 1993), pp. 129–36. For a similar explanation of the 1937 slump, see Benjamin M. Anderson, *Economics and the Public Welfare: A Financial and Economic History of the United States, 1914–1946* (Indianapolis: LibertyPress, 1979 [1949]), pp. 432–38.

34. Timberlake, "The Reserve Requirement Debacle," p. 27.

35. Weiher, pp. 75–86.

Economics



Comparative Advantage

One of the most powerful and straightforward economic concepts is "comparative advantage." As important and simple as this concept is, however, it seldom seems to inform public discussions of international trade. Almost everyone "knows" that we can't compete with countries that have cheap labor—if we have free trade with such countries either wages will be driven down or many workers will lose their jobs. As Will Rogers once observed, "It's not what people don't know that is the problem, it is what they do know that's not true."

Understanding comparative advantage has the same effect on concerns about free trade as water had on the Wicked Witch of the West. Free trade with other countries (regardless of how much or little their workers are paid) doesn't increase unemployment or lower wages. Indeed, one of the best ways of increasing the wages of U.S. workers is by allowing them to compete with workers (even very low paid workers) in other countries through free trade.

Absolute Versus Comparative Advantage

The most straightforward case for free trade is that countries have different absolute advantages in producing goods. For example, because of differences in soil and climate, the United States is better at producing wheat than Brazil, and Brazil is better at producing coffee than the United States. Obviously both countries are better off when Americans produce wheat and exchange a portion of it for some of the coffee that Brazilians produce.

But does this mean that a country with an absolute advantage in the production of a good should always produce that good rather than import it? No, as the English economist David Ricardo first explained in the early 1800s. A country can have an *absolute* advantage in the production of a good without having a *comparative* advantage. Comparative advantage is what determines whether it pays to produce a good or import it.

Assume that there are only two goods, cars and computers, and one productive resource which is some composite of land, labor, and capital. Assume also that producing 100 cars requires two units of the productive resource (PR) in the United States and four units in Brazil, and producing 1,000 computers requires three units of PR in the United States and four in Brazil.

Thus:

	U.S.	Brazil
100 cars	2	4
1,000 computers	3	4

Americans have an absolute advantage in producing both cars and computers.

It may seem that Americans can realize no gain by trading with Brazilians. Why not produce both cars and computers here? Because

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it *costs* more to produce computers in the United States than in Brazil. All costs are opportunity costs. The cost of producing computers is the cars that *could* have been produced. Using the three units of PR required to produce 1,000 computers in the United States requires sacrificing the production of 150 cars. Using the four units of PR required to produce 1,000 computers in Brazil requires sacrificing only 100 cars.

So even though Americans have an absolute advantage in producing computers, Brazilians have a comparative advantage. Compared to what has to be sacrificed, Brazil produces computers for only two-thirds as much as it costs in the United States. The United States, of course, has a comparative advantage over Brazil in the production of cars. Producing 100 cars here costs 666 computers, while producing 100 cars in Brazil costs 1,000 computers.

Clearly the United States benefits from specializing in cars, which it produces more cheaply than Brazil, and trading with Brazil for some of the computers it produces more cheaply. If, for example, the United States produced both cars and computers it might devote 70 units of PR to car production and 30 units to computer production, yielding 3,500 cars and 10,000 computers. If Brazil produced both products, it might devote 56 units of PR to car production and 24 to computer production, yielding 1,400 cars and 6,000 computers. On the other hand, by specializing in their comparative advantages, the United States can produce 5,000 cars and Brazil can produce 20,000 computers, or a total of 100 additional cars and 4,000 additional computers. The United States could trade 1,450 cars to Brazil for 12,500 computers and have 50 additional cars (3,550) and 2,500 more computers (12,500), while Brazil would have 50 more cars (1,450) and 1,500 more computers (7,500). Trade is productive since it generates more output of both products.

Low Wages Don't Mean Low Cost

Notice that in determining that it is less costly to produce cars in the United States and computers in Brazil, we never mentioned how much U.S. or Brazilian workers are paid. Workers in the United States will be paid more than those in Brazil because they are more productive in our example. So in terms of output, lower wages don't mean lower costs. Indeed, asking whether U.S. or Brazilian workers are less costly ignores the relevant question: less costly doing what? U.S. workers are less costly at producing cars, but Brazilian workers are less costly at producing computers. This is true no matter what U.S. and Brazilian workers are paid.

Moreover, free trade does not cause unemployment in either the United States or Brazil. True, free trade eliminates U.S. jobs in the computer industry and Brazilian jobs in the car industry, but it increases U.S. jobs in the car industry and Brazilian jobs in the computer industry.

Furthermore, the jobs that free trade eliminates are lower-paying jobs than the ones it creates. Without free trade, the United States and Brazil would each employ workers who produce both cars and computers. This means that many workers in each country would be doing jobs in which they do not have a comparative advantage, and therefore in which they are less productive than they could be. With free trade these workers would be directed into more jobs where they are more productive and receive higher pay, since the compensation workers receive ultimately depends on how productive they are.

The concept of comparative advantage is deceptively simple. Tiger Woods surely has the potential of being one of the best caddies in the world. How many people could give you better advice on lining up a putt or selecting a club? He has an absolute advantage. But everyone knows that the opportunity cost to Tiger Woods of becoming a caddie is too high to make that a sensible option. He would be sacrificing the return from being a professional golfer, the activity in which he has a strong comparative advantage. Understanding why Tiger Woods doesn't become a caddie is enough to understand why high-paid U.S. workers benefit when free trade puts them in competition with lower-paid foreign workers. □

THE FREEMAN
Ideas On Liberty

Market Money and Free Banking

by Bettina Bien Greaves

> "If we want to have money, it must be something that cannot be increased with a profit by anybody, whether government or a citizen. The worst failures of money, the worst things done to money were not done by criminals but by governments, which very often ought to be considered, by and large, as ignoramuses but not as criminals."
>
> —LUDWIG VON MISES, speaking at the Foundation for Economic Education, November 8, 1969.

Most people who write about money and banking nowadays from a free-market perspective criticize the Federal Reserve—and rightly so—for contributing to uncertainty by alternating between expansion and contraction. They point to the Fed-induced monetary manipulations that have led to the boom-bust business cycle. They criticize especially the Fed's arbitrary contractions of 1929–1933 and 1936–1938, which resulted in economic downturns and were alleviated only when monetary expansion resumed. They fault the Fed for sitting on its stockpile of gold and for not using it as a basis for further expansion. They object to the Fed's inconsistency, alternating between easy credit one moment and tight credit the next. At the root of their criticism there appears to be a belief, however, that a continual expansion in the quantity of money is not only desirable but also necessary for an economy to prosper.

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As an alternative to national control of the monetary system, these free-market critics of the Fed would prefer private banking. In their view, private banks would be well able to satisfy the market's "need" for currency by issuing bank notes to satisfy the demands of their clientele. Such issues of currency would hold no threat of inflation, they say, for the issues would necessarily be limited by the competition of the issues of other private banks as well as by the obligation of each bank to redeem its notes in real commodity money according to terms agreed upon.

Private banks with the freedom to issue notes are certainly consistent with free-market theory. However, by starting from the premise that the very *purpose* of free banks is to issue currency, it would seem that the advocates of private banks ignore basic economics; they fail to consider, first, what market money is and, second, the basic role of banks in a free market.

Money is not a piece of paper with a dollar sign printed on it; money is basically a *medi-*

um of exchange, something with market value that market participants are willing to accept in exchange. Second, banks are institutions dedicated to handling, safeguarding, lending, and/or managing the funds of depositors, according to agreed-upon terms. Emphasizing the note-issuing aspect of private banking assumes (1) that the paper currency itself is money, (2) that the economy "needs" a certain supply of readily available paper bank notes, and (3) that a less-than-"adequate" amount of currency necessarily leads to economic disaster.

Everyone wants more money—you, I, our friends, families, employers, businessmen. It is not money per se that we want, but purchasing power; we want what money can buy—food, clothing, and shelter, of course, and also automobiles, televisions, computers, medical care, travel, and entertainment. There is practically no end to the wants we can satisfy if we have more money. Government too wants more money to buy things—guns, planes, highways, and the ability to pay its employees; it wants to provide health care, to take care of the poor and the elderly, to clean up pollution, to insure bank deposits, to give humanitarian aid to foreigners, to assist some foreign governments militarily, and so on ad infinitum. There seems to be no limit to the amount of money people would like to have.

Some people carry over into the field of economics the idea that each of us would like more money in his own wallet or bank account. They reason that if everyone would be better off if he had more money, then it should follow that the more money in the whole economy the more prosperous the whole economy would be. Some have even carried this idea to the extreme and have recommended that the government needn't collect taxes at all but may simply print all the paper money it wants, and hand it out to people on the theory that their spending will then bring prosperity. Of course, if this idea were really put into practice, the printed money would soon be so plentiful that it wouldn't be worth anything on the market; it would no longer be serviceable as a medium of exchange, and thus, also, it would no longer be any good as money. Producers would stop producing and there wouldn't be anything to buy—at any price.

Continually Increasing Money

Fortunately economists see through such proposals and do not recommend the unlimited issue of paper money. However, many persons, unfortunately, believe that for an economy to prosper the total quantity of money in the economy must be continually increased.[1] They point to occasional monetary contractions (deflation) in this country and claim that the economy began to pick up only after the Federal Reserve began again to inflate. Deflation, they say, must be avoided at all costs. And most people believe it is the task of government and of the banks to provide the currency, to keep prices relatively stable, and to prevent deflation.

Private banking, according to its advocates, would eliminate violent monetary fluctuations. Private banks of course should be free to issue currency, but their notes would not be legal tender. Their paper notes would represent the medium-of-exchange-commodity on deposit at the bank and would be redeemable by the bank at any time. As such, their notes *could* become the community's money. But their status as money would have to be earned; it would not result from the mere issue of paper currency labeled "money." A private bank's notes would have to compete with readily marketable commodities, as well as with other bank notes, for acceptance as media of exchange. The bank would have to persuade market participants that its notes had value on the market, were generally acceptable to traders, and thus were reliable media of exchange.

The method for introducing the bank's notes into circulation and the interest rate it asked of borrowers would limit the effectiveness of supply and demand in checking under- and over-issue. For instance, a below-market interest rate would invite an increased demand for loans, which the bank could satisfy only by expanding its note issue; an above-market interest rate would discourage loan applications and lead to contraction. However, it is true that the bank's willingness to redeem on demand all its notes submitted for redemption would prevent any over-issue.

The monetary problem that the advocates of free banking are trying to solve, as described by modern monetary economists, is very complex. But this complexity is not a consequence of the economics of money. Rather it is caused by governmental, not economic, factors—especially the designation of government's notes as legal tender for the payment of debts. The complexity of the monetary situation is the outcome of many regulations and controls. To analyze the problem and the views of today's advocates of free banking, one must review some basic economic principles.

Medium of Exchange

There is really nothing complex about money itself. Money is simply a medium of exchange. Money came out of barter as a result of countless purposive actions of individuals. As the development of specialization and the division of labor expanded to encompass more and more persons, it became difficult and cumbersome to exchange goods for goods, that is, to engage in direct exchange, to barter. If Jones wanted to trade his output for things to consume, he was not always able to locate a would-be trader willing to take his goods and services in exchange for the precise items he wanted. As a result, step by step, Jones and other would-be traders discovered in time that exchanging what they had for a more widely desired commodity would bring them one step closer to a successful exchange.

Traders came to recognize, as the outcome of countless voluntary exchanges, agreements, and contracts, that some particular commodity could serve as a generally useful medium of exchange in their community. Such a readily marketable commodity might be held for a while and then used later when a suitable trading opportunity arose. Thus, over centuries, perhaps millennia, money evolved. No government conceived the idea; it came out of the market. The medium of exchange in any community *must* be something that has market value, purchasing power. If a commodity is easily available and free to everyone, no one will be willing to take it in trade for what he is selling. Such a "free good" will never become a medium of exchange.

The availability of a medium of exchange was a big step forward toward economic progress. The name given to it is "money." Over millennia, many commodities have been used as money—gold, silver, wampum, tobacco, cattle, and more. As a result of voluntary transactions undertaken by countless traders over years, the various commodities used as money were finally narrowed down to practically only one—gold.

Although we now talk about our paper U.S. dollars as if they were money, we should never forget that whatever we use as money must be something people will take in trade. Only its tradability, its acceptability, assures that money is something you and I can exchange for things we want. It should be "something that cannot be increased *with a profit* by anybody, whether government or a citizen," lest that government or citizen take advantage of the situation to increase its quantity until it loses its value as a medium of exchange.

However, we should not dismiss money as unimportant because it is *simply* a medium of exchange. In today's world, almost every interpersonal transaction depends to some extent on a reliable money. It is essential for a viable economy. It facilitates trade, calculation, and production. It enables entrepreneurs operating in a finely specialized division of labor to estimate production costs, calculate potential income, and anticipate future markets. It makes it possible for entrepreneurs to carry out far-ranging and complex financial transactions over long periods of time and across great distances.

Strictly speaking, the government-issued currency in use today, the U.S. dollar, is not money per se. It is a transmogrification of market money foisted on the people by force through the legal-tender laws. It is a derivative of the commodity—gold—that emerged over centuries as the market's medium of exchange. Similarly, privately issued notes would have to earn their reputation as reliable media of exchange to become accepted as money.

Banks and Banking

To understand money, it is important also to analyze banks and their economic beginnings. Banks originated as market custodians for funds entrusted to them by depositors. They soon began to serve as middlemen to help arrange financial transactions for customers. A bank's assets consisted of the funds left with it for safekeeping and money entrusted to it for managing and/or lending. If banks lent funds left with them for safekeeping they did so only at the risk that their depositors, who expected their money to be kept safe and available on demand, might ask for it and find it gone. However, experience taught bankers that all depositors would not ask for all their money at the same time; so a bank could lend a portion of these funds—if it was careful. The bank knew that the rate of interest it asked could influence a person to borrow more or less. If the bank lowered its interest rate, it could expand its currency issue and lend more *for its own profit*. But lending more increased the bank's risk. It always realized that such over-lending might be discovered and it would then have to make up the shortfall from elsewhere or face bankruptcy.

It is argued that expanding credit to lend more money promotes prosperity because it puts money in the hands of businessmen who can use it to good advantage. This argument depends on considering the "seen" and ignoring the "unseen." It ignores the fact that new credit over and above the available supply of savings can be granted only by issuing loans at below-market interest rates. This means expanding credit artificially. Those who benefit from the additional new credit, created *for the profit* of the issuing bank, are helped; they appear on the market ahead of others, bid up prices, and walk off with their credit-financed purchases. Those who do not benefit from the new credit, the savers on whose funds the expansion was based, are hurt. But they are not seen. Not having received any of the new credit, they do not become visible spenders; they are prevented by the beneficiaries of the new credit from using their own money as they wish.

Banks are expected, of course, to lend the money that savers leave with them for that purpose, sharing part of the interest earned with those who furnished the funds. But even in such cases, banks must be cautious. They soon learned from experience that the periods for which loans are made must be coordinated with the dates when the money lent has to be repaid to depositors. In other words, deposits that its customers could claim on demand at any time must always be redeemable from funds on hand. Funds to repay short-term loans must be financed by credits that will be repaid by the end of the short terms specified. And long-term loans may be financed by funds repayable to the bank over longer periods. But those funds too must be back in the bank by the date when they must be repaid to the depositors. For instance, if a bank's short-term loans are backed by long-term mortgages, the bank would be in trouble.

The Role of Government

Much has changed over the centuries since money first evolved on the market and since entrepreneurs first opened banks to serve the needs of persons who engage in money transactions. But the basic economic principles remain the same. To serve as money, a commodity must still possess widespread marketability as a medium of exchange. And to remain in business private banks must still fulfill their obligations.

Governments have become more and more involved with monetary matters. It started when they were called on to settle disputes that arose over contracts. Courts and judges were frequently asked to decide whether the two parties to an agreement had actually complied with the terms agreed upon. Suppose one person agreed to exchange bushels of wheat for money of the realm, and the other agreed to pay a certain amount of money for wheat. When the time came for the farmer to deliver wheat and the buyer to deliver money, one or both parties might object that the other had not complied with the agreement. It was then up to the courts to decide. Was the wheat delivered actually the quantity and quality specified in the contract? Was the money paid—whether gold, silver, wampum, tobacco, dollars, or pesos—actually "money" as called for in the contract? Only that, and nothing more than that, the courts and judges had to decide.

Government's role in the field of money was soon broadened. From the idea that courts must settle disputes over what was meant by "money" in specific cases, there developed the doctrine that money was whatever the government said it was. Governments took advantage of this situation. They not only decreed what money was but they expanded *for their own profit* the quantity of whatever they decreed to be money. Then they compelled people to accept that money in trade by declaring it to be legal tender for the payment of debts.

Counterfeiters try to piggyback *for their own profit* on a community's money. A government does essentially the same thing. In ancient times, governments clipped or adulterated their coins and then compelled the people to accept them at their previous nominal value. Later, with the invention of the printing press, it became easier to debase the currency. The government could simply declare anything to be money, even a piece of paper. Then government privileged certain banks and protected them from bankruptcy if they printed bank notes *for the profit of the government* over and beyond the gold or silver deposits in their vaults. And the government gave these bank notes legal-tender status. With the establishment of the Federal Reserve system in this country in 1913, the monetary system of legal-tender paper bank notes based on reduced gold and silver backing was formalized. In time the U.S. government itself, through the Federal Reserve, assumed the responsibility for issuing this country's currency. And these paper notes enjoy legal-tender status today.

The redemption in gold or silver of legal tender was at first discouraged and then halted completely. In 1933 it became impossible for citizens to obtain gold for their paper money, and they were eventually prohibited from owning any monetary gold at all. The U.S. government even reneged on its own promises to redeem its bonds and debts in gold. In January 1975, U.S. citizens regained the right to own gold, but they are still compelled to accept the government-issued legal-tender notes.

Throughout all the years since the Federal Reserve Banks opened, the quantity of legal-tender money has continually increased. And the market value, the purchasing power, per unit of this money has continually declined, reflecting the subjective value that individual market participants place on the dollar relative to other goods and services.

Inflation: More Money or Higher Prices?

One reason for confusion over money results from the changed definition of the word "inflation." Originally and traditionally it meant an increase in the quantity of money and/or credit, and it is so defined in *Merriam Webster's Second International Dictionary* (1954).[2] Only in recent decades has the word been widely used to refer to one consequence of a monetary increase: an increase in prices. Granted, this new definition is now widely accepted, but that does not make it correct or expedient. Not only does it leave the language without a term for a monetary increase, but it shifts the blame away from the real culprits to the victims. While the U.S. government and the government-established Federal Reserve are responsible for increasing the quantity of money *for their own profit* and hence for causing prices to rise, it is the victims—businessmen, savers, workers, investors, consumers, and so on—who are blamed for asking or paying higher prices.

Now let us consider the Federal Reserve as "an engine of inflation." Granted, it is difficult to compare the number of dollars in circulation over the years. Statisticians frequently revise their "money stock" estimates, even changing what they include. However, there can be no doubt that there has been a tremendous increase in the number of dollars since 1913 when the Fed was established. There was a Fed-inspired monetary expansion from 1921 to 1929. In 1913, the country's "money stock" (gold, coins, and notes) was estimated at $3.798 billion.[3] On June 30, 1929, at the peak of the stock market boom, this figure had more than doubled to $8.538 billion, representing a substantial inflation. If market prices did not climb to the same extent during those years, as most economists agree they didn't, it is because the effect of the monetary increase on prices was hidden by increased production, due to the initiative, innovation, and productivity of entrepreneurs, creating a downward pressure on prices.

To return to the statistics, the money stock reported on June 30, 1930, dropped slightly from 1929 to $8.306 billion, but by June 1932 it had climbed to $9.004 billion. The Fed's figures show that the country's money has been increased more or less steadily ever since, bounding up especially during war years.[4] By the end of 1998, M2 figures came to $4,288.3 billion. And they continue to climb. If U.S. prices have not risen proportionately, it is due not only to the tremendous initiative, ingenuity, adaptability, and productivity of entrepreneurs but also to the mushrooming demand by foreigners to hold dollars—as their preferred medium of exchange—for their own security and as a hedge against the potential loss in value from inflation of their own country's currencies.

Being unable to trade in gold, and having long since been compelled to accept the U.S. legal-tender dollars in payment of debts, market participants have come to accept them by default as the best available medium of exchange. Having no other realistic alternative, entrepreneurs do their best to calculate their costs and potential markets in terms of dollars. In making business plans, they try to anticipate future fluctuations in the value of the dollar. And as long as the Federal Reserve practices relative restraint, market participants worldwide adjust and adapt fairly successfully. But in the last analysis, the market value of the U.S. paper/credit dollar depends on the judgment of fallible human beings who take into consideration, among other factors the political climate, the interests and *profit* of the U.S. government.

The Effects of Inflation

Supply, demand, and competition for the medium-of-exchange commodity are determined by the subjective values of market participants. This is true whether the medium is gold, a paper substitute for gold, a paper note decreed by government to be legal tender, or a private bank's paper note. Every dollar added to the existing supply of money to which the market has adjusted has at least three inevitable consequences: (1) it confiscates some wealth from anyone who owns dollars; (2) it upsets the calculations of entrepreneurs; and (3) it reduces purchasing power.

New issues of money and/or credit withdraw or extract some value, some purchasing power, from every existing dollar asset, whether in a wallet, savings account, bond, insurance policy, or debt payable in dollars. The value of every person's dollar holdings shrinks even as he sleeps. New issues of money and/or credit upset the calculations entrepreneurs made in dollar terms, distorting production, causing malinvestment, and setting the stage for a boom/bust business cycle. Of course, holders of privately issued currency that does not enjoy legal-tender status are not helpless; they may refuse to accept it if it loses value and turn to some other medium of exchange.

When the quantity of money is increased, the new money is passed from one person to another throughout the economy. But this takes time. Every additional monetary unit created—whether by gold miner, the printing press, credit expansion, or deficit financing (monetization of debt)—goes to some individuals first. It necessarily affects their value judgments, reducing in their minds the marginal utility of each unit of money. Those who receive the new money or new credit first benefit, feel more affluent, spend more freely, and are willing to offer higher prices for goods and services. Their demand for goods and services creates pressures on the market pushing prices upward. The delayed and uneven effect on the market of an inflation helps the early recipients of the new money at the expense of others. Those who do not receive any of the new money until later are hurt; they must pay the higher prices resulting from the pressure of the increased demands of the early beneficiaries before they get any of the new money themselves.

There have been many times in history when the value of money has dropped drastically because governments have increased the quantity *for their own profit.* One of the most dramatic cases is that of the German mark after World War I. By 1923, the number of German marks was increased by billions, the market value of a single mark fell practically to zero. The marks still enjoyed legal-tender status. However, they were no longer reliable and ceased to serve as money. Creditors engaged in all kinds of subterfuges to avoid being repaid in marks, and debtors tried various tactics to trick their creditors into accepting payment in the depreciated marks.

Many other national currencies have suffered similar fates in recent years—the Bolivian and Argentine pesos, the Russian ruble, the Italian lire, the Thai baht, the Indonesian rupiah, the Hungarian forint, to name a few. Such examples show clearly that there can be too much money.

How Much Is Enough?

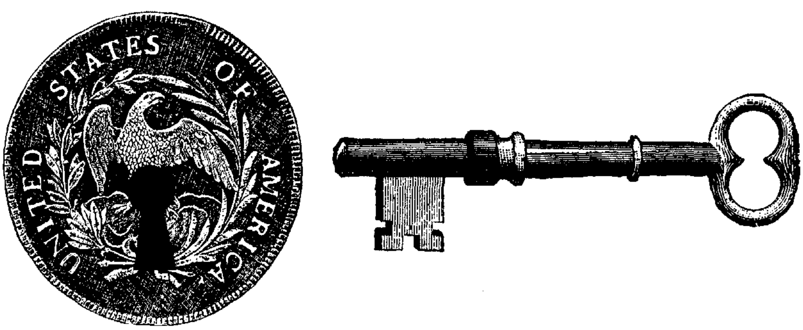
Any quantity of money is adequate because prices will adjust. Individual market participants, bidding and competing with one another, will bring the purchasing power parity principle into effect. They will bid more or less for units of money, and more or less for goods and services, depending on their subjective values. The purchasing power per monetary unit will tend to decline as the number of monetary units increases. It will tend to rise as the number of monetary units drops. In the end, the purchasing power per monetary unit will shrink or stretch so that the total available quantity of money, large or small, will suffice to purchase the available goods and services. Thus, any amount of money is enough money, if it is not changed abruptly or arbitrarily and if it is not made legal tender. □

1. This article was sparked by Professor Richard H. Timberlake's three articles in *The Freeman* (April, May, and June 1999).

2. It defines inflation basically as a "Disproportionate and relatively sharp and sudden increase in the quantity of money and credit, or both, relative to the amount of exchange business."

3. Statistics approximate, taken from the monthly *Federal Reserve Bulletins*.

4. The Fed's monetary statisticians apparently took a holiday in 1933 along with the banks. But they returned to the task after the gold stock was revalued from $20.67 to $35.00 per ounce by FDR's *diktat.* The value of the money stock as of December 3, 1933 ($17.470 billion) reflected the increased value of the government's gold holdings. By December 1941, when World War II started, the money stock had increased to $90.435 billion. By the end of the war, it had been expanded to $113.597 billion. In the 1950s, the U.S. gold holdings began to go down as other countries started to withdraw their gold from the United States. However, money stock statistics continued to climb. At the end of the Korean War (1955) it was approximately $133.3 billion. In 1971, Federal Reserve statisticians revised their money stock figures (M2 consisted of currency outside of banks, demand deposits, plus time deposits at commercial banks) and backtracked, calculating M2 in 1964 to have been $273.8 billion. In 1971, Nixon stopped the sale of gold to foreign governments and foreign central banks. He devalued the U.S. dollar in December 1971, to $38 an ounce, and then again in February 1973 to $42.22. In January 1975, the U.S. government resumed selling gold and U.S. citizens regained the right to own gold coins and gold bullion. The price of an ounce of gold zoomed off the charts, indicating the extent to which the effects of inflation, defined as monetary increases, had been suppressed. After the end of the Vietnam War, M2 figures came to $576.5 billion.



CAPITAL LETTERS

Constitutional Question

To the Editor:

Concerning David N. Mayer's article in the July issue of *The Freeman*, yes, "Monica's War" (as broadcaster Paul Harvey labeled it) against Yugoslavia was "immoral," but as to whether it was "unconstitutional" requires clarification.

In Mayer's article, I find no mention of Article VI, paragraph 2, of the U.S. Constitution, which states:

> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, *any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.* (emphasis added)

This, I presume, was the basis for Mayer's writing that "Some legal scholars have advanced the extraordinary argument that Congress has neither a constitutional obligation nor a right to declare war before the United States joins in a 'police action' sanctioned by either the United Nations or NATO. They argue that U.S. ratification of the U.N. Charter or the North Atlantic Treaty after World War II made us part of a 'new world order' in which member nations can no longer 'make war,' in the classic sense."

Because of paragraph 2, I see nothing extraordinary in the legal argument that the United States is bound by the U.N. Charter and the North Atlantic Treaty. The certain way out of the legal argument and the "new world disorder" is for the U.S. Senate to repeal approval of the U.N. Charter and the North Atlantic Treaty.

—EARL ZARBIN
Phoenix, Arizona

David Mayer replies:

The "Supremacy Clause" of Article VI, paragraph 2, notwithstanding, there is one and only one way in which the U.S. Constitution can be amended, and that is by the procedure stipulated in Article V. Neither the U.N. Charter nor the North Atlantic Treaty can give the U.S. president powers he does not have; the sole source of presidential power is the U.S. Constitution. The Constitution provides that Congress alone has the power to declare war, and that power (to be meaningful) today means the power to decide where and when U.S. military force should be used offensively; the president has only the power of commander-in-chief, which (properly viewed) is the power to determine *how*, not *where*, U.S. military force is used. Constitutionally, then, prior to any U.S. military involvement under either U.N. or NATO auspices, Congress should debate and vote whether or not to commit U.S. troops: under our constitutional system, it is a question to be decided by the legislative, not the executive branch, of the U.S. government. We needn't repeal our ratification of either of these treaties (although there may be other good reasons for doing so) in order to follow the separation of powers mandated by the Constitution.

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THE FREEMAN (Ideas On Liberty)
OCTOBER 1999

Chicago Gun Show

"According to the economic approach, criminals, like everyone else, respond to incentives."

—GARY BECKER[1]

The Chicago boys are at it again. This time the economists at the University of Chicago are making headlines in today's hotly disputed debate about gun control. Milton Friedman set the general standard a generation ago by insisting on rigorous empirical work to support sound (though often unpopular) theory and policy. More recently, Gary Becker extended Chicago-style economic analysis into contemporary social problems such as education, marriage, discrimination, professional sports, and crime.

Now John R. Lott, Jr., until recently the John M. Olin Law and Economics Fellow at Chicago, is making the case that a well-armed citizenry discourages violent crime. Lott analyzed the FBI's massive yearly crime statistics for all 3,054 U.S. counties over 18 years, the largest national surveys on gun ownership, and state police documents on illegal gun use. His surprising conclusions, published in his recent book, *More Guns, Less Crime*:

• States now experiencing the largest drop in crime are also the ones with the fastest-growing rates of gun ownership.

• The Brady five-day waiting period, gun buy-back programs, and background checks have little or no impact on crime reduction.

• States that have recently allowed concealed weapon permits have witnessed significant reductions in violent crime.

• Guns are used on average five times more frequently in self-defense than in committing a crime.[2]

According to Lott, recent legislative efforts to restrict gun ownership may actually keep many law-abiding citizens from protecting themselves from attack. (There's that Law of Unintended Consequences again.)

The Incentive Principle

Underlining Lott's findings is a basic economic concept, the law of demand: If the price of a commodity goes up, people use less of it. In the case of criminal activity, if the cost and risk of committing a crime rises, less crime will be committed. This is often referred to as the market's incentive principle.

Gary Becker has showed that increasing the cost of crime through stiffer jail sentences, quicker trials, and higher conviction rates effectively reduces the number of criminals who rob, steal, or rape.[3]

Similarly, Lott argues that state laws per-

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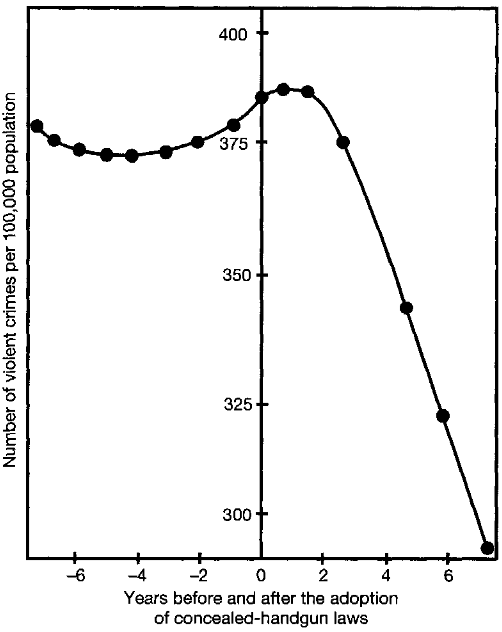
mitting concealed handguns deter crime. "When guns are concealed, criminals are unable to tell whether the victim is armed before striking, which raises the risk to criminals."[4] He produces a variety of statistics and graphs to support his case. For example, the following graph compares the average number of violent crimes in states before and after the adoption of a concealed-handgun law.



The effect of concealed-handgun laws on violent crimes

Source: John R. Lott, *More Guns, Less Crime,* Figure 4.5

Lott's crime figures also remind me of Frederic Bastiat's brilliant essay "What Is Seen and What Is Not Seen." In 1850, this great French journalist wrote, "In the economic sphere,. . . a law produces not only one effect, but a series of effects. Of these effects, the first . . . is seen. The other effects emerge only subsequently; they are not seen."[5]

According to Lott, Bastiat's principle applies in crime statistics. "Many defensive uses [of guns] are never reported to the police."[6] Lott gives two reasons. First, in many cases of self-defense, a handgun is simply brandished, the assailant backs off, and no one is harmed. Second, in states that have stringent gun laws, citizens who use a gun for protection fail to report the incident for fear of being arrested by the police for illegal use of a weapon. Thus, Lott confirms (through extensive surveys) the initial work of Gary Kleck, professor of criminal justice at Florida State University, that guns are used far more frequently in self-defense than in committing crimes. Kleck, by the way, used to have a strong anti-gun bias until he uncovered this revealing statistic.

All this confirms a long-standing constitutional principle: People have the right to own a gun for self-protection. □

1. Gary S. Becker and Guity Nashat Becker, *The Economics of Life* (New York: McGraw-Hill, 1997), p. 143.
2. John R. Lott, Jr., *More Guns, Less Crime* (University of Chicago Press, 1998).
3. Becker and Becker, p. 137.
4. Lott, p. 5.
5. Frederic Bastiat, "What Is Seen and What Is Not Seen," *Selected Essays on Political Economy* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1995 [1850]), p. 1.
6. Lott, p. 5.

BOOKS

The Great Philanthropists and the Problem of "Donor Intent"

by Martin Morse Wooster

Capital Research Center • 1998 • 198 pages • $15.00

Reviewed by George C. Leef

According to a book titled *The Right Guide* and its companion volume, *The Left Guide*, funding for the various organizations that promote the expansion of government is between three and four times as great as the funding for the organizations that seek to protect freedom, private property, and limited government. The principal reason for this lamentable situation is that several huge foundations that were built on the fortunes of men who were staunch laissez-faire advocates have been turned into cash cows for statist advocacy, among them the Ford, Rockefeller, and MacArthur foundations.

The Great Philanthropists examines the problem of the subversion of the wishes of individuals who create vast wealth and foundations to disburse that wealth after their deaths. The villains of the piece are the "professional" and almost invariably statist foundation managers who think that they know how to use the fortunes amassed by entrepreneurs to refashion society and have no qualms whatsoever about employing the funds in ways the donor would not have approved.

Wooster introduces us, for example, to William H. Allen, one of the earliest of these types, who denounced the "dead hand" of donor intentions and argued that trustees should be free to use foundation money for any purpose they thought worthy 20 years after the donor's death. (In truth, many don't see why they should have to wait 20 minutes.) The philosophy and objectives of "professionals" like Allen usually differ markedly from those of the wealth creators, yet in case after case, they succeeded in taking control of the foundations of the great capitalists. The book explains how it happened.

Consider John D. Rockefeller, creator of Standard Oil. During his lifetime, he made sure that his charitable giving did not promote dependency or waste. But people were constantly hounding him for money, and he was persuaded that he could insulate himself from that hounding by setting up a foundation and letting others handle the giving away of his money; this was "wholesale" rather than "retail" philanthropy. Within one year of the establishment of the Rockefeller Foundation in 1913, Wooster writes, "many foundation trustees and employees were looking for ways to exclude Rockefeller from the foundation's affairs." They would succeed.

Equally harmful was the fact that John D. Rockefeller, Jr., was philosophically much different from his father. Young Rockefeller surrounded himself with advisers who were hostile to capitalism and allowed them to quickly steer the foundation radically away from the desires of the senior Rockefeller. This was a heist worthy of the most audacious bank robbers, yet all done perfectly legally.

In 1919, Rockefeller, Sr., tried to reassert control. He wrote to his attorney explaining what he wished to do to put his foundation back on what he regarded as the right track. The lawyer, however, was aghast at the idea of Rockefeller's controlling his own money and maneuvered to thwart his client's intentions. The foundation continued on its merry statist way, as it does to this day.

The story of the Ford Foundation was similar to Rockefeller's. Henry Ford was a staunch advocate of capitalism. He was virtually the only prominent industrialist who refused to cooperate with the National Recovery Act, thus making himself a target of FDR and his New Dealers.

Confronted with New Deal "share the wealth" legislation that threatened to cost the Ford family control over the business he had built, Ford established the Ford Foundation in 1936. The foundation remained relatively small and unobtrusive until after World War II, but a tremendous infusion of wealth came in following Ford's death in 1947. Henry Ford II, a political moderate, allowed the foundation to fall into the hands of statist philanthropic professionals. Eventually, the younger Ford would resign from the board after being haughtily told by the foundation's president, McGeorge Bundy, that he was just one vote out of 16 and his family lineage meant nothing. On resigning, Ford wrote that "the foundation is a creature of capitalism, a statement that, I'm sure, would be shocking to many professional staff people in the field of philanthropy. It is hard to discern recognition of this fact in anything the foundation does."

Wooster recounts other such disasters, but he also points to several instances where the wishes of the donors have been honored by their foundations, showing that the problem is not insoluble. He identifies several means by which wealthy individuals can ensure that their money is not later turned to purposes of which they would disapprove.

The most important step is simply deciding to buck the trend of giving a free hand to "the professionals." Wooster writes, "The fundamental problem of philanthropy today is not "dead hand" control. It is donors who meekly follow prevailing wisdom and leave their fortunes to professionals who spend the money on causes they like—which are usually not the causes preferred by the donors."

A timely, much-needed book. □

George Leef is director of the Pope Center for Higher Education Policy at the John Locke Foundation and book review editor of The Freeman.

The Crisis of Global Capitalism

by George Soros

PublicAffairs • 1998 • 245 pages • $26.00

Reviewed by Brink Lindsey

Reading George Soros on international economic policy is like watching Michael Jordan—at bat. Both experiences reinforce the lesson that excellence in one field of endeavor doesn't necessarily translate into other areas. In Soros's case, success at playing the market does not extend to success at understanding it—or more precisely, the government policies that shape or distort it.

In *The Crisis of Global Capitalism,* Soros rails against what he calls "market fundamentalism," or the belief that "the common interest is best served by allowing everyone to look out for his or her own interests and that attempts to protect the common interest by collective decision making distort the market mechanism." This dogma, he asserts, "has rendered the global capitalist system unsound and unsustainable."

His proposed response to the present peril: "To stabilize and regulate a truly global economy, we need some global system of political decision making. In short, we need a global society to support our global economy." Specifically, Soros recommends the creation of an International Credit Insurance Corporation, which would add up-front guarantees of foreign loans to the IMF's current post hoc mop-ups.

To assert as Soros does that the world today is in the grip of "market fundamentalism" reveals a profoundly distorted view of events. Where are the governments today that toe a strict laissez-faire line? Where even are the opposition parties of any size that do so?

Certainly the world has moved in leaps and bounds toward more market-oriented policies over the past couple of decades, but look who has led the charge—in China, Deng Xiaoping, a committed Communist; in India, P. V. Narasimha Rao, a product of the Congress Party that instituted Soviet-style central planning there; in Argentina, Carlos Menem, a Peronist; in Peru, Alberto Fujimori, an agricultural engineer and ideological cipher; and so on and so on. Yes, there have been reformers who made their case in ideological terms—Ronald Reagan, Margaret Thatcher, Vaclav Klaus—but they have been exceptional. By and large, the worldwide rediscovery of markets has been guided by pragmatism—a rejection of the failed dogma of collectivism in favor of something, anything, that works.

And, of course, the move toward market-oriented policies still has a very long way to go. Although collectivism may have perished as a living ideal, government interventionism remains a huge and distorting presence in the world economy. Market forces enjoy nothing like the unchallenged ascendancy that Soros claims for them; rather, they must contend with, struggle against, and slip through the loopholes of a massive and overextended public sector.

It is this uneasy coexistence between markets and statism that is the true source of instability in the global economy today. And oddly enough, Soros is not blind to this fact. The author frequently acknowledges how misguided interventionist policies—including unsustainable currency pegs and moral hazard-infected financial systems—led to the recent crises in Asia. Nevertheless, Soros urges, as a response to those crises, the creation of another layer of moral hazard in the form of international credit guarantees. Talk about the triumph of hope over experience!

Soros's hostility to markets stems from his theory of "reflexivity"—which boils down to the common-sense observation that sometimes people act not because of what they think, but because of what they think other people think. In financial markets, this phenomenon can cause herd behavior, which in turn can cause bubbles and panics.

Let's admit that all this is true. But what of it? The question isn't whether markets are perfect; it's whether markets and competition generally and in the long run work better than centralized bureaucratic control. The fact is that markets do sometimes overshoot, but there are limits: bubbles eventually burst, and panics subside. When a market trend begins to look precarious and unsustainable, there are enormous incentives—namely, the prospect of making a killing—to buck that trend and bring it down. George Soros should know: he's made billions that way.

What are the equivalent feedback mechanisms that restrain and reverse the mistakes governments make? Are they as effective and reliable as those of the market? Let's see what Soros himself has to say:

> [M]arkets have a way of correcting their excesses; bull markets are followed by bear markets. Representative democracy seems to be less successful in this respect. It is true that governments and legislatures are regularly replaced by the electorate; that is how the system is designed. But democracy seems incapable of correcting its own excesses.

Well, well. If Soros would only take his own words to heart, he would see that opposition to his interventionist nostrums need not be a matter of dogmatic "fundamentalism." Simple realism is all that's required. Meanwhile, it is the continued recourse to government interference which requires blind faith that somehow, this time, it will succeed. ☐

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Nixon's Economy: Booms, Busts, Dollars, and Votes

by Allen J. Matusow

University Press of Kansas • 1998 • 324 pages • $35.00

Review by David L. Littmann

Allen Matusow's book is a play-by-play description of Nixon's overwhelming priority—get elected! Not that Nixon was uninterested in the economy. He fully understood the political punishments and rewards that are meted out by rising or falling unemployment and interest rates. Nixon's feel for fiscal and monetary policies probably exceeded that of most, if not all, of his economic advisers, from whom he received a lot of dreadful advice.

But Nixon, the author observes, made economics subservient to politics. Economic policies were simply tools of political expedience. Matusow portrays a President Nixon bored to death and even irritated by economic advice or theories that were not clear catalysts to his political ambition. Conversely, when economic theories, such as the "full employment budget" concept or quotas on Japanese textiles, seemed to further his objectives, he was rapt in attention, participating actively in the ensuing policy debates and critiques.

Nixon's Economy is well organized to take us through the economic turbulence of the

Nixon years. Its chief strength is Matusow's description of the duplicity of Nixon's conduct of economic policy. He reveals the blatant contradictions between the so-called conservative philosophy that one might think would have led Nixon to advocate tax cuts, smaller government budgets, repeal of regulations, removal of trade barriers, and other laissez-faire policies. But no, precisely opposite policies prevailed, culminating in the 1971–74 wage and price controls.

Matusow's commentary on the contradictions between theoretical Republican support for markets versus actual adoption by the administration of socialism is illuminating. Few politicians are long able to resist the temptation to wield governmental power for short-run political advantage. Professed limited-government principles are forgotten or deliberately cast aside when interventionism seems to offer better political rewards. (The author's observations are also relevant to what has befallen the "Republican Revolution" since 1995.)

Sadly, Matusow, professor of history at Rice University, is himself weak on economics. While good at exposing the weaknesses and contradictions in Nixon's economic policies, one sees little indication that he is familiar with serious free-market analysis. Especially as regards monetary policy and the origins of the lethal inflation generated by the Nixon programs of the late '60s and early '70s, the author confuses cause and effect. For example, in chapter three Matusow claims that "the main reason why prices kept rising through 1970 . . . was the big wage increases that workers were demanding and getting." He compounds this confusion in later chapters, suggesting that currency devaluation and oil price hikes are causes of inflation.

Errors like this are not isolated. By chapter six, perhaps in an effort to make the book more readable, the author resorts to normative assertions, using "good" and "bad" with reference to Uncle Sam's manipulation of the dollar vis-à-vis foreign currencies. Later, Matusow falls into the trap of stating that "controls deserved some credit for declining inflation." Yet, he elsewhere credits Milton Friedman's monetarist warning that inflation is always and everywhere a monetary phenomenon.

This unevenness is forgivable for a non-economist. But some shortcomings cannot be excused. The story of the Nixon years would have been a considerably more valuable exposition for future generations of readers and economists had the author included fewer retrospective testimonies from apologists for the Keynesian school, and instead emphasized the disservice of "political economists" and power-hungry advisers, such as Paul Volcker, Arthur Burns, and John Connally. Also, contrary to the author's gratuitous statement that "no one in or out of government [in 1973] foresaw the approach of the [inflation] cataclysm," there were many non-political economists who foresaw and wrote about the futility of controls and catastrophes that awaited economies adopting these bankrupting policies.

Nixon's Economy is worthwhile and germane reading, making clear the important point that the incentives of politicians tend to put them disastrously at odds with sensible economic policies. The author's own lack of economic comprehension, unfortunately, renders the book less valuable than it might otherwise have been. Read the book for its good history and take the author's economic pronouncements with a grain of salt. □

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To Serve and Protect: Privatization and Community in Criminal Justice

by Bruce Benson

New York University Press, Political Economy of the Austrian School Series • 1998 • 416 pages • $37.50

Reviewed by Morgan O. Reynolds

Over the last three decades, the share of GDP consumed by the public sector on crime control has tripled and now exceeds $100 billion annually, or about $1,000 per household. Crime rates have declined in the 1990s, suggesting some benefit from the expenditure, yet crime stubbornly remains three times higher than 30 years ago, according to FBI statistics. These data imply a substantial decline in the productivity of law-enforcement bureaucracies.

The natural thought of a public choice economist is, "So what else would you expect?" Big government is no more likely to be the answer to crime than to any other problem. Private-sector solutions and market-driven reforms are more likely to work. The root solution for crime is a set of institutions that get incentives right. Custom and law must internalize (privatize) more benefits for crime suppressors and make crime producers pay more of the costs they impose on victims.

Bruce Benson, professor of economics at Florida State University, pursues this logic brilliantly. Benson is a veteran researcher on crime and law, and in this volume he integrates a sprawling literature in a way that changes the whole discussion. The book works on two distinct levels. First, it provides nearly encyclopedic coverage of private techniques in criminal justice that range from medieval Anglo-Saxon days to contracting out of prisons today. Second, and more important, it elevates us to a high philosophical plane by redirecting our attention from social-engineering goals like deterrence and rehabilitation toward a focus on justice and individual rights and responsibilities.

Like education, criminology has long been a field rent by fads. Lacking a real intellectual anchor and populated primarily by sociologists, criminology has for the most part ignored a rights-based perspective. Benson's book fills that void. His premise is that justice for victims should be the goal of our justice system. All else follows from that premise.

Offenses thought of as crimes today, like murder and robbery, were once treated as private torts, with economic compensation as the primary remedy. This private system of justice worked well and could do so again, according to Benson. With the prospect of recovery of damages, the victim had a greater incentive to report a crime, correcting a major failing in our present system where victims only report about 40 percent of crimes to the police. Restitution rights were transferable, thereby promoting efficiency in apprehension and liability.

Our present reliance on the state to protect our property rights and control criminals is very recent, less than two centuries old in most respects. The historical reason for this evolution was that kings took away victims' property rights to restitution, and the path of criminal justice in England then wandered away from individualism toward collectivism. In the tradition of Ronald Coase and Steven Cheung, who debunked the theories that private markets must fail to supply lighthouses or pollinate fruit, Benson's historical research explodes the doctrine that a justice system is a "public good" that only government can provide.

Perhaps Benson's most arresting evidence comes from Japan, which has the lowest crime rate among industrialized nations by far. A primary reason, claims Benson, is that their system is more privatized and victim-oriented than ours. There, the fundamental right is for the victim to be restored to his original condition. In contrast to our culture, in the Japanese culture there is no acceptable excuse for criminal activity. The criminal must bargain for forgiveness with the victim and if the wrongdoer negotiates an acceptable settlement package and shows contrition, public-sector punishment is lenient.

Benson documents the substantial private effort to combat crime in the United States, estimated at $300 billion a year, and therefore larger than the public-sector effort. This will continue to grow rapidly, Benson predicts, if only to compensate for continuing public failure. Our system is also moving toward victims' rights, recently enshrined in many state statutes and constitutions. Benson sees these as largely illusory gains because law-enforcement bureaucracies have co-opted victims' rights organizations. He warns victims' groups that they must forge an independent path in order to transform criminals' "debts to society" into private, transferable debts to individual victims.

Shortcomings in the book are few and usually amount to legitimate differences of judgment or opinion. Benson sometimes fails to use the latest data available, and ignores the best estimates, say, for the probability of prosecution on arrest. Sometimes he attributes facts like exclusionary rules to the statist nature of the justice system too quickly, ignoring competing hypotheses like rent-seeking by lawyers.

Clearly, the crime solution lies in more individual responsibility and less public responsibility. Benson's daring conclusion—privatize both the demand for and the supply of criminal justice services—leaves us with a wealth of provocative diagnoses and examples for further research. Benson has given us a breakthrough book. □

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Seeing Like a State: How Certain Schemes to Improve the Human Condition Have Failed

by James C. Scott

Yale University Press • 1998 • 445 pages • $35.00

Reviewed by Aaron Steelman

Amazing progress has been made in the twentieth century. The Western world has grown tremendously rich, and many developing countries around the world have "emerged." Today, most people enjoy living conditions that their ancestors could have only dreamed about.

But the twentieth century has also witnessed horrific brutality. Millions have been killed in wars. And an even greater number, perhaps, have been killed by their own governments in the name of "progress." What has been the source of such inhumanity?

In *Seeing Like a State*, Yale political scientist James C. Scott examines "the failure of some of the great utopian social engineering schemes of the twentieth century." He argues that "the most tragic episodes of state-initiated social engineering originate in a pernicious combination of four elements."

First, Scott argues, are "transformative state simplifications," that enable the state to easily track and classify its citizens. This includes the creation of permanent last names, population registers, and the standardization of language.

Second is what Scott calls "high-modernist" ideology. "It is best conceived," he writes, "as a strong, one might even say muscle-bound, version of the self-confidence about scientific and technical progress, the expansion of production, the growing satisfaction of human needs, the mastery of nature (including human nature), and, above all, the rational design of social order commensurate with the scientific understanding of natural laws." National economic planning during World War I excited high-modernist theorists and led them to believe that society actually could be run by enlightened technocrats.

The third element is an "authoritarian state that is willing and able to use the full weight of its coercive power to bring these high-modernist designs into being." Such regimes often gain power during times of war, revolution, depression, and struggle for national liberation.

The last element is a "prostrate civil society that lacks the capacity to resist these plans."

"In sum," Scott writes, "the legibility of a society provides the capacity for large-scale social engineering, high-modernist ideology provides the desire, the authoritarian state provides the determination to act on that desire, and an incapacitated civil society provides the leveled social terrain on which to build." When those four elements are present, the stage is set for the likes of Hitler, Stalin, and Pol Pot—and for the forced villagization of 5 million Tanzanians in the 1970s, a lesser-known tragedy that Scott recounts in a fascinating chapter.

High-modernist ideology, Scott points out, manifests itself in less disastrous ways, too. Consider centrally planned cities. Traditionally, cities have grown naturally to fit the desires and needs of their citizens. The streets of many European and Middle Eastern cities don't fit a grid-like pattern: they sprang up as the population grew and moved. To a resident, everything makes sense. But to a government official who thinks he knows best, it appears chaotic. Surely, a planned city would be much better than one developed seemingly by chance.

Such was the mindset of architect Charles-Edouard Jeanneret, better known as Le Corbusier. He wished to redesign Paris, Buenos Aires, Algiers, and Moscow according to his own plans. He argued, "We must refuse to afford even the slightest concession to what is; to the mess we are in now. There is no solution to be found there." He envisioned a world, Scott writes, in which "door frames, windows, bricks, roof tiles, and even screws would all conform to a uniform code. [Le Corbusier] called for the new standards to be legislated by the League of Nations, which would develop a universal technical language to be compulsorily taught throughout the world."

In the end, Le Corbusier built only one city, a provincial capital in India. Scott notes, however, that he influenced many people, including Brazilian president Juscelino Kubitschek. Kubitschek created the city of Brasilia from scratch and made it the country's capital. Originally, there was one huge public square, but few informal gathering places such as parks, and all its residents were supposed to live in uniform housing projects called "superquadra," which had their own nurseries, schools, stores, and clubs.

The planned city quickly failed; people found life in it undesirable and stifling. Now, most of the population lives in settlements that were never anticipated by Brasilia's planners. High-modernist ideology didn't result in mass slaughter in the case of Brasilia, but it did produce great unhappiness. People didn't want what the planners tried to force on them. The planners weren't able to acquire the "practical knowledge," as Scott calls it, to pull off such a grand scheme. They were ignorant of "the limits . . . of what we are likely to know about complex, functioning order."

This is excellent analysis, but unfortunately, Scott thinks "large-scale capitalism" suffers from similar defects. It "is just as much an agency of homogenization, uniformity, grids, and heroic simplification as the state is . . . . [I]n markets, money talks, not people," he argues. But when I decide to eat breakfast at McDonald's, who is making the decision? I am. I'm using money to buy the meal, but I'm the one doing the talking. In the market, producers cater to the consumers' desires—not the other way around. Scott fails to grasp that point. Nevertheless, *Seeing Like a State* is a brilliant work of remarkable scope. □

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Silencing Science

by Steven Milloy and Michael Gough

Cato Institute • 1998 • 68 pages • $8.00 paperback

Reviewed by Kenneth Silber

This slim volume is an ironic how-to guide for heavy-handed regulators, panic-mongering activists, demagogic politicians, venal trial lawyers, dogmatic religionists, and anyone else with an interest in stifling or manipulating science. In breezy style, the authors explain how to impede research and suppress data, using lawsuits, regulation, intimidation, and other methods. They also show how to fill the resulting void with misinformation.

The authors—Milloy is publisher of the Junk Science Home Page (www.junkscience.com); Gough is the former director of science and risk studies at the Cato Institute—draw on numerous examples of science under siege. They present the persecution of Galileo as a cautionary tale (the Inquisition didn't crack down quickly enough to eliminate his influence) and cite the Scopes Monkey Trial as a useful model for interfering with science education. They then launch into more recent anecdotes of obscurantism and obstructionism. Unfortunately (or fortunately, if one remains in the book's ironic mode), there are many ways to silence science.

Outlawing research is one option, the authors explain, pointing to efforts to place a wide-ranging ban on cloning experiments. Alternatively, science can be regulated into the ground, as when the Environmental Protection Agency moved to control pest-resistant plants as if they were pesticides. Government purse strings can be useful in tying up undesired research, such as fetal tissue studies during the Reagan-Bush years. Nor is privately funded science immune to political attack; one need only stigmatize the research as profit-driven or linked (however tenuously) to Big Tobacco.

Legal harassment works well, too. The authors describe how lawyers representing the alleged victims of silicone breast implants intimidated the Mayo Clinic with onerous demands for medical records. Another form of harassment is to make bogus claims of scientific misconduct; this approach was used by "multiple chemical sensitivity" activists against researchers who raised doubts about that "disease." And don't forget about street protests and celebrity letter-writing campaigns; such techniques helped animal-rights proponents prevent NASA from studying monkeys in orbit.

Even after a research project has been completed, there are various ways to hide or distort the resulting information, the authors point out reassuringly. Careful editing, for instance, allowed a United Nations report to overstate the threat of global warming. Another method is simply not to publish the data; the Energy Department has kept a major radiation study under wraps for years, providing only a brief summary in an obscure bulletin. California's environmental agency went this one better, systematically destroying research documents that did not support the agency's final decisions.

The authors explain how to replace genuine science with various phony substitutes, such as "official science," "consensus science," and "the precautionary principle." The first consists of governmental or other seemingly authoritative pronouncements that happen to be unsupported by evidence, such as a U.S. Senate resolution that women in their 40s should have mammograms. The second involves claiming that there is agreement when in fact there is not, as occurs often in the global-warming debate. The precautionary principle, embraced by environmentalists, means that industrial chemicals and radiation are to be regarded as extremely dangerous, while contrary evidence and uncertainties are swept under the rug.

While *Silencing Science* takes a lighthearted approach, the underlying seriousness of the subject shines through. The suppression of science—whether motivated by politics, ideology, or personal and financial gain—produces bad decision-making, increased risk, and diminished freedom. One comes away from this book with a heightened awareness of danger—a danger not only to scientists but to anyone who depends in any way on their research (everyone, that is, whose participation in modern society exceeds that of, say, the Unabomber).

The book's format does impose certain constraints. The "how-to" approach, while funny, would start to wear thin if the book were to go on much longer; at the same time, the overall subject deserves a more extensive treatment. A somewhat broader picture of the threats to science would take notice of academic postmodernism and New Age mysticism, movements that go unmentioned here. A deeper analysis, rather than merely reporting anecdotes, would delve into the conditions that enable anti-scientific tactics to thrive.

Nevertheless, *Silencing Science* packs a great deal of valuable and thought-provoking material into its slender frame. The book deserves a wide readership. May that readership not include the anti-science types who might actually take its advice. □

Kenneth Silber has written about science and technology for Reason, Insight, the New York Post, *and other publications.*

Staring into Chaos: Explorations in the Decline of Western Civilization

by B. G. Brander

Spence Publishing • 1998 • 418 pages • $29.95

Reviewed by Gleaves Whitney

The right is temperamentally pessimistic. The left is philosophically nihilistic. Both camps have long tended to see the West as culturally decadent, a civilization in decline. So it is odd that, for decades, virtually every major English-language reference work in the social sciences included articles about progress, but not its opposite. It was as though Americans were reluctant to give the imprimatur to decadence and decline as major categories of thought. One had to look to the French for scholarship on decadence—perhaps because they have had more firsthand experience with it than Americans.

Only in recent years has cultural pessimism received the attention it deserves on this side of the Atlantic. After all, one cannot do serious intellectual history without confronting the pessimism of Nietzsche, Burckhardt, Darwin, and legions of other theorists of decline since the Renaissance. Their works are so numerous as to constitute a veritable type of literature, what I call the "decline-of-the-West" genre.

Because English-language surveys of that genre have been few and far between, it is a pleasure to discover B. G. Brander's most recent book, *Staring into Chaos: Explorations in the Decline of Western Civilization*. Brander is a full-time writer and a former editor for *National Geographic*—not the typical credentials for a student of cultural pessimism. Yet it is precisely because Brander is a layman who has escaped the perils of academic specialization that he is able to read the classic statements of the decline of the West from a fresh perspective.

Brander is clear about his purpose from the outset, and readers should be too. He aims to "distill the insights of more than two-dozen thinkers into this single volume. . . . Where writers contributed whole books on the topic, I offer concise digests of their works." Thus Brander's book, while not categorized as such, functions as a reference work that will give readers a crash course in the decline-of-the-West literature.

Early chapters introduce notions of cultural decadence and civilizational decline in the thought of Albert Schweitzer, Nikolai Berdyaev, Ernst von Lasaulx, Nikolai Danilevsky, and Henry and Brooks Adams, among others. Brander then trains his sights on three twentieth-century giants of the genre—Oswald Spengler, Arnold Toynbee, and Pitirim Sorokin (to whose memory the book is dedicated). In some 400 pages of text, Brander devotes about 100 pages to each one of these three, ably surveying their works and making them accessible to the educated lay public.

Readers of this magazine will find much of interest in all three, but perhaps most of all Sorokin because of his concern over the fate of freedom and the rule of law. Sorokin, a Harvard sociologist, was already arguing in the 1930s that the West was undergoing one of the greatest transitions in history. Brander encapsulates some of Sorokin's predictions: "Governments will turn increasingly fraudulent and tyrannical. Contracts and covenants will lose binding power and contractual society will collapse. Democracy, capitalism, and [our] free society of free people will be swept away. Freedom will become a mere myth for the majority of people, whom centralized governments will deal with as puppets. Meanwhile, the dominant majority will turn their freedom into unbridled licentiousness." And this: "Private educational institutions will lose autonomy from government control and diminish in favor of public or state-controlled schools." Prescient.

One question that inevitably arises in a survey is why certain thinkers were not included or were given only cameo roles. Christopher Dawson, for example, qualifies as one of the twentieth century's most insightful historians and theorists of decline. Brander, however, cites him only once in the text, and then fleetingly, and lists none of his books in the bibliography. Perhaps this oversight will be addressed in a later edition.

As we approach the millennium, many will seek to understand the signs of the times; many will have premonitions of decline. They would do well to go behind the culture wars of the present day and seek perspective through the provocative historical and social analysis of these giants. In Brander, they will find a competent and congenial guide. □

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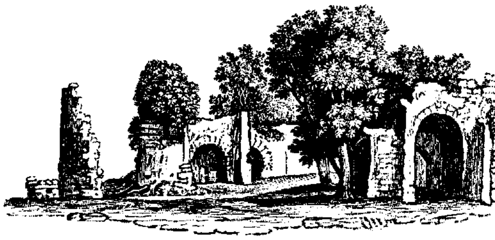

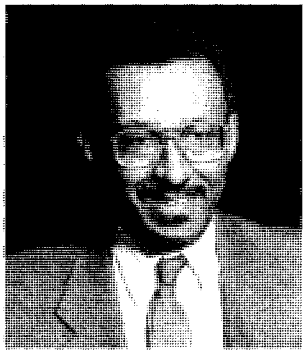

Conflicting Visions

People generally share common goals. Most of us want: poor people to enjoy higher standards of living, greater traffic safety, fewer wars, greater racial harmony, cleaner air and water, and less crime.

Despite their common goals, more often than not we see people grouped into factions, fighting tooth and nail to promote differing government policies. The policies are often unproductive and have the unintended consequence of sabotaging the goal.

A good example of this conflict is found in the periodic debates over the minimum wage and tariffs. Many people profess concern for the welfare of low-skilled workers. To achieve their goal of helping those workers, one group adamantly demands that Congress legislate higher minimum wages. Another group professing the identical concern is just as adamant in demanding that Congress *not* legislate higher minimum wages. Similarly, one group of advocates for greater employment opportunities might lobby Congress for higher tariffs and stricter quotas on imports. Another group sharing the identical goal will fight against tariffs and quotas and lobby for fewer trade restrictions.

Why do people, who are assumed to be honest, intelligent, selfless, and not motivated by a hidden agenda, arrive at polar-opposite policy proposals as a means to achieve commonly shared goals that may indeed produce polar-opposite results? One possible explanation in the case of unions and companies seeking protection from imports is that they are dishonest and simply promoting their own interests. Their political strategy is to express concern for the unskilled and to lobby for greater employment opportunities simply as a ruse to conceal their true agenda: higher wages, profits, and monopoly wealth.

But there's another answer. They share different visions of how the world works. Consider the effects of different visions by going back to a time prior to Pythagorean and Ptolemaic proofs that the earth was round. Imagine two honest and intelligent people in 1000 B.C. One person's premise is that the earth is flat. Based on that premise, he would argue strenuously that it is not possible to sail west from Greece and reach the Orient. The other person, whose premise is that the world is round, would argue just as strenuously that it is possible to reach the Orient by sailing west from Greece.

Given the premise, the conclusions (one can or cannot reach the Orient by sailing west from Greece) are internally consistent and logical. After all, if the world is flat, one would sail right off the edge and into the abyss before reaching the Orient. On the other hand, if the earth is round, the trip can be safely made. Incidentally, before one condemns the flat-earth vision it should be noted that, while inaccurate, it was nonetheless useful, providing reliable navigation over relatively short distances.

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Of course, the flat-earth vision was ultimately laid to rest when people actually circumnavigated the globe. Also, scientific evidence and simple empiricism weighed in to settle the debate. People saw that the shadow of the earth on the moon during eclipses was round, and they also saw that the mast of a ship approaching from the sea is visible before the hull. The incorrect vision about the shape of the earth was demolished by falsifying its premise—not by questioning the internal consistency of the arguments.

Often the underlying premises supporting the conclusions of some arguments are so baseless they are deliberately left unstated. In these cases, they must be teased out by questions such as: for that conclusion to hold, what assumptions are being made about human behavior? Consider the minimum-wage debate. Assuming that both proponents and opponents of higher minimum wages are guided solely by an honest concern for low-wage, low-skilled workers, what is the premise held by those who favor increases in the minimum wage versus that held by opponents? If one's premise (stated or not) is that employers need a certain number of employees to do a particular job, the logic behind increasing the minimum wage as a means to raise incomes of low-skilled workers is internally consistent. The effect of a higher minimum wage would be higher wages for workers and lower profits for employers.

Opponents of higher minimum wages have a different premise. They assume that employers are responsive to changes in labor costs. They believe that there are alternative methods to accomplish a particular task. Employer responses to higher labor costs might include: substitution of capital for labor (automation), employment of self-service techniques (such as self-service gas stations), relocation to a country that has cheaper labor, use of disposable utensils instead of washable ones, fewer theater ushers, and automatic elevators. These and many other substitutes allow employers to economize on labor and produce fewer employment opportunities for low-skilled workers.

The vision that higher mandated wages (that exceed productivity) produce no employment effects also assumes that investors are insensitive to the company's profits and customers are insensitive to higher product prices. Neither is likely. If companies are required to pay higher wages and make no response they will see their profits decline relative to companies that do respond. In turn, investors will see a reduction in their return on equity and will likely move their capital elsewhere.

The company might try to forestall declining profits by attempting to recover higher labor costs by raising product prices. However, consumers are not insensitive to higher prices. They will seek cheaper substitutes, thereby reducing the company's sales. In the wake of higher minimum wages, surviving companies will be those that have found ways to economize on labor.

Zero Elasticity of Response

The premise that employers are not responsive to changes in the cost of labor is what economists call a zero elasticity of response. Put another way, changes in the independent variable (wages) have no effect on the dependent variable (the number of workers hired). There is little evidence that people are insensitive to price changes, whether it be changes in taxes, gas prices, food prices, labor prices, or any other price. The issue is not whether people change their behavior when relative prices rise or fall; it is always how soon and how great the change. Thus with minimum-wage increases it is not an issue of whether firms will economize on labor, it is how much they will economize and who will bear the burden of that economizing.

Thus, it is easy to see how two groups of honest and caring people with the same concern for low-skilled, low-wage workers can advocate opposite policies. They simply have different visions of how the world works. Convincing people how the world really works, in the hopes of promoting better policies, requires examining and debunking false visions and premises—a yeoman's task. □