THE FREEMAN
IDEAS ON LIBERTY

VOLUME 62, NO 2 MARCH 2012

Features

6 **How Government Distorts Labor Markets** *by Robert P. Murphy*

10 **The Politics of Health Care Rationing** *by Chidem Kurdas*

16 **Why the Titanic Is Sinking** *by James L. Payne*

19 **Never Mind the Gap** *by Max Borders*

25 **Of Constituents and Clans** *by Richard W. Fulmer*

28 **The Smoot-Hawley Tariff and the Great Depression** *by Thomas C. Rustici, Theodore Phalan, and Deema Yazigi*

35 **The Best Bet Is Freedom** *by Jason Riddle*

37 **The Volcker Rule** *by Warren C. Gibson*

Page 10

Columns

2 **Perspective ~ Lawrence O'Donnell and Government Job-Creation** *by Sheldon Richman*

4 **The Buffett Rule Will Create Jobs? It Just Ain't So!** *by Roy Cordato*

14 **Our Economic Past ~ Are We Looking at the Wrong Depression?** *by Stephen Davies*

23 **Peripatetics ~ Fearing Hayek** *by Sheldon Richman*

33 **The Therapeutic State ~ Who Killed Michael Jackson?** *by Thomas Szasz*

41 **Give Me a Break! ~ Obamacare Abominations** *by John Stossel*

47 **The Pursuit of Happiness ~ The Case Against Sanctions on Iran** *by David R. Henderson*

Page 23

Book Reviews

42 **Adam Smith: An Enlightened Life**
by Nicholas Phillipson *Reviewed by Martin Morse Wooster*

43 **Homeschooling: A Hope for America**
edited by Carl Watner Reviewed by Karen Y. Palasek

44 **The Cultural and Political Economy of Recovery: Social Learning in a Post-Disaster Environment**
by Emily Chamlee-Wright *Reviewed by Daniel J. D'Amico*

45 **Handbook on Contemporary Austrian Economics**
edited by Peter J. Boettke *Reviewed by George Leef*

Page 42

THE FREEMAN

Published by
The Foundation for Economic Education
Irvington-on-Hudson, NY 10533
Phone: (914) 591-7230; E-mail: freeman@fee.org
www.fee.org

FEE The Foundation for Economic Education (FEE) is a nonpolitical, nonprofit educational champion of individual liberty, private property, the free market, and constitutionally limited government.

The Freeman is published monthly, except for combined January-February and July-August issues. Views expressed by the authors do not necessarily reflect those of FEE's officers and trustees. To receive a sample copy, or to have *The Freeman* come regularly to your door, call 800-960-4333, or e-mail mnolan@fee.org.

The Freeman is available electronically through products and services provided by ProQuest LLC, 789 East Eisenhower Parkway, PO Box 1346, Ann Arbor, Michigan 48106-1346. More information can be found at www.proquest.com or by calling 1-800-521-0600.

Perspective

Lawrence O'Donnell and Government Job-Creation

The commercial seems like a parody, but that sure *looks* like Lawrence O'Donnell of MSNBC's "Last Word." In the spot O'Donnell mocks politicians who say that "government can't create jobs."

"The government created *your* job!" O'Donnell fires back, smiling triumphantly.

Imagine: In a battle of wits with a phantom politician, O'Donnell lost. Of course he doesn't know it.

On the off-chance this is not a "Saturday Night Live" bit, let's take a closer look.

First—I don't even know where to start—it's so ridiculous. How about this? The claim that government can't create real jobs *is not refuted by the existence of politicians*. Must that really be explained?

Perhaps O'Donnell would applaud a proposal to make every adult American a member of Congress, paid a salary drawn on the Federal Reserve. Unemployment would vanish overnight.

But maybe that wouldn't satisfy him. He might want at least some people working to make useful things. What do politicians make? Besides messes, that is.

But what things? Here's where it gets tricky. Alas we live in a world of scarcity. People making widgets can't also be making wudgets (a similar but not identical product). Should the government create widget-making jobs or wudget-making jobs? Neither? Some of each? How many? And how would the program administrators even go about making the decision?

In a freed market a process exists for answering those questions. Prices generated by free consumer purchases and producer competition for inputs guide decisions about what to make, how to make it, and in what quantities. In contrast, government "job creation" is like flying in a heavy fog without instruments: Prices—what Ludwig von Mises called the tools of economic calculation—are absent.

It has to be said yet again: In economic terms a "job" is not mere physical or mental exertion for which one gets paid. As someone once put it, "A thing cannot have value, if it is not a useful article. If it is not useful, then the labor it contains is also useless, *does not count as labor*, and hence does not create value" (emphasis added).

Karl Marx said that. Yes, Mr. O'Donnell, Karl Marx understood that exertion aimed at making things no one wants is not real labor. When I say "things no one wants," I don't mean intrinsically useless things. In a world of scarcity, if we consumers believe we have enough widgets but not enough wudgets, then efforts to produce more widgets at the cost of wudgets are counterproductive. Inputs are transformed into things we want less badly (if at all) than other things those inputs could have been transformed into. Value is destroyed when it could have been created.

Admittedly it is technically wrong to say, "Government cannot create jobs." We must concede there is some slim chance that a government program could finance a project that would have been undertaken in the freed market. But it would be pure luck, and we couldn't know for sure it had happened even after the fact because government, which procures its resources at the point of a gun and doesn't have to offer its "services" to consumers free to say no, faces no market test.

Persistent high unemployment does not demonstrate a need for government to create jobs. On the contrary, it demonstrates a need for government to get out of the way so the market process can undergo the correction called for by the earlier government-induced boom, which itself was an unsustainable jobs-creation program. Politicians aggravate an already bad situation when they generate a tax and regulatory environment in which anything can happen.

* * *

The Austrian theory of the business cycle famously blames the inflationary boom for causing malinvestment in the capital structure. What's less often noticed is that the boom also creates a mismatch between the type of labor supplied and the type demanded. Robert Murphy explores this aspect of the business cycle.

Unless the Supreme Court invalidates Obamacare, the multifaceted law will soon be kicking in. Medical rationing, Chidem Kurdas says, is in our future.

With government spending out of control, the search for ways to rein it in goes on. James Payne has a suggestion to at least get people thinking about what underlies all government spending.

One thing on the minds of Occupy Wall Street protesters is the income gap between the superrich and the rest of us. Is this something advocates of freedom need to be concerned about? Max Borders takes a close look.

James Madison's warning about contentious factions is often invoked. But despite his prediction a large-scale republic did not prevent special interests from using the levers of power to obtain privileges at the expense of the people. Richard Fulmer ruminates on corruption in America.

More than 80 years later a debate still rages over the infamous Smoot-Hawley Tariff's role in the Great Depression. Was it a major or minor factor? Or none at all? Thomas Rustici, Theodore Phalan, and Deema Yazigi make their own assessment.

Politics and Las Vegas casinos are filled with zero-sum games. Losers provide the winners with their rewards. Not so in the free market, says Jason Riddle.

The new Dodd-Frank financial regulations feature the Volcker Rule, proposed by a former Federal Reserve chairman. What's the rule about, and is it a good idea? Warren Gibson takes us through the maze.

Our columnists are on point as usual. Stephen Davies thinks people compare the current economic quagmire to the wrong past depression. Thomas Szasz explores self-responsibility and the law in celebrity drug deaths. John Stossel asks businesspeople about the costs of Obamacare. David Henderson wonders about the wisdom of economic sanctions against Iran. And Roy Cordato, encountering the claim that the Buffett Rule for taxing the rich will create jobs, responds, "It Just Ain't So!"

Book reviews this issue cover Adam Smith, homeschooling, post-disaster recovery, and Austrian economics.

—*Sheldon Richman*
srichman@fee.org

The Buffett Rule Will Create Jobs? It Just Ain't So!

BY ROY CORDATO

In the Raleigh *News and Observer* last fall (tinyurl.com/84b7r43), David McAdams, associate professor of economics at Duke University's Fuqua School of Business, claimed—contrary to even Keynesian economics—that President Obama's proposed tax on millionaires would create jobs. The so-called Buffett rule, named after billionaire investor Warren Buffett, is supposed to ensure that "millionaires and billionaires" pay no smaller a percentage of their income in taxes than a middle-income family.

In a perverse twist on supply-side analysis of how marginal tax rates affect economic growth, McAdams argues that the Buffett rule, while forcing very-high-income individuals to pay more in taxes, would lower their marginal tax rate, stimulate investment, and hence create jobs. In reaching this odd conclusion, McAdams shows a level of understanding of tax analysis that is shockingly pedestrian, if not sophomoric, particularly for a professor at one of the most prestigious business schools in the world. (McAdams is not a professor in Duke's highly respected economics department.)

McAdams illustrates his argument with the following example:

> Consider . . . a millionaire whose income consists of \$1 million in capital gains and \$100,000 from a chain of hot dog stands. This millionaire pays taxes of 15 percent on capital gains and 35 percent on net income from the hot dog stands, for a total of \$185,000 (\$150,000 plus \$35,000). This amounts to an average tax rate of 16.8 percent, less than the 25 percent marginal rate paid by many middle earners.
>
> Under the Buffett rule he would have to pay 25 percent of all income in taxes, for a total of \$275,000. However, he would be keeping 75 cents of every additional dollar generated by the hot dog stands, compared with 65 cents of every dollar without the Buffett rule. So this millionaire would have more incentive to expand his hot dog business, hire more workers, and so on. For the millionaires it would apply to, the Buffett rule would effectively cut marginal tax rates 10 percentage points even as it raises the overall tax burden.

McAdams shows a level of understanding of tax analysis that is shockingly pedestrian, if not sophomoric.

Let's assume for the moment that his example is analytically correct—which it is not—and the millionaire's marginal tax rate for the year in question is lowered from 35 percent to 25 percent. This result is completely an artifact of the hot dog vender's particular situation during that tax year, and he could not have known about it in advance. In other words he doesn't know that his marginal tax rate will be 25 percent going into the tax year. He discovers it only after the fact, when he does his taxes or, at best, speculates that it might be the case as the year draws to a close.

For the marginal rate of 25 percent to function as an economic incentive, a person would have to know that his investments are going to generate a million dollars

Roy Cordato (rcordato@johnlocke.org) is vice president for research and resident scholar at the John Locke Foundation in Raleigh, N.C.

in capital gains before the market actually does so. In fact he would need to know that this would continue to be the case for a considerable length of time. But obviously this knowledge is not available to anyone.

This millionaire-for-a-year hot dog stand owner would never make expansion decisions based on the expectation of a continued marginal tax rate of 25 percent. In fact the only reasonable thing for him to do would be to base his future investment on the (presumed) statutory marginal rate of 35 percent. McAdams seems not to understand the difference, in terms of incentives, between an *ex ante* marginal tax rate, which is all that matters, and an *ex post* marginal tax rate, which matters not at all. The fact that he conflates these two does not bode well for students at Duke's Fuqua School.

For a lower marginal tax rate to function as an economic incentive, a person would have to know in advance what his investments were going to generate.

Marginal vs. Average Rates

What is just as troublesome is that he confuses marginal and average tax rates. Before giving his example McAdams states:

> [B]ut suppose "middle-class families" pay 25 percent of their income in taxes, which is the marginal tax rate for many middle-income earners. If a "millionaire" already pays more than 25 percent of his income in taxes, the change won't affect him. But a millionaire whose income derives from both capital gains, taxed at just 15 percent, and business income, taxed at a marginal rate of 35 percent, may well be paying less than 25 percent of his total income in taxes—and therefore would pay more under the Buffett rule.

While McAdams is correct in saying that the *marginal* tax rate for middle-class families is about 25 percent, it does not mean those families "pay 25 percent of their income in taxes." With a progressive income tax, the marginal rate is the percentage paid on the last increment of taxable income, not the rate paid on total income. A middle-class family pays 10 percent on the first $12,149 of taxable income and 15 percent on income from $12,150 to $46,250. The 25 percent bracket applies only to taxable income between $46,250 and $119,400, after which the marginal rate goes to 28 percent.

Thus a family facing a 25 percent marginal rate would not pay anything like 25 percent of its total income in taxes, as McAdams asserts. On an income of $75,000, the average rate would be 18 percent. As I said, this is a sophomoric mistake.

The same would be true for the hot dog vendor earning $100,000. McAdams confusingly claims the vendor would face a 35 percent marginal tax rate—wrong again—and pay $35,000 in taxes on the $100,000. Once again McAdams confuses marginal and average tax rates. Furthermore, not only is McAdams wrong about the amount paid by the vendor, he also gets the marginal rate wrong. In fact he's off by two whole tax brackets and possibly three. A single person earning $100,000 in taxable income faces a marginal tax rate of 28 percent, not 35 percent, and if that vendor is a family man, making it an apples-to-apples comparison with the "middle-class family," his marginal rate would be 25 percent. Because there is not enough information provided, it is impossible to go back to McAdams's example and plug in the actual rates to see how far off his numbers really are.

Suffice it to say that when people write about taxation and job-creation incentives, they really should make sure they know what they are talking about. FEE

How Government Distorts Labor Markets

BY ROBERT P. MURPHY

In a recent post at the ThinkMarkets blog (tinyurl.com/cld8pbm), *Freeman* author Gerald P. O'Driscoll cited Union Pacific Railroad's labor woes as an example of the mismatch between the skills workers possess and the skills potential employers are seeking. O'Driscoll argues that there has been an unsustainable boom in "human capital" characterized by massive malinvestments, just as Austrian economists typically claim for physical capital goods. This perspective is a useful antidote to the Keynesian analysis of our current slump and leads to radically different policy recommendations.

O'Driscoll based his post on a *Wall Street Journal* report that referred to "survey results showing that 83 percent of manufacturers reported a moderate or severe shortage of skilled production workers. . . . Wages for skilled labor are rising, in some cases at double-digit rates."

There has been an unsustainable boom in "human capital" characterized by massive malinvestments.

He noted: "Malinvestment in labor markets is the counterpart to malinvestment in capital goods. Higher education is a bubble, and colleges churn out graduates with degrees that have no application in the workplace. Student borrowing to acquire such degrees is malinvestment in the same way that construction loans to build homes in Las Vegas was malinvestment."

And here is his policy conclusion: "There is no mechanism by which lowering interest rates ('monetary stimulus') or spending money on public workers ('fiscal stimulus') is going to cure the problem. Labor mismatch is a manifestation of a coordination failure. . . . It is a microeconomic problem."

O'Driscoll's remarks underscore the stark theoretical contrast between today's Keynesians and Hayekians as they approach "macro" problems, notwithstanding recent claims by Paul Krugman and others that Hayek's contributions to the field were insignificant. (See pp. 23–4 for details.)

Today's economic problems do not emanate primarily from a shortfall in aggregate spending but rather from a poor synchronization among all the millions of individual productive inputs (including labor) that typically interact seamlessly to support our fantastic standard of living. Once we recognize this as the fundamental problem, the standard Keynesian medicine turns out to be not merely a placebo but a poison.

In the traditional exposition by Ludwig von Mises and F. A. Hayek, the Austrian theory of the business cycle explains recessions as the inevitable consequence of a preceding inflationary boom. The boom occurs when the commercial banks (nowadays acting in concert with the central bank) issue new loans even though the public isn't saving more, thereby increasing the quantity of money and driving the interest rate below its "natural" level. The lower interest rates—"cheap money"—foster a feeling of euphoria, as businesses invest more and households consume more.

The Austrians argue that the boom is illusory because the banks can't create genuine resources sim-

Robert Murphy (rpm@consultingbyrpm.com) is an adjunct scholar of the Ludwig von Mises Institute and the author of The Politically Incorrect Guide to the Great Depression and the New Deal.

ply by extending loans on their balance sheets. If the economy had previously been in a sustainable equilibrium, it will now be "growing" on an unsustainable trajectory.

When mainstream economists hear the Mises-Hayek explanation of the boom-bust cycle, they often characterize it as an "overinvestment theory." Yet Mises himself took pains in *Human Action* (chapter 20) to clarify that this wasn't the case:

> The erroneous belief that the essential feature of the boom is overinvestment and not malinvestment is due to the habit of judging conditions merely according to what is perceptible and tangible. The observer notices only the malinvestments which are visible and fails to recognize that these establishments are malinvestments only because of the fact that other plants—those required for the production of the complementary factors of production and those required for the production of consumers' goods more urgently demanded by the public—are lacking.

Mises goes on to make his famous analogy, which remains the best metaphor yet for his theory:

> The whole entrepreneurial class is, as it were, in the position of a master builder whose task it is to erect a building out of a limited supply of building materials. If this man overestimates the quantity of the available supply, he drafts a plan for the execution of which the means at his disposal are not sufficient. He oversizes the groundwork and the foundations and only discovers later in the progress of the construction that he lacks the material needed for the completion of the structure. It is obvious that our master builder's fault was not overinvestment, but an inappropriate employment of the means at his disposal.

In a standard neoclassical growth model we could meaningfully speak of "overinvestment" leading to suboptimal results. Specifically, if people for some reason (perhaps because they were cajoled by government policies) save a higher fraction of their income than they would have chosen in a neutral setting, then capital goods will accumulate at a faster rate, and gross domestic product (GDP) will grow at a faster rate.

However, this outcome is a bad thing—as judged by the real preferences of the households in the model—because the higher investment and faster growth are achieved at too high a price in forfeited consumption in the present and near future. If an eccentric gangster has a standing threat to blow up a family-owned business unless it reinvests 99 percent of the profits for ten years straight, on paper the business may actually prosper, but the family members are clearly harmed by the arrangement.

Yet this type of overinvestment isn't at all what Mises and Hayek have in mind when discussing the unsustainable boom. As the quotations from Mises illustrate, the fundamental problem is *not* that society (during a boom) leans too heavily to the left side of the investment/consumption spectrum. Rather the problem is that *the investments are not in sustainable lines*.

The fundamental problem is not that society (during a boom) leans too heavily to the left side of the investment/consumption spectrum. Rather the problem is that *the investments are not in sustainable lines.*

The Wrong Tools

To give an exaggerated example, mainstream economists—by classifying the Austrian theory as one of "overinvestment"—have in mind that businesses produce too many tools and not enough pizzas. Yet *this* type of mistake wouldn't require a recession; it would simply mean that consumers would be trading off present enjoyments (which they valued more, by stipulation) for a higher income in the future made possible by the productivity-enhancing tools.

Rather than being about making too many tools and not enough pizzas, the Austrian story is more about businesses producing tools consisting only of thousands of screwdrivers and millions of nails. For a short while, especially if we just focused on a few of the factories, such an absurd economy would seem very "productive" indeed, poised on the verge of explosive growth. But from a systemwide perspective it is obvious this economy would soon collapse once its existing tools wore out and workers had to rely on the new batch. When the crisis occurred it would be wrong to characterize the problem as one of "too much investment in tools." The fundamental problem would be *malinvestments* in the *composition* of the stock of new tools.

Idle Resources

Because they lack the Austrian emphasis on the structure of production, Keynesian economists look at idle resources, or "excess capacity," during a recession and see pure waste. Of *course* the market economy is malfunctioning if factories are running below capacity and especially if workers are sitting at home watching TV. This is why (the Keynesians claim) a recession calls for expansionary fiscal and monetary policies to increase aggregate spending and put those resources back to work.

Notwithstanding the tragedy of high unemployment, it is a necessary consequence of a preceding inflationary boom.

This simple-minded view is dead wrong in light of the Austrian explanation. Continue with Mises's master builder, who embarks on construction of a house using blueprints that rely on an erroneous brick count. When the builder discovers his error—he realizes he only had 18,000 bricks in the beginning instead of the 20,000 called for by the blueprints—what will be his immediate reaction? He will yell, "Everybody stop working!"

The reason for this immediate stop order is clear. If every worker continued in what he had been doing, the dwindling stocks of various resources (bricks, shingles, nails, window panes, and so on) would have been transformed into less "liquid" items. The builder obviously has to adjust the blueprints in light of the new information; it is physically impossible to complete the house as originally conceived. Therefore he needs to halt all activity until he decides the best way to deploy the remaining inputs, all things considered.

Reintegration

Eventually more and more of the workers can gradually resume activity, but many of them won't be doing *exactly* what they were doing before, and some of them might be doing very different tasks. Also, some of the workers who were highly specialized might not be needed at all for the remainder of the project. It made sense for them to show up at the site based on the *original* blueprints, but after the necessary revisions the master builder realizes these particular workers serve no role.

The analogy with a modern economy should be clear. When an unsustainable boom collapses there is an initial surge in unemployment of both human and physical resources. Gradually—especially if the government leaves the market process to operate freely—more and more resources are reintegrated into the (revamped) structure of production. The process unfortunately might be agonizingly slow for some resources and workers with highly specialized skills.

Notwithstanding the tragedy of high unemployment, it is a necessary consequence of a preceding inflationary boom. Austrians stress that the *boom* is the problem; the *bust* is ironically the cure. Like many types of medicine, recessions are not nearly as enjoyable as the activities that brought on the calamity.

Considerations such as these led O'Driscoll to describe our current economic woes as "microeconomic." Think again of the master-builder analogy. Before the discovery of his mistaken brick count the problem wasn't that the builder was "building too aggressively." It was that he was building a house with the wrong proportions. Then, after the discovery of his mistake, the problem wasn't that the builder was "building too timidly." Instead, the problem—if we want to call it that—was that the remaining stocks of usable resources were ill-suited to complete the half-finished house.

In the master-builder metaphor the analog of expansionary policies would be to reassure the builder that his brick count is accurate after all. For example, a subordinate might not want the workers to "lose morale" and so he might keep moving tarps around, covering up the dwindling brick supply and lying to the master builder about how many remain. This would keep the "good times" rolling, at least for a while. Yet it will just make the crisis that much worse when it finally arrives, as it must. Moving tarps around can't create more bricks, just as moving bad loans around with TARP can't create more physical resources.

We've seen that even the canonical exposition of Austrian business cycle theory involved labor, as it must if it is to explain high unemployment. However, the typical Mises/Hayek story focused on malinvestments in *physical* capital goods, which eventually led to high unemployment in the labor market. The twist O'Driscoll gives is that the original malinvestments during the boom period might themselves be in "human capital."

Some of the brightest minds on the planet literally spent years working grueling schedules to (in effect) devise various techniques to amplify the financial fallout from an economic downturn. This was hardly an optimal use of scarce labor.

Boom Builders

Some of this malinvestment can be tied directly to the housing boom. Just as too many nails and shingles went to Las Vegas and Miami from 2002–06, so did too many human beings move to these cities and spend years developing skills in home construction. When the housing bubble popped, the nails and shingles had been irrevocably devoted to houses that never should have been built, while hundreds of thousands of workers had a difficult-to-modify skill set that never should have been learned.

There was a similar toll in financial services. During the giddy years top-flight students with an aptitude in mathematics were drawn out of physics and other scientific fields and flocked to Wall Street to become rich as "quants." In retrospect we now realize that some of the brightest minds on the planet had literally spent years working grueling schedules to (in effect) devise various techniques to amplify the financial fallout from an economic downturn. This was hardly an optimal use of scarce labor.

As O'Driscoll notes, even higher education itself can be viewed as an unsustainable bubble in light of Austrian theory. The false prosperity of the boom years led to large increases in education budgets, fostering erroneous expectations of how many jobs would be available for future Ph.D.s in the "soft sciences" and other fields that do not have a market outside academia.

The Austrian theory of the business cycle shows how monetary disturbances can lead to "real" imbalances in the structure of production. The classical version of the theory focused on malinvestments in physical capital goods, but the theory can easily be amended to include the unsustainable development of human capital. In either case the best government response is to eliminate the subsidies, low-interest loans, and other policies that encourage the very problems under consideration. FEE

The Politics of Health Care Rationing

BY CHIDEM KURDAS

The Obama administration's remake of the U.S. health care system stands on three legs. One, it makes the purchase of insurance compulsory. Two, it doles out new entitlements via expanded Medicaid, subsidies, and certain coverage requirements. And three, it promises to control the growth of medical costs. These three parts differ in their implications and prospects. The first leg may give way altogether; the second is partially already in place; the third provides the rationale for centralized allocation of resources in health care.

This summer the Supreme Court is to decide on the constitutionality of the 2010 Patient Protection and Affordable Care Act, which faces various challenges to its thousands of sections. Moreover the centerpiece challenge to the individual insurance mandate may invalidate other provisions as well. In fact the uncertainties extend well beyond the Supreme Court decision and its consequences. Not only the results of the 2012 presidential election but also congressional and state elections may result in changes to the law or to the way it is applied.

The individual mandate is interlinked with the state insurance purchase exchanges required by the law. If the Supreme Court finds the individual insurance mandate unconstitutional, the exchanges will have fewer customers and higher costs. Conceivably some form of exchange could survive as an insurance market for small businesses. Firms are required to make a contribution toward employee insurance if they have 11 or more employees—this employer mandate could endure even if the individual mandate does not.

By comparison there is greater certainty about the second leg of the restructuring. For instance the requirement that parents' insurance cover young adults until age 26 has already been put in practice and is unlikely to be reversed. That is, health care entitlements are expanding regardless of the Supreme Court decision and election outcomes. It was

---

Chidem Kurdas (chidem.kurdas@att.net) is a financial journalist and economist in New York. She writes about investing for HedgeFundSmarts.com and about policy for ThinkMarkets.com.

obvious from the start that this expansion necessitated and yet clashed with the goal of cost containment.

The title of the 2010 law proclaims affordable care as its aim, and commentators such as *New York Times* columnist Paul Krugman have cited a Congressional Budget Office prediction that the act will keep down costs and thereby help reduce the federal budget deficit. This claim, not very credible to begin with, looks even dodgier now that we start to see the initial impact of the coverage requirements.

Immediate Cost Increases

Much of the law will not go into effect until 2014. The insurance coverage requirements that have been put in place already, though, have increased its cost. A Kaiser Family Foundation survey shows that family premiums went up by 9 percent from 2010 to 2011, compared to a significantly lower 3 percent increase from 2009 to 2010.

To be sure, Obamacare requirements such as the enrollment of millions of adults in their parents' plans account for a fraction of the recent increase. But this is only the beginning of the law's implementation. Higher premiums inflate business costs and at least in part are passed on to workers. The government attempted to limit the growth of insurance premiums through regulatory measures, such as requiring insurance companies to spend less on administration. But those measures will be exhausted as growing demand pushes up medical costs and hence the price of insurance.

> The law entrusts cost containment largely to federal bureaucrats. To control the long-term growth of costs, health care use is to be subject to central direction.

While insurance coverage requirements show up as premium increases for individuals and businesses, the other major new entitlement, wider Medicaid eligibility, puts an added burden on taxpayers. This expansion will require many states to spend significantly more on Medicaid at a time when government finances are precarious. In 2014 general revenue Medicaid expenditures will be 22 percent higher in Illinois, 13.5 percent higher in Texas, and 9 percent higher in Florida, according to estimates by Jagadeesh Gokhale of the Cato Institute. The increases are in addition to already expected increases.

The federal government is supposed to pay the full cost of the Medicaid expansion the first three years but this support may falter given large and persistent federal budget deficits. The states understandably don't want to be left holding the bag for the Affordable Care Act—and so the Supreme Court will hear their challenge to the Medicaid expansion.

Cost Containment and Rationing

Who is to pay is one big question; the other is how much. Liabilities have been created, with some entitlements already effective and others to come. If the cost turns out to be unexpectedly large, American health care will be in worse shape. Without effective cost containment, in time the expense of the entitlements, including insurance coverage requirements, will put a growing burden on insurance buyers and taxpayers. State and federal budgets will be squeezed even more than they already are by Medicaid and Medicare. Hence the third aspect of the new system, cost containment, is key to its viability.

The law entrusts this mission largely to federal bureaucrats. To control the long-term growth of costs, health care use is to be subject to central direction. The Department of Health and Human Services (HHS) has started to define "essential" medical goods and services to be covered by the insurance exchanges run by states. However, recently the administration modified the plan, as we will see below.

To understand the full implication of rationing, consider Britain's National Health Service (NHS), the government system through which most health care is provided in that country. The NHS keeps down costs by limiting access to certain resources such as specialist physicians. Health care is rationed in this sense within the national system. People can go outside the system and purchase what they wish in private transactions, but very few do since they already pay for the NHS via taxes. And of course modern medical technology is expensive. If the NHS does not allow for a test or a visit to a specialist, then most people do without.

The United States is moving in a similar direction by determining what insurance should and should not cover. While outside the exchanges private insurers will presumably be free to diverge from the defined package, to offer less coverage would be to invite legal challenge. Most insurers will likely gravitate to the package, so its effect will go well beyond the exchanges.

Advocates of expanding the government's role in health care, such as Donald Berwick, head of the Centers for Medicare and Medicaid Services through 2011, say private insurance companies ration access already and it is better for the government to do this. Markets *in effect* ration goods and services by making them available only to those able and willing to pay. What Obamacare facilitates is political rationing.

(Politically) Essential Health Care

Last October the Institute of Medicine of the National Academies produced a report on how to go about defining "essential" health care. The Institute's committee recognized that two competing goals are involved: "to provide health insurance coverage for a wide range of health needs and to make it affordable. If it was not affordable, then many people would not be able to obtain it, even with government help, and this would conflict with the purpose of the Affordable Care Act."

The report uses the metaphor of grocery shopping. The committee recommends starting with "a firm idea of what you can spend and to fill the cart carefully, with only enough food to fit within your budget." Any new item added to the cart has to be within the budget, keeping in mind what small businesses and their employees can afford, as well as medical necessity. Once the cart is as full as the budget allows, adding a new item requires removing an item.

Recall that the relevant shopper here is not you or me. It is mainly HHS that's deciding what to put into the health care cart. However, we'll be paying at the checkout as taxpayers and consumers. Meanwhile the department is expanding to perform additional functions.

The Institute of Medicine puts the veneer of expertise on this health care rationing. You can scream, "Death panel!" but the real eye-opener is how the "essential" package is already being shaped. The law and the administration mandate certain benefits that were not part of a typical insurance plan. These specific requirements are in addition to broad mandated categories like preventive services and hospital care.

Thus HHS Secretary Kathleen Sebelius has decreed that insurers are required to pay for birth control, including contraceptive drugs, devices, and procedures. The administration says this is based on science under the law's mandate for preventive care. A religious institution—say a Catholic charity—can get an exemption, but not if it employs a number of non-Catholics. In that case it has to finance employees' birth control pills even if this violates the organization's religious principles. Catholic groups want greater flexibility in the exemption, but congressional Democrats oppose this.

> What Obamacare facilitates is political rationing.

In other words, coverage is required for some products and services while others are left vulnerable to being removed from the cart. More money for contraception, less money for something else. These are political decisions. Why did politicians prequalify contraception as essential and thus protected while other services have no such status? Women are relatively heavy users of medical services and pay more attention to health care than men do, so politicians can get votes—as well as campaign donations from product suppliers—by appealing to women.

For the makers of contraceptive drugs and devices, the coverage requirement is worth a lot of money because it will encourage people to buy more expensive products rather than use the cheap contraceptives widely available in drugstores. With the insurance coverage requirement, the consumer won't be paying the price.

But this is also part of an ideological package that favors creating special privileges for groups officially regarded as victims. The law gave women's health its own bureaucracy within HHS, headed by a deputy assistant secretary with a brief to establish objectives for issues of concern to women and provide advice, information, coordination, and other assistance to the rest of the bureaucracy. I found no corresponding Office of Men's Health, although in fact men die earlier than women and hence presumably have more urgent need for attention to their health issues. Men's health problems are evidently not a political and ideological winner.

Last December the Obama administration announced it will let each state determine the essential benefits that insurance policies sold on the state exchange will have to cover. This sounds like a major change but in fact the states remain subject to myriad requirements. The categories specified in the law and by HHS have to be covered. In effect the law and the federal government have decided most of what will go into the shopping cart, but for now the states are to be allowed to adjust around the edges.

This presumably defensive move by Obama as the presidential election approaches makes the situation more fluid and uncertain. The states will bear the brunt of complaints if they do not cover a certain benefit. Conversely states risk spiraling costs if they make their mandates generous. The federal government faces less political fallout and can impose further requirements once the election is over. For the administration the politics work out nicely.

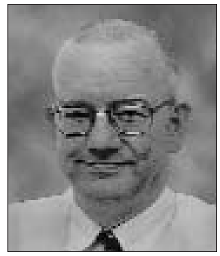
Whether at the state or the federal level, the best guess is that ration-proof status will go to services of interest to suppliers or consumers with strong political influence. Health care companies had the second largest average political spending per million dollars of revenue among S&P 500 corporations in 2010, according to a study by the Investor Responsibility Research Center. Only utilities spent more on lobbying by that standard. Health care is becoming a utility, as was pointed out in the run-up to the act.

What's being established is a heavy regulatory overlay that covers almost all aspects of health care—the law ranges from general mandates to a specific program of nutrition and exercise planning at community health centers. One could describe the Affordable Care Act as a giant reallocation scheme that will channel resources from other uses to medical industries and within health care to favored areas. Suppliers of goods and services want to maximize their share of the new entitlements on the one hand and, on the other, minimize the impact of cost controls on their businesses. All medical providers lobby to channel more goodies their way—everybody is certain his services and products are essential. But some lobby more effectively or with more resources. By all evidence this mode of operation will continue.

> Obamacare will channel resources from other uses to medical industries and within health care to favored areas.

What Obamacare will do to medical costs is at best uncertain, with the expanded coverage and Medicaid eligibility pushing up expenditures while cost containment devolves on the less politically protected. That Obamacare has raised the income of lobbyists is clear, the President's protests against them notwithstanding.

Some people prefer political rationing to free markets. Perhaps they honestly believe politicians and bureaucrats make better choices than the numerous players that constitute a competitive market. Or perhaps they themselves are likely to do better under government rationing. But do they really want their medical options dictated by the lobbying success of this or that interest group? Because that is what happens in the political allocation of resources, whatever the pretense of science-based decisionmaking. FEE



Are We Looking at the Wrong Depression?

BY STEPHEN DAVIES

Today a lot of people are looking to economic history for help in understanding the current world economic situation and the options open to us. (This includes economists, many of whom have finally rediscovered an interest in economic history.)

Most of this attention is being paid to the Great Depression of the 1930s. However, it is worth pointing out the important ways in which the present situation differs from that of the 1930s. Many observers (most notably Paul Krugman) argue that we are presently in a classic liquidity trap, where monetary policy has no purchase on the real world economy. The main evidence for this is that despite massive expansion of the basic money supply by the Federal Reserve and other central banks, there has not been the kind of inflation that many had predicted. The argument is that this situation is similar to the one Keynes identified in the early 1930s and that therefore the same policy response—fiscal stimulus—is appropriate.

So far there has not been the kind of sharp and sustained decline in world trade and economic activity that happened after 1930.

Leaving aside whether the "Keynesian" analysis and prescription were correct in the 1930s (or indeed whether that was the argument Keynes actually made), it is worth pointing out a number of big differences between the events of the last four years and those of 1929–32. Most important, we have not seen the kind of decline in prices that took place then; indeed there have been short-term spikes in a number of prices, notably food and fuel. Furthermore, and fortunately, there has not been the kind of dramatic collapse in economic activity and employment that we saw in the entire world in the early 1930s. Although the present unemployment situation in the United States is not good, it is not catastrophic in the way it was by 1932. In other parts of the world, notably the United Kingdom, job losses have actually been less than most economists feared and predicted. Moreover while there is economic stagnation or very low growth in the United States, Europe, and Japan, the world economy as a whole is still growing, even if at a slower rate than a few years ago. So far there has not been the kind of sharp and sustained decline in world trade and economic activity that happened after 1930.

In other words what we are seeing is stagnation in large parts of the world economy instead of a sudden and acute contraction globally.

Perhaps we are looking at the wrong "Great Depression."

Until as late as the 1950s, "Great Depression" in economic history generally referred to the period between 1873 and 1879 (in the United States) or 1873 and 1896 (in the United Kingdom and much of Europe). When we look more closely at those years, the likeness to where we are now becomes noticeable. The "Long Depression" (as it has come to be known) was sparked by a global financial panic in 1873, which arose from the bursting of several speculative bubbles, particularly in railroads and real estate. The panic started in Europe, then had a second phase in the United States before returning to the other side of the Atlantic. What followed were 30 years of gradually declining prices (deflation) in most parts of the world. Agricultural prices collapsed. This caused serious hardship for many farmers and peasants, and led to a massive movement

Stephen Davies (sdavies@iea.org.uk) is academic director at the Institute of Economic Affairs in London.

of labor from agriculture and the hard-hit parts of the world (such as southern Italy, Scandinavia, and Russia) to places like the United Kingdom, United States, and Argentina. Most historical GDP records show a significant slowdown of growth in most of the world for at least part of the period between 1873 and 1896. On the other hand there was not the kind of dramatic collapse seen after 1930.

However, this picture of prolonged stagnation needs to be severely qualified. One early observer who questioned this widespread perception at that time was the American economist and historian David Ames Wells. His argument, and that of many other economic historians, was summed up in a short work by S. B. Saul, *The Myth of the Great Depression, 1873–96*. Wells pointed out, among other things, that the years after 1873 saw very large increases in global output of a number of key products, not only in agriculture but also steel and a range of manufactured products. As Wells explained, this was because of an unprecedented series of innovations in both technology and business organization. In fact the 30 to 40 years after 1870 saw the advent of technologies that would define modern life, including electricity, the internal-combustion engine, the telephone, the diesel engine, and the modern petroleum industry.

As a result, the official figures are seriously misleading. While nominal wages stagnated or declined, real living standards increased because of the falling cost of products. Output increased, but this is not captured unless one applies a GDP inflator to account for the increasing value of money. So the Long Depression of the 1870s and 1880s was not a simple story of economic standstill.

So what happened? Essentially a set of innovations in technology and business organization made in the later eighteenth and early nineteenth centuries had exhausted their potential to raise productivity and growth by the 1860s. This, combined with mistaken policies, had led to malinvestment and a significant buildup of debt by the early 1870s in both Europe and the United States.

What followed, Irving Fisher argued, was a crisis brought about by the realization that many investments were not going to pay enough and the consequent need for sustained "deleveraging" (paying back or writing off of debt). At the same time there was a burst of technological and organizational innovation. This increased productivity and created many new products but also led to large adjustments as older industries and forms of employment shrank, prompting a large movement of labor. This took some time, so the costs of the transition in human terms were significant.

A shift in the focus of the world economy also took place—away from established areas such as the United Kingdom and France (both of which were more adversely affected by the changes and for a longer period than other parts of the world) toward the new developing parts of the world, such as Germany, the United States, northern Italy, and Japan. Significant parts of the population in many places were worse off, but the majority gained because of the rise in living standards brought about by technical innovation and the consequent "benign deflation."

> Increasingly it looks like the world is going through a long-term realignment like that of the late nineteenth century.

Increasingly it looks as though the world as a whole is going through the same kind of experience: an exhaustion of profitable investment opportunity in some places and sectors, leading to an artificially stimulated bubble the bursting of which has triggered sustained deleveraging and a decline in growth in many parts of the world. At the same time other parts of the world are enjoying continued growth. This is not simply "catch-up growth," since much of it comes from a shift in activity brought about by the early stages of a new wave of innovation. There is going to be a change in the patterns and locations of employment, but a rise in living standards for the majority because of the innovation and global growth.

This means that a fiscal stimulus would be ineffective and wasteful, since the underlying problem is one of a long-term economic realignment rather than a simple decline in demand. FEE

Why the Titanic Is Sinking

BY JAMES L. PAYNE

Washington is now deep into the process of attempting to deal with the budget deficit, an exercise that leaves experienced observers with a sinking feeling. Presenting plans to cut spending and balance the budget is like the proverbial activity of rearranging the deck chairs on the Titanic. It involves a lot of busyness but does not address the real problem.

We've been enacting plans to control spending and balance the budget for generations. One of the first efforts was the 1974 Budget and Impoundment Control Act passed in the Nixon administration. Then we had the Gramm-Rudman-Hollings Act, signed into law by President Reagan in 1985. A few years later, in 1994, feisty Republicans took over both houses of Congress and provoked a government shutdown in the crusade for fiscal responsibility.

When the deficit committee is finished, these could use rearranging.
Sam Chua

The lesson of history, then, is that you can't cut spending by trying to cut spending. It's a hard point for budget makers to digest, because it seems to defy the rules of arithmetic. Well, when it comes to national budgeting, these rules don't apply. What matters are the rules of political perception.

Most Americans perceive that government is an effective provider of valuable services. They see it as a super store that supplies education, medical care, retirement income, housing, assistance to the needy, safe drugs, safe foods, scientific research, and so forth. That's why spending cuts can never be more than temporarily effective. As soon as the specifics of the cutting become apparent, the public will be reminded how very much it *likes* government programs. As people learn about the autistic child who will be left unassisted, the hospital that will close, and the food inspectors who will be laid off, the public clamors to fund these functions, and the campaign to cut spending falters. We've been through this cycle many times.

The lesson is clear: The real cause of red ink is the widespread belief that government programs are effective responses to national needs. If you don't counter this belief, you can never really cut government spending.

Where does this confidence in government come from? One possible answer is that it is based on reality and that we have numerous careful, unbiased, scientific studies that prove government is a cost-effective provider of services.

Contributing editor James Payne (jimpayne@nctv.com) has taught political science at Yale, Wesleyan, Johns Hopkins, and Texas A&M. His latest book is Six Political Illusions: A Primer on Government for Idealists Fed Up with History Repeating Itself. *This article first appeared at TheFreemanOnline.org.*

There are several difficulties with this position. The first problem is there are *no* such studies. There are studies that purport to evaluate government programs, but they *never* include *all* the overhead costs. By my count, there are 14 overhead costs in the typical government transfer program, seven involving taxation and seven involving disbursement. Such cost-benefit studies as have been done include, at best, only three or four of these costs. Evaluations of government action are shallow and incomplete because the researchers are biased. Before they attempt their study they already believe government action is beneficial. In other words, the cart—the belief that government is effective—comes before the horse—the evidence that it is.

Faith in Government

Historically, too, confidence in government has preceded the evidence that might justify such confidence. The modern faith in government as a problem-solving machine emerged in the late nineteenth century, decades before any interventionist policies had been attempted. For example, in 1888 Edward Bellamy published a hugely successful utopian novella, *Looking Backward*, which posited a federal government in charge of everything, and solving all problems of poverty, unemployment, old-age assistance, and so on. Bellamy and the thousands who formed "Bellamy Clubs" all around the nation had no way of knowing if government programs in these spheres would be cost-effective solutions. They took it on faith.

> The modern faith in government as a problem-solving machine emerged decades before any interventionist policies had been attempted.

The belief in government efficacy is not empirically based. It is the product of illusions. When they first notice government, children tend to see it as a super-parent, an authority figure that has many virtues—including great wealth, foresight, objectivity, and maturity—and is without ugly vices such as selfishness, irresponsibility, callousness, and a tendency to violence. This benign impression forms the basis of the popular view of government. Over time, as the result of actual experience with government, people begin to overcome this naive faith, but in most cases they do not move far beyond the child's view. They continue to see government as a machine that can fix everything—if only the right people are put in charge. Telling a public with this naive confidence that spending should be cut is like trying to tell a child that a birthday cake should not be eaten: It has no understanding of, or sympathy for, the recommendation.

To restrain spending, therefore, one needs techniques that counteract the mistaken, illusion-based view of government. These measures will not resemble traditional spending reforms. They will not be laws that address the *amount* of spending. Instead they will address the *perceptions* underlying spending, since once those attitudes are corrected, the pressure for spending will abate. To illustrate this approach consider the simple idea of reminding people where government money comes from.

The Philanthropic Illusion

One misunderstanding that gives the public a false view of government is the *philanthropic illusion*. This is the idea that government *has money*, that it is like a wealthy philanthropist with extra cash to give to needy people and worthy causes. In fact government has no money of its own. The money it spends has to be first taken away from taxpayers, and if you do the arithmetic carefully, tracing out all the indirect and shifted burdens of taxation, you will discover that *everyone* is a taxpayer. Therefore, to get money for its spending programs, government inflicts privation on *everyone*, including low-wage workers, college students, the homeless, and so on, and it drains resources from vital activities like technological innovation, medical care, job creation, and so forth.

Under the spell of the philanthropic illusion, politicians and the public downplay or forget the harm and injury of taxation. A simple device that will help counteract this myopia is the "Declaration of Gratitude." Everyone who receives government money would be required to sign this statement:

"I realize that the funds I am about to receive come from the nation's taxpayers, and I am grateful for the sacrifices they are making on my behalf."

Its administration is simple. When you fill out the paperwork for any government grant, subsidy, or payment, you also must sign the statement, whatever the benefit: food stamps, cotton subsidy, small business loan, government paycheck, research grant.

In monetary terms signing this statement doesn't change anything: Everyone gets whatever government dollars he was going to get. No one can be accused of starving grandma. What it does do is change the psychological climate. It destroys the assumption that government spending harms no one. This frank reality is covered up today. Take the Earned Income Tax Credit. This is a $50 billion welfare program, yet the people receiving this benefit call it a "tax refund" when they get their check. Most of them have no idea that this is a subsidy paid for by taxpayers. Well, if they had to sign the Declaration of Gratitude, they would know.

There is likely to be a lot of resistance to the Declaration of Gratitude idea. Most Americans seem to feel themselves "entitled" to whatever government funds they get and are loath to recognize their dependent status. This entitlement mentality produces the bizarre contradiction of a country with a national debt of $15,000,000,000,000 whose citizens believe they are paying their own way.

But resistance or no, reforms that change the perceptual climate are essential for national economic health. Sound fiscal policy will not be achieved until the public attains a disillusioned view of government. FEE

Never Mind the Gap

BY MAX BORDERS

The Wall Street occupiers are settling in to the public consciousness now, for better or worse. Somewhere in the chanting is an inchoate worry about the gap between rich and poor. According to the Congressional Budget Office (CBO), between 1979 and 2007, income grew by (tinyurl.com/43pwhb3):

- 275 percent for the top 1 percent
- 65 percent for the next 19 percent
- Just under 40 percent for the next 60 percent
- 18 percent for the bottom 20 percent.

This seems like a damning picture. Even if we were to argue that some of these data don't account for government goodies at the bottom (such as entitlements and tax credits), it worries a lot of people.

But in fact we should stop worrying about the so-called "gap" between rich and poor. To make that case from my perch here in the humbler part of the spectrum, I suggest engaging in a thought experiment:

Worrying about the wealth gap is a distraction from the real issue: making everyone better off.
Clicsauris [Wikipedia]

If you were dictator for a day and you could choose between two states of affairs, which would you choose?

A: Permanently institute a policy that significantly reduces the gap between rich and poor.

B: Permanently institute a policy that makes everyone better off, including the poor.

Notwithstanding this readership a lot of people out there would choose A. Consider a few examples of folks I'd put in Group A, which we'll call "the Atavists." (Those who are unnerved by "the gap" are not so much enlightened as in the grip of an inborn hoarding taboo. Most of us share this taboo to some degree because we're all human. But for some of us it burns in the DNA and becomes expressed as indignation. That's why I call Group A "Atavists.")

Famous atheist Sam Harris says, "Yes, we must cut spending and reduce inefficiencies in government. . . . But this does not mean that we can ignore the astonishing gaps in wealth that have opened between the poor and the rich, and between the rich and the ultra-rich. Some of your neighbors have no more than $2,000 in total assets (in fact, 40 percent of Americans fall into this category); some have around $2 million; and some have $2 billion. . . . Each of these gaps represents a thousand-fold increase in wealth." Surely he means net worth, not total assets.

The New Yorker's James Surowiecki believes "there's a yawning chasm between the professional and the plutocratic classes, and the tax system should reflect that. A better tax system would have more brackets, so that the super-rich pay higher rates."

Max Borders (maxborders@gmail.com) is a 2011–12 Robert Novak Fellow. He is writing a book on the rich-poor gap.

Nobel laureate economist Joseph Stiglitz shares a similar view in *Vanity Fair:* "Some people look at income inequality and shrug their shoulders. So what if this person gains and that person loses? What matters, they argue, is not how the pie is divided but the size of the pie. That argument is fundamentally wrong."

What ties these perspectives together?

Atavists have a couple of things in common. First, they share an automatic response any time they perceive a social ill: *Tax the rich*. This elixir is offered before any other treatments for what may be deeper, underlying diseases—diseases of which *some* inequality may be a symptom.

Then let us entertain a rather seditious question: Before deploying another IRS agent, why not first fix any policies that *cause* wealth disparity? Whether we identify with group A or B, we shouldn't tolerate transfers from poor to rich, and yet if we open our eyes, examples of such transfers are everywhere:

- *Corporate Welfare*. From Wall Street bailouts to agribusiness subsidies to "economic incentives" giveaways by states, politicians are doling out corporate welfare at every level of government. (Solyndra comes to mind.)
- *Regressive Regulation*. Excessive regulation makes goods and services more expensive for everyone and raises the costs of starting a small business. Such policies deny poor people opportunities many rich can afford.
- *Loophole Labyrinth*. Our tax code is complicated, and it is easier for wealthier people than others to purchase the energies of CPAs and tax lawyers to find loopholes.
- *America's Pyramids*. Local boondoggles like light rail and sports arenas mean higher sales taxes, a burden that falls disproportionately on the poor. (Developers make out like bandits.)
- *Medicare Monstrosity*. Why should struggling young people have to fund the health care costs of richer elderly people in Boca Raton? Medicare requires just such transfers.
- *Cadillac Care*. Duke Law professors Clark Havighurst and Barak Richman write: "[T]he U.S. health care system operates more like a robber baron than like Robin Hood, burdening ordinary payers of health insurance premiums disproportionately for the benefit of industry interests and higher-income consumer-taxpayers." Read: People with good jobs get nice tax exclusions while the working poor have to fend for themselves in the individual market where the cost of insurance is not deductible from income.

I could go on. "Progressive" policies that have the side effect of enriching the wealthy at the poor's expense are just necessary evils, right? Besides, they say, it's easy to mitigate the effects of those policies: tax more and redistribute!

But why not stop all this epicyclical thinking? Why not make the rules apply to everyone equally instead of tilting the tax code more?

But why not stop all this epicyclical thinking? Why not make the rules apply to everyone equally instead of tilting the tax code more? Why shouldn't the first thought be to reduce the burdens of the State on the poor? And why not let value creators get rich honestly so they continue to offer things people want?

To the Atavist, it doesn't matter whether you're a maker or a taker. You can be John Mackey, who offers wholesome foods to health-conscious consumers, or Jeffrey Immelt, who gets rich by lobbying government for favors and contracts. If you're superrich it's all the same. What roils the Atavist is the very existence of the rich. Individuals, with their unique contributions, get reduced to slogans or plot-points on a distribution graph.

Venture capitalist Kip Hagopian picks up on this problem when he concludes: "The flaw in virtually all of the intellectual arguments on the issue of the progressive income tax . . . is a lack of appreciation for how income is determined." Indeed, in a truly free market, for there to be any wealth to redistribute, there has to have been an initial "distribution," which is a prosaic way of saying somebody—through *effort and ability*—had to create the wealth to start with.

Let's call those who would choose alternative B the "Better-offs." This group wants to improve the conditions of the poor even if that means the rich get richer. According to the Better-offs, things improve when it's possible for successful investors and entrepreneurs to get rich. (This assumes they don't use government to gain their wealth.)

Differences in Perspective

Between the Atavists and the Better-offs, there are five major differences in perspective.

1. Harming the rich or helping the poor. Concern about the conditions of poor people is not the same as worrying about how much rich people have. Our thought experiment teases out this difference. More straightforwardly: Would youimprove the conditions of the poorest people modestly if it meant making the top 1 percent richer? "No" suggests one cares more about what the rich have than what the poor lack. An Atavist's primary concern is equality of outcome.

Timothy Noah's multipart series in *Slate* is Atavism on display (tinyurl.com/44cpwl5). The series includes passages like this:

> All my life I've heard Latin America described as a failed society (or collection of failed societies) because of its grotesque maldistribution of wealth. Peasants in rags beg for food outside the high walls of opulent villas, and so on. But according to the [CIA], income distribution in the United States is more unequal than in Guyana, Nicaragua, and Venezuela, and roughly on par with Uruguay, Argentina, and Ecuador. Income inequality is actually declining in Latin America even as it continues to increase in the United States. Economically speaking, the richest nation on earth is starting to resemble a banana republic.

Gasp. A banana republic?

Language like "grotesque maldistribution" isn't helpful. If any sense can be brought to such a phrase it would come in the "how" questions of the "distribution"—namely, how did the rich get rich? Creating value or bribing officials? Common sense diffuses Noah's misuse of the Gini index, the standard measure of income inequality. If you define a banana republic in terms of the gap, the United States, Hong Kong, and Singapore are all banana republics. By the same logic, then, North Korea, Venezuela, and Myanmar are veritable utopias. Measuring the wealth gap in a country doesn't tell us anything about levels of poverty or opportunity. It only tells us the statistical spread between richest and poorest.

> There are some really destitute people out there, to be sure. But we can't simply appeal to shoddy statistics as if they were, well, Scripture.

2. Win-Lose or Win-Win. Despite the protestations of a couple of Nobel laureates who should know better, the market is not a zero-sum arrangement. All this discussion of the gap obscures the fact that whenever people engage in voluntary exchange, all parties benefit. Recall Stiglitz above: "So what if this person gains and that person loses? What matters, they argue, is not how the pie is divided but the size of the pie." This straw man doesn't look like anyone I know. The whole point of a free economy is that exchange is mutually beneficial. Only outside the market (or in a government-rigged market) does one party gain because another loses. In such cases, only one of four things could have happened: force, theft, fraud, or some variation of these sanctioned by government. Wealth transfers—whether from poor to rich or rich to poor—are inherently zero-sum. That means someone has to lose in order for someone else to gain. Better-offs want a "win-win" society. So it's not just a question of the size of the pie, but how the pie gets baked.

3. Static Statistics or Real People. Sam Harris laments that 40 percent of Americans have a net worth of less than $2,000. One problem with this factoid is that about a quarter of the population is under 18, which leaves about 15 percent of adults with low net worth. I don't know many kids with a net worth over $2,000, but I'm comfortable with the fact that my five-year-old has little more to his name than some Legos and Wii games. Otherwise the remaining individuals in this low-net-worth group may have wildly different circumstances. There could be those with high incomes but debt, college kids with little besides ramen noodles and a laptop, or people who gambled flipping houses in '08. There are some really destitute people out there, to be sure. But we can't simply appeal to shoddy statistics as if they were, well, Scripture.

Steven Horwitz has explored data on wealth distribution more deeply. He says it's true that the poor's share of total income today is less than 30 years ago. But that doesn't matter, says Horowitz. Total income is larger today. So the poor's income is still *greater* than in the past. Absent government doing counterproductive things like stimulus and quantitative easing, the total almost always gets bigger over time. Statistical snapshots can also be misleading because most people are upwardly mobile. That doesn't mean there aren't people who get stuck in the lowest income bracket throughout their lives. It means there are far fewer such folks than critics like Harris care to admit.

4. Income or Well-being. A minute of work today buys you a whole lot more than it did 20, 50, or 100 years ago. Poor people enjoy phones, fridges, TVs, food, and a far higher standard of living because their purchasing power is greater.

In 1920 a working stiff had to labor 37 minutes at the prevailing wage to buy a half-gallon of milk. In 1997 our working stiff only had to work seven minutes. To buy a pair of Levi's, one had to work 10.5 hours. In 1997? Three hours, 24 minutes. And in 1997 it took nine minutes to buy one MIPS (million instructions per second) of computing power. No computing product was available in 1920. Zoom out from any pessimism about the near term, and things look better. Competition among firms to serve customers yields continuous improvement across tax brackets. The really big gains, though tough to measure, have gone to the poor. Philosophical economist Deirdre McCloskey says:

> [A] rich man cannot, after all, eat much more than his chauffeur can, speaking of sheer volume and nutrients. Nor can he wear right now more than one pair of Italian designer trousers, speaking of mere leg-covering ability. Nor can he live in more than one enormous room at a time, speaking of gross roofage and wallage.

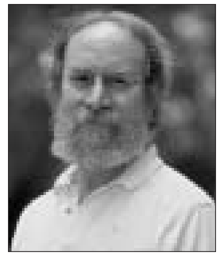
With just a little perspective the poverty picture changes. By historical standards our poorest quintile today is much better off than at any other time in human history.

5. Compulsion or Compassion. Maybe we should think of a positive-sum society as a happy byproduct of good institutions that protect freedom and property, as opposed to a policy goal per se. The original thought experiment is designed to reveal people's deeper commitments. Atavists, for example, are comfortable with compulsory compassion: If you've got it and someone else needs it, the State should take it. Better-offs see things differently. Most think of compassion as a value, not a policy. Compassionate acts flow from those who hold those values, which can't be passed by Congress or enforced by IRS agents.

All this fretting about the gap is a big blinking distraction.

Now that we've identified these gaps in perspective, what do they tell us?

All this fretting about the gap is a big blinking distraction. For when we pull back the moral mantle, concern about the gap between rich and poor reveals a kind of aesthetic fetish. For all the talk of "social justice," it's hard to ground an Atavist's concerns in anything like concern for the poor. The further away from indignation about the rich an Atavist moves, the closer he gets to becoming a Better-off. Ask yourself honestly: Are you worried about the poor? Or are you simply averse to wealth accumulation? An honest answer could start a more productive conversation about wealth and want. FEE



Fearing Hayek

BY SHELDON RICHMAN

Economics and business reporter David Warsh (tinyurl.com/7fnsz76) is getting much attention for suggesting that F. A. Hayek, far from being one of the two most prominent economists of the 1930s—the other being Keynes—is rather more like the woman who was thought to have won the Boston marathon in 1980 when in fact she had joined the race, mostly unnoticed, a half-mile from the finish line.

Hayek's fans "have jumped a caricature out of the bushes late in the day and claim that their guy ran a great race," Warsh writes. "But the fact remains that Hayek just didn't contribute very much to the development of technical economics," he continues.

Friedrich Hayek (right) with Ludwig von Mises.
Archive photo

Warsh, whom we may judge by the fact that he calls *The Road to Serfdom* "an embarrassment," nonetheless does have some positive things to say about the 1974 Nobel laureate: "With the publication of 'The Use of Knowledge in Society' in the *American Economic Review* in 1945, he essentially won on the 'calculation debate,' conducted with Ludwig von Mises and Oscar Lange, concerning the possibility of central planning."

Considering how many respectable economists favored central planning—essentially the abolition of spontaneous competitive markets—until fairly recently, that would seem to be no mean feat. He also said that "Hayek himself may yet turn out to have been a very great economist after all" because of his work showing "that markets are fundamentally evolutionary mechanisms. . . ." Warsh even suggests that Hayek may be misjudged today because (quoting David Colander) he "was running a different race" from most other economists. We'll get back to this point.

As McGill University professor Jacob T. Levy surmises, not everyone eager to dismiss Hayek as a lightweight read Warsh's post to the end. Take Paul Krugman, ever ready to trash anyone who doubts that Keynes was the fount of all wisdom: "David Warsh finally says what someone needed to say: Friedrich Hayek is not an important figure in the history of macroeconomics. . . . [T]he Hayek thing is almost entirely about politics rather than economics. Without *The Road To Serfdom*—and the way that book was used by vested interests to oppose the welfare state—nobody would be talking about his business cycle ideas."

The Hayekian wing of the blogosphere has responded in force, and properly so. A common theme is that Hayek furnished the grounds for a proper skepticism about macroeconomics, the branch of economics launched by Keynes that treats large statistical aggregates (demand, income, unemployment, and so on) as though they were concrete entities that interact with each other according to fixed quantitative rules rather than historical "summations" of individual purposeful actions in a particular institutional context. As Hayek wrote, "Mr. Keynes' aggregates conceal the most fundamental mechanisms of change." (See Steven Horwitz's "Mr. Keynes's Aggregates," tinyurl.com/35247k5.)

Sheldon Richman (srichman@fee.org) is the editor of The Freeman.

George Mason University (GMU) professor (and FEE trustee) Peter Boettke wrote at Coordination Problem:

> Hayek's influence in modern economics is ubiquitous, even if sadly modern economics is not as Hayekian as I would like it to be. Information economics, theories of dynamic competition, equilibrium theory of the business cycle, and complexity theory all owe a debt to Hayek's economic contributions. The work on legal origins owes a debt to Hayek's work on law and political-social philosophy as well. Hayek impacts the DNA of economics and political economy to such an extent that many are unaware of the pervasive influence. . . .
>
> The final problem I have with both Krugman and Warsh is that they don't actually consult the historical record and the accounts of those who were there in the 1930s when the battle was engaged or the direct citation evidence from post-WWII thinkers. . . . Instead they rely on impressionistic accounts from their education and discourse communities, and cherry-pick from recent journalistic histories of economics.

And there's this from GMU professor Alex Tabarrok at Marginal Revolution:

> It is true that many of Hayek's specific ideas about business cycles vanished from the mainstream discussion under the Keynesian juggernaut but what Krugman and Warsh miss is that Hayek's vision of how to *think* about macroeconomics came back with a vengeance in the 1970s. . . .
>
> Hayek was an important inspiration in the modern program to build macroeconomics on microfoundations.

GMU's Russ Roberts responded this way at Café Hayek:

> Was Hayek an important macroeconomist? I would argue that the macroeconomic skepticism of the later Hayek is more valuable than the macroeconomic theorizing of the early Hayek. But he wasn't an important macroeconomist in the mainstream sense of the title. So what? That's a badge of honor. He was merely a great economist, without any prefix.

There are others, but I will close with a post written by New York University's Mario Rizzo, one of the most perceptive people I know, at ThinkMarkets. Remember the remark above that "It could have been that Hayek was running a different race"? That's Rizzo's take:

> I think the real issue is this. Hayek's approach attacks, root-and-branch, the *macro*economic way of thinking. It is not simply a challenge to a *particular theory* of the determinants of mass unemployment, inflation, business cycles and the like. Hayek is not accepting the rules of the game or the parameters of the sub-discipline of modern macroeconomics. . . .
>
> In short, he does not want to focus on aggregate spending and aggregate consequences. Hayek's approach says: Let us pierce the veil of aggregates and look at the distortive effects on relative prices and relative output produced by boom-time credit expansions. Let us look at the distortive effects that booms leave us as we work our way through a recession. . . .
>
> Suffice it to say this greatly erodes the intellectual capital of a field of economics—although one not noted for its successes. It mocks the claim that Keynes was a true revolutionary in economic thought. It opens the possibility that he was muddled, inconsistent and unaware of the contributions to monetary and business cycle theory made by the "classical economists" on the eve of the *General Theory*.

Hayek is important politically for demonstrating the practical social necessity of individual freedom. But he is just as important for what he taught us about markets: They provide *the only way* for human beings to overcome their individual deficiencies in knowledge, which would otherwise keep them from flourishing through social cooperation and the division of labor. FEE

Of Constituents and Clans

BY RICHARD W. FULMER

"Understanding Corruption," an article by Lawrence Rosen appearing in the March-April 2010 issue of *The American Interest* (tinyurl.com/26372pz), explained how "corruption" is defined differently in the Middle East from in the West. To an American it would be unethical for public officials to steer government contracts to relatives, while to an Arab it would be unethical not to.

According to Rosen, in the Arab world "*[c]orruption is the failure to share any largess you have received with those with whom you have formed ties of dependence.* Theirs is a world in which the defining feature of a man is that he has formed a web of indebtedness, a network of obligations that prove his capacity to maneuver in a world of relentless uncertainty." (Emphasis in the original.)

Within a tribe such reciprocal relationships and expectations are constructive. When, as is typical in earlier, primitive societies, lives are lived with little material margin of safety, traditions based on mutual ties of indebtedness increase the chances that a tribe will survive. If a hunt goes badly, the hunter and his family do not go without food. Scaling up tribal mores is problematic, however. Trust is rarely extended beyond the tribe; in some ancient languages, the word "stranger" was synonymous with "enemy."

The Western understanding of corruption is more amenable to a large diverse nation of laws and institutions. In a nation of any size trust must extend beyond the family, tribe, or clan, otherwise transaction costs will escalate and trade will collapse. The problem of nation-building in a region dominated by the tribal ethos is primarily one of forging trust between tribes and shifting loyalties from tribe to nation.

In a nation of any size trust must extend beyond the family, tribe, or clan, otherwise transaction costs will escalate and trade will collapse.

Consider trying to form a nation out of an area in which trust and loyalty remain confined to the tribe. Suppose a member of Tribe A becomes the new nation's leader. He will select his lieutenants from among those he trusts—members of his own tribe. In addition his tribe will expect to share in his good fortune, which they can only do at the expense of tribes B and C. If the nation is poor, gaining and keeping power could literally mean the difference between life and death, so elections will be hotly, perhaps violently, contested. Coalitions between tribes may form, but will be limited by mutual suspicion, lasting only until one or more of the coalition believe they have gained the upper hand and no longer need the others.

Suppose, however, that Tribes A, B, and C manage to form a stable alliance by agreeing that Tribe X will pay the bills. This works only until members of Tribe X flee the country. What is needed is a new tribe (Tribe Z, say) that can neither outvote the coalition nor leave.

If the word "tribes" is replaced by "special interests," we could be talking about the problem of sustaining the

Richard Fulmer (richard_w_fulmer@hotmail.com) is a freelance writer in Humble, Texas.

United States as a nation, not of nation-building in the Middle East or Afghanistan. Make two additional term changes: Replace "Tribe X" with "the rich" and "Tribe Z" with "the unborn," and the analogy is complete.

Factions and the Founders

America's founders were very much concerned with the problems that factions, as they called special interests, pose to democracies. James Madison in *Federalist* 10 defined a faction as "a number of citizens, whether amounting to a majority or minority of the whole, who are united and actuated by some common impulse of passion, or of interest, adverse to the rights of other citizens, or to the permanent and aggregate interest of the community."

Factions, he said, are "sown in the nature of man": "As long as the reason of man continues fallible, and he is at liberty to exercise it, different opinions will be formed. As long as the connection subsists between his reason and his self-love, his opinions and his passions will have a reciprocal influence on each other; and the former will be objects to which the latter will attach themselves."

The danger factions pose is that government, a nation's sole legitimate wielder of force, may give itself to one or more factions, thereby granting it or them coercive and arbitrary rule over others. The source of many if not most of the tragedies in American history has not been differences in opinions, race, sex, class, talent, wealth, or religion. Rather it has been that people divided along such lines were able to subvert government's coercive power to advance their own ideas and interests through force.

Slavery could not have survived without government's sanction and support; slave owners were empowered by law to draft private citizens to hunt down and recapture runaways. The Salem witch trials of 1692 were initially conducted by county magistrates and later by a special court established by the governor of Massachusetts. The federal government repeatedly violated treaties with Native Americans when those treaties conflicted with the interests of white settlers. Private companies in the late 1800s and early 1900s were able to prevent their workers from organizing only with the complicity, and sometimes active involvement, of both local police and the military. Between 1907 and 1963 over 64,000 Americans were forcibly sterilized under the "eugenics" laws of more than 30 states as Progressives attempted to rid the population of the "feeble-minded" and other "unfit" human beings. Before the Civil Rights Acts whites were routinely accorded preferential treatment by state and local laws. More often than not government largess was, and is, bestowed on those in control of the two things elected officials value most: money and votes.

Growing Incentives

As government grows in power, so grow incentives for factions to form and to try to bend that power in their favor. Factions find ever-more niches among the various nooks and crannies of the ever-growing, ever-more-complex body of laws and regulations spewing from local, state, and federal institutions. The tribute paid to factions comes from the pockets and freedoms of those lacking government favor. As this exaction becomes increasingly onerous, elections become more important and more vigorously fought, by means both fair and foul. Media outlets become increasingly tailored to the tastes of self-interested parties, reflecting their opinions and providing them with their own "facts." The resulting information divide further intensifies interfactional disputes as people become convinced of their own moral and intellectual superiority and less able to comprehend other points of view.

> As government grows in power, so grow incentives for factions to form and to try to bend that power in their favor.

As government grows, its employees become an ever larger constituency. In a democracy numbers translate into power, and the power of public-sector unions is growing apace. As *The Economist* points out (January 8, 2011), "Private-sector bosses are accustomed to playing hardball with unions because they know they can go bankrupt if they don't. Politicians have no such discipline: they can always raise taxes or borrow from future generations."

Bipartisan cooperation, so cherished these days, can more easily be achieved when politicians borrow to pay for their constituents' demands. Everyone can be made happy as long as costs are borne by the unborn. Eventually, though, lenders dry up, bills come due, and government is left with the choice of either printing money and impoverishing voters, or cutting spending and enraging them.

Madison wrote that the Constitution's restrictions on government were intended to ensure that issues were decided "according to the rules of justice and the rights of the minor party, [and not] by the superior force of an interested and overbearing majority." History, however, is made largely by the struggle over power—power not to ensure justice but to plunder. Government power is the greatest prize of all because it enables legalized plunder. Factions have sought that prize throughout our nation's history. Two strategies have been proposed for limiting this threat: decrease government's power, reducing the *incentive* to abuse it; or increase government's power, eliminating the *ability* to abuse it. The problem with the second strategy is that people in government themselves constitute an interested faction. Increasing their power means reducing the power individuals have over their own lives and, in the end, reducing the role of citizens to serving as eggs to be broken and stirred into the State's collective omelet. FEE

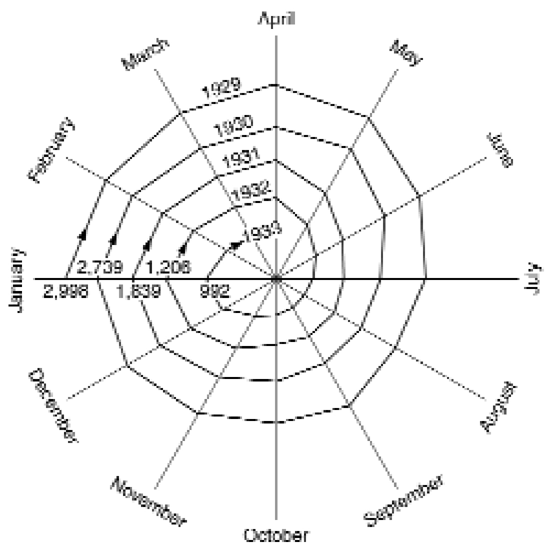
The Smoot-Hawley Tariff and the Great Depression

BY THOMAS C. RUSTICI, THEODORE PHALAN, AND DEEMA YAZIGI

Few areas of historical research have provoked such intensive study as the origins of America's Great Depression. From 1929 to 1933 America suffered the worst economic decline in its history. Real national income fell by 36 percent; unemployment increased from 3 percent to over 25 percent; more than 40 percent of all banks were permanently closed; and international investment and trade declined dramatically.

The dimensions of the economic catastrophe in America and the rest of the world from 1929 to 1933 cannot be captured fully by quantitative data alone. Tens of millions of humans suffered intense misery and despair. Because of this trauma the Great Depression has dominated much of the macroeconomic debate since the mid-twentieth century.

Contracting Spiral of World Trade, January 1929 to March 1933: Total Imports of 75 Countries



Monthly values in terms of old U.S. gold dollars, millions

Source: Charles Kindleberger, ***The World in Depression, 1929–1939*** (Berkeley: University of California Press, 1973), p.172.

In 1930 a large majority of economists believed the Smoot-Hawley Tariff Act would exacerbate the U.S. recession into a worldwide depression. On May 5 of that year 1,028 members of the American Economic Association released a signed statement that vigorously opposed the act. The protest included five basic points. First, the tariff would raise the cost of living by "compelling the consumer to subsidize waste and inefficiency in [domestic] industry." Second, the farm sector would not be helped since "cotton, pork, lard, and wheat are export crops and sold in the world market" and the price of farm equipment would rise. Third, "our export trade in general would suffer. Countries cannot buy from us unless they are permitted to sell to us." Fourth, the tariff would "inevitably provoke other countries to pay us back in kind against our goods." Finally, Americans with investments abroad would suffer since the tariff would make it "more difficult for their foreign debtors to pay them interest due them." Likewise most of the empirical discussions of the downturn in world economic activity taking place in 1929–1933 put Smoot-Hawley at or near center stage.

Economists today, however, hold a different view of the effects of Smoot-Hawley. While economic histori-

Thomas Rustici (trustici@gmu.edu) is an associate professor of economics at George Mason University and author of Lessons from the Great Depression. *Theodore Phalan (tphalan@gmu.edu) is pursuing an M.A. in economics and Deema Yazigi (dyazigi@gmu.edu) is a third-year Ph.D. student in economics at GMU.*

ans generally believe the tariff was misguided and may have aggravated the economic crisis, the consensus appears to relegate it to a minor status relative to other forces. We believe many modern economists are wrong because flawed modeling leads to two systematic understatements of the tariff's negative effects. The first reason for this is that reliance on macro aggregates can sometimes mask serious underlying problems by dissipating their apparent impact over a broad area. For example, U.S. national income declined 36 percent in real terms from 1929 to 1933, and the view held by prominent economists, ranging from University of Chicago Nobel laureate Robert Lucas and Yale economist Robert Shiller to MIT economists Rudiger Dornbush and Stanley Fischer, is that since the foreign-trade sector was only about 7 percent of gross national product (GNP), the tariff (though misguided) could not explain much of this decline.

Viewed at the level of "macro magnitudes," critical micro connections suffer from a "dissipation effect" and always *look* small. But size does not equal significance. While it is true that foreign trade represented only a small percentage of the overall domestic and international economy, it does not follow that the tariff was insignificant in its effects. The Panama Canal contains but a small fraction of the world's ocean water, but if it were closed the effects would be quite devastating to world trade. A focus on aggregates risks missing the trees for the forest, and not all trees are created equal.

A focus on aggregates risks missing the trees for the forest, and not all trees are created equal.

Here's a second way Smoot-Hawley is underestimated: If regulations or tariffs are studied in partitioned models, their interrelationships are missed and their true impacts are trivialized. For example, recent attempts have been made to quantify price distortions caused by the tariff. Mario Crucini and James Kahn have tried to correct systematic underestimates of the harm of Smoot-Hawley found in a variety of macro studies that ignored the effect of tariff retaliation on the rate of capital accumulation. Using a general-equilibrium model, they calculate that the microeconomic distortion effects reduced U.S. GNP by only 2 percent in the early 1930s. Likewise economist Douglas Irwin computed the general-equilibrium inefficiencies caused by the tariff at nearly 2 percent of GNP.

So when even ostensibly free-market, free-trade economists such as Lucas, Irwin, and others downplay the negative effects of the Smoot-Hawley Tariff, what's the verdict? Were the loud protests of over a thousand professors of economics just unsophisticated exaggerations? Were these pre-Keynesian classical theorists misguided because they lacked the tools of modern macroeconomics and econometrics? Or did their vision remain unclouded for the same reason? Were they Chicken Littles or Cassandras?

Ignored Effects

Modern measurements of Smoot-Hawley often ignore a wide range of important negative effects. For instance, the secondary financial markets, such as the New York Stock Exchange, crashed twice during the last eight months of Smoot-Hawley's legislative history. Jude Wanniski and Scott Sumner have linked concern over the impending tariff to the October 1929 crash and the June 1930 crash. The Dow Jones Industrial Average fell 23 percent in the first two weeks of June 1930 leading up to President Herbert Hoover's signing the bill into law. On June 16 Hoover claimed, "I shall approve the tariff bill," and stocks lost $1 billion in value that day—a huge sum at the time.

Furthermore, if losses of GNP were *not evenly distributed* across the economy but were concentrated (say, in export-oriented states), the tariff most likely distorted monetary conditions significantly. Two percent of GNP does not sound like a big change, but if it's concentrated in one-fifth to one-third of the states, it's very large indeed. The tariff dramatically lowered U.S. exports, from $7 billion in 1929 to $2.4 billion in 1932, and a large portion of U.S. exports were agricultural; therefore it cannot be assumed that the microeconomic inefficiencies were *evenly* distributed. Many individual states suffered severe drops in farm incomes due to collapsing export markets arising from foreign retaliation, and it's no coincidence that rural farm banks in the Midwest and southern states began failing by the thousands.

Agriculture was not the only export sector destroyed by the tariff. The worldwide retaliation against U.S. minerals greatly depressed income in mining states and can be partially blamed for the collapse of the Wingfield chain of banks (about one-third of the banks in Nevada, with 65 percent of all deposits and 75 percent of commercial loans). U.S. iron and steel exports decreased 85.5 percent by 1932 due to retaliation by Canada. The cumulative decrease in those exports below their pre-tariff levels totaled $369 million. Is it any wonder that Pittsburgh saw 11 of its largest banks, with $67 million in deposits, close in September 1931? How about U.S.-made automobiles? European retaliation raised tariffs so high that U.S. exports declined from $541 million per year to $97 million by 1933, an 82 percent drop! Thus there was a cumulative export decline of $1.57 billion from the pre-tariff volume to 1933. Is it any wonder that the Detroit banking system (tied to the auto industry) was in complete collapse by early 1933?

The tariff and retaliations against it destroyed the world trade system and demolished the integrated world financial structure operating under the gold-exchange standard as well.

Let's not forget World War I, which made America the world's creditor. The center of the financial world moved from London to New York, and billions of dollars were owed to large U.S. banks. The Smoot-Hawley Tariff threw inter-allied war-debt repayment relations into limbo by shutting down world trade. An international moratorium on debtor repayments to the United States froze billions in foreign assets, thus weakening the financial solvency of the American banks. Specifically, over $2 billion worth of German loans were obstructed by Germany's inability to acquire dollars through trade to repay its debts. This same scenario played out in many other countries as well. The tariff wars created widespread financial crises across America, Europe, and a host of nations in South America. In September 1931 England abandoned sound money; America would follow suit in 1933. The functional operation of the post-World War I gold exchange standard was sabotaged by worldwide protectionism in reaction to Smoot-Hawley.

Historians of the Great Depression have overlooked important connections between trade conditions and monetary collapse. The tariff and retaliations against it destroyed the world trade system and demolished the integrated world financial structure operating under the gold-exchange standard as well. America's monetary and capital structure from 1921 to 1929 was primarily shaped by six factors: first, a centrally planned monetary system; second, a decade of disguised inflation; third, branch-banking restrictions; fourth, state deposit insurance programs; fifth, agricultural subsidies; and finally, a plethora of taxes and regulations.

Smoot-Hawley placed enormous pressure on the central banking system and capital structure. In addition it caused the dramatic loss of export markets and declining farm income (due to foreign retaliation), rendering much agricultural capital useless. This was responsible for widespread agricultural bank failures, which then led to contagion effects. Due to the uncertainty of trade conditions, each of the ten largest world economies had their secondary financial markets crash. It created international financial chaos leading to foreign debt repayment suspensions. As a result of thousands of bank failures, the U.S. money supply dropped 29 percent from 1929 to 1933. (The weighted average of the world money supply of the eight largest economies annually declined by double digits from 1931 to 1932). All of this, and much more—*and yet only 2 percent of GNP?* We think not.

Macroeconomic Thought and Smoot-Hawley

Modern macroeconomics falls into three broad schools of thought: Keynesian, monetarist (including New Classical), and Austrian. While great differences exist among the different theories of the business cycle, all seem to agree that the tariff had little causal relevance to the severity of the Great Depression. For example, Keynesian Peter Temin never cites the tariff once in his *Did Monetary Forces Cause the Great Depression?* Likewise Milton Friedman and Anna Schwartz delegate a mere footnote to Smoot-Hawley in their massive treatise, *A Monetary History of the United States, 1867–1960*. To his credit Austrian economist Murray Rothbard at least devotes one and a half pages to the tariff in *America's Great Depression*.

As noted Smoot-Hawley can be directly linked to the U.S. agricultural crisis of the early 1930s and the initial banking crises in a variety of Midwestern agricultural states. Therefore trade policy may have indirectly, but severely, worsened monetary conditions. If the great monetary contraction was an important factor in the severity of the Great Depression, then the Smoot-Hawley tariff must be held responsible in large part. Estimates that downplay the significance of the tariff on aggregate economic activity are dangerous because the correct lessons will not be learned. The relationship between monetary policy and trade policy is not a one-way street. Policymakers speak of affecting the terms of trade by manipulating the money, but they do not realize that their money has become vulnerable to the terms of trade. Modern macro and micro modeling biases preclude economists from seeing this full impact.

Both prior monetary inflation and restrictive trade policy led to and exacerbated the economic downturn. They are *not* mutually exclusive alternatives.

Smoot-Hawley and Bank Crises

In 1976 monetarist Allan Meltzer noted, "Given the size of the decline in food exports and in agricultural prices, it is not surprising that many of the U.S. banks that failed in 1930 and in 1931 were in agricultural regions." Meltzer's observation indicates that misguided trade policy may have triggered the bank failures and resulting monetary collapse in a significant way. We believe Meltzer's insight gives us a better understanding of the Great Depression.

The most widely accepted theory for the beginning of the Great Depression is the monetarist narrative, which has the collapsing banking system as the prime causal factor. The empirical evidence suggests that a *disguised* monetary inflation throughout the 1920s was followed abruptly by an *open* and severe deflation following 1929. The appreciable financial disintegration and deflation caused by over 10,000 bank failures and an implosion of the inverted credit pyramid certainly had very real negative economic effects.

The thesis that a negative trade shock can impact monetary policy fits these empirical puzzle pieces together. The tariff not only closed off the U.S. export market to farmers, it also left a vast volume of heterogeneous and specific capital goods used in agricultural production idle and suddenly worthless. Empty silos and buildings, rusting tools and machinery, and unused acreage—all in particular geographical regions—led to severe liquidations and farm foreclosures in the states experiencing the first banking crisis, with the vast bulk of failures involving small state-chartered rural banks. Economic historian Eugene White, who examined individual bank balance-sheet data, identifies the agricultural distress in the Midwestern states as a central reason for the pattern of failures. The Smoot-Hawley tariff was a direct factor in both the pattern of failures and their geographic location.

Microeconomic Connections

Here is where the Austrian business cycle model can aid our understanding of the crisis. The monetary theory of capital malinvestment arises from relative price distortions and heterogeneous capital. Both points are by and large absent from most macro modeling of business cycles. These microeconomic connections are, however, fundamental. Disguised inflation in the 1920s probably created a constellation of malinvestments in need of liquidation, meaning that by 1929 a business recession was likely inevitable. However, an extraordinary tariff war brought world trade to a screeching halt. The tariff created additional malinvestment in a capital structure already in need of market readjustments. Both prior monetary inflation and restrictive trade policy led to and exacerbated the economic downturn. They are *not* mutually exclusive alternatives.

Misguided public policies, such as state-run deposit insurance and branch-banking restrictions, created a banking system vulnerable to pervasive failures caused by adverse trade shocks. The moral-hazard problems associated with inaccurate risk-pricing—and the fragility of the system due to restrictions on geographical risk diversification—would prove fatal. At the same time that intervention was leading rural banks to commit capital to riskier loan portfolios, intervention was exposing them to additional risk. When unexpected changes in regional economic conditions arise from arbitrary interventions in the free-trade system, undiversified banks will fail in large numbers. Smoot-Hawley, one of the most massive tariffs in American history, destroyed an enormous portion of the vulnerable capital structure. The resultant contagion, bank runs, and failures that followed show that *trade policy can affect monetary conditions.*

Central Bank Illusion

Whether the Federal Reserve could have stopped the contagion and subsequent bank failures misses the main economic point. Central-banking advocates sell an illusion of monetary stability, when in reality the system is wide open to adverse shocks and therefore is highly unstable over the long run. A central bank can easily overexpand or overcontract the stock of money and credit. This is best illustrated by the contrast of the Federal Reserve System to its freer Canadian counterpart. Canada did not have antibranching regulations, socialized deposit insurance, or a central bank. This is significant because over 30 percent of Canada's GNP originated in foreign trade. Smoot-Hawley escalated tariff barriers between Canada and the United States, yet Canada did not experience *any* bank failures or bank runs, and its money supply declined by only 13 percent (versus 29 percent in America). There is every reason to believe that a free-banking system most likely would have prevented the disguised inflation of the 1920s and averted the geographical vulnerabilities along with the open secondary deflation characteristic of the 1930s. After World War I many countries tragically established central banks under the illusion that monopoly and central planning in money would lead to economic stability. History has rendered its verdict on central planning: Whether it be shoes, screws, or money, it always fails.

Whether the Federal Reserve could have stopped the contagion and subsequent bank failures misses the main economic point.

All of which brings us to today. While "welfare-warfare" states throughout the world are running huge fiscal deficits, their central banks are recklessly monetizing massive quantities of debt (inflation). Extraordinary volatility now characterizes financial markets amidst a worsening sovereign debt crisis. Major financial institutions throughout the world hold mountainous portfolios of worthless assets that government policy has steered them into holding. Defaults threaten to destroy the world monetary systems in spite of all the short-run political machinations of prime ministers and central-bank leaders. And in these dangerous waters, what do we hear from the politicians, many already with their hands red? Trade protectionism!

When political agents denounce China on trade and demand an appreciation of its currency, it is the functional equivalent of placing a tariff on each and every Chinese export. This type of protectionist saber-rattling risks igniting not only a destructive international trade war but also, with the economy in the aftermath of a colossal bubble and the world's banker growing restless with its hoard of depreciating IOU's, vastly more damage than the world is prepared to handle. Have we learned nothing from the past? FEE

Who Killed Michael Jackson?

BY THOMAS SZASZ

The blog WhyQuit.com asks: "How should your family describe your cause of death? Was it suicide, murder, an accident or stupidity?" Playing Russian roulette, engaging in extreme sports, taking large doses of soporific drugs, and many other activities fit each of these options. When do we blame such deaths on the deceased, and when do we not? The answer lies mainly in the language and setting in which the question is framed.

Our basic biological needs are air, food, water, sleep, and sex. We are provided with air by our normal environment. We trade food and water in the free market. Buying sex was generally legal in the past, while selling it was often prohibited. Now in many "advanced" societies selling sex is legal but buying it is penalized.

In a free society adults would pay for the drugs they want and would be responsible for their use.

The trade in sleep belongs in a different category. Most chemicals for inducing sleep are available only to medical personnel for specific purposes, or to private individuals indirectly, with the assistance of licensed physicians or drug dealers in the black market. We must keep this legal-social context in mind if we wish to understand and judge certain contemporary "tragedies," such as the deaths of two of the most popular American entertainers of their times, Elvis Presley and Michael Jackson.

Screaming into a microphone on a brightly lit stage in the evening in front of a wildly cheering crowd is not conducive to sleeping soundly later that night. "Downers" in the evening and "uppers" in the morning may be regarded as part of a popular entertainer's professional equipment, as well as an occupational health hazard for the profession. However, prescription laws prevent performers from procuring the drugs they want, turning them into dependents managed according to what doctors deem they need, ostensibly for the proper treatment of their fictitious diseases. This arrangement makes doctors necessary for VIPs seeking "controlled substances" and endangers VUPs (very unimportant physicians) willing to succumb to the temptation to service them. In a free society adults would pay for the drugs they want and would be responsible for their use.

Elvis Presley started to use drugs early in his career and, as his fame grew, became a big-time drug user. On December 21,1970, when President Nixon received Presley in the White House and presented him with a Bureau of Narcotics and Dangerous Drugs badge, identifying him as an agent of the government's drug enforcement apparatus, Presley was heavily drugged. He took the opportunity to express his patriotism by telling Nixon that the Beatles, whose songs he regularly performed, exemplified what he saw as a trend of anti-Americanism and drug abuse in popular culture. After Presley died of a drug overdose on August 16, 1977, at age 42, President Jimmy Carter issued a statement that credited Presley with having "permanently changed the face of American popular culture."

In 1980 Presley's personal physician, Dr. George Nichopoulos, aka "Dr. Nick," was indicted on several counts of "overprescribing drugs." The jury acquitted him on all counts. The Tennessee Board of Medical Examiners then found him guilty of overprescribing, imposed a three-month suspension of his license and three years' probation, and then in 1995, permanently revoked his license. Evidently it never occurred to the

Thomas Szasz (tszasz@aol.com) is professor of psychiatry emeritus at SUNY Upstate Medical University in Syracuse. His latest book is Suicide Prohibition: The Shame of Medicine.

Tennessee judicial authorities, or anyone else, to blame Presley's death on his doctor and charge him with killing his patient.

Contributory negligence is the legal defense against a claim based on negligence, where the plaintiff/claimant, through his own behavior, contributes to the harm he suffers. The knowing and deliberate use of prescription drugs—categorized as treatment for the disease called "drug addiction"—fits that criterion perfectly. In the past we did not demonize drugs; we called persons who traded in sedatives "druggists," "pharmacists," "doctors," or simply "sellers." Now we call them "enablers," another weasel word generated by the therapeutic state.

In the 1950s and 1960s, when President and Mrs. John F. Kennedy were "enabled" by the now-forgotten Dr. Max Jacobson, aka "Dr. Feelgood," the drug dispenser was not yet called an "enabler." Jacobson's customers, in addition to the President and First Lady, included many celebrities. Before the first debate with Nixon on September 26, 1960, Jacobson injected Kennedy with a combination "of amphetamines, steroids and vitamins. Within minutes Kennedy felt a surge of energy and optimism. Kennedy then had sex with a young woman brought to his room so that by the time he confronted Nixon, he was going to feel both energetic and relaxed" (tinyurl.com/86ey8hz). Jacobson was also part of the presidential entourage at the Vienna summit in 1961.

By May 1962 Jacobson had visited the White House to treat JFK 34 times. In 1972 Jacobson told *New York Times* science writer Boyce Rensberger: "I worked with the Kennedys; I traveled with the Kennedys; I treated the Kennedys; they never could have made it without me." In 1975 the New York State Board of Regents revoked Jacobson's medical license. *Sic transit gloria pharmacopolae*. (So passes the glory of the quack.)

No physician was blamed for the suicide-"murder" of Marilyn Monroe, one of JFK's, and RFK's, paramours. Indeed, Dr. Ralph Greenson—a prominent Los Angeles psychoanalyst who, qua psychoanalyst, was not supposed to have used drugs in his practice but had prescribed large quantities of barbiturates to her and was one of the first persons to see Monroe after her death—was quickly exonerated as attempting to wean her off drugs. Neither he nor another physician who had prescribed sedatives for Monroe was deprived of his license.

De facto, Michael Jackson killed himself or contributed heavily to his own demise. De jure, his physician, Dr. Conrad Murray, killed him. Jackson was exonerated of any role in his own death. Having medicalized suicide, we delude ourselves into believing we have made large advances in the diagnosis and treatment of self-killing but are unaware of having lost our ability to see what's in front of our nose. In 1899 a certain Dr. Ward in Arizona observed: "I have never been called to attend a case of Gila monster bite, and I don't want to be. I think a man who is fool enough to get bitten by a Gila monster ought to die. The creature is so sluggish and slow of movement that the victim of its bite is compelled to help largely in order to get bitten" (tinyurl.com/6vwex6j).

De facto, Michael Jackson killed himself or contributed heavily to his own demise. De jure, his physician, Dr. Conrad Murray, killed him. Jackson was exonerated of any role in his own death.

After Murray was convicted he was denied bail. "This is not a crime involving a mistake of judgment. . . . This was a crime where the end result was the death of a human being," explained Judge Michael Pastor. "That factor demonstrates rather dramatically that the public should be protected."

Dr. Ward disagreed that the public needed to be protected from Gila monsters. I disagree that public security requires that Murray be incarcerated. Taking away his license would suffice to accomplish that end. (This statement must not be interpreted as an endorsement of medical licensure laws. Here I address the drug-related death of certain celebrities and the legal fate of their physicians. I have critiqued our drug laws elsewhere.) FEE

The Best Bet Is Freedom

BY JASON RIDDLE

As I was watching a recent GOP debate in Las Vegas, I couldn't help but think of the millions of people who enter the casinos expecting to beat the odds. Some do. Most do not. There is a reason gambling is a multibillion-dollar industry. Big profits are made as relatively small amounts are lost by the masses trying to beat the system. Of course gambling may be regarded as entertainment, but the relevant feature of gambling for present purposes is that it is a zero-sum game. One person's winnings are necessarily another's losses. Wealth is transferred, and the house always wins so long as enough people play the game.

Government and poker are both zero-sum games, but at least in poker, you can walk away.
Frisko [Wikipedia]

Similarly, politics operates as a zero-sum game. Economist Robert Murphy points out that our current political system is actually a negative-sum game, but even if we could eliminate all bureaucratic waste, we cannot escape the simple truth that when an individual wins political favor, he or she only benefits at the less obvious expense of someone else. There is no such thing as a magical public fund from which political gifts spontaneously generate. No matter how noble the intention or the cause, the benevolent politician is not Santa Claus. All goods distributed by government must first be created or produced by somebody. Whatever is given must first be taken. This is true for corporate subsidies and bank bailouts, just as it is true for transfer payments made to the very poorest members of society.

People by and large accept such a system because they believe they will be able to draw more in political advantage than they lose by way of political plunder. This mentality keeps the population playing the game, and like the casino, if enough people play the game, it is the political class and the politically connected who always win.

The government spends more, regulates more, and interferes more in our lives each year—and the economy barely grows. Even with the odds stacked against the average person, people still seem eager to place their bets on the system by looking for political solutions. In Vegas they would call this a "sucker bet."

To better the odds of reaping political spoils, individuals with shared interests tend to join together to increase political influence. Teachers, lawyers, labor unions, banks, farmers, defense contractors, the elderly, and myriad other identifiable individuals band together in groups to maximize potential benefits for their special interests. What seems to go unnoticed is that the government itself is one of the largest special interest groups of

Jason Riddle (jason@butleronbusiness.com) is the cohost of Butler on Business, a free-market talk show in Atlanta. This article first appeared at TheFreemanOnline.org.

all, now comprising 15 to 17 percent of the total workforce. As Ludwig von Mises observed, "Seen from the point of view of the particular group interests of the bureaucrats, every measure that makes the government's payroll swell is progress."

The goal of politicians is to create the appearance of providing free goodies to the public. Lack of knowledge about the true costs of these goodies may be one explanation for mass participation in a system of gross exploitation. While the gambler's winnings and losses are visible, it is more difficult to identify the true costs of the political game. Even under the most transparent federal budget, the costs of political programs are dispersed across the population in amounts indiscernible to any single person. It is virtually impossible to calculate net political profit or loss for any individual or group in the tangled web of taxes, subsidies, patents, regulations, transfer payments, services, and prohibitions.

> While the gambler's winnings and losses are visible, it is more difficult to identify the true costs of the political game.

Moreover, when resources are consumed by any government program, there is the unseen cost of what never comes to be. For example, when lobbyists persuade politicians to spend millions every year to maintain a vacant desalination plant in Yuma, Arizona, that money is no longer available to be invested in the creation of products consumers want and jobs people need. When resources are diverted into subsidizing jobs in a failing industry, new jobs in a sustainable industry are never created. This is the unseen cost of politics.

Not only are the odds of winning better at the casino, but gambling is far more ethical than actively seeking political loot. While both politics and poker are zero-sum games, the gambler bears the full risk of the bet. Through the political process people are able to profit only when the costs and the risks are spread to others.

Furthermore, all wagers made in the casino are voluntary. It is difficult to make the case that you or I voluntarily consent to having our money taken for Wall Street bailouts or even unemployment benefits. It is even harder to make the case that children not yet born offer their consent to the debt burdens we incur today.

Some people may argue that shared sacrifice is simply part of an implicit social contract. I find it less than convincing that a mad grab for the property of others is fundamental to civilization. Humans come together in society because of the benefits reaped from the cooperative actions of knowledge sharing and the division of labor. The degree to which societies have prospered is directly related to the degree to which individual property rights are respected.

Fortunately, there is a proven system where wealth is not merely transferred in a win-loss fashion. In the free market wealth would be created and exchanged for mutual benefit. It would not be a zero-sum game. The free market entails voluntary exchange and thus is also the only moral arrangement because it is the only system that does not necessitate violence, theft, or exploitation. Some argue that the free-market process would be cold and compassionless, but as Penn Jillette explains:

> It's amazing to me how many people think that voting to have the government give poor people money is compassion. Helping poor and suffering people is compassion. Voting for our government to use guns to give money to help poor and suffering people is immoral self-righteous bullying laziness.

The greatest threat to the established political order is for people to fully realize that whenever the force of government is used to obtain special privilege, it is done at the expense of our neighbors, friends, and family. All that would be required to end political plunder would be to cease asking politicians to do for us what we would never ourselves do to our friends. The system of voluntary exchange offered by the free market does not claim to offer utopia or immediate gratification of all of society's wants, but it is the only sure bet for incremental progress toward human flourishing. FEE

The Volcker Rule

BY WARREN C. GIBSON

Paul Volcker is a man of considerable stature, and not just because he's six feet, seven inches tall. He gained a reputation for courage and plain talk as chairman of the Federal Reserve System under Presidents Carter and Reagan because he broke the back of the 1970s inflation. He did so by (mostly) sticking to a tight monetary policy even though that meant sky-high interest rates and sharp back-to-back recessions before the economy could enter its vigorous recovery. Now 84, he has enjoyed a comeback in recent years as an adviser to President Obama. His Volcker Rule, prohibiting proprietary trading by banks, was heralded as one way of preventing a repeat of the recent financial crisis, and it became part of the Dodd-Frank Act signed into law in July 2010.

The Dodd-Frank Act was passed with only slightly more detail than this.
Wikimedia Commons

Dodd-Frank's full title, incidentally, is the Wall Street Reform and Consumer Protection Act. Like most current legislation its name reflects hoped-for outcomes, not its actual provisions. Reading the act (tinyurl.com/3kxwrnl[PDF]) is not for the faint of heart. There are 16 titles consisting of 1,601 sections for a total of 848 dense pages. Only a lawyer could love sentences like this:

> Any nonbank financial company supervised by the Board that engages in proprietary trading or takes or retains any equity, partnership, or other ownership interest in or sponsors a hedge fund or a private equity fund shall be subject, by rule, as provided in subsection (b)(2), to additional capital requirements for and additional quantitative limits with regards to such proprietary trading and taking or retaining any equity, partnership, or other ownership interest in or sponsorship of a hedge fund or a private equity fund, except that permitted activities as described in subsection (d) shall not be subject to the additional capital and additional quantitative limits except as provided in subsection (d)(3), as if the nonbank financial company supervised by the Board were a banking entity.

Volcker initially outlined his proposal in a three-page memorandum. It came to life as Section 619 of Dodd-Frank, expanded to 11 dense pages. This section is supposed to prevent banks from buying and selling securities for their own account, in contrast to brokering customer trades. It also prohibits banks from holding interests in hedge funds or private equity funds or from sponsoring such funds. These prohibitions are supposed to lessen the need for future bailouts like those that were provided to financial institutions in 2008 and 2009.

Warren Gibson (warren@gibson2.com) teaches engineering at Santa Clara University and economics at San Jose State University.

But Volcker is not happy. "I don't like it, but there it is," he said. "I'd love to see a four-page bill that bans proprietary trading and makes the board and chief executive responsible for compliance." On the other hand Rep. Frank, former Sen. Dodd, President Obama, and all the other Dodd-Frank sponsors should be happy. They achieved their purposes when the act was signed. They can now boast of having tamed the Wall Street beast so that the little people will never again be stuck with a bill for bailouts. But the full effects of Dodd-Frank won't be felt until after this year's election because so much depends on how the bureaucracy makes the rules that give meaning to the act. Exaggerating just a bit, one wag called Dodd-Frank a blank piece of paper for rule-makers to write on.

Inter-Agency Squabbling

Four federal regulatory agencies are charged with writing the Volcker rules. Those agencies are supposed to play nice with one another—a 94-word sentence on page 247 orders them to do so. But a squabble has already broken out between the Fed and the Federal Deposit Insurance Corporation. Recently Bank of America moved some derivatives from its Merrill Lynch subsidiary to a subsidiary that holds insured deposits. The Fed favored this move as a way of providing relief to the bank's holding company, while the FDIC, which would have to pay off depositors in the event of a failure, objected.

Last October the four agencies issued a tentative set of rules extending to 298 pages, inviting public responses to about 400 questions. A sample: "Should the Agencies use a gradual, phased in approach to implement the statute rather than having the implementing rules become effective at one time? If so, what prohibitions and restrictions should be implemented first? Please explain." This is a pretty basic question, suggesting that regulators are in over their heads and are trying to get private parties to rescue them. This would be no surprise given their daunting task plus the fact that the smartest financial people can make a lot more money on Wall Street than they can working for regulatory agencies.

The draft rules are full of exemptions, which caught the attention of Ted Kaufman, former senator from Delaware and now a Duke University Law School professor. "We've been through this before," he said. "I know these folks, these Wall Street guys. . . . [T]hey're smart as hell. You give them the smallest little hole and they'll run through it."

The full effects of Dodd-Frank won't be felt until after this year's election because so much depends on how the bureaucracy makes the rules that give meaning to the act.

Loopholes and Ambiguity

Why the exemptions? Have the bankers bullied the regulators into line? Maybe, but the rule writers seem to recognize that proprietary trading isn't so easy to recognize and may not always be a bad thing. Prop trading can actually help keep markets running smoothly by providing liquidity. The exemptions fall into several broad categories that are fraught with loopholes and ambiguity.

First, trading on behalf of customers is exempt. But when a firm seeks a buyer for a customer's securities, it may have possession of those securities for some period of time, during which it is exposed to market risk just as if it were conducting proprietary trading. How long must these intervals become before the transaction becomes a proprietary trade? If the regulators tried to pin this down they would very likely suppress some perfectly good trades while letting others through that really should be called proprietary. A big ambiguity here.

Hedging is also exempt. This is the practice of taking a secondary position to offset the risk of another investment. For example, if I expect to receive a million euros next year but fear that the euro will decline before I get paid, I can hedge by entering a contract obligating me to deliver a million euros next year at an exchange rate agreed on today. But sometimes hedges only partially offset a particular risk. Hedges are another big ambiguity in the rules.

Underwriting and market-making are exempt. A firm that makes a market for some security usually carries an inventory of it, and that means risk. It is entirely possible that a firm could label an asset as inventory for its market-making operation when in fact its real motivation is speculation for its own account. Motives can be elusive.

Finally, the feds have issued a blanket exemption for proprietary trading of their own securities. No surprise here. We all know that Treasury securities are free of risk—or are they? If you buy a ten-year bond yielding 1.8 percent and then two years later the rate for such bonds rises to a more normal 3 percent, your bond's market value will decline by nearly one-fifth. If you had borrowed 80 percent of the bond's price, you would have lost all your equity. Trading Treasury bonds, even if considered free of default risk, can be risky in terms of market price.

Rule makers accepted comments through January 2012 and have until July to finish the rules. They may well miss that deadline, but Dodd-Frank will take effect all the same. Then nobody will really be sure of what it means. Business uncertainty will increase, and prospects for robust economic recovery will dim.

Rule makers have until July to finish the rules. They may well miss that deadline, but Dodd-Frank will take effect all the same. Then nobody will really be sure of what it means.

Phantom Deregulation

Obama recently said that "of course" there had been too little regulation during the recent financial crisis. Really? Notwithstanding some deregulation in recent years, banking and finance remain more heavily regulated than almost any other industry. Such deregulatory changes as we have had, like the opening of interstate banking, have been overwhelmingly beneficial and are not the source of the recent financial crisis. (See "The Rise and Fall of Glass-Steagall" in *The Freeman*, October 2010, tinyurl.com/2btnngm.) Problems in the financial system will not be solved by piling on more layers of regulation. Better qualified or more dedicated regulators, if such could be found, can't do it either.

Should we get rid of all regulation? In its broadest sense, to regulate an activity simply means to make it regular and orderly. Regulation by government agencies will always be problematic. For one thing, as Kaufman observed, those who are subject to government regulation will find ways around the rules, and the result is invariably a call for yet another layer of regulations. Government regulators, no matter how well-intentioned, cannot possibly acquire the detailed knowledge of dozens or hundreds of individual firms. They usually have no choice but to rely on those managers, as shown by the question quoted above. If their relationship is at all cordial, the regulators tend, perhaps unconsciously, to take on the perspective of the regulated firms rather than the customers they are supposed to protect. This is called "regulatory capture."

Can greedy managers be trusted to regulate themselves? First, greed is nothing new, and it's not going away. Second, the question implies that managers must be trusted to walk a narrow path and avert their eyes from temptation. This is a false alternative. In fact free-market institutions, if allowed to operate, will "regulate" greedy managers more strictly and more effectively than government agents can. Free markets offer long-term rewards to those who earn the trust of customers while keeping managers focused on the fear of failure.

Market Regulation

We have to emphasize that markets must operate in a proper legal framework, one that does not tolerate theft or fraud. These activities must always be sanctioned and, when uncovered, be met with restitution and punishment.

So without the Volcker Rule or similar regulations, what would stop bank managers from dumping risky assets into government-insured banks? In a free market there wouldn't be government deposit insurance. There might be private insurance, but the providers would be powerfully motivated to ride herd on the insured. Bank managers, with or without insurance, would have to earn depositors' trust. And depositors would have to pay attention to the soundness of the banks they patronize. How can ordinary individuals judge the soundness of institutions as complex as banks? The same way we judge the quality of all kinds of providers these days: by looking online for five-star ratings.

Without government deposit insurance, might bank failures sometimes result in depositor losses? Yes! Occasional failures would put the fear of God into managers and depositors alike. Customers who would avoid risk altogether could seek pure custodial banks rather than loan banks. But then they shouldn't expect free checking or free ATMs. At the same time, customers seeking high returns and willing to accept the necessary risk would be happy to see their funds deployed in assets like the derivatives that Bank of America recently moved. Perhaps such risk-taking institutions would no longer be called banks.

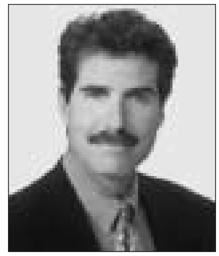
"Creative destruction" sounds harsh, and indeed it can be. But the benefits of free markets cannot be had without the possibility of failure, and in the end, failures are benefits too.

"Creative destruction" sounds harsh, and indeed it can be. But the benefits of free markets cannot be had without the possibility of failure, and in the end, failures are benefits too.

A dramatic tale of failure has unfolded before our eyes just now: MF Global declared bankruptcy last October. There are allegations that the firm misappropriated customer funds, a serious charge that has not been resolved at this writing. We are not concerned here with any criminal behavior but rather MF's errors of judgment and the fate of its shareholders and creditors.

This publicly held firm was headed by John Corzine, former boss of Goldman Sachs, former governor of New Jersey, and a former U.S. senator. MF traded sophisticated securities, such as futures and options, both for its own accounts and on behalf of clients. On taking the reins of MF Global, Corzine decided the firm should assume more risk, and never mind the 2008 collapse, which had sobered most financial managers. The firm bet heavily and wrongly on European sovereign debt securities and paid with its corporate life. MF was engaged in risky proprietary trading, but because it was not a bank, it would have been exempt from Dodd-Frank's Volcker provisions even if they had been in effect. MF Global's missteps provide a textbook illustration of what should happen when a firm conducts unwise proprietary trading or any other sort of excessive risk. No trading prohibitions were necessary, and the consequences of management's errors fell just where they should. Shareholders were wiped out, management is unemployed, and creditors will line up in bankruptcy court.

Notwithstanding the MF story there is little cause to hope for a turn to *market* regulation any time soon. The rules will be written, Dodd-Frank will take effect, and new crises will arise. More legislation will be proposed and the cycle will repeat. FEE



Obamacare Abominations

BY JOHN STOSSEL

President Obama says his health care "reform" will be good for business.

Business has learned the truth.

Three successful businessmen explained to me how Obamacare is a reason that unemployment stays high. Its length and complexity make businessmen wary of expanding.

Mike Whalen, CEO of Heart of America Group, which runs hotels and restaurants, said that when he asked his company's health insurance experts to summarize the impact of Obamacare, "the three of them kind of looked at each other and said, 'We've gone to seminar after seminar, and, Mike, we can't tell you.' I think that just kind of sums up the uncertainty."

Brad Anderson, CEO of Best Buy, added that Obamacare makes it impossible to achieve even basic certainty about future personnel costs:

"If I was trying to get you to fund a new business I had started and you asked me what my payroll was going to be three years from now per employee, if I went to the deepest specialist in the industry, he can't tell me what it's actually going to cost, let alone what I'm going to be responsible for."

You would think a piece of legislation more than a thousand pages long would at least be clear about the specifics. But a lot of those pages say: "The secretary will determine. . . ." That means the secretary of health and human services will announce the rules sometime in the future. How can a business make plans in such a fog?

John Allison, former CEO of BB&T, the 12th biggest bank in America, pointed out how Obamacare encourages employers not to insure their employees. Under the law an employer would be fined for that. But the penalty at present—about $2,000—is lower than the cost of a policy.

"What that means is in theory every company ought to dump their plan on the government plan and pay the penalty," he said. "So you don't really know what the cost is because it's designed to fail."

Of course, then every employee would turn to the government-subsidized health insurance. Maybe that was the central planners' intention all along.

An owner of 12 IHOPs told me that he can't expand his business because he can't afford the burden of Obamacare.

Many of his waitresses work part time or change jobs every few months. He hadn't been insuring them, but Obamacare requires him to. He says he can't make money paying a $2,000 penalty for every waitress, so he's cancelled his plans to expand. It's one more reason why job growth hasn't picked up post-recession.

Of course we were told that government health care would increase hiring. After all, European companies don't have to pay for their employees' health insurance. If every American employer paid the $2,000 penalty and their workers turned to the government for insurance, American companies would be better able to compete with European ones. They might save $10,000 per employee.

That sounded good, but like so many politicians' promises, it leaves out the hidden costs. When countries move to a government-funded system, taxes rise to crushing levels, as they have in Europe.

The law's impenetrable complication does almost as much damage. Robert Higgs of the Independent Institute is right: If you wonder why businesspeople are not investing and reviving the economy, the answer lies in all the question marks that Obamacare and other new regulations confront them with. Higgs calls this "regime uncertainty." It's also what prolonged the Great Depression.

No one who understands the nature of government as the wielder of force—as opposed to the peaceful persuasion of the free market—is surprised by this. FEE

John Stossel hosts Stossel *on Fox Business and is the author of* Myths, Lies, and Downright Stupidity: Get Out the Shovel—Why Everything You Know is Wrong. *Copyright 2012 by JFS Productions, Inc. Distributed by Creators Syndicate, Inc.*

Book Reviews

Adam Smith: An Enlightened Life

by Nicholas Phillipson
Yale University Press • 2010/2012 • 352 pages • $32.50 hardcover; $23.00 paperback

Reviewed by Martin Morse Wooster

Anyone who reads Adam Smith's *The Wealth of Nations* or *The Theory of Moral Sentiments* would want to know more about the author of those classic works. The Library of Congress says there are at least 300 works in several languages about Smith, but only about a dozen biographies, including James Buchan's *The Authentic Adam Smith* (2006).

There are two reasons there aren't many Adam Smith biographies. First, Smith, like so many intellectuals of his time, was not a man who enjoyed baring his soul in print. He didn't like letter writing, for example, and relatively few of his letters survive. But Smith's reticence went further than that of most thinkers of his day. In 1787, three years before his death at age 67, he ordered his friends to destroy all his papers and lecture notes except for seven philosophical essays, which were published posthumously. Smith's friend and literary executor, Dugald Stewart, observed that Smith "seemed to have wished that no materials should remain for his biographers, but what were furnished by the lasting monuments of his genius, and the exemplary worth of his private life."

Although Smith could have his own papers destroyed, he couldn't stop his friends (including Stewart) from writing about him. In addition, extensive lecture notes compiled by Smith's students in the 1760s provide evidence of how his ideas emerged and changed. Using all the available archives, Phillipson, a lecturer in history at the University of Edinburgh, has produced an elegant and forceful biography.

It should be noted that Phillipson doesn't care much how Smith discovered the importance of free markets. He is far more concerned about how Smith saw himself, as a philosopher who was the foremost disciple of David Hume, a man whose goal was "to develop philosophical accounts of the principles of law and government which would be of use to the rulers of modern Europe."

Consider Phillipson's description of the legacy of *The Wealth of Nations*. He sees Smith's book as "the greatest and most enduring monument to the intellectual culture of the Scottish Enlightenment." The book, he adds, "was a call to his contemporaries to take moral, political and intellectual control of their lives and the lives of those for whom they were responsible. It is in such context that the *Wealth of Nations* needs to be read by historians. The rest can be left to his disciples and critics."

Phillipson signals to his readers that he is neither a disciple nor a critic of Smith's work. Readers interested in Smith's libertarian development should look to other books. What Phillipson is best at is describing Smith's life and his ideas. In doing that, he offers many clues as to why Smith was so successful. Phillipson shows that the reason Glasgow and Edinburgh attracted so many smart people in the eighteenth century can be traced to free trade. In 1707 Scotland and England formally merged to form the United Kingdom. Scottish merchants agreed to that to have free access to English markets.

The wealth created by those traders not only generously endowed the University of Glasgow and the University of Edinburgh, but also allowed some merchants to hire professors for special projects. One of them, Henry Home, hired Smith in 1748 to deliver lectures on rhetoric and in jurisprudence. His public lectures were so popular that Smith repeated them in 1749 and 1750. Those lectures not only convinced the University of Glasgow to hire Smith to teach logic and metaphysics, they also proved to be highly profitable—Smith earned 100 pounds per year from his lectures, which was more than most professors earned.

In 1751 Smith began his career as a university lecturer. He was so popular that students flocked to Edinburgh just to hear him. One of his best-known students was James Boswell, who wrote in 1759 that Smith "has nothing of that formal stiffness and Pedantry which is too often found in Professors. So far from that, he is a polite well-bred man, is extreamly [sic] fond of having his students with him and treats them with all the easiness and affability imaginable."

Smith spent 13 years at the University of Glasgow, then left in 1764 to become the private tutor to the Duke of Buccleuch. The Duke was so grateful for Smith's skill as a teacher that he paid him 300 pounds a year until 1778, when Smith became a customs commissioner. Buccleuch's investment gave Smith the time he needed to produce *The Wealth of Nations*.

Phillipson's book will not tell you why Adam Smith became a great economist. But it superbly shows *how* Smith became important and why *The Wealth of Nations* remains significant.

Martin Morse Wooster (MMWooster@yahoo.com) is a writer and editor living in Silver Spring, Maryland.

Homeschooling: A Hope for America

edited by Carl Watner
The Voluntaryists • 2010 • 258 pages • $19.99

Reviewed by Karen Y. Palasek

In his foreword, John Taylor Gatto, the New York City Teacher of the Year from 1989 through 1991, raises the following question: "What would happen if we let the imagination and energy of the young free again—as it was in Ben Franklin's day—free to add value directly to the world around them as the young did when America was coherent? . . . What if they were taught the truth of things instead of having their heads filled with sound bites? What if they learned hard skills instead of 'subjects'?" Reaching back in time is reaching forward in American educational, economic, and civic value, Gatto argues. To get back what has largely been lost or left behind, we must abandon the ongoing "trophy" approach to schooling, along with its anti-entrepreneurial, feel-good leveling effects.

Government schools have failed. They are in any case not designed to deliver authentic education. If we are sincere about regaining coherence and preserving our free society, we must arise from complacency and train young people not in "subjects," but rather in lessons of personal integrity, self-responsibility, and self-control. Homeschooling is the best means of achieving that objective, and Carl Watner's book *Homeschooling: A Hope For America* offers a collection of essays, analyses, and perspectives on education inside and outside of government-run schools. The book serves as a broad introduction to an array of freedom-oriented education topics and provides an interesting and valuable section of references. Readers will find discussions appropriate for new homeschooling families; for those considering homeschooling but who need some history, a rationale, or a track record to present to skeptical friends and family; and for seasoned homeschoolers as well.

Other than its status as a personal alternative to government education, there is no single "right" model for homeschooling. Indeed the broad outline of what is legally possible is the province of each individual state and sometimes also of local school authorities. Homeschoolers need to know the legal landscape. Once past the legal considerations, homeschooling offers a virtually infinite assortment of possibilities and thus its appeal to and fit with the individualist, the freedom-minded, the creative, the educationally unorthodox as well as the very orthodox, the patriot, the libertarian, the anarchist, and any number of unique configurations of civic, religious, social, ethnic, family, economic, political, or other personal circumstances or styles.

Most readers probably will not read the book cover to cover. Instead they will find within each of its six sections a collection of articles that cover fundamental ideas in that area. A majority of the articles are authored by the editor and originally appeared in his publication, *The Voluntaryist*. Many read like conversations and are in fact parts of larger conversations on the subject.

Section I, "Homeschooling!" is an initiation into the what and why of homeschooling. Titles reflect typical areas of concern: the legal defense of homeschooling, an intellectual and moral justification, and parental rights and responsibilities. For families thinking of getting their feet wet in homeschooling, the articles included give a brief idea of what the water is like, who is already in that water, some of what has drawn them (and their children) to that shore, and how a free society requires that children receive a genuine education.

The next two sections of Watner's volume offer essays that recount the history of government schools and take the reader through critiques of government schools' operations and effects. In those sections the reader encounters comments on morality, propaganda, the development of the intellect, and the poor outlook for freedom as products of the government schooling system.

The role of parenting and family values is the focus in "Family—Why Parenting Matters" and "A Potpourri of Hope for America" (sections IV and V, respectively). From Bryce Christensen's essay, "Abolish the Family?" we get this explanation for the hostility toward homeschooling among "liberals": "Individual freedom counts for little, but traditional family autonomy counts for even less, since the family is an obstacle to social engineering."

A short catchall section ("Aphorisms") concludes the book.

In sum Watner's book lays out some of the reasons for which families have taken their children back from the State, back into their homes to educate them. The topics and conversations ask parents to examine what they believe and why. As Gatto writes, "We need, I think, to reach backwards in time to the better open-source educational way America enjoyed when we dominated the inventiveness of the world; back to the time before the rigid, militaristic procedures of universal schooling foreclosed our imagination."

That journey backwards in time is the journey to America's best hope for individual freedom—back to homeschooling. FEE

Karen Palasek (karenyvonp@gmail.com) is a leadership and organizational development consultant in North Carolina who homeschooled her daughter.

The Cultural and Political Economy of Recovery: Social Learning in a Post-Disaster Environment

by Emily Chamlee-Wright

Routledge • 2010 • 240 pages • $145

Reviewed by Daniel J. D'Amico

Emily Chamlee-Wright's latest book, *The Cultural and Political Economy of Recovery*, has been awarded the F. A. Hayek Prize from the Atlas Economic Research Foundation, and rightly so.

A professor of economics at Beloit College, Chamlee-Wright draws insights from a variety of disciplines to explain the processes of recovery endured in the Gulf Coast region after Hurricane Katrina. She synthesizes insights from social network theory, Austrian economics, cultural economics, and the growing literature on natural disasters to make meaningful this complex mix of human decisions and social behaviors that will forever be a part of American history. In the process she makes a valuable contribution to refocusing the social sciences on their proper object of inquiry: people as individuals and in groups.

In *The Counter Revolution of Science*, Hayek described why and how the physical sciences purged humanism from their disciplines. Presuming that physical phenomena operate like people acting intentionally can lead to serious error. Thunder does not result from the anger of the gods.

Hayek explained that this purging unfortunately also affected the social sciences. Positivism, scientism, formal modeling, and empirical measurement became the dominant techniques to assure objectivity in economics and most other social disciplines. But to purge the human element from social science is to ignore the essence of the very subject matter we seek to understand—real human behavior and decisionmaking.

Nobel laureate Vernon Smith coined the term "contextual rationality" to describe behaviors that, although seemingly costly and/or irrational, are on closer reflection effective reactions to unique environmental constraints. The ability of outside observers to recognize rationality is restricted by their own limitations in recognizing the incentives, knowledge, and constraints faced by an actor.

Chamlee-Wright's version of social science, like those surveyed above, is one that recognizes the reasons so many people since Katrina have endured extreme costs, forgone significant alternatives, and in many cases have carried significant risk to return and rebuild the city of New Orleans. Though an imperfect paraphrase, she describes the recovery as a symbiotic relationship amid flux. The citizens contribute to a stock of social knowledge and social value that feeds their community's identity, culture, and economic welfare. Vice versa, the city provides a navigable network of social, pecuniary, and intangible benefits to those who returned to her. These people loved their families, their neighbors, their places of business, and the city of New Orleans.

Knowing what actors hold as their abstract goals and knowing what they believe to be their optimal strategies helps reveal the rational character of their behaviors. What better way to start than by simply asking them?

Chamlee-Wright's most innovative contribution to humane economics is her unique method and source materials. Her own form of introspection is a micro complement to Deirdre McCloskey's. As McCloskey tunes into literature, culture, and folk narrative to allow society to reflect on itself, Chamlee-Wright allows real people to self-reflect by offering personal testimonies. Her open-ended interviews expose the procedural elements of recovery, discovery, innovation, and adaptation that "mainstream" perspectives often overlook. Where conventional political economy models, such as market-failure theory and public-goods logic, presume a necessary role for central planning in disaster recovery, Chamlee-Wright's subjects seem not only capable of serving their recovery needs themselves; they are also ingenious discoverers of solutions that government bureaucrats would never recognize.

I have lived in New Orleans since 2008. Like Chamlee-Wright I am fascinated by my neighbors' narratives about government failure after the storm. I trust that New Orleanians themselves know the best ways to structure their lives within their unique city.

Early in the book Chamlee-Wright quotes Thomas Schelling, who offers the opinion that "[t]here are classes of problems that free markets simply do not deal with well. If ever there was an example, the rebuilding of New Orleans is it." I believe most of the residents she interviewed would read her book and say something like, "If free markets are just people, Chamlee-Wright is much more correct about New Orleans than Schelling."

Not many residents would think that more FEMA activity would have made things better. I'd go so far as to bet that many would find it insulting to suggest that government assistance made the revival of the city and its culture today possible. The reality is that the returners have worked very hard to rebuild the city they loved and have done so through their own efforts. Credit is not due to government help and planning. That is the big message of the book—free people can and will recover from natural disasters through the voluntary mechanisms of the market and civil society. FEE

Daniel D'Amico (danieljdamico@gmail.com) is assistant professor of economics at Loyola University in New Orleans.

Handbook on Contemporary Austrian Economics

edited by Peter J. Boettke
Edward Elgar • 2010 • 174 pages • $165.00

Reviewed by George Leef

Why are many young economists drawn to the Austrian school? George Mason University professor and FEE trustee Peter Boettke, the editor of this volume, explains it this way: "I once described Austrian economics as humanistic in its method and humanitarian in its concern. This is what attracted me to the school. It promised philosophic understanding of the complex world around us and when combined with some basic concepts of morality produces a powerful argument for a society of free and responsible individuals."

That's a strong calling card, and readers of Boettke's book—consisting of ten essays written by relatively young Austrian scholars—will find many more reasons to investigate the Austrian school. The book is brimming over with insights into Austrian analysis, along with some jousting with non-Austrians.

In the first essay, "Only Individuals Choose," Anthony Evans explains that individuals are the building blocks of the social sciences. That is why Austrians insist on approaching economics through methodological individualism. Only individuals can act, not aggregates or collectives. Evans attacks the competing notion of methodological holism, which accounts for individual agency by appealing to "society." Evans argues that the real debate is among differing conceptions of individualism.

In the second essay, "Economics as the Study of Coordination and Exchange," Christopher Coyne contrasts two approaches to economics—one that centers on optimizing resource allocation and the other that centers on exchange relationships. Why does that distinction matter? Coyne writes that under the former, "the study of economics becomes one of computation and maximization instead of focusing on purposeful human action and the process through which individuals interact and coordinate their plans and goals."

The book's third essay, "The Facts of Social Science Are What People Believe and Think" by Virgil Henry Storr, shows that the "data" of economics are subjective in character. We can only comprehend economic phenomena by trying to comprehend individual beliefs, not through the crunching of numbers, as non-Austrians would have it.

Edward Stringham elaborates on subjectivism in his essay, "Economic Value and Costs Are Subjective." He argues that economists can believe in subjectivism in different ways and to differing degrees, and concludes, "Exactly how much one embraces economic subjectivism is likely to influence the types of policies one is willing to support."

The book's fifth essay, "Price, the Ultimate Heuristic" by Stephen Miller, argues that the free market does not magically cause people to overcome their cognitive limitations, but has the virtue of getting them "to discard their counterproductive biases and mental shortcuts." That is, the price system encourages rational behavior by compelling individuals to examine more information than they might otherwise have done.

Scott Beaulier contributes the next essay, "Without Private Property There Can Be No Rational Economic Calculation." He introduces readers to the most famous Austrian dispute with non-Austrians—the calculation debate—and elaborates on it. "Since property rights are crucial for the coordination of economic activities," he writes, "the central question for economists and policymakers becomes how to gather accurate information about the scarcity of resources in a world with imperfect property rights." Beaulier shows how that problem is especially important in efforts at privatizing State enterprises and functions.

In "The Competitive Market Is a Process of Entrepreneurial Discovery," Frederic Sautet explores the implications of the Austrian approach to competition. "To compete means to be entrepreneurial," Sautet writes. He traces the history of economic thinking about the nature of market competition and concludes that "[p]rofit opportunities and knowledge gaps in the market are one and the same thing."

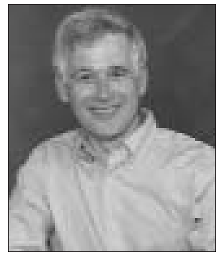
The final three essays all deal with macroeconomic issues. J. Robert Subrick's "Money Is Non-neutral" explores the trouble that stems from the Monetarist and Keynesian ideas that money is, at least in the long run, neutral. Subrick shows that changes in the money supply have both short- and long-run consequences that lead to malinvestment, shifting resources away from their optimal uses and thus reducing national prosperity. Benjamin Powell's essay, "Some Implications of Capital Heterogeneity," explores Austrian capital theory, especially the importance of coordinating investment with consumer desires. Powell also elaborates on the Austrian theory of the business cycle and the folly of "stimulus spending."

The book's concluding essay is by Peter Leeson: "Anarchy Unbound: How Much Order Can Spontaneous Order Create?" It asks whether the self-interested activities of individuals could generate enough law and order to make the State unnecessary. Leeson's analysis is fascinating, and I encourage readers to immerse themselves in it.

Those who are new to economics will find these essays rather difficult, but students who are already familiar with economic issues and language (and I should add that the writing is mostly in plain English) will find them to be most enlightening and thought-provoking. FEE

George Leef (georgeleef@aol.com) is book review editor of The Freeman.

The Case Against Sanctions on Iran



BY DAVID R. HENDERSON

When I was a kid, Glen, the boy next door, once played a nasty trick on my brother, Paul. Glen held his cat in his arms, brought it within a few inches of Paul's face, and pulled its tail. The suddenly angry cat bit Paul's face. My brother and I were upset; we both thought the cat, if it bit anyone, should have bitten the perpetrator.

When governments impose economic sanctions on people in other countries, they too are pulling the cat's tail. Glen's intent was to get his cat to bite my brother. His plan worked. The intent of a government that imposes sanctions is to get the people in the target country to "bite" *their* government. That typically does not work. Why? People are smarter than cats.

For the last few years the U.S. government and some other governments have wanted to dissuade Iran's government from pursuing nuclear weapons. To do so they have imposed increasingly stringent sanctions on Iran. In May 2011, for example, the U.S. government imposed sanctions to try to reduce the supply of gasoline. Drying up gasoline supplies to Iran—which, surprisingly, imports much of its gasoline—has been a method favored by those who want to hurt Iranians.

When Iranians suddenly find gasoline in short supply or more expensive, so that even getting to work or to the store is a challenge, they will wonder who is responsible. It won't be hard to find out.

It's not clear how effective such sanctions can be. The companies and governments that the U.S. government threatens to penalize if they export gasoline to Iran might just be replaced by companies over which the U.S. government has little leverage.

But let's assume that the sanctions can do real harm. What happens next?

One thing we can be sure of is that President Mahmoud Ahmadinejad, who, according to Hoover Institution scholar Bruce Bueno de Mesquita, is approximately the 18th most-powerful politician in Iran, and Ali Khamenei, *the* most powerful politician there, are not doing without gasoline. No. The people who do without gasoline, or with less gasoline, are everyday Iranians who have approximately zero say in the policies that the U.S. government wants to change.

So what is the U.S. government hoping for? It hopes that Iranians—like my neighbor's cat—will lash out at whoever's face is right in front of them. The idea is to induce Iranians to see their own government as the enemy so they will put pressure on it.

But when Iranians suddenly find gasoline in short supply or more expensive, so that even getting to work or to the store is a challenge, they will wonder who is responsible. It won't be hard to find out. Although the government of Iran has a great deal of power to censor newspapers, radio, and television, one piece of information that it's sure *not* to censor is the role of outside governments in the country's economic distress.

Of course, the government will exaggerate the harm done by the sanctions. Although socialism is what's killing poor people in Cuba, for example, Fidel Castro for almost 50 years blamed Cuba's economic problems on the "blockade," his word for the embargo imposed by the U.S. government in the early 1960s. But he can plausibly make this claim because the embargo exists.

David Henderson (davidrhenderson1950@gmail.com) is a research fellow with the Hoover Institution and an economics professor at the Graduate School of Business and Public Policy at the Naval Postgraduate School in Monterey, California. He is the editor of The Concise Encyclopedia of Economics *(Liberty Fund, 2008) and blogs at econlog.econlib.org.*

Likewise, much of the Iranian people's pain is caused by their own government's intrusive limits on economic freedom. In the annual index of economic freedom, published in *Economic Freedom of the World*, Iran dropped from 80th of 141 countries in 2006 to 112th in 2007, a breathtaking drop for one year. It inched up slightly to 105th in 2009, but that still places Iran low on economic freedom. Although, as in Cuba, this lack of economic freedom is the most important cause of Iran's pain, sanctions cause further pain. And the Iranian government will be sure to tell its citizens who imposed the sanctions.

What do people in embargoed countries do when they find out that foreign governments threaten them? They want to do what my neighbor's cat would not do: bite the perpetrator. The idea that one country's government can, by inflicting pain on people in another country, cause them to pressure their government to change is simply wishful thinking.

> The idea that one country's government can, by inflicting pain on people in another country, cause them to pressure their government to change is simply wishful thinking.

To understand this, ask yourself how *you* would feel if another country's government imposed sanctions on Americans that were serious enough to cause us real harm. Is your first instinct to be upset at your own government? If it is, you are unusual. I'd bet you would feel some animosity toward that foreign government.

The further tragedy in the case of Iran is that there appears to be a strong moderate element that would like better relations with the United States, as well as with other people and governments in the West. By tightening the screws on Iran, the U.S. government is nipping this movement in the bud.

Do I have the solution to stop the Iranian government from developing nuclear weapons? No, I don't. But for three reasons it doesn't matter for the issue of sanctions.

First, the Iranian government does not appear to be developing nuclear weapons. If you have read otherwise in U.S. newspaper headlines, then read beyond the headlines. In 2007 and 2011 U.S. intelligence agencies concluded that Iran scrapped its weapons program in 2003. The International Atomic Energy Agency (IAEA) late last year certified that Iran has diverted no uranium to weapons purposes. Moreover, investigative journalist Gareth Porter has debunked some well-publicized but unsubstantiated claims made in the latest IAEA report. Just one example: The Russian scientist identified by the IAEA as a nuclear-weapons expert who helped Iran's government construct a detonation device is in fact not a nuclear-weapons expert. Instead, in Porter's words, he "has worked solely on nanodiamonds from the beginning of his research career."

Second, even if the Iranian government were to develop nuclear weapons, that in itself would not be a threat to Americans. It would not even be much of a threat to Israel. Although the Israeli government has never acknowledged having nuclear weapons, everyone knows it does. An Iranian government that "nuked" Israel would face a second-strike response from Israel's nuclear-armed submarines—*and the Iranian government officials know it*.

Third, if a proposed measure would harm innocent people and not even achieve its goal, that's a sufficient argument against the measure. Yet instead of even asking themselves if their proposed measures will be effective, officials resort to a way of thinking so common among politicians—one that was parodied in the British comedy show *Yes, Prime Minister*: "Something must be done. This is something. Therefore, it must be done."

But I do have a partial solution: Have the U.S. government end all current sanctions on Iran, end subsidies to all countries in the Middle East, and pull all troops out of the region. These actions, more than any others, would go a long way toward convincing Iranians that the U.S. government is not a threat. Otherwise, many of them will think, justifiably, that it is like my cruel neighbor. FEE