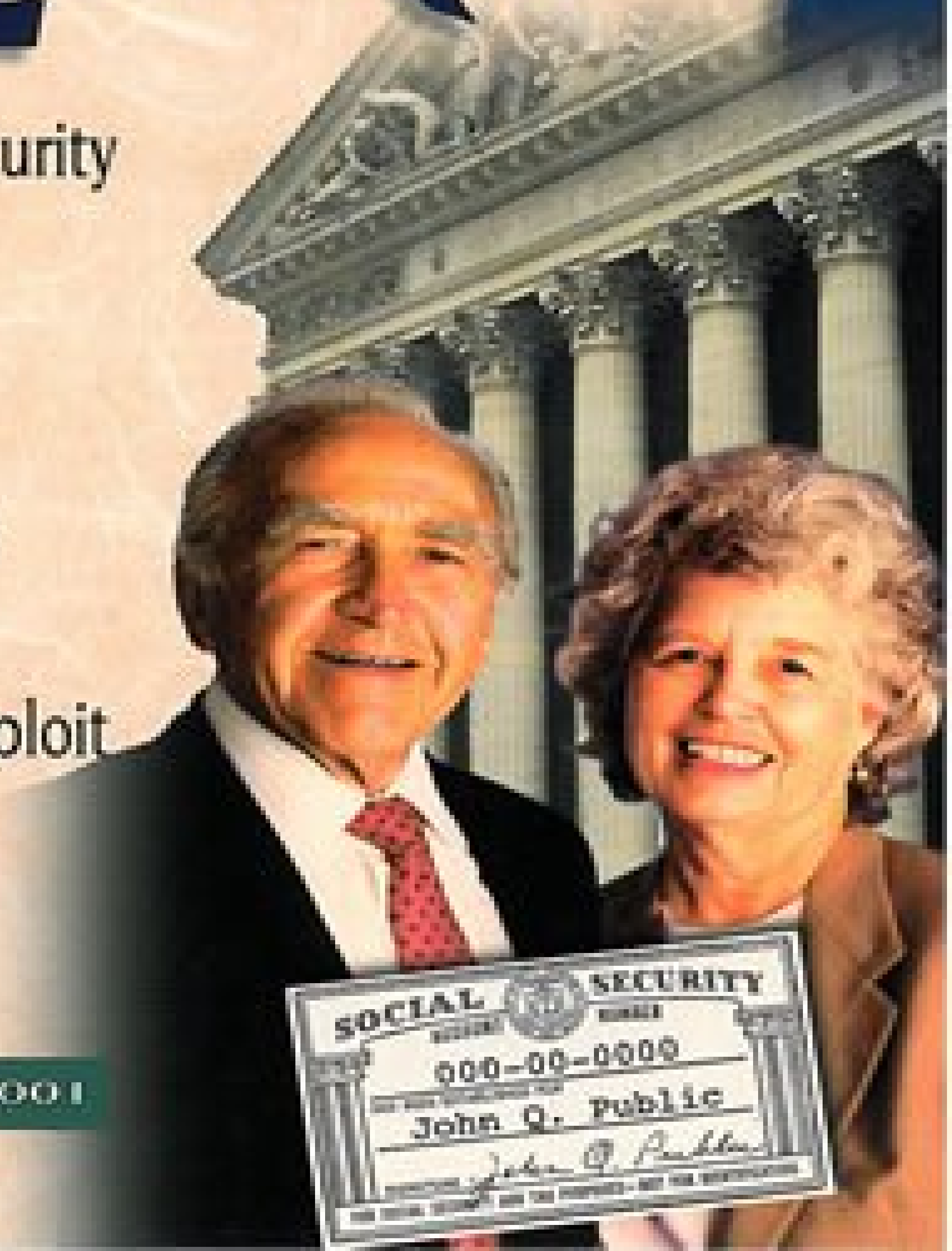
IDEAS ON LIBERTY

- Why Social Security Is Popular
- Of Genomes and Lemons
- The Great Irish Famine
- Does Trade Exploit the Poorest of the Poor?



SEPTEMBER 2001

September 2001

Gary M. Galles
Hugh Macaulay
E. Frank Stephenson
Michael E. Rupert
Larry Tritten
David Laband
Stephen Davies
Norman Barry
Pierre Lemieux
Christopher Mayer
Christopher Westley
Charles W. Baird
Donald Boudreaux
Lawrence W. Reed
Doug Bandow
Dwight R. Lee
Mark Skousen
Russell Roberts
Sheldon Richman

Roger W. Garrison
George C. Leef
Alexander Franco
Robert Holland
and
Burton Folsom

FEE

FEE's mission is to inspire, educate, and connect future leaders with the economic, ethical, and legal principles of a free society.

Find us online at:
FEE.org
Facebook.com/FEEonline
Twitter.com/FEEonline (@feeonline)

Contact us directly at: 1-800-960-4FEE (4333)

Foundation for Economic Education
1718 Peachtree St. NW, Suite 1048
Atlanta, GA 30309

Produced by
MiceEatCheese.co

Published by
Benjamin Tucker Institute, z.s.

Foundation for Economic Education

Contents

The Record of Conservative Free Marketeers after the Fall of Communism Is a Sorry One
SEPTEMBER 01, 2001 by Norman Barry

Sovereign Traders

Consumers Are the Greatest Beneficiaries of Free Trade
SEPTEMBER 01, 2001 by Pierre Lemieux

Illusion of Control

No One Can Control the Complexity and Mass of the U.S. Economy
SEPTEMBER 01, 2001 by Christopher Mayer

Winners and Losers in the Transfer Game

No State Ever Became Rich by Relying on Federal Wealth Transfers
SEPTEMBER 01, 2001 by Christopher Westley

A Reply to a Labor Priest

Is There a Moral Duty to Pay Union Dues?
SEPTEMBER 01, 2001 by Charles W. Baird
School choice--the general concept that parents should have much more freedom and responsibility for their children's education than they have now--is an idea that has captured the imagination and support of legions of freedom-loving Americans. Where the rubber hits the road, however, is how to achieve it.

An Open Letter to Senators Clinton and Schumer

Cap Energy Prices to Further Economic Education
SEPTEMBER 01, 2001 by Donald Boudreaux
School choice--the general concept that parents should have much more freedom and responsibility for their children's education than they have now--is an idea that has captured the imagination and support of legions of freedom-loving Americans. Where the rubber hits the road, however, is how to achieve it.

School Choice via the Universal Tax Credit

Separating School from State Represents a Bright Future for All Children

SEPTEMBER 01, 2001 by Lawrence W. Reed

School choice--the general concept that parents should have much more freedom and responsibility for their children's education than they have now--is an idea that has captured the imagination and support of legions of freedom-loving Americans. Where the rubber hits the road, however, is how to achieve it.

Demonizing Drug Makers

Governments Risk Killing the Goose That Lays the Golden Eggs

SEPTEMBER 01, 2001 by Doug Bandow

Most government attempts to protect the environment involve imposing detailed regulations on how, and how much, pollution must be reduced. This command-and-control approach does reduce pollution, but as I explained last month, it does so at high cost.

The Perverse Popularity of Command and Control

How Industry Is Protected against Competition at the Expense of the Environment

SEPTEMBER 01, 2001 by Dwight R. Lee

Most government attempts to protect the environment involve imposing detailed regulations on how, and how much, pollution must be reduced. This command-and-control approach does reduce pollution, but as I explained last month, it does so at high cost.

I Like Hayek

Who Better to Lead Economics into the 21st Century?

SEPTEMBER 01, 2001 by Mark Skousen

Who should take the place of Keynes to lead economics into the 21st century? Should it be the economics of Friedman, Ludwig von Mises, Joseph Schumpeter, or F. A. Hayek? While all four have much to offer, I favor Hayek. I am not alone.

Does Trade Exploit the Poorest of the Poor?

Both Parties Benefit from Trade Even When There Are Gross Inequalities of Skill and Productivity
SEPTEMBER 01, 2001 by Russell Roberts
Roughly 180 years ago David Ricardo discovered comparative advantage. He showed that trade benefits both trading partners even when one is less productive than the other across all activities. There are gains from trade and specialization even in that case.

The Bad Old Days

World War II Nostalgia Is Thinly Veiled Collectivism
SEPTEMBER 01, 2001 by Sheldon Richman

The Economy Is Cyclical?

The Central Bank Whipsaws the Economy
SEPTEMBER 01, 2001 by Roger W. Garrison

Feeling Your Pain: The Explosion and Abuse of Government Power in the Clinton-Gore Years by James Bovard

Clinton Is Gone, But Not His Governmental Detritus
SEPTEMBER 01, 2001 by George C. Leef

America's Great Depression by Murray N. Rothbard

Rothbard Reasserts the Austrian View of Boom and Bust Cycles
SEPTEMBER 01, 2001 by Roger W. Garrison

Greenspan: The Man Behind Money by Justin Martin

A Book Lacking in Critical Analysis
SEPTEMBER 01, 2001 by Alexander Franco

Open Society: Reforming Global Capitalism by George Soros

Soros Doesn't Understand the First Thing about Economic Systems
SEPTEMBER 01, 2001 by Pierre Lemieux

Left Back: A Century of Failed School Reforms by Diane Ravitch

An Extraordinary Review of 100 Years of Education Fads

SEPTEMBER 01, 2001 by Robert Holland

American Dreamer: A Life of Henry A. Wallace by John C. Culver and John Hyde

A Portrait of How Statist Ideas Were Conceived and Implemented in the New Deal Era
SEPTEMBER 01, 2001 by Burton Folsom

Put Robinson-Patman, Not Bookstore Chains, on Trial

Does the 1936 Act Really Help Consumers?

SEPTEMBER 01, 2001 by Gary M. Galles

Gary Galles is a professor of economics at Pepperdine University.

Independent bookstores have lost substantial market share to competitors during the past decade. So in 1998 they responded in the current American fashion. Twenty-six of them, along with the American Booksellers Association (ABA), sued their larger competitors, Barnes & Noble and Borders, for unfair competition under the 1936 Robinson-Patman Act. The plaintiffs spent $18 million on their action, but had their major damage claims dismissed by the trial judge. Nevertheless, during last April's trial, the suit was settled, with the defendants paying the plaintiffs $4.7 million.

If the intent was to help consumers, it is not the chain booksellers that should have been put on trial. Their growing market shares reveal that consumers benefit from their offerings. Instead, the Robinson-Patman Act should have been put on trial, because of its anticonsumer effects. As federal Judge Richard Posner, a leading expert in the field, has written, "The Robinson-Patman Act . . . is almost uniformly condemned by professional and academic opinion, both legal and economic."[1]

Price Discrimination

The ABA suit alleged that the large-volume discounts the book chains receive from publishers violate Robinson-Patman's prohibition of price discrimination between customers not based on provable cost differences, "where the effect of such discrimination may be to substantially lessen competition or tend to create a monopoly." Unfortunately, while the act reads like a defense of competition, its effect is to restrict competition, because the quantity discounts attacked benefit consumers by leading to lower retail prices.

How do quantity discounts help consumers? To get them, book retailers must sell lots of books. And they have, through lower retail prices, wider selection, more stores, longer hours of operation, more enjoyable atmosphere, and more. That these features benefit consumers is shown by the growing patronage of stores that provide them. Threatening to take away the quantity discounts whose results consumers clearly prefer is anticonsumer rather than proconsumer.

Robinson-Patman has long been known to be bad law. U.S. Supreme Court Justice Felix Frankfurter noted that "precision of expression is not an outstanding characteristic of the Robinson-Patman Act,"[2] and former federal judge Robert Bork described it as "the misshapen progeny of intolerable draftsmanship coupled to a wholly mistaken economic theory."[3]

Rulings under the act have often, without economic logic, held that quantity discounts somehow hurt competition. Those rulings confused harm to competitors who lose out to preferred suppliers with harm to the competitive process. But superior offerings from competitors—the essence of competition—necessarily "harm" less efficient rivals in the process of benefiting consumers. As a result, this semantic confusion has frequently led the courts to undermine the competitive process and its consumer benefits by protecting inefficient rivals from competition—all the while claiming to defend competition.

Robinson-Patman supposedly allows firms to defend their quantity discounts by showing that specific cost savings justify different prices. However, that defense is little more than an illusion. The courts virtually never find the cost data sufficient. Of course, given that costs (opportunities forgone) are subjective and given the limitations of historical accounting data for forward-looking decisions, especially for multiproduct firms with no clear "right" way to allocate overhead costs, advertising, storage costs, and so on, to particular products, unambiguous proof that costs justify price differences is impossible.

Confusion-Based Strategy

These confusions were the key to the independent bookstores' hopes. If they could get the courts to buy the claim that large chains harmed competition because they took customers away from some competitors, then the chains would have to turn to the cost defense. And given the court's historic refusal to accept cost defenses, the chains would lose, regardless of whether there was really any harm to competition. The result would have been far smaller discounts to the chains, leading to higher costs, which they would pass on in higher prices. (Robinson-Patman cases almost always result in higher consumer prices.) That anticonsumer result, wrapped in proconsumer language, is what the plaintiffs were looking for because it would help them keep their customers from better alternatives.

Before the settlement was reached, U.S. District Judge William H. Orrick ruled that the plaintiffs were unable to show the discounts had harmed them. Unfortunately, past cases indicate that many judges do not share his correct understanding of competition. The next Robinson-Patman case brought before a judge who interprets the statute's ambiguous language differently will likely threaten consumers, the primary beneficiaries of the market process.

Notes

1. Richard Posner, *The Robinson-Patman Act: Federal Regulation of Price Differences* (Washington, D.C.: American Enterprise Institute, 1976), p. 1.
2. Automatic Canteen Co. of America v. FTC, 1953.
3. Robert Bork, *The Antitrust Paradox* (New York: Basic Books, 1978), p. 382.

Why Social Security Is Popular

The Conditions That Make Social Security Popular Are Temporary and Rapidly Disappearing

SEPTEMBER 01, 2001 by Hugh Macaulay

Hugh Macaulay was Alumni Professor of Economics Emeritus at Clemson University.

Polls show that people under 40 believe they are more likely to see an unidentified flying object than a penny of benefits from Social Security. Those 40 to 65 think they may see some return on the Social Security taxes they have paid. But expenditures will exceed receipts beginning in 2015, and even the fictional Trust Fund is supposed to run dry by 2035. So their returns are uncertain and likely to be very low. Those about to receive benefits or who have just begun receiving them are told that the annual return on the taxes they paid will be under 2 percent, much less than they could have gotten anywhere else.

Yet despite all these marks against Social Security, it has been so popular that, at least until recently, any politician who suggested a change in the program was described as having touched a deadly third rail. (President Bush has recommended that people be able to invest a small portion of their payroll tax in private retirement accounts, and has set up a commission to propose a specific plan to that effect.)

Social Security is a “social insurance” program: retired people are not supported by returns on money they contributed in the past. Rather, they are supported with taxes paid by current workers, who, in return, will be supported in retirement by workers from the next generation. As fast as money flows into the Social Security coffers from taxpayers, it gushes out to beneficiaries and is consumed.

This is the same principle that is used in chain letters and Ponzi schemes, both of which are universally ridiculed and usually outlawed.

How can we explain this enthusiastic support for Social Security given the sorry past and the bleak outlook for so wide a group of voters?

There are several reasons why the present program is so popular. The early retirees were big-time winners in this lottery. Take 100 workers who each work 50 years, from ages 15 to 65, as was common when the program began in 1937, and expect to live five years after retirement. With the annual wage income of white males in 1939 equal to $1,112 and women and blacks earning much less, we can conservatively assume that each contributes $10 a year while working and expects to draw $250 a year during his retirement. Those sums appear outlandishly low today, but they approximate the amounts applicable at the outset of the program. Each worker thus puts in $500 over 50 years of work and draws out $1,250 in five years of retirement.

Suppose that at the end of the first year of operation, two workers turn 65 and retire. Each has put in only $10, but each is now set to draw $250 a year for five years. At the end of the second year two more workers reach 65 and retire. Each has contributed $20 total and will also draw $1,250 over five years. If we were to ask these people if they think Social Security is a good idea, the hosannas could be heard in the next state.

As a real-world example, consider Ida May Fuller of Ludlow, Vermont, the first recipient of Social Security benefits. She had paid in a total of $24.75 over three years, and her first month's benefit was $22.54 in January 1940. She lived to be 100 and drew $22,888.92, or 924 times what she put in. While this is an extreme case, someone who received only two, ten, or 100 times what he contributed would have felt he hit the jackpot. This was at a time when interest rates were 3 percent a year.

Young Workers' Contributions

Had nothing changed since the program's inception, the youngest workers who turned 15 in 1940 would put in $500 over their 50 years of work, ending in 1990, and withdraw $1,250. Workers older than 15 in 1940 would have contributed for a shorter period and would have gained even more. Since we are now over 50 years beyond 1940, this level of gain should be the most any worker could expect. But Congress has used several policies to keep the gains growing.

First, Congress has periodically expanded the list of those covered. Only workers in private industry were covered at first, but then at later random intervals, Congress added farmers, self-employed workers, employees of nonprofit and charitable institutions, members of the armed forces, and government workers. Whenever a new group was added, the game started over again, with big winners at first, just as explained above. Those winners have always been enthusiastic supporters.

Second, note that in the early years, when each new group began to contribute and there were few retirees, much more money came into the pot than went out to retirees. Congress has been reluctant to see idle funds sitting in its honey pot, so it has periodically increased benefits for current as well as future retirees. In 1950 and 1952 Congress increased the benefits, doubling the amount that had been promised. Instead of $1,250, retirees would receive $2,500. In later years Congress again increased promised benefits, and in 1972 it tied the benefits to the consumer price index with "cost of living allowances" (COLAs) beginning in 1975. Thus retirees were protected against the ravages of inflation, a provision notably lacking in private retirement plans. Observe that with new groups being added periodically, there would be many new workers paying into Social Security and few newly qualified retirees to receive benefits from it. Again, is it any wonder that retirees believe if they have not found a fountain of youth, they at least have found a fountain of money?

Third, as life expectancy grows, the retirees receive payments for a period longer than that for which they paid. Using our earlier example, instead of paying in $500 and receiving $1,250 during five years of retirement, if the retiree lives only one year longer, he will receive benefits for six years. This is a 20 percent increase in his retirement benefits, which would rise to $1,500. With improvements in nutrition and medical care, life expectancy has continued its march. The gains here have been much greater than in this example. Life expectancy for white males in 1935 was only 61 years. Thus many, if not most, workers would never see any benefits. If life expectancy had been 66 years in 1940 and 75 in 2000, total benefits received would be ten times what was earlier expected. Instead of anticipating a benefit of $500 for only one year, a retiree would expect benefits of $5,000 over ten years, all for the constant level of contributions. Santa Claus has come again.

A fourth benefit has come from the baby-boom generation. When this large population joined the tax-paying labor force in the late 1960s, much more money again poured into the Social Security Trust Fund, and Congress again increased the benefits of those retired and about to retire.

This last benefit increase will turn into a burden when these boomers reach retirement age, beginning about 2010. Then that large generation will depend for its benefits on the smaller Generation X and the good times will be over. Members of Congress and the president have a two-, four-, or six-year time horizon, so they want to do what will heap praise and re-election on themselves today. Future politicians will bear the burden, but that is their problem.

Overstating the Cost of Living

A fifth source of benefits is inflation, which has added to the misperception. As noted, starting in 1975 Congress indexed Social Security benefits to the Consumer Price Index. When prices rose, benefits rose by an equal percent. Economists have long noted, however, that such an arrangement overstates the true cost of living for those so benefited by about 1.5 percent per year. After seven years of retirement the typical beneficiary has had his real benefits raised by an effective 10 percent. Another six years and he is 20 percent better off in real terms. This means his standard of living is not constant, but rises each year. Note how many senior citizens travel extensively, though they never did so while working nor expected to do so when retired.

Another change constitutes a sixth reason for the system's popularity. Just as new groups were added to the system, so were new benefits added. From 1954 through 1960 disability benefits were added and extended to survivors and dependents. While an added premium was levied for this benefit, those already retired did not have to pay anything for it and those nearing retirement did not pay its full cost. In 1965 Medicare was added to the benefits, and once again those at or near retirement got full benefits for less-than-full payment of premiums. Another 40–50-year game of gain got underway.

There is an additional gain to Medicare recipients. The program is divided into two parts: hospitalization and physician care. Payroll contributions finance, again on a money in-money out basis, the hospital-care portion. The physician's care portion is financed by voluntary payments by retirees, plus an additional contribution from general tax revenues. At present, Social Security recipients pay approximately 25 percent of the cost of their medical care; the other 75 percent is paid by general taxpayers. Who would want to abandon a system whereby others pay 75 percent of his medical bills? Not the present Social Security recipients.

A seventh reason for the popularity of Social Security is due to our asking only the ones who are alive and have benefited or think they will benefit. Many workers contributed for a lifetime and then died just before or after becoming eligible to collect. They do not get to express an opinion, which might well be highly negative.

For most retirees, benefits have far exceeded costs for the reasons cited. But what about these costs? The government has raised the use of smoke and mirrors to an art form in hiding the true cost of Social Security. Here's how:

First, remember that present retirees are receiving money from present workers, so any increase in costs is not of concern to retirees. The current push by retirees to have Medicare cover the cost of pharmaceutical drugs is an excellent example of this principle. They expect to gain from this new program, though they have never contributed a cent to finance it. And when Social Security contributions are raised, those already retired care not at all. Someone else will pay these taxes.

Second, when Congress arranged to finance the plan, it required the worker to pay half the amount and his employer the other half. The worker sees only his explicit half of cost. But as any economist will explain, the full cost falls on the employee because the employer's payment will come from money that would have gone to wages. The employee sees the government providing him with this wonderful plan at low cost and his employer as a mean-spirited capitalist who is not giving him the wage he so fairly deserves.

Third, the employee's low-cost tax (which the Social Security Act formally calls a "contribution") has been withheld from his wages since World War II. He never sees that money and thus parts with it with minimal pain. It is truly a hidden tax.

Originally retirement benefits were not taxable income. But in the 1980s and 1990s increasing portions of these benefits were included in retirees' income subject to the income tax. The sums collected, however, do not go into the general revenue but go instead to the Social Security trust funds. The sums collected are thus hidden Social Security taxes, another concealed cost of the program.

For the first 13 years of the system, the maximum tax paid by the worker each year was 1 percent of his wages up to $3,000, or $30; employers "paid" another $30. Today a worker pays 7.65 percent on wages up to more than $76,000, or over $5,800 a year, with an equal sum from his employer, reducing his nominal salary by that amount. The worker's maximum tax of $60 in 1937 has now risen to $11,600, or over 190 times as much. The cost of all those increased benefits has now come home for future beneficiaries. The enchantment with the program is likely to decline commensurately in the future.

The most serious cost of Social Security, however, is its social-insurance method of financing. Under a private plan, workers produce, save, invest, produce more goods, and finally retire and consume from this increased store of goods their investment has created. Under social insurance, employees work and pay taxes, and retirees receive these funds immediately and consume. There is no investment or increased output. Consumption is merely transferred from the young to the old. Is it any wonder that old people love Social Security?

If the approximately $600 billion annually contributed to Social Security were invested in ways that produced a 14 percent return, a rate that approximates that realized by manufacturing corporations for the past two decades, there would be $84 billion of additional goods each year. Over the 40 or 50 years when workers are employed, between $3.3 and $4.2 trillion of additional goods would be produced and available at retirement. This would provide an added $12,000 or $16,000 in goods for every man, woman, and child in the United States. These estimates are based on static analysis, meaning that we assume nothing changes in the future. If, however, productivity, incomes, and population rise, as they are sure to do, the gains will be even greater. Under the present system, no new goods will be produced and workers will be poorer by the sums just cited. Social insurance sounds good, but the result is fewer goods than with free-market insurance.

The reasons cited help explain why Social Security is so popular. But these conditions are temporary and rapidly disappearing. When they are gone, the house of cards will come tumbling down. If we cannot see beyond 15 years and change the system to include private savings and benefits, young and middle-age workers today will receive the paltry benefits they so richly deserve.

Of Genomes and Lemons

How Well-Intentioned Laws Can Harm the People They Mean to Protect

SEPTEMBER 01, 2001 by E. Frank Stephenson, Michael E. Rupert

Michael Rupert is a senior majoring in economics at Berry College in Rome, Georgia. Frank Stephenson is an assistant professor of economics in Berry College's Campbell School of Business.

While the recent announcement of the mapping of the human genome was greeted with optimism about cures for dread diseases, it also led to predictable teeth-gnashing about possible genetic discrimination.

Genetic discrimination ostensibly occurs when economic decisions are based on genetic information about people's susceptibility to disease. For example, medical or life insurers might use genetic information in deciding whether to cover an individual or what premium to charge. Likewise, employers seeking to minimize employee-benefit costs might use such information in deciding whom to hire.

Predictably, bills have been introduced in Congress to ban genetic discrimination by insurers and employers. (The 1996 Health Insurance Portability and Accountability Act already prohibits the use of genetic testing by group health insurers; this barrier has probably had little impact thus far since the genome has only recently been mapped and because genetic testing is still in its infancy.) Some 18 states and at least one locality (the well-meaning Montgomery County, Maryland) have enacted genetic-discrimination bans of one form or another, and the Equal Employment Opportunity Commission (EEOC), not waiting for additional federal legislation, claims that genetic discrimination is already illegal under laws prohibiting discrimination against the disabled. It is under this legal theory that the EEOC recently sued Burlington Northern Santa Fe Railroad seeking to prohibit its testing workers who submit carpal-tunnel-syndrome complaints for “a predisposition [for the syndrome] within the body chemistry of the individual” that “has nothing to do with work.”

Legal bans on the use of genetic information appeal to a perceived, though somewhat perverse, right of privacy. After all, people can keep their genetic information to themselves by not purchasing insurance. And people’s privacy could be protected by prohibiting insurance companies from disseminating information gleaned from genetic testing without the consent of the subject.

If, however, individuals wish to purchase insurance, they might be required to submit to testing as a condition of coverage. (Use of such background information is analogous to banks performing credit checks before making loans.) Such use of genetic testing would not be fundamentally different from the now-common use of blood and urine tests and the required submission of information on lifestyle factors such as diet and smoking habits.

Legislation prohibiting genetic testing as a condition of purchasing insurance could ultimately undermine the insurance market and make it difficult for people to be able to purchase insurance. Consider the life insurance market. Currently individuals and insurance companies enter into policies under a large cloud of uncertainty. While people have some inkling about their expected life spans from family history and lifestyle, they nonetheless know little because family history is not definitive and their parents often come from families with different histories. Of course, uncertainty about life span also exists because accidental death is possible.

Similarly, insurance companies can obtain some information about potential policyholders from blood and urine testing and lifestyle questionnaires, but they remain largely uncertain about the expected life spans of particular individuals. Insurers can, however, make reasonably accurate predictions of the mortality rate and life expectancy for the population as a whole, and they use that information to set premiums. Insurance is essentially risk-pooling, which works well when both insurer and insured have similar levels of uncertainty.

Delicate Balance Upset

Bans on genetic testing threaten to upset the delicate balance of mutual uncertainty in the life-insurance market by creating the possibility of asymmetric information. Asymmetric information exists when individuals and insurers have different information about life span. Outlawing genetic discrimination could create informational mismatches by prohibiting companies, but not individuals, from engaging in predictive genetic testing. Individuals could legally undergo tests to determine their life expectancies and could use the resulting information in buying insurance.

To consider how asymmetric information might undermine the life-insurance market, consider the following example. Imagine three people, Anne, Becky, and Cara, who because of genetic differences have life expectancies of 60, 70, and 80 years, respectively. Their life-insurance policies are with Big Global Insurance Company, Inc. Big Global knows that the average life expectancy of its policyholders is 70 years, and it sets its premiums accordingly. Of course, Big Global also knows that some of its policyholders will die before 70 and some will die after 70, but it cannot, based on blood and other tests, predict which customers will die young and which will die old.

Now suppose that a predictive genetic test is introduced. Individuals can get themselves tested, but insurers are legally prohibited from using the test in setting premiums or making coverage decisions. Anne, Becky, and Cara all avail themselves of the test and each learns her life expectancy based on genetic factors. Since Cara learns that she has a life expectancy of 80 years, barring accidents, and therefore has a very low probability of premature death, she judges that life insurance is not a good deal for her. Put differently, Cara is paying a premium that is too high because it is based on her dying at 70 rather than 80. The information gleaned from the test enables her to enhance her well-being by spending her money on things she values more than life insurance.

When Cara cancels her policy, Big Global has only two policyholders remaining. Their average life expectancy is 65 years, and Big Global now raises its premium accordingly. Becky, who was happy when her premium corresponded to her 70-year life expectancy, now finds life insurance to be too expensive and cancels her policy. As a result, Big Global has only one policyholder, Anne, left, and it adjusts its premium to match her 60-year life expectancy. (In practice, since Big Global is proscribed from performing genetic testing, it only learns of the change in the life expectancy of its policyholders over time as it notices its customers dying younger than before. Hence, it is probably more accurate to say Big Global raises its premiums over time and scares off future Beckys. For simplicity, we ignore this complication of timing, but it does not alter our conclusions.)

Consumers Harmed

Perversely, the result of the ban on genetic testing by insurance companies is harmful to two consumers, Becky and Cara, who would still like to purchase actuarially fair life insurance because of the uncertainty arising from accidental death. They are unable to do so, however, because the insurance company is barred from using technology to learn, as Becky and Cara have, that they are genetically low-risk (they have high life expectancies) and then setting a correspondingly low premium.

Moreover, while genetic antidiscrimination laws are supposed to help people like Anne, who have short life expectancies because of "bad" genes, future Annes will nonetheless pay premiums that match their riskiness, because future Beckys and Caras will forgo insurance. So antidiscrimination laws harm the Beckys and the Caras of the world, while providing only temporary relief to the Annes.

In other words, the imbalance of information created by the ban on genetic discrimination results in an adverse selection process in which the genetically healthy choose to forgo life insurance because companies are unable to identify them as such. People who are genetically risky continue to purchase insurance because companies are not able to immediately adjust their premiums to fully account for these people's higher risk. Over time the average level of riskiness in the pool of policyholders rises, causing firms to further increase their premiums and scaring off more potential customers. As a result, many people are unable to purchase insurance against the risks they do face and a lot of insurance companies go bankrupt.

Recognizing the possible harmful effects of asymmetric information on its insurance markets, the British government has explicitly allowed life-insurance companies to ask for genetic screening for Huntington's disease and is considering granting approval to test for other diseases.

Though well-intentioned, laws banning predictive genetic testing by insurers are lemons that will, oddly enough, harm the very people they are intended to protect.

The New China

A Capitalist Country with a Communist Government

SEPTEMBER 01, 2001 by Larry Tritten

Larry Tritten is a freelance writer whose work has appeared in Vanity Fair, Harper's, the National Lampoon, *and other publications.*

My first impressions of China came from the movies and comic books of the World War II era. The Chinese were always presented as our courageous allies, the salt-of-the earth people who risked their lives to help American airmen who had been shot down or crash-landed in Japanese-occupied territory. By the late '50s, when I was in the Army, the media and government were united in giving Americans an altogether new take on China, one that portrayed the Chinese as wicked communists. As a young soldier engaged in espionage against Red China (we monitored Chinese radio broadcasts from a field station on Okinawa), I was given regular doses of that concept.

So I'm not sure quite what I expected when I went to China recently. I guess I was prepared for a highly regimented, clinically bureaucratic, repressive place, something along the lines of the state in Kafka's novel *The Trial* or the world suggested by George Tooker's bleak paintings of urban isolation.

What I didn't expect was to discover that at virtually every turn I would come eye to eye with the iconic picture of the well-known Kentucky colonel and that almost every cityscape would feature plenty of silhouettes of the familiar Golden Arches. There was also the ubiquity of Coke and Pepsi signs, so many of them that it was clear that the classic rivalry of the two venerable soft drinks had found a new theater of operations in China. Along some stretches of urban highways the Pepsi signs are placed in proliferating rows, 20 or 30 within a few hundred yards.

It quickly became clear to me that Madison Avenue has come to China and is alive and kicking, doing the hornpipe in fact.

As popular as they are universally, fast food and soft drinks are hardly the measure of any society's level of sophisticated consumerism, but neither do they indicate the extent of China's free-enterprise aspirations. At the Palace Hotel, where I stayed in Beijing, I was surprised to find galleries of shops by just about every major couturier and purveyor of upscale lifestyle accessories—Gucci, Cartier, Armani, Hermès, Louis Vuitton, Versace, Givenchy, Christian Dior, Nina Ricci, Bruno Magli, Baccarrat, Bally—to name a few. I used to live a few blocks from Rodeo Drive in Beverly Hills, and walking the lower lobbies of the Palace Hotel was like nothing so much as window-shopping on that luxurious street.

Conditioned by the imagery of popular culture (the aforementioned movies, comic books, and the like), one tends to envision the cities of Asia as having business districts reminiscent of Middle Eastern bazaars, composed of innumerable tiny stalls, mini-shops, and street vendors. There is that element in Chinese cities, to be sure, but in Shanghai (a city with seemingly more neon than Las Vegas and a new-wave architecture that gives its skyline the look of one in a science fiction movie) I stood on the main floor of a mall that reminded me of the Beverly Center in West Los Angeles—or any other trendy American mall: myriad shops on consecutive floors in a maze of glass, polished gold and silver surfaces, futuristic designs, and high-tech logos.

Western Pleasures Sought

My guide in Shanghai described China as a capitalist country with a communist government, and everywhere I looked this was borne out. At the golf course I visited in Wuhan, in the bowling alley in my hotel in Shanghai, in the yearning of one of my guides to see a copy of *Playboy*—the popularity of Western-style pleasures and recreation was inescapable. *Playboy*, incidentally, is banned in China, but considering the sexiness of some of the music videos I saw on Channel V, China's version of MTV, I wonder how long this restriction can last.

Yet I also got the impression that these features are in the embryonic stage. The mall, for example, was anything but crowded, and the shops in the Palace Hotel had a newly minted, just-opened look, with few customers anywhere in sight and the clerks who kept vigil as if watching for an anticipated influx of big spenders. This is hardly the case with the fast food and soft drinks, though. There are 45 McDonald's franchises in Beijing, 65 KFCs in Shanghai. I have a picture of myself standing in Tiananmen Square in front of a building displaying a huge portrait of Chairman Mao—but what most people don't know is that at the other end of the square is a three-story KFC (the biggest one in the world) with a watchful picture of Colonel Sanders. There was also a Popeye's a couple of blocks from my hotel in Beijing. American fried chicken, it appears, has come to China with a vengeance.

And free enterprise is not just endemic to urban areas. It is an act that has traveled upriver and to the outlands. One of my favorite memories of China is associated with a trip up one of the tributaries of the Yangtze River. Our cruise ship docked at Badong, and a small group of us, Americans from such places as San Francisco, New York, Atlanta, and Washington, D.C., were taken upriver in wooden sampans. Plumped up in orange lifejackets, we were poled through the shallow rapids by native boatmen who sang traditional songs, abandoning their poles where the river was especially shallow to run along the banks and pull the boats with ropes. Along the way, we saw water buffalo and tiny ancient houses on the steep hillsides. We passed through gorges that seemed primeval, and I thought we could be in New Guinea or Burma (Myanmar). And, ultimately . . . when we reached our destination it was to discover that a lively backwater flea market awaited us—a hundred or so small tables set up along the shore, the goods tending toward bowls and plates, statues, amulets, old coins, and more. It was essentially a bucolic mini-mall, and the vendors, tightly packed, were aggressively competitive, hawking away loudly and persistently. It was a keen sight: the lifejacket festooned American tourists, captive consumers, pacing back and forth and appraising the merchandise on the tables, assailed by a barrage of pidgin-English sales pitches. I think that's when I thought: Capitalism 12, Marx 3.

Whatever the future of capitalism in China may be, I came away with a clear impression of the people as being extremely intelligent, industrious, savvy, friendly, and warmly hospitable. I think it's unfortunate that they find American fast food so appealing—but that, of course, is an international vice. I do hope that a Chinese edition of *Playboy* is published sometime soon, and I suspect that the game of Monopoly will probably catch on in a big way sometime in the near future.

Regulating Biodiversity: Tragedy in the Political Commons

Urbanites Want to Have Their Cake and Eat It, Too

SEPTEMBER 01, 2001 by David Laband

David Laband teaches natural resources economics and policy at the Forest Policy Center in the School of Forestry and Wildlife Sciences at Auburn University.

Last summer, lightning struck and killed an enormous pine tree on one side of my backyard. At about the same time, voracious pine bark beetles girdled and killed an equally impressive pine tree on the other side. Now bereft of needles, these two arboreal giants pose a potential threat to my house: if they were to fall at just the right angle, the damage could be substantial. In the interest of safety, my wife wants to have the trees removed; for the sake of promoting biodiversity on my two-acre lot, I do not.

Our personal dilemma mirrors a much larger struggle that quietly threatens to destroy the rights of private timberland owners across the United States—the desire of urban dwellers to have their cake and eat it too. They demand houses made of wood, wood furniture, paper and paper products, and so on, while also demanding environmental amenities such as aesthetically pleasing landscape views, biodiversity, and animal habitat. At a personal level this can't be done. If the trees are removed, my wife has peace of mind, but the many animals that depend on dead pine trees for their existence, either directly or indirectly, will vanish. If the trees stay, we will be promoting the ecological diversity of our property, but my wife will worry about our house with every gust of wind. We can't have it both ways. Similarly, at a macro level, there is a tradeoff between production/consumption of timber and production/consumption of related environmental amenities.

The Role of Intensively Managed Forests

The problem of how to grow and harvest increasing amounts of timber while simultaneously producing a steadily increasing array and level of environmental amenities associated with forested land has resulted in an industry-wide discussion of how to simultaneously achieve both objectives. There is a growing appreciation within the forestry community for the prospect that intensively managed forests may yield increasing amounts of wood while minimizing the total acreage from which wood is harvested. This maximizes the amount of acreage available to meet other demands—such as agricultural production, animal habitat, and other environmental amenities associated with natural forests.

However, intensively managed forests have come under heavy fire from self-proclaimed environmentalists. In these so-called plantation forests, man, not nature, regenerates the trees, which accordingly grow in even-aged stands. Their well-being is affected by the application of herbicides and pesticides, as well as by occasional thinning and fire management. In contrast to naturally (re)generated timberland, plantation timberland has been described as an "ecological desert," with the stated or implied conclusion that the nature and extent of biological diversity associated with natural forests is both greater and therefore more desirable than that associated with plantation forests.[1]

The Threat to Private Landowners and Social Welfare

Such pejorative rhetoric is both misleading and counterproductive. The unfortunate but nonetheless compelling truth is that we can't have our cake and eat it too. We must make responsible choices about what to produce and how to produce it. A serious threat to private landowners develops when citizens living in urban areas demand that private owners of timberland (definitionally located in rural areas) produce environmental amenities such as aesthetically pleasing views, biodiversity, animal habitat, and the like, provided the urbanites don't have to pay for it.

Further, they seek to enforce their demands by using the political process to pass regulations that require landowners disproportionately to bear the cost of producing these environmental amenities. For example, Oregon law requires private timberland owners to replant within two years areas from which they cut trees. Other regulations forbid clear-cutting of timberland. Federal regulations pertaining to endangered species are incredibly restrictive and intrusive with respect to an individual's property rights. The pursuit of environmental amenities that we are told are vital to some vaguely defined public interest through policies that impose virtually all the costs on relatively small numbers of private landowners generates what might be termed a "tragedy of the political commons."

Garrett Hardin introduced us to the tragedy of the commons.[2] Hardin developed a stylized example of a communal pasture open to all comers. There are no private property rights to the pasture, or rules, customs, or norms for shared use. In this setting, each shepherd, seeking to maximize the value of his holdings, keeps adding sheep to his flock as long as doing so adds an increment of gain. Further, the shepherds graze their sheep on the commons as long as the pasture provides any sustenance. Ignorant of the effects of their individual actions on the others, the shepherds collectively (and innocently) destroy the pasture. As Hardin concludes: "Therein is the tragedy. Each man is locked into a system that compels him to increase his herd without limit—in a world that is limited. Ruin is the destination toward which all men rush, each pursuing his own best interest in a society that believes in freedom of the commons."

Man's exploitation of the political commons is analogous to his exploitation of natural-resource commons. Our majority-rule voting process, which permits a majority of citizens to impose differential costs on the minority, encourages overprotection of endangered species, and overproduction of biodiversity, animal habitat, and landscape views. This occurs because each individual who bears a negligible portion of the costs of providing environmental amenities has a private incentive to keep demanding additional environmental protections as long as there is any perceived marginal benefit. As with the overgrazed pasture, the result of overprotecting Bambi is, as has become apparent all over the eastern United States, disastrous. Moreover, and not surprisingly, we are starting to hear real concern voiced about the recent proliferation of other animal species such as black bears, mountain lions, and coyotes. We are creating social tragedies that result from the political commons.

The tragedy is compounded by the incentives generated for private landowners by the heavy hand of command-and-control policies. When government abrogates property rights without compensation, landowners have strong incentives to mitigate their expected losses. They can do so by changing their land use from timber production to housing or commercial development. There is no incentive to promote habitat for endangered species; doing so means only that use of one's land will be seriously compromised by the highly restrictive provisions of the Endangered Species Act.

Instead, a landowner who finds a member of an endangered species on his property has a well-understood incentive to "shoot, shovel, and shut up." Such behaviors are not likely to further environmental objectives.

Other People's Costs

It is relatively easy to demonstrate that because private timberland owners bear the cost of producing biodiversity, nonland-owners demand excessive amounts of it. The first point to be made in this regard is that urbanites do not in fact place a high value on biodiversity. One need look no further than the readily observable behavior of urbanites for proof of this claim. Urbanites have the ability and prerogative to produce biodiversity on their own residential property. That is, they could let their residential lots grow wild with natural flora and fauna. This would, without question, promote ecological diversity. In practice, virtually no residential property owners, living anywhere in the United States, do this. Instead, they invest (implicitly through their time and explicitly by purchase) hundreds, if not thousands, of dollars annually in the care and maintenance of their lawns and grounds in a decidedly unnatural state. Like owners of intensively managed timberland, owners of residential property chemically treat and harvest the growth on their property. In so doing, they create a landscape with relatively little floral or faunal diversity. What this behavior reveals, of course, is that urban dwellers place a higher value on having their own aesthetically pleasing ecological deserts than on personally promoting local biodiversity, even when the latter would save them hundreds, perhaps thousands, of dollars each year. The clear implication is that urbanites simply do not attach much importance to biodiversity.

This leads directly to a second point: notwithstanding that biodiversity is of little importance to them personally, urbanites may favor local, state, and federal statutes that ostensibly enhance biodiversity, provided such statutes impose the cost burden on rural landowners. The feel-good benefit of such regulation may be small, but with no personal costs to worry about, urbanites can be convinced to vote for them. However, if there were even a moderate cost to urban dwellers, we can be reasonably certain that restrictive regulations would not be passed. This explains why, for example, Oregon's replanting regulations are not imposed on owners of residential properties who cut down trees.

Earth's limited resources cannot provide all things to all people simultaneously. For that matter, the earth cannot provide all things just to self-proclaimed environmentalists. Consequently, responsible choices about the use of resources must be made. It is irresponsible to enact environmental policies that impose costs disproportionately on private timberland owners. Such policies lead to overproduction of environmental protection because urban voters who place little value on environmental amenities support regulations that impose little or no cost on themselves personally.

Further, these policies create incentives for private timberland owners to minimize, not maximize, their production of environmental amenities. This problem of incompatible incentives makes it less likely that public policy will actually attain its stated objectives.

Notes

1. National Audubon Society, www.audubon.org/campaign/fh/chipmills.htm, no date.
2. Garrett Hardin, "The Tragedy of the Commons," *Science* (162), 1968, pp. 1243–48; see www.dieoff.org/page95.htm.

Lessons of History: The Great Irish Famine

Who Is to Blame for This Great Disaster?

SEPTEMBER 01, 2001 by Stephen Davies

History is a subject that often arouses strong emotions. What seems to some people to be a topic of limited academic interest is for others the source of deeply held and passionate feelings. The task of the historian is to try to establish, as dispassionately as possible, what actually happened in a given time and place and to give an explanatory account of why and how what happened came to pass.

It is at this point that the trouble starts since this inevitably involves an evaluative judgment, which can be controversial. It is nowadays fashionable in some circles to assert that the idea of honest or true historical accounts is a delusion, that all historical narratives are driven by an agenda and should be seen as mythical or quasi-fictional. This view is persuasive insofar as many widely accepted historical narratives are of this kind and are constructed with an eye to having an effect in the present rather than explaining the past. This does not mean, however, that historical scholarship as traditionally understood is impossible, merely that it is difficult. The study of history can actually undermine popularly accepted views of the past and reveal that, in Artemus Ward's expression, much of what people know "just ain't so."

The history of Ireland is a case in point. Until recently Irish history was dominated by an account of how the Irish resisted, and eventually threw off, the oppressive rule of the English and their collaborators. Recently this has been questioned by a new generation of Irish historians and a new, more nuanced picture has appeared.[1] This has led to a deeper understanding and has meant that we now draw very different conclusions and lessons from the past.

The classic example of this is the Irish Potato Famine of the 1840s. The basic facts of the event, one of the most tragic in modern British history, are not in question. In 1845 the Irish potato crop became infested with a fungal parasite (Phytophthora infestans), causing a partial failure of the crop that year.

Unusually wet weather meant that there was a total harvest failure the following year, and again in 1847 and 1848. The result was the death of over 1.5 million people from starvation or famine-related disease. The same number of people emigrated, many to the United States. Because of this and subsequent emigration, Ireland has never recovered demographically: there are 6 million people in Ireland today, compared to 8 million in 1841.

In traditional Irish history the blame for this great disaster is placed firmly on the British government. For exponents of this view such as Cecil Woodham-Smith, the death and suffering happened because of the incompetence, callous indifference, and rigid attachment to laissez faire of the British government and its Irish chief secretary, Charles Trevelyan.[2] For some the culpability was even more serious. For nationalist historians the British policy was genocidal and the outcome intended or welcomed. This view is still widely held, and not only in Ireland. In 1996 an act was passed in New York State requiring that all schools teach the Irish famine as an act of British genocide.[3] The reality is more complex, more interesting in some ways, and leads to very different conclusions about events both then and today.

British to Blame?

In one sense the British were to blame for the disaster. The blame however lies not with Lord John Russell and his colleagues in 1846, but much earlier, in the seventeenth and eighteenth centuries.

After the defeat of James II in 1690 a series of "penal laws" were passed by the Irish Parliament, dominated by the Protestant minority who had supported William III. The first, in 1695, took away the right of Catholics to bear arms. Another forbade Catholics to go overseas for education and prohibited them from teaching or running schools within Ireland. The most important however was the Act to Prevent the Further Growth of Popery (1704). This prevented Catholics from buying land or inheriting it from Protestants, or from leasing land for more than 31 years.[4] At about this time the potato was introduced as a major crop. The combination of the legislation and the new crop was ultimately disastrous.

The penal laws, together with other legislation, created a set of powerful and perverse incentives. Because Catholic tenant farmers could not own land or hold it on anything but short-term leases, with little or no security of tenure, they had no incentive to improve their land or modernize agricultural practice. All the benefit would go to the hated alien class of Protestant landlords in higher rents or more expensive leases.

The potato made it possible to support a family on a very small piece of land, with a labor-intensive crop. This combination of legal institutions and the potato had the following effects. Irish agriculture did not improve or develop, but remained a subsistence, labor-intensive activity. The land was repeatedly subdivided since there was no incentive to improve production and profitability by consolidating farms, and a family could survive on a small area because of the high yield of the nutritious potato.

By 1841, 45 percent of all holdings were of less than five acres. The lack of capital and the restraints on the Catholic majority meant that Irish commerce and manufacturing did not develop, and by 1841, 5.5 million out of a population of over 8 million were totally dependent on agriculture. The final, extra twist was the impact of the Corn Laws, the system of protection for English agriculture set up in the early nineteenth century that prohibited the import of grain until prices reached a particular level. This had the effect of preserving the flawed Irish farming system.

By the early nineteenth century Ireland was a Malthusian time bomb waiting to explode. There were several local failures in the 1820s and 1830s and the eventual disaster was almost inevitable.

Laissez Faire to Blame?

How culpable were the British ministers of the 1840s? They are charged with having given inadequate, limited relief because of their commitment to a doctrine of laissez faire. However, given the scale of the problem and the acute nature of the crisis once the harvest had failed for a second time in 1846, there was little they could do. Moreover, the root of the problem, as most contemporary observers agreed, was the nature of the Irish land system, and to support the system would only lead to further famines in the future. A policy that had the effect of keeping large numbers on the land and preventing agricultural improvement was bound to have disastrous results. Moreover, the Corn Laws prevented large-scale importation of grain into Ireland until after they were repealed in 1846 (partly because of perceptions of their impact on Ireland) and so the initial response of market forces to the acute food shortage caused by the blight was so blunted as to be minimal.

What should we learn from this terrible story? First, governments are not as powerful or effective in relieving disaster as many believe. The cry "We must do something" is very seductive, but often "doing something" will be ineffective, may even make matters worse, or will preserve the factors that produced the problem in the first place.

Second, laws that affect economic choice can have far-reaching and frequently perverse results. In particular, actions and laws that create the wrong kind of economic incentives can be truly disastrous and produce effects that are hard to reverse. The laws passed by the vengeful Protestant minority after 1690 created a set of institutional incentives in Ireland that continued to work for over a hundred years until they culminated in a disaster that was by then probably unavoidable.

Finally there is one serious lesson for contemporary policymakers. Many people today are foolish enough to advocate the deliberate support of traditional subsistence peasant farming in many parts of the world and resistance to measures such as free trade, which would lead to modern commercial farming. "Five acres and independence" may seem an inspiring slogan. Ireland in the 1840s shows that it is a recipe for eventual catastrophe on a terrible scale.

Notes

1. David George Boyce and Alan O'Day, eds., *The Making of Modern Irish History: Revisionism and the Revisionist Controversy* (London: Routledge, 1996). See also Joel Mokyr, *Why Ireland Starved: A Quantitative and Analytical History of the Irish Economy, 1800–1850* (London: Unwin Hyman, 1983).
2. Cecil Woodham-Smith, *The Great Hunger: Ireland 1845–1849* (New York: Harper Row, 1962).

3. William D. Rubinstein, *Britain's Century: A Political and Social History 1815–1905* (London: Arnold, 1998), p. 90.
4. S. J Connolly, ed., *The Oxford Companion to Irish History* (Oxford: Oxford University Press, 1998), p. 438.

Phony Marketeers

The Record of Conservative Free Marketeers after the Fall of Communism Is a Sorry One

SEPTEMBER 01, 2001 by Norman Barry

Contributing editor Norman Barry is professor of social and political theory at the University of Buckingham in the UK. He is author of An Introduction to Modern Political Theory *(St. Martin's Press).*

Which political movements benefited most from the collapse of communism in Eastern Europe and the Soviet Union? Certainly not libertarianism or the free-market brands of conservatism. It is the left that has gained most. Although anybody interested in a political career will avoid calling himself a communist, collectivist thinking and public policy is no less potent than it was ten years ago.

Some former communist parties have simply changed their names, slightly moderated their collectivism, and paraded themselves as democratic socialists with new market-friendly language. It is a triumph of marketing that should send Madison Avenue firms hunting through their files. It could well become a case study for an MBA at a prestigious business school. The erstwhile socialists and central planners are now seen to be advocates of the market (with a "human face" or preceded by an anodyne adjective) and are taking credit for the obvious achievements of capitalism.

This spectacular example of economic and political deception is more prevalent in Europe than America; for although the latter has had its phony marketeers and ersatz advocates of liberty and property, the spokesmen of the American left have not had to perform the intellectual acrobatics of their European counterparts.

At least ten members of the European Union, including major ones like Britain, France, and Germany, are controlled by center-left parties. And although Italy has just recently elected the allegedly free-market government of Silvio Berlusconi for the second time, one must be skeptical of its chances of unraveling (if it needs to—see below) decades of interventionist inefficiency, massive welfare spending, and straightforward crime and corruption in government.

What is foreboding about the new socialist marketeers is that their affection for economic freedom is a veneer underneath which lurks a form of interventionism with serious consequences for liberty. Some of us might have thought that the road to serfdom had been incorrectly signposted, or had led to a stable equilibrium of privilege-seeking pressure groups rather than straight tyranny, but the evidence suggests that, although we haven't experienced a communist nightmare, we are as far from a market nirvana as we ever were.

British Socialism and the Market

The Labour government, first elected in 1997 and re-elected in June, did appear to have jettisoned its socialist (and economically negative) intellectual patrimony, abandoned Clause Four of its constitution (which committed the party to complete nationalization of commerce and industry), promised to reform welfare (yes, "as we know it"), and presaged a new relationship with business over elegant lunches in the City of London. Indeed, their first moves did seem to suggest a new way (better than a "third way"). The Bank of England was given de facto independence, so ending decades of Keynesian manipulation of money; spending targets were set so as not to exceed growth; and the promise not to raise the income tax was honored. The first four years of New Labour were not a market paradise, but I for one went to bed for the first time under a socialist government not thinking I was going to wake up in East Germany.

But an analysis of the 1997–2001 period shows that it really was an illusion; socialism remains a threat, if not quite so deadly as in the past. However, the new socialists have found subtler ways of bringing about a collectivist society—and selling it.

True, Britain has not experienced an increase in the income tax, but there has been an addition of 3 percent of GDP taken in tax (a staggering £60 billion). The state now spends close to 40 percent of GDP (up from Thatcher's 37 percent, and she was no paragon of minimal government) but still lower than Germany's 44 percent and France's 51 percent.[1] In America the figure (for the federal government alone) is about 25 percent.[2]

In Britain this new, scarcely noticed burden came about through the pioneering of a novel fiscal phenomenon: the socialists knew they could not get away with a wealth tax or higher income tax, so they invented the "stealth" tax. And there are lots of them—for example, double taxation of dividends was extended to pension investments totaling £6 billion. Those who work in the public sector have pensions fixed irrevocably to final salaries (and paid for by the taxpayer) while everyone else depends on the buildup of a genuine fund. It is now more costly.

Fuel taxes are unbelievable by American standards—the price of gas is approaching $6 a gallon, 80 percent of which is tax. The yield of National Insurance (Social Security tax) has increased by £14 billion through widening its scope without affecting the rate; the stamp duty on the sale of property has been increased three times; and there was a "windfall" tax on profits from the privatization of utilities. This last tax was retrospective and straight theft.

Gordon Brown, chancellor of the exchequer, has even managed to make minor tax reductions for those at the bottom while overall adding an extra £1 billion a week plus.

But it gets worse. The commitment to keep spending in line with growth only holds for the life of the first Labour government; after 2002, with a new government, quite literally anything goes. Labour has already promised to increase government spending overall by 3.8 percent (with an extra 5.5 percent on education and health) and with economic growth not likely to exceed 2.5 percent, the gap can only be filled by extra taxation.

And they have the stealthiest tax increase of all—National Insurance—in reserve. At the moment there is a ceiling on this; nobody pays it on income above £29,000 a year. It has been calculated that the abolition of the ceiling would be equivalent to a 10 percent increase in income tax (something they dare not do).

But only the moderately well off (and not all of them) would notice if the ceiling were removed. And that is probably how they will plug the gap mentioned above. Anyway, the bulk of the population is under the illusion that National Insurance actually funds its health-care costs, unemployment pay, and pensions, so they think that such tax expenditure has an economic rationale.

But the real basis for the charge that New Labour is not really interested in markets is in its attitude toward government spending. The party cannot believe that the private sector can provide education and health more efficiently than the state, so its response to any problems here is to throw more taxpayer money at them. But it is never very much and never nearly enough. The state spends, through taxation, much less than people would spend privately. That is why the country has one of the worst health care systems in the developed world. Although France and Germany are superficially more socialistic, they spend, respectively 10 percent and 11 percent of GDP on health while Britain spends only 7 percent. The reason is that these countries finance health care by a form of social insurance while Britain operates primarily through direct taxation (the social insurance element there is derisory).

Also, the first two countries have up to 25 percent additional financing from entirely private sources. In France, for example, 84 percent of the population pay extra private insurance on top of the compulsory social insurance. This enables people to pay the user charges which are a feature of the French system.

The so-called market-friendly New Labour government has shown no interest in radical reform of health care. Anyone who genuinely believes in the market must oppose socialized medicine. The quasimonopolistic, rigidly organized, and choice-denying National Health Service is the last relic of Stalinist planning in the modern world, and only its complete abolition can lead to any rationality in health care. But the Conservative response to New Labour socialism has been pusillanimous. It has simply promised to match, and even exceed, Labour's spending plans. On health the most radical thing the Conservatives have done is simply to drop hints about tax relief for those who take out private health insurance.

Europe and Liberty

The prospects for freedom are little better on the continent of Europe, and the deception proceeds on two fronts. First, the subtle assault on the market occurs within individual countries, and more ominously, the European Union makes any market-led improvement difficult. In both cases the socialism occurs behind a façade of enterprise and freedom. The façade has persisted, and has been persuasive, because the left is divided between the communists and the socialists, and the desire to keep the communists out guarantees some kind of freedom.

Britain in the early postwar years was much more socialist than the rest of Europe because the communists were not isolated but rather in the Labour Party (and government). That is why Mrs. Thatcher's attack on the left was mildly successful. She took on the whole of the socialist movement, whereas in Europe the noncommunist left was always more respectable and not viscerally antimarket. Mrs. Thatcher is now publicly reviled in Britain.

Pre-unification Germany was the most interesting case of all in Europe.[3] For Ludwig Erhard established in 1949 just about the only genuine free market (outside Switzerland) in Europe. He was a member of the Mont Pelerin Society and only used the expression "Social Market" to appease the Keynesian advisers who had swarmed round postwar Western Germany. And despite the numerous modifications that were made to the market system, Erhard was not a phony. Nor were those socialists who eventually joined him. (One, Karl Schiller, resigned from the coalition government of Christian Democrats and Social Democrats in the 1970s on a free-market issue and ended his life a convinced capitalist.) But it was not to last, and the German Social Democratic party has slipped back to old collectivist ways and has members with dubious left-wing pasts.

Still, perhaps the most dangerous of the phony marketeers were the European nominal conservatives (Christian Democrats). Their connection with classical liberal individualism was extremely tenuous, and many not only accepted the socialist consensus that governed Europe, they actually extended it. This was especially so of the British conservatives before Mrs. Thatcher.

Italy was the most egregious example of conservative legerdemain. The Christian Democrats had a permanent hold on power entirely because of the fear of communism. They used it to strangle the economy with unenforceable regulations that led to crime, nearly bankrupted the country through unsustainable welfare obligations, and enriched themselves personally.

But again, events, not ideas, are causing some more market-based policies in mainland Europe. Herr Schroeder, of the Social Democrats in Germany, has been compelled to privatize partially the ruinously expensive pension system and to introduce, reluctantly, other minor tax and welfare reforms. He has also been forced to watch as the Anglo-American model of individualistic capitalism replaces the communitarian one and as the drive toward globalization upsets the delicate but inefficient balance of “stakeholders” that characterizes the German corporate economy. They now have takeovers in Germany.

In Italy it looks, superficially, as if free-market ideas are driving the conservative/classical-liberal alliance led by Berlusconi. He himself is an amazingly successful entrepreneur who hopes to bring that style to the whole of Italy. He also has a libertarian and respected figure in the international free-market movement, Antonio Martino, in his government. But Berlusconi already has a program that, in addition to including welcome tax cuts, has ambitious spending goals for the “infrastructure.” Perhaps he should listen more to Martino than to conventional advisers.

But does it really matter? Italians ignore the regulations, don’t pay too many of the taxes, and have an underground economy that produces at least a third of national output. They might look like anarchists but they are not nihilists: they have constructed an immensely complex private world, embracing the family and business, which has quietly, and without the aid of government or “ideas,” created one of the top six economies in the world.

The real threat to economic freedom in Europe is the European Union. Its administrative headquarters in Brussels houses the phoniest of the market phonies. Still, its historical origins look free market. Originating as a free-trade area through the Treaty of Rome in 1957, the European Economic Community simply wanted to break down customs barriers that had separated Europe’s countries in the past, created massive inefficiencies, and led to war. It seemed that the old classical-liberal dream of Montesquieu, Turgot, Say, and Bastiat—that world peace would come about through commerce—could be a reality at last.

But it was not to be. Under the rubric of commerce and free trade, and the mantra of “harmonization,” the institutions of Europe actually proceeded to raise insurmountable barriers to commerce with the outside world. Trade-union power was entrenched, and American-style “civil rights”were extended to the workplace. Worst of all, genuine jurisdictional competition between member states has been gradually eliminated under the waves of centralizing regulations and directives that are enveloping the member states. Soon they will have the same welfare laws, identical industrial rules, and similar environmental standards—all in the name of free competition.

The influence of the Union is quite corrosive of any lingering market ideas. José María Aznar, the prime minister of Spain, is actually pro-free market (despite being a former tax collector), but he is currently engaged in a desperate battle to preserve the European regional grants to Andalusia, an allegedly poverty-stricken area of Spain. Well, if any people on vacation in Marbella or Málaga think they are in a poor province on the Iberian peninsula, they are obviously unaware of a basic axiom of modern economic life: hearsay and casual observation beat econometrics.

Which Way Forward for Genuine Freedom Lovers?

The record of conservative free-marketeers after the fall of communism is a sorry one. Instead of trying to carve out a distinctive position around the minimal state, free trade, the abolition of compulsory welfare, and the elimination of all regulations not directed at the protection of persons and property, they have tried to outspend the socialists and outregulate the regulators in a desperate battle to capture the middle ground.

The recent performance of British conservatives in all this has been lamentable. They say it is electoral suicide to come out against the National Health Service or cash-based and wasteful welfare. But it was shown at the recent election that it was just as self-destructive when they tried to compete with Labour at the spending game.

Statist policies are breaking down according to the iron laws that govern economic and social life. Is it not better to be in a good position, untarnished by socialist meddling, to make the minimal but effective curative recommendations when this finally happens?

Notes

1. The share of spending taken by the state in major European countries increased on average from about 12 percent in 1910 to 46 percent now.
2. According to the Tax Foundation, the burden of federal, state, and local governments combined is 33.8 percent of Net National Product; see http://taxfoundation.org/tax-topics/tax-freedom-day.

3. See H. Giesch, K-H. Paque, and H. Schmieding, *The Fading Miracle* (Cambridge: Cambridge University Press, 1992).

Sovereign Traders

Consumers Are the Greatest Beneficiaries of Free Trade

SEPTEMBER 01, 2001 by Pierre Lemieux

Pierre Lemieux is an economist and visiting professor at the University of Quebec at Hull.

The third Summit of the Americas, held in Quebec City (Canada) in April, was attended by 34 heads of state (or prime ministers) representing all North and South American countries except Cuba. It also attracted some 45,000 demonstrators against Free Trade Area of the Americas (FTAA), a project launched at the first Summit in Miami, in 1994. The demonstrators included a small fringe that clashed with the police, resulting in injuries to some 180 people and close to 500 arrests.

The alternative "People's Summit," which preceded the real thing, was directly subsidized by the Canadian government to the tune of $300,000 (Canadian). Presumably, the government wanted to channel dissent and to marshal support for its own agenda. The amount of indirect subsidies and union financing is unknown, but financial editor Terence Corcoran writes: "[T]his protest, and the People's Summit that preceded it, is almost entirely a union affair. Big Labour provides the money, the organization, the office space, the global contacts and the momentum."[1] So the moving force behind the protests comes from special interests who fear the foreign workers' competition.

Yet many protesters were college students who had no direct interest in preventing trade. Moreover, one would expect the fringe anarchist demonstrators to oppose state protectionism. The protesters were partly motivated by fear of change, like the eighteenth-century British Luddites, who destroyed machines to stop the Industrial Revolution. However, the Luddites were poor, while the modern protesters have cell phones and put up Web sites. Still, both groups share a glaring ignorance of what free trade is, how free markets work, and how they are related to individual sovereignty.

This can be seen in the following way. Let an antitrade demonstrator imagine that his ideal society stretches from the North Pole to Cape Horn. It does not matter whether it is anarchic or state-based, how income is distributed, or what level of diversity it shows. Just assume that our antitrade activist does not reject individual sovereignty—the idea that, as John Stuart Mill put it, "Over himself, over his own body and mind, the individual is sovereign."[2] Now suppose that one individual from, say, Alaska and another one from Argentina want to exchange their respective products. Or suppose the Argentinean wants to borrow something (or money) that the Alaskan legitimately owns and is willing to lend. Or suppose, for that matter, that the Argentinean decides to physically go and work for the Alaskan. It would obviously be a violation of individual sovereignty to enact laws, enforced by armed men, to prohibit such capitalist acts between consenting adults.

The appearance of trade intermediaries doesn't change the argument. Instead of the Canadian coffee drinker and the Brazilian coffee producer having to arrange a deal between themselves, importers, wholesale distributors, and supermarkets import the coffee, package it, and make it conveniently available. Once we realize that free trade is but the liberty of individuals to associate and exchange across political borders, it is easy to see that forbidding it requires violence or threats of violence. You have to fine or jail the importer or the traveler who doesn't abide by trade restrictions.

Many antitrade activists would object that since society is unjust, free trade would only deepen the injustices. The first part of the argument parallels the standard welfare-economics conclusion that market outcomes, and their normative value, depend on the initial distribution of income. Let us grant that we don't start from the ideal society (although the nature of the injustices is quite different from what antitrade activists believe). There remains the second claim about whether free trade would improve or worsen the condition of individuals who are disadvantaged by the present system. Virtually all economic studies show that free international trade would increase the incomes of the poor in absolute terms if not in relative terms as well.

This is not surprising. If it were desirable to prohibit free trade between citizens of different countries, the same argument would apply to residents of different regions in the same country. If it were desirable to prevent trade between inhabitants of rich and poor countries, it would also be advisable to forbid the poor from exchanging with richer individuals in their own countries.

It is often unspecialized workers in poor countries who outcompete their counterparts in rich countries—and this is indeed what the latter's labor unions fear. In turn, producers in developed countries specialize in more capital-intensive or knowledge-based goods and services. Increased demand for labor in poor countries leads to increased wages: while in 1960, the typical manufacturing wages in underdeveloped countries were 10 percent of the U.S. level, they have climbed to nearly 30 percent three decades later.[3] In other words, international trade tends to bring income convergence at the same time as it generally pulls up average incomes.

Free international trade, then, is also desirable if we start from a non-ideal situation because it allows wider choice and opportunities for the disadvantaged. The ability to buy goods and services that don't correspond to the national establishment's preferences, or moral standards, is also liberating. So is the capacity to move one's resources, however meager, to other countries, as Europeans realized when (until two decades ago) they were subjected to foreign-exchange controls and their credit cards were not honored outside their home countries.

Free international trade is just an extension of the general argument for free markets. Capitalist acts between consenting adults don't stop at arbitrary national borders. As suggested by World Bank economist Keith Marsden, let's consider, and update, the comparison between South Korea and Ghana.[4] In the late '50s and early '60s, these two countries had similar economies, and both showed a real GDP per capita equal to 10 percent of the same income measure in the United States. Over the next three decades, the relative Ghanaian GDP per capita decreased, while the Korean GDP per capita reached 42 percent of the U.S. level (see figure). In fact, the World Bank now classifies Korea among the high-income countries. General free-market policies as opposed to the government intervention that Ghana experienced certainly played the major role in Korea's success, but we can also see that the openness of the Korean economy (total imports and exports over GDP) increased, while the Ghanaian economy tended to become less open.

The black box of "cultural factors" is not a sufficient explanation, as illustrated by the different levels of prosperity between North and South Korea, or between former East and West Germany.

The argument, often made by anti-FTAA activists, that only corporations—and especially multinational corporations—profit from free trade does not make sense. For if it were true, disadvantaged individuals would only have to buy shares of these corporations, thereby redistributing the gains. Large corporations are largely owned by ordinary people in developed countries through pension funds and other savings instruments. If the activists were right, they could play a useful role in helping inhabitants of underdeveloped countries create cooperatives and get loans to purchase shares in multinational corporations.

The truth is that the inhabitants of poor countries profit from private foreign investment, which brings jobs, higher wages, technology and know-how. The Africans' problem is indeed that they don't have enough of it—mainly because their institutions are poorly geared to a market economy. Total private investment in sub-Saharan Africa has stagnated at around 10 percent of GDP over the past 30 years, while private investment climbed from 15 percent to more than 20 percent (and, at times, more than 30 percent) of GDP in Korea.[5] As leftist economist Joan Robinson wrote, "the misery of being exploited by capitalists is nothing compared to the misery of not being exploited at all."[6]

It is true that free trade produces gainers and losers, but the losers are those who were previously able to exploit others through coercive barriers and monopoly power. Moreover, the gainers in today's globalization include the poorest of all—unspecialized workers in poor countries—and the losers tend to be comparatively rich trade-unionized workers in developed countries. In a free economy, constraints facing individuals are the results of choices by other equally free individuals; in a managed economy, social and economic constraints are made of political authorities' arbitrary diktats.

Managed Trade

If free trade is a natural part of the interaction among sovereign individuals, managed trade is a very different animal. Managed trade is trade regulated by the state, or by a cartel of states.

Its aim is to assure that trade does not conflict with whatever happen to be the state's public-policy objectives—that is, that it does not reduce state power. Existing trade treaties and organizations are often a mix of managed trade and free trade. The Summit of the Americas process that officially started at the 1994 Miami meeting—if not the eventual trade agreement itself—seems closer to the "managed" than to the "free" end of the continuum.

Besides FTAA, the Declaration of Miami contains a host of projects that are more akin to creating a cartel of states than to letting individuals trade freely.[7] The Declaration espouses the shibboleths of "social justice" and "sustainable development," and the heads of state pledge to "invest in people"—to increase their shares in us, as it were.

The accompanying "Plan of Action" talked about much more than free trade: "universal access to education," "equitable access to basic health services," "strengthening the role of women in society," and a host of other coercive state agendas.[8] Note this: "Governments will . . . [e]nact legislation to permit the freezing and forfeiture of the proceeds of money laundering and consider the sharing of forfeited assets among government[,] . . . [e]ncourage financial institutions to report large and suspicious transactions to appropriate authorities and develop effective procedures that would allow the collection of relevant information from financial institutions[,] . . . [s]trengthen efforts to control firearms, ammunition, and explosives to avoid their diversion to drug traffickers and criminal organizations." All this under the objective of "strengthening democracy"!

Four years later the 1998 Declaration of Santiago put new emphasis on previously defined goals such as "progress towards social justice" under the so-called Universal Declaration of Human Rights, or "greater support to micro and small enterprises."[9] New statist objectives were added, such as "strengthen[ing] banking supervision in the Hemisphere," and "promot[ing] core labor standards recognized by the International Labor Organization (ILO)." The updated Plan of Action included new ideas for exporting statism, like "internal rules that regulate contributions to electoral campaigns."

With all this, the politicians and bureaucrats thought they had co-opted the government-subsidized activists. The Quebec City Summit demonstrated that they were mistaken, which did not stop them from showing more of their statist colors.

The worthy goal is still “trade, without subsidies or unfair practices, along with an increasing stream of productive investments and greater economic integration,” but the participants have other agendas.[10] The updated Plan of Action, now 43 pages long, calls for “the effective application of core labor standards,” international redistribution, and “corporate social responsibility.”[11] It adds tobacco and alcohol to the evils to be fought. Governments, the document states, will “[p]articipate actively in the negotiation of a proposed [World Health Organization] Framework Convention on Tobacco Control; develop and adopt policies and programs to reduce the consumption of tobacco products, especially as it affects children; share best practices and lessons learned in the development of programs designed to raise public awareness, particularly for adolescents, about the health risks associated with tobacco, alcohol and drugs.”

At the Summits of the Americas, as in other international trade meetings, state representatives behave as agents of their countries’ exporters. You give us this “concession” and in return we will allow your exporters to enter our markets; you stop trampling on your citizens’ liberty to import, and we will similarly liberate our own subjects! This approach misrepresents the nature of trade and a free economy, where consumers, not producers, are sovereign. The primary advantage of free trade is not that exporters will gain larger markets, but that consumers will have more choice—even if the former is a consequence of the latter. By presenting themselves as members of different exporters’ clubs, trade negotiators bring grist to the mill of the enemies of free trade.

Illusion of Control

No One Can Control the Complexity and Mass of the U.S. Economy

SEPTEMBER 01, 2001 by Christopher Mayer

Christopher Mayer *is a commercial loan officer and freelance writer.*

Every day at noon a man shows up at a street corner with a green flag and a bugle. Every day he waves the flag and blows a few notes on the bugle. Then he goes away. A police officer notices this man's behavior and after several days is finally overwhelmed with curiosity. He approaches the man and asks, "What the heck are you doing?" The man replies, "Keeping away the giraffes." "But there are no giraffes around here," the officer answers back. "Then I'm doin' a good job, ain't I?"

This is an old story that has been told many different ways, but it makes an important point. It shows the logical fallacy of inferring causality from mere proximity. This particular version of the story appeared in Max Gunther's 1977 book, *The Luck Factor*. As Gunther notes, "When two events happen simultaneously or consecutively, it may or may not be true that one is the cause of the other."

In a similar vein, pundits lavish praise and adulation on Chairman Greenspan for allegedly successfully navigating the U.S. economy. They applaud his various maneuverings or offer their own suggestions, as if Greenspan, the central bank, and the U.S. government were all somehow in control, simply throwing levers and pushing buttons on a machine. Here again, just because Alan Greenspan's Federal Reserve chairmanship has been coincident with the booming economy does not mean he is necessarily in control of it.

Perhaps the credulousness of these observers, their susceptibility to the illusion of control, satisfies some psychological desire to remove uncomfortable uncertainties that seem inherent in a market economy.

Unfortunately for them, uncertainty cannot be separated from human existence. "The uncertainty of the future is already implied in the very notion of action," Ludwig von Mises observed in Human Action.[1] To assume that Greenspan or any other government agent can guide the economy down some primrose path is to assume he knows what the future will look like and what the outcome of his actions will be before he takes them.

The Guesswork of Predictions

Many more people might reject the notion that Greenspan should tinker with interest rates and make complicated pronouncements to Congress if they appreciated the impossibility of predicting the future of anything so vast and complicated as the U.S. economy.

Again, Mises understood the folly of this. He wrote, "There is neither constancy nor continuity in the valuations and in the formations of exchange ratios between various commodities. Every new datum brings about a reshuffling of the whole price structure."[2] In the U.S. economy, new data enter constantly and the price structure is always shifting. There are billions of prices, and none of them is constant; nor do they respond in easily predictable ways.

One illustration of the difficulty of prediction is to look at the job analysts have done in predicting the earnings of companies they are paid to follow and study. Investment expert David Dreman studied analyst forecasts in collaboration with Michael Berry of James Madison University.[3] The study was subsequently updated to include data to 1996. They took analysts' quarterly forecasts and compared them to the actual quarterly earnings for the period 1973 through 1996. The forecasts included 94,251 consensus forecasts (each consensus forecast included at least four separate analyst predictions resulting in over 500,000 individual predictions).

The analysts were able to speak with management to help guide them in their own forecasts. They were also able to change their forecasts within three months of quarter-end. These analysts are highly compensated and often educated at the nation's top schools; their compensation is often tied to their ability to predict.

Despite all these advantages, the study found the average error rate was 44 percent. The error rates also seemed to grow larger over time. Thus despite advances in communications and technology, error rates in the last eight years of the study (from 1996) averaged 50 percent, with two of those years having error rates of 57 and 65 percent.

Dreman eliminated all earnings estimates less than ten cents per share to prevent large percentage errors from distorting the study. (The difference between 3 cents and 4 cents is a whopping 33 percent.) Even after this conservative adjustment, the error rates still averaged 23 percent. This means that, on average, if the consensus forecast called for a dollar in quarterly earnings, the analysts were off by an average of 23 cents. Dreman and Berry further broke down the data and found that the error rates were indistinguishable by industry type. Mature or budding industry, analysts were often wrong by wide margins.

It is astounding that they were so wrong so often.

Now imagine the complexity Greenspan faces in predicting the U.S. economy and determining what the fed funds rate or monetary policy ought to be. Not only does the U.S. economy consist of thousands of individual companies, but they also interact with other countries' economies. It is truly staggering in complexity.

How likely is it that Greenspan has any clue where the economy is "headed" or what interest rates should be?

Predicting the Past

It is not only difficult to predict the future; often it is also difficult to predict the past. Money manager Murray Stahl published a volume of essays titled *Collected Commentaries and Conundrums Regarding Value Investing*.[4] In the third part of the book, Stahl conducts an interesting experiment.

The start date for his experiment was the summer of 1982. He began by creating a portfolio of six companies that all had major problems: Chrysler, General Public Utilities, Pan American, Massey Ferguson, International Harvester, and White Motor. Chrysler's problems at the time are well known. General Public Utilities had the problem at the Three Mile Island nuclear plant. Pan American was facing all sorts of difficulties, from intense competition stemming from deregulation to high fuel, interest, and labor costs, and poor management. Massey and International Harvester were agricultural manufacturing companies facing a farm crisis. White Motor was a trucking manufacturer facing similar problems to Chrysler's. Not having the benefit of a government bailout, White Motor, however, went out of business. Pan American did too.

Stahl asked how such a six-company portfolio would have performed given that two of its holdings became worthless and the other four all faced problems that threatened their very existence. As Stahl notes, "If one had chosen to create on June 30, 1982, an equal weighted portfolio comprised exclusively of these six companies, one's sanity might well have been questioned." Even today, knowing ahead of time that two companies would not make it, most investors would not give this portfolio much of a chance.

Surprisingly enough, from June 30, 1982, through December 31, 1993, the portfolio would have returned a compound annual return of 19.2 percent versus only 17.6 percent for the S&P 500 (often used as a benchmark for performance purposes).

Again, even having some knowledge of the market over the period, it is surprising to find that this collection of companies outperformed the market as a whole.

Next time Greenspan solemnly pontificates on the "direction" of the U.S. economy, think about the error rate of Wall Street analysts and think about Stahl's little experiment. Appreciate the complexity and mass of the U.S. economy and realize the futility of Greenspan's pronouncements. Greenspan, like the man with the flag and the bugle keeping away giraffes, is every bit the quack for pretending that his maneuverings can guide the economy down some predetermined path.

Notes

1. Ludwig von Mises, *Human Action: A Treatise on Economics* (Scholar's Edition) (Auburn, Ala.: Ludwig von Mises Institute, 1999), p. 105.
2. Ibid., p. 118.
3. David Dreman, *Contrarian Investment Strategies: The Next Generation* (New York: Simon & Schuster, 1998), pp. 91–93.
4. New York: Horizon Asset Management, 1995.

Winners and Losers in the Transfer Game

No State Ever Became Rich by Relying on Federal Wealth Transfers

SEPTEMBER 01, 2001 by Christopher Westley

I like lists, be they David Letterman's Top Ten lists, the mainstream historians' best-presidents lists, or my wife's honey-do lists. They tell us much about the kind of society in which we live. Frequently, these lists reveal more about whoever compiled them than about whatever data is actually included on them.

One list in particular makes the news every year where I live, and it receives more press than the college football rankings. This list compares the net "donors" and the net "winners" of the transfer game.

This game has become a trillion-plus dollar operation over the years, and it behooves us to know as much about it as possible, because we are all forced to play it. It is morally justified by an egalitarian ideal that is contrary to human nature, and thus requires force to impose it.

This is how it works: The Feds take money from us, keep a portion for themselves, and then give back the remainder in the form of spending projects. States that get more back than they give are called the winner states. States that get less than they give are called donors, thus giving the scheme a charitable aura. (In truth, calling them losers might result in their losing interest in playing.) A Washington, D.C.-area think tank called the Northeast-Midwest Institute www.nemw.org has been compiling lists of the top winner and donor states for several years. They result from studies of each state's contribution in federal taxes and its take in fiscal spending. This is the transfer system, and it amounts to a zero-sum game: winner states can only win to the extent that the donor states lose. In 1999, my own state of Alabama was ranked tenth among the top ten winners. (See tables below.)

Invariably, the press reports these findings as good news for the winner states. For instance, in Alabama the press bias is that while local culture may be congenitally opposed to a large federal government, the state sure benefits from the system. However, it's far from clear whether findings such as these are accurate depictions of a state's fiscal health or its distribution of benefits.

Nobel laureate Milton Friedman once argued that increases in the money supply are distributed in the economy through what he termed "the helicopter effect." If the Federal Reserve increased the money supply by $1 billion, Friedman said, the increase in money would be spread equally through the country, as though it were dropped from a helicopter at a high altitude.

As any undergraduate money and banking student knows, however, that is not true, and Friedman himself has backed away from this analysis. The newly created money isn't evenly distributed among the population. Rather, the groups that benefit from the new money are those that receive it first. Usually, by the time the money is spread out across the entire economy, its benefits have been lost because of inflation.

Uneven Distribution

The same is true for fiscal spending as well. Federal spending in the states does not benefit each resident equally. Otherwise, if the results from these studies were to be taken seriously, federal spending in Alabama would be equivalent to each resident receiving a 50 percent federal tax refund. In fact, those individuals who directly receive the money are the actual beneficiaries.

In Alabama, as in most of the winner states, the lion's share of this surplus goes to the military, benefiting areas of the state that house bases, arms depots, and training and testing facilities. But even in these areas, the economic benefits are not evenly distributed. Rather, they are limited to local firms that directly and indirectly serve these facilities.

Furthermore, if you live in another part of the state that is not affected by military spending, you may not benefit at all—and yet the state rankings imply that you do.

Alabama is likely to move up to a higher ranking next year if only because of the December 2000 storms that devastated the south. Millions of

FEMA (Federal Emergency Management Agency) dollars will be added to the regular federal outlays earmarked for the state. If the 1995 Hurricane Opal disaster relief is any guide, the funds will go to construction firms that are politically well connected, not to those in the counties where the destruction actually took place or to organizations on the scene that are best situated to deal with crises at hand. Not only does this practice slow the rebuilding process, it also brings with it hidden costs, such as the squelching of private relief efforts that otherwise would have sprung up and promoted a quicker rebuilding effort.

This is not the type of spending that suggests an improvement in the quality of life, as is implied by these rankings. It only reflects the kind of growth that results from the destruction of capital. This amounts to forced spending that restores the status quo. Unfortunately, these are costs not easily measured by analyses of fiscal spending or easily included in the identification of winners and donors.

Cost of Capital Transfers

Another cost not conducive to measurement is the cost of transferring capital from private uses to those deemed necessary by the federal government. Taxation is simply forced capital spending, or the diversion of money from private uses to those determined by the transfer state. Alabama may receive some benefit from these capital flows, albeit unevenly distributed, but at a cost to donor states such as Connecticut, New Jersey, and Nevada. Individuals have less disposable income in these states to spend on things they deem important, and the money is transferred to support those causes deemed important by the political class. The larger this transfer system gets, the more force is required to maintain it. Certainly, this is a cost that does not make it into the analyses of the efficacy of fiscal spending.

Besides, it is far from clear that being among the nation’s leaders in net federal spending should be a game any state wants to win in the first place. No state ever became rich by depending on federal wealth transfers. Policies that create and attract wealth are no secret. A state becomes wealthy by protecting private property, maintaining a stable system of low taxes, decentralizing its infrastructure, and minimizing intervention in private capital flows. Such policies, from generation to generation, encourage good work habits, higher time preferences, and increased capital from other states where wealth is less secure.

Unfortunately, these are policies that will be pursued by the political classes that inhabit our state capitals only to the extent that they promote the mobilization of voting blocs that ensure the maintenance of power. As a result, economic and political incentives can be at odds with each other. Policies that reward the existing political class in the short run can hinder a state's ability to develop a legal and economic infrastructure that promotes long-term capital creation and that encourages capital mobility and investment.

Federal spending can become an enemy of such outcomes. Increasing federal funding to the poor states enables them to avoid these reforms, while at the same time it penalizes rich states for implementing them. Why should a state correct for poor policy prescriptions if the federal government compensates for the resulting shortcomings? The long-run consequence of maintaining such a system is a skewing of incentives and a diminution of the ethos of wealth creation that allows states to become wealthy places in the first place.

Federal Dollars Received in Fiscal Spending for Each Dollar Paid in Taxes

Top Ten "Winner" States Top Ten "Donor" States New Mexico 2.01 Connecticut 0.66 Montana 1.75 New Jersey 0.66 West Virginia 1.74 New Hampshire 0.71 Mississippi 1.71 Nevada 0.74 North Dakota 1.68 Illinois 0.74 Alaska 1.59 Minnesota 0.80 Virginia 1.56 Michigan 0.83 Hawaii 1.52 Delaware 0.84 South Dakota 1.49 Wisconsin 0.85 Alabama 1.49 New York 0.86

A Reply to a Labor Priest

Is There a Moral Duty to Pay Union Dues?

SEPTEMBER 01, 2001 by Charles W. Baird

In his 1981 encyclical letter, *Laborem Exercens*, Pope John Paul II declared that workers have "the right of association, that is to form associations for the purpose of defending the vital interests of those employed in the various professions. These associations are called labor or trade unions" (§20). He went on to say that unions "are an indispensable element of social life, especially in modern industrial societies." Ten years later in his encyclical Centesimus Annus, the pope said that the "reason for the Church's defense and approval of . . . trade unions [is] because the right of association is a natural right of the human being" (§7). Quoting from Pope Leo XIII's 1891 encyclical, *Rerum Novarum*, John Paul noted that "the State is bound to protect natural rights, not to destroy them; and if it forbids its citizens to form associations, it contradicts the very principle of its own existence."

Apart from the question of whether unions are "indispensable" in social life, I find nothing in the above statements with which to disagree. In fact, I enthusiastically endorse those views, and I did so before I became a Catholic. Freedom of association is a natural right of all men and women. Because the authors of the original U.S. Constitution and the Bill of Rights thought that the primary role of government is to protect and defend the natural rights of its citizens, they prohibited American governments from abrogating the freedom of association. Any law that prohibited the formation of voluntary labor unions would be unconstitutional as well as contrary to natural law.

Is there anything in the principle of freedom of association which logically implies that workers have a moral obligation to join or support unions? I think not. Yet Monsignor George G. Higgins, who was awarded the Presidential Medal of Freedom by then-President Clinton in August

2000 for his more than 50 years of work as a "labor priest," disagrees. In his 1993 book, *Organized Labor and the Church*, he tells the story of his 1990 testimony before the Illinois Educational Labor Relations Board against the application of a Catholic teacher in Illinois for a religious exemption from the forced payment of union dues. The teacher argued that Catholic social teaching opposes such coercion. Citing John Paul and the 1986 American bishops' pastoral letter, *Economic Justice for All*, to establish the Church's approval of unions, Monsignor Higgins expresses agreement with certain "authoritative commentators" that "because unions are morally necessary, there is no denying a certain moral obligation to join a union" (p. 219). I suppose that if something is "morally necessary" one has a moral obligation to support it. But it is a huge leap from John Paul's statement that unions are an indispensable part of social life in industrial society to the conclusion that they are "morally necessary." Electricity is an indispensable part of social life in industrial society, and it is even more indispensable in the information technology society of today, yet it is not morally necessary.

Let us examine the statements of the authoritative commentators Monsignor Higgins cites to make his case. Two Jesuit priests, Jean Yves and Jacques Perrin, writing in 1961, asserted a "moral obligation to join a union," first on the grounds that nonmembers in enterprises that are unionized benefit from the actions the unions undertake (p. 219). This is easily refuted by noting that if unions represented only their voluntary members and no one else there could be no free riders. A quirk in the law that grants unions monopoly bargaining privileges hardly establishes a moral obligation.

Moral Solidarity

Their second argument, which they assert is even stronger than the first, "rests on the moral solidarity of the members of the workers' group" (p. 219). They argue that although unions are not free to harm members who are out of favor with a union, and they are not free to cut off nonmembers from employment, "it cannot be maintained that workers are absolutely free to refuse to join a union, nor even that they ought not to suffer in some way for not joining." This supposedly strong argument is nothing more than an assertion. What is the nature of the assumed moral solidarity of members of a "workers' group"? If they are voluntary members they have a moral obligation to live up to the rules or quit their membership. This says nothing about the moral obligation of nonmembers. It is certainly no logical basis for their conclusion, which is a non sequitur.

Monsignor Higgins also cites Father John F. Cronin, writing in 1950, who "sees the obligation [to join a union] as growing out of the social nature of human beings" (p. 220). Father Cronin says, "The soundest basis for such an opinion is the obligation of all to participate in group action aimed to infuse a proper order in economic life, so that the institutions of society will be directed toward the common good." Moreover, Father Cronin continues, "in view of the power concentration in modern life, there is need of buffer groups to safeguard individual rights."

There are many groups that aim their actions toward "a proper order in economic life," but they do not all agree on what that means. Do we have a moral obligation to participate in the actions of Jesse Jackson's Rainbow Push Coalition simply because he claims, with about as much legitimacy as labor unions, to seek a "proper order in economic life"? Moreover, civil society includes many "buffer groups to safeguard individual rights." The private, nonprofit Institute for Justice in Washington, D.C., comes immediately to mind. Do we have a moral obligation to participate in its actions?

Humans are social beings, but morally we must be allowed freely to choose our social affiliations. There is no moral merit in doing something because you are forced to do so. Moral merit consists in choosing to do those things that are right. That is what free will is all about.

Monsignor Higgins then writes, "I do not mean to argue that all workers, always and everywhere, are obliged to join a union" (p. 220). That's nice, but which workers do not have the obligation? He doesn't say. He does say that Catholic social teaching "favors some form of guaranteed union security that would require workers to contribute their 'fair share' to the cost of administering a legally constituted union" (p. 221). Coerced membership is sometimes not proper, but coerced dues paying is always proper.

Why? He gives no logical answer at all.

The teacher who sought the religious exemption quoted from two church documents to make her case. One was the Second Vatican Council's Constitution on the Church in the Modern World: "Among the personal rights of the human person must be counted the right of freely founding labor unions. . . . Another such right is that of taking part freely in the activity of these unions without the risk of reprisal" (p. 221). She reasoned that the "taking part freely" clause precluded being forced to take part. Monsignor Higgins argues that the intent of the authors of the passage was to admonish employers and governments against taking reprisals against those who choose to organize unions. He is right on the intention of the authors, but he is wrong to say that the passage does not support the teacher's argument. Words have meaning. The passage speaks of voluntary participation in unions, which should be immune to reprisals. But it remains true that if participation is to be voluntary it cannot be coerced.

The second document quoted from by the teacher was the 1963 encyclical of Pope John XXIII, *Pacem in Terris*: "If we turn our attention to the economics sphere, it is clear that man has a right by natural law not only to an opportunity to work, but also to go about his work without coercion" (p. 222). She argued, correctly, that forced dues paying is a forbidden form of coercion. Monsignor Higgins's reply is to refer to the "authoritative commentators" he cited earlier.

There is a happy ending to this story. The Illinois Education Labor Relations Board was unconvinced by Monsignor Higgins's unconvincing arguments. They decided in favor of the teacher.

An Open Letter to Senators Clinton and Schumer

Cap Energy Prices to Further Economic Education

SEPTEMBER 01, 2001 by Donald Boudreaux

Dear Senators Clinton and Schumer:

Having accepted a position on the economics faculty at George Mason University, I just moved from New York to Virginia. But until recently, you were my representatives in the world's greatest deliberative body. I write to you now on a matter of maximum importance to me, to the Foundation for Economic Education, and, indeed, to all teachers and students of economics across the land.

I encourage you to follow your instincts and vote for price caps on energy. By doing so, you will promote a goal that I sincerely believe to be both righteous and timely—namely, enhancing the quality of economic education across America.

My colleagues and I toil year in and year out to impart economic understanding to young people. But it's a struggle. With all of the competition today for students' attention—gazillions of cool Web sites, scores of cable-TV channels, dozens of fascinating opportunities to protest in interesting towns such as Seattle, Davos, and Quebec City—we economics teachers find it increasingly difficult to grab and keep our students' attention. And the students don't know what they're missing.

"How is this stuff relevant?" they ask us. "What do your supply-and-demand graphs and your stories about opportunity cost and the role of prices have to do with anything that we care about? That's all dull textbook theory."

Of course, not all students dismiss economics as irrelevant or dull. But a renewed national commitment to price ceilings will be such a dynamo at re-energizing economic instruction that the number of students who come to appreciate the relevance of economics will increase probably 20- or 30-fold.

I speak from personal experience, having had the good fortune of growing up amid the numerous energy shortages of the 1970s. Back then, of course, I didn't regard these shortages as good fortune, but I realize now that they were in fact a tremendous boon to me.

I got my first driver's license in September 1973, just in time for the November 1973 gasoline shortage. Rather than carefree cruising with my girlfriend—as I'd imagined on the day I got my license—my time behind the wheel was spent mostly in a car parked in a line, waiting impatiently for the opportunity to buy a maximum of five gallons of gasoline. No fun.

Three years later, in early January 1977, I heard a tragic news report about an elderly couple in Buffalo who froze to death in their home because of the natural-gas shortage.

At first, I accepted the popular myth that these shortages resulted from some combination of greed, monopoly power possessed by energy suppliers, and an irreversible depletion of the world's supply of petroleum and natural gas.

Just a few days after hearing about the couple in Buffalo, however, my understanding radically changed. My Economics 101 professor drew a supply-and-demand graph on the chalkboard and explained how the interactions between buyers and sellers cause markets to clear—how prices coordinate supply and demand not through the design or dictate of government functionaries but rather through the voluntary adjustments of countless individual market participants.

This story made some sense, but it didn't much grab me until . . . until the professor showed what happens when government imposes price ceilings.

I remember the moment as if it were yesterday. "When government sets the price below the market-clearing level," my professor explained as she pointed to the supply-and-demand curves on the board, "the amount that buyers seek to buy exceeds the amount that sellers make available for sale. The inevitable outcome is a shortage."

Then and there I fell into my lifelong love of economics. Within a few weeks I decided not to drop out of school but instead to earn a doctorate in this incredibly relevant and illuminating subject.

But would economics have grabbed me so forcefully had I not waited in interminable lines at gasoline stations? Would economics have spoken to me so convincingly had I not been moved by the report of an elderly couple dying because of the natural-gas shortage?

Probably not. It was the evidence of the laws of economics cascading all around me that breathed life and relevance into the theories and diagrams.

I'm Not Unique

And other students were like me. When I first began teaching economics in 1982, I reminded my students of the long gasoline lines of 1973 and 1979. All heads shook knowingly. I had an easy time grabbing these students' attention in my classroom because economics explained so convincingly why they suffered those long lines.

But by then President Reagan had ruined things. In 1981 he abolished price controls on oil and gas. Shortages ended. The intervening two decades of freer energy markets have robbed students of firsthand experience with the ill consequences of government price caps on energy. Even OPEC was forgotten. (A couple of years ago, a student I encountered speculated aloud that OPEC was a defunct video game popular in the early '80s, "sorta like Pong.") Because today's students have no memory of the gasoline lines and other absurd aggravations of the 1970s, they too easily misperceive economics as irrelevant.

This is where you can help. Impose price ceilings on energy! Sure, there will be long lines at gasoline pumps and even more blackouts as consumer demand for low-price energy outstrips supply. Sure, the full cost of energy will rise because waiting in lines and dealing with blackouts devour valuable time and effort. Sure, these shortages will spawn black markets favoring the rich and the politically connected. Sure, price ceilings will severely discourage investments in generating capacity, in exploration, and in the development of other energy sources. And sure, some people may even die because there is insufficient energy to heat or cool their homes. But first things first: beleaguered economics professors will once again be able to point to a reality that makes economics relevant and interesting.

I urge you to cap energy prices. By doing so you will promote the worthy cause of economic education.

School Choice via the Universal Tax Credit

Separating School from State Represents a Bright Future for All Children

SEPTEMBER 01, 2001 by Lawrence W. Reed

School choice—the general concept that parents should have much more freedom and responsibility for their children's education than they have now—is an idea that has captured the imagination and support of legions of freedom-loving Americans. Where the rubber hits the road, however, is how to achieve it.

When all parents understand that a truly free society means that it is their responsibility to take care of their children's education, not that of everyone else in general or agents of the government in particular, we'll have the best of all worlds. Freedom will be greatly enhanced, and the competitive market will do for schools what it has done for everything from cheeseburgers to computers—produce high quality at a good price. Complete separation of school and state will put parents back in the saddle and liberate schools and teachers from incessant meddling by politicians.

Separation is the ideal, the goal we should all hope for and work toward. But since no one has the power to snap his fingers and make it happen tonight, some means for moving in the right direction as quickly as possible, consistent with liberty, is required.

Would vouchers get us there? Tax-funded vouchers are simply direct payments from the government to individuals to enable them to purchase a particular good or service—in this case, education—in the open market. Those payments can be in the form of checks that the beneficiaries deposit in their bank accounts and draw on to pay for the vouchered item. Or they can be coupons that beneficiaries give to private providers of the vouchered item; the providers then redeem them for cash from the government.

It’s abundantly evident that the opposition has succeeded in stigmatizing vouchers to the point where “the V-word” is shunned even by proponents. A significant number of private schools that might be eligible for vouchers don’t want to touch them with a ten-foot pole because they understand that government shackles inevitably follow government shekels. Fortunately, there is a superior option that is not only more in line with the principles of liberty, but is more politically viable as well. That option is tax credits.

Tax credits are designed to provide parents with tax relief linked to expenses incurred when they send their children to nongovernment schools. The credit is usually a dollar-for-dollar reduction in income or property taxes, unlike a tax deduction, which merely reduces taxable income.

Proponents of educational tax credits prefer them to vouchers on the grounds that they entail less government regulation of private schools and less risk of entanglement between church (through religious schools) and state because of their indirect nature. Unlike vouchers, credits do not transfer money from the state to schools or taxpayers.

Indeed, because vouchers are funded out of taxpayer money, some citizens will always argue that “Some of my money will be going to send your child to a school I don’t like.” They will want government to regulate how, when, and where their tax money can be used. The legislators who appropriate it and the bureaucracy that dispenses it will be more than happy to oblige. With private schools dependent on voucher revenue, few will be able to wean themselves away when regulation becomes invasive.

Tax credits don’t represent a claim by anyone on someone else’s wallet. You don’t get the credit if you don’t pay tuition or if you don’t pay taxes. A credit on your taxes represents your own money, period.

School Stamps

Here’s another way to see this crucial difference: Vouchers are food stamps for education, a mechanism for the forcible redistribution of wealth from many citizens to some citizens. Tax credits are mechanisms for fairness, an accounting device that permits people to keep at least some of their own money they would otherwise pay for the government school they are not using.

Some prefer vouchers to tax credits because, they argue, we should not use the tax system as a social-engineering tool. But a tax credit for education is fundamentally different from a tax credit for solar panels or electric cars or any other politically correct gimmick du jour: Not only is education mandatory, but taxes to pay for it are too, a sad fact that's not likely to change soon. A tax credit designed to get you, say, to buy a solar panel is not the same as one that refunds some of what the government charges you for something you don't want to buy anyway. Most people are instinctively sympathetic to the element of fairness in a tax credit.

What about parents who have little or no tax liability?

The "universal" tax credit, which the Mackinac Center for Public Policy first proposed in 1996, allows any taxpayer—individual or corporate, parent or grandparent, neighbor or friend—to qualify for a dollar-for-dollar credit by contributing to the education of anyone's child. It envisions private scholarships financed with tax-credit money.

Would tax credits be sufficient to encourage businesses to contribute to scholarship funds? After explaining the concept, I've asked CEOs all over Michigan this question: "Suppose you had a choice. You could send a million dollars in taxes to government for the politicians to spend. Or you could send that million to one or more scholarship funds to help children who might be your future employees get a good education. Which would you do?" I've never met one who preferred option number one.

Any school-choice plan should start with the recognition that private schools are not the problem we face today. They are an important part of the solution. We must not bargain away their independence to get choice even if it's in the form of a universal tax credit. We must not burden them with new government mandates cloaked in the guise of "accountability." Private schools are already accountable—unlike the government's schools, they have customers who can take a walk.

Some libertarians oppose a universal tax-credit plan because they see it as a halfway measure that doesn't immediately remove government from education. However, it would allow people to "opt out" of the government school system and use their money to buy education in the marketplace instead. True, it doesn't eliminate the government system for those who still want it, but it will do more to promote an array of flourishing, affordable, and attractive private options than any other politically viable plan afoot.

In time, that will make it easier to convince almost everybody that separating school from state represents a bright future for all children.

Demonizing Drug Makers

Governments Risk Killing the Goose That Lays the Golden Eggs

SEPTEMBER 01, 2001 by Doug Bandow

Doug Bandow, a nationally syndicated columnist, is a senior fellow at the Cato Institute and the author and editor of several books.

The pharmaceutical industry is under siege. Congress is considering various measures to control drug prices and use. More than 40 states are debating proposals to do the same. Demonstrators around the world are targeting drug makers for selling the AIDS drugs that they created.

The more good the companies do, the more hated they become.

The driving issue is cost. The National Institute for Health Care Management Foundation reports that total pharmaceutical outlays rose 18.8 percent last year—faster than medical expenditures and overall inflation.

This raises Medicaid spending for the state and federal governments, encouraging legislators to clamp down. Moreover, people accustomed to largely "free" medical care are complaining to the same politicians. Patients feel the brunt of drug expenditures more than other medical expenses because private insurance and Medicare cover less of the former.

Unfortunately, many lawmakers lean toward the simple answer of price controls. Under one guise or another, government would steal revenue from the firms, in effect confiscating their property.

Similar complaints are being lodged overseas. In many poor nations the standard treatment for AIDS costs many times the local per capita income.

Foreign patients can't directly lobby American states or the federal government. So nations such as India and South Africa are attempting to lower prices by disregarding patents and producing cheap substitutes.

Alas, drug industry critics at home and abroad have gotten the issue almost entirely wrong, from the statistics they cite to the solutions they promote. Thus governments risk killing the goose that lays the golden eggs.

Increased Demand

Costs are not rising dramatically because drug makers are hiking prices. It only seems so because, as the old adage goes, if you torture statistics long enough, they will confess to anything.

According to the National Institute for Health Care Management Foundation, just 22 percent of last year's rise was attributable to price hikes. The bulk of the cause, 42 percent, was increased demand for drugs. Another 36 percent was due to the use of newer, more effective, and thus more expensive drugs.

Explained the National Institute, "Americans are demanding, and physicians are prescribing, a higher volume of medicines." That is, more patients are better meeting their medical needs. Drugs cannot be looked at only as a negative, an expense to be controlled. After all, people demand access to pharmaceuticals because they offer enormous benefits.

Medicines extend and improve the quality of lives, including those of family members and caregivers. Moreover, drugs cut alternative medical expenditures by reducing hospitalizations, surgeries, and other more-invasive treatments. Columbia University economist Frank Lichtenberg figures that every $1 increase in pharmaceutical expenditures actually lowers hospital spending by $3.65.

Most dramatic is the life-saving potential for drugs, which have contributed much to the dramatic increase in longevity, up seven years since 1960 alone. Today 402 medicines to fight cancer and 122 to combat heart disease and strokes are currently in the industry pipeline.

The value of drugs is particularly obvious with a disease like AIDS. When it was first identified in the early 1980s there was no treatment. In 1987 there was one. Now there are 64 AIDS drugs available, with another hundred in development. Such advances warrant a high price.

Thus government action that discourages creation and distribution of drugs will "save" money only at enormous cost. People will die sooner. Their lives will be more painful. And other health-care spending will rise.

Moreover, there should be no doubt that intrusive regulatory proposals will deter innovation. Many people seem to believe that drugs fall from the sky rather like manna from heaven. In their view employees of the evil drug companies got up before anyone else and grabbed the manna, and then put it up for sale at outrageous prices.

In fact, the U.S pharmaceutical makers spent more than $26 billion last year to find needles in haystacks. In contrast, government R&D expenditures through the National Institutes of Health are primarily for basic research; less than $1 billion goes to pharmaceutical work.

No Guarantees

Even $26 billion doesn't guarantee results. Of every 5,000 to 10,000 substances reviewed, one, on average, finally makes it onto the market. Even then, seven of ten new drugs actually lose money.

Just one of every 60,000 substances studied between 1961 and 1983 was considered to be "highly successful," generating more than $100 million in annual sales. These few medicines must pay for everything—research, administration, and all the failures.

But critics complain about industry advertising. The $2 billion devoted to ads in the mass media, is, however, dwarfed by R&D expenditures. Moreover, what industry makes a product and tells no one about it? Imagine General Motors developing a new car but keeping it secret.

In fact, pharmaceutical companies devote a larger share of sales to R&D than does the medical industry generally, or computer makers, software developers, or automakers. And advertising informs patients and doctors about what is available. Patient advocates in Canada's nationalized system, in contrast, complain about the lack of information available to them.

Still, some low-income people have trouble paying for medicines. Wealthy and compassionate individuals should lend a hand. But "first, do no harm" should be the principle that governs any action, private or public.

Thus government should not interfere with a pharmaceutical market that works as well as it does only because it remains relatively free. Instead, private remedies should be narrowly targeted to meet genuine needs.

The pharmaceutical companies already do their part. Forty-nine companies have programs for the uninsured and indigent, and gave away 2.8 million prescriptions in 1998. The Pharmaceutical Research and Manufacturers of America (PhRMA) maintains RxHope.com, a Web site to match patients to private charitable drug-assistance programs. The site states, “The Pharmaceutical Industry is committed to ensuring that everyone who needs prescription medications is able to receive them.”

As for the elderly, what must be avoided is a stand-alone prescription-drug program, which would inevitably lead to runaway costs and overwhelming pressure for price controls.

Americans are rightly concerned about rising pharmaceutical costs. But the reason they are concerned is because of the great benefits provided by drugs. Which means that government must not wreck a world-leading industry and deny people access to lifesaving medicines.

Today, high costs pose a serious, but manageable problem. Intrusive regulation and price controls would pose a far more serious and essentially unmanageable problem tomorrow. Drugs are saving countless lives. Government should keep out of the way.

The Perverse Popularity of Command and Control

How Industry Is Protected against Competition at the Expense of the Environment

SEPTEMBER 01, 2001 by Dwight R. Lee

Most government attempts to protect the environment involve imposing detailed regulations on how, and how much, pollution must be reduced. This command-and-control approach does reduce pollution, but as I explained last month, it does so at high cost.

I now consider why the command-and-control approach is so popular politically. One possibility is that though command and control is a costly way to reduce pollution, there is no less costly way. Just because a policy is costly does not mean it is inefficient, unless there is a cheaper way of realizing the goal. So it may be that Congress and the EPA are concerned only with protecting environmental quality and have embraced this approach because, as costly as it is, it is cheaper than feasible alternatives.

We are about to see that this is not the case. The political popularity of command and control has far more to do with protecting special interests than with protecting the environment. Next month I shall discuss an alternative approach to environmental protection using market incentives, one that is resisted politically because it would do far more to protect the environment than to protect special interests.

I hope I don't sound outrageously cynical when I say that employees of the EPA are willing to sacrifice environmental quality for personal gain. I hasten to add that I am not singling out EPA employees for special criticism. They are just like the rest of us. We all do things for personal benefit that harm the environment (almost everything we do causes some environmental harm). It shouldn't be surprising that EPA employees do the same. Command-and-control policies are not the best for protecting the environment, but they are great for protecting (and expanding) EPA budgets and jobs. The EPA has more to do when it is involved in the details of pollution control than it would if decisions were shifted to those with more information on local conditions. As *The Economist* pointed out, "The EPA exists to regulate things, not to see the market do the job for it."[1]

Few things are easier than convincing yourself of the social virtue of things that serve your interest, so most EPA officials are likely convinced that command-and-control policies are justified.

But even if they are motivated by civic virtue, EPA officials benefit by reducing pollution through detailed regulation. And since they are well organized and considered experts on pollution control, their views have significant influence on environmental policy.

Another political advantage for the command-and-control approach is its public appeal. If big businesses are polluting our environment, then nothing seems more appropriate than for government to step in and make them stop. Discussions about local knowledge and least-cost reduction are far too subtle to capture the attention of the public. Also, the market approach, which (as we shall see) allows people to pollute as much as they want as long as they are willing to pay a price, is easily dismissed with bumper-sticker phrases like "it's a license to pollute."

Don't Throw Me in the Briar Patch

The public may believe that the command-and-control approach is the best way to get tough on big-business polluters, but businesses are among its most enthusiastic and politically influential supporters.

True, businesses often object to environmental regulations, but most of these objections are like Br'er Rabbit's begging the fox not to throw him into the briar patch. True, businesses don't like all environment regulations (they don't want to be thrown just anywhere in the briar patch), but some types of regulation are just fine with them, especially big businesses.

Command-and-control regulation typically increases the costs of doing business. But those costs are often easier for a big business to handle than a small business, because large firms already have legal departments to deal with the inevitable litigation that comes with environmental regulation, and they can spread the costs of pollution control over more units of output.

Also, pollution-control regulation often reduces an industry's output. This can increase industry profits by allowing firms to raise prices and act like a monopoly cartel, something that is normally illegal. For example, EPA regulations for reducing sulfur in gasoline have recently improved the profit outlook for refiners by causing them to shut down some plants.[2]

Sometimes command-and-control policies are intentionally used to protect an industry against competition at the expense of the environment. One blatant example involves air-pollution policy. The 1970 Clean Air Act established acceptable levels of several pollutants, including sulfur dioxide (SO2), the primary pollutant of coal-fired electric generating plants. While requiring those generating plants to reduce their SO2 emissions, the Act did not specify how. The cheapest way to reduce SO2 emissions is often to shift from high-sulfur eastern coal to low-sulfur western coal, and that is exactly what many coal-fired plants did, even some in the east. The alternative is to install stack scrubbers that remove much of the sulfur from the flue gas, but they are expensive, consume large amounts of energy, and often do less to reduce SO2 emissions than simply burning western coal.

Unsurprisingly, the eastern coal industry and the United Mine Workers Union were unhappy about the shift to western coal. (It requires little labor to mine and the labor is not heavily unionized.) So they were prepared to lobby for the elimination of the competitive advantage of western coal when the Clean Air Act was amended in 1977, even if it meant dirtier air and higher electricity bills. They backed amendments requiring that all new (or substantially modified) power plants install the "best available control technology," which meant scrubbers, regardless of the sulfur content of the coal used. Furthermore, they pushed through a "local coal amendment" that outlawed "importing" western coal if it threatened jobs in eastern coal-mining states.

This command-and-control policy mandating how pollution has to be reduced means that coal-fired power plants have neither the incentive nor, in many cases, the legal right to reduce pollution as cheaply as possible. This mandate had nothing to do with protecting the environment, but a whole lot with protecting an organized interest group. Because of these amendments to the Clean Air Act, the price of electricity increased in all parts of the country (power plants in the west continued to use western coal but still had to install expensive scrubbers) and the environment was actually harmed in many parts of the country.[3]

Next month: a market approach that would improve the efficiency of pollution control.

Notes

1. "William Reilly's Green Precision Weapons," *The Economist*, March 30, 1991, p. 28.
2. Peter A. McKay, "New EPA Rules May Fuel Refiners' Profits," *Wall Street Journal*, February 2, 2001, p. C-1.
3. For a more detailed discussion on the 1977 amendments to the Clean Air Act, see Peter Navarro, "The Politics of Air Pollution," *The Public Interest*, Spring 1980, pp. 36–44.

I Like Hayek

Who Better to Lead Economics into the 21st Century?

SEPTEMBER 01, 2001 by Mark Skousen

"Half a century later, it is Keynes who has been toppled and Hayek, the fierce advocate of free markets, who is preeminent." —Daniel Yergin and Joseph Stanislaw [1]

Last year *Time* magazine named John Maynard Keynes the economist of the twentieth century for his countercyclical demand-management thesis—that big government is necessary to stabilize an inherently shaky capitalist system. But in the latest biography of Keynes, Robert Skidelsky declares that arch-critic Milton Friedman disproved Keynes's theory by demonstrating with convincing empirical evidence that market economies were far more stable than Keynes believed, and that government—particularly central-bank monetary policy—is the real source of the boom-bust cycle. "It was as though Keynes had never been," Skidelsky pronounced solemnly.[2]

Who should take the place of Keynes to lead economics into the 21st century? Should it be the economics of Friedman, Ludwig von Mises, Joseph Schumpeter, or F. A. Hayek? While all four have much to offer, I favor Hayek. I am not alone. Lately there has been a plethora of books and articles about Hayek, so extensive that an entire Web site, maintained by Professor Gregory Ransom, is devoted to this eminent economist and philosopher. (See www.hayekcenter.org.) For the past dozen years, the University of Chicago Press has published the collected works of Hayek up to volume ten, with another ten expected.

In addition, an excellent biography has just been released, *Friedrich Hayek: A Biography*, by Alan Ebenstein. It offers a comprehensive look at Hayek's life and ideas, and even includes some surprises, such as his controversial divorce and remarriage; how his bestseller, *The Road to*

Serfdom, may have cost Sir Winston Churchill re-election in 1945; and the remarkable similarities between Hayek's and Marx's theories of crises.[3]

Hayek's Political Contributions

What do I like about Hayek? First, Hayek advanced the case for an institutional framework for liberty. In his classic work *The Constitution of Liberty*, he set out the legal and constitutional system needed to create the delicate balance between liberty and law in a liberal society.[4] Hayek rejected central planning by technocrats and emphasized the "spontaneous order" and prosperity generated by individuals using their own specialized knowledge and pursuing their own self-interest. According to Hayek, intervention could only lead down "the road to serfdom," the title of his most famous book. This book was written during World War II and reflected his pessimism about the future of government and Western civilization. When he wrote chapter 10, "Why the Worst Get on Top," he had in mind Hitler, Stalin, and Mussolini.

In 1976 he was even more dejected: "Both the influence of socialist ideas and the naive trust in the good intentions of the holders of totalitarian power have markedly increased."[5] Yet, only a few years later, Margaret Thatcher and Ronald Reagan appeared on the scene and under the influence of Hayek and other free-market economists, reversed the tide of socialism and inflation. The worst don't always get on top!

New Advances in Hayek's Economics

Hayek's economics has been both lauded and attacked by his colleagues. Economists have readily incorporated his concept of prices and profits as essential communicators of critical information. They signal where scarce resources should be allocated in the economy, thus creating "order without command."

But it's another story when it comes to the "Austrian" theory of capital, the business cycle, and monetary policy. "I am an enormous admirer of Hayek, but not for his economics," confesses Milton Friedman, "His writings in [political theory] are magnificent . . . [but] . . . I think his capital theory is unreadable. . . . There hasn't been an iota of progress."[6]

But Friedman spoke prematurely. There has been considerable progress in Austrian capital theory. Recent advancements in theoretical Austrian macroeconomics include Roger Garrison's *Time and Money*, which deftly compares the flawed models of Keynesian and monetarist theory with the more advanced Austrian theory, and Steve Horwitz's *Microfoundations and Macroeconomics*. Both books were published in the past year by Routledge.

On the statistical side, I reported in my April column that the U.S. Department of Commerce's Bureau of Economic Analysis has recently begun to measure Hayek's triangle, that is, the total amount of annual spending at all stages of production. This new national statistic, called "Gross Output," is based on my original work *The Structure of Production*, an updated vision of Hayekian macroeconomics.[7]

The Austrian Business Cycle and NASDAQ

The Hayek-Mises theory of the business cycle is also relevant to today's business cycle and financial markets. Indeed, the most recent boom-bust in technology stocks and the NASDAQ is a perfect example of Hayekian economic behavior. Hayek's theory predicts that an easy credit policy will create an artificial inflationary boom in the earlier stages of capital and technological development that will eventually and inevitably collapse. "Every period of inflation ends with a crash," he said. Indeed, that is precisely what has occurred in the past few years on the technology-weighted NASDAQ.

The 1997–99 easy-credit policies by the Federal Reserve pushed the NASDAQ index far above its natural level, and when the Fed stopped inflating, the bubble burst. What goes up must come down.

On a personal note, I had the opportunity to meet Nobel-laureate Hayek twice, once in the late 1970s at the New Orleans Investment Conference and again in the mid-1980s, when Gary North and I visited him at his summer home in the Austrian Alps and conducted what turned out to be his last interview. Even at the age of 86, he greeted us warmly and for three hours spoke masterfully of his career and his contributions to economics. His biggest regret was that his theory of capital had not been pursued. Now all that is changing.

Yesterday's heresy is tomorrow's dogma!

Notes

1. Daniel Yergin and Joseph Stanislaw, *The Commanding Heights* (New York: Simon and Schuster, 1998), p. 431.
2. Robert Skidelsky, *John Maynard Keynes: Fighting for Britain, 1937–1946* (London: Macmillan, 2000), p. 506.
3. Alan Ebenstein, *Friedrich Hayek: A Biography* (New York: Palgrave/St. Martin's Press, 2001).
4. F.A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960).
5. F.A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1976 [1944]), p. xxi.
6. Quoted in Ebenstein, pp. 81, 273.
7. Mark Skousen, *The Structure of Production* (New York: New York University Press, 1990).

Does Trade Exploit the Poorest of the Poor?

Both Parties Benefit from Trade Even When There Are Gross Inequalities of Skill and Productivity

SEPTEMBER 01, 2001 by Russell Roberts

Roughly 180 years ago David Ricardo discovered comparative advantage. He showed that trade benefits both trading partners even when one is less productive than the other across all activities. There are gains from trade and specialization even in that case.

Ricardo's insight is in the news these days as talk continues about broadening free-trade agreements to the Americas and as the antitrade forces that raised their heads in Seattle remain in the spotlight.

Or perhaps it is more accurate to say that Ricardo's insight is not in the news. For it remains misunderstood or underappreciated by almost everyone other than professional economists.

I was recently discussing comparative advantage with a student. She said that the whole concept seemed to miss the point of how trade exploits the poorer nations. In explanation, she told me that when she had lived in Nepal she had done her laundry by hand. She considered hiring a local woman to do it for her. But to pay someone the tragically low prevailing wage would be, in the student's view, a form of exploitation. She could have chosen to pay more than the prevailing rate—an amount that she would have considered "non-exploiting." But at that rate, it was worth it for her to do her laundry herself. So rather than "exploit" the washerwoman, the student continued to do her own laundry.

I argued that the washerwoman did not see it as exploitation. She saw it as an opportunity. Surely she would be thrilled to have the job and would be better off from having it.

Ricardo was right: both parties benefit from trade even when there are gross inequalities of skill and productivity. Ironically, the poor may have more to gain than the wealthy. My student saved herself from the indignity of paying someone a pittance in return for cleaner clothes. Her arms and shoulders got a little sore from the novelty of washing her own clothes by hand.

But the washerwoman probably paid a higher price. She may have lost an opportunity to clothe her child. She may have lost an opportunity to keep a child in school instead of sending him off to work. What my student saw as a pittance may have been life-altering for the washerwoman.

The same is true at the national level. If we closed our borders, the impact on Americans would probably be smaller than the impact on our poorer trading partners.

If we closed our borders to avoid "exploiting" the poorer nations of the world, we would face higher prices and have a lower standard of living. There would be less innovation without the spur of foreign competition. The jobs that would be available would be a little less interesting. But if we only bought things made by other Americans the impact would be mitigated by the size and diversity of the U.S. economy.

Malaysia, Indonesia, and many of our other trading partners, however, would pay a heavy price. You can see the difference by imagining more and more severe forms of protectionism in the United States.

"Buy Missourian!"

I live in St. Louis. Suppose I could buy things made only in Missouri. Life would get dramatically less interesting and a lot poorer. Missouri has some car factories, but they would get a lot smaller and be a lot less efficient if the cars had to be sold in-state. As a result, they'd be a lot more expensive. Think about the food in the grocery. If the store couldn't import produce from California or Florida, oranges and avocados and garlic would either get a lot more expensive or they might not be available at all.

Then think of how poor life would be if I had to buy products made only in St. Louis and no imports were allowed from outside the city. I'd probably lose my job. There wouldn't be enough students here in town to support the current number of universities here in town. A lot of us would have to become farmers if we wanted to feed our families. Houses would have to be destroyed in order to devote land to farming, pushing people into apartments. A whole string of economic changes would occur and all of them would be impoverishing.

The poorest countries are a lot like St. Louis or Missouri in that their size makes self-sufficiency extremely expensive. Trade lets them avoid that trap. Trading with them doesn't exploit them—it allows them to escape the poverty of self-sufficiency.

The protesters of free trade would have us believe that Nike and other multinationals exploit their workers by paying low wages and creating an unpleasant work environment. Their claim would be that Nike pays pitiful wages and exploits its workers because it can.

But the workers in those foreign countries are thrilled to see a Nike factory open. They don't stay away for fear of being exploited. People line up in China and Indonesia and Malaysia when American multinationals open a factory. And that is because even though the wages are low by American standards, the jobs created by those American firms are often some of the best jobs in those economies.

Even with trade, life is not easy for the Nepalese washerwoman or the Nike worker in Malaysia. It may make us uncomfortable at times to trade and interact with people who have such hard lives. But lack of education and marketable skills, not trade, are the cause of that hardship. Trade helps poor nations and their workers accumulate a bit of wealth and comfort. That in turn allows the poorest of the poor a chance to keep their children in school. It allows them the possibility of a brighter future. To deny them the opportunity to trade is the ultimate exploitation.

The Bad Old Days

World War II Nostalgia Is Thinly Veiled Collectivism

SEPTEMBER 01, 2001 by Sheldon Richman

Collectivism runs deeper in our society than we like to think. Several phenomena indicate this. One of them is the regular display of nostalgia for World War II, the latest of which was sparked by release of the movie Pearl Harbor. It's understandable that people whose lives were disrupted by the war would get together to relive their common experiences. People do that about all kinds of things.

What I'm referring to goes deeper and actually is insidious. Political leaders, pundits, television historians, and regular people longingly look back on the war as a grand time when, as a commercial for recordings of war-era songs put it, "we all pulled together." Apparently, an era of peace, freedom, and privacy just can't compare.

The commentators go further and lament that the baby-boom generation didn't face something comparable: there was no great, unifying crisis. (Alas, Vietnam does not measure up.) Roosevelt-Johnson hagiographer Doris Kearns Goodwin recently whined that no leader has come along to "challenge" the boomer generation. These are the same people who swoon when they see the film of President Kennedy saying, "Ask not what your country can do for you—ask what you can do for your country." (Now there's a false alternative!)

What's wrong with all this? Two things. First, there is the implication that a society's commitment to a single cause is a good in itself. This is sheer collectivism. As a general principle, if a free society is attacked and its members must drop what they were doing to defend themselves, it is only so that they can resume their private lives as soon as possible. Solidarity at best is an emergency measure. Second, those nostalgic for what war produces on the home front ache to make it the normal condition minus the blood and destruction. Thus the unending search for “the moral equivalent of war” (William James’s phrase) in the form of destructive government crusades for this, that, and the other.

What it all comes down to is a thinly veiled collectivism, in which individuals are increasingly deprived of control over their own lives and resources—in the mantle of a sappy patriotism.

Rather than indulging in such nostalgia, friends of liberty should identify it for what it is.

* * *

When independent bookstores found themselves at a competitive disadvantage against Barnes & Noble and Borders, they—what else?—asked the government to do something. The economic theory they used to make their case was faulty, writes Gary Galles.

Social Security is palpably a bad deal, yet for many it’s the most wonderful thing the government has ever done. Hugh Macaulay resolves the paradox.

With the mapping of the human genome, the boon to health may be unfathomable. But some fear that genetic testing may permit insurance companies and others to know too much. Michael Rupert and E. Frank Stephenson counsel against the government’s interfering with the market for genetic information.

China doesn’t look the way it looks in old movies. The difference isn’t accounted for simply by the presence of Golden Arches and a finger-licking colonel, however, as Larry Tritten relates from personal experience.

Biodiversity appears to be valued more highly when someone else is forced to pay for it. The result, according to David Laband, is bad public policy.

When the Irish potato crop failed in 1845, laissez-faire capitalism suffered yet another black eye. But like the others, this one was undeserved. Stephen Davies sets the record straight.

With the re-election of the Blair government in Britain, another European nation remains in the hands of socialists in free marketeer’s clothing. Norman Barry strips away the disguise of the clever leftists. There was supposed to be a conference in Quebec City on making the Western hemisphere a free-trade zone. But beneath the trade rhetoric was the same old protectionist song. Pierre Lemieux scrutinizes the Third Summit of the Americas.

The news commentators talk about Alan Greenspan as though he were the helmsman steering the economy with pinpoint precision. But can you imagine what it would take to run an economy? Christopher Mayer gives it a try.

The federal government taxes producers in the 50 states and then sends some of the money back, giving rise to a list of states that apparently either win or lose in the transfer process. That's the collectivist manner of looking at the issue. Methodological individualism brings Christopher Westley to another conclusion.

A prominent Catholic cleric has written that workers have a moral obligation to join unions. That brought him into conflict with a Catholic teacher who claimed that being required to join a union violated the church's social teachings. Who has the better argument? Charles Baird sorts it all out.

Here is what our columnists have come up with. Donald Boudreaux urges Congress to enact energy price caps. Lawrence Reed looks at education tax credits. Doug Bandow defends the pharmaceutical companies. Thomas Szasz exposes pseudocritics of psychiatry. Dwight Lee rejects command-and-control environmentalism. Mark Skousen sees new appreciation of F. A. Hayek. Russell Roberts asks if trade harms the poor. And Roger Garrison, hearing claims that the economy is naturally cyclical, retorts, "It Just Ain't So!"

Books coming under review this month focus on the Clinton record, the Great Depression, the chairman of the Fed, George Soros's views on capitalism, the failure of education reform, and Henry Wallace.

The Economy Is Cyclical?

The Central Bank Whipsaws the Economy

SEPTEMBER 01, 2001 by Roger W. Garrison

According to a memorable title, "Business Cycles Aren't What They Used to Be—and Never Were" (Gerald Sirkin, *Lloyd's Bank Review*, v. 104, 1972). In today's political and economic environment, we need to be clear about which characteristics endure and which ones can and do change over time. We might begin with a reminder about characteristics that have never been justifiably associated with the business cycle. The term itself suggests a rhythmic variation of business activity. But despite the once-popular notion of a built-in 55-year cycle dreamed up by Russian economist Nicolai Kondratieff, no such econo-rhythms have any claim on our attention.

The "cycle" as applied to twentieth-century fluctuations—and to 21st-century worries—is better described as a boom-bust sequence. It is a whipsaw effect with no necessary recurrence implied. The economy is somehow set off on an unsustainable growth path—a path on which market forces are pitted against one another. Eventually and inevitably, the tradeoff between maintaining an excessively high growth rate and accommodating people's current demands for consumables is made in favor of the latter. When resources are finally diverted away from the future-oriented investment projects, jobs are lost and a period of liquidation ensues.

The most conspicuous enduring characteristic of the boom-bust sequence is revealed by investigating the originating "somehow." The origin of this macroeconomic misstep must have an essential element of centrality about it. A fully decentralized economic system cannot "somehow" set itself off on an unsustainable growth path. Such a systematic distortion suggests central decision-making, and the central element of note in our economic system is of course the central bank.

Credit expansion by the Federal Reserve orchestrates a boom. Abundant credit at artificially low rates of interest encourages more investment activity than can be carried through to completion. Entrepreneurs borrow the new money and buy resources. If the central bank had the power to print more resources too, the boom would be sustainable. But neither the Federal Reserve nor any other governmental institution has such powers. Hence, the boom is artificial and leads to a bust.

Beyond its origins in ill-conceived or politically motivated monetary policy, the boom-bust sequence has other enduring characteristics, such as excessive investment in long-term projects and dramatic movements in the prices of interest-sensitive and highly speculative assets. One curiously enduring complement of a maturing boom is the widely held belief that business cycles are a thing of the past. In the 1920s Irving Fisher believed we had reached a new plateau of prosperity. References to the "new economy" in today's financial press should be seen as dark reminders of Fisher's plateau. Editorials sounding related themes ("Conquering the Business Cycle"; "Have the Laws of the Cycle Been Repealed?"; "An Era of Cycle-Free Growth") should be read as old hat rather than new era.

Even the reasons offered for believing that we've entered a new economy, while different in their details, are tellingly similar. The expansion of the 1990s actually involved real economic growth—attributable to the Internet, the digital revolution, and just-in-time inventory management. True enough, but the expansion of the 1920s also involved real economic growth—attributable to technological advancements in automobiles, home appliances, and food processing.

In both periods the real growth, which in the absence of credit expansion would have been accompanied by price reductions, helped keep price inflation in check. That is, increases in the money supply and the ongoing real economic growth had largely offsetting effects on the overall level of prices. F. A. Hayek described this circumstance as artificial price-level stabilization—a term that could only be puzzling to Irving Fisher and modern-day monetarists, who take price-level stability as the hallmark of macroeconomic health. But Hayek demonstrated that the absence (or slightness) of price inflation is of little comfort in a period when cheap credit is stimulating investment beyond people's willingness to save. Price-level constancy does not equal macroeconomic stability.

Business cycles aren't what they used to be if only because some people—and policymakers—make judgments and take actions on the basis of their experience with previous booms and busts. The history of the art of "Fed watching" illustrates the point. During the early years of the Federal Reserve, there were no Fed watchers.

In fact, there was precious little that one could have watched. Data on the monetary aggregates and credit conditions were not readily available—a circumstance that helps explain how the boom (the monetary deception) could be so long-lasting.

During the 1960s and 1970s the availability of data on the key money-supply aggregates allowed Fed watchers to monitor its efforts to manipulate credit conditions. And in the early 1980s, when money-growth targeting replaced interest-rate targeting, those same aggregates allowed Fed watchers to compare track records to intentions and to make predictions about the Fed's habitual overshooting. This was a period of relatively short business cycles.

In today's environment, the monetary aggregates have lost the meaning they once had. The much-watched M1 and M2 derived their significance from two vital links: (1) the ability of the Federal Reserve to control those aggregates by adjusting the monetary base and (2) the near-constancy of the velocity of money, which maintained a near-constant ratio between the money supply and the price level. After extensive banking reforms severely weakened both links, the Federal Reserve returned to interest-rate targeting.

Present-day Fed watchers can only watch and wonder. The monetary aggregates are readily available but not very helpful. M1 is essentially the same as it was a year ago. Over that same period, M2 has risen by 8 percent and the new MZM has risen by 13 percent. (The "ZM," which stands for zero maturity, indicates all financial instruments payable at par on demand.) Unfortunately, none of these money aggregates are both readily controllable and strongly correlated with the price level or any other macroeconomic variable.

Currently, there is timely information about the Federal Reserve's changing interest-rate target. Both the administered discount rate and the targeted federal funds rate are publicly announced within a couple of hours of each decision to change them. What is not known, however, is the interest rate that would prevail in the absence of credit-market management by the Federal Reserve. The all-important "natural rate of interest"—like the "natural rate of unemployment"—becomes unobservable in a Fed-dominated environment.

Our suspicions of political motivation—along with the 13 percent MZM growth—suggest that the managed rates (of interest and unemployment) are somewhere below the respective natural rates. If so, the resulting pattern of investments is unsustainable; the economy is living on borrowed time. It's a familiar story. The Internet and MZM notwithstanding, business cycles are what they used to be: The central bank has whipsawed the economy once again.

Feeling Your Pain: The Explosion and Abuse of Government Power in the Clinton-Gore Years by James Bovard

Clinton Is Gone, But Not His Governmental Detritus

SEPTEMBER 01, 2001 by George C. Leef

St. Martin's Press · 2000 · 426 pages · $26.95

Reviewed by George C. Leef

The battle over the history of the Clinton presidency is on and the early reports from the battlefield indicate that the fight is going in favor of those who prefer truth to spin. The jaw-dropping last-minute pardons seem to have at least temporarily thrown the Clinton mouthpieces on the defensive while books like James Bovard's *"Feeling Your Pain"* sweep the field.

For years, Jim Bovard has been one of the most dependable scourges of big government writing about the political scene. His 1994 book, *Lost Rights*, was a compendium of the liberties Americans have had taken away by government. Bovard has a tremendous talent for digging into the details of government actions that waste our money and deprive us of our freedom, so it was inevitable that he would be quick out of the gate with a book on the Clinton administration, which, as he demonstrates, hardly did anything except waste our money and deprive us of our freedom. He writes that "From concocting new prerogatives to confiscate private property, to championing FBI agents' right to shoot innocent Americans, to bankrolling the militarization of local police forces, the Clinton administration stretched the power of government on all fronts."

Precisely. While Clinton capitalized on his ability to mesmerize voters with sappy lines like "I feel your pain"—hence the title—he and his lieutenants presided over eight years of almost unchecked growth in federal power and abuse of power that had previously existed. Millions of

Americans felt the pain of Clinton policies as he went careering around the country in pursuit of his holy grail of electoral success. Bovard counts the ways.

Here's a good example of Bovard in action. The AmeriCorps program was one of those innumerable lofty-sounding inventions of the Clintonites that serves as camouflage for waste and skullduggery.

Among its activities is to send its "volunteers" (who soak up lots of tax money) into schools to talk about child abuse. The yardstick by which the "effectiveness" of that activity is measured is reported incidents of child abuse, and in 1999 the AmeriCorps director aimed at a 25 percent increase in reports of child abuse. Parents or guardians so accused face a stacked deck because, Bovard points out, the government pays the court costs for the accuser.

It is well known that false accusations of abuse have been numerous, and some have had tragic results. So Bovard called the director to ask if there were any safeguards against false accusations. He was told that there weren't, but that the "sophisticated" justice system could deal with any that might be made. Bovard pressed on: "I asked how many of the charges of child abuse that resulted from AmeriCorps activism were 'sustained'—i.e., how many of the parents were found guilty. Ms. [Cynthia] Rogers replied: 'We would not even address that' and stated that she had no information on the results of the charges. This practically implies that increasing the number of child accusations is in the public interest, regardless of whether the charges are valid."

The IRS takes it on the chin too. Although Congress has passed legislation designed to protect taxpayers from abuse by the IRS, that did nothing to stop it; neither did Bill Clinton, who was quite happy with an agency that would maximize government receipts, individual rights be damned. The cases Bovard reports are truly sickening—vindictive IRS personnel who like to shoot first and cover up their misdeeds with threats and bluster afterward. Besides cases of hapless citizens who had their lives ruined by the IRS, the author supplies the details for the often-heard claim that Clinton had the IRS harass his political enemies.

A recurrent theme during the Clinton years was the administration's refusal to take "no" for an answer, whether from Congress or the courts, and "Feeling Your Pain" gives many examples of such "we're above the law" behavior. Consider, for example, the "Know Your Customer" (KYC) regulations that were proposed by the Federal Deposit Insurance Corporation in 1998. Those regulations would have turned banks into unpaid government snoops and they elicited a tremendous outpouring of opposition. The proposed regulations were eventually withdrawn, but that did not mean that the Clintonites had given up. In 1999 the FDIC issued a "Manual of Examination Policies" that told financial institutions that it was "imperative" that they adopt the KYC procedures. With that and other episodes, Bovard has identified one of the hallmarks of the Clinton era—contempt for the rule of law.

But maybe you'd rather simply forget about Bill Clinton. Why read this book? The answer is that although Clinton is gone that doesn't necessarily mean his governmental detritus has vanished. I recommend reading "Feeling Your Pain" and keeping it around as a way of checking on George W. Bush and future presidents. If, for example, we still have quotas for child-abuse allegations and the IRS still treats citizens like prisoners in the Gulag, you'll know that the Clinton influence lives on.

America’s Great Depression by Murray N. Rothbard

Rothbard Reasserts the Austrian View of Boom and Bust Cycles

SEPTEMBER 01, 2001 by Roger W. Garrison

Ludwig von Mises Institute · 2000 · 368 pages · $29.00

Reviewed by Roger W. Garrison

It may not be conventional to review the fifth edition of a book that appears several years after its author’s passing. But *America’s Great Depression* is not a conventional book. It is written with verve and aplomb. And its rendition of the Austrian theory of the business cycle, critique of alternative theories, and detailed history of the early part of the Great Depression (1929–1933) have captured the attention of a small but growing group of students and researchers for nearly four decades.

Each of the five editions has had a different publisher, the first four with an introduction by the author. With the fifth edition, we get a quality hardback, new typesetting with footnotes instead of endnotes, and a spirited introduction by historian Paul Johnson. A new dust jacket is fashioned from a photograph showing throngs of men in winter coats and fedoras standing despondently in line and casting long shadows. The image cries out for an explanation: How could things have gone so wrong?

The Great Depression has cast a long shadow of its own over twentieth-century economic history and policy issues. In many circles—even academic circles—it is still acceptable simply to point to the experience of the 1930s as clear evidence that market economies are prone to collapse. Rothbard provides an alternative understanding. Unsound policies of the central bank set the economy off on an unsustainable growth path in the 1920s, creating the conditions for the crash at the end of that decade.

Attempts by the government to undo or mitigate the damage only made matters worse.

The excesses of the twenties, the downturn, and the dramatic slide into deep depression are all traced to governmental disruptions of the market process.

Reasserting the Austrian view of boom and bust, the initial publication of *America's Great Depression* had a certain strategic significance. Through the 1930s and into the early 1940s, F. A. Hayek had contributed importantly to our understanding of business cycles but then abandoned the topic in favor of the broader issues of political economy. Rothbard offered the Austrian view anew in 1963. America's Great Depression stood as a complement to the relevant chapters of Ludwig von Mises's *Human Action*, issued in a revised edition that same year, and as a supplement to Rothbard's own *Man, Economy, and State*, which had been published the year before.

Equally significant in 1963 was the book's contrast with competing views of the events of the interwar period and its relationship to the general development of macroeconomic thought. In that same year, Milton Friedman and Anna Schwartz published their *Monetary History of the United States: 1867–1960*. They too blamed the Federal Reserve for the Great Depression. However, the central focus in their treatment of the episode was the collapse of the money supply (1929–1933) that took the economy into deep depression. There was no suggestion that during the previous boom, credit expansion had caused interest rates to be artificially low and hence had caused resources to be systematically misallocated in a way that would eventually require liquidation and reallocation. To the contrary, the nearly constant level of prices throughout the twenties was taken as a sign of macro-economic health.

Rothbard showed that policy-distorted interest rates give rise to a mismatch between the intertemporal production plans of entrepreneurs and the preferences of consumers, the latter being expressed by people's willingness to save. With the central bank's policy of cheap credit, more investment projects are initiated than can actually be completed. Too many resources are committed to the early stages of production, leaving insufficient resources for the late stages. The artificial boom is destined to end in a bust.

But wasn't it the subsequent collapse of the money supply that converted the bust into deep depression? Rothbard says no, pointing out that the Federal Reserve, instead of trying to reflate in the early 1930s, should have deliberately deflated—"to bolster confidence in gold" and to "speed up the adjustments needed to end the depression." With this argument, he dismisses the monetarists' concern about monetary deflation and about the resulting economywide discoordination that accompanies the piecemeal downward adjustment of prices. (Then and now, some of Rothbard's readers would acknowledge the harmful effects of monetary collapse—though without this acknowledgment detracting from the key Austrian insights about the nature of the initial downturn.)

Blaming business cycles on government was a hard sell in the 1960s—the decade in which Keynesianism ruled supreme—both in the seats of power and in the halls of academe. Rothbard is to be credited for keeping alive (during a period when the Austrian school was almost completely in eclipse) the key ideas about how the market process goes right if left on its own and how it goes so wrong when the central bank induces more growth than savers are willing to finance.

In the introduction to the fourth edition, Rothbard remarked that interest in his book on business cycles itself exhibited a cyclical pattern. Each subsequent edition was published during a period of macroeconomic disorder—high unemployment, high inflation, or both. His final introduction was written during the inflationary recession of the early 1980s. Since that time, the economy has experienced almost uninterrupted economic expansion. It seems fitting that the fifth edition appears at the end of a record-breaking expansion that is widely attributed to the pro-growth policies of the central bank.

Greenspan: The Man Behind Money by Justin Martin

A Book Lacking in Critical Analysis

SEPTEMBER 01, 2001 by Alexander Franco

Perseus Publishing · 2000 · 284 pages · $28.00

Reviewed by Alexander Franco

He has been called the second most important man in America and the nation's most enigmatic public official. Yet the public knows little of Alan Greenspan's personal life or of the secretive inner workings of the Federal Reserve System. Justin Martin has provided a biography that promises a "full and fascinating portrait" of the elusive chairman of the Federal Reserve Board (Fed), but, alas, the book fails to live up to its billing. Rather, it provides a portrait that is incomplete and that dodges the really fascinating question about Greenspan, namely his intellectual metamorphosis.

The first half of the book takes us through Greenspan's uneventful childhood in New York City during the Depression, his musical training at the Juilliard School, his brief stint as a professional jazz musician, and his higher education at New York University's School of Commerce and Columbia University. Martin also devotes an entire chapter to Greenspan's decades-long friendship with philosopher and novelist Ayn Rand, a friendship first formed in 1954. Greenspan's participation in Republican politics, beginning with Richard Nixon's presidential campaign in 1968 and later with Gerald Ford and Ronald Reagan, is also chronicled.

The second half of the book focuses on Greenspan's tenure as chairman of the Fed. Martin lucidly describes how monetary policy works and the intricacies of our complicated financial system. He also journeys into tangential but interesting discussions about the history of central banks in the United States, the domestic financial panics of the nineteenth and twentieth centuries, and even the demonetization of silver at the turn of the century, which led to the famous William Jennings Bryan speech about crucifying mankind on a “cross of gold.” Unfortunately, Martin never gets into the case against government management of money.

What is crucially missing in this biography is the essence of Greenspan himself. After finishing the book, one finds him as enigmatic as at the start. What makes the man tick? Those familiar with the literature of liberty know that Greenspan was an unabashed laissez fairist during his years as part of Rand’s inner circle, and we know he penned an essay, “Gold and Economic Freedom” (*The Objectivist*, July 1966), that assaulted the concept of the Fed and instead advocated the gold standard. Martin fails to explain what triggered Greenspan’s remarkable transformation from Objectivist to chief banker for the welfare state. A thorough understanding of this metamorphosis would have spoken volumes about the essence and character of the man.

The book is lacking in critical analysis, and the author’s writing is hagiographic in both tone and content—one might say that he is irrationally exuberant about his subject. The reader is constantly reminded of Greenspan’s “brilliance” within a superficial discussion that largely avoids the realm of ideas. There are no citations of any of Greenspan’s writings, much less analysis of them. Amazingly, Martin managed to find but two sources of criticism regarding Greenspan’s policies: Steve Forbes and disgruntled Objectivists. Both are treated lightly. Missing entirely is the serious scholarly criticism of central banking generally and Greenspan’s performance in particular. That criticism is out there for any biographer to consult.

A serious focus on Greenspan’s intellectual odyssey, beginning with his early libertarian thinking, should have triggered a discussion of the perils of state intervention in the capital market and the inevitable centralization of economic decision-making by a political class within a state-capitalist system. Instead, we are informed by the fawning author (a member of the cult of Greenspan?) that the chairman works six to seven days a week, starting at 6 a.m. and on into the late evening, to steer the economy. Ironically, the once-champion of the spontaneous order has now become the key locus of central economic planning.

No need for statists to worry about the future, for Senator John McCain provides a solution in the book: “If [Greenspan] would happen to die . . . I would do like they did in the movie Weekend at Bernie's. I would prop him up and put a pair of dark glasses on him."

We need a good biography of Alan Greenspan, but Martin's isn't it.

Alexander Franco is an adjunct professor at Florida International University College of Urban and Public Affairs.

Open Society: Reforming Global Capitalism by George Soros

Soros Doesn't Understand the First Thing about Economic Systems

SEPTEMBER 01, 2001 by Pierre Lemieux

Public Affairs · 2000 · 369 pages · $26.00

Reviewed by Pierre Lemieux

In his latest book, *Open Society*, retired billionaire speculator George Soros continues to argue against capitalism and its justification in economic theory. The book doesn't put a dent in capitalism, but shows that billionaire financiers don't necessarily understand the first thing about economic systems.

Soros opens with an indictment of the concept of equilibrium. In the real world, equilibrium is compromised by what Soros calls "reflexivity." Reflexivity ("the cornerstone of my conceptual framework") refers to the fact that people's opinions about social phenomena affect those very phenomena. All knowledge is therefore imperfect, and all social events unpredictable, he concludes.

The first problem is that Soros's theorizing is confused. "Our thinking guides us in our actions," he writes, "and our actions have an impact on what happens." The actions of all individuals certainly have an impact on social reality, but a single individual can safely take the environment as given when making his own plans. The price of tomatoes depends on all individual demands, but an individual buyer can take prices as fixed. In cases where one individual's actions influence another's, strategic behavior (taking into account other people's reactions) becomes rational, but this does not imply that the system is unstable. "Reflexivity" is much ado about nothing.

Secondly, Soros does not seem aware that many economists—the Austrians foremost among them—have developed similar critiques against orthodox neoclassical economics. Ludwig von Mises, Murray Rothbard, and Israel Kirzner, among others, have attacked the concept of equilibrium and showed the importance of entrepreneurship in market processes. It is because social reality depends on what people think that economists try to trace the unintended consequences of individual actions. Consider another example of Soros's ignorance: "The idea that some values may not be negotiable is not recognized," he writes about economic theory, "or, more exactly, such values are excluded from consideration." This is patently false. Any "value" can be included in individual preferences. And when private property rights are recognized, anybody can decide that something belonging to him is not negotiable.

Criticizing the Efficient Market Hypothesis (the theory that financial prices incorporate all available information), which he confuses with rational expectations in general, he admits: "I never studied it. I dismiss it out of hand because it is so blatantly in conflict with the concept of reflexivity." It is true that this theory doesn't account for the entrepreneurial behavior of speculators who look for, and jump on, new information and, by acting on it, actually incorporate it in market prices. Like Mr. Jourdain speaking prose without knowing it, Soros has been a Kirznerian entrepreneur helping to stabilize financial markets through his contrarian speculation.

Soros believes that central banks regularly save developed countries from depressions, and that a similar institution is required at the world level. He proposes the creation of the "Open Society Alliance," a new state association that would aim at coordinating existing international organizations. Like all statists, he envisions only benefits from this further centralization of power and sees none of the dangers.

The thrust of the book is an argument in favor of the "open society" and against capitalism. Soros takes capitalism to mean "the unbridled pursuit of self-interest," while it is actually a specific set of institutions that channels self-interest toward efficient social cooperation. He defines the muddled concept of "open society" as a one where there is no monopoly on truth, but he wants state coercion to impose his own ideas, "social justice" included.

Soros deems “market fundamentalism” more dangerous than communism for the “open society,” because free-market ideas appear everywhere triumphant. This would be good news if it were true—that is, if the state had not grown virtually nonstop during the twentieth century. Soros even sees a “dismantling of the welfare state” from 1980 on, which is not borne out by official statistics. And who are these “market fundamentalists”? He cites Milton Friedman twice, and F. A. Hayek once, mistakenly identifying the latter with the Chicago School. He doesn’t seem to know the real market radicals—people like David Friedman or Murray Rothbard—much less understand them.

By backing his opinions with his money, Mr. Soros is tilting the playing field to his side. What about the “level playing field” that pops up in his discourse? Not for him, it seems. Of course, he has the right to express his opinions, but not to use state coercion to dictate how we live our lives. This is what his espousal of all politically correct causes amounts to.

“Not many people,” Soros writes with his usual good-heartedness, “share my predilection for identifying error, and even fewer share my joy in finding it in themselves.” Let him now seize the opportunities for intellectual joy as efficiently as he seized profit opportunities in correcting market errors.

Pierre Lemieux is an economist, author, teacher, and consultant.

Left Back: A Century of Failed School Reforms by Diane Ravitch

An Extraordinary Review of 100 Years of Education Fads

SEPTEMBER 01, 2001 by Robert Holland

Simon & Schuster · 2000 · 555 pages · $30.00

Reviewed by Robert Holland

In his 1996 book, *The Schools We Need and Why We Don't Have Them*, E.D. Hirsch categorized and then proceeded to demolish the doctrines of progressive education that hold American education in thrall. Hirsch exposed the intellectual shallowness behind such notions as "child-centered schooling," "multiple intelligences," "authentic assessment," and "constructivism." He also traced the origins of progressive education to the Teachers College, Columbia University, in the teens and twenties.

The "education schools" of the nation have mindlessly perpetuated this anti-intellectual tradition and passed it along to new teachers.

The Hirsch tome, it turns out, was the first of a powerful one-two punch. In *Left Back: A Century of Failed School Reforms*, education historian and Brookings scholar Diane Ravitch has written an extraordinary review of 100 years of education fads. Where Hirsch critiqued ideas, Ravitch names names and provides dates so that it is possible to assign responsibility.

Among the first progressives she identifies is G. Stanley Hall, winner of the first doctorate in psychology from Harvard. In 1901 Hall declared before the National Education Association that guardians of the young "should strive first of all to keep out of nature's way." Educators, declared Hall, "must overcome the fetishism of the alphabet, of the multiplication table, of grammars, of scales, and of bibliolatry." There are many children, he asserted, who would be better off not being educated at all.

The elitist-progressive hostility to such core academic subjects as history, literature, algebra, and chemistry clashed with the desire of immigrant parents for their children to have a solid grounding in English and the American heritage. The intellectual heirs of Rousseau sought instead to impose a system of social efficiency whereby children would be sorted at an early age into useful occupations. They created industrial schools for children as young as 12 and junior high schools for the specific purpose of tracking children toward predetermined vocations.

The progressives' penchant for pigeonholing children and selling their intellectual potential short has resurfaced periodically under deceptive new labels. In late '30s and '40s it was the infamous "life adjustment" movement, which amazingly held that 60 percent of American children lacked the brains to aspire either to college or to skilled employment. The benevolent schools would have to "adjust" them to be decent drones. With a 1945 U.S. Office of Education conference playing a pivotal role, "life adjustment" steered most children away from books and academics and toward home and family living, vocational guidance, and such vital questions as "What causes pimples?"

Even now, when economic change would seem to put a premium on broadly educated people, progressives seek to shove aside classical disciplines in favor of attitudes, "real-world" concerns, and a niche in a government-managed workforce. In the 1990s that mindset showed up in such freshly minted fads as Outcome-Based Education and the federal School-to-Work system, though Ravitch chooses not to mention either abomination by name. Whether from a lack of candor or an excess of modesty, she also fails to mention her own prominent involvement as an Education Department higher-up during the first Bush Administration in the failed movement toward national education standards.

The most eye-opening chapter in *Left Back* relates the fondness that the progressives' hero, philosopher John Dewey, developed for the system of education in the Soviet Union. Dewey relished the fact that the Marxists had hammered schools into agencies of social uplift, with teachers leading students in applied "project" learning—taking them into the community for problem-solving in sanitation systems or bringing the peasants around to the communist way of thinking. This demonstrated a naïve affection for statist use of schools as instruments of a new social order. Progressives still see them that way.

From a century's litter of failed fads, Ravitch concludes that anything in education labeled a "movement" ought to be "avoided like the plague." That seems to be a wise caution when one considers the likes of the self-esteem movement, the whole-language movement, the multicultural movement, and dozens of other mindless education fads.

Both Ravitch and Hirsch are education egalitarians in the best sense. In contrast to the progressives who would level us down by draining intellectual content from mass education, they believe all children can benefit from a core curriculum grounded in the liberal arts. If they err on the side of idealism, they are at least correct that it is wrong to sell children short without giving them a chance to master serious subject matter.

Robert Holland is a senior fellow at the Lexington Institute, a public-policy think tank in Arlington, Va.

American Dreamer: A Life of Henry A. Wallace by John C. Culver and John Hyde

A Portrait of How Statist Ideas Were Conceived and Implemented in the New Deal Era

SEPTEMBER 01, 2001 by Burton Folsom

W. W. Norton & Company · 2000 · 608 pages · $35.00

Reviewed by Burton Folsom, Jr.

Possibly the most prominent statist politician in America in the first half of the twentieth century was Henry A. Wallace—vice-president, secretary of agriculture, and candidate for president in 1948. In *American Dreamer*, former U.S. Senator John C. Culver and journalist John Hyde have written the first full-length biography of Wallace. By studying him and his career, we can explore how statist ideas were conceived and implemented in the New Deal era.

Henry A. Wallace (1888–1965) grew up in Iowa in a family of prominent journalists. His father, Henry C. Wallace, edited *Wallaces' Farmer*, an influential farming newspaper. His grandfather wrote for the family paper as did young Henry when he was growing up. Until the 1920s, as the authors make clear, the Wallaces tended to promote free markets and vote Republican. The farm depression after World War I was what turned them toward government intervention. Henry C. Wallace became secretary of agriculture under Presidents Harding and Coolidge, and both Henry and his son became ardent enthusiasts for the McNary-Haugen farm plan, the first massive government farm program to pass Congress.

Under McNary-Haugen, the government would prop up crop prices by tariffs and export subsidies. Farmers could overproduce with full confidence that price supports would guarantee them profits. The crop surplus, which would of course steadily increase year by year, would be dumped on the foreign market—where other countries would presumably buy it even though we would be tariffing their exports. Liberty must be sacrificed to raising farm prices, the elder Wallace argued in his defense of McNary-Haugen. But President Coolidge vetoed the bill and called it a recipe for national debt and bureaucratic meddling. The Wallaces, however, persevered. With the death of Henry C. Wallace, young Henry A. took charge of Wallaces' Farmer and backed Democrat Franklin Roosevelt, who won the presidency in 1932.

When Roosevelt appointed Wallace secretary of agriculture, American farming was changed forever. Their program, the Agricultural Adjustment Act (AAA), was a response to the Great Depression, which had beaten down farm prices to all-time lows. It would artificially raise prices by cutting production—farmers would be paid not to produce. In 1933, the first year of the program, Americans were forced to pay farmers to plow under corn and cotton and to kill and destroy six million pigs. Wallace was no sentimentalist. "Some people may object to killing pigs at any age," Wallace observed. "Perhaps, they think that farmers should run a sort of old-folks home for hogs and keep them around indefinitely as barnyard pets."

Wallace himself, however, confessed that plowing under cotton and killing pigs "were not acts of idealism in any sane society." But the program won votes. Farmers with government checks voted Democratic in droves. The subsidies and the rise in farm prices outweighed, in the minds of most farmers, the loss of liberty and the sharp increase in the number of bureaucrats—tens of thousands of whom were needed to keep farmers from secretly overproducing. In other words, the political benefits of the farm program—subsidies and higher crop prices—were concentrated on farmers; the costs of the program—a spiraling federal debt and increased inflation—were spread out among the general population. Thus even though the AAA was an economic failure, it was a political success.

Roosevelt and Wallace played the subsidy game to perfection in the election in 1936. The authors, who strongly support both Roosevelt and Wallace, print a revealing quotation from that campaign: "Henry," the President told Wallace, "through July, August, September, October, and up to the fifth of November [just after election day] I want cotton to sell at 12 cents [a pound]. I do not care how you do it. That is your problem. It can't go below 12 cents. Is that clear?" The authors draw no inferences from the way Roosevelt and Wallace were using government. If Culver and Hyde had researched more deeply, they would have noticed that even within the cabinet there was dissent: Treasury Secretary Henry Morgenthau deplored the unintended consequences of pegging cotton prices this way to win southern votes. If American cotton is priced artificially high, Morgenthau wrote in his diary, exports will decline, and markets might be permanently lost.

When Roosevelt won re-election in a landslide, Wallace moved further into his inner circle and was tapped as vice president for his third term. In 1948 Wallace challenged Truman and made a run for the presidency as an independent. His platform called for national health insurance and public ownership of many banks, railroads, and utilities. He raised and spent over $3 million—"the most costly campaign [up to that time] in American history," according to the authors—but received less than 2.4 percent of the vote.

Culver and Hyde, both Iowans and headstrong "liberals," admire Wallace and celebrate with him the growth of government in America. Yet for free-market thinkers, Wallace's life is worth scrutinizing as well. In the 1920s Wallace was merely a man with an idea—that farming should be subsidized by government. But he wrote, talked, and cajoled until others began listening to his idea and taking it seriously. In the next decade, Wallace's idea became reality; in the decade after that, Wallace was second in line to the throne and in a position to make his idea a permanent fixture in the American economy. Ideas have consequences only when men care enough to fight for them, shun the critics who scorn them, and then fight some more until the climate of opinion changes.

About Gary M. Galles

Gary M. Galles is a professor of economics at Pepperdine University. His recent books include *Faulty Premises, Faulty Policies* (2014) and *Apostle of Peace* (2013).

About Hugh Macaulay

FEE

About E. Frank Stephenson

About Michael E. Rupert

About Larry Tritten

About David Laband

FEE

About Stephen Davies

Stephen Davies is a program officer at the Institute for Humane Studies and the education director at the Institute for Economics Affairs in London.

About Norman Barry

About Pierre Lemieux

About Christopher Mayer

FEE

About Christopher Westley

About Charles W. Baird

Charles Baird is a professor of economics emeritus at California State University at East Bay.

About Donald Boudreaux

About Lawrence W. Reed

Lawrence W. ("Larry") Reed became president of FEE in 2008 after serving as chairman of its board of trustees in the 1990s and both writing and speaking for FEE since the late 1970s. Prior to becoming FEE's president, he served for 20 years as president of the Mackinac Center for Public Policy in Midland, Michigan. He also taught economics full-time from 1977 to 1984 at Northwood University in Michigan and chaired its department of economics from 1982 to 1984.

He holds a B.A. in economics from Grove City College (1975) and an M.A. degree in history from Slippery Rock State University (1978), both in Pennsylvania. He holds two honorary doctorates, one from Central Michigan University (public administration, 1993) and Northwood University (laws, 2008).

A champion for liberty, Reed has authored over 1,000 newspaper columns and articles and dozens of articles in magazines and journals in the United States and abroad. His writings have appeared in *The Wall Street Journal, Christian Science Monitor, USA Today, Baltimore Sun, Detroit News* and *Detroit Free Press*, among many others. He has authored or coauthored five books, the most recent ones being *A Republic—If We Can Keep It* and *Striking the Root: Essays on Liberty*. He is frequently interviewed on radio talk shows and has appeared as a guest on numerous television programs, including those anchored by Judge Andrew Napolitano and John Stossel on FOX Business News.

Reed has delivered at least 75 speeches annually in the past 30 years in virtually every state and in dozens of countries from Bulgaria to China to Bolivia. His best-known lectures include "Seven Principles of Sound

Policy” and “Great Myths of the Great Depression,” both of which have been translated into more than a dozen languages and distributed worldwide.

His interests in political and economic affairs have taken him as a freelance journalist to 81 countries on six continents. He is a member of the prestigious Mont Pelerin Society and an advisor to numerous organizations around the world. He served for 15 years as a member of the board (and for one term as president) of the State Policy Network. His numerous recognitions include the Champion of Freedom award from the Mackinac Center for Public Policy and the Distinguished Alumni award from Grove City College.

He is a native of Pennsylvania and a 30-year resident of Michigan, and now resides in Newnan, Georgia.

About Doug Bandow

Doug Bandow is a senior fellow at the Cato Institute and the author of a number of books on economics and politics. He writes regularly on military non-interventionism.

About Dwight R. Lee

Dwight R. Lee is the O'Neil Professor of Global Markets and Freedom in the Cox School of Business at Southern Methodist University.

About Mark Skousen

About Russell Roberts

About Sheldon Richman

Sheldon Richman is the former editor of *The Freeman* and TheFreemanOnline.org, and a contributor to *The Concise Encyclopedia of Economics*. He is the author of *Separating School and State: How to Liberate America's Families*.

About Roger W. Garrison

About George C. Leef

George Leef is the former book review editor of *The Freeman*. He is director of research at the John W. Pope Center for Higher Education Policy.

About Alexander Franco

About Robert Holland

About Burton Folsom