

## To Our Readers

You care about freedom. That is one reason you read *The Freeman*. For thirty-five years it has been the most important first source for ideas on liberty. Beginning in this issue, those ideas are clothed in a new size and design.

This change in design is not the first in the *The Freeman*'s history, but it is the most extensive. We have enhanced the appearance of *The Freeman* to make it easier for you to use and read, and more inviting from cover to cover.

The new format will also help us to present our ideas more clearly and noticeably to new generations of business people, educators, students, and others who aren't familiar with the freedom philosophy. This is one of our continuing goals and one we hope you share.

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## FEE's Anniversary

Now is an auspicious moment for such a change. First of all, 1986 marks the 40th anniversary of The Foundation for Economic Education. The case for the free market economy was rarely heard in 1946. It is to the great credit and vision of the late Leonard E. Read and the other members of The Foundation staff that FEE and *The Freeman* have constantly and consistently explored the freedom philosophy when other organizations and publications have had erratic lives. Today, there is a much wider understanding of the principles which serve as the basis of our freedom and prosperity. This is due in no small part to the efforts of FEE and *The Freeman*.

January also begins *The Freeman*'s thirty-sixth year—another remarkable accomplishment. *The Freeman*'s heritage, however, reaches back even further. A very different *Freeman* began in 1920 through the efforts of a number of brilliant men and women under the tutelage of Albert Jay Nock. His enterprise lasted four years.

Efforts to resurrect it were particularly successful in 1950 when Henry Hazlitt, John Chamberlain, and Suzanne LaFollette launched the current *Freeman*. They did so, they wrote, to meet the "urgent need in America for

a journal of opinion devoted to the cause of traditional liberalism and individual freedom." (We are very pleased that both Henry Hazlitt and John Chamberlain still write regularly for us.)

*The Freeman* was first housed at FEE beginning in July 1954, under the editorship of Frank Chodorov. In January 1956, *The Freeman* changed format and became the primary outlet for FEE materials, with Paul Poirot as managing editor. It continues in that capacity today. During this time, *The Freeman* has presented and interpreted the freedom philosophy with fairness, honesty, and skill. For many individuals, it has been the beginning of a lifelong dedication to liberty. *The Freeman* is indebted to hundreds of fine authors and thousands of readers and FEE supporters for its success.

## A Rededication to Principle

As you and 70,000 other individuals read through this and subsequent issues, you will find the same dedication to freedom that has graced these pages since FEE began publishing *The Freeman*. Our job is to provide the principles and facts necessary for interested readers to develop their own understanding of freedom. In a very

## PREFACE

real sense, we are all students of liberty in the pursuit of those things that are peaceful and creative.

Attaining full liberty in America, and indeed throughout the world, is a complex and exciting challenge. Many people seek the answer in politics and policy studies. But unless there is a clear understanding of the root ideas of a free market society and the moral basis of individual liberty, there can be no lasting freedom. To that purpose *The Freeman* is dedicated.

Whether you view yourself as a conservative, libertarian, or classical liberal, there is a common ground we share as we strive to loosen those bonds which restrict human creativity, individuality, and self-fulfillment. Nobel Prize winner F. A. Hayek described "our common task" at FEE as "*the defense of our civilization against intellectual error.*" That remains the challenge before us.

## A Note about Me

I have been working at FEE for over a year now, and I have been editing *The Freeman* for a number of months. To many of you I am a new name, so let me introduce myself.

My background includes extensive experience in foundation work and, for fifteen years, I have worked as a book and magazine editor and publisher. I have also devoted time to writing on various topics of libertarian history.

I first read *The Freeman* while in high school. Troubled by an article on monopoly, I wrote for an explanation. Within a week I received a letter from Leonard E. Read and then a packet of material from Bettina Bien Greaves. I was so impressed that I sent in a \$12 donation. I had no idea then that, twenty-three years later, I would be part of a great FEE tradition! I'm hoping—after you read a few issues—that you will decide to keep me on.

Charles H. Hamilton  
Editor

Editor: Charles H. Hamilton  
Publisher: Paul L. Poirot  
Managing Editor: Beth A. Hoffman

Book Review Editor: Edmund A. Opitz  
Contributing Editors: Robert G. Anderson  
Howard Baetjer Jr.  
Bettina Bien Greaves  
Gregory F. Rehmke  
Brian Summers  
Joan Kennedy Taylor

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*The Freeman* considers unsolicited editorial submissions, but they must be accompanied by a stamped, self-addressed envelope. Our author's guide is available on request.

Cover photo of the home of The Foundation for Economic Education by Perry Alan Werner.

Design by Beth Whitaker

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# THE FREEMAN

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# The Market and the State

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by Ludwig von Mises

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**F**or every species of animal and plant the means of subsistence are limited. Hence every living being's vital interests are implacably opposed to those of all members of its own species. Only human beings know how to overcome this irreconcilable nature-given conflict by embarking upon cooperation. The higher productivity of work performed under the principle of the division of labor substitutes for the grim antagonism created by the scarcity of food the solidarity of interests of people intentionally aiming at common goals. The peaceful exchange of commodities and services, the market process, becomes the standard type of interhuman relations. Mutual agreement of the parties displaces the recourse to violence, to the law of the stronger.

The market in the broadest sense of the term is the process that encompasses all voluntary and spontaneous actions of men. It is the realm of human initiative and freedom and the soil upon which all human achievements thrive.

The state, the power protecting the market against destructive recourse to violence, is a grim apparatus of coercion and compulsion. It is a system of orders and prohibitions, and its armed servants are always ready to enforce these laws. Whatever the state does, is done by those subject to its commands. State power forced its subjects to build pyramids and other monuments, hospitals, research institutes, and schools. People see these achievements and praise their authors to the skies. They do not see the buildings that state power destroyed, nor those that were never constructed because the government had taxed away the means that individual citizens had destined for their erection.

The fundamental antagonism between the realm of mutual peaceful agreement and that of compulsion and coercion cannot be eradicated by idle talk about two "sectors" of the economy, the private and the public. There is no conciliation between constraint and spontaneity. The attempts to resuscitate the totalitarianism of the Pharaohs of Egypt or of the Incas of Peru are doomed. And violence does not lose its antisocial character by being re-baptized "non-violence." All that man has created was a product of voluntary human cooperation. All that violence has contributed to civilization consists in the—certainly indispensable—services it renders to the endeavors of peace-loving people to restrain potential peace-breakers. □



# The Freedom to Move

**F**reedom of movement underlies the concept of private property rights. A person has the right to exclusive possession and use of that which he has assembled and improved without trespass against others—the right to the product of his own labor. Any move of a man might be deemed proper and beneficial when he acts to assemble, transport, or otherwise convert the free gifts of Nature so that they may satisfy human needs more readily. This involves no infringement on the equal right of others. It would seem to be the kind of movement that should not be discouraged by man or by government.

On the other hand, freedom of movement may lead to trespass. A person may move or act in such a way as to threaten the life, or to seize or damage the property, of someone else. His apparent personal gain would be at the direct expense of another person. Surely, government should lend no encouragement to such harmful actions or threats of harm by individuals.

The problem of society, then, is to permit and encourage individuals to move and act in a productive and beneficial manner, and to avoid harmful intervention or trespass. The founding fathers wisely depended upon voluntary exchange—freedom of trade in the competitive market place—as the automatic, non-governmental guide to productivity and progress among men. They delegated to government the power to restrict only those actions of individuals designed to circumvent the free market through fraud, deceit, or coercion. The penalty for violation was restitution for damages, or imprisonment, or some other restraint upon that person's freedom to act or move.

The freedom of the individual to move toward greener pastures, wherever they may seem to be, has been a vital part of the freedom of commerce—the freedom of choice that has constituted the truly distinctive characteristic of “the American way.”

In view of our long experience of near-perfect freedom to move about as each might choose, some of us may not realize the limitations that confront people in many other parts of the world who might like to move toward something better. Many who might choose to enter the United States, peacefully observing our laws and paying their own way, are denied entry. Our community slogans now seem to read: “Welcome to all peaceful and productive newcomers—except foreigners.” And a foreigner here is an individual who has crossed a

**Can we hope to explain the blessings of freedom to foreign people while we deny them the freedom to cross our boundaries?**

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by Oscar W. Cooley and Paul L. Poirot

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Oscar Cooley, a retired economics professor, is a regular columnist for the Freedom Newspapers. Paul Poirot is a member of the staff of The Foundation for Economic Education and is publisher of *The Freeman*.

This article is excerpted from a pamphlet originally published by FEE in 1951.

special political line, supposedly which bounds "the land of the free"!

If it is sound to erect a barrier along our national boundary lines, against those who see greater opportunities here than in their native lands, why should we not erect similar barriers between states and localities within our nation? Why should a low-paid worker—"obviously ignorant, and probably a Socialist"—be allowed to migrate from a failing buggy shop in Massachusetts to the expanding automobile shops of Detroit? According to the common attitude toward immigrants, he would compete with native Detroiters for food and clothing and housing. He might be willing to work for less than the prevailing wage rate in Detroit, "upsetting the labor market" there. His wife and children might "contaminate" the local sewing circles and playgrounds with foreign ways and ideas. Anyhow, he was a native of Massachusetts, and therefore that state should bear the full "responsibility for his welfare."

Those are matters we might ponder, but our honest answer to all of them is reflected in our actions—we'd rather ride in automobiles than in buggies. It would be foolish to try to buy an automobile or anything else in the free market, and at the same time deny any individual an opportunity to help produce those things we want.

Our domestic relationships would be harmed seriously by restraints upon man's freedom to migrate. But why shouldn't the same reasoning hold for our foreign relationships?

**Fear No. 1: The "melting pot" might fail to assimilate newcomers.** This notion has as little merit as the idea that a third-generation Yankee's digestive tract isn't capable of assimilating a bunch of carrots grown by a foreign-born Japanese or Italian vegetable gardener. The assimilation of a foreign-born person is accomplished when the immigrant willingly comes to America, paying his own way not only to get here but also after he arrives, and peacefully submitting to the laws and customs of his newly adopted country. Freedom to exchange goods and services voluntarily in the market place is the economic catalyst of the American "melting pot." Christian-like morality is the social catalyst—and if it has come to be in short supply among native Americans, the blame for that shortage should not be laid upon our immigrants.

**Fear No. 2: The "wrong kind" of people might come to America.** The danger that "a poorer class" might come from Asia or Africa or Southern and Eastern Europe and contaminate our society, undoubtedly seems real to any person who thinks of himself as a member of a superior class or race. Such a person, like any good disciple of Marx, is assuming the existence of classes and is convinced that he is qualified to judge others and to sort them into these classes.

Perhaps what is feared is the importation of a new idea of the relationship between the individual and his government. If that has been our fear, it very well might have been justified. For America has been rapidly substituting a socialistic state control for the traditional system of private enterprise. But let us not mistake persons for ideas; the ideas are the root of the problem. Migration of persons is not a reliable measure of the flow of ideas.

**Fear No. 3: Immigrants might deprive our own workers of jobs and depress the wage scale.** The fear that immigrants might take the jobs of American workers is based on the fantasy that the number of jobs to be filled within our economy is strictly limited. Individuals still do—and undoubtedly always will—entertain unsatisfied desires for more and more goods and services, which industrious and ingenious individuals constantly are producing in response to opportunities. If there is freedom to think, to trade, and to move, then opportunities for new, creative jobs are not limited to the wilderness or a spot of idle land.

The fear that heavy immigration of workers would depress the wages of native workers is an outgrowth of socialist doctrine. Socialism is so concerned with consumption and “equitable distribution” that it neglects the source of production. It fails to recognize that there can be more and more to consume only if capital and tools are first produced to give leverage to the productive power of man.

Can we hope to explain the blessings of freedom to foreign people while we deny them the freedom to cross our boundaries? To advertise America as the “land of the free,” and to pose as the world champion of freedom in the contest with communism, is hypocritical, if at the same time we deny the freedom of immigration as well as the freedom of trade. And we may be sure that our neighbors overseas are not blind to this hypocrisy.

A community operating on the competitive basis of the free market will welcome any willing newcomer for his potential productivity, whether he brings capital goods or merely a willingness to work. Capital and labor then attract each other, in a kind of growth that spells healthy progress and prosperity in that community. That principle seems to be well recognized and accepted by those who support the activities of a local chamber of commerce. Why do we not dare risk the same attitude as applied to *national* immigration policy?

Our collective abandonment of the economic system of the free market leaves for us the controlled communal life, where everyone wants to be a consumer without producing anything.

**O**ur immigration policy merely reflects the existence of this serious internal problem in America. Our present policy toward immigrants is consistent with the rest of the controls over persons which inevitably go with national socialism. But the controlled human relationships within the “welfare state” are not consistent with freedom. Great Britain once thought she could deny freedom to American colonists. And now, her own people have traded their freedom for nationalized austerity. Even a “prosperous” modern America can ill afford traveling that same course. If we do, our community, too, will lose its capacity to attract newcomers. Then we wouldn’t need an immigration policy. But who among us would want to remain in a community where opportunities no longer exist? □

## The Basic Problem

# What About Immigration?

**Immigrants invigorate the country and contribute healthy economic benefits.**

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by Julian L. Simon

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Julian L. Simon teaches at the University of Maryland and is a fellow at the Heritage Foundation and the Cato Institute. He is the author of *The Ultimate Resource*.

**I**mmigration is one of the most important topics of our times. The issue seems to pit (though it really does not) two fundamental values against each other—lending a helping hand to strangers and ensuring the economic self-interest of family and community. Also involved are values that may not appeal to all but which are in no way irrational, such as the desire to maintain some degree of cultural or racial homogeneity in the country, and to keep a particular political balance. Hence it arouses interest and passions to an unusual degree.

Passions have *always* been aroused over the question of immigration. Even before the independence of this nation, some natives and earlier immigrants inveighed against admitting “alien influences” to these shores. A recent study by Rita J. Simon shows that public opinion toward immigration has been hostile at almost all times in the past century. But while Americans express negative views toward admitting more immigrants in general, they express positive feelings toward the immigrants whom they know personally.<sup>1</sup>

Immigration is particularly salient now. For only the fourth time in this decade, *Time* magazine devoted its July 8, 1985 contents to a special issue—this time on immigration. In this, the largest editorial issue in its history, *Time*’s publisher wrote that sentiment about immigration today “represented a change of historic dimensions.”

Here are some possible reasons why this topic is so high on the public agenda:

- Americans’ mood about their economic situation is less optimistic than in most other periods since World War II. The idea that immigrants take jobs from natives seems particularly unpleasant in such a period.
- Environmental organizations—worried about the effects of more persons upon the environment and upon the supply of natural resources—have joined forces with anti-population-growth organizations (such as the Environmental Fund) and special-interest anti-immigration organizations (such as the Federation for American Immigration Reform, FAIR) in an umbrella organization called Global Tomorrow Coalition.

The combined weight of these organizations, with their membership of more than five million, constitutes a large body of anti-immigration sentiment.

- The dramatic waves of refugees in recent years from Vietnam, Haiti, and Cuba have drawn much attention to immigration. American citizens seem to have been less sympathetic to these refugees than to refugees from Hungary and Czechoslovakia in the 1950s and 1960s.
- Congress has not passed a comprehensive immigration law since 1965. The anachronisms and law-bending complications that inevitably accumulate with time have become troublesome, suggesting that a "reform" might be timely.
- The absolute number of immigrants arriving has been greater recently than at any time since the 1920s.
- The racial composition of immigrants has shifted, due in considerable part to the 1965 law, and now includes more Orientals and Mexicans (legal and illegal), and fewer Europeans.

Whereas the objections to immigration expressed in past years often were simply the crude bigotry of race and religion, the objections heard now (though they are not necessarily the real objections) are mostly economic. Let us then address the economic issues in order to engage in honest dialogue with those whose objections are truly economic, as well as to try to cut the ground from under those who cloak other objections against immigration in economic guise. Let us examine three issues: Are we being swamped by immigrants? Does immigration increase unemployment? And do immigrants pay their way?

**M**any people assume, as FAIR says, that "immigration to the United States is at record levels."<sup>2</sup> Yet only in 1980, when an exceptionally large number of refugees arrived, were the numbers of legal immigrants even two thirds of the numbers in peak years around the turn of the century, and the recent numbers as a whole clearly are far smaller than the numbers then. Nor does the inclusion of illegal immigrants alter this conclusion, as we shall see shortly.

From the point of view of the economic impact on natives, more appropriate than these absolute numbers is the volume of immigration as a proportion of the native population. The immigrants who arrived between 1901 and 1910 constituted 9.6 per cent of the population, whereas between 1971 and 1980 immigrants constituted only two per cent of the population. So the recent flow is less than a sixth as heavy a burden for the native population to absorb as it was in that earlier period.

Another way to think about the matter: In 1910, 14.6 per cent of the population was foreign born. In 1980, only 6 per cent of the population was born abroad. Not only is the present stock of immigrants only about a third as great proportionally as it was earlier, but it also is a small proportion considered by itself. That is, less than one person in 15 in the U.S. now was born abroad, including those who arrived many years ago. We tend to think of ourselves as a "nation of immigrants," but the U.S. has a smaller share of foreign-born persons than do many countries that we tend to think of as closed homoge-

## **What Is the Level of Immigration Today?**

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***“The U.S. has a smaller share of foreign-born persons than do many countries that we tend to think of as closed homogeneous populations—including Switzerland, France, Great Britain, and even Sweden.”***

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neous populations—including Switzerland, France, Great Britain, and even Sweden.

The anti-immigration groups cannot dispute these numbers, because they come from standard sources. But they say illegal immigration is so large as to make meaningful the claim that immigration is at a record level in absolute terms. By now, however, demographers have a quite solid understanding of how many illegals are in the U.S. At the request of the Select Commission on Immigration and Refugee Policy, a blue-ribbon team of demographers from the Bureau of the Census surveyed the wide variety of studies that have been done, and concluded, “The total number of illegal residents in the United States for some recent year, such as 1978, is almost certainly below 6.0 million, and may be substantially less, possibly only 3.5 to 5 million.” As to Mexicans, they estimated that there are “almost certainly less than 3.0 million, and may be substantially less, possibly only 1.5 to 2.5 million.”<sup>3</sup> Furthermore, of the Mexicans illegally in the United States at any given time, a large proportion are here for a matter of months and then return voluntarily.

Sometimes the claim that total immigration is at record levels is inferred from assertions that the *rate* of illegal immigration is very high. For example, FAIR says that “illegal immigration is estimated to add 800,000 to one million more [immigrants] every year.”<sup>4</sup> It is quite obvious that so large a yearly *flow* of immigrants—800,000 to one million—is quite inconsistent with the Census Bureau’s estimate of the existing total stock of 3.5–5.0 million illegals. And Jeffrey Passel—part of the original blue ribbon team, and the Census Bureau official responsible for estimating illegal flows—uses the numbers 200,000 or 250,000 net illegal immigrants per year.<sup>5</sup> Adding 200,000 or even 250,000 illegals to the known number of legal immigrants indicates that even with adjustments, immigration is nowhere near record levels even in absolute numbers, let alone proportional to the population.

Even more astonishing, the 1985 National Academy of Sciences study, *Immigration Statistics*, concludes as follows about illegals:

As a result of of this review of empirical estimates of the size of the illegal population of the United States, what can we conclude? First, the procedures that have been used, though often imaginative and sometimes elaborate, all invoke numerous assumptions that often cannot be adequately justified and to which the estimates obtained are sensitive. Second, . . . though no range can be soundly defended, a population of 1.5 to 3.5 million illegal aliens in 1980 appears reasonably consistent with most of the studies. Third, there is no empirical basis at present for the

widespread belief that the illegal alien population has increased sharply in the late 1970s and early 1980s; the only data available on recent trends, INS records of locations of deportable aliens, in fact suggest that the population has increased little if at all since 1977. . . .<sup>6</sup>

**T**he most politically powerful argument against admitting immigrants has been that they take jobs held by natives and thereby increase native unemployment. The logic is simple: If the number of jobs is fixed, and immigrants occupy some jobs, then there are fewer jobs available for natives.

Theory says that there must be some short-run unemployment in some sectors as a result of immigration. But theory does not say whether the effect will be huge or trivial. And no empirical study has found such unemployment in noticeable amounts. Even in the few sectors where immigrants concentrate, such as the restaurant and hotel industries, there tends not to be a deleterious effect on native employment because natives do not want these jobs. Evidence comes from experiments conducted by the Immigration and Naturalization Service together with San Diego County. In one case, 2,154 illegal aliens were removed from jobs, and the California State Human Resources Agency tried without success to fill the jobs with U.S. citizens. The County of San Diego Human Resources Agency reported:

Some of the reasons for the failure were: (1) most employers paid less than the minimum wage rate, (2) the job categories were not appealing to the local resident (a matter of prestige), and (3) applicants were discouraged by not only the low wages but also the difficulty of some jobs, and the long hours demanded by the employers.<sup>7</sup>

Research also does not show across-the-board unemployment caused by immigrants, either in the U.S. as a whole or in particular areas of relatively high immigration. Heretofore such studies have been rather casual. Therefore, Stephen Moore and the author recently mounted a systematic attempt to detect whether such immigrant-caused unemployment exists in significant amount. The effect is either insignificantly small or non-existent. It seems fair to conclude, therefore, that while in theory immigration ought to produce some unemployment in the short run, the amount is in fact negligible. And in the long run, when there is not even a theoretical reason to believe that immigration causes unemployment, there is no evidence at all to think that it does.

One reason that unemployment is not caused is that potential immigrants have considerable awareness of labor-market conditions in the U.S., and tend not to come if there is little demand for their skills. Also, immigrants tend to be varied in their skills and therefore do not have a disproportionate impact on a few industries.

At the same time, immigrants increase demand for labor across the range of occupations, because immigrants consume goods as well as produce them. This point is crucial, but too little understood. Immigrants not only take jobs, they make jobs. Immigrants create new jobs indirectly with their spending, and they also create new jobs directly with new businesses, which they are more likely than natives to start. A Canadian government survey found that almost 5 per cent of

## **Immigrants Add Jobs to the Economy**



The American Melting Pot.

JIM KALETT/PHOTO RESEARCHERS

2,037 immigrants surveyed had started their own businesses within the first three years in Canada. Not only did they employ themselves, they employed others, “creating” a total of 606 jobs. Expressed as a proportion of the 2,037 total immigrants, roughly 30 per cent as many jobs were created from scratch as total jobs were held by immigrants. Furthermore, these numbers surely rose after the three-year study period.

U.S. experience should be quite similar. Admittedly, the businesses immigrants start are small at first. But remember that small businesses in general are the most important source of new jobs, according to a recent MIT study.

The impact of immigration is likely to be greater on wages than on unemployment rates, because potential immigrants with skills that are in low demand choose not to migrate, and those with salable skills gravitate to industries where there are jobs. This will have some downward pressure on wages. For example, immigrant physicians are more likely to reduce a native physician’s yearly income than to throw him or her out of work.

Barton Smith and Robert Newman found that adjusted wages are just 8 per cent lower in the Texas border cities where the proportion of Mexicans is relatively high, compared to Texas cities away from the border where the proportion of Mexicans is much lower, a considerably smaller difference than they had expected to find.<sup>8</sup> Much of the apparent difference is accounted for by a lower cost of living in the border cities.



**I**t is frequently alleged that immigrants no sooner arrive in the U.S. than they become public charges, draining welfare money from the U.S. taxpayers and paying no taxes. Solid evidence disproves this charge.<sup>9</sup>

In 1976 the Census Bureau interviewed 156,000 households (including about 15,000 immigrant families) to learn about 1975 family income and welfare services patterns. From this sample I constructed a picture of lifetime economic behavior by assuming that the information on the sample immigrants who had been here, say, two years, or ten years (as of 1975) described the representative immigrant family after two years, or after ten years.

For all transfers and services, the average immigrant family was found to receive \$1,404 in welfare services in years 1 to 5, \$1,941 in years 6 to 10, \$2,247 in years 11 to 15, and \$2,279 in years 16 to 25. Native families overall averaged \$2,279.

One important reason for this is that immigrants typically arrive when they are young and strong, and they do not bring elderly persons with them who might be a burden on the system. When these immigrants retire, their children support them with their taxes, as in the case of natives.

If immigrants paid relatively little in taxes, they might still burden natives, even with fewer welfare services for immigrants than for natives. While there is no direct information on taxes paid, data on family earnings allow a reliable estimate.

Within three to five years after entry, immigrant family earnings reach and pass those of the average native family. The average native family paid an estimated \$3,008 in taxes in 1975. In comparison, immigrant families here 10 years paid \$3,359, those here 11 to 15 years paid \$3,564, and those here 16 to 25 years paid \$3,592. Such substantial differences benefit natives.

Assuming that 20 per cent of taxes finance activities that are little affected by population size (for example, maintaining the armed forces and the Statue of Liberty), the data on services used and taxes paid, taken together, show substantial differences that benefit natives: an average of \$1,354 yearly for years 1 to 5, and \$1,329, \$1,535, and \$1,353 for years 6 to 10, 11 to 15, and 16 to 25 respectively. These are the amounts by which each additional immigrant family enriches U.S. public coffers. Evaluating the future stream of differences as one would a dam or harbor, the present value of an immigrant family discounted at 3 per cent (inflation adjusted) was \$20,600 in 1975 dollars, almost two years' average earnings for a native family: at 6 per cent the present value is \$15,800, and \$12,400 at 9 per cent. We can conclude, then, that immigrants, far from causing unemployment and costing society more than they contribute, are a direct, dollars-and-cents economic asset to the community.

But these figures are for legal immigrants. What about illegals? Many studies have shown that, contrary to common belief, illegal immigrants from Mexico and elsewhere receive little in welfare precisely because of their illegal status. A recent study by Weintraub and Cardenas of illegal aliens in Texas provides reliable evidence that the taxes paid by the immigrants greatly exceed the cost of services that they use. "Despite our biasing the costs upward and the revenues downward, tax revenues from undocumented aliens clearly exceed costs to

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***“We should be glad that our society is sufficiently attractive to have what is called an immigration problem. The Soviet Union and other totalitarian countries have no difficulty of this sort.”***

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provide public services to them.”<sup>10</sup> They estimate the combined state and local costs and revenues attributable to the illegal immigrant as follows: *Cost*—high estimate: \$132 million; low estimate: \$63 million. *Revenue*—high estimate: \$286 million; low estimate: \$162 million.

But even these figures greatly understate the overall positive effect of these illegal immigrants upon natives, because they omit any consideration of the Social Security taxes paid to the federal government and they do not include 32 per cent of their federal income taxes which does not return to the state. (The authors assume that 68 per cent of federal income tax eventually comes back to the state.) Also, these omitted quantities are large relative to the quantities included in their calculation; including them makes the low and high estimates of revenues—\$359 million and \$580 million respectively—more than twice the state revenues alone. And the federal costs omitted from the Weintraub-Cardenas state calculations cannot be large, since food stamps is the only major federal welfare program used by illegal immigrants, they found. Thus, the overall excess of government revenues over government costs caused by the illegal aliens is very great, in dollars as well as in percentage terms.

## **Facts vs. Myths**

Going beyond the three issues we have just discussed, immigrants tend to bring an unusually high degree of skill, education, self-reliance, and innovative flair. These are less tangible benefits, but not less important, because they raise productivity and stimulate economic vitality. The widely held belief that immigrants arrive with little or no education, few marketable skills, and in a generally tired and depressed condition is one of the most powerful, least accurate, and most persevering myths about immigration. It was never so.

The central fact about immigrants now, as throughout U.S. history and in almost all places at almost all times, is that immigrants are just entering into the prime of work life. This is the very best time to make a maximum contribution in all ways to the country receiving them. In contrast, the U.S. resident population is rapidly aging. But the immigrants are concentrated in their twenties and thirties, when they are flexible about job and geographical location, and therefore contribute importantly to the constant adjustment of the economy to changing conditions. They are of the age of greatest physical and mental vigor.

Even more surprising is that immigrants on average have as much education as do natives. Though contemporary immigrants include slightly larger proportions of persons of very low skill and low education than does the native labor force, they also contain a *much* larger

proportion of those of high skill and high education—physicians, engineers, scientific researchers, and the like—than does the native population. And recent research shows that even before the turn of the century, immigrants compared favorably with the native populations with respect to education and skill.<sup>11</sup> This makes sense. A person with little education and skill is not necessarily stupid, and understands that life without salable human capital is particularly tough in a new and strange environment, and therefore that it is wiser to stay home. On the other hand, it is sensible for a person with a good amount of salable human capital to take the chance to improve his or her lot by moving to a new and richer country.

**T**hough hard to nail down, the long-run benefits of the productivity of these additional workers and consumers are likely to dwarf all other effects. Some of the productivity increase comes from immigrants working in industries and laboratories that are at the forefront of world technique. We benefit along with others from the contribution to world productivity in, say, genetic engineering that immigrants would not be able to make in their home countries. More immigrants mean more working persons to think up productivity-enhancing ideas.

Empirically, all the studies that relate the rate of population growth to the rate of economic growth show no negative effect of the former upon the latter, whether over a long span of history for the few countries on which data are available, or for the many countries for which data are available starting after World War II. And studies of the relationship of population density to economic growth suggest that higher density leads to faster economic growth, contrary as this may be to casual thinking and common sense.

Other increases in productivity—about which we have more solid evidence—come from increased production in particular industries through learning-by-doing and other gains from larger industry scale. Also, increasing the number of customers and workers increases investment, which brings more technology into use. And immigrants contribute to the vitality of our institutions because they tend to be more intellectually vigorous as well as harder-working than natives. How much of this vigor is due to being “hungry” rather than settled and affluent, how much due to their being self-selected for vigor among the populations they come from, and how much due to the stimulating effects of living in the tension of two cultures are open questions, but not crucial in this context.

One of the nice things heard about immigration is that it increases cultural variety as well. Chinese and French restaurants are common examples. But the benefits of variety go beyond consumer and esthetic pleasures. Immigrants stimulate natives to produce more and be more innovative as the natives attempt to keep up with the new competition. And we should not forget that just as the movement of people in earlier times was crucial in transmitting ideas, it is important today.

Even though, as I said in the beginning, the issue of immigration *seems* to pit humanitarian values against native self-interest, we can now see that this is not so. On balance, immigrants are not a drag on the economy. As workers, consumers, entrepreneurs, and taxpayers, they invigorate it and contribute healthy economic benefits. Admitting

## The Productivity Factor

immigrants improves everyone's standard of living, theirs and ours.

We sometimes seem frightened at the number of persons who want to come to the United States; we act as if we are under siege. If we Americans just plain don't want any more foreigners in our midst, let's say so, but let's be aware that we are hurting ourselves economically. And let's not justify our xenophobia with unsound economic arguments.

I suggest that we should be glad that our society is sufficiently attractive to have what is called an immigration problem. The Soviet Union and other totalitarian countries have no difficulty of this sort. What a sad commentary on those societies that people want so much to leave that they are willing to risk their lives. This should remind us how wonderful it is that people want to come here.

We do not need to balance the gains to them against the sacrifice to ourselves. We do not even need to raise the ethical issue of drawing a boundary around our nation and saying that those lucky enough to be born within are entitled to opportunities that we deny to others. Immigration is good for ourselves at the same time that it is good for the immigrants. □

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## In Future Issues . . .

### February

- "The Constraints on Helping" by Charles Murray
- "The War on Poverty Revisited" by Edmund A. Opitz
- "Free Trade and Prosperity" by Steven E. Daskal

### March

- "Productivity vs. Exploitation" by Henry Hazlitt
- "Who Will Control Medical Care?" by Jane M. Orient

# How to Gain Liberty

**“I** want less talk and more action.” Thus speak Americans when they suddenly awaken to the fact that their liberties are endangered. Talk, they say, is useless; only action counts. But perhaps talk and action aren’t necessarily opposites. What if studying, talking, writing, and explaining should turn out to be the only worthwhile action there is? What then?

There are only two types of action: physical and intellectual. Do those who would save liberty advocate physical action? If so, how? To use physical force against others, except defensively, is to destroy the liberty of others which, by definition, is not liberty. To adopt this tactic—to employ physical force against others in any form or degree, except in self-defense—would be merely to substitute a new form of compulsion for the existing forms of compulsion, trading violence for violence—revolution! At best, it is the court of last resort and is not, really, what most persons have in mind when they insist they want action. Most of them mean only that they want “something done,” and quickly! They want to fight peacefully. The thought of using fists or guns never as much as enters their heads; they reject physical action, in their calculations, by not even contemplating it. Thus, according to their own thesis, nothing logically remains but intellectual action.

How, then, does one fight for liberty intellectually? The best thing to do even in an intellectual fight for liberty, many think, is to organize—which is a form of action. Usually they think in terms of organizing someone else to do something instead of organizing their own time and energies. This damaging tactic is employed as though organizing had the power, somehow, to absolve individuals from doing any more than joining some organization. This mania for organizing is usually little more than an effort, doubtless unwitting, to transfer responsibility from oneself to some other person or persons whose competence is often unknown.

Responsibility and authority always go hand in hand. Thus, if this process of organizing succeeds, authority over one’s own actions is lost precisely in the degree that responsibility is shifted to someone else. The citizen who “wants action,” and resorts to this type of tactic, ends up further from his goal than ever. In fact, organizing, more often than not, is merely an attempt to “pass the buck.” Yet, oddly enough, the mere act seems to have the strange power of conferring a sense of accomplishment on the ones who organize.

**How can we best achieve a free society? Self-improvement is the only answer.**

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by Leonard E. Read

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Leonard E. Read was the founder of The Foundation for Economic Education in 1946, and its president until his death in 1983. This article was first published in 1955.

Organization, though much used, seems to be little understood. In the field of extending individual liberty, organization has strictly limited, technical possibilities. Unless these limitations are scrupulously observed, organization will inflict on liberty more harm than good; thwart, not abet, the spread of understanding. Sobering is the thought that if there were no organization, there could be no socialism!

Organizations can, however, serve a highly useful purpose in developing and spreading an understanding of liberty if organization is confined to its proper sphere. For the purpose of advancing liberty, which depends solely on the advancement of individual understanding, the only usefulness of organization would seem to be to accommodate and to make easier the joint contribution to, participation in, and ownership of the physical assets that will aid in the process. These physical assets may include typewriters, buildings, specialized libraries, printing presses, telephones, and the many other tools helpful to individuals who are attempting to extend their understanding of liberty. These physical accommodations can enable searchers for truth to exchange and disseminate ideas and knowledge more effectively. They can be used to secure the advantages which derive from specialization or division of labor. Organization, limited to this form of voluntary cooperation, is a useful and efficient means for achieving these desirable ends.

Organization, however, like government, if extended beyond its proper sphere, becomes positively harmful to the original purpose. This fact constitutes the need for much careful thought on organizational limitation. Just as government becomes dangerous when its coercive, restrictive, and destructive powers are extended into the creative areas, so do voluntary organizations pervert and destroy the benefits of intellect when the capacity to merge is carried to the point of subjecting individual judgments to the will of the majority or group. Truth, as each person sees it, is the best that the mind of man has to offer. Its distortion, inevitable when achieving a collective chorus, does injury to understanding.

## A Simple Answer

**I**f organization is not the best way to secure liberty, then what is? My answer—self-improvement—is the essence of simplicity. The reasons which lie behind the answer, however, are not so simple.

The inclination to escape personal responsibility—plus the belief that somehow intellectual miracles can be wrought by us on someone else—is too pervasive for easy rejection. Unless we fully understand that these inclinations and beliefs are wholly without merit, we will continue to indulge in them. I wish to make the argument that self-improvement is the only practical course to liberty.

Is there one book or one article written by anyone at any time that can be designated as the final word on liberty? Perhaps the best that can be said is that the finest minds of all time have been in pursuit of its understanding and that now and then a tiny ray of new light has been thrown on what theretofore was darkness and lack of understanding. These few most advanced searchers have been among the first to say, “The more exploration I do, the more I find there is to learn.”

The reason for this difficulty in understanding liberty is that liberty, like truth, is an object of infinite pursuit, a quest without end, ever!

The understanding of liberty requires intellectual ventures into the areas of the unknown or, more likely, into the areas that have become unknown or that majorities have declared taboo. Have you not noticed the vigor we employ when a present liberty is threatened and then, when it is lost, how soon we refer to it as a "social gain"? How can one who has been thus trapped, or who himself has lapsed into thinking of a new restraint as a "social gain," possibly identify the liberties he has lost?

Every individual ought to realize that he has not mastered the subject of liberty until he thoroughly understands, and can competently explain, this idea: With government properly limited to its legitimate function of defense, our problems of interdependence can be resolved through voluntary effort, and only through voluntary effort. If that is a correct appraisal, then most persons are inexpert in their understanding of this subject.

In brief, not a single person among us is justified in regarding himself other than as a student of liberty. No know-it-all exists or ever will.

In searching for a student of liberty, the search must be within one's self. In the world of persons, it is only within each of us that the fertile, explorable areas exist. The best explorer of oneself is oneself. It is not possible to impart to others that which we do not possess. And even after we have made some progress in understanding, the most we can do for others is to make known to them a willingness to share what we have discovered by our own thinking, or what we find edifying from recorded thinking. Whether or not what we offer is, in fact, shared, is beyond our power; and we should realize this.

It is conceded that the student attitude, this search within ourselves, may at times appear unrewarding. But if the understanding of liberty is to be advanced, the attempt must be persisted in, regardless of its seeming extravagance in time and effort.

**A**ction? The casual thinker might imagine that the best course is to try to tell others what to do and how to think. But reason supplies a contrary answer. It suggests that pursuit of one's own personal understanding is the only practical action for one to take. If a person advances his own understanding of the true and the false, the understanding thus acquired will be sought by others. Reason recommends that a person get the horse before the cart; that first one must learn; that influencing others will take care of itself. Reason says that influence in the creative areas can have no effectiveness prior to learning; that learning has no end.

Some persons will assert that the conclusions herein set forth are self-evident, but will argue that this suggested student approach—this process of self-improvement—is too slow to meet the challenge of these times.

I am in no position to deny this. But, in my opinion, there is no short cut. The only way to truth—that is, to understanding—is through one's own person. When we gain an appreciation of this simple fact, we will be on our way to as little violence against persons, and thus to as much liberty among persons, as is within our power.

Action? For authoritarians it is physical force. For libertarians it is first understanding and then explanation—the latter being "talk," either verbal or written. □

## Improving Oneself

# Toward a Market Monetary System

**Getting  
government  
out of  
the money  
business . . .**

**by Alberto  
Benegas  
Lynch, Jr.**

Dr. Benegas Lynch, Jr., is Professor of Economics at the University of Buenos Aires, and executive vice president of the Argentine Graduate School of Economics and Business Administration. He is author of *Fundamentos de Analisis Economico*, 1984.

**W**hen monetary matters are discussed, it is important to specify that money originated and developed spontaneously in the market. Money came into use because people accepted the advantages of indirect exchange when compared with direct exchange or barter. One of the main advantages obtained from the use of a money commodity in relation to direct exchange is that it allows economic calculation. Only prices expressed in a common means of exchange makes accounting operations and project evaluations possible.

The main function of the price system consists in guiding the productive structure. This market system requires the enforcement of private property, since price becomes possible as an expression of those interactions of individual valuations through the use and disposal of what is owned. Individuals participating in the market modify the relative price structure according to the changes that take place in their individual valuations. At the same time, these modifications in relative prices guide the always limited productive factors toward those areas considered as more urgent by consumers.

However, when government money is involved, i.e., when government decides the quantity of money, relative prices are influenced by political decisions. Relative prices will become distorted or misrepresented. Within this context, inflation can be seen as an increase in the amount of currency due to external or political causes, and deflation as the monetary contraction due to external or political causes. The economy will not be responding to events that originate and develop within the market but instead to political decisions—a phenomenon that comes from outside the market.

The problem lies in the fact that *one will never know what the market wants if it is not allowed to operate.*

Essentially three courses of action can be established in the monetary field: to have a monetary authority, to establish a monetary rule, or to adopt a market money system. Having a monetary authority implies that it will be a political decision whether the money stock expands, contracts or is left unchanged. Regardless of the decision taken, relative prices will be altered as a consequence of that decision. The establishment of a monetary rule will also affect relative prices as a result of its application. It is true that this last possibility will avoid erratic



behavior in the quantity of money but the essence of the monetary problem still remains.

**I**t is only possible to remove the problem of inflation and deflation *when the political decision of not adopting more political decisions in the monetary field is taken*. In other words, the market money proposal implies that money must be considered just like the rest of the goods and services traded in the market.

This approach goes to the root of the problem, and thus eliminates the causes of monetary corruption. This is the idea, proposed by Hayek, of *eliminating legal tender* (that is, government's monopoly on money). Other institutions can then mint, print, and convert the currency or currencies accepted by the market. Another stipulation should be the elimination of all laws regarding minimum banking reserves. We should also remove all restrictions on the ways in which each financial institution handles its business. Not only must the government monopoly on money be eliminated, but government must completely withdraw from monetary management. To this end, the central bank and the printing institution must be sold, together with the government money "brand."

Hayek's concept of market money obviously includes its denationalization, separating it completely from the idea of sovereignty. This means adopting (or rejecting) as money the good or goods the market judges adequate. This is similar to the way in which potatoes are sold in the international market, with no reference made to "national potatoes." In this way, market money is separated from the idea of nationality.

Of course, the idea of a free society does not just mean a monetary reform. Its main goal is to limit government activities to specific functions. Government spending must be reduced and, as a consequence of that, taxes will also be reduced.

If public expenditure is not reduced, what is now an implicit tax in the form of inflation will turn into taxes proper. The state's share in the national income will be unchanged, but prices will now reflect the real situation. A much more economic use of the available resources will then result.

Of course, it is possible to conceive the adoption of government money related to the market through a commodity whose volume depends on market conditions, as in the case of the classical gold standard prior to World War I. If, furthermore, government money is not of legal tender, possibilities appear for alternative currencies selected by the market. However, in order to make money compatible with the basic principles of a free society, it is necessary not only to eliminate legal tender (i.e., the government's monopoly on money), but to remove the government from the money business.

In relation to currency matters, we will have a truly free society only when we understand that our personal ideas about what money *should be* can be offered to the market and compete with other ideas. But we cannot impose them on society any more than we impose our personal feelings with respect to other goods and services in a free society. The government's function is to resort to defensive force to protect individual rights and not to get involved in banking, financial, monetary, industrial or commercial activities in general. □

## **Eliminate Government's Monopoly**

# What Is a Just International Economic Order?

**Free trade  
brings the world  
together and  
promotes peace  
and prosperity.**

by William H.  
Peterson

Dr. Peterson is director of the Center for Economic Education and holds the Scott L. Probasco Jr. Chair of Free Enterprise at the University of Tennessee at Chattanooga.

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**W**e are under attack, both at home and abroad. The target is the rather open—and I think, rather moral—international trading and investment system that has prevailed, evolved, and expanded since the end of the Second World War.

Here in America the attack is now put in the context of the United States having suffered a record foreign trade deficit of \$123.3 billion in 1984 with an even greater deficit in prospect for 1985, as a flood of U.S. imports swamps modest increases in U.S. exports. The Commerce Department reported that the 1984 deficit total came close to doubling the old record of \$69.4 billion set in 1983 and was almost three times higher than the previous record 1982 deficit figure of \$42.7 billion.

These skyrocketing deficits are leading to growing political pressure for further stifling our nation's imports and thereby, however inadvertently, setting back economic development throughout the world, especially the Third World. In Washington the political pressure springs from industries suffering the most from foreign competition, such as steel, autos, and textiles. Friends of these industries in Congress are legion. Congressmen and lobbyists claim that millions of jobs have been lost, that more millions of jobs are at stake, and that only further protection will preclude disaster. Imports of everything from cameras to footwear, from copper to copiers, from garments to autos, from Italian wine to Danish silver, are under veiled or open attack. Now a prominent businessman promotes a 20 per cent manufactured-goods surcharge on all imports (phased out over three years) as a means of "attacking" the big U.S. trade deficit.

The very word attack has military as well as moral overtones, and I don't believe it is unwarranted for me to say that over the longer run world peace, apart from world prosperity, hangs in the balance. A growing system of international cooperation, of freedom and free enterprise—for these are the roots of a just international economic order—is at bay.

Permit me, then, to recall in this regard the slogan of IBM, one of the world's great trading corporations, "World Peace Through World Trade." The remarkable 19th-century French economist Frederic Bastiat made this similar observation, "When goods can't cross frontiers, armies will."

In other words, I believe that the present international economic order is indeed a just one or at least an increasingly just one, despite the incursions of the Soviet Union and other aggressive states such as Libya, Iran, and Vietnam. But the growing forces of protectionism at home and abroad are inadvertently threatening that order and are asking for retaliation. They are playing with fire.

**D**o I exaggerate? Historical evidence abounds on the disruptive power of protectionism, on the correlation between free trade and world peace. In the 17th and 18th centuries, protectionism was, of course, a factor leading to the American Revolution. The American Revolution was triggered by such Parliamentary acts as the Sugar Act of 1764 and the Stamp Act of 1765. The Sugar Act imposed a duty of three pence a gallon on "foreign"—i.e., non-British—molasses, a duty which the New England rum manufacturers insisted would ruin them. The Stamp Act hit lawyers, publishers, and traders, requiring all legal documents to be affixed with royal stamps.

But as Adam Smith noted in his *Wealth of Nations*, the fundamental economic issue of the American colonists was larger than duties and stamps. It was the central problem of mercantilism, of protectionist Britain putting down the American colonies, regarding them as but a source of raw materials and a market for its wares, with Britain as the master manufacturer, banker, merchant, and shipper.

Protectionism was also a factor in causing the Civil War, with the protectionist forces of the industrial North goading the agricultural South. When Congress passed the so-called Tariff of Abominations of 1828 and succeeded it with an even higher tariff in 1832, for example, John Calhoun led a state convention of South Carolina to issue an Ordinance of Nullification, the idea that the U.S. Constitution, correctly interpreted, empowered a state to nullify Federal laws inimical to its interests. The tariff issue became embodied in the question of states' rights leading right up to the question of secession and the Civil War.

Again, the McKinley Tariff of 1890 and the Dingley Tariff of 1897 pushed protectionist walls to the highest levels in the history of America and contributed to the international frictions and retaliations culminating in the First World War. If there was a lesson on the counterproductivity of protectionism to world peace and prosperity, it wasn't learned after that war. For in 1930 came the giant Smoot-Hawley Tariff, approved by President Herbert Hoover. Not only did Smoot-Hawley worsen the tensions that precipitated World War II but it held back in America the recovery that characterized most of the industrial world by the early 1930s.

After World War II, America, to its great credit, extended a program of reciprocal trade agreements, and helped to organize the General Agreement on Tariffs and Trade (GATT) aimed at reciprocally reducing trade barriers around the globe. Postwar historical barriers

## Why Trade?

***It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves not to their humanity but to their self-love and never talk to them of our own necessities but of their advantages.***

—ADAM SMITH  
THE WEALTH OF NATIONS

to world trade indeed have been breaking down the world over, and it is worth noting that since World War II no big international war has occurred. Moreover, a good example of the freer trade movement in action happened in the early 1960s when the Kennedy round of tariff reductions produced a pronounced lessening of protectionism and a speed-up of international development, especially in the Third World.

Against this backdrop, however, is a growing return of the philosophy of protectionism. The job of economic education of people everywhere remains unfinished. We must set forth the case for a system of individual private property rights (without which no other human rights are possible), of open international trade and investment—the things which are the basis for a just international economic order. We should get down to the very basis of society: social cooperation, mutual help, mutual production, and mutual trade. The answer lies in the idea of freedom, free enterprise, and limited—repeat, limited—government.

## The Law of Scarcity

**I**s not trade a kind of glue that holds society together? As a teaser, let me remind you of the dozens of English family names that reveal an occupation of generations past. Consider family names like Archer, Smith, Clark, Cook, Banker, Butcher, Fisher, Farmer, Carpenter, Sawyer, Wheeler, Baker, Cooper, Binder, Mason, Hammer, Saddler, Hunter, Teacher, Brewer, and so on. The phenomenon also applies to foreign tongues. Eisenhower, for example, translates to “iron-maker.”

Man trades because of the primordial law of scarcity, the very underpinning of economics, the idea that man must work and produce the means of his survival, or he will perish. Or, as the Lord Jehovah thundered down on disobedient Adam and Eve as they passed through the gates of Paradise: “In the sweat of thy face shalt thou eat bread.”

Work overcomes scarcity, but how effectively? To what extent? Because of the principle of what Adam Smith called division of labor (the idea of particularized work skills, of specialization by occupations to bring about greater productivity), work became more meaningful and far more productive. Men and women over time have sought out different walks of life, different trades, different occupations, different professions, different callings.

Yet specialization or division of labor, of lands as well as people, presupposes the market mandate of barter, of trade, of swapping one's surplus goods for someone else's surplus goods, as did Robinson Cru-

soe and Friday to such salubrious effect. So let me invoke another great principle of basic economic law—the principle of comparative advantage. This principle maintains that total economic well-being is furthered as each person, region, and nation, specializes in the creation of those goods and services which can be produced, in relative terms, most efficiently. In this manner the great bugaboo of scarcity—so universal, so ubiquitous—can be better overcome, with that delightful spinoff, as I noted earlier, of greater international peace. In other words, we can hardly expect a supplier in one country to go around and shoot his customers in other countries.

To be sure, the vehicles for world trade are overwhelmingly multinational corporations. And these MNCs are, of course, greedy, imperialistic, profit-hungry, uncaring, exploitative, and suffering from every other evil invective known to man.

I've invoked the concept of profit, the drive behind the multinationals, the drive which I equate with self-interest. How can we defend what appears to me so basic and inescapable a part of human nature? This is not to denigrate altruism and the qualities of faith, hope, and charity. But it is to assert the essentially individualistic self-motivated nature of human action, of man ever scouting and weighing options on how to survive, on how to overcome scarcity. And hence the worldwide social need of trade, including international trade, and the universal social need to recognize the innate self-interest side of human nature. In this regard, let me resort to that eminent professor of moral philosophy—for that was his title—Adam Smith, who declared in his *Wealth of Nations*: “It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves not to their humanity but to their self-love and never talk to them of our own necessities but of their advantages.”

**S**elf-interest—the profit motive—mightily serves the public interest, the common good. But, in truth, it is not an unalloyed good. The mugger in Central Park, for example, is pursuing his self-interest. Hence, trade must itself be subject to ethical considerations, to the absence of fraud, force, and moral turpitude.

Third World nations must realize, I think, that trade is a two-way street. Profit is mutual and without transfer of capital and technology their peoples will languish in poverty and squalor. Yes, MNCs in pursuit of profits will seek out areas of low wages and natural resources as well as areas of high wages and hence high demand. But is it a crime to seek out low wages (and thereby drive them higher)?

Let me remind you that a century and a half ago the U.S. was itself a developing nation, and MNCs, especially those from England and France, invested heavily in our country, most notably in our railroads which bound our fledgling nation together, North and South, East and West. So, too, have MNCs greatly helped write the success stories of “the Gang of Four” in the Pacific Basin—South Korea, Hong Kong, Taiwan, and Singapore. I also want to take note of how French, British, German, Japanese, and American multinational corporations figured in the successful development of the West African nation in which in the early 1960s I served as an economic consultant—the Republic of the Ivory Coast.

## The Ethics of Trade

***The motive of all these regulations is to extend our own manufactures, not by their own improvements, but by the depression of those of all our neighbors, and by putting an end, as much as possible, to the troublesome competition of such odious and disagreeable rivals.***

—ADAM SMITH  
THE WEALTH OF NATIONS

Now, is such an international economic order, as I have described, just? Justice is not the easiest word to define. Aristotle said it is a matter of equal rewards for equals and unequal rewards for unequals. The important black American economist, Walter Williams of George Mason University, defines social justice as a matter of "I get to keep what I earn and you get to keep what you earn." I connect justice with ethical choices—rewards for good choices, retribution for bad ones. At any rate, I believe the word "exploitation," in or out of the Third World, is largely in the eye of the beholder whenever choice abounds in a free society.

The key to understanding the relationship between a buyer and seller, employee and employer, saver and investor, producer and consumer is freedom—i.e., voluntarism, the absence of coercion, the ability to shop around for the best offers and the best bids. Such freedom for the individual tends to lead to strong and vigorous economic development as well as to individual well-being.

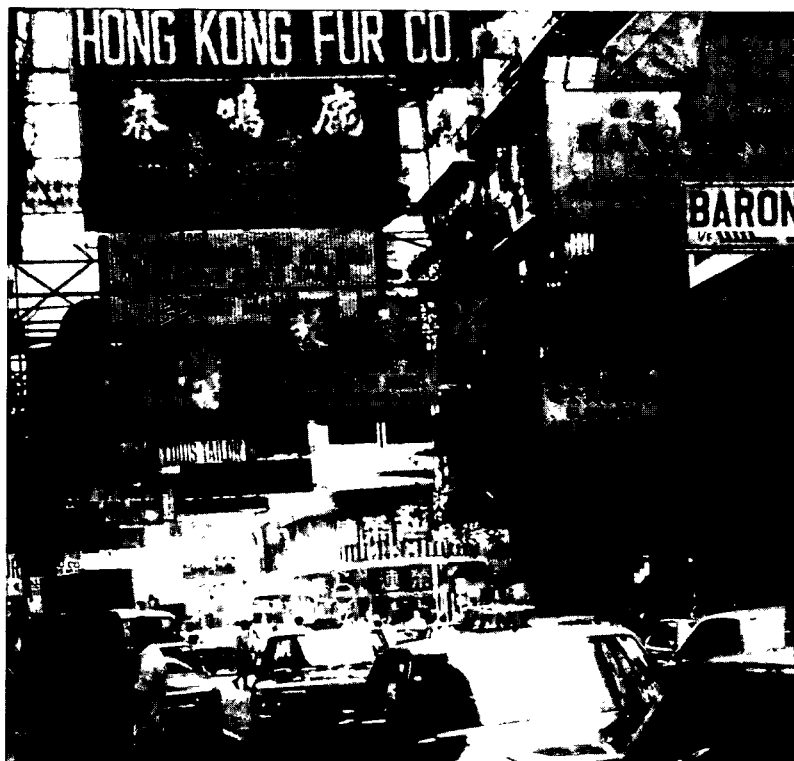
As a model of such economic development let me offer the case of Hong Kong. Hong Kong is not without problems, but it has prospered without much, if any, government planning and with minimum taxation and regulation. This British Crown Colony, which reverts to Chinese Communist control in 1997, stands as a monument to the remarkable creativity of free trade.

Hong Kong is a city with a population of 5.5 million, mostly refugees from Mainland China, occupying an area of 400 square miles at the tip of South China. Among other things, it is:

- the world's largest exporter of garments, toys and games;
- the world's major supplier of light consumer items including clocks and watches, plastic and artificial flowers, batteries, watchbands, candles, electric fans, and so on;
- the second busiest container port in volume in the world after Rotterdam;
- the second largest shipowning center in the world;
- the third largest international banking and financial center in the world.

On top of the above, Hong Kong has:

- a GNP per capita only lower than that of Japan in Asia;
- the second highest per capita consumption of electricity in Asia;



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- on a per capita basis, more bank branches or representative offices than any other territory in the world;
- the highest telephone density in South-East Asia;
- the highest vehicle density in the world next to Monaco.

Having said all this, I am hopeful that you see that the push for protectionism and the assault on multinationals are destined, for the most part inadvertently, to hurt the very people that the purveyors of these ideas say they wish to help—namely, the consumers at home and abroad, including the consumers in the Third World. Protectionism, you see, crushes choice. It denies competition. It depresses living standards. It robs the consumer of one of his most precious possessions—his sovereignty. Where has the consumer fared best, for example, in Ghana where for the most part MNCs have fled, or in its next-door neighbor, the Republic of the Ivory Coast where MNCs proliferate and average per capita income is around three times greater than in Ghana?

Despite all of this, in Washington we witness bills dropped in the Congressional hopper to curb the power of foreign MNCs, especially those of Japan, which are “viciously” flooding the country with Toyotas, Sonys, Canons, and Panasonics, and so on. The United Automobile Workers, for example, has pushed for “domestic content” legislation—legislation designed to make sure that new cars sold in America have up to 90 per cent of their parts manufactured in the U.S. and that up to 90 per cent of the labor in the assembly of those cars be supplied by American workers. Such 90 per cent parts and labor requirements would make auto imports all but an impossibility.

## The Need for Economic Education

It would make the price of new cars greater by many hundreds of dollars, just as now the so-called "voluntary" auto import quotas imposed on Japanese producers result in the American consumer having to pay hundreds of dollars more for his new car today. Are such attempts with such results moral? I think not.

**T**he only solution to the problem and challenge of achieving an even more just international economic order is economic education. I believe we as educators should reassert the moral basis of freedom and free enterprise. The moral basis of government was well stated, in effect, by Lord Acton, the great English Catholic lay philosopher, who said that "power tends to corrupt and absolute power corrupts absolutely." Acton saw the case for *limited* government, as did John Locke before him. Locke declared that the only reason for government was for the protection of life, liberty, and property—a phrase reflected not by coincidence, in the Fifth and Fourteenth Amendments to the Constitution. To be sure, Locke used the word protection but here what he meant was not freedom from competition. Rather, he meant the inviolability of property from arbitrary seizure by the state. He meant the right of property owners to sell or hold or invest their property at will. He meant, in a phrase, freedom and free enterprise.

In other words, economic educators have the considerable job of making clear:

- that tariffs don't protect jobs (actually they destroy jobs),
- that the rich hardly become richer by exploiting the poor (actually they get rich in a market economy by enriching the poor, and by raising living standards through capital formation),
- that if we don't buy Japanese cars and copiers the Japanese won't be able to buy our airplanes and soybeans,
- that if we don't buy Mexican cotton and Brazilian sugar the Mexicans and Brazilians won't be able to repay their huge debts to American banks.

In a free society choice is critical. The sovereign consumer has every producer, big and little, by the jugular, as Ludwig von Mises pointed out. In the market the consumer is King or Queen Customer.

The market system is a moral system, a system of voluntary social cooperation. What is more, it is the Golden Rule in action. As you know, the Golden Rule says, "Do unto others as you would have others do unto you." What does the market say? It says, in the words of Adam Smith in his *Wealth of Nations*: "Give me that which I want and you shall have this which you want." The market, in other words, says, let's cooperate, let's work for each other, let me help you so you can help me.

Let us view a just international economic order as a worldwide system of exchangeable private property rights and limited government—government steeped in the philosophy of free trade and open investment. Let us, then, educate on the case for unhampered world commerce as a key way to help each other at home and abroad. International free trade is a way to bind the world together and elevate it to a new vista of world peace and prosperity, of world respect and understanding. □



# Product Information on the Market

**O**ne often overlooked dimension of competition is *information*. Information, it must be recalled, is an economic good: it is both scarce and valued. (See Gary North, "Exploitation and Knowledge," *The Freeman*, January 1982.)

Product information will thus sometimes be available and sometimes not, depending on whether it is more profitable to procure and disseminate it or more profitable not to do so. This in turn depends on whether or not consumers value the information more than the resulting increment in price.

Thus food processors providing the extensive testing necessary to label cholesterol content to the nearest milligram only under threat of harassment by government agents are not denying consumers information they "ought" to have. Such information, like any economic good, is provided in quantities determined by the intersection of its demand curve with its supply curve. If rather little information is provided, this indicates not malevolent exploitation of ignorance, but rather that consumers are unwilling to pay the price that would generate a greater stock. That is a decision that should be left to them. Under the market system it is.

When the demand for accurate information about a product is sufficiently high as to support the price needed to call forth the supply, competition will assure its presence. But, the critics contend, doesn't such simple-minded supply-demand analysis suppose that the information in question is *neutral*? What if provision of the information would cause the demand curve to fall off sharply? What recourse do buyers have when the product fails to perform adequately? And what prevents the unscrupulous seller from masking defects or other information which reflects undesirably on his product? If the market is based on the profit motive and incentives, what about cases where the incentives are apparently in all the wrong places: to be insensitive rather than sensitive, to be unscrupulous rather than honorable, and so on? There is genuine moral concern underlying these questions, concern that should be addressed.

As usual, critics of the market believe that if government does not regulate, there will be chaos. In reality, however, liberty is self-regulating and the free market turns chaos into order. Specifically, the

**Consumers determine the amount of information available to them.**

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by Joseph S. Fulda

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Joseph Fulda is assistant professor of computer science at Hofstra University.

consumer has several sources of protection from the competitor who shields nonneutral information: the law, other competitors, other consumers, and himself.

By recourse to the law we do not refer to regulatory law, "consumer law," or any other of the new areas of statutory endeavor—all of which, in greater or lesser degree, presume guilt in the producer—but rather to the common law, as it has developed over the centuries. If outright fraud is perpetrated or the warranty of merchantability is breached, the purchase lacks informed consent and redress by the courts is in order. Likewise, the time has long passed when poison can be sold as medicine—violence done to person or property, willfully or through negligence, is not specially protected by its perpetration through economic transactions. But recourse to the law, as the critics remind us, is a cumbersome and expensive process and one which is necessarily undertaken only after the improper action is taken and the damage is suffered. If the law is not to presume guilt, it can sanction retaliatory measures only. Preventive measures must be left to the marketplace, a topic to which we now turn.

Circumscribing the actions of competitors on the market are other competitors who seek business, consumers who seek the best buy, and groups of these acting in concert to protect their common interests. To begin with, it must be understood that just as there can never be complete product information, there can never be neutral product information. All information about a product affects the choices of the consumer and is thus nonneutral. Information about proper use or care for the product will usually not change a consumer's mind about a product. But if it is absent it presents a risk to consumers buying the product or imposes the cost of obtaining the information elsewhere. Likewise, if the instructions indicate that the product is one that is not easy to use, the decision about its purchase may be negatively affected. Risk, it might be added, is central here. The less complete the information, the greater the risk. The willingness to bear that risk is ultimately up to the consumer and it is he, therefore, who has ultimate responsibility for his purchases.

But everyone prefers to operate under a minimum of risk and a maximum of information. Thus information becomes a dimension of competition. Sure, producers might prefer to offer their wares without the information that is a necessary concomitant; but the existence of other competitors who provide more information and consumers who value such information leaves them no such choice. Other competitors may even supply the decidedly nonneutral information that the wayward producer shields from view. News organizations, responding to the same demand, may also reveal it. Even if not revealed, however, the absence of information, like the presence of discouraging information, is often enough to deter the consumer from making the purchase.

## Guarding Against Risk

There will be instances where information cannot be verified by consumers even when present and where substantial danger would result from poor quality and an accompanying lack of information, as with medication. In such cases, the after the fact penalties exacted by the law—in damages, including possible punitive damages—and the market—in loss of future sales—



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would be correspondingly high. Too high to risk. There can be little doubt but that such companies would take out insurance. They have every incentive to do so, *especially* if they are not conscientious. But the insurance companies have every incentive to see to it that claims are not made and, if made, not collected. They will thus act to guard their assets. Inspections by private insurance companies with millions of dollars at stake and whose inspectors may well have their jobs on the line will surely be more thorough than disinterested bureaucrats working for indifferent agencies. Likewise, the expensive and cumbersome legal process of proving fraud or negligence when an insured company does market a dangerous product is now gladly undertaken by the insurance company.

Premiums for such insurance will be determined on the basis of the company's record and inspections. A company with substantially higher premiums than its competitors, and that includes companies insured on the basis of statistics without inspections, will soon find its prices noncompetitive and its customers switching loyalties. A company without insurance at all is likely to be boycotted by most consumers. The existence of insured firms and consumers seeking security insures this. Once again, producers and suppliers who are insured have every incentive to advertise the fact, and to attach inspection labels with the name of the certifying company onto their wares. (The insurance company may either insure the client company against liability or extraordinary loss of business due to product failure, or insure consumers directly. The certifying company need not be known as an insurance company—it could be a magazine—but in this respect it will function as one.)

It must be admitted, however, that on the free market consumers who wish to bear the risk of buying from an uninsured, uninspected drug company either to save money or for other reasons are free to do so. The market adequately prevents and retaliates for harm done us by others; it does not prevent us from harming ourselves.

Notice, though, what has happened. Through the complex interplay of a series of market incentives, retaliatory legal and market penalties

have been transmuted into preventive measures. Such insurance schemes as we have described are not more widespread only because government heavily regulates both the insurance industry and the potential client industries. Because government has effectively monopolized and usurped the insurance business, some of the insurance industry's most natural constituencies have never been fully cultivated.

Another market mechanism for protecting the consumer which has been adopted under pressure of competition is the guarantee. Because prior information about the quality of some goods and services is difficult to obtain (e.g., repair services), guarantees have become a standard substitute. Although this remedy works only after the transaction, it both removes the incentive for and imposes a cost on making a sale on false pretenses. Thus, once again a subsequent remedy is transmuted by market incentives into a preventive measure.

## Competition Promotes Information

**I**f one wishes evidence that competition promotes rather than stifles the dissemination of product information, one need only compare the readily available information about goods and services offered on the market with that available about services offered by the government. It is legend that taxpayers inquiring about government services are shifted endlessly from office to office in a vain quest. Despite reams of published material detailing every last function of government, taxpayers are often unable to obtain answers to even the simplest of questions. Likewise it is interesting to note that just those areas of enterprise deprived of competition, notably utility and other companies with direct or indirect grants of monopoly power, are the least satisfying when it comes to information about their products and prices. Computing the price for even a relatively simple service often entails poring through pages of cross-referenced tables with notes and addenda. Some of this excess is due to the absence of competition decreed by the state. Not surprisingly much of it is the result of company response to state agencies which take it upon themselves to set a "just price," a task which belongs to the market.

Yet another market mechanism that competitors must worry about is the voluntary inspections and standards of trade groups and consumer associations. Yes, companies can deny these entry, but to many consumers that would be *prima facie* evidence of failure to meet those standards. Yes, the standards themselves may be weak or poorly enforced, but if demand for the product or underlying need is even reasonably elastic (as it almost always is), the incentives are in all the right places: weak or poorly enforced standards cause the public to view the entire industry with distrust (this has happened with the mass media, for example) and that is bad for business. Furthermore, consumer groups which undertake such projects as comparative rating of products, product testing, determining best buys, and listing appliances together with their specifications can be a formidable opponent of shoddy production practices. Nevertheless, as we remarked about insurance, neither trade groups nor consumer associations have developed on the market to the extent that manifest concern about these matters—consumer demand—would call forth. These initiatives, too, have been largely usurped by the activities of government regulators.

It must be admitted, however, that at times none of these sources of consumer protection will operate. The presence of residual fraud,

misrepresentation, or omission of damaging information that obtains under the market system is often defended by the advocates of capitalism as the price of freedom from prior controls, constant supervision, and the like. The simple truth is that *no* system can eliminate abuse. The market system at least minimizes it. Abuse is the price of being human, not the price of being free. The quality and safety of products manufactured under command economies, where every stage of the production process is under supervision and subject to government standards and controls, is a powerful indication of this.

Where the market fails, planning must fail spectacularly, for the mistakes of central planners, unlike those of entrepreneurs, are centrally imposed on the entire economy. Where the market and the law under which it operates may at least take action after an abuse occurs, the system of planning with its unnatural disjunctions between profits and success, losses and failure, and responsibility for actions and liability for their consequences remains indifferent. The market attends to economic signals which duly report mistakes. Planners, on the other hand, having destroyed or distorted economic calculation, attend only to political signals which report whatever meets the party line.

**B**efore concluding, we should take note of the moral issue involved in forcing the release of information. In finding the forced recitation of the Pledge of Allegiance by school children unconstitutional, the Supreme Court has declared the right not to speak at least as protected as the right to speak. (See *West Virginia State Board of Education v. Barnette* [1943].) Circumscriptions of speech generally involve a mild contraction of choice, whereas coerced speech eliminates all choice. It is thus a mark of how far the artificial dichotomy between economic and personal freedom has permeated our law that, despite the reasoning above, producers and suppliers are daily forced to make all manner of declarations, issue all sorts of lists, and post a wide variety of information.

Notice that what is moral and what is pragmatic are harmoniously aligned. The forced release of information is thus not only inefficient and counterproductive. It is a violation of privacy and the natural right of free expression. There are natural laws governing human action, just as surely as there are laws governing the operation of the physical universe. For human action to be productive and beneficial to mankind, the self-evident moral constraints on such action must be observed with care. □

# Thirty Years of Freeman Reviewing

by John Chamberlain

I have been reviewing books for *The Freeman* for thirty years. To my memory I missed appearing in one issue, when the mails went wrong from Taiwan. At twelve reviews a year for thirty years, minus one review that went astray, the sum total of books read and commented on would come to 359, quite a shelf of the literature of freedom.

The question is: how do you hit the high spots when so many of the books made worthy contributions to conservative or classical liberal thought? I've combed over the issues of *The Freeman* going far back into the Fifties and find at least a hundred titles that are important. How do you winnow these down to ten or twelve without doing violence to history?

Maybe the way to do it is to begin with the seminal thinkers whose names crop up more than once, either because their books get reprinted or because they have essays written about them. The three names that automatically qualify here are those of Ludwig von Mises, Friedrich Hayek and Henry Hazlitt.

I reviewed Mises' *Human Action* for Eugene Lyons' *American Mercury* before there was a *Freeman*. Accordingly, when it became a question of doing something about a new edition of *Human Action* for a special Mises issue, Paul Poirot suggested that I re-

view my original review. Earlier on, in November of 1956, I had had the opportunity to review Mises' *The Anti-Capitalistic Mentality*. And much, much later there was Margit von Mises' sensitive and beautifully written *My Years With Ludwig von Mises*.

With Hayek, there were plenty of opportunities to get acquainted with an old Whig, from a reissue of *The Road to Serfdom* in 1956 and *The Constitution of Liberty* in 1960 to *The Essence of Hayek* in October of 1985. And there was Hayek's notable editing of *Capitalism and the Historians*, which came out of a memorable meeting of the Mont Pelerin Society.

Henry Hazlitt, at age 91, is still going strong on the subject of inflation. It was his introduction to Andrew Dickson White's *Fiat Money Inflation in France*, written in 1959, that gave many of us a first clear glimpse of the dangers of reliance on a paper currency. Hazlitt's books on the failure of Keynesianism and the "new" economics, followed by his prophetic collection of *New York Times* editorials on the shortcomings of Bretton Woods, have given us plenty of warning of new inflation crises to come.

Other names that recur more than once in my thirty-year list of reviews are those of Russell Kirk, Frank Meyer, and Otto Scott. It was Meyer's

voice in the Sixties that sought to hold conservatives and libertarians together, reminding us that virtue is individually meaningless if it has to be imposed by State force. Kirk professes to a disdain for economists, but his books (*The Roots of American Order*, *Eliot and His Age* and *Decadence and Renewal in the Higher Learning*, all of them reviewed in *The Freeman*) help define the social framework needed to sustain freedom that Wilhelm Roepke talks about in *A Humane Economy*, also re-reviewed here. Otto Scott is another who is concerned with the cultural prerequisites of a free society. Two of his books, *The Secret Six* (the abolitionists who backed John Brown), and *Robespierre* (the French revolutionary terrorist), show us that we make a mistake to suffer fools gladly. The third Scott book which I reviewed in *The Freeman*, *The Creative Ordeal*, which is an account of the Raytheon Company's development of radar, is about good men who saved the western democracies from defeat in World War II. It shows the constructive side of Scott's thinking.

Going back over *The Freeman* reviews, I am struck by the fecundity of the Fifties. I reviewed Ayn Rand's novel, *Atlas Shrugged*, in October of 1957, making the point that it was a startlingly great fable about the human prerequisites for free development. Almost as an afterthought I wondered at the Randian objection to private charity, which seemed to me to be inconsistent with her general philosophy of voluntarism. Ayn Rand let me know that she did not like the criticism. She had not digested the meaning of Leonard Read's "anything that's peaceful."

Another accomplishment of the Fifties which was noted in a *Freeman* review was Karl A. Wittfogel's monumental study of *Oriental Despotism*. Wittfogel related this despotism to State control of the people's water

supply. Wittfogel's researches into what had happened in ancient China to make serfs of the people came out at a time when the Fabians in England, and the followers of Norman Thomas in America, were chattering about the need for government to take control of the "commanding heights of industry." Socialists are still oblivious to Wittfogel, just as they are oblivious to Louis Baudin's *A Socialist Empire: The Incas of Peru*, which we reviewed in the early sixties.

In the Fifties we lamented the waste of John Kenneth Galbraith's good style in *The Affluent Society* on such nonsense as the contention that people can't be trusted to make their own economic and cultural decisions. In spite of Galbraith, however, some of the anti-capitalist clichés were dying at the end of the Fifties. Larry Fertig's *Prosperity Through Freedom* helped with the killing. Matthew Josephson, who had popularized the thesis that the big industrialists of the Nineteenth Century were all robber barons, seemed to be switching his ground in his laudatory *Edison*. T. A. Boyd's *Professional Amateur*, a study of Charles Franklin Kettering (Boss Kett), and his subsequent collection of Kettering's speeches in *Prophet of Progress*, were two excellent testimonials to the truth that inventiveness comes when its sources in individual freedom are unhampered. Kett, the creator of the self-starter, did his best inventing in a barn, and always resisted being institutionalized by General Motors. And Jane Jacobs, in *The Death and Life of Great American Cities*, made the individualized point that people took better care of themselves in unplanned neighborhoods, where they could do their own policing and where shops and houses were intermingled.

In the Seventies it was good to welcome in *The Freeman* George Roche's analysis of "enmassment" in *The Bewildered Society*. And we had a consummate summary of twenty-five

years in George Nash's *The Conservative Intellectual Movement Since 1945*. (Nash later did a first-rate work on Herbert Hoover's career as a mining engineer.) Another good summary, reviewed in *The Freeman* in 1976, was the *Plain Talk Anthology*, which included the first map of the Soviet Gulag Archipelago (this was some years before Solzhenitsyn). Laurence Beilenson's *The Treaty Trap* warned us against putting our trust in scraps of paper. Felix Morley, one of the founders of *Human Events*, timed his autobiographical *For the Record* for review in 1979. And the resurrection in 1979 of an old book of the Nineties, Auberon Herbert's *The Right and Wrong of Compulsion by the State*, made one wonder at the obtuseness of the British Fabians (including George Bernard Shaw and H.G. Wells) in rejecting the luminously clear Auberon Herbert arguments that might have saved England from fifty years of welfarist state torpor.

**W**e come down to the Nineteen Eighties, when some really excellent books have been published. A New Zealander, Ronald Nairn, who has had farming experience in Oriental countries, wrote a book which, if it were only heeded, could liberate peasants everywhere to produce a world plenty. It is called *Wealth of Nations in Crisis*, and it has had the commendation of Hayek. Richard Cornuelle, in his *Healing America*, brought his *Reclaiming the American Dream* up to date in some stirring appeals to voluntary action that should have been pushed by Reaganites all over the country. In 1981 we had Bert Wolfe's fascinating story of *A Life in Two Centuries*. It took a long time for Bert Wolfe to wriggle free of his Communist connections, but the time was profitably spent for what it reveals to us about Soviet methods. Anne Wortham, a black sociologist, in another 1981 book, *The*

*Other Side of Racism*, has made an eloquent plea to blacks to put their trust in their own individualism lest they be sold back to a big plantation run by the coercive state.

The Friedmans, Milton and Rose, deserted economics for the moment to take a flier into political science with their *The Tyranny of the Status Quo*, the thesis being that if a new Administration can't put through a program in its first 100 days it will get very little for all its pains. Rael and Erich Isaac, in *The Coercive Utopians*, have shown how well-meaning perfectionists can betray us to the totalitarians. Warren Brookes, in *The Economy in Mind*, has proved that wealth starts with ideas in people's heads. George Gilder's collection of marvelous yarns about individual creativeness, called *The Spirit of Enterprise*, backs up Warren Brookes' contention to the hilt. So does Rabushka's *From Adam Smith to the Wealth of America*. Sven Rydenfelt's *A Pattern for Failure: Socialist Economies in Crisis*, makes it plain why starvation comes to those who rely on government control of agriculture (the prices are invariably fixed against the peasants).

It was Leonard Read's *Freeman* that has given me the freedom to keep up with all the permutations of anti-Statist and anti-interventionist thought for thirty years. And what of Leonard's own books, which numbered more than twenty? I have reviewed many of them, to my profit and pleasure. Leonard had a marvelously epigrammatic faculty for putting complex things into a single sentence. When he remarked that "helping people to become helpless is not an act of kindness," he anticipated some 300 pages of Charles Murray's recent *Losing Ground*. This is not to say that Murray's book was unnecessary—lots of people need elaborate statistical proof before they can accept an epigram. □



## **Equality and Liberty: A Defense of Radical Egalitarianism**

by Kai Nielsen

Rowman & Allanheld, Totowa, NJ 07512 • 1985 • 320 pages, \$27.50 cloth

*Reviewed by John Hospers*

**E**quality of consideration, equality before the law, equality in human dignity or worth, are discussed by this author, but they are not the distinctive thrust of the book. The main thesis is that every individual—or every family, one isn't always sure which (and it makes a great practical difference which is meant)—should receive an approximately equal income. It is *economic* equality which the book is primarily concerned to defend. What is to be equally possessed is money, or articles of one's choice purchasable with money. The money is presumably to be doled out by the government after being extracted from each citizen in taxes—though Nielsen says that things like hospitals and parks and playgrounds should be taken care of before such a distribution is made.

To establish his case, Nielsen relies heavily on "our commonly held reflective moral intuitions." But many persons, myself included, have moral intuitions sharply at odds with Nielsen's.

For example: If a man repeatedly spends his entire allotment on cocaine or heroin, Nielsen would say that he should still receive an equal portion from the common store. The man who works hard must thus be forced to spend a part of his earnings to sustain the other's drug habit. I consider this morally shocking in the extreme; but how else are we to interpret Nielsen's assertion that "income and wealth is to be so divided that each person

will have a right to an equal share'"? (p. 289)

If our moral intuitions are so widely at variance, we are left with an unbridgeable impasse from the start, with presumably nothing more to discuss. It is just possible, however, that we disagree (at least in part) on matters of fact rather than moral intuitions. I suspect that if Nielsen knew the full implications of his stated views, he would shrink from the conclusions that he now espouses.

One basic fact is that human beings must work in order to live. A second is that the main thing which motivates people to work is the desire to have a decent life for themselves and their families, and some security for the future. If people know that the fruits of their labor will be taken from them in the name of some cooperative enterprise to which they never consented, their motivation to produce will be undermined, and any enterprises they have planned which would involve risking their savings (and possibly giving others employment) would be abandoned as no longer worth the trouble. And a third fact is that throughout most of human history the earth has not produced enough to feed its population, with resultant malnutrition and starvation; only in a technological society, where machines do most of the work of human muscles, can a large population be sustained on a relatively high economic level.

A fourth fact is that human beings are unequal in their incentives, capacities and abilities: Give one person \$1,000 and he will work hard and double the amount in a year; another person will spend it in a year. When the next redistribution occurs (to make sure that everyone's income is equal), the person with initiative and imagination who has just had his earned income taken from him for his pains will

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be less motivated to labor the next time round; he will have every motivation to be penniless by the time of the next redistribution so that he can collect the full amount. Inevitably before long there will be nothing left to distribute, production will falter and cease, and everyone will be equal at base zero!

Nielsen is committed to the socialist state. Yet the socialist state has never been able to deliver the economic abundance which Nielsen's utopia requires. His desire for human welfare and his desire for socialism in all nations are incompatible. The great economic leaps forward achieved by human beings—chiefly in North America and Western Europe in the last couple of centuries—have been made possible only to the extent that the free market operated. While other nations continued to be unable to feed themselves, capitalist America during the nineteenth century doubled its per capita income approximately every 30 years.

Nielsen does concede that his egalitarian state could not come into existence until "we first have the productive capacity and resource conditions" (p. 286) to put it into practice. Since the immense productivity of the free market is so repeatedly proved throughout history as to be without serious question (even Marx conceded it), does this mean that according to Nielsen we first need a free market for its golden eggs, before killing the goose later in the interests of equal distribution? What happens to those who worked the hardest to better their condition? Are they to be ripped off to effect equal distribution for the productive and nonproductive, the wasteful and the thrifty, alike? And is *this* justice?

Knowing they will be ripped off, people will lack any incentive to work hard; the production on which forced distribution depends will never occur. "In a society of abundance," he says (p. 306), "everyone will be well off and secure." The problem is that no such abundance can be created in the socio-economic system he favors. The moral ideal Nielsen espouses requires for its implementation a socio-economic base which he rejects.

Professor Nielsen's book is the culmination (but surely not the end) of a whole series of books—by Michael Bayles, Ronald Dworkin, Nicholas Rescher, Richard Brandt, and others—recommending egalitarianism in one form or another. They are so interested in *distributing* the goods produced by others that they have paid scant attention to the conditions necessary to ensure continued production. Having been brought up in the affluence made possible by capitalism, it has become fashionable to denigrate the source of that affluence, and so they strive to ensure that no such affluence will ever occur again. It is all very chic, very trendy. It is easy to get full professorships for doing this sort of thing, and to impress students with one's virtue and humane concern. Socialist professors themselves, far from being in want, find it ego-gratifying to recommend these egalitarian utopias, especially when doing so costs them nothing, and impresses students with how superior they are to the wicked world which pays their salaries. If only these professors could be philosopher-kings and rule mankind! But it is fortunate, indeed, that philosophers—from Plato's *Republic* to Nielsen's latest utopian tract—are in no such position. Had their ideas ever been put into practice they would long since have destroyed the world.

□

## My Favorite Magazine

Ever since John Williams began writing for *The Freeman*, I've gained tremendous knowledge of the freedom philosophy. His articles are most lucid and it would be difficult to pose arguments against his many theses.

I was particularly impressed with "The Disease From Which Civilizations Die," (September 1985). The messages contained should be shouted from the housetops.

I was fortunate to attend a FEE seminar in 1972 on a scholarship when the late Leonard Read was president. What a gifted man he was in explaining the freedom philosophy.

Thanks to John Williams and your other contributors for such carefully thought out ideas which appear in *The Freeman*. It is my favorite magazine, and one which I promote among my friends.

*Irene Green  
Coeur D'Alene, Idaho*

## Productive Justice

*The Freeman* is to be commended for providing an unabashed free-market analysis of the recent draft of the Catholic bishops' pastoral on the U.S. economy. Both Messrs. Baird and Kern raise a number of important questions which one hopes will be taken into consideration by the bishops in the subsequent and final draft. Indeed, it would appear that, at least in some respects, the bishops have taken to heart a few of the concerns expressed by advocates of the free-market, concerns which were glaringly absent in the previous draft. While there appears to be a move toward utilizing private sector solutions to social problems, the bishops continue to approach the question of economics as though it were a zero-sum game, which leads them to presume

that if someone has more, this can only be the result of the fact that someone else has less. Such an assumption on their part should, at the very least, be questioned and defended, yet in this regard they are silent. Great things could happen if the bishops came to see that the market is not stagnant. It is dynamic and growing: people really do "make money."

Mr. Baird notes that at the heart of the bishops' concern is what an economic system does for and to *people*, and as teachers of the Gospel they rightly focus their attention on *poor people*. The question is, then, how can the poor be lifted from their poverty? The answer clearly is, produce more wealth. Yet this is not the primary answer the bishops give. In favoring governmental (i.e., non-productive) solutions, and rarely exploring market (i.e., productive) possibilities, the bishops tend to fall back on various kinds of governmental experiments which *distribute* rather than *produce* wealth. The readers of *The Freeman* are all too familiar with what happens to the productive sector when this occurs.

The Church has developed a keen sense of distributive justice. When will they explore the possibilities of productive justice?

*Robert A. Sirico  
Washington, D.C.*

## Freedom and the Law

Professor Joseph Fulda has provided a valuable contribution to libertarian legal theory in his article on "Declarative Law" (November). The superiority of a system which holds people responsible for their actions, rather than merely ordering them about, is one which cannot be stressed enough.

What is not discussed is the difficulty of imposing legislative notions of legal responsibility upon sponta-

neously evolving legal processes. While the legislative and executive branches may properly assume a role in codifying principles which develop through judicial decision-making, they may cause more harm than good when they attempt to reconstruct the common law. Ignorance of this principle flies in the face of such landmark works as Bruno Leoni's *Freedom and the Law*, and Friedrich Hayek's *Law, Legislation and Liberty*.

While Professor Fulda does much to illuminate the form which a just and libertarian law code would take—that its laws would be declarative and be founded upon the notion of responsibility—he does little to address the way in which the system would develop. By stressing the means by which legislators can reinstitute the “declarative law,” he obscures the importance of spontaneously grown legal standards.

*Kenneth L. Marcus  
Williams College  
Williamstown, Massachusetts*

## The American Republic

Has *The Freeman* lost its way? Recently I have noticed essays that elevate the notion of democracy.

Kenneth McDonald's essay, “America's Two Elites” (November) goes so far as to state, “America, after all, is a democracy.” Sorry, Mr. McDonald, but the United States of America is a republic. Read the Constitution of the United States. The words democracy and democratic are not part of the text.

Democracy is majority rule and democracies ultimately crush the rights

of the minority. Unfortunately, we have become more democratic in recent years; and because we have become more democratic we have suffered a significant loss of liberty and gained a weighty burden of forced collectivism.

*William F. Kerschner  
Elm Grove, Wisconsin*

## Misgivings

I have misgivings about the inclusion of letters in *The Freeman*. I'm afraid they will dilute and detract from the flavor unique to your monthly.

Of course, you will probably print this and set up a contradictory self-reference thereby. Ha-ha. □

*Robert Goodman  
Bronx, New York*

Let us hear from you! We would like to share with readers the most interesting and provocative letters we receive regarding *Freeman* articles and the issues they raise. Since FEE's activities encompass much more than just publishing *The Freeman*, we will also include reactions to other FEE activities.

Limited space will preclude our printing all the thoughtful letters we receive. Letters may be edited for purposes of clarity or space. And opinions expressed are not necessarily those of *The Freeman*. Address your letters to: To the Editor, *The Freeman*, The Foundation for Economic Education, Irvington-on-Hudson, New York 10533.

# The Privatization Revolution

John Naisbitt's new book on ten trends shaping our future, *The Year Ahead: 1986*, identifies a very old idea whose time has come: "In the year ahead, the reprivatization of America will become a swollen tide of private industry rushing in to fill the gaps left by federal government budget cuts, local governments' inability to finance basic public services, and consumer demand for quality service and greater accountability."

In fact, from Great Britain to Brazil, and including a great many third world countries, a privatization revolution is forcing the return of nationalized industries to the private sector. This is not an example of a change of heart on the part of government policy makers, merely the inexorable lesson of economic law: government interventionism doesn't work.

Privatization may presage an explosion of entrepreneurial effort and the kind of economic growth the world needs. Governments may not abolish enough of the regulations that strangle commerce. But there is an apparent world-wide shift toward the market process. As one senior development consultant put it, "governments sometimes do the right thing, but only after they've exhausted all the alternatives."

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## Capitalism Wins Again

The Soviet Communist Party has had to deal with reality once again. For the third time in its history, it is preparing a new program on the goals and strategies of the Party. Between the lines, capitalism comes out a winner.

Each of the two previous Soviet programs since 1903 has become progressively less optimistic of the final overthrow of capitalism. Now the current draft to the third program criticizes capitalism because it "is constantly maneuvering to adjust itself to the changing situation."

That is precisely the point! While planners make promises they cannot keep, the free market produces. While communism and socialism move from one failed plan to another, capitalism adjusts to the changing needs and desires of consumers. While all forms of interventionism try to control everything, the market permits "anything that's peaceful." Communism, indeed any form of totalitarianism, is doomed to failure because it cannot

cope with change. Only freedom and a market society encourages diversity, freedom, and economic progress.

## Discovering Property Rights

Bill Landreth, the teenage author of *Out of the Inner Circle*, gives us a glimpse of how property rights naturally evolve in society. He tells the story of a group of brilliant computer "hackers" who anonymously discover each other, expand their own knowledge of computer systems, and find their way into highly secret and private computer systems.

Admittedly, much of what the Inner Circle hackers did was quite wrong (breaking into other people's computer systems, for example). At the same time, Landreth gives a fascinating account of how they developed "an unwritten code of ethics that became a philosophy holding the Inner Circle together." Landreth concludes, "We had many good reasons to follow these basic rules. But the most im-

portant . . . had to do with the basic principle of respecting other people's property and information."

These bright young men discovered on their own something they probably would never have stumbled across in school: clearly defined property rights are essential for a moral society to operate.  
—GFR

## Seatbelts

We have invented a new victimless crime that is sparking a groundswell of opposition—driving without a seatbelt. A number of people are convinced that seatbelts save lives, and they presumably would buckle up whether or not the law required it. But others are impressed by the occasional accident in which an unbuckled person survives by being thrown clear.

The issue is not, of course, whether statistics prove that seatbelts reduce accidents. The issue is the right of individuals to evaluate risks for themselves. Is it a proper function of government to forcibly decide such issues for us? For a growing number of people, mandatory seatbelt laws are the equivalent of Prohibition in the twenties. And we all know what a success that was.  
—JKT

## Thirty Years Ago

In the February 1956 *Freeman*, we ran an article by Ludwig von Mises on "Facts About the 'Industrial Revolution'." He showed how "The Laissez-faire ideology and its offshoot, the 'Industrial Revolution' blasted the ideological and institutional barriers to progress and welfare." What Mises wrote then is still sadly true: "There are millions and millions of people for whom there is no secure place left in the traditional economic setting. The fate of these wretched masses can be improved only by industrialization. What they need most is entrepreneurs and capitalists."

Editor: Charles H. Hamilton  
Publisher: Paul L. Poirot  
Managing Editor: Beth A. Hoffman

Book Review Editor: Edmund A. Opitz  
Contributing Editors: Robert G. Anderson  
Howard Baetjer Jr.  
Bettina Bien Greaves  
Gregory F. Rehmke  
Brian Summers  
Joan Kennedy Taylor

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# THE FREEMAN

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# Government, The State, and Private Property

**“The positive testimony of history,” wrote Albert Jay Nock in *Our Enemy, The State*, “is that the State invariably had its origin in conquest and confiscation.”**

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**by Kenneth McDonald**

Kenneth McDonald is a free-lance writer and editor living in Toronto.

**F**rom earliest times, roving bands of warriors raided settlements, expropriated the coveted possessions, and slaughtered or dispersed the owners. Before long, the technique was modified. It was more profitable to reduce the vanquished to dependence and use them as a workforce. The conquerors established the State, with themselves as aristocracies.

Western man's attempts to limit the State's power brought representative Government. Its purpose was to secure unalienable rights, a very different concept from that of the State, which admitted no rights other than those it chose to grant.

Between those two concepts, the struggle is endless. The State shows no sign of withering away. Today's aristocracies exercise power in subtler ways. By influencing the political process they subordinate Government to the State.

Here we draw a distinction between sectional interests, whose endeavors to swing things their way are, however discriminatory in effect, a legitimate part of representative Government, and the social engineers whose aim is to reshape society. Their instrument is the State.

Let us call them planners. They and their adherents share a characteristic that is both human and paradoxical: the sin of pride. The paradox consists in the fact that the planners are highly educated and articulate, yet so rooted in their convictions as to be blinded to the humanity that destines them to err.

No doubt acceptance of one's failings is an ingredient of maturity. It inspires astonishment that any combination of people could be so credulous as to think that other people—the planners—who are every bit as fallible as they, could spend their money and otherwise arrange their affairs to better purpose than they could on their own.

Unfortunately, the failings that breed maturity in others leave the planners untouched. If people do not behave the way they are supposed to, the plans may have to be modified here and there but the principle still stands: the economic forces of society are amenable to planning that is directed by people like themselves.



Failure to question the principle stems from its adherents' failure to relate their individual fallibility to what they prescribe for others. Society is seen not as an assortment of individuals but as a coherent mass. Perfectible man will be molded by the pressures of a benevolent State. Missing from this endeavor is a recognition that people are different.

**A**t the root of all this is the matter of private property, and the right of individuals to own it. It is from invasion of that right that the State draws its power. As more and more of the right, and of the property, are transferred to the State, so does the power increase.

The conquest and confiscation in which the State originated are still in evidence. The planners may not regard themselves as conquerors but the way they have implanted their theories, and the way those theories have been communicated by education and the media, bear all the attributes of conquest. Rather than coveting possessions, the planners covet power. As the State's power expands, so does theirs.

Opposing that power is a different kind that comes from independence. Private and personal, it comes from the testing and practice of certain values. They rest upon the simple foundations of working hard and saving. Together they make possible the accumulation of capital and the security of a competence, neither of which could be achieved without the private ownership of property.

The independence that flows from these values confers not only independence from the State and its supplements but also freedom to criticize them. The planners' ideas, which look to the impersonal State for authority, are contested by other ideas that bear the authority of personal experience.

That is where the struggle is joined: between citizens who strive for the freedom they cherish, and other citizens who would whittle it down.

For all its faults, representative Government is on the side of freedom. The State is not. The ground the two struggle over is symbolized by the right to own property; the one charged with securing it, the other intent on taking it away. □

## The Right To Property

## On THE STATE

**I**t [the State] has taken on a vast mass of new duties and responsibilities; it has spread out its powers until they penetrate to every act of the citizen, however secret; it has begun to throw around its operations the high dignity and impeccability of a State religion; its agents become a separate and superior caste, with authority to bind and loose, and their thumbs in every pot. But it still remains, as it was in the beginning, the common enemy of all well-disposed, industrious and decent men.

HENRY L. MENCKEN, 1926

IDEAS  
ON  
LIBERTY



# The War on Poverty Revisited

**Capitalism, by conquering poverty, creates the “problem” of poverty.**

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by Edmund A. Opitz

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The Reverend Mr. Opitz is a member of the staff of The Foundation for Economic Education, a seminar lecturer, and author of the book, *Religion and Capitalism: Allies, Not Enemies*

**I**f we look back over the history of the past two or three thousand years we realize that most people who have ever lived on this planet were desperately poor, not merely poor by our standards—poor by any standards; miserably housed, shabbily clothed, and continually on the verge of starvation, only to go over the edge by the hundreds of thousands during the regularly recurring famines.

Medieval Europe is regarded by many scholars as one of the high points in world civilization. It gave us the great cathedrals, scholastic philosophy, magnificent works of art, literature like Dante’s *Divine Comedy*, specimens of craftsmanship that grace our museums, and chivalry. But the Middle Ages in Europe suffered from a number of famines. Between 1201 and 1600 there were seven famines, averaging ten years of famine per century. Coming down to 1709, there was a famine in France that wiped out one million people, five percent of the population. The last great natural famine in Europe was the Potato Famine in Ireland in the late 1840s, which claimed about one and a half million lives.

But Europe has always been a favored region, more prosperous than the rest of the world, less subject to natural disasters than Asia. There have been starving times in Western civilization, but never were they of the same order of magnitude as the disasters in the Orient. India and China have been especially vulnerable to famines. A famine in China between the years 1876 and 1879 resulted in an estimated 15 million deaths. And within living memory, a famine in China’s Hunan Province in 1929 resulted in two million dead. Ten major famines in India between 1860 and 1900 caused the death of close to 15 million people. During the Bengal famine of 1943–44—in and around Calcutta—one and a half million people died of starvation and the epidemics that followed.

I have recited these rather unpleasant facts, not for their own sake, but to emphasize a neglected or overlooked truism: *Poverty is the natural state of mankind*. Poverty is the rule; prosperity is the exception. In most parts of the globe, in most periods of history—including the present—most people most of the time have been or are desperately

poor. Prosperity is what the ruling class enjoys. The rich are the superior warriors, the superior hunters, the favorites of the gods, and these wealthy few—it was believed—deserve what they have.

Water runs downhill, fire burns, grass is green, the masses of people are poor. This was the perceived natural order of things, accepted and rarely questioned. Such was the mentality that prevailed throughout most of the world most of the time—until a few centuries ago. Poverty for the multitudes was simply a fact of life. It was a hardship, but being poor was not perceived as deprivation.

The rich were envied, but the envy rarely translated into thoughts of redistributing their wealth. Occasionally something triggered a peasants' revolt or a slave rebellion, but when each of these fizzled out, all ranks went back to "The good old rule/ The simple plan/ That they should take who have the power/ And they should keep who can." Universal poverty was a fact. But poverty was not a problem! The distinction is simple: a fact or situation just is; a fact or situation for which there is perceived to be a solution becomes thereby a problem, and a new mentality is generated.



**M**asses of people, the world over, have now been persuaded that someone or something keeps them poor, and their resentment follows. This fact helps to explain the modern world's hostility toward capitalism. Capitalism is not at all the cause of the poverty of the noncapitalistic nations, but it is the source of their dissatisfaction with their poverty. Capitalism in fact overcomes poverty; but in overcoming poverty capitalism creates the problem of poverty.

There was a breakthrough a few centuries ago, one of those great tidal movements in human affairs resulting in a new mentality and a different way of viewing the human condition. It was the discovery by the people of a few western nations of the complex set of institutions which later came to be called capitalism. The breakthrough might be symbolized by two documents, one penned by Thomas Jefferson setting forth the vision of a nation founded upon a new philosophy, that "all men are created equal," that they are "endowed by their Creator with certain unalienable rights," and that everyone is entitled to equal justice under the law. These axioms form the cornerstone of the free society.

At the same time, on another continent, a man named Smith wrote a great book which explained why the economy need not be centrally planned, directed, and controlled by the government—as it was under the mercantilism of his day. Let the law be vigilant to protect the life, liberty, and property of all—as the Whigs advocated—and the buying habits of freely choosing men and women in the marketplace will provide all the directives needed for the producers to grow and manufacture the things consumers want most. This is the market economy, the backbone of a free society. Under these conditions a free people will multiply their productivity and thus generate their own prosperity.

Capitalism is the name given to the set of institutions which enable free people to produce wealth up to the limit of their time, talents, capacity, and desire; and then to voluntarily exchange the fruits of their labors with others. Capitalism becomes fully operative only when there are institutional guarantees of individual liberty, with laws de-

## The Capitalist Alternative

signed to secure the God-given rights of every person to life, liberty, and property.

The intelligent and ethical way of arranging human action in society, the free society-market economy way of life which we are labeling capitalism, was like a bootstrap by which whole nations of people could and did elevate themselves out of misery, grinding poverty, and periodic starvation. Capitalism tackled poverty using the only means by which poverty can be alleviated, namely, by increased productivity.

Remove every obstacle that hinders the productive and creative energies of men and women and you create an abundance of goods and services, shared by everyone involved according to his contribution to the productive process, as that contribution is judged by the man's peers. This ever-increasing supply of goods and services will move the entire society up the rungs of the ladder of wealth. Some will climb to the top rungs, but even the least well-off on the bottom rungs will experience a level of well-being that would be regarded as affluence in noncapitalistic societies past or present.

## Liberty and the Economic Miracle

**T**he results of this new social order were almost miraculous, but there was nothing magical about the way the results were achieved. The results were achieved by people who had the intelligence to understand the requirements of a free and prosperous commonwealth, and who possessed the integrity and character to live by those requirements. We had a significant number of people a couple of centuries ago, who "pledged their lives, their fortunes, and their sacred honor" to establish not simply a new nation, but a nation founded upon new principles.

Capitalism generated a new mentality, a new perception of the human condition. After the experience of capitalism anywhere, people everywhere came to regard prosperity as the rule; poverty as the exception. The fact that we launched a "war on poverty" demonstrates this. No one would contemplate a war on poverty in India or Africa, where need is much more desperate than here. Only in a prosperous nation like our own, where the great war against poverty had already been won—by means of the market economy—would the elimination of the last, lingering remnants of poverty emerge as a political issue. The trouble is that if we employ the wrong remedy to eradicate the remaining pockets of poverty—as we are doing—we may find that we have destroyed prosperity instead, as in the familiar story about killing the goose that laid the golden eggs. Charles Murray's recent book, *Losing Ground*, demonstrates that we have been losing the political war against poverty despite spending hundreds of billions of dollars yearly.

The 18th-century breakthrough I've referred to brought with it a new understanding of how economic goods come into being, the nature of material wealth, and how this new wealth is allocated in differing amounts among all the participants in the productive process. The economic breakthrough was not miraculous; it was preceded by a new vision of how the ancient ideas of liberty, justice, and law should be applied. No longer were these venerable ideas to be the prerogative of the few; equal justice under the law was for everyone; liberty was to be enjoyed by all, and every person had a natural right to the property created by his labor.

For thousands of years the planet was regarded as a static warehouse, containing a fixed amount of wealth, impossible to increase, never enough for everyone. The serf tilling his field grumbled that he had to pay various feudal dues to the lord of the manor, but he was realistic enough to know that even if he kept everything he produced, he'd still go hungry much of the time. He was cursed by low productivity, caused by a faulty understanding of the nature of wealth.

When it is believed that the earth contains only a fixed amount of wealth, the preoccupation is with the allocation of what's already here, which means, invariably, that one man's gain is another's loss.

The new perception that dawned during the 18th century was that new wealth is in a process of continuous creation, in ever-increasing amounts, with more for everyone resulting from each new cycle of production. This new abundance would be distributed—not equally, but equitably—by voluntary exchanges in the marketplace, with each person receiving from his fellows what they think his contribution is worth to them. Each of us benefits in such a voluntary exchange.

This is a paradigm of capitalistic society; peaceful exchanges within the rules, with the rules designed to protect person and property. Each participant in a voluntary exchange is a net gainer, having given up what he wants less to get what he wants more. And as these exchanges multiply every person has a strong inducement to work harder, producing more of the things other people will want from him in exchange. And as each person better his own circumstances he improves the lives of other people. Production, in a free society, begets production, with more for everyone.

In the pre-capitalistic ages the kings and nobles used their political power to enrich themselves at the expense of the peasants. The serfs who did most of the work were entitled to enjoy only a portion of the goods they produced. Post-capitalistic societies operate in similar fashion. Those who possess political power in welfarist America or socialist Britain or Soviet Russia, exercise the taxing power to deprive productive people of a huge chunk of their earnings. These tax dollars—minus the political costs of effecting these transfers—are then doled out to various “deserving” pressure groups in the private sector.

We witness what Frederic Bastiat might have called a Plunderbund—the law designed to protect life, liberty, and property perverted into an instrument to enrich some by impoverishing others. Albert Jay Nock referred to the law thus perverted as The State—holders of public office in cahoots with factions in the private sector to operate a scam against productive people.

**O**ur basic political structures were largely built around the conviction that, “to the producer belongs the fruits of his toil.” We were to have a private property order. The Declaration does not mention a right to property, substituting a right to “the pursuit of happiness.” We cannot read Jefferson’s mind as he wrote the document, but we do know what was in almost everyone else’s mind at the time; it was Life, Liberty, and *Property*.

The colonists had migrated out of situations in Europe where they lived on the estate of a master, working mostly for his benefit and only partly for their own. Here in the colonies the idea of freehold property was established. You owned your farm in fee simple, which

means that your estate was your very own. You could will it to your descendants, sell it, dispose of it as you wished.

What you produced on your property was yours to keep, or sell, or give away. Now, you owned what your labor created, and you had an enormous incentive to devise labor-saving devices and work harder, longer, and more skillfully because everything you produced was yours. *You* got the added benefit; not some absentee landlord. Wealth creation increased by geometrical progression under these circumstances, with free men and women living under a just system of laws, holding a strict property right in the fruits of their labor.

The American colonists of the 17th and 18th centuries lived in a society whose primary institution was not government, or the press, or business, or the academy; it was the Church. As Alexis de Tocqueville observed of us in the 1830s: "Religion . . . is the first of their political institutions." And it was the colonial churches which labored for the creation of the kind of personal character in men and women which a free society, with its market economy, demands as its basic ingredient.

We are reminded of this need for exemplary character by the late, great economist Wilhelm Roepke who said that the market economy cannot ". . . go on in a moral vacuum . . . . Self-discipline, a sense of justice, honesty, fairness, chivalry, moderation, public spirit, respect for human dignity, firm ethical norms—all of these are things which people must possess before they go to market and compete with each other." And as these early Americans entered the marketplace they practiced the Puritan ethic of work and thrift, believing that thus they served God as co-creators of a new nation, and proved that poverty is not mankind's fate.

## The Wealth of the West

**T**he Western World is relatively wealthy because it is relatively capitalistic. The Third World is poor because it shuns capitalism. This is the truth of the matter, obvious to any person who examines the issues impartially. But this truth is overcome by a worldwide ideology which declares that the wealth of the West is the cause of Third World poverty!

President Julius Nyerere of Tanzania voiced this Third World ideology when he wrote: "In one world, as in one state, when I am rich because you are poor, or I am poor because you are rich, the transfer of wealth from the rich to the poor is a matter of right; it is not an appropriate matter for charity." Along the same line, Third World voices tell us that the United States is to blame for the famine in Ethiopia—a country which *exported* its surplus grain and other foodstuffs until the Communists took over.

Third World politicians have a method in their madness: they want things from the West—American dollars, foodstuffs, machinery, and other goods—so they try to convince us that we owe it to them because we are to blame for their plight. This is the Marxist notion that the rich, under capitalism, get richer by making the poor poorer. This ploy would not work except that millions of Americans have also swallowed the Marxist exploitation theory; that those who are better off got that way by making others worse off; that the wealth created by capitalism is the cause of poverty.

Here, for example, are the words from a keynote address given at

the World Council of Churches Assembly held in Vancouver two years ago: "We inhabitants of the industrial nations . . . exploit the majority of the world's population . . . . The demon of profit for the few at the expense of the many, i.e., their impoverishment, has the whole world economic system firmly in its grip." These false and defamatory sentiments are echoed by many academic and ecclesiastical voices, here and abroad.

Americans do consume more than most people elsewhere and it might be interesting to find out why. The answer is simple, to the point of being self-evident: Americans consume more because Americans produce more. Americans produce more, not because we are superior beings, but because our relatively free institutions impose fewer restraints on our productive energies than is the case in other nations, and our private property system guarantees to the producer that he will own the fruits of his toil. Any nation that adopts the free market will be more productive, and thus more prosperous, and in the long run this is the only way to feed the world's hungry.

**T**he redistributionist policies of our own welfare state, as well as similar international policies which tax Americans in order to subsidize other nations, is based on the false axiom that the wealth of some is the cause of the poverty of others. Something like this *was* true during the pre-capitalistic ages, but capitalism introduced an entirely new ball game in which each one of us prospers to the degree that he contributes to the well-being of other people, as they see it. Walter Lippmann puts it this way: "For the first time in human history men had come upon a way of producing wealth in which the good fortune of others multiplied their own." Freedom in production and exchange does not promise perfection. When people are free, many of their choices may offend us, which means that the free society demands infinite tolerance for each other's foibles. But that's a small price to pay for all the benefits received.

To believe that wealth is the cause of poverty makes as much sense as to assume that health is the cause of disease. And to contend that the remedy for poverty is to soak the rich and give to the poor is as idiotic as believing that the only way to heal the sick is to make the healthy ill. The sick can be made well only as they adopt the sensible regimen of the healthy, and the poor can move out of poverty only as they become more productive. The world's economic problems and other ills will only worsen unless there is a revival of that sound philosophy, which, two centuries ago, gave us the free society and the market economy which I've been labeling capitalism. Education along these lines—replacing bad ideas with better ones—is slow, frustrating, uphill work. But there is no other way.

Meanwhile, we try to live with—while working to correct—the false assumption of people everywhere, that wealth is the cause of poverty. The truth of the matter is that poverty in a nation is caused by the low productivity in that nation. And it is our good fortune that there is a simple recipe for overcoming low productivity while moving in the direction of prosperity. The recipe is: follow the prescriptions of people like Jefferson and Madison; Adam Smith, and Bastiat; Mises, Hayek, Roepke, Friedman, and others. The remedy is simple, but simple is not necessarily easy! □

## A False Axiom

# The Constraints on Helping

**There are laws that explain why social programs not only *do not* but *cannot* produce the intended effects.**

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by Charles Murray

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Charles Murray is a senior research fellow at the Manhattan Institute for Policy Research and the author of several books including *Losing Ground: American Social Policy 1950-1980* (© 1984 by Charles Murray) from which this essay is adapted and reprinted with permission of Basic Books, Inc.

**L**et me pose a problem in the form that Einstein used to call a “thought experiment.” Whereas Einstein used the device to imagine such things as the view from the head of a column of light, we will use it for the more pedestrian purpose of imagining the view from the office of a middle-echelon bureaucrat. Our task: to think through how to structure a specific government social-action program so that it might reasonably be expected to accomplish net good.

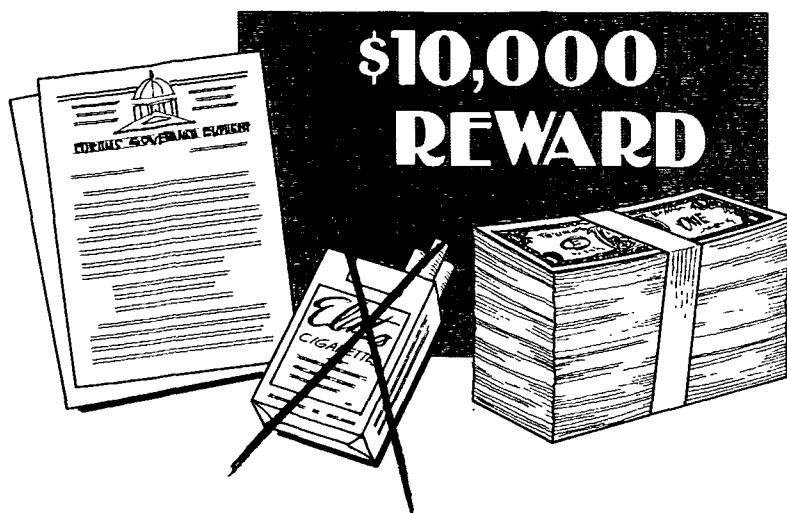
The experiment calls for us to put ourselves in the role of a government planner who must implement a new piece of legislation, The Comprehensive Anti-Smoking Act. The Act has several provisions common to the genre. It establishes a federal agency to coordinate the federal government’s activities related to the goal of less smoking. A large anti-smoking advertising campaign is planned. Federal matching funds are provided for school systems that teach courses on the perils of smoking.

In addition to these initiatives, the legislation provides for direct, concrete incentives for people to quit smoking. A billion dollars will be appropriated annually for the indefinite future, to be used for cash rewards to persons who quit. We are in charge of designing this effort, with complete freedom to specify whatever rules we wish, provided they are consistent with constitutional rights. After five years an evaluation will be conducted to determine whether the number of cigarettes consumed and the number of smokers have been reduced by the program.

The challenge in this experiment is to use the \$1 billion in a way that (in our own best estimate) will meet this test. **My proposition is that we cannot do so: that any program we design will either (1) have no effect on smoking or (2) actually *increase* smoking. I maintain that we are helpless to use the billion dollars to achieve our goal.**

The heart of the problem is designing a reward that will induce smokers to quit—and will not induce others to begin smoking, continue smoking, or increase their smoking to become eligible to receive the reward. Let us work through one scenario to illustrate the nature of the conundrum.





Three sets of choices will decisively affect the success or failure of the program: choices about

- the size of the reward,
- conditions for receiving the reward, and
- eligibility to participate in the program.

What is a first approximation of a program that has a good chance of working?

*Choosing the size of the reward.* We know from the outset that the reward cannot be small. No one will quit smoking for pocket change, other than those who were going to quit anyway. On the other hand, the theoretical power of a cash reward is plausible—almost anyone would become and remain a nonsmoker in return for a million dollars. We settle on the sum of \$10,000 as a reward that is an extremely powerful inducement to large numbers of persons.

*Conditions for receiving the reward.* We seek a middle ground between conditions that maximize the likelihood that a person has permanently quit smoking and conditions that make the reward so difficult to win that few will bother. Thus, for example, we reject plans that would spread the reward over several years. Eventually we decide to require that a person must remain smoke-free for one year. We make the award a one-time prize, so that people have no incentive to recommence smoking to qualify for another \$10,000. A repayment scheme is added: People who begin smoking again will have to give up their award.

*Eligibility to participate.* The intent of the program is to appeal to the heavy smoker whose health is most at risk. On the other hand, it would defeat our purpose to limit eligibility too severely—to persons, for example, who have smoked three packs a day for twenty years—because in so doing we would disqualify many people in the vulnerable group of moderate smokers who are likely to become heavy lifelong smokers unless something is done. The compromise solution we reach is to require that a person have smoked at least one pack a day for five years.

Now let us consider the results.

## Designing the Program

**After one year:** We think ahead a year, and are pleased. The \$10,000 reward has substantial effects on the people who are eligible for the program on day one—that is, persons who have smoked at least a pack a day for five years at the time the experiment begins. The effect is not unfailing; not everyone quits smoking to get the reward; and we must assume that not everyone who stops for a year is able to avoid a relapse. Some cheating occurs despite our precautions. But some people quit smoking permanently as a direct result of the program.

We recognize, of course, that we achieve the effect inefficiently. Thousands of persons in the target population quit smoking every year even in the absence of a monetary reward. Under the program, they collect money for doing what they would have done anyway. But the problem posed in our thought experiment says nothing about being efficient; the problem is only to create a program that reduces net smoking.

**After two years:** We think ahead two years, and are disturbed. For now comes time to examine the effects of the program on people who have been smoking a pack a day but for a period of less than five years when the program begins.

We find that for all persons who have been smoking less than the required period of time, the program provides a payment to continue. For the person who has been smoking for exactly four years, the payment is \$10,000 in return for smoking for one more year. Given that the smoking habit has its own attractions, the payment is exceedingly effective. In fact, we notice an unfortunate imbalance: For the person who has already smoked for five years (our target population), the inducement of \$10,000 to quit must fight against the attractions of smoking and is not always adequate to achieve the desired result. For the smoker who has not reached this limit, the inducement to continue smoking is reinforced by those very attractions. Thus the effective power of \$10,000 to induce continued smoking for one year in the one population is much greater than its power to induce cessation of smoking for one year in the other.

To this point, we have been concerned only with those who were already smoking at the pack-a-day level. Now we consider the effects of the program on smokers who had been smoking less than that amount. We find that a significant number of smokers increase their consumption to a pack a day, for the same reason. (Everyone who smokes nineteen cigarettes a day increases to twenty, almost everyone who smokes eighteen cigarettes a day increases to twenty, and so on.) This effect is strongest among those persons who think they “should” quit but who doubt their ability to quit without help. For them—through a process of plausible but destructive logic—it seems that the best way to do what they think they want to do (to quit smoking) is to smoke more.

Among those who are nonsmokers, the effects are entirely negative. A considerable number of teenagers who were wavering between starting or not starting to smoke decide in favor of smoking—they can enjoy smoking now, and then give it up when they qualify for the reward.

**After five years:** When we think ahead five years, we note a final logical by-product of the program. Quitting the habit after five years of smoking a pack a day is generally more difficult than quitting sooner

and after lesser levels of smoking. Many people who try to stop when the fifth year is ended find that the \$10,000 is no longer a sufficient inducement, though it may have seemed to them a few years earlier that it would be. The rules of the program have made heavy smokers out of people who would have remained light smokers and thereby have induced a certain number of people not only to smoke more and longer until they became eligible for the \$10,000 but to become impervious to the effects of the reward once they do become eligible.

What is the net outcome? If 90 percent of the population had been smoking for five years when the program began, we might still argue that the program would show a net reduction in smoking. But only about 15 percent of the adult population smokes a pack a day or more. Let us estimate that a third of this number have been smoking at that rate for more than five years. If so, our plan has the potential for reducing smoking among five percent of the adult population and the potential for increasing smoking among 95 percent of the adult population. It is exceedingly difficult to attach numbers to the considerations we have just reviewed without coming to the conclusion that the program as specified would have the net effect of increasing both the number of cigarettes consumed and the number of smokers.

**W**hen we reconsider the three parameters and try to select a combination that meets the challenge, the nature of their interdependence becomes clear. Suppose, for example, that we require a smoking history of at least ten years, and thereby, as intended, reduce the number of persons who are drawn into smoking just because of the reward. But such a step makes no difference in the calculations of those who have already been smoking more than five years (they are, in effect, operating under the logic of a five-year eligibility rule). Among those who have smoked less than five years, the change in the eligibility requirement has two counterproductive effects. First, persons who have smoked less than five years constitute a large proportion of smokers that the program should be reaching—younger, with more to gain from quitting. By extending the requirement to ten years, the program has been made irrelevant to many of them. For those who do think that far ahead, the effects will tend to be harmful, inducing a sense that there will be time to quit—and profit to be made—at a later point in their lives. Thus lengthening the eligibility period to ten years does not help; it makes matters worse.

As we ponder ways out of this bind, it becomes clear that the most dramatic reductions in smoking occur among persons who quit the soonest—a person who quits smoking at age sixty-five saves only a few years' worth of smoking, whereas a person who quits at twenty saves decades. Why not focus our efforts among the very young? Even granting the tendency of the award to encourage smoking so as to qualify, perhaps this will be more than counterbalanced by the very long periods of "savings" that will result from each success. So we target the program at youth (perhaps by installing an age-eligibility criterion—the specific method makes no difference). But the results are even more disastrous. The qualification criteria must be loose, because only a tiny fraction of the teenaged smokers we want to reach have had time to smoke very long. The result, when combined with

## Back to Square One

***“The burden of the smoking example is not that we failed to reduce smoking—to achieve the desired behavioral change—but that we increased the number of people who end up in the undesired condition. This charge applies to transfers in general.”***

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a significant reward for quitting, is that the inducement effect is overpowering. Even teenagers who have no desire to smoke at all find it worth inculcating the habit for a year (or whatever our time limit is reduced to). Once started, only a proportion of those who smoked *only* because the program existed and who fully intended to quit are actually able to quit. The age effect backfires: While it is true that inducing a youngster to quit (who otherwise would not have quit) saves decades of smoking, it is equally true that inducing a youngster to start costs decades of smoking, and we produce far more of the latter than the former.

## Two Ways Out

**W**e give up on a continuing program. Instead, we propose that the program be made a one-time, never-to-be-repeated offer: Announce the program, give everyone who is *already* eligible a chance to enroll, but give no one a reason to start smoking or to increase their smoking in order to become eligible. State loudly and unequivocally that the program will never be repeated. We will at least achieve the success of the first year.

Theoretically, this scheme might (but only might) reduce net smoking. In practice, it is guaranteed that the program will be continued. A successful one-time effort will be refunded immediately and on a larger scale. Congress rarely cancels even a failed social program, let alone a successful one.

Ultimately, the logic of the situation drives us to the one configuration of awards that surely will reduce net smoking: we offer a dollar amount to everyone who does not smoke, but make them pay it back if they ever start. Since this will cost far more than a billion dollars a year, we seek permission to increase the budget, pointing out that, while it may be expensive, our way out will in fact reduce smoking, whereas the alternatives will not. But some unfriendly critic points out that all we need do is levy a fine on everyone who begins smoking (or who continues to smoke) that is equal to the reward we propose to offer for not starting. The effects on smoking will be essentially the same (a \$10,000 penalty ought to have about as much effect as a \$10,000 reward for persons at most income levels), and the government will get a lot of revenue to boot. This proposal is of course also rejected, on grounds that it is unfair to the poor.

As one experiments with different combinations of rules, it becomes apparent that the traps we encounter in the first approximations are generalizable. Any change in the parameters intended to reduce one

problem raises a new one. Why should this be? Is it intrinsic to the process? Or is it a peculiarity of an example I carefully chose?

**A**t first glance, the smoking example seems most apt for a certain type of social program, the one that seeks to change behavior from X to Y—what might be called “remedial” social programs. But in fact it applies to transfer programs of all types. In all cases, the transfer is legitimized by the recipient’s being in a certain condition (whether smoking or poverty) that the government would prefer the recipient not be in. The burden of the smoking example is not that we failed to reduce smoking—to achieve the desired behavioral change—but that we increased the number of people who end up in the undesired condition. This charge applies to transfers in general.

The reasons why are not idiosyncratic. Let me suggest some characteristics we observed in the thought experiment that occur so widely and for such embedded reasons that they suggest laws. That is, no matter how ingenious the design of a social transfer program may be, we cannot—in a free society—design programs that escape their influence. Together, they account for much of the impasse we observe in the anti-smoking example and point to some important principles for designing social programs that work.

- **#1. The Law of Imperfect Selection.** Any objective rule that defines eligibility for a social transfer program will irrationally exclude some persons.

It can always be demonstrated that some persons who are excluded from the Food Stamps program are in “greater need” than some persons who receive Food Stamps. It can always be demonstrated that someone who is technically ineligible for Medicaid really “ought” to be receiving it, given the intent of the legislation.

These inequities, which are observed everywhere, are not the fault of inept writers of eligibility rules, but an inescapable outcome of the task of rule-writing. Eligibility rules must convert the concept of “true need” into objectified elements. The rules constructed from these bits and pieces are necessarily subject to what Herbert Costner has called “epistemic error”—the inevitable gap between quantified measures and the concept they are intended to capture. We have no way of defining “truly needy” precisely—not those who truly need to stop smoking, nor those truly in need of college scholarships or subsidized loans or disability insurance. Any criterion we specify will inevitably include a range of people, some of whom are unequivocally the people we intended to help, others of whom are less so, and still others of whom meet the letter of the eligibility requirement but are much less needy than some persons who do not.

Social welfare policy in earlier times tended to deal with this problem by erring in the direction of exclusion—better to deny help to some truly needy persons than to let a few slackers slip through. Such attitudes depended, however, on the assumption that the greater good was being served. Moral precepts had to be upheld. Whenever a person was inappropriately given help, it was bad for the recipient (undermining his character) and a bad example to the community at large.

**Laws of Social Programs:  
We cannot design programs that escape their influence.**

When that assumption is weakened or dispensed with altogether, it follows naturally that the Law of Imperfect Selection leads to programs with constantly broadening target populations. If persons are not to blame for their plight, no real harm is done by giving them help they do not fully "need." No moral cost is incurred by permitting some undeserving into the program. A moral cost *is* incurred by excluding a deserving person. No one has a scalpel sharp enough to excise only the undeserving. Therefore it is not just a matter of political expedience to add a new layer to the eligible population rather than to subtract one (though that is often a factor in the actual decision-making process). It is also the morally correct thing to do, given the premises of the argument.

• **#2. The Law of Unintended Rewards.** Any social transfer increases the net value of being in the condition that prompted the transfer.

A deficiency is observed—too little money, too little food, too little academic achievement—and a social transfer program tries to fill the gap—with a welfare payment, Food Stamps, a compensatory education program. An unwanted behavior is observed—drug addiction, crime, unemployability—and the program tries to change that behavior to some other, better behavior—through a drug rehabilitation program, psychotherapy, vocational training. In each case, the program, however unintentionally, *must* be constructed in such a way that it increases the net value of being in the condition that it seeks to change—either by increasing the rewards or by reducing the penalties.

For some people in some circumstances, it is absurd to think in terms of "net value," because they so clearly have no choice at all about the fix they are in or because the net value is still less desirable than virtually any alternative. Paraplegics receiving Medicaid cannot easily be seen as "rewarded" for becoming paraplegics by the existence of free medical care. Poor children in Head Start cannot be seen as rewarded for being poor. Persons who are in the unwanted condition *completely involuntarily* are not affected by the existence of the reward.

But the number of such pure examples is very small. The paraplegic anchors one end of the continuum labeled "Degree of Voluntarism in the Conditions that Social Policy Seeks to Change or Make Less Painful." The apparent unattractiveness of most of the conditions that social policy seeks to change must not obscure the continuum involved. No one chooses to be a paraplegic, and perhaps no one chooses to be a heroin addict. But the distinction remains: very few heroin addicts developed their addiction by being tied down and forcibly injected with heroin. They may not have chosen to become addicts, but they *did* choose initially to take heroin.

Let us consider the implications in terms of the archetypical social program for helping the chronic unemployed escape their condition, the job-training program.

Imagine that a program is begun that has the most basic and benign inducement of all, the chance to learn a marketable skill. It is open to everybody. By opening it to all, we have circumvented (for the time being) the Law of Unintended Rewards. All may obtain the training, no matter what their job history, so no unintended reward is being given for the condition of chronic unemployment.

On assessing the results, we observe that the ones who enter the program, stick with it, and learn a skill include very few of the hardcore unemployed whom we most wanted to help. The typical "success" stories from our training program are persons with a history of steady employment who wanted to upgrade their earning power. This is admirable. But what about the hardcore unemployed? A considerable number entered the program, but almost all of them dropped out or failed to get jobs once they left. Only a small proportion used the training opportunity as we had hoped. The problem of the hardcore unemployed remains essentially unchanged.

We may continue to circumvent the Law of Unintended Rewards. All we need do is continue the job-training program unchanged. It will still be there, still available to all who want to enroll, but we will do nothing to entice participation.

The alternative is to do something to get more of the hardcore unemployed into the program, and to improve the content so that more of them profit from the training. And once this alternative is taken, the program planner is caught in the trap of unintended rewards. Because we cannot "draft" people into the program or otherwise coerce their participation, our only alternative is to make it more attractive by changing the rules a bit.

Suppose, for example, we find that the reason many did not profit from the earlier program was that they got fired from (or quit) their new jobs within a few days of getting them, and that the reason they did so had to do with the job-readiness problem. The ex-trainee was late getting to work, the boss complained, the ex-trainee reacted angrily and was fired. We observe this to be a common pattern. We know the problem is not that the ex-trainee is lazy or unmotivated, but that he has never been socialized into the discipline of the workplace. He needs more time, more help, more patience than other workers until he develops the needed work habits. Suppose that we try to compensate—for example, by placing our trainees with employers who are being subsidized to hire such persons. The employer accepts lower productivity and other problems in return for a payment to do so (such plans have been tried frequently, with mixed results). Given identical work at identical pay, the ex-trainee is being rewarded for his "credential" of hardcore unemployment. He can get away with behavior that an ordinary worker cannot get away with.

**M**ay we still assume that the program is making progress in preparing its trainees for the real-world marketplace? Will the hardcore unemployed modify their unreliable behavior? What will be the effect on morale and self-esteem among those trainees who were succeeding in the program before the change of rules? It is tempting to conclude that the program has already ceased to function effectively for anyone anymore, that the change in rules has done more harm than good. But my proposition is for the moment a more restricted one: The reward for unproductive behavior (both past and present) now exists.

What of the case of a drug addict who is chronically unemployed because (let us assume) of the addiction? It might seem that the unintended reward in such a case is innocuous; it consists of measures to relieve the addict of his addiction, measures for which the nonaddict

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***“Social programs in a democratic society tend to produce net harm in dealing with the most difficult problems. They will inherently tend to have enough of an inducement to produce bad behavior and not enough of a solution to stimulate good behavior.”***

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will have no need or use. If we were dealing with an involuntary disability—our paraplegic again—the argument would be valid. But in the case of drug addiction (or any other behavior that has its rewards), a painless cure generally increases the attractiveness of the behavior. Imagine, for example, a pill that instantly and painlessly relieved dependence on heroin, and the subsequent effects on heroin use.

Thus we are faced with the problem we observed in the thought experiment. The program that seeks to change behavior must offer an inducement that unavoidably either adds to the attraction of, or reduces the penalties of engaging in, the behavior in question.

We are now ready to tackle the question of when a social program can reasonably be expected to accomplish net good and when it can reasonably be expected to produce net harm. Again let us think in terms of a continuum. All social programs, I have argued, provide an unintended reward for being in the condition that the program is trying to change or make more tolerable. But some of these unintended rewards are so small that they are of little practical importance. Why then can we not simply bring a bit of care to the design of such programs, making sure that the unintended reward is *always* small? The reason we are not free to do so lies in the third law of social programs:

- **#3. The Law of Net Harm.** The less likely it is that the unwanted behavior will change voluntarily, the more likely it is that a program to induce change will cause net harm.

**A** social program that seeks to change behavior must do two things. It must induce participation by the persons who are to benefit, as described under the Law of Unintended Rewards. Then it must actually produce the desired change in behavior. It must succeed, and success depends crucially on one factor above all others: the price that the participant is willing to pay.

The more that the individual is willing to accept whatever needs to be done in order to achieve the desired state of affairs, the broader the discretion of the program designers. Thus, expensive health resorts can withhold food from their guests, hospitals can demand that their interns work inhuman schedules, and elite volunteer units in the armed forces can ask their trainees to take risks in training exercises that seem (to the rest of us) suicidal. Such programs need offer no inducement at all except the “thing in itself” that is the *raison d’être* of the program—a shapelier body, a career as a physician, membership in the elite military unit. Similarly, the drug addict who is prepared to sign over to a program a great deal of control over his own behavior may



very well be successful—witness the sometimes impressive success rates of private treatment clinics.

The smaller the price that the participant is willing to pay, the greater the constraints on program design. It makes no difference to an official running a training program for the hardcore unemployed that (for example) the Marine Corps can instill exemplary work habits in recruits who come to the Corps no more “job-ready” than the recruits to the job-training program. If the training program tried for one day to use the techniques that the Marine Corps uses, it would lose its participants. Boot camp was not part of the bargain the job trainees struck with the government when they signed on. Instead, the training program must not only induce persons to join the program (which may be fairly easy). It must also induce them to stay in the program, induce them to cooperate with its curriculum, and induce them, finally, to adopt major changes in outlook, habits, and assumptions. The program content must be almost entirely carrot.

There is nothing morally reprehensible in approaches that are constrained to use only positive inducements. The objections are practical.

First, it is guaranteed that success rates will be very low. The technology of changing human behavior depends heavily on the use of negative reinforcement in conjunction with positive reinforcement. The more deeply engrained the behavior to be changed and the more attractions it holds for the person whose behavior is involved, the more important it is that the program have both a full tool kit available to it *and* the participant’s willingness to go along with whatever is required. The Marine Corps has both these assets. Social programs to deal with the hardcore unemployed, teenaged mothers, delinquents, and addicts seldom do.

Second, as inducements become large—as they must, if the program is dealing with the most intractable problems—the more attractive they become to people who were not in need of help in the first place. We do not yet know how large they must finally become. At this point, it appears that any program that would succeed in helping large numbers of the hardcore unemployed will make hardcore unemployment a highly desirable state to be in.

**T**he conditions that combine to produce net harm are somewhat different in the theoretical and the practical cases, but they come to the same thing. Theoretically, any program that mounts an intervention with sufficient rewards to sustain participation and an effective result will generate so much of the unwanted behavior (in order to become eligible for the program’s rewards) that the net effect will be to increase the incidence of the unwanted behavior. In practice, the programs that deal with the most intractable behavior problems have included a package of rewards large enough to induce participation, but not large enough to produce the desired result.

My conclusion is that social programs in a democratic society tend to produce net harm in dealing with the most difficult problems. They will inherently tend to have enough of an inducement to produce bad behavior and not enough of a solution to stimulate good behavior; and the more difficult the problem, the more likely it is that this relationship will prevail. □

## The Theoretical and Practical Result

# Consumers, Not Special Interests

**Consumers are harmed by all forms of special interest legislation. Three are examined here.**

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by Dean Russell

Dr. Russell teaches economics, and is the author of *Government and Legal Plunder*, published by FEE.

**W**e human beings have always organized ourselves into groups to increase our ability to get the goods and services necessary for survival. Even our most primitive ancestors eventually learned that production (and thus survival) could be increased by organizing and specializing.

When we use this organization for peaceful production, it usually proves successful. But when we organize to increase our possession of products by plundering our neighbors, the ultimate consequences are usually more costly than profitable.

Both of these methods for increasing our supply of products and services are still used in the United States today. When the method of voluntary exchange of goods and services is used, the results are successful indeed; production skyrockets and prosperity is widespread. But special interest groups inevitably organize to increase their share by voting for laws that compel us to pay for products and services we don't want at their "special privilege" prices.

When special interest legislation is used, when voluntary exchange is interfered with, all of us consumers are directly and indirectly harmed. Ultimately, even the special interest groups find the consequences of this approach to be more costly than profitable.

I'm here selecting three of the most familiar and harmful of these special interest laws for brief examination. They are price supports for farmers, legally imposed wage increases for employees, and rent controls for tenants.

Price supports injure us consumers by keeping inefficient producers in business, or they encourage producers to take uneconomic actions that eventually increase costs, or they directly and immediately increase the price of the supported product, or (most likely) they increase the cost to us consumers by a combination of all three categories.

Further, as is now becoming increasingly obvious, even the recipients of the price supports (the producers) are also injured—frequently to a much greater degree than are we general consumers of their products. For example, so many farmers have been literally forced into

bankruptcy by the government's "support programs" that were supposed to help them by keeping prices higher than they would be in a market economy.

Beguiled by our government's promise to pay for unwanted production, farmers bought (or held on to) land at double and treble the price it would be in a free market; and they increased production accordingly. That, of course, only worsened a situation that had been caused in the first place by more production than we consumers would buy at prices needed to keep all those farmers in business.

In an effort to decrease the unwanted production, our government began paying farmers to keep a part of their land idle. Our government then began buying and storing vast quantities of the excess production at a cost of billions of dollars to us consumers (taxpayers). But "political considerations" forced the officials to dispose of the surplus products by giving them away to low-income groups and by selling them below cost in the world agricultural market. Both of those giveaway programs reduced the number of paying customers. That, in turn, put further pressure on the farmers to reduce prices in order to sell the products that were not bought by government but had to be sold to us consumers directly.

Eventually, of course, the economic reality of consumer demand and producer supply re-established itself in our still reasonably free economy. And the recipients of the price supports (the farmers) ended up the most injured of all. Their liabilities in debts were soon much higher than their assets in overpriced land and unreliable political promises for special treatment. They were bankrupt.

Farmers seem strangely unaware that they, too, are consumers. And as consumers, they just can't pay the artificially inflated prices for products they themselves have to buy to stay in business. When they voted for "special privilege laws for farmers," they simply ignored the connection between their price supports and the rising prices for all products and services. The consequences of governmental interventions in the market place can't be restricted to just one item or category; there's a "neighborhood effect" that inevitably affects all prices to the detriment of all consumers.

**S**imilar economic consequences also come from labor laws that interfere with the market allocation and price of that particular factor of production. Those laws usually increase the cost of labor above the market price, or decrease the productivity of labor, or both. In turn, those uneconomic political decisions cause an increase in prices to all consumers of the products and services.

Once again, the recipients of those "special interest" labor laws frequently end up as the most injured of all. They price themselves out of the market, especially the world market. Their employers move or go bankrupt. The employees then turn to their government for welfare support. And thus their economic misfortunes are compounded by loss of personal pride that usually comes from lengthy unemployment, plus the inevitable decrease in respect by many of their neighbors. That, of course, is the most destructive consequence of all.

When I buy a product, my invariable policy is to look behind the label, and to search for the best quality and lowest price. I'm not unduly interested in who produces it, or where. In fact, if it comes

## **Labor Laws Decrease Productivity**



The effect of rent controls, The Bronx.

P. KARAS, FPG INTERNATIONAL

from abroad at a lower price, I know that products in general are thereby *increased* for us consumers; we get the wanted product, plus the additional products we buy with the "leftover" money.

As a third example of the harm done by these governmental interferences in a market economy, consider housing. Rent controls do great injury to us consumers in general but, more likely than not, they are especially damaging to persons who live in the price-controlled apartments.

The first and immediate effect of rent controls on housing is to stop the building of new houses and apartments for rent. That's why there hasn't been a single house or apartment building constructed by private investors at rent-controlled prices in New York City since those laws were imposed "temporarily" in 1942. The reason is simple: You and I, as reasonably prudent investors, will not voluntarily agree to build products that are obviously price-limited below the market in a situation that's controlled by politicians. Those elected officials are well aware that "more tenants vote than landlords." That fact also explains why those "temporary laws" are likely to remain with us until all the buildings controlled by them finally disappear—either literally or by conversion to more profitable categories.

In an attempt to increase housing in New York, Governor Thomas Dewey sponsored a law in 1954 to permit the owners of *new* apartments to charge market prices. While that did induce new construction of apartments for rent, the continuing rent controls on all pre-war apartments contributed greatly to the near-destruction of a once-great city. Here's a personal story to show how it works.

When I first visited New York in 1937, the first bed I slept in was a sofa in the apartment of a friend living in the South Bronx. That area was a friendly and well-tended neighborhood with thousands of apartments, rented mostly to families with moderate incomes. I visited

there again in 1948, after six years of rent controls. It was still a desirable neighborhood, but the deteriorating process had begun.

An inevitable companion of rent control is the decay of the buildings. The owners of those buildings act precisely as you and I always act with our own investments. We look for safety and a good return. And just as you and I would have done, the owners of those rent-controlled properties began to skimp on upkeep and to transfer back into a market economy whatever capital they could recover from gross income.

When that process became obvious, the tenants organized to keep the rents low and legally to compel the owners to paint and repair the buildings and to provide adequate heat during the winter. But turning to the law to force investors to spend their money uneconomically never works. Since you and I don't act that way, why do we expect the owners of rental buildings to act against their own self-interests?

In due course, the more desirable tenants began to move out of those deteriorating rent-controlled buildings in the South Bronx. Their places were increasingly taken by unemployed people existing on government welfare. That development soon induced almost all of the original tenants to move out.

Rent control laws help nobody, perhaps least of all the tenants trapped by them. Even high-income tenants frequently remain in their present locations and thus forgo more desirable jobs because of the higher rents they would have to pay if they accepted the offer of a better job and moved to another city. Anyway, rent-controlled tenants in general are increasingly being dispossessed by the owners who convert their uneconomic rental buildings into cooperatives and condominiums in an effort to get a market return on their investments.

When we turn to government to stop the voluntary exchanging of goods and services that goes on among peaceful persons in a free market economy, the process does injury to all consumers, i.e., everybody, and often literally destroys the people who receive the government's help. □

## **In Future Issues . . .**

### **March**

- "The Open-Endedness of Knowledge—Its Role in the FEE Formula" by Israel M. Kirzner
- "Productivity vs. Exploitation" by Henry Hazlitt
- "Who Will Control Medical Care?" by Jane M. Orient

### **April**

- "Cyclical Unemployment" by Hans Sennholz
- "Disasters Unlimited" by John W. Sommer

# Free Trade and Prosperity: A Global Approach

**International development and domestic prosperity are ensured by free trade.**

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**by Steven E. Daskal**

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Mr. Daskal of Annandale, Virginia, is a defense systems analyst and writer.

Americans are especially prone to feel obligated to help others on a global scale. Whether it is the unfortunate plight of our fellows in the under-developed nations, often known as the "Third World," or the difficulties and unemployment facing some Americans at home, we care. Within that context, free trade is a vital issue, because it is one of the primary means by which the market economy helps create global prosperity.

When surveying the world economic situation, some Americans feel guilt over our comparative wealth and comfort in contrast to the millions living at the subsistence level. Our size, power, and wealth appear to some as being of little value unless we use that wealth to help the less fortunate. We send food, money, training advisors, educators, and missionaries around the world in a sincere effort to help others. These efforts have been undertaken by individuals, religious and social organizations, charitable associations, and the government. As believers in voluntarism and limited government, it is inappropriate for us to criticize how individuals freely spend their money. However, when the government coerces us through taxation to send aid overseas, we often have cause to object to the way our involuntary contribution is being spent on activities that appear unnecessary, wasteful, or even counterproductive.

Sometimes efforts to feed the starving prove well-intentioned, but sadly ineffectual. Even if the entire U.S. budget were directly distributed to the poorer half of the world's population, it would amount to less than \$1,000 per person, certainly not enough to cure global poverty. Of course, with both our own bureaucracy and that of the recipient nation serving as intermediaries, a lot of that \$1,000 would never reach the poor, but would instead support a small army of administrators, investigators, analysts, and auditors in both countries. If the recipient country's government were less than scrupulously honest, as is all too often the case, the poor would wind up with a couple of cups of milk and grain, while the U.S. government would be bank-

rupt. After decades of receiving such aid, the recipient country would still be poor, and in fact there would be more poor people to feed in the future. One would hope that a better way to help these people would have been discovered by now.

**W**hile we continue to be concerned about the poor overseas, we also feel an obligation to ensure maximum employment of our own citizens. Unemployment is generally recognized as a significant problem, for both personal and social reasons. Given current law, the financial drain the unemployed place upon society through the wide range of "compensation" and support programs is also of growing concern. While in most cases, the value of the welfare benefits an individual can receive is less than working wages, welfare pays well enough to support many people for extended periods of time. As government regulations and compensation plans directly and indirectly increase the cost of labor, and commensurately decrease the average worker's net pay, more and more businesses find it less profitable and more difficult to hire workers. Thus, unemployment, like global poverty, seems unlikely to disappear, despite the growing expenditures attempting to combat it. The more the government spends and regulates, the fewer people can be hired by private enterprise.

A popular scapegoat for unemployment in the United States (and in many other "industrialized" nations) is the "trade deficit." Many people, especially manufacturers and unionized workers, see imported vehicles, electronics, machine tools, and textiles flooding our markets and "taking away" sales from American manufacturers. These lost sales translate, they contend, into reduced production requirements, and ultimately lost American jobs. The fact that imported goods create sales, financing, service, and other related employment is generally ignored, because domestic industrial workers and manufacturers are far better organized, have more political clout, and are much more vocal. The result is a periodic frenzy of proposals to "protect American jobs and industry" through tariffs and quotas intended to limit or eliminate imports. As natural and unavoidable consequences of such moves:

- the cost of a given item to the American consumer rises due to the higher cost of producing the American product and the loss of competitive pressure on prices;
- consumers have less choice and fewer products available for purchase, reducing the incentive to increase earnings;
- the overall strength of the American economy falters as consumer spending drops in response to rising prices;
- Americans involved in buying and selling imported goods would be faced with significant losses and possibly unemployment;
- foreign manufacturers lose business, resulting in higher unemployment, lower tax revenues, and higher government spending in foreign countries;
- foreign individuals, corporations, and governments have fewer dollars to buy U.S. goods and services, or to pay off their heavy debt burdens; and
- growing economic problems in foreign nations often lead to

## Maximizing Employment

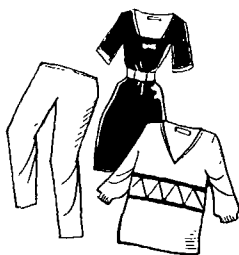
political instability and increased anti-Americanism, increasing requirements for non-productive defense spending both overseas and in the United States.

Protectionism, like any other form of government intervention in economic life, has a cost. Government tariffs and quotas transfer money to certain people who have invested in, manage, or work for, industries that aren't competitive on their own merits. This forced transfer guarantees these firms that they will have a greater market share than they would have had without protection from competition. Without facing the pressures of the free market, they can continue to produce more expensive, less desirable goods, knowing their market cannot be taken by foreign competitors. Thus, the consumers (which often include the people benefiting from the protection) pay for protection—they get less, and pay more.

## Protectionism Costs Consumers Billions

**H**ow much do we pay, as consumers, for protection of a few industries? Michael Munger, in "The Costs of Protectionism," estimates the total burden (in 1980 dollars) to be over \$58 billion, and it is probably even greater today. Nearly a third of that cost was in the textile and apparel market, a burden that fell most heavily on the poor, who tend to buy the least expensive clothing that doesn't look cheap. They tended to favor foreign-made goods because they looked good, and didn't cost as much as American-made items. This value differential existed despite the tariffs and quotas involved, but it was greatly reduced. While the more affluent could afford the higher prices or even switch to American products, the poor were faced with buying less.

### Apparel, Textiles



**\$18.3 Billion**

Six billion dollars worth of tariffs and other barriers were applied to agricultural products, another area where the poor pay the cost for protectionism. On the other hand, protecting the jobs of highly-paid auto, steel and machinery production workers (and their employers) accounted for \$26 billion in added protection costs. These costs affect all of us in a myriad of ways, because higher-priced transportation and manufacturing equipment raises the cost of all commodities to the consumer. Since these indirect costs are not included in the \$26 billion, the true cost of protectionism in this segment of the economy could in fact be far higher.

Despite the "chance to modernize and catch up" that protection was supposed to offer these industries, most of them have chronically cried for protection against imports for decades. Only the threat of protection being phased out forced automakers and some steel manufacturers to begin modernizing. Some still haven't, and are slowly crumbling despite protection. The loss of employment in various aspects of importing and exporting goods is another unknown cost.

Another common cause of pleas for protection is the accusation that foreign states are selling goods in the U.S. at a price lower than it costs the foreign manufacturer to produce it. This practice, known as "dumping," is more often a reflection of some economist's incorrect analysis of the cost of production of a given item, rather than an example of some competing nation's attempts to undermine our economy. True "dumping" results in the "dumper" losing money on every piece sold, while the recipient, an American consumer, has saved money

### Footwear



**\$ 3.5 Billion**



***“A global trade war would have disastrous consequences at home, and could create enormous security problems for us abroad. As reliant as we are upon free trade, the rest of the world is even more dependent on it . . .”***

that can be invested elsewhere. True “dumping” will ultimately bankrupt the “dumper.”

Even when Communist bloc nations with their controlled economies “dump” goods in the West to obtain hard currency, they are doing even more damage to their already inefficient, stifled economies. If they manage to temporarily “corner” a market, they will still have to provide equivalent goods at the same low prices, or face the re-entry of Western firms into competition with them. Despite the rock-bottom pricing structure subsidized by the various Eastern European governments, Russian “Ladas,” “Polski Fiats,” and Czech “Skodas” have not cornered the relatively open automobile market in Canada or Switzerland. Due to their greater economic efficiency, the Japanese and South Koreans provide far better cars for only a little more money. All “dumping” provided the Communists was a chance to subsidize the poorest segment of the Canadian auto market.

The French economist and legislator Frederic Bastiat recognized the fallacy of protectionism in the 1840s. He often resorted to satire to illustrate the absurdity of being preoccupied with maintaining a “favorable balance of trade.” One of these was so believable that many thought it was a good example of the benefits of protection!

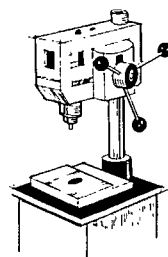
A French merchant shipped \$50,000 worth of goods to New Orleans and sold them for a profit of \$17,000. He invested the entire \$67,000 in American cotton and shipped it back to France. Thus, the customhouse record showed that the French nation had imported more than it had exported—an *unfavorable* balance of trade. Very bad.

At a later date, the merchant decided to repeat the personally profitable transaction. But just outside the harbor his ship was sunk in a storm. Thus, the customhouse record showed that the French nation had exported more products than it had imported—a *favorable* balance of trade. Very good. Additionally, more jobs were thereby created for shipbuilders.

Since storms at sea are undependable, perhaps the safest government policy would be to record the exports at the customhouse and then throw the goods into the ocean. In that way, the nation could guarantee to itself the profit that results from a favorable balance of trade.

That economic disaster results from trade restriction and protectionism is not just theoretical speculation, however. The events of the period between 1922 and World War II illustrate them very graphically. The mid-1920s was a period of generally increasing prosperity. How-

### Machinery



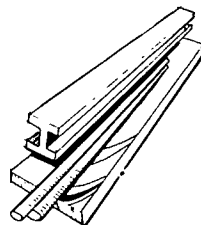
**\$10.9 Billion**

### Sugar



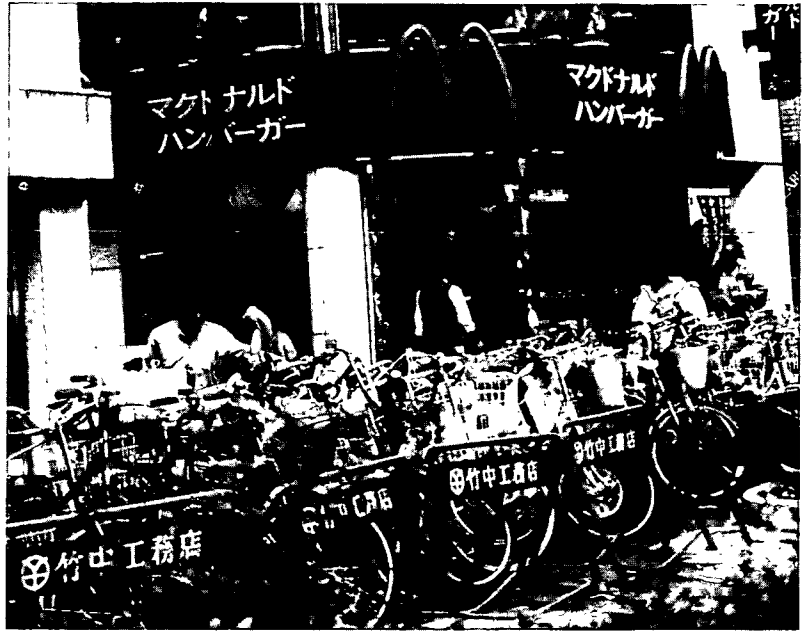
**\$ 2.7 Billion**

### Iron and Steel



**\$ 5.7 Billion**

Source: *The Costs of Protectionism*, Center for the Study of American Business, by Michael C. Munger, 1983.



Free trade promotes peaceful relations between nations.

BETTINA BIEN GREAVES

ever, then as now, the rapid changes in economic organization, management and technology had severe impact on a few outdated industries that relied heavily on manual labor, and hurt those farmers who were still using nineteenth-century techniques.

Jude Wanniski, a former member of the *Wall Street Journal's* editorial staff, wrote a book entitled *The Way the World Works*. He describes the manner in which the beleaguered "low-tech" manufacturers and farm lobbyists pushed through the infamous Smoot-Hawley tariff act. The idea of keeping out foreign competition sounded good to the news media, but it terrified the bankers and investors of Wall Street. When it appeared certain the bill would be passed, the stock market panicked. The result was the stock market crash of the autumn of 1929, followed by the Depression that was fueled by the general collapse of world trade. Consumers in America and the rest of the world were forced to buy inefficiently produced domestic goods, or pay extortionate prices for foreign ones. Foreign governments of course retaliated in kind, many having already begun economic warfare against the rest of the world. Markets for American goods dried up, investment collapsed, businesses failed, jobs disappeared.

Despite the popular belief that laws passed since 1929 could prevent another Great Depression, it *could* happen again. America is far more dependent upon imports and exports today than it was in the 1920s. A global trade war would have disastrous consequences at home, and could create enormous security problems for us abroad. As reliant as we are upon free trade, the rest of the world is even more dependent upon it, even though they may not recognize it. A collapse of world trade would hurt virtually all of our allies, and threaten the survival of many developing nations barely able to avoid default on their debts.

If one looks at things from a sufficiently broad perspective, one begins to see a major contradiction in our foreign policy. On the one hand, we want to help the poor overseas, and try to do so at great

expense, but with limited success. We spend great sums of money to help defend foreign nations from present and potential enemies. Yet, on the other hand, we are willing to threaten the economic and political stability of these same nations (and our own) by creating insurmountable walls against their ability to freely sell goods in the world's richest market—the United States. This is a significant and costly inconsistency.

We have sent aid money to strengthen the economies of countries such as Japan, Thailand, Israel, Italy, Turkey, South Korea, and West Germany (to name a few). If these nations are to develop strong economies, they will naturally try to export goods to the United States and other nations. Yet, our response is to consider tariffs to shut out their products—threatening the same economies we ostensibly wanted to develop. The consumer ultimately pays the bill for all of this. They pay taxes to support efforts aimed at creating productive enterprises overseas, and pay higher prices (and have less free choice) because of attempts to protect American businesses against competition from overseas. And, as the ultimate blow to the budget and good sense, we pay to defend the same nations that supposedly “threaten” American jobs and profits.

**A**mericans sincerely want to help people overseas. The question has become *how* to help them to the greatest extent while spending the least of our own hard-earned money. We also care about the health of our economy. Once again, the question is *how* to help preserve U.S. economic prosperity without disrupting international trade and causing ever-higher prices. The best method for accomplishing both goals is through free trade!

Why free trade? A basic economic reality—buying the best goods at the lowest prices—makes free trade more economical than closing our markets to foreign competitors. American consumers (all of us, including businesses and unionized labor) benefit by obtaining more goods for less money, while the foreign manufacturers and workers benefit by having jobs, making profits, and paying taxes to governments which then have a better chance to pay off their enormous debts. This, in turn, will make American banks more secure.

Free trade allows consumers around the world to buy more for less, which in turn creates more revenue for businesses. Governments have less call to provide tax-supported benefits to individuals or businesses, thus relieving the need to continue increasing taxes, inflation, or deficits. Ultimately, free trade will allow all but the poorest, least educated, and least diligent nations to get ahead. Examples of this are easy to find.

The most successful of the developing countries, states such as Singapore, the Republic of Korea, Republic of China (Taiwan), and Hong Kong, have built themselves up from illiteracy and poverty largely due to their respect for the power of free trade and relative economic freedom. Potentially wealthy developing nations, such as China, Brazil, Argentina, Nigeria, and Mexico, have stifled their own economic development through confused myriads of protective tariffs, import quotas, and centralized government manipulation of the economy.

Free trade also helps Americans and our trading partners overseas increase national security against both invasion and subversion. Open

## The Benefits of Free Trade

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***Free trade is a sound basis for relations between free nations. It is the best type of foreign aid. And it is good for American consumers.***

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trade tends to improve the economic health of all trading nations. These nations tend to be more stable internally, since strong economies generally result in reduced unemployment, greater availability and affordability of food, clothing, and other commodities, and relief from the sense of desperation felt by people barely able to survive—a desperation that often leads to disorder and revolution. These increasingly self-sufficient nations also are better able to defend themselves against invasion. Their industries are strong, their people are more confident, and they are able to obtain necessary imported supplies easily. Thus, nations dedicated to free trade tend to be more valuable as friends and allies, and less of a liability needing continuous costly support and military assistance.

If this sounds too easy, too good to be true, just reflect on the benefits we gained in our own country by the elimination of trade restrictions between the colonies/states after the adoption of the Constitution. Free trade allowed for better direction of local economic activity. New Englanders didn't have to struggle to be self-sufficient in agriculture on their rocky soil, while Southerners could freely purchase better, less costly tools and machinery built in large New England and mid-Atlantic factories. Entire new industries developed to support this commerce, as evidenced by the growth of banks and by the flurry of railroad, steamship, and canal companies that were formed in the 19th century. While inflexible individuals and businesses may have suffered, the overall prosperity of all of the states increased dramatically, and employment grew rapidly despite the destruction of the Civil War and the influx of impoverished immigrants from around the world.

**F**ree trade works, both in the context of international development and in ensuring greater domestic prosperity. It helps the poor and at the same time helps the working class, the middle class, and the wealthy. It works because it represents efficiency—from each according to his ability, to each according to his work (work in the scientific sense of energy expended that has a tangible result). Money is not wasted administering complex trade agreements, monitoring the “fairness” of international trade practices, or buying overpriced goods. Money is not involuntarily taken from taxpayers to subsidize inefficient American businesses or the poor overseas.

Open international trading relations, especially between private individuals and businesses, facilitates peaceful relations between nations. Warfare is often a costly, destructive, and unsuccessful means to acquire another nation's goods and services—trade is a far more efficient and mutually beneficial way to obtain the desired goal. Free trade is a sound basis for relations between free nations. It is the best type of foreign aid. And it is good for American consumers and investors. □

# Summer Seminars

## 3 Week-long sessions at FEE

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First: June 15–21, 1986  
 Second: July 13–19, 1986  
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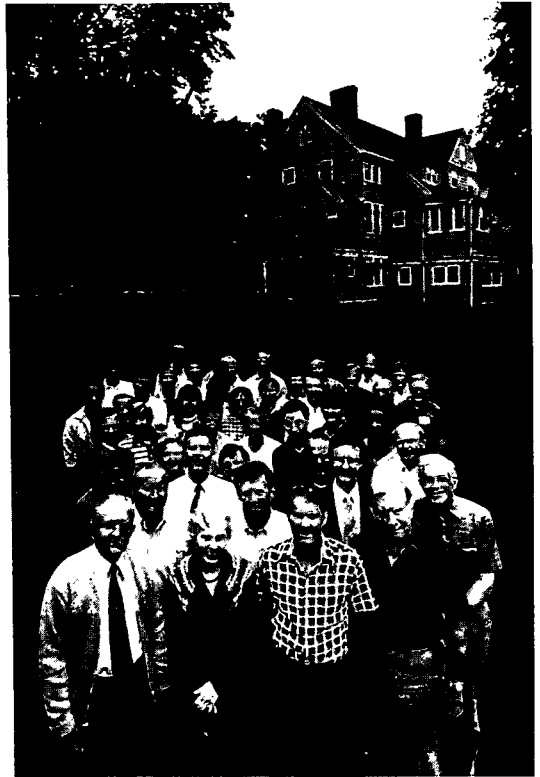
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For the 24th consecutive summer, FEE will conduct its noted seminars in the freedom philosophy and the economics of a free society. Here, in the company of like-minded individuals, with experienced discussion leaders, and in a setting ideal for the calm exchange of ideas, is an opportunity for those who believe that the proper approach to economic problems is through the study of individual human action. These seminars continue to attract individuals from all walks of life who seek a better understanding of the principles of a free society and are interested in exploring ways of presenting the case more convincingly.

Each seminar will consist of 40 hours of classroom lectures and discussions in economics and government. In addition to the regular FEE staff, there will be a number of distinguished visiting lecturers.

The FEE charge for a seminar—tuition, supplies, room and board—is \$400. Fellowships (including partial travel grants) will be made available. High school and college teachers or administrators are given special consideration.

Individuals, companies, and foundations interested in furthering this educational enterprise are invited to attend or otherwise investigate the program and to assist with the financing of the fellowship grants.



The formal announcement, giving details of the seminars as well as information about fellowships, will be sent immediately on request.

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 Attention: Summer Seminars

# Liberalism

by John Chamberlain

When Ludwig von Mises wrote his *Liberalismus* (in German) in the Twenties, he was already worried about the title. As he was to observe much later in 1962, the tenets of nineteenth-century liberalism (free trade in a setting of limited government) had been pretty well forgotten on the European continent. In England, the Fabians were using the word "liberalism" to describe their slow-motion approach to socialism. And in America, the editorial policies of the weeklies that called themselves liberal (*The Nation*, *The New Republic*) favored all the interventionist ideas that would shortly become law with the coming of the New Deal.

Fearful that a literal translation of the original German title would be confusing, Mises, in 1962, called the English version of his book *The Free and Prosperous Commonwealth*. This was accurate enough in the context of Mises' assertion that freedom was menaced by every departure from the so-called "night watchman State," but Mises wasn't satisfied with it. Bettina Bien Greaves describes Mises' feeling that the word "liberalism" must be rescued from the collectivists. She quotes him as saying, in *Human Action*, that "there is simply no other term available to signify the great political and intellectual movement" that had fostered the free market economy.

So we come to the third edition of *Liberalismus*. It now bears the title of *Liberalism: In the Classical Tradition*. The translation is by Ralph Raico, and there are, in addition to Mises' own introduction to the 1962 edition, a new

preface by Bettina Bien Greaves, and a foreword by Louis M. Spadaro of Fordham University. The book (208 pages, \$9.95) is published by The Foundation for Economic Education (Irvington-on-Hudson, New York 10533) and the Cobden Press, 1800 Market Street, San Francisco 94102.

*Liberalism* represents Mises at his most positive. He had already explained in the early Twenties why socialism can't work. Without a price system based on the higgling of the market as individual traders go through the motions of buying and selling, there can be no way of calculating. Socialism can stagger along in Soviet Russia or middle way Scandinavia as long as there is a free world to the West to provide international price references. But when monetary calculation can't be applied to the grain trade, for example, nobody would know how much wheat to plant, or where, and even the production of hoes would have to be a matter of guesswork, to say nothing of such advanced things as reaper combines and tractors.

Mises gives full attention to this negative aspect of socialism in his *Liberalism*. But he is more concerned with the positive foundations of liberal policy. Leftists accuse liberalism of putting the interests of the propertied classes ahead of all other concerns. But this assertion, says Mises, is "completely mistaken." Liberalism had always had in view the good of the whole, as expressed in the Benthamite formula of "the greatest happiness of the greatest number."

Mises didn't think this formula was

**lib er-al-ism** (lib er-al iz m), *n.*

The great political and intellectual movement that (1) substituted free enterprise and the market economy for precapitalistic methods of production, (2) established constitutional representative government in place of absolutism, and (3) promoted freedom for all individuals instead of slavery, serfdom, and other forms of bondage.

particularly well-phrased (it tries to multiply a quality by a quantity), but it does convey something. The early liberals tried to get away from the short-time promotion of special interests. Peel and Gladstone in England wanted to lower taxes to encourage a production that, in the long term, would benefit both workers and property owners. But, as the nineteenth century grew older, the anti-liberal parties grew stronger. They wanted tariffs to benefit specific manufacturers. The socialists among them wanted a steadily increasing welfarism. The rich must be made to pay for cradle-to-grave support of the poor, without regard to what this might do to the capital formation needed to create more jobs.

**M**ises doesn't name names in *Liberalism*. But his gift for clear abstraction will enable the 1986 reader to make the jump from the Twenties to modern times. His "parties of special interest" in the Twenties included the British laborites, the German social democrats, the French dirigistes, the fascists of various stripes, the Viennese socialists, the American "progressives" and farmer-laborites, and the union-oriented political bosses in the American big cities. In the Eighties there is a slight turn for the better. Fascism and Nazism have been discredited. In England, Margaret Thatcher has won something of a victory by breaking the stranglehold which the leftist coal miners had on British energy policy. In America, there are so-called supply siders in both major parties. Republican Congressman Jack Kemp can

agree with Democratic Senator Bill Bradley that something must be done for the investment system as a whole by cutting high marginal tax rates.

Mises puts it all in a paragraph when he says "liberalism has demonstrated that the antagonism of interests, which, according to a widely prevalent opinion, is supposed to exist among different persons, groups, and strata within a society based on private ownership of the means of production, does not in fact occur. Any increase in the total capital raises the income of capitalists and landowners absolutely and that of workers both absolutely and relatively . . . The interests of the entrepreneurs can never diverge from those of the consumers."

When Mises was writing in the Twenties, Bolshevik Russia was the poorest power in the world. Mises would have left the Russians to try to make up for their deficiencies on their own. "Let the Russians be Russians," he said. "Let them do what they want in their own country. But do not let them pass beyond the boundaries of their own land to destroy European civilization . . . the governments of Europe and America must stop promoting Soviet destructionism by paying premiums for exports to Soviet Russia and thereby furthering the Russian Soviet system by financial contributions. Let them stop propagandizing for . . . the export of capital to Soviet Russia."

The Mises advice is still good. But it must be extended a bit to include the denial of help to such Communist outposts as Castro's Cuba and Ortega's Nicaragua. Liberalism has no business propping up its enemies. □

**Competing Visions**

by Richard B. McKenzie

Cato Institute, 224 Second Street, SE, Washington, D.C. 20003 • 216 pages, \$8.95 paperback

*Reviewed by Joseph S. Fulda*

**R**ichard McKenzie's *Competing Visions* is a Cato Institute study of the fallacies of national industrial policy being urged on us by an increasing number of economists, intellectuals, and politicians.

McKenzie begins by surveying the varied proposals that fall under the rubric of national industrial policy. All of them have in common the view that America has undergone and continues to undergo severe deindustrialization avoided by other nations (notably Japan) only because of national industrial policy (NIP). Through careful analysis of data on the manufacturing sector, McKenzie shows that the doomsayers' positions on deindustrialization are either misleading, overstated, or both. NIP enthusiasts forget or do not mind that "government control of capital ultimately translates into control of people, whether the control is instituted by democratic or by authoritarian means." Also misleading, overstated, or both is the displaced worker myth and the inevitable proposals for government retraining programs.

One proposal virtually all NIP advocates call for—and the centerpiece of many of the bills introduced in Congress—is the reinstitution of the Reconstruction Finance Corporation. As McKenzie shows, however, the old RFC is "hardly a model to be followed." The original RFC was marked by "years of scandals" with "funds . . . often allocated on the basis of political friendship and bribery." Moreover, after its abolition, pieces of the original RFC continued to exist in various government agen-

cies, none of which can be credited with economic success.

The Chrysler bailout, "touted as the quintessential example of what" an NIP might do, deserves special attention. As McKenzie quotes Heritage Foundation scholar James Hickel: "Chrysler has renegotiated its debt and restructured its organization in a way that greatly resembles a company that has gone through bankruptcy." Indeed, for all practical purposes, "the Chrysler Corporation *has* gone bankrupt" (emphasis added). McKenzie then presents an analysis showing that in all likelihood, the bailout aided stockholders and lenders, but saved no jobs. Even Chrysler's current success is questionable. Various accounting methods, unsound managerial decisions favoring short-term profits over long-term growth, and continued government protection all contribute to the appearance of success.

McKenzie then departs from his empirical approach to present a chapter on "the fatal conceit" of centrally managing an economy. His arguments derive from and are credited to Hayek, although they lack Hayek's rhetorical elegance and force. Tripartite councils consisting of key politicians, industrialists, and union officials, McKenzie assures us, could never duplicate the efficiency and justice of the market system.

Much of the concern motivating the industrial democracy movement stems from the desire of its proponents to ensure greater job security for workers. They justify such security with the language of individual rights. Workers, they say, have a right to their jobs. Well, that is one position that *Competing Visions* thoroughly explores, both philosophically and economically. The discussion is nothing short of brilliant and it is left for the reader to enjoy.



Other topics discussed at length are capital mobility and taxation, the various forms of protectionism, their rationales, and the fallacies that undergird them.

McKenzie closes his study with a "competing vision," a view opposite to that of the NIP enthusiasts. "The case against managed capitalism," McKenzie writes, "is actually a set of arguments for constraints on the economic powers of government." Government must be barred, he warns, from the market function of picking "winners" and "losers." "That is the kind of economic future we must seek in order to remain prosperous and free." □

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### **Discovery and the Capitalist Process** by Israel M. Kirzner

The University of Chicago Press, 5801 S. Ellis  
Avenue, Chicago, Illinois 60637 • 1985 • 192 pages,  
\$22.50 cloth

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*Reviewed by Brian Summers*

**G**overnment creates barriers. In a market economy, it sets up barriers against fraud and coercion, so that people can go about their peaceful affairs without let or hindrance. Interventionist government, however, creates barriers which tax, regulate, subsidize and generally hinder peaceful exchange.

What are the economic effects of such government interventions? At first glance, the consequences seem clear. Tax something and you get less of it. Subsidize something and you get more of it. Set up barriers to entry and you have less competition.

On this basis alone, economists have made compelling arguments against government intervention. By examining incentives, supply and demand, and the availability of investment capital, they have shown that tariffs, regulations, and other barriers to free exchange can only harm consumers.

But underlying much of this analysis is the troubling assumption of perfect knowledge. For example, to delineate how people will react to a given set of incentives, most economists assume that people are completely aware of all their options. In the real world, of course, such assumptions are overly heroic, thus raising serious doubts as to the real world applicability of most economic analysis.

Professor Israel M. Kirzner of New York University addresses these questions in *Discovery and the Capitalist Process*. Kirzner, long noted for his pathbreaking work on entrepreneurial alertness, shores up the economic defenses of capitalism, while providing fresh insights into the market process.

Suppose, for example, an entrepreneur discovers a new use for tin. Standard economic theory tells us that entrepreneurs will tend to stop using tin in old, low-valued ways, and shift it to more highly valued uses. In this way, consumers are best served by the market process.

But why did the entrepreneur perceive the new use for tin in the first place? And why, in a world of imperfect knowledge, did his competitors notice his discovery and adapt their behavior accordingly?

The answer, according to Dr. Kirzner, is the heady scent of profits. People tend to notice what it is in their interest to notice. When they are free to pursue profits, they tend to notice discoordinations in the market, and move scarce resources to more highly valued uses. Freedom is not only essential for efficient production, it is also needed for entrepreneurs to first perceive that efficient production is possible at all.

By the same token, the absence of freedom prevents entrepreneurs from first perceiving that scarce resources may, in fact, have more valued uses. Thus, the total cost of a government intervention is not only immeasurable, it is also unimaginable, because

no single mind or group of minds can perceive the opportunities which, in a very real sense, are hidden by the barriers of intervention.

It is difficult to assess the full impact of Dr. Kirzner's work. For the economist, he has helped remove the crutch of perfect knowledge, and thus brought economic analysis one step closer to the real world. For public policy analysts, he has provided a

richer, deeper understanding of the consequences of government intervention. And for students of liberty, he has provided a firmer foundation for free market economics. □

(Discovery and the Capitalist Process is available from The Foundation for Economic Education, \$22.50 cloth, postage paid on prepaid orders.)

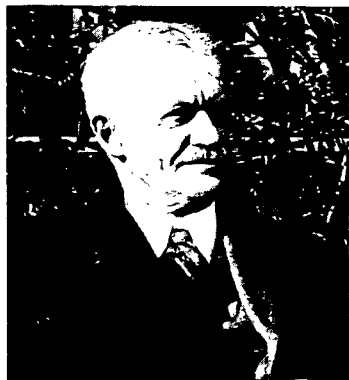


Ludwig von Mises

## LIBERALISM: IN THE CLASSICAL TRADITION

**LIBERALISM: In The Classical Tradition** by Ludwig von Mises is a book-length essay that sums up the ideas and principles of classical liberalism as they apply to the twentieth century. First published in Germany in 1927, it was published in the United States under the title *The Free and Prosperous Commonwealth* in 1962 and reissued in the mid-seventies by The Institute for Humane Studies. It has just been republished by The Foundation for Economic Education in association with the Cobden Press.

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## Free vs. Unfree

Over the years, FEE's activities have earned my trust. But it is much more than trust alone. FEE's activities, particularly *The Freeman*, are a source of inspiration and hope for the future. South Africa must be one of the most over-governed countries around, with an entrenched statist regime. The writings from the Foundation have given me much ammunition in my, albeit small, "fight" for a free society.

The task ahead is immense, almost overwhelming, but the work to restore our liberty must go on. In South Africa the politicians would like us to believe the "battle lines" lie somewhere between the white and the black communities (or sometimes between Communist and Christian). But this is not so. The division is between those people believing in a free society and those supporting a regulated one—I suppose, as in most countries. Yet there are already many signs pointing the way to a better South Africa. There is much hope for the future. May the Foundation continue to prosper and carry on the good work.

Walter Kassier  
Wandsbeck

*Rep. of South Africa*

## Tribute to Mises

It was a pleasure to attend FEE's recent seminar on liberalism (November 2-3) and to read the symposium on *Liberalism* by Ludwig von Mises in *The Freeman* (November). Mises was indeed a man alone, a heroic battler on a barren intellectual landscape. His intellectual ability was remarkable, as was his unconquerable spirit and his uncompromising persistence in advocating his principles despite overwhelming odds. He was, as speaker Ralph Raico pointed out, a man who "could do no other."

The seminar's distinguished speakers paid eloquent tribute to both the economist and the man, but most moving of all were the taped remarks of Margit von Mises. Mrs. Mises observed that her husband was a "great humanitarian" who "lifted economic science out of a materialistic rut." Mises "challenges the reader—not only to understand the economic principles involved in human action, but also to realize the full meaning of human action in terms of human welfare, and the fatal results for humanity if that lesson is not learned. All through his writings there is glowing evidence of his concern for his fellow human beings. . . . And there was always a challenge in his books for the readers to display the same persistence and courage that he himself displayed throughout his whole life."

This FEE seminar both intensified its participants' thirst for knowledge, and inspired them with an exemplar of human greatness.

David M. Brown  
*Syracuse, New York*

## Liberalism: "Old" and "New"

I read with considerable interest the symposium section in the November *Freeman*, "Classical Liberalism Reconsidered." I found the various pieces quite instructive. I was surprised at one thing, however. Although the contributors clearly noted that "old-style" (19th century) liberalism is quite different from contemporary liberalism, the character of the change was not mentioned as clearly as it might have been.

The main distinction between "old" and "new" liberalism can be stated simply: classical liberalism emphasized the importance of liberty, whereas today's liberalism is equality-centered, or egalitarian in character.

Of related significance is the fact that classical liberalism sought to protect the individual from *government* tyranny, whereas modern liberalism generally seeks to protect individuals and groups from *social* injustice.

Precisely at what point "liberalism" began to change its emphasis is not clear to me, but two transition periods in the present century deserve careful consideration: the Progressive Era and the New Deal. One possible clue to this change in emphasis might be to notice which of our nation's political leaders have been commonly described as "liberal" in their day.

Michael Bordelon  
St. Thomas' Episcopal School  
Houston, Texas

## A Liberal Social Order

*The Freeman* is to be commended for its recent symposium on classical liberalism. In particular, it is to be applauded for bringing to the attention of its readers the single best book on the subject—Ludwig Mises' brilliant, but sadly all too often neglected, *Liberalism*.

The lesson taught us by Mises and his most famous student, F.A. Hayek, is that what is essential for the vitality and the cohesion of the free market social order is the free interplay of the *unintended* effects of freely chosen entrepreneurial and exchange activities of market participants. It is these unintended or second order effects that create an understandable and systematically functioning social order out of what otherwise might be seen as unrelated and, perhaps, even seemingly chaotic behavior.

The liberal social order needs no overseer, no outside planner, director or coordinator. The hallmark of liberal social theory was to recognize that the free society has *within* it a superbly sophisticated adaptive process which ensures its continuing self-ordering and system-wide coordination. Any coercive intervention into this

free exchange process will lead only to a breakdown in social order and cohesion which is the very opposite of the benign, self-ordering, unintended effects produced by the freely operating voluntary exchange process.

To waver from this insight and from these fundamental principles is to risk the collapse of any civilized, humane, just, and prosperous social order. This is why it is so important that *The Freeman* continue its comprehensive and unrelenting advocacy of the freedom philosophy.

Walter Grinder  
Institute for Humane Studies  
Fairfax, Virginia

## Much to Learn

I like the idea of letters to the editor very much and read them first when the November issue arrived. Unlike Robert T. Smith, writing in the November issue, I don't try to read all the articles at one time but take them slowly and thoughtfully, often marking and underlining some phrases and paragraphs that I feel are especially significant. I have learned much that way and I further expect to learn something from the "Letters."

Bob LeFevre used to write a brief comment to each letter he printed in his journal and I think this practice might enhance your new endeavor. It produces an interesting dialogue.

My best wishes for your continued success.

Ewald H. J. Stechholz  
Rockville, Connecticut

Let us hear from you! We will share with readers the most interesting and provocative letters we receive. Letters may be edited for purposes of clarity or space. And opinions expressed are not necessarily those of *The Freeman*. Address your letters to: To the Editor, *The Freeman*, The Foundation for Economic Education, Irvington-on-Hudson, New York 10533. □

# The Workfare Fallacy

“If able-bodied people are to be supported at public expense, then they should be made to work in exchange for support.” So goes the defense of workfare.

This plausible statement is a trap for the unwary, another lure along the twisted path at the end of which lies authoritarianism, welfare-state style. It implies that government, not self-interest or necessity, should force the able-bodied poor to work. One recent book on workfare asserts that “For recipients [of government welfare], work must be viewed . . . as an obligation to society.” They should work not to pursue their own happiness, not out of free choice, but because “society” requires it, and the government commands it. Lenin would approve.

The key error in this thinking is the false premise that anyone, able-bodied or otherwise, should be supported at public expense. Private efforts made throughout the country to help the poor can be commended. But having the government tax Peter to pay Paul is plunder. If we avoid that, the excuse for drafting the disadvantaged into the labor force disappears.

—HB

## Private Solutions

For several decades, environmentalists have fought the energy companies over the use of public lands. But they have learned to work together in a small corner of southern Louisiana.

The 26,800-acre Rainey Wildlife Sanctuary is a natural habitat for birds and other wildlife. It also contains deposits of oil and natural gas. Since the mid-1950s these deposits have been carefully extracted, without disturbing the habitat.

What is different about Rainey is that it doesn't lie on public land, but is owned by the Audubon Society. Being privately owned, arrangements could be worked out so the environment is preserved, consumers get oil and gas, the energy companies earn a profit, and the Audubon Society receives approximately a million dollars a year in royalties.

The Rainey Sanctuary is a promising, private model for the use and conservation of scarce resources.

—BJS

## FEE's Best Sellers

A recent list of some of the best-selling conservative books in the last forty years failed to mention some of FEE's favorites which would easily make the list. In our fortieth anniversary year, it is appropriate for us to point them out:

- In all of its editions, Henry Hazlitt's wonderful *Economics in One Lesson* has sold over one million copies. FEE has sold about 250,000 of those over the years.
- Approximately 500,000 copies of Frederic Bastiat's *The Law* have come off of FEE's presses since 1950. FEE has sold over 800,000 copies of Henry Grady Weaver's important primer on the history of human freedom, *The Mainspring of Human Progress*, and of course a number of Mises' shorter works would make the list: *Planned Chaos*, *Bureaucracy*, *The Anti-Capi-*

*talistic Mentality, Economic Policy, and Planning for Freedom.*

These are some of the most popular "first source" books for anyone seeking to understand and explain the free market, private property, limited government philosophy.

## Two-Way Trade

Most people think of foreign imports as foreign products coming in and American dollars going out. But have you ever wondered what foreigners do with all these dollars?

Consider, for instance, a Japanese auto manufacturer. When he sells us a car, the American dollars he gets won't do him much good in a Tokyo department store. He must take them to a bank and convert them into Japanese yen.

The bankers can't spend these dollars in Japanese stores either, so they are traded on the world market until they wind up in the hands of people who need American dollars to buy American exports. When a foreigner buys an American-made product, he uses the dollars we spent on foreign imports. Trade is a two-way street.

—BJS

## Thirty Years Ago

In the March 1956 *Freeman*, John Chamberlain reviewed the paperback edition of F. A. Hayek's *The Road to Serfdom*. He rightly called it "one of the great books of a generation."

The book was originally published twelve years earlier, a timely warning of the incipient totalitarian tendencies of planned economies. Hayek's guiding principle has been an inspiration to many: "A policy of freedom for the individual is the only truly progressive policy."

*The Road to Serfdom* has been a landmark in alerting generations to the correct path to freedom.

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*The Freeman* considers unsolicited editorial submissions, but they must be accompanied by a stamped, self-addressed envelope. Our author's guide is available on request.

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# 40 Years At FEE

**The job of economic education must be undertaken now while those who appreciate the value of liberty are still in a position to support it.**

**I**n March 1946, Leonard Read and a small group of colleagues began The Foundation for Economic Education to present the ideas of liberty to a new generation who had no real understanding of the principles and practices of freedom. And yet they would soon reach responsible positions in the business, intellectual, and political life of the country. The task FEE set for itself was to be a first source, to provide the moral and economic case for limited government and a free market economy.

Time has proven the correctness of FEE's approach. The theory, practice, and moral bankruptcy of all the various forms of collectivism are now clearer than ever. The role played by FEE, and all the friends of FEE, is substantial. As the late Dr. Ben Rogge so eloquently said, "Throughout this country, throughout the world there is 'activity of soul' underway that would never have been undertaken but for the work and the inspiration of . . . The Foundation for Economic Education."

In a time of renewed hope in and understanding of the nature of our free society, some people now feel that the battle is over. What a tragic misconception! Without constant vigilance, self-improvement and a growing understanding of the principles behind the renewed faith in freedom, public policy will once again fall back on expediency, coercion and the abrogation of individual rights.

Thus we celebrate our 40th anniversary with appreciation for what FEE has done to improve our prospects for liberty, *and* to look forward to the needs and prospects for the next forty years. The task remains, now more than ever, to understand and communicate the constructive possibilities of the freedom philosophy.

We will celebrate our 40th anniversary in gentle ways throughout the year: by example and through our ongoing programs and activities. Our approach is not a boisterous one.

For that reason we start this issue with an article by Dr. Israel Kirzner. Some of you may be familiar with it, many more will not be. It is a solid, perhaps even inspiring, presentation of two threads in the FEE philosophy. First, it shows how it is that "The free life . . . is at the heart of one's being." Second, Dr. Kirzner, shows how FEE's soft-spoken style is the most appropriate and most effective for presenting the freedom philosophy. □



# The Open-Endedness of Knowledge:

I intend to explore in this article some aspects of the uniqueness which is FEE, and to express my fervent hope and confidence that such uniqueness will continue to permeate every nook and cranny of FEE's activities in the years to come. I will begin by noting two related but separate paradoxes that have over the years repeatedly caught my attention.

First paradox: FEE's style is one of modesty, humility, tolerance, a steadfast refusal to browbeat those who do not agree with us. Now at least superficially, this attitude of tolerance and modesty appears to be inconsistent with what the late Ben Rogge used to call "FEE's predictability."

Quite frankly, I know of no other organization on our general side of the street whose position on any given issue is as predictable as FEE's. No ifs, ands or buts. No equivocation. Just right down the line, ramrod straight, for a society based on the principle of anything that's peaceful.<sup>1</sup>

All of us know how Leonard Read used to detest anything that resembled a "leak." Well now, surely this inability to compromise, this apparently intransigent attitude would seem difficult to reconcile with the characteristic courtesy, tolerance and genuine humility of FEE's style. This is my first apparent paradox.

Let me turn to a second apparent paradox. FEE expresses, by its very being, a passionate belief in the sanctity of individual freedom, in the dignity and profound moral worth of a free society. Well, this profound belief surely seems difficult to reconcile with FEE's refusal to evangelize for what it believes in so passionately. If freedom is so sacred, then how can we sit back and refuse to sell it? That is my second paradox.

## Its Role in the FEE Formula

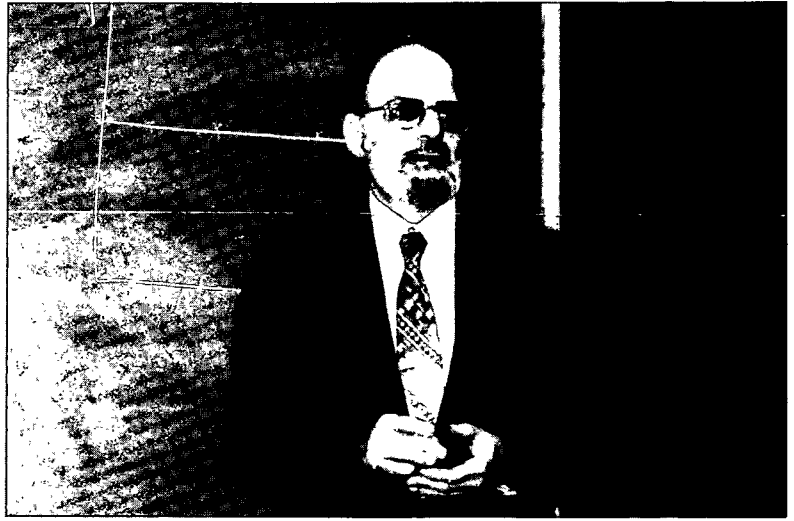
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by Israel Kirzner

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Dr. Kirzner is professor of economics at New York University as well as a Trustee of The Foundation for Economic Education. His latest book is *Discovery and the Capitalist Process*.

This article is a shortened version of a talk given at the Annual Meeting of The Foundation on May 15, 1984. A pamphlet version of the talk in its entirety is available upon request.



Israel Kirzner

BETTINA BIEN GREAVES

## The Open-Endedness of Knowledge

**T**he resolution of these apparent paradoxes, I suggest, brings us close to the very core of FEE's mission and its identity. I believe the key to all this can be provided by what I shall call the *open-endedness of knowledge*. *Knowledge is open-ended in the sense that no matter how much we know, this is as nothing compared with what we know that we do not know.* We all remember Sir Isaac Newton's remark about playing with pebbles of knowledge on the beach while the great ocean of scientific knowledge remains out there untouched before us—a magnificent and lofty thought.

Surely, one critically important premise of FEE's philosophy is this very lively awareness of the limits of our knowledge. So, knowledge is open-ended in the sense of always being seen as incomplete. It is always only a fragment of that which is available to be known.

There is a second idea included as an integral part in this notion of the open-endedness of knowledge. Knowledge is open-ended also in the sense that no matter where the limits and boundaries of one's present knowledge may lie, free human beings possess *an innate propensity to transcend spontaneously those barriers, those limits*, to continually escape those limits, through discovery of new horizons of knowledge the very existence of which was hitherto unsuspected. Life consists, in this sense, of a never-ending series of spontaneous leaps of discovery. The life of freedom is thus a continual expression of the dynamics of continual discovery. The free life, a life for which the open-endedness of knowledge is a central ideal, is one in which the sense of potential—unending potential, unending discovery—is at the heart of one's being. Open-endedness in this sense is the very opposite of the state of stagnancy.

I would like to illustrate and explore the significance of this open-endedness of knowledge for each of *three* separate facets of FEE's philosophy and approach. *First*, the basic understanding of economic relationships. After all, FEE is a foundation for "economic education." *Second*, the deep commitment mentioned earlier to the dignity and fertility of individual freedom. (The "fertility of freedom" is a phrase coined by the late Fritz Machlup; it expresses a profoundly

important idea.) As to FEE's ideal of a free and peaceful society—what role does the open-endedness of knowledge play in that ideal? *Third*, what role does the open-endedness of knowledge play in FEE's soft-spoken, non-aggressive style of communicating its message and its philosophy to the world?

**L**et us consider the first of these three facets of FEE's work—the open-endedness of knowledge as a source of economic understanding. Here I may be excused for referring to the essential differences that separate Austrian economics, the economics that we've learned from Mises and Hayek, from the standard mainstream view. To the standard mainstream view in economics, since about 1930, the view of the world has been one in which the future is essentially known, in which the participants in markets are in effect completely informed about the relative decisions made throughout the market by fellow participants. This is a world of equilibrium, a world in balance, a world in which quantitative economic predictions are entirely feasible. Austrian economics has a quite different view of the world, and a quite different view of the way in which economic relations can be grasped. I quote from Ludwig von Mises:

The fundamental deficiency implied in every quantitative approach to economic problems consists in the neglect of the fact that there are no constant relations between what are called economic dimensions. There is neither constancy nor continuity in the valuations and in the formation of exchange ratios between various commodities. Every new datum brings about a reshuffling of the whole price system, the whole price structure. Understanding, by trying to grasp what is going on in the minds of the men concerned, can approach the problem of forecasting future conditions. We may call its method unsatisfactory and the positivists may arrogantly scorn it. But such arbitrary judgments must not and cannot obscure the fact that understanding is the only appropriate method of dealing with the uncertainty of future conditions.<sup>2</sup>

It was Mises' disciple, Friedrich Hayek, who fully explained the importance for economic understanding of recognizing the limitations of knowledge. It was as a result of his attempt to explicate the Mises-Hayek side of the celebrated socialist economic calculation debate that Hayek first articulated the significance for market competition of dispersed information. Hayek taught us that the crucial element in market competition is the circumstance that knowledge is never concentrated in a single mind—always dispersed. We never know everything. None of us. No single mind can possibly know everything. No single mind can possibly grasp the entire economic problem that tends to be solved through spontaneous market processes. In more recent work, Hayek has emphasized the character of market competition as, in his terminology, a *discovery procedure*—and I quote:

Competition is . . . first and foremost a discovery procedure. No theory can do justice to it which starts from the assumption that the facts to be discovered are already known. There is no pre-determined range of known or "given" facts, which will ever all be taken into account. . . . The real issue is how we can best assist

## Open- Endedness of Knowledge and Economic Understanding

the optimum utilization of the knowledge, skills and opportunities to acquire knowledge, that are dispersed among hundreds of thousands of people, but given to nobody in their entirety. Competition must be seen as a process in which people acquire and communicate knowledge; to treat it as if all this knowledge were available to any one person at the outset is to make nonsense of it.<sup>3</sup>

Hayek's broader philosophy has proceeded from these fundamental insights to appreciate their even more far-reaching implications. And Hayek in fact says that, "Civilization rests on the fact that we all benefit from knowledge which we do *not* possess."<sup>4</sup>

So far it might seem that these Austrian insights rest fundamentally on the awareness of human ignorance, on the limitations of human knowledge, but in fact they rest also on that second element in the open-endedness of knowledge that I have referred to. These insights rest, that is, also upon an appreciation for the propensity within human action to discover what was hitherto unknown—what I like to call the *entrepreneurial* propensity in human action. It is this propensity that is responsible for entrepreneurial alertness for pure profit opportunities, for entrepreneurial discovery, for bursting asunder the limits of existing knowledge. It is upon this alertness that we rely for the manner in which the market continually propels prices and decisions in the direction of greater mutual coordination. It is entrepreneurial alertness to existing errors that leads to their discovery and their eventual tendency to be corrected.

## Commitment to Freedom

Let me turn to the second of the three applications of the open-endedness of knowledge: the importance of the open-endedness of knowledge for our commitment to the dignity of freedom and its fertility in a free society. Here a great deal depends, I would suggest, on our instinctive recoil from the arrogance of benevolent dictatorship. Let me quote Leonard Read here:

There are numerous virtues and vices that account for the rise and fall of societies. Near the top of the list, are the two opposites, humility and pride . . . Pride sprouts and grows from ignorance and self-blindness. Those with a haughty spirit foolishly believe they know the most, whereas they know the least. While they don't know how to make a pencil, or why grass is green, or who we are, they "know" how to run our lives. In their blind pride, the least taste of political power drives them to become power addicts. Until such persons seek help there is little we can do to curb their addiction. What we can and must do is to develop in ourselves the strength of character to resist the temptations of power.<sup>5</sup>

I would suggest that our disgust for the arrogance of dictators is only part of the story. Surely, our commitment to a free society rests also on our appreciation for the immensely valuable spontaneous discoveries that the human spirit can generate when left free. It is our admiration for individual creativity that is responsible for our reverence for the free society. So here we have both of those elements in the open-endedness of knowledge—undergirding our regard for freedom in a free society: (1) our recoil, our disgust for the arrogance of

those who believe they know how to run other people's lives, and (2) our awareness, our appreciation for the propensity in human beings to continually expand what they know, what they can create.

Let me turn to the third aspect of FEE's work and illustrate the significance of the open-endedness of knowledge for FEE's unique style and approach in communicating its message to the world. Here I think two points of contact ought to be noticed between the open-endedness of knowledge and FEE's characteristic style. We recall that this style involves first of all an innate courtesy, modesty and tolerance. (No name-calling, Leonard Read taught us, no arrogance!) Second, the FEE "style" reflects a confidence, a faith, if you like, that those who can benefit from our message *will find us almost of their own accord*. They will discover us. Certainly this confidence is a remarkable feature of FEE's style.

I have one final quote from Ben Rogge, taken from a high school commencement address. He was talking to these youngsters about what they might expect of college. Ben said:

Hopefully, you will . . . come to know how little you know, in fact how little is known about man and his world by even the most knowledgeable around you. This is to say that you may come to carry with you through life a deep sense of wonder and of awe, not of what you do understand, but of the deep and mysterious processes which neither you nor anyone else fully understands.<sup>6</sup>

Open-endedness of knowledge is the root of FEE's modest, tolerant style. But then we said there was another aspect to that style—the confidence, the faith, that those who can benefit from our teachings, from what we have to offer will find us out, will seek us out. Listen to Leonard Read:

Forget the "selling freedom" notion! Right method calls for concentration on the improvement of the most approachable person on earth—one's self. This is practical because accomplishment is possible. This tactic disposes of the numbers problem, the impossible—selling the masses. Do not seek followers! . . . What seek ye then? The achievement of understanding and clarity of explanation . . . so that those who wish to learn may come upon enlightenment. If you are successful, those with inquiring minds will find you out.<sup>7</sup>

Here, surely, we have Leonard Read thinking of the spontaneous discovery potential that will bring our audience to our doors. If we hold up the standard, if we show them what a free society means, they will find us out.

Let us return to the two apparent paradoxes that I mentioned earlier. I believe that it should be easy to see that these paradoxes dissolve immediately just as soon as we recall the significance of this open-endedness of knowledge. We asked how a passionate commitment to freedom could be reconciled with an attitude that refuses to go out and sell the freedom principles to others. We asked how FEE's refusal to compromise, refusal to recognize exceptions could be reconciled with its attitudes of modesty and tolerance. But these questions are easily answered.

## FEE's Style

## The Formula for FEE's Future

A passionate love of freedom as well as FEE's modest style and courtesy *both* grow out of our awareness of our own fallibility and of the arrogance of those who presume to know enough to control others. We know how little we know!

If we appear uncompromising, this is because we are absolutely sure of this one thing that we know with certainty; that is, that human knowledge is open-ended and inescapably limited.

Concerning this item of knowledge, we cultivate no false modesty. We know for sure how little we know. And we know for sure how this open-endedness of human knowledge is responsible for the spontaneously coordinated operation of free markets. And we know for sure how this vitiates so much fashionable economics.

We have begun to understand the open-endedness of human knowledge—including the potential for spontaneous discovery that rests in the human breast. This understanding nourishes our conviction that what we need to do is to deepen our own understanding of the nature of a free society with full confidence that others will seek us out. We do not need to sell. We do not need to attack, to indulge in name-calling.

**I**n a word, FEE's unique style, its unique and quietly passionate commitment to a free society, its commitment to the basic principles of sound economic understanding—all of these fit cohesively into a single integrated whole. This I submit is an important element in FEE's formula. I believe that a renewed self-appreciation for these basic principles can continue to provide stimulation and motivation for FEE's activities for many years to come.

I believe that by mobilizing the dedicated and informed enthusiasm of those many thousands of persons connected with FEE, we can proceed to translate these abstractions—and they are abstractions—into the day-to-day activities of FEE.

Let us never lose our courtesy and our tolerance. Let us never forget our distaste for the arrogance which lies at the root of all threats to a free society. Let us never lose our confidence in intellectual alertness of a free citizenry. Let us persevere in our search for understanding in our economic studies.

We need never fear new ideas. We need never be unsure concerning new proposals, provided we appraise each one of them against our own standards and our own criteria involving leak-proof economic understanding, unified with unfailing courtesy to others in the way in which we reveal our own passionate love of freedom. Let the open-endedness of human knowledge be our inspiration and our guide as we navigate our way through a future of limitless possibilities for free human beings. □

1. Benjamin Rogge, "The Power of Tomorrow: Whither FEE?" mimeographed version of talk given to FEE Fall meeting, November 18, 1979, p. 4.

2. Ludwig von Mises, *Human Action* (New Haven: Yale University Press, 1949), p. 118.

3. F. A. Hayek, *Law, Legislation and Liberty, Vol. 3: The Political Order of A Free People* (Chicago: University of Chicago Press, 1979), p. 68.

4. F. A. Hayek, *Law, Legislation and Liberty, Vol. 1: Rules and Order* (Chicago: University of Chicago Press, 1973), p. 15.

5. Leonard E. Read, *Liberty: Legacy of Truth* (Irvington-on-Hudson: Foundation for Economic Education, 1978), p. 15.

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# Bocce and the Economics of Collusion

**I**t's all in the wrist. That was my conclusion after learning the basic techniques of bocce from my Uncle Rocco (Si Rocco). The lessons consisted mainly of his shouting in my ear, "Don't-a roll the ball; you pull-a the ball and-a throw, like-a this."

The pull-throw served me well. After moving to Chicago's "Little Italy" to attend a nearby university, I was recruited during my second summer in the neighborhood to play in the legendary Sons of Italy Bocce League. The four-man team I played on was called "The Undertakers," which in addition to myself consisted of three local area morticians.

The importance of the bocce games was reflected by the team's post-game meetings at the neighborhood conference center—Whitey's Tavern. It was there under the backdrop of moving water scenes from the "land of sky-blue waters" and crudely patched plaster walls that many business decisions in the neighborhood were made. Even in the case of our post-game wrap-up which ostensibly took place to review our team's performance, it turned out that the supply of local funeral services also hung in the balance.

After roundly attacking each other's performance at bocce, the business part of our meeting would usually start with Nick Mortadella, owner of Mortadella and Sons Funeral Home, saying something like, "What are we gonna price the new fake bronze caskets at? We go too low; nobody'll buy da real ones."

It usually took a while before Vinnie and Sal Sallamagotta, owners of Sallamagotta Bros. Funeral Parlor, could change their thought processes from bocce to business.

"Well, did ya hear me? Whatta we price it at?"

Getting no response from the brothers, Vinnie suggested, "Listen, how 'bout if we all agree that we don't buy da fake one."

We all looked over to the elder brother, Sal, who was busily engaged in examining a fennel seed on the pizza he was eating. When he realized a reply was in order, Sal gave a characteristic shrug of acceptance.

So it was that imitation bronze caskets never made inroads in Little Italy's funeral parlors.

The harmony demonstrated by my team members' ability to compromise and work in consort at their weekly meetings at Whitey's turned out to be short-lived. War clouds were clearly evident one Friday evening when I noticed a milling of people outside Sallamagotta Bros. Funeral Parlor. Getting closer to investigate, I saw Nick Mortadella standing outside in the street staring daggers at the hubbub of

**Without government intervention, monopolistic agreements are inherently unstable.**

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by James Doti

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Dr. Doti is Dean of School of Business and Management, Chapman College, Orange, California. The names of the characters in this article are fictitious.



people. When I asked Nick what was going on, he motioned for me to follow him.

Nick walked into his competitors' funeral home and led me down into the basement where coffee and cookies were generally served to the mourners. But in place of the usual aluminum tray of store-bought cookies was a "sweet table" filled with a bountiful supply of the most luscious-looking Italian pastries that I have ever seen. People wandered with delight around the table as they ogled cannoli, pasticciotti, spugliatelli, and zeppoli. In fact, if it were not for the fact that we were in the basement of Sallamagotta Bros. Funeral Home, I would have thought we were at a first-class wedding reception. Indeed, except for Nick who still glowered, everyone seemed to be in a festive spirit. One mourner was heaping pastries on his platter when he nudged Nick and said, "Hey Nick, what are ya going to do to top this? Haw Haw."

I was just about to select an especially delicious-looking cannoli from the table when Nick pulled me away and said we have to go and talk to Sal. Upstairs we found a stoic-looking Sal wearing a dandruff-flaked pinstripe suit and positioned in front of the main parlor greeting mourners. When he saw the austere expression on Nick's face, he said to wait for him at his home. Since his home was attached to the funeral parlor, all we had to do was walk behind the curtain where some poor soul was "laid-out" to be at Sal's back door.

Mrs. Sallamagotta, a portly woman whose cheerful personality be-



lied her association with the funeral business, greeted us warmly. After leading us into the living room, Mrs. Sallamagotta brought us coffee and cannoli, the familiarity of which intensified Nick's anger.

When Sal finally arrived, he looked at the uneaten cannoli on Nick's plate and said, "Whazza matter Nick, don't-a you like-a the cannoli?"

Nick exploded with several rhetorical questions: "Forget da cannoli. Whatta ya think is going on here? Are we in da catering business or something?"

From here the argument quickly generated into the type of shouting match where the logical basis of an argument is far less important than the decibel level in which it is carried out.

The unresolved nature of the shouting match was obvious as Nick yelled a final insult at Sal and then indicated to me that we make a rapid exit. As we left, Mrs. Sallamagotta grabbed each of our hands and wrapped them around the strings that held a bakery box full of leftover pastries, an offering that Nick did not refuse.

Outside in the street, Nick was still seething. "Wait till he sees what I can do . . . he hasn't seen da last of dis . . . two people can play his game."

**I**n his monumental work, *The Wealth of Nations*, Adam Smith discusses the ease in which monopolistic pricing agreements among competitors can be made: "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices." (*The Wealth of Nations*, Modern Library edition, 1937, p. 128.)

The collusion that took place between funeral home owners during the post-game meetings at Whitey's is the same type of collusion that has occurred at one time or another in every sector of an economic system.

During the 1950s, a conspiracy among electrical goods suppliers involving such industrial giants as General Electric and Westinghouse took place. Following a costly price war that occurred in the transformer and switchgear electrical goods industry in 1954-55, profits in that industry tumbled. As a result, pressure was placed on key executives to turn the profit picture around.

In an article that presents a detailed review of the electrical conspiracy, Richard Austin Smith explains how the collusion was facilitated over several rounds of golf:

At the Switchgear Division (General Electric), the pressure was so great that a lifelong believer in tough competition underwent a remarkable conversion. He called a department manager into his office and told him the old cartel was to be cranked up again . . . Shortly thereafter, they trotted off to mix in a little conspiracy with a little golf in Bedford Springs, Pennsylvania. Every month that year one company conspirator would initiate a memorandum to the others . . . listing every pending job whether sealed bid or open and stating what the calculated book price would be. Then the conspirators would reassemble and compare calculations to forestall any chiseling from the agreed-upon book. (*Fortune*, "The Incredible Electrical Conspiracy," April, 1961, p. 172.)

## Pricing Agreements: Why Monopolies Are Unstable

## Unstable Agreements

The similarity of the electrical conspiracy with my experience in Chicago's Little Italy should not be surprising. Rewards from evading competitive market forces can be substantial. This can be more clearly seen by considering a simple example.

Assume that a funeral home owner incurs 300 dollars of additional costs to produce funeral services worth 1,000 dollars of increased revenue. Each "customer" is therefore worth 700 dollars ( $\$1,000 - \$300$ ) in additional profits to a funeral home owner.

The situation changes, however, if a new competitor enters a market. There is a greater likelihood that price-cutting will take place as each competitor strives to increase market share. Indeed, the collusion typified by the post-game meetings at Whitey's Tavern and that among major electrical goods suppliers over a round of golf represent attempts by individuals to prevent competitive market forces from eating into monopolistic returns.

Fortunately, monopolistic agreements among competitors tend to be highly unstable and short-lived. One need not look far to see the reason for such instability. In the numerical example presented above, each additional "customer" to a funeral home represents \$700 of additional profits—certainly a healthy inducement to violate monopolistic pricing agreements. To avoid retaliation, the initial violations often involve giving customers hidden discounts or providing additional services rather than announcing actual price cuts. Hence, the initial violation in the funeral home business of Little Italy involved providing a bountiful sweet table in place of store-bought cookies. In the case of the electrical goods conspiracy, the initial violations involved under-the-table price cuts:

Westinghouse had proposed to Florida Power that it add all its circuit-breaker order (about a million dollars worth) to its order for Westinghouse transformers. In return, Westinghouse would take 4 per cent off circuit-breaker book and hide the discount in the transformer order . . . Retaliation was not long in coming. Westinghouse went to Baltimore Gas and Electric . . . and said they would give 5 per cent off on switchgear and circuit-breakers, and a week later Allis-Chalmers gave Potomac Electric 12 per cent off. A week after that, Westinghouse gave Atlantic City Electric 20 per cent off, and it went down to much worse . . . in the winter of 1957-58 prices were 60 per cent off book. That was the end of the cartel. (*Fortune*, p. 176)

Even if one were to unrealistically assume that the participants in collusion abide by iron-clad agreements and are successful in preventing violations, there is still to consider the likely entry of new competitors into the market. Of course, a new competitor could be asked to join the cartel, but that would generally mean that a given level of profits would be divided among more participants resulting in smaller profit shares for all. In addition, a greater number of participants in the cartel increases the likelihood that the agreements will be violated and therefore increases the enforcement costs of the cartel. The recent experience of the OPEC cartel is a case in point. The only way a cartel can become permanently entrenched is to elicit the aid of government by making competition illegal.

In retaliation to the Sallamagotta brothers' sweet table, Nick Mortadella's opening salvo was to distribute felt-backed holy cards at funerals instead of the cheaper and more ordinary paper ones. When this strategy failed in generating the interest he hoped for, Nick resorted to lowering his base-rate charges for funeral services.

Meanwhile, the Sallamagotta brothers found the additional number of mourners generated by their sumptuous sweet table getting out of hand. People were coming from as far as Gary, Indiana to partake in the goodies. When the Sallamagotta brothers finally put an end to the sweet table and followed Nick's price cuts, a funeral home price war had begun.

It is difficult to imagine where events would have turned were it not for an unforeseen business development in the neighborhood. The change was evident during an unusually peaceful bocce game that was devoid of the acrimonious display of insults that had characterized recent play.

Something was definitely in the wind as we all agreed to meet together at Whitey's. It was like old times sitting in our usual red vinyl booth. This time, though, we skipped the bocce talk as Nick moved immediately to the business at hand.

"OK, ya all know dat Frenchy is gonna open up a new funeral home in da neighborhood. Whatta we gonna do?"

Frenchy, a neighborhood local of questionable French ancestry, owned a funeral home in nearby Greektown. Evidently, Frenchy's move to expand his market share was behind the team's renewed spirit of cooperation.

"We've already dropped our prices," said Nick diplomatically avoiding mention of the factors that led to this turn of events. The intensity of Nick's feelings was evident when in a highly charged and emotional tone he said, "If we get anoder funeral home, we won't feed our families."

"I checked with da Alderman's boys. We pay three grand; dey won't give Frenchy a license—simple as dat," said Nick in the self-satisfied manner of a person who had obviously done one's homework. He added that the payoff would be made next week to Alderman Cooley's local precinct captain after the bocce games.

"There's one hitch," cautioned Nick whose sly smile implied there was no hitch at all. "Da alderman is catching heat from Alderman Czebinski; I guess da funeral homes in his ward don't much like our prices. We make peace and go back to our old prices, or Frenchy gets da license."

A round of clinking beer steins suggested that peace and order was again restored in the funeral trade in Little Italy.

The following week, after a brilliant round of bocce with my pull-throw in top form, I looked forward with silent anticipation to celebrating our bocce victory. As we walked towards Whitey's, Nick in an obviously embarrassed and self-conscious tone said, "Da precinct captain don't want ya to be dare when we pay im da money. Meet us later at Sal's."

I understood. The precinct captain's pull in City Hall was far more important than the bocce pull I learned from Uncle Rocco. □

# The Legacy of Karl Marx

## How the Communist Manifesto fails as an economic guidebook.

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by Henry Hazlitt

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Henry Hazlitt has had a long and distinguished career as economist, journalist, and author. Best known of his numerous books is *Economics in One Lesson*.

A number of women (and men) have recently been contending that women who are just as productive as men are being employed on the average for only about 70 per cent as much pay, and that the statistics prove it.

I am not going to quarrel with the comparisons of men's and women's actual wages, but with the contention about productivity. In a market in which competition is permitted between employers and between workers, the situation ascribed could not long exist. What would prevent it, what does prevent it, is the selfishness of employers.

Let us suppose that there was an industry in which both male and female workers were producing enough to bring the employer an ascertainable added profit of just over \$10 an hour, but in which the men workers were receiving \$10 an hour, and the equally productive women workers only \$7 an hour.

It would soon occur to an unscrupulously selfish employer that he should henceforth employ only women workers from which he could make a net \$3 more an hour than from his male workers. He would let his men workers go. Other employers would follow his example, and for the same reason. But this would mean that the female workers would start demanding higher individual wages until their pay was on an equality with that previously received by males.

In other words, selfish employers would prefer to make only \$2 an hour net by employing female labor at \$8 an hour rather than see competing employers make \$3 net out of them. They would even choose to make only \$1 an hour net by paying them \$9 an hour rather than stand by and watch other employers making \$2 net out of them. This would continue until prevailing female wages in that industry were

very close to female labor productivity in dollar terms. (In the long run, of course, there would be no drop in the prevailing men's pay, because their productivity would still make it profitable to employ them at that rate.)

To state this more briefly and bluntly, any employer would be a fool to hire male workers for \$10 an hour when he could hire equally productive women workers for \$7 an hour.

There are, it is true, special conditions, temporary and localized, in which labor productivity might not be the dominant factor in determining wage levels. In a small mill town, for example, in which there was only one mill, not large enough to employ the entire working population, the wages paid by that mill might fall below the worker-productivity level. But this would tend to prove only a temporary situation. Two developments would be likely to change it. The unemployed surplus workers would start to leave for other towns. And the mill owners would be tempted to reinvest their profits and expand their operations.

So far, I have been writing about the factors that tend to eliminate wage discrimination on sexual grounds where it exists. But the same considerations would also tend to eliminate wage discrimination on grounds of color, race, nationality, or other reasons. Where such wage differences persist, they tend to reflect real differences in productivity.

Let me now carry my contention a giant step further. The selfishness of individual employers is the force that, under competitive capitalism, brings the level of wages up close to the full value of the productivity of the workers.

Of course, there are never conditions of perfect competition; of full knowledge on both sides, employer and employed, of their respective opportunities. There are individual accidents, immobilities, prejudices, and other factors that prevent everybody's wage or salary from corresponding with the approximate value of his or her contribution or output. But this correspondence is the dominant long-run *tendency*.

There is nothing original in this explanation. I have simply been stating, in fact, in an unusual form, what is known as the marginal productivity theory of wages. This is the theory held by the overwhelming majority of serious economists today.

**T**his theory was astonishingly late in its development. It did not make its appearance until the very end of the 19th century, in the principal works of the Austrian economists, Carl Menger (1871), Friedrich von Wieser (1884) and Eugen von Böhm-Bawerk (1884), and of the American economist John Bates Clark (1899).

Why did its development take so long? It took so long partly because the field was already occupied by other theories—wrong theories. And how did they in turn get started? They got started partly through the errors of writers that were in some respects acute and even profound thinkers. The first of these was the economist David Ricardo (1772-1823), who, by abstract reasoning, developed a labor theory of value in which the contributions of capital investment, initiative, invention, and management somehow got buried.

Then, along came Karl Marx. Ostensibly taking off from Ricardo, he presented a pure "exploitation" theory of wages, and declared out-

## The Marginal Productivity Theory of Value

right that as long as the "capitalist system" continued in existence there could be no real improvement in the condition of workers.

This assertion was made in the face of some very noticeable improvement in the economic condition of the "masses" before 1848, when the *Communist Manifesto* was published, and certainly in the remaining 35 years of Marx's life.

Doubtless there was some excuse for Marx's failure to notice this improvement. In the early years of his life some relics of the medieval system were still around. Great tracts of land were still held by princes, dukes, and barons, and the men who tilled the soil were often forced to pay excessive rents. Production was by our present standards incredibly low. Capital goods—tools, implements, machinery, vehicles, and other equipment—were still rare, crude and primitive. There was a scarcity of donkeys, horses, and other farm animals. On the farms, human beings were forced to carry great burdens on their own backs, as they still do in China today. Only very slowly were more capital goods produced. The great bulk of labor went into producing tomorrow's food and other necessities.

But let us now turn to the actual text of the *Communist Manifesto*. That document, of approximately 40 pages, was written by Karl Marx and Friedrich Engels partly as a call for civil war—"Working men of all countries, unite!"—partly as propaganda, and partly to explain the economic theories of Communism to the workers. But the reader will look in vain to find those theories spelled out in any reasoned form.

We are told that there are two main classes in society—the "proletariat," which consists of the "workers," employed and unemployed, and forms allegedly about nine-tenths of the population, and the "bourgeoisie," which consists of the employers and a few other groups who are comfortably well off. The bourgeoisie rule. They hire the proletariat; and because they do, they necessarily "exploit" them. The only way this dreadful situation can be changed is by revolution, in which the proletariat must seize all the property of the bourgeoisie, and, if they object, kill them.

## The Marxist Exploitation Dogma

No explanation is offered in the *Manifesto* of how this "exploitation" is possible, or what is its exact extent. The word implies that the employers pay their workers only a fraction of what they are worth—of what they add to production or profits. The fraction is not mentioned. Let us say it is only 50 per cent. As individual employers would be making such a big profit at that rate, and would obviously want to hire workers away from other employers, what stops them? The exploitation theory implies that the employers must all be in some secret agreement to keep wages down to this existing near-starvation level, and maintain it through the most drastic penalties against humane employers, if any, who attempt to offer more. "The average price of wage-labor is the minimum wage, i.e., that quantum of the means of subsistence which is absolutely requisite to keep the laborer in bare existence as a laborer."

All this is pure fiction. The exploitation theory implies that the wage-level cannot rise. In trying to maintain this, the *Manifesto* quickly falls into inconsistencies and self-contradictions. We are told that: "The bourgeoisie, by the rapid improvement of all instruments of production . . . draws even the most barbarian nations into civilization. The

cheap prices of its commodities are the heavy artillery with which it batters down all Chinese walls . . . The bourgeoisie, during its rule of scarce one-hundred years, has created more massive and more colossal productive forces than have all preceding generations together,” with “whole populations conjured out of the ground.”

But this enormously increased production could not have been possible without equally increased consumption. The increased population that the increased production made possible must have consisted mainly of the proletarians, and the increased production itself could only have taken place in response to an increased demand. This demand must have been made possible by increased purchasing power, and that in turn either by increased wages or lower prices. But nowhere in the *Manifesto* is this necessary chain of causation acknowledged. The exploitation dogma blinded Marx to the obvious.

The *Manifesto* keeps compounding its economic errors. Obviously capital—which is most usefully thought of as capital goods—is used because it increases production. And because it increases production, it must increase the income of the owner or user. The carpenter would get nowhere without the use of hammers, saws, chisels, and even more elaborate machinery. And so for all other artisans. These tools and machines must at least promise to “pay for themselves” before they are acquired.

Yet we find the authors of the *Manifesto* writing: “In proportion as *the use of machinery* and division of labor *increases*, in the same proportion the burden of toil *increases*, whether by prolongation of the working hours, by increase in the work exacted in a given time, or by increased speed of the machinery, etc.” [My italics.] Even if the reduction in weekly working hours recorded through the years did not show this *Manifesto* statement to be false, it was nonsense on its face. Yet Marx and Engels go on: “Machinery obliterates all distinctions of labor, and *reduces* wages to the same level!” [My italics.]

**F**rom the 1830s on, however, the historic record shows a reduction of hours and an increase of wages from the introduction of machinery. Prof. W. H. Hutt, in his essay on *The Factory System of the Early Nineteenth Century*, writes: “That the apparent benefits wrought by the early Factory Acts are largely illusory is suggested by the steady improvement which was undoubtedly taking place before 1833, partly as a result of the development of the factory system itself.” (*Capitalism and the Historians*, edited by F.A. Hayek, p. 181.)

Tooke and Newmarch, in their book *A History of Prices From 1792 to 1856*, publish extracts from a report issued by the City Chamberlain of Glasgow in 1856. This records that in 1856 wages of skilled labor in the building trades (masons, carpenters, and joiners) increased 20 per cent from the level of 1850–1, and wages of unskilled labor 48 per cent in the same period. He attributes this principally to “increased production in consequence of improvements in machinery.”

“It must also be borne in mind,” he adds, “that weavers and spinners worked 69 hours per week in 1841 and only 60 hours in 1851–6, and hence received in 1851–6 more money for less labor.” He also notes at another point that in 1850: “The number of hours per week worked by masons, carpenters and other artisans employed in the building

## The Historical Record



## The Ominous Appeal of Hatred

trades was 60 hours, or six days of 10 hours each, with a deduction of 1½ hours for meals. Since 1853, the weekly time has been reduced to 57 hours."

For the United States (which seems to have lagged greatly behind England), the official publication, *Historical Statistics of the U.S.: Colonial Times to 1957*, reports (p. 90) that in 1860, the weighted average of working hours in all industries was 11 hours a day (Monday through Saturday inclusive), and that by 1891 this had fallen to 10 hours. In 1890, the working week was 60 hours (6 times 10 daily) and by 1926 had fallen to 50.3.

Recent issues of government publications, the annual *Statistical Abstract* and the current monthly *Economic Indicators*, show that the average of manufacturing hours fell from 51 a week in 1909 to 39.8 in 1957 and to 35 in 1985. Thus average working hours per week under capitalism, in other words, show a steady fall for nearly a century and a half.

In the *Manifesto*, our two authors mention frequently how "the competition between the workers" undermines solidarity and reduces wages. But they never once acknowledge the existence of competition among employers for workers. It is precisely this that brings wages up to the value of the workers' specific contribution to output. And this is not because the employers have or need to have any altruistic motives, but simply the motive of maximizing their own individual profits.

Karl Marx must himself later have felt a great deal of misgiving about the lack of any real explanation of the maleficent workings of the existing economic system that he had portrayed in the *Manifesto*. For in 1867 he published (in Germany) a volume entitled *Das Kapital*. This was apparently intended to be the first of further volumes, but though Marx lived to 1883, nothing more appeared. Some commentators have surmised that Marx had reached an impasse, and could not decide how to continue. After Marx died, Engels undertook to "complete" the work in three volumes by supplementing his friend's unfinished manuscripts. The Austrian economist Eugen von Böhm-Bawerk thoroughly demolished the argument of the finished work in his *Karl Marx and the Close of His System* (1896), a masterful refutation that does not have to be done again.

Let me remind the reader once more that the thesis with which I began this piece—that the assumption of pure selfish competition on the part of the employers would be enough to explain how workers on the average receive practically the full value of their productive contribution—is only a novel way of presenting the marginal productivity theory of wages, now accepted by the overwhelming majority of present-day economists.

The factual substantiation of that theory is particularly impressive in the United States. The annual report of nonfinancial corporation earnings, going back for more than thirty years, show that the employees today receive an average of about 90 per cent of corporate gross earnings in their wages and the stockholders only about 10 per cent in their profits. In fact, a man's personal income often seems to have little to do with whether he is technically an employee or an employer. A baseball, football, basketball, or prize-fighting star may



***“Under competitive capitalism the self-interest of individual employers is the force that brings the level of wages up close to the full value of the productivity of workers.”***

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receive an income in the million-dollar range, far above that of the promoter who technically employs him. It is a result of the star's “productivity”—his box-office appeal. It is the competition among promoters, employers, that brings this about.

**F**rom the standpoint of common sense, the appeal of the *Manifesto* to violence and class war seems entirely needless. If the proletariat (supposedly some nine-tenths of the population) would be better off under a Communist economy, all that was necessary was to make this clear to them, and they could be trusted to vote themselves into power and such an economy into being. (Democracy was emerging in Britain in 1848, and, for whites, already functioning in America.)

But such an appeal gave little promise of starting a “movement” or leading to early political action. Marx and Engels were agitators, activists—and shrewd psychologists. They knew that most people who find themselves at the bottom of the economic ladder are tempted to put the blame, not on themselves, but mainly on somebody else. The exploitation theory, however weak as an economic doctrine, was tremendously persuasive psychologically and as a call for action. It was an essential part of their propaganda.

So, though the *Communist Manifesto*, even in its own time, failed completely as an economic guidebook, it did succeed thoroughly in instilling class hatred. This hatred, unfortunately, has been its most permanent contribution. It was originally directed ostensibly against a special class, the bourgeoisie—the employers, and all those comparatively well off—in revenge for “exploiting” the workers.

But, with the passing years, the target of this hatred has been quietly changed. As the employing class in Russia was liquidated by various means, a still existing group had to be substituted. To stay in command, a dictatorship must continue to point to a powerful enemy to be feared and destroyed. Fortunately, such an enemy can still be pointed to. It is the “capitalist” nations as a whole, especially the United States. Sixty-eight years after the Bolshevik Revolution, most of the American population is notably better off than the population in the Soviet Union. Though Russian school children are taught that we are an “imperialist” nation, the American “proletariat” are now tacitly included, as the Russian “bourgeoisie” once explicitly were, among the people to be envied and somehow blamed for the plight of the Communist-ruled countries.

This newly directed fear and hatred are ominous. They have led to an enormous armament buildup in Russia, and to the development and storage of multiple nuclear weapons which are forcing the West to try to keep uneasy pace. None of us can foresee the ultimate outcome. □

## **Selfish Capitalists vs. the Communist Manifesto**

# The New Information Age

**The impact of the data-communications revolution on the free market.**

by John Jefferson Davis

Dr. Davis is Professor of Theology at Gordon-Conwell Theological Seminary in South Hamilton, Massachusetts, and the author of the book, *Your Wealth in God's World*.

**“W**henever you reduce computing cost significantly, you change the world,” observed Robert F. Elfant, general manager of the micro-component group at the Burroughs Corporation.<sup>1</sup> Elfant’s comment reflects revolutionary new developments in computer technology, data processing, and telecommunications that are transforming the American economic landscape and challenging much of the conventional economic wisdom. At the same time, disturbing trends in the area of government regulation threaten to stifle these exciting new prospects—developments which may prove to be as crucial for America’s future world leadership as the development of atomic fission in the 1940s.

The global datacommunications industry is staggering in its sheer size. In 1984 the top 100 data processing companies in the world had \$132 billion worth of business. IBM was number one with gross revenues of \$44.2 billion. Lotus Development Corporation, a leading software firm, was number 100 with revenues of \$157 million.<sup>2</sup> These corporations represent new wealth-producing entities that Adam Smith could scarcely have envisioned in his own day.

In recent years personal computers have exploded on the American scene as a dynamic cultural and economic force. During 1984 personal computer hardware shipments grew 60 per cent to a hefty \$20 billion. By 1989 it is estimated that personal computer sales will top \$50 billion—more than mainframe shipments—and personal computer sales could number more than 125 million.<sup>3</sup>

Computer expert John Gantz predicts that very soon the consumer will be able to buy a \$4,000 personal computer with 500 times the disk storage, 20 times the memory, and twenty times the power of a 1978 computer at the same price! These dramatic changes, he notes, “. . .

are comparable to finding in 1990 that your new \$10,000 car will travel triple the speed of sound and get from Miami to Seattle on half a gallon of gas."<sup>4</sup> Such developments show that human ingenuity and creativity can disprove dire predictions that mankind is inevitably doomed to an ever-shrinking economic pie.

**M**any of these new economic opportunities are being created by advances in chip technology, the tiny silicon microprocessors that are the real "brains" of today's computer. Scientists in California's Silicon Valley are now working on units so small that a quarter-inch square chip will contain more than a million transistors—four times the number on today's cutting-edge 256 K memory chips. These new smaller and more powerful microprocessors will make possible consumer products that are far "friendlier" and "smarter" than anything available today. These "superchips" will give rise to mobile, personal robots, and "silicon secretaries" that can speak and be spoken to, organize messages, schedule meetings, and issue gentle reminders to absent-minded executives.

Spokesmen for Trilogy Systems Corporation have reported on their company's progress in producing a self-repairing computer chip. Trilogy scientists are putting two or three times as many circuits on each chip as are actually needed to perform a given function. If one circuit breaks down, special diagnostic circuits in the unit detect the problem and divert the signal to another part of the chip. Adding such self-diagnosis and self-repair capability to conventional chips "could revolutionize the semiconductor business," believes Trilogy President Frederick T. White. Trilogy's research is yet another example of the crucial economic truth that in today's world the creation of new wealth is not so much dependent on the extraction of physical resources from the earth as it is on knowledge, insight, and creativity—qualities promoted by a social system that values and fosters human freedom.

The new economic frontiers of the datacommunications revolution are to be found in outer space as well as in the laboratories of Silicon Valley. Communications satellites and the space shuttle are creating burgeoning new markets that did not exist a decade ago.

Today, only nine years after the first backyard satellite receiving station was built by H. Taylor Howard, a professor of electrical engineering at Stanford, perhaps a million Americans now own satellite antennas of various shapes and sizes. It is estimated that 20,000 to 40,000 new home satellite stations are being installed every month, and the pace is quickening. Owners of these systems can receive as many as a hundred different television channels carrying everything from X-rated movies to Russian weather reports to talk shows whose hosts are nuns.<sup>5</sup>

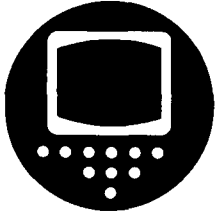
Edwin B. Parker, also of Stanford University, has patented a small earth station with an antenna only two feet in diameter that can receive satellite signals with no interference. The scaled-down dishes allow workers using computer terminals in remote sites to receive data back from the home office at a cost of about 60 per cent of what AT&T charges to carry the same signals on its telephone lines. "The market opportunity was just sitting there to bypass AT&T," noted Parker. News services such as Reuters and Dow Jones have bought 20,000 of

## What Hath the Microchip Wrought?

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***“Twenty-five years from now the scale of industrial activities in space could rival that of today’s computer industry.”***

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Parker’s dishes in the last three years, and industry analysts believe that the Stanford scientist and entrepreneur has created a market with a \$2 billion annual potential.<sup>6</sup>

The American space shuttle program is creating revolutionary new possibilities not only in the area of national defense, but also in the American economy as well. Twenty-five years from now the scale of industrial activities in space could rival that of today’s computer industry. Some analysts believe that space-based materials processing involving drugs, alloys, and crystals could become more important commercially than genetic engineering. Some pharmaceuticals, for example, are worth literally millions of dollars per kilogram because they are used in saving human lives. One such drug, urokinase, an enzyme that dissolves blood clots, can be produced on earth only in minute quantities and at great expense. In the weightless environment of space, production costs of urokinase could be brought down from \$1,200 a dose to around \$100. This would be a tremendous benefit in light of the fact that bloodclotting disorders kill some 200,000 people every year.<sup>7</sup>

Satellite communications already represents a \$3 billion a year business, involving the transmission of television and radio broadcasts, telephone messages, electronic mail, and business data. Sensitive cameras on satellites have sophisticated remote-sensing capabilities that are improving weather forecasts, reducing deaths from hurricanes, detecting air pollution, and assisting geologists in oil, gas, and mineral exploration. According to one estimate, Florida citrus growers save \$35 million each year because satellite weather data tell them exactly when to turn on the heaters in their orange groves, anticipating crop-killing frosts.<sup>8</sup> The economic potential of such satellite capabilities is only beginning to be realized.

## Telephones and Computers

Corporate leaders are now realizing that computer and telephone technologies are becoming inextricably intertwined. Long-distance calls are routinely routed by computerized switching banks. Office switchboards, or PBX’s, are equipped with computers and software that enables telephone conferences and call forwarding. As computers proliferate in offices and factories, they “talk” to one another over telephone lines. In a move which is symptomatic of converging trends in this field, IBM last year bought for \$1.3 billion Rolm, a leading manufacturer of PBX’s.<sup>9</sup>

For the individual consumer, the newer, computerized “smart” phones offer auto-dial, repeat, and features that answering machines have. “The new machines have the potential to revolutionize office communications,” notes computer analyst Paul Freiburger. “They resemble traditional squat black phones about as much as a Hasselblad resembles a box camera.”<sup>10</sup> This trend toward the convergence of telephone and computer technologies, like the new developments in space,

open vast new economic vistas for entrepreneurs who are alert enough to respond quickly to new conditions.

Clouds are beginning to emerge which threaten to darken these bright new economic horizons. Inept and inappropriate forms of government regulation, and protectionist sentiments within the American high-tech industry are disturbing trends in an area which should be among those with the greatest promise for America's economic future.

Domestic computer manufacturers are finding it increasingly difficult to compete with Japan and other foreign producers. American high-tech firms are generally very strong in innovation and new product development, but are not as competitive in the manufacturing area. Most computer terminals, for example, are now being made in Korea, and the Japanese dominate the computer printer and disk drive market. As a result, Silicon Valley executives, long supporters of free-trade, are now beginning to speak in protectionist tones. "I'm not being asked to seek Detroit-style quotas," states Silicon Valley lobbyist Ralph J. Thomson. But he says that many top computer executives are now beginning to question "whether we should retain our unfootnoted free-trade stance."<sup>11</sup>

Part of the industry's problem is the overvalued dollar that inflates the cost of American goods relative to foreign competitors. The overvalued dollar is related in part to the ballooning federal deficit, which in turn attracts foreign investors to treasury bills and other debt-servicing instruments, thus keeping the dollar high relative to other currencies.

More fundamentally, however, American computer manufacturers are losing their competitive edge by investing too little in basic research and development. As business writer John W. Wilson has aptly observed, "Americans save too little, the government spends too much, and the tax system is biased against investment."<sup>12</sup> The consequences of these misplaced economic priorities are now beginning to make themselves felt.

**T**he danger of inappropriate government regulation in the telecommunications field is another cloud on the horizon. As more and more nations begin to appreciate the importance of telecommunications linked to computers, governments "... are beginning to treat information as they once treated goods," commented former Citibank Chairman Walter Wriston. "We are seeing the growth of a kind of electronic mercantilism as sovereigns move to protect their power." Some governments are now requiring that electronic codes used by private communicators to protect their privacy be registered with government agencies. These governments are reacting to the information revolution in the classic manner, notes Wriston, "by attempting to regulate, tax, and control the new technology."<sup>13</sup>

The problems of government regulation of high technology are complicated by national security considerations. Pentagon investigations revealed that the Soviet Union had pirated from the U.S. the manufacturing technology used in the engine that powers the Tomahawk submarine-launched cruise missile. The Soviet counterpart contained a radar guidance system so sophisticated that U.S. officials were convinced that its computer chips were also stolen from U.S. designs.<sup>14</sup>

## The Coming of Electronic Mercantilism

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***“In the new Information Age where decision times can be measured in minutes and seconds, preserving the freedom of human choice is more crucial than ever.”***

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The problems of how to stop such dangerous technology leaks without stifling the freedom and creativity of the private sector is tying U.S. policy makers in knots.

Closer to home, the nation's largest phone company, AT&T, is being hampered by bureaucratic regulations issued by the Federal Communications Commission. The FCC rules require AT&T to keep its telephone operations entirely separate from its computer business. AT&T's splendid research division, Bell Laboratories, invests millions of dollars each year to design software for the company's long-distance network, but is not allowed to share that work with the company's commercial computer division.<sup>15</sup> Such regulations “. . . put the company at a significant disadvantage in the exploding new market for customer services that integrate computers and telecommunications,” notes Princeton economist William J. Baumol. Such policies are not only deleterious to AT&T's bottom line, but also affect adversely U.S. technology's position as a whole relative to foreign competitors such as the Japanese.

## Where Should We Go from Here?

One way that government can help rather than hinder U.S. high technology's position is by retaining and even expanding tax credits for research and development spending. U.S. research and development expenditures have fallen behind those of our trading competitors as a percentage of gross national product. Military research and development spending, which accounts for nearly half of the country's total outlay of \$100 billion, no longer drives civilian technology to the extent that it once did in the 1950s and 1960s.<sup>16</sup> Revising the tax code generally to encourage savings and long-term investment is a key element in any strategy seeking to retain America's competitive edge.

Governments can also help by implementing policies that encourage rather than discourage the free flow of international information. Restoring the effectiveness of our patents and copyrights<sup>17</sup> will encourage innovators to invest time, energy, and money in new ventures, since such policies will give greater assurance that they will be able to reap the benefits of their labors.

In the complicated field of technology transfer and national security, J. Fred Bucy, president of Texas Instruments, Inc., has offered a simple yet valuable suggestion. Instead of trying to control the tens of thousands of end products produced by the American high technology industry, a more workable approach would be to concentrate on the far smaller number of *manufacturing* processes and machines that make the advanced products possible. It may be practically impossible to prevent a foreign agent from obtaining the latest computer chip, but it is far easier to monitor the plants and machines that manufacture the chips. As things now stand, the Pentagon's list of controlled products “is the size of a book, but it should be on five sheets

of paper," states Bucy. By concentrating on the far smaller number of manufacturing processes, the need for government controls would be diminished and American manufacturers would experience fewer regulatory headaches.

The trend toward deregulation evident under the current administration needs consistent application in the telecommunications industry. In the case of AT&T, for example, the Federal Communication Commission's fears that AT&T's combined activities in the areas of telephones and computers would constitute a monopolistic restraint of trade are unfounded. Since 1980 competition throughout the industry in long-distance service has accelerated enormously. It has been projected that by 1986 the total long-distance transmission capacity of the competitors will be several times larger than AT&T's.<sup>18</sup>

In the area of computer technology, given the dominant position of IBM, there is little danger that AT&T will exercise monopolistic influences in this field. The Federal Communication Commission's rules concerning the artificial separation of telephone and computer activities have made necessary a duplication of capital, labor, and other facilities for AT&T. The net result of these regulations, as William Baumol has noted, has been to favor ". . . AT&T's integrated foreign competition, which are not subject to similar restrictions and which market combined computer and communications services on a global scale."<sup>19</sup>

While deregulation and divestiture have created some uncertainties for the consumer, analysts believe that such policies will justify themselves in the longer run. Economist Manley Irwin of the University of New Hampshire believes that out of the current flux in the telecommunications industry ". . . will result a phenomenal cornucopia of new industries, new services, and new jobs."<sup>20</sup>

In order to harvest fully the rich economic yields of the data-communications revolution, policy makers need to be wise enough to let the market do its work. Deregulation, investment tax credits, and new thinking in the areas of patent and copyright law will help American industry stay competitive in the world economy. In the new Information Age where decision times can be measured in minutes and seconds rather than months and years, preserving the freedom of human action is more crucial than ever. □

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# Who Will Control Medical Care?

**Recent changes in Medicare make it difficult for patients to retain control over their own medical care.**

by Jane M. Orient

Jane Orient, M.D., is in the private practice of medicine in Tucson, Arizona. She is also an associate in internal medicine at the University of Arizona College of Medicine.

**F**ear that the Medicare trust fund may be bankrupt by the 1990's—about five years from now—has been used to justify a number of changes in the program. As a result, the day of reckoning may be postponed for a few years longer. But the changes in medical practice might be permanent.

In the name of "cost control," Medicare has changed the payment mechanism. Some payments have decreased, and some have increased. But the amount of the payment is far less important than the method for determining it. The stated issue is cost—the real issue is control.

In the original act that created Medicare, Public Law 89-97, July 30, 1965, Congress disavowed any intention of controlling medicine: "Nothing in this title shall . . . authorize any Federal officer or employee to exercise any supervision or control over the practice of medicine . . . or the compensation of any . . . employee of any institution . . . providing medical services."

But as the Medicare carte blanche for expensive services had its predictable effect of skyrocketing expenditures, the folly of the promise of no controls became apparent. Restrictions on the types of covered services were tightened, and the patient deductibles were increased. These measures were perceived, correctly, as a reduction in benefits. Yet the patient and the physician still made the choice about which services would be purchased. Medicare only decided on the reimbursement.

Recent changes, called mandatory assignment and prospective payment, are of a fundamentally different type. The diminution of benefits is not so obvious, but the threat to freedom of choice is far greater. Under these schemes, the check to the "provider"—the physician, hospital, or other agency—is signed by Medicare (or another third party), rather than by the patient. Usually this apparently subtle change is greeted with relief by patients, who no longer have to worry about the amount written on the check. That worry may be replaced by more serious worries about the quality and availability of services, as we shall see. The person or agency that signs the check is the one with the greatest degree of control over the provider.



“Assignment” means simply that the patient and physician agree that the physician will be paid directly by the insurer (Medicare, Aetna, Blue Cross, etc.) If a physician “accepts assignment” on a Medicare claim, he has agreed to work for Medicare’s fee. Medicare will pay 80% of what it determines to be the reasonable fee (based on the code assigned to the procedure, the doctor’s past charges for that procedure, and other factors), and the physician is supposed to bill the patient for the remaining 20% (the “coinsurance”) and *no more*. Sometimes, physicians waive the 20%—especially if the total fee was inflated to start with. Medicare has now threatened to cut the fees of physicians who routinely fail to collect the coinsurance, assuming that the fee *must* have been inflated.

If the physician does not accept assignment, then the patient is responsible for paying the bill and for collecting from his insurer whatever reimbursement he is entitled to. Most physicians are willing to wait until the patient receives the insurance check, and to negotiate the fee in cases of hardship.

Under the Deficit Reduction Act of 1984, two classes of physicians were created, “participating” and “nonparticipating.” (The constitutionality of this act has been challenged. Litigation sponsored by the Association of American Physicians and Surgeons is pending in circuit court.) Participating physicians sign a contract with the government, agreeing to accept assignment for *all* Medicare patients. Nonparticipating physicians may choose to accept assignment or not, on a case-by-case basis. Once he accepts assignment, the physician may not bill for any portion of the bill that Medicare disallows, but collects from the patient the copayment for the fee that is allowed. About 30 percent of physicians have elected to participate. A proposal to make 100 percent assignment mandatory for all physicians treating Medicare patients has been defeated in the Congress.

From the patient’s point of view, the participation arrangement might seem ideal. No forms to fill out, no money to pay except for the nominal copayment, and no worry about whether or not the services will be covered. The doctor and his staff take care of all those details. The participating doctors are listed in a little book published by Medicare, and influential groups of senior citizens reinforce the idea that these doctors are the “good guys.”

The second innovative “cost containment” method is prospective payment. That means that a predetermined sum is paid to take care of whatever needs happen to come up. The sum may be determined by capitation—so much per head—as in many HMOs (Health Maintenance Organizations). The government is considering ways to encourage more Medicare recipients to sign up for HMOs.

Another type of prospective payment is by the diagnosis. All hospitals now bill Medicare under the DRG (Diagnosis Related Group) system, receiving what is allowed for a particular diagnosis, regardless of how much it costs to take care of the individual patient. Insurance companies, such as Blue Cross, are extending the concept to non-Medicare patients as well. Although so far prospective payment by diagnosis is used only for hospital services, various plans are under study for applying the method to physicians’ fees also. This idea appeals to insurers because it makes their payments more predictable. The risk

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*Assignment and prepayment seem to make the patient's life so much easier. But the incentives that they create have had unintended consequences.*

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of overly large costs must now be assumed by the providers of the service, rather than by the insurance company.

Assignment and prepayment seem to make the patient's life so much easier. But the incentives that they create have already had unintended consequences.

Although the "good guys" are not collecting much money directly from the patients, it would be a mistake to think they are not getting paid. Since people tend to do more of what they get paid for, and less of what they don't get paid for (all other things being equal), it's important to wonder just what the third parties are interested in rewarding.

With assigned claims, the activity that actually results in the payment is the submission of a properly prepared and coded claims form. If all the right blanks are filled in, and if the service is one that Medicare approves of, then a check arrives in due time.

Some things do not appear on the claims form, because they are not important to Medicare. But they just might be important to the patient. For example: 1. How much time did the doctor spend? 2. Was the evaluation thorough, or cursory? 3. Was the diagnosis correct? 4. How much did the treatment help?

In other words, Medicare pays for preparing forms, and the doctor makes more money by being more "productive": by "processing" more patient visits into coded forms. Medicare does *not* pay for spending extra time with patients, an activity which conflicts with the demands of high productivity. Doctors who do more complete, time-consuming evaluations, and who do not require the patient to come back frequently, are financially punished.

## Getting Paid for not Providing Care

**P**rospective payment works a little differently. The "providers" get paid the same amount, regardless of how much is done for the patient. So, in effect, they get paid for *not* doing things. The hazards of prospective payment for medical services are really no different from the pitfalls of paying in advance for other things—such as used cars, dancing lessons, or unexamined bags of diamonds.

While the "providers" have incentives to do less under prospective payment, the consumers have the incentive to demand more, in order to get their money's worth. To be sure that patients don't get more service than they are entitled to, every prospective payment system has a UR (Utilization Review) department. UR's job is to deny services that they feel are "unnecessary" although a doctor and a patient have

requested them. What are the qualifications for that job? According to a newspaper advertisement for a UR clerk at a major HMO, the applicant must be a "high school graduate or equivalent," have good "communication skills," and be able to "work in a fast-paced environment" and to "prioritize duties."

Hospital Utilization Review has become much more stringent since the DRG system went into effect. And most hospitals now have to get permission from Medicare (called "precertification") for most kinds of admissions. Otherwise, the patient's stay will not be covered.

Here are some actual experiences with UR:

- A surgeon wanted to operate on a patient for a hiatus hernia—the stomach bulging up into the chest. The clerk wanted to know how big the hernia felt. Obviously, she didn't know the difference between a hernia into the chest and the "rupture" that makes a lump in the groin.

- An elderly man with Alzheimer's disease became dehydrated and unconscious. His gastrostomy, the opening into the stomach through which he received nourishment, was not working properly. Medicare decided on a "retrospective denial," that is, they announced that they would not pay the bill, *after* the patient had already been admitted to the hospital. The patient was sent home by ambulance—still in a coma—and died a few days later. The decision was eventually reversed, and the brief hospital stay paid for, but only after a lengthy appeals procedure. Although treatment in the hospital would not have greatly prolonged this patient's life, it would have eased his family's burden during his last days.

- A man called the doctor about his ailing wife, and was told that precertification would require several days. He insisted on taking her to the hospital by ambulance anyway, and she was found to have pneumonia and a bowel obstruction. In several days, she would have been dead.

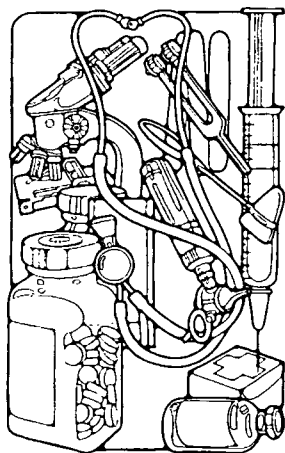
- Cataract surgery is now supposed to be done in an out-patient setting. Medicare denied a claim for a very elderly patient who lived alone in a small town 50 miles away, who was blind in one eye, and unable to see with the other eye for a few days after surgery.

Most doctors could tell a few horror stories like these. Of course, there is also a "quality assurance" committee, which works right alongside Utilization Review. The doctors who do quality reviews don't get paid for it, and if they find a potential problem, it is usually just "trended." Some record is kept, and more reviews may be done. However, the UR doctors are paid, and if *they* find a problem, the patient may be on his way home in an ambulance. And UR is much easier to do. Anyone can see what was done for the patient by reading the chart. But the chart doesn't list all the things that the patient *didn't* receive.

**I**ronically, although the high cost of medical care is used to justify the changes in reimbursement and the accompanying regulations, nobody knows yet whether they will save any money.

If they do save money, it will not be by reducing *costs*, which are increased by regulation (already about one-fourth of the hospital bill is due to the costs of complying with regulations). UR clerks and

**Bureaucracy  
Controls  
Medicine**



their "physician advisors," computer operators, and clerks to code the DRGs must all be paid. The only savings will be reduced *expenditures*—meaning simply that fewer medical services will be rendered.

Or at least that fewer *unprofitable* medical services will be rendered. Under DRGs, the hospital is reimbursed for the *average* cost of caring for a patient with a particular diagnosis. Some patients cost the hospital less than the average, and the hospital is supposed to make a profit on them. They are called "winners." Patients with expensive illnesses for which Medicare pays too little are called "losers." Hospitals, in order to survive, are supposed to "manage the case mix." That means to bring in more "winners," and somehow to keep out the "losers."

In addition to some doctors and hospitals, others are making profits from Medicare. Manufacturers of computer software are making lots of sales to help the hospitals manage the complex DRG system. Certain medical equipment is heavily advertised because of its hefty profit margin—such as chair lifts, which go for \$1500. "Home health services"—which are said to be less expensive than hospital services—are springing up to do *only* those things that Medicare covers. They may not be interested in supplying a low-cost homemaking aide if that's all the patient needs. But they would be happy to send a high-cost physical therapist, occupational therapist, social worker, and nurse (providing that the patient is "certified" to "need" several such services). Medicare pays \$44 for a house call by the nurse, and about \$22 for a house call by the doctor.

**A**ll of these "providers" are following the normal human inclination to take the job that pays best. And those generous people who do things that actually *lose* money—like doctors who make house calls—will soon be out of business. They are "inefficient," to use the popular term.

But don't patients *want* the most "cost-efficient" health care? Maybe not.

For bad diabetic foot ulcers or poor blood supply to the foot, the most cost-efficient treatment is probably to amputate the leg. Prolonged hospitalization for meticulous nursing care and high dose antibiotics don't always save diabetic feet—and they always do cost a lot of money. Bypass operations to bring a new blood supply to the foot don't always work and are also very expensive. The best interests of society would be served by spending the money where it would do more good.

The patient, however, might have a different opinion. He might place such a high value on his leg that he'd be willing to mortgage his house to pay for an operation that might save it. And if he's in real financial difficulties, he might even find a surgeon to donate his services, because it is so much more rewarding to save a foot than to amputate one.

An indemnity insurance plan also pays by the diagnosis, and might allow just enough for the amputation—but the patient would be free to use that payment to defray part of the cost of the more expensive treatment. In contrast, under the DRG system, the amount allowed by Medicare is *all that can be charged*. If the hospital provides a more expensive treatment, it just loses the money, whatever the patient's

willingness and ability to pay. The patient who wants a noncovered service in a hospital that has a Medicare contract (as nearly all do) could renounce his Medicare benefits altogether, but would then have to pay the *entire* amount himself, not just the excess amount.

**T**he control of medical services cannot be divorced from the payment mechanism. As the payment has become more and more remote from the service and the patient who receives it, the "providers" become less responsive to the choices and preferences of the patient, and more constrained by the requirements of the payers. To correct for the distorted incentives, punitive controls are instituted, increasing costs and creating still more problems.

If a patient assumes responsibility for paying his own medical bill, he takes the risk that the service will not be covered by his insurance. Assignment or prepayment frees him from that worry, but substitutes the risk that the service will not be available to him. For example, in Canada, he would be certain that his CT scan would be covered, but in some areas the waiting time for an "urgent" CT scan is about six months.

Under assignment or prepayment, it appears that providers have assumed the risk of not being paid for their work (or even of losing money) if costs turn out to be high. However, the reality is that patients are being sent home, even in a coma, when the payment runs out.

The responsibility for paying medical bills can be shifted. However, the control over medical decisions must eventually be transferred along with it. The person who signs the check is the one who does the utilization review.

Whom will you choose to control *your* medical services? The government? An insurance company that hires high school graduates to do UR? A doctor who is being paid by the head? An ethics committee? A hospital that is deeply in debt?

Those who would prefer to keep the controls in their very own hands must understand the ominous implications of the current changes in insurance, starting with Medicare, however benevolent they may appear. □

## In Future Issues . . .

### April

- "A Bad Time for Giants" by John K. Williams
- "Cyclical Unemployment" by Hans F. Sennholz
- "Disasters Unlimited" by John W. Sommer

### May

- "The Continuing Plight of Agriculture" by Dennis Bechara
- "Unemployment Compensation" by Hans F. Sennholz
- "Hostile Acquisitions: The Restructuring of Corporate America" by Frank Bubb

# How Democracies Perish

by John Chamberlain

**T**he first thing to say about Jean Francois Revel's *How Democracies Perish* (Doubleday, Garden City, New York, 376 pp., \$17.95) is that it was written by a Frenchman. It represents a profound break with the neo-Marxism of the Paris intellectual community, the Gides and the Sartres who, even though they might differ with the Moscow line on some occasions, still considered Marxism-Leninism to be the wave of the future. The book is ably translated by William Byron.

Revel is something of a secular humanist (he likes the United States because it is willing, as he phrases it, to get along without either Marx or Jesus), but his values are Christian nonetheless. As a pragmatist he observes that democracy, with its capitalism, works, and he is certain that, in the long run, the Communist nations of the Eastern bloc are going to collapse. But what frightens him is the prospect that the democracies of the West will fall to pieces while Moscow still packs its ICBM nuclear lead that gives it blackmail power in spite of its own economic weaknesses.

The thesis is similar to that of Schumpeter, who thought that capitalism, though successful, would be fatally undermined by critics who in-

sist on contrasting it to their dream of socialist perfectionism. In the real world, of course, the existing socialist bloc lives off what it can scrounge from nations that depend on market economies.

Revel goes back to Alexis de Tocqueville in order to make a running start. Tocqueville had been greatly impressed by the democracy of the young United States, but he also noticed that when a society becomes richer it rebels against authority "in proportion as its needs are met." The more that claims are satisfied, the greater the clamor for something better. In the third quarter of the Twentieth Century the democracies were more affluent than they had ever been. But, perversely, they tended to be "increasingly unstable, explosive, ungovernable." It is not stagnation that breeds revolutions, says Revel, echoing Tocqueville, "but progress, because it has already created the wealth that makes revolution viable."

The Communist societies don't have this trouble. Says Revel, "Where the State is everything and civilian society is nothing, economic stagnation and social sclerosis foreclose all hope, and the absence of freedom blocks the spread of discontent." The Communist dictators cover their weakness by

a calculated military expansionism. What we get is the survival of the least fit. It would not be so if the democracies only realized that they could bring about the collapse of Communism by matching it in military might and, at the same time, depriving it of access to western foodstuffs and western technology.

Revel gives us a long history of western failure to unite on a common anti-Communist policy that might have blocked Soviet expansionism. We didn't have to give Stalin the Kurile Islands and the southern half of Sakhalin Island in the Far East, for example. We might have let General Patton's tank forces stay in Prague at the close of military operations in Europe in 1945, which would have given us the "Bohemian bastion" that Bismarck regarded as the key to the continent. We might have beaten the Russians to Berlin if Eisenhower hadn't been ordered by Roosevelt to let the Soviets take Germany up to the Elbe River.

Revel is sarcastic about Roosevelt's feeling that he could "handle" Uncle Joe Stalin by making him laugh and Truman's statement that "old Joe" was a decent sort who couldn't do what he wished "because he was the Politburo's prisoner." "I like old Joe," said Truman a couple of years after Potsdam. But Truman, unlike Roosevelt, lived to make amends for his mistake about Stalin's character, and about Marxism-Leninism in general.

Truman, with his aid to Greece, did manage to check the Soviet advances after World War II. But we never really fought the Cold War as it should have been fought. As for detente, it was a disaster.

The democracies, says Revel, have always failed to reckon with the constancy of the Soviet plan to take over the world by eating it leaf by leaf, like an artichoke. The Soviets never take a single defeat as final. They make

tactical retreats, but only to renew their attacks elsewhere. When they were pursuing detente in eastern Europe, they were girding themselves for take-over in Asia, Africa and Central America.

Revel considers our handling of the Polish bankruptcy threat to be symptomatic of our general failure to use economics as a weapon. We were afraid that if we were to force Poland into the political equivalent of a receivership, we would panic all the Third World countries that owed us so much money. We could have handled this fear selectively by refinancing the loans to non-Communist nations while we were denying such favors to the Communists. The Third World would have been grateful, and Moscow would have had to like it or lump it.

Revel thinks it ridiculous that we made \$70 billion in loans to the Soviet bloc in the decade of the Seventies. The Communists didn't use this money to feed their own people. Instead, the money went into more and better ICBMs, and into financing subversion around the world.

The Western willingness to lend money at low rates to build the gas pipeline from Siberia to central Europe is another thing that outrages Revel. Looking back, he likes Jimmy Carter for one thing. Carter had enough spunk to embargo American grain sales to Russia.

There could be more of an argument about this than about most of Revel's criticisms, as he himself recognizes. If the Soviets are forced to pay in gold or foreign exchange for wheat, it means that they will have to keep people digging for gold in Siberia. People who are employed in such digging won't be manufacturing tanks and armored lorries to send to Angola or Nicaragua.

This is a first-rate book in spite of small objections to detail. It teaches us that Marxism has a plan for universal conquest, and that we must meet it if we are to live free. □

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**Essays: Moral, Political, and Literary**  
by David Humeedited and with a foreword, notes and  
glossary by Eugene F. MillerLiberty Classics, 7440 North Shadeland, Indianapolis,  
Indiana 46250 • 1985 • 679 pages, \$11.00 cloth

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*Reviewed by John K. Williams*

Students of the freedom philosophy are indebted to Liberty Fund. From that body comes Liberty Classics, a superbly produced series of works of inestimable value to any person desirous of making the acquaintance of the great thinkers of history who defended political and economic liberty.

The latest addition to that series is David Hume's *Essays: Moral, Political, and Literary*. The volume's editor, Eugene F. Miller, has contributed a foreword, notes, and glossary of interest to any reader but invaluable to students of Hume's writings. Included also is a brief autobiographical outline of Hume's life and a moving letter penned by Hume's admiring and fond friend, Adam Smith. Then come no less than forty-nine essays, graced by the subtlety of insight and clarity of expression typical of Hume.

It would be unfortunate if readers of *The Freeman* who peruse this volume merely study Hume's essays dealing with explicitly economic issues (those on trade, interest, and money, for example). Hume's comments on the "Dignity or Meanness of Human Nature," on "National Characters," on "Civil Liberty," on "Passive Obedience," and on the "Study of History" merit thoughtful consideration.

All students of Hume's works will be delighted to find in this volume the full and accurate text of two of Hume's most controversial essays: "On Suicide" and "On the Immortality of the Soul."

The freedom philosophy needs enthusiastic advocates. It also needs informed advocates. Shallowness of historical insight does not become any person who wishes to further the cause of liberty. We all do well to steep ourselves in the works of the great thinkers who have explored and expounded the philosophy that is ours. Liberty Classics has long made available the works of such thinkers in an attractive, and remarkably inexpensive, form. This edition of Hume's essays is a significant addition to an already distinguished series. □

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**Free Trade: The Necessary  
Foundation for World Peace**

edited by Joan Kennedy Taylor

FEE, Irvington-on-Hudson, NY 10533 • 1986 • 144  
pages, \$5.95 paperback

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*Reviewed by Roy A. Childs, Jr.*

When, in the eighteenth and nineteenth centuries, the classical liberals took up the cause of free trade against the ruling doctrines of mercantilism, protectionism, and colonialism they did so not only out of a high regard for freedom of commerce. They did so to promote peaceful relations between nations, as well. They believed that by confining the functions of government to the protection of life, liberty, and property, the tensions between nations would gradually disappear, and that free trade would usher in a new era of international harmony, free of the scourge of war.

Today we have the benefit of hindsight, and these liberals seem to have been right. The nineteenth century was the closest we have come to a century of free trade, and peace seemed to follow. The twentieth century, on the other hand, has witnessed the abandonment of laissez faire ideals and the



growth of statism of all varieties. It is no accident that it has also been the bloodiest century in history. The movement from limited government to unlimited government, from free trade to economic nationalism, has produced a century of conflict and violence.

This volume collects fifteen short essays by thirteen authors, most culled from the pages of *The Freeman* over the past three decades, to put some meat on the bones of this argument. The authors of these essays will for the most part be familiar to *The Freeman's* readers, because they have been frequent visitors here: Bettina Bien Greaves and Hans Sennholz, Henry Hazlitt and Ludwig von Mises, Frederic Bastiat and Frank Chodorov join with others in making out a complex case. They tell us convincingly that free trade not only brings prosperity, but may help peace along, as well.

Frank Chodorov reminds us that "the will to live is not merely a craving for existence; it is rather an urge to reach out in all directions for a fuller enjoyment of life, and it is by trade that this inner drive achieves some measure of fulfillment." People fulfill their needs through production and exchange, and erase conflicts through cooperation, bargaining and voluntary trade. And this process does not stop at a nation's borders. That is why Chodorov finds that "any interference with the marketplace, however done, is analogous to an act of war," and why Mises reminds us that "economic nationalism is incompatible with durable peace."

Unfortunately, in turning our backs to the ideal of limited government, and embracing forms of socialism and the welfare state, we have got more than we bargained for. Once an impartial arbiter of disputes, govern-

ment has decided to help some citizens at the expense of others. It wants to "protect" some producers at the expense of consumers, by putting roadblocks in the way of free trade. When tariffs aren't enough, as Bettina Bien Greaves points out, they stoop to other kinds of restrictions on trade: "quotas, embargoes, 'Buy American' acts, licensing requirements, quarantines, food and drug standards, anti-dumping laws," and the like. All of these restrictions are meant to stop domestic consumers from voluntarily buying the products they desire from foreign producers.

A result is the rise of aggressive nationalism, which, as Mises argues, "is the necessary derivative of the economic policies of intervention and national planning. While laissez faire eliminates the causes of international conflict, socialism and government interferences with business create conflicts for which *no peaceful solution can be found.*" (emphasis added)

This book is a call for us to step back from the brink of economic nationalism and trade wars to consider what we are doing. It is concerned simultaneously with principles and reality. And its authors focus clearly on some of the great issues of our time: world hunger, foreign aid, international investment, unemployment and international conflict are all seen through the eyes of principles that enable us to understand what is happening to our world. In doing that, it makes a bold case for the re-examination of the ideals we have so thoughtlessly abandoned: individual rights, private property, economic freedom, limited government and free trade. In the nineteenth century these ideals helped promote peace; in the twenty-first, perhaps they can do so again. □

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Sven Rydenfelt

# A Pattern for Failure

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Introduction by Milton Friedman

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—From the introduction by  
Milton Friedman

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Irvington-on-Hudson, New York 10533

## The Argentine Crisis

The article, "The International Debt Problem: The Case of Argentina" (December), is excellent. Michael Adamson envisages the Argentine state of affairs with more accuracy than many people living in this country.

Deliberately provoked misinformation and a great lack of understanding of political, social, and economic matters have allowed many governments to mislead the Argentine population.

At the end of the 19th century and the beginning of the 20th, Argentina had reached a prosperous situation in the world. It lasted till the early twenties. Prospects and conditions began to decline when rulers got wrong ideas about their duties. Instead of realizing that circumstances had given them a responsibility, they felt anointed by the Almighty to execute His will on earth. The perverse creation called the welfare state was the excuse for those messianic governments to assume missions and to perform charity with plunder taken from some to benefit others. The result of this redistribution of wealth was crisis and poverty for all. There will be no solution to the Argentine problem unless the oversized budget of this bureaucracy is reduced. Further international loans will only make this situation worse.

Congratulations to Mr. Adamson for writing and to *The Freeman* for publishing the facts about such irresponsible behavior.

*Pablo Klimann  
Buenos Aires  
Argentina*

## The Bishops and Individual Rights

The second draft of the Bishops' letter on the economy is now public. The most that can be said for it is that it's not as bad as the first.

Economic fallacies still abound, as pointed out by the articles by Charles Baird and William Kern in your December issue. But there is an additional political problem.

The only hope we have of limiting the power of government is the rule of law, the nonarbitrary application of general principles based on individual rights. The bishops' proposal that incomes be determined by moral merit would require some individual or group to be aware of all the motives that prompt anyone to do anything and to reward or punish accordingly. Acquiring such information, even were that possible, would be incompatible with the cherished right to be secure in one's home and person.

The bishops do not seem to understand the totalitarian overtones of their own proposal. Eloquent rhetoric about the sanctity of human rights stands next to calls for the government to determine which industries should be "socialized," which regulated, and which left alone. But what is this if not a grant of unlimited arbitrary power to government? The bishops apparently assume that since they are referring to property, human rights are unaffected. Nothing could be further from the truth. The freedom to use one's honestly acquired property is a fundamental human right.

*David Osterfeld  
St. Joseph's College  
Rensselaer, Indiana*

## The New Format

As a long time reader of *The Freeman*, I'm very impressed by the new size and design. Efforts like these to revitalize such a well-established publication will undoubtedly expand its audience. I believe that you will attract many new, young readers to join the ranks of those already aware of *The Freeman's* excellent coverage of subjects vital to the cause of liberty.

*Andrea Millen Rich*  
*New York City, New York*

I'm sorry to say that I don't like your new size for *The Freeman*.

One big advantage to me and, I believe, to others of your prior size was that it would fit into my coat pocket. As a result, it was more handy to take with me to read while I was waiting in offices for appointments.

Why has the *Reader's Digest* its large circulation? I believe its size is one reason.

*Harry H. Hoiles*  
*Tustin, California*

I was surprised to see the new format and cover of the first 1986 issue of *The Freeman*. It looks most attractive. Did one of your generous sponsors offer to pay that added cost?

I wish FEE every success in its great work. May it move forward in spreading the word on freedom.

*George F. Platts*  
*Ormond Beach, Florida*

**Editors' Note:** We would like to thank our readers for their many comments on the new *Freeman* format. Our goal, as always, is to provide the very best in the literature of freedom in an attractive and accessible format. We welcome your comments and support as we move forward in this task.

## Coming of Age

Twenty-four years ago I was given a list of several hundred recommended books, most of which I had never heard. It was from these that I discovered *The Road to Serfdom* by F. A. Hayek and became acquainted with *The Freeman* and thus *The Law* by Frederic Bastiat. These put foundations under beliefs and principles I already held but to which I had not given deep thought.

In recent years it has been encouraging to witness a growing awareness that there might be some relation between morality and the free market. The dawning was evident when Leonard E. Read expressed his observations in *Reflections on Coming of Age*, written after twenty-one years of FEE. He had come to the realization that teaching free market economics was not enough, that it was also necessary to stress the virtues that make a moral society.

Would it be proper to suggest that the free market is the natural evolution from a practicing morality?

*Phil Clark*  
*Carthage, Illinois*

## A Team Effort

I have just read "Production Is a Team Effort," by Bettina Bien Greaves in the December *Freeman*. She has put it so clearly that it seems to me it ought to be sent to all labor leaders in the country.

It is such a shame that many of our basic industries are being priced out of the world market due in large part to excessive wage demands on the part of union leaders.

*B.C. Carlson*  
*Weston, Connecticut*

## The Decline of OPEC

The recent collapse in crude oil prices seems to have taken OPEC by surprise. Perhaps they would have been better prepared had they read University of Virginia Professor S. Fred Singer's 1984 anthology, *Free Market Energy*. Addressing the question of "Future Oil Demand," Singer wrote:

"Saudi Arabia and the other 'core' producers made two principal mistakes: (1) in 1979-80 they permitted the price of oil to rise; and (2) they did not bring it down right away . . . The Saudis apparently misjudged the degree of conservation the price rise would precipitate among consumer countries. . . .

"When consumers expect prices to rise, they will install insulation and other heat-saving devices or buy more fuel-efficient cars. Once the investments have been made, they are not likely to be reversed, even if oil prices go down. Industry has been particularly effective in making such changes, introducing new and efficient processes and replacing old machinery with energy-saving equipment, with particular emphasis on substituting other fuels for oil."

Consumer sovereignty, more than any other factor, has reduced world oil prices to current levels.

---

## Borrowed Time

The national debt recently topped \$2 trillion, and is climbing ever higher.

What does this mean for the average American? According to a recent study by the Tax Foundation, for every man, woman, and child in the United States, the Federal debt will reach \$8,600 by the end of 1986, an increase of nearly \$900 in a single year. This figure has quadrupled in little more than ten years.

What is the cause of this burgeoning debt? The study concludes:

"The debt grows because the American people are receiving government benefits, but passing on the costs of these goodies to future generations. More importantly, the debt is growing because interest charges on the debt are growing and the principal is not being repaid. In other words, more and more of the debt is caused by debt. And the process seems locked in an inescapable spiral."

## Thirty Years Ago

In the April 1956 *Freeman*, Leonard E. Read, founder and president of The Foundation for Economic Education, contributed his insightful essay, "On That Day Began Lies." He started by quoting one of his favorite authors, Leo Tolstoy:

"From the day when the first members of councils placed exterior authority higher than interior, that is to say, recognized the decisions of men united in councils as more important and more sacred than reason and conscience; on that day began the lies that caused the loss of millions of human beings and which continue their unhappy work to the present day."

These are powerful words, evoking images of Star Chambers, pogroms, and concentration camps. We Americans are inclined to feel safely removed from such proceedings. But coercion is often subtle, and when we act in a group, it is sometimes difficult

to see the full import of our actions. Read brought the issue home with a parable he was to use in hundreds of FEE seminars:

*Imagine this: Joe Doakes passed away and floated up to the Pearly Gates. He pounded on the Gates and St. Peter appeared.*

"Who are you, may I ask?"

"My name is Joe Doakes, sir. I plead admittance."

*St. Peter scanned his scroll and said, "Yes, Joe, you are on my list. Sorry I can't let you in. You stole money from others, including widows and orphans."*

"Mr. St. Peter, I had the reputation of being an honest man. What do you mean, I stole from widows and orphans?"

"Joe, you were a member, a financial supporter, and once on the Board of Directors of the Updale Do-Good Association. It advocated a municipal golf course in Updale which took money from widows and orphans in order to benefit you and a hundred other golfers."

"Mr. St. Peter, that was The Updale Do-Good Association that took that action, not your humble applicant, Joe Doakes."

*St. Peter scanned his scroll again, slowly raised his head, and said somewhat sadly, "Joe, The Updale Do-Good Association is not on my list, nor any foundation, nor any chamber of commerce, nor any trade association, nor any labor union, nor any P.T.A., nor any church. All I have listed here are persons, just persons."*

How to stop the collectivized lies which threaten people everywhere? Read concluded:

"It is simply a matter of personal determination and a resolve to act and speak in strict accordance with one's inner, personal dictate of what is right—and for each of us to see to it that no other man or set of men is given permission to represent us otherwise." □

Publisher: Paul L. Poirot  
Senior Editors: Beth A. Hoffman  
Brian Summers

Book Review Editor: Edmund A. Opitz  
Contributing Editors: Robert G. Anderson  
Howard Baetjer Jr.  
Bettina Bien Greaves  
Gregory F. Rehmkne  
Joan Kennedy Taylor

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*The Freeman* considers unsolicited editorial submissions, but they must be accompanied by a stamped, self-addressed envelope. Our author's guide is available on request.

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# THE FREEMAN

## IDEAS ON LIBERTY

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There is no right to be maintained at the standard of living we have come to expect.

# How to Stop Wars

**When trade is truly free, peace is present.**

by Dean Russell

Dr. Russell teaches economics and is the author of *Government and Legal Plunder*, published by FEE.

**F**or thousands of years, nations have fought each other to get “raw materials,” which they then usually refused to share with other nations. Thus the wars go on, from one generation to the next—almost always to get goods and services that would have been readily available at lower prices (in blood, as well as money) if markets were free.

More than anything else, that’s what free trade is all about—peace. For when trade is free (truly free, in all nations, among all people), peace is necessarily present. It is the only possible arrangement to accommodate that peaceful activity. But when trade is forbidden, a form of war automatically exists to some degree—both within nations and among nations.

Some unknown writer a hundred years or so ago expressed that sentiment on free trade and peace in dramatic terminology: *If goods don’t cross borders, armies will.* He was right.

If I could travel freely in Russia, and trade my goods and services with like-minded Russians on terms negotiated by us as traders, it would be impossible to induce me to spoil that desirable arrangement by fighting them. It works both ways. What in the world would we fight about if we could peacefully visit and trade with each other; baseball versus ballet?

But as it is, I am literally scared of the Russians. I just don’t know what they’re doing behind those walls that are designed to keep their own people in and me out. Perhaps they’re plotting against me. Maybe they even want to kill me. Since I don’t know for sure, perhaps we’d better send more missiles to Europe. Be prepared, whatever the cost. I just don’t trust people I can’t visit and trade with.

When you get right down to it, that’s the basis of fear, as well as wars that grow out of fear, i.e., it’s mostly lack of information. And I’m quite sure it works both ways. The Russians are doubtless as scared of me as I am of them. That “fear of the unknown” will begin to evaporate when individuals and groups from one country have full



## If goods don't cross borders, armies will.

---

opportunity to travel and trade freely in other countries. *That's* the secret of peace; and in its absence, the best we can hope for is an armed-to-the-teeth standoff.

While I'm quite certain that the path to peace is the abolition of all restrictions on trade and travel for peaceful persons in any nation, I don't know how to persuade the Russians to agree. Their system of common ownership of all means of production and distribution seems to forbid much (if any) trade between individual Russians and individuals from other countries. For how can you trade with a person who can't own resources of any kind?

Even so, before we begin to fret unduly about the part to be played by the Russians in this vital process toward world peace, a prior step is needed. We've first got to agree among ourselves here at home that a free market for all goods and services among peaceful people is preferable to the controls we now have. I suspect that task will keep us busy for a few years yet to come. □

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## No Restrictions

**F**REE TRADE, as I would define it, can only exist when there are no restrictions on either side. Therefore, it is absurd to think of its existing in the world today with practically all countries operating under some degree of socialism. But, I would argue that it is to our own advantage to remove *our* restrictions, then trade as best we can under the restrictions imposed by other nations. It would be far from ideal, but their restrictions are basically their responsibility and not ours. My entire argument is based on what I think would be best for our own citizens, as producers and consumers, and I am not too much concerned with policies of other nations, however foolish I may think they are. Perhaps I should say I am concerned, but it is not within my province to try to force their reform. . . .

I believe that the principle most commonly lost sight of in our discussions of trade is that consumption is the sole purpose of production. We sometimes tend to think that the preservation of an industry or a particular firm or a man's job is the important thing to preserve. This leads to all sorts of uneconomic measures which adversely affect the consumer—the king.

W. M. CURTISS,  
 “Removing Our Trade Barriers”

IDEAS  
ON  
LIBERTY



# A Bad Time for Giants

**Big can be beautiful, if we let the market and consumer demands decide.**

by John K. Williams

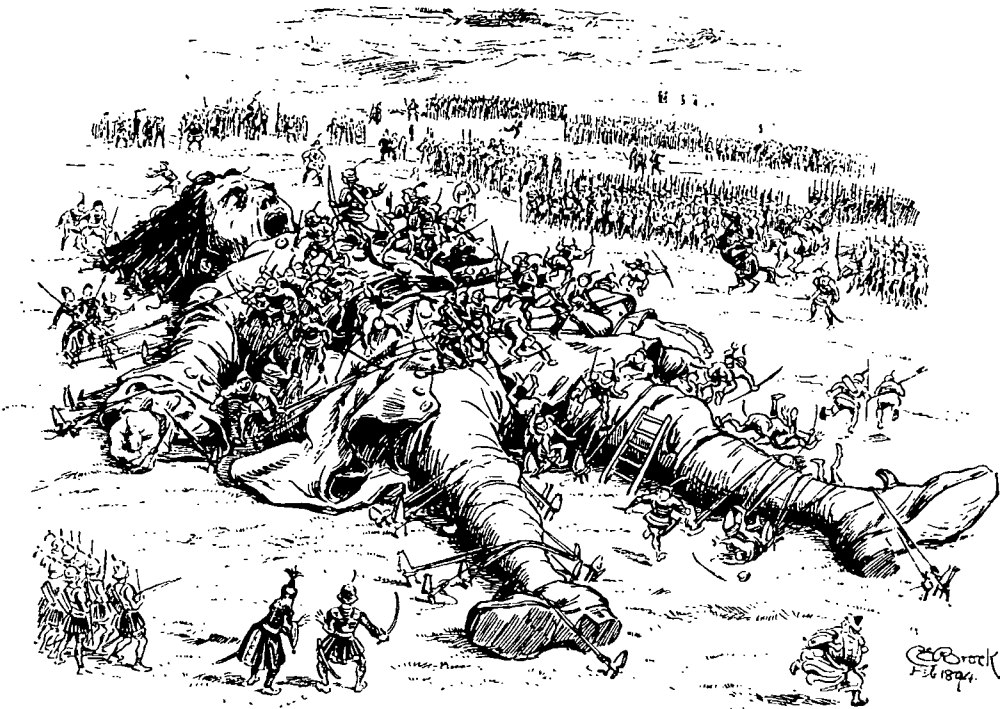
The Reverend Dr. John K. Williams has been a teacher and is a free-lance writer and lecturer based in North Melbourne, Australia.

**S**amuel Goldwyn once remarked that he would like to make a film “which begins with an earthquake and works up to a climax.” In so speaking, the film mogul gave voice to the spirit of an age which positively valued the big, the spectacular, and the colossal, an age in which the slogan, “The bigger, the better!” accurately expressed a widely held attitude.

Today, popular sentiment has undergone a change. The world, by and large, looks with suspicious eyes at bigness. Large nations, large cities, and large corporations are portrayed as sources of mischief. General Motors can do nothing right. The college president planning expansion is an “empire builder.” A squatter holding out in an abandoned tenement building against developers is an heroic David taking on a gargantuan Goliath. “Small,” we are informed, “is beautiful,” and the converse of that somewhat breathtaking generalization is that “Big is ugly.” It is a bad time for giants.

Critics of market capitalism in a classically liberal social order are conspicuous among those who equate “bigness” and “badness.” Market capitalism, it is claimed, has undergone a mutation. Once upon a time it may have been true that the market curbed the activities of businessmen and industrialists, but no more. Market capitalism has given way to “late capitalism” or “monopoly capitalism.” Giant corporations have rid themselves of the constraints imposed by Lilliputian consumers, and today stride the world. They manipulate the masses and treat governments as playthings. The big, the bad, and the ugly rule.

It is easy, and legitimate, to dismiss *socialists* who so characterize market capitalism. Whatever else market capitalism in a liberal society may be or do, it maintains institutions relatively free from the organisms of the state, the most massive concentration of power in human history. Socialists, in advocating an economic system coordinated by political edicts as against market forces, are advocating rule by a giant to end all giants: an all-present, all-powerful, and allegedly all-knowing giant. For such people to deplore the large institutions characterizing modern capitalist nations is, surely, the height of inconsistency.



Yet, not all people who assert that market capitalism has undergone a metamorphosis advocate a socialist alternative. The claim that market capitalism in a liberal society is inherently unstable merits thoughtful examination, whether or not that claim is accompanied by the prescription of an alternative socio-economic system.

**T**he simplest version of the claim that market capitalism generates excessively large and unconscionably powerful corporations is grounded *not* in any economic or social theory, but in ordinary perception. An Australian church paper recently editorialized thus: "Giant corporations move in a world ordinary people do not understand. The balance sheets of these corporations casually refer to projects involving hundreds of millions of dollars. Corporate structures are complex and impersonal. What can these corporations know of the needs and frustrations of the average person? How can such a person, dwarfed by massive conglomerates, sensibly be described as free?"

Clearly, these rhetorical questions can be taken seriously and answered. Yet so to do in a sense misses the point. An attitude is being expressed rather than an argument being developed. The attitude is composed of suspicion, of resentment, and even of fear.

The words "big" and "small" are *relational* terms. A "big" dog is simply a dog larger than most dogs; a "small" house is simply a house smaller than most houses. Hence, when someone asserts that a corporation is "too big," the question, "Big in relation to what?" must be asked. Simply, the claim that a corporation is "too big" in the sense that the corporation is big in relation to a solitary individual, is little more than an expression of the sort of disquiet some people experience when observing the vastness of the Grand Canyon. The claim, as noted, is understandable. Nonetheless, it is irrational.

## How Big Is "Too Big"?

## Perfect Competition

**I**n sharp contrast to this nonrational, almost phobic suspicion of the large corporation, a highly abstract and intellectual framework can function as a context for antagonism to such a corporation. This framework, elaborated in most standard economic textbooks, is the theoretical model described as the “perfectly competitive” or “purely competitive” market.

The world depicted in this model is far removed from what observedly is the case in developed, capitalist nations. In this theoretical world, no firm’s activities have any appreciable effect upon the market, nor does any firm so satisfy consumers that entry into the market might prove difficult for people planning to produce and trade the same good or service. My ten-year-old nephew, Patrick, who breeds parakeets in a small aviary at the bottom of his parents’ garden and sells these, is probably a producer of sorts whose activities satisfy these criteria. The activities of General Motors or of I.B.M. would not.

Again, the parakeets bred and sold by my nephew are, despite his protestations to the contrary, very much like any other parakeet, and thus comply with a further criterion for perfect competition: the product traded must be *homogeneous*, indistinguishable from that traded by any firm manufacturing the same sort of good or providing the same sort of service. As noted, even my nephew insists that his parakeets are, by virtue of the secret mixture of seed he feeds them and the love he gives them, “better” than other parakeets sold in the market. Certainly, most firms in the real world diligently strive to produce goods differentiated from those of their fellow producers.

Most startlingly, participants in a perfectly competitive market are quite unlike the fallible, fumbling, finite beings one encounters in the real world; sellers and buyers alike possess, in the world of perfect competition, perfect knowledge and unerring foresight. Confronted by a vast array of possible choices, all of which are somehow known to them, they infallibly and instantaneously select the optimum option. No unwanted situations arising out of human ignorance or errors of judgment exist.

This abstract, theoretical model has very limited applicability in the real world. The absence of a plethora of tiny firms manufacturing or providing an absolutely homogeneous product or service is in no sense ominous. *No static model depicting an ideal allocative outcome of market processes captures the essence of a capitalist economy.* Joseph Schumpeter puts it well: “Capitalism . . . is by nature a form or method of economic *change* and not only never is but never can be stationary.” Indeed, Schumpeter is worth quoting at length. “In capitalist reality as distinguished from its textbook picture, . . . [the] kind of competition which counts . . . [is] competition from the new commodity, the new technology, the new source of supply, the new type of organization.” This form of competition “acts not only when in being but also when it is merely an ever-present threat. *It disciplines before it attacks.*”

The abstract model of a perfectly competitive market depicts a situation in which all potential mutually beneficial transactions have been realized. A state of equilibrium obtains. In the real world of changing circumstances and human finitude, *disequilibrium* is the reality. The *absence* of equilibrium generates in a market economy systematic entrepreneurial activity that tends to eliminate existing imbalances, mov-

***“Market capitalism can only be understood in terms of ongoing market processes, not any particular static allocative outcome of these processes.”***

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ing the situation closer to an hypothesized state of equilibrium defined by the market data which obtained prior to the beginning of this entrepreneurial activity. Yet before this activity results in even an approximation to this hypothesized equilibrium state, the data of the market will have changed. People's tastes will have altered; available resources will be marked by different relative scarcities; new technologies will have been born; new ideas will have emerged. A new state of disequilibrium exists. Further entrepreneurial activity is thus generated. On and on the process goes. *Market capitalism can, in other words, only be understood in terms of ongoing market processes, not any particular static allocative outcome of these processes.*

**H**ad one asked a typical mainstream economist some two decades ago to outline a desirable program of governmental economic management, he or she probably would have insisted upon fiscal and monetary policies to promote macroeconomic stability. Some sort of antitrust legislation, regulation, or nationalization of natural monopolies would be proffered. Subsidization of various activities productive of positive externalities (especially education and research), and taxation policies promoting greater economic equality, would also be eagerly promoted.

More recently, however, mainstream economists have seriously questioned the theories of so-called “market failure” and of governmental behaviors informing such a program. It is conceded that such abstract and simplified models as the perfectly competitive market assume away institutional details which may in fact fulfill an extremely useful purpose. More significantly, it has become clear that while governments eagerly embrace rationalizations for intervention in the market—and that many economists are no less eager to elaborate such rationalizations—governments have their own purposes. The dynamics of political processes are such that the outcomes of intervention may be quite other than those intended by economists. Similarly, bureaucracies have built-in incentive structures which largely determine the way they perform. Some disillusioning observations have led to a heightened interest in comparative institutional analysis, in which deterministic theories of the performance of market, government, and bureaucratic institutions are deduced from their underlying incentive structures, on the assumption that decisionmakers are rational and desirous of improving their own situations.

Insights provided by this sort of analysis confirm what Ludwig von Mises long ago asserted, namely, that non-market decision-making entities have serious deficiencies with respect to the weighing or registering of individual preferences, the taking of a long-term point of view, operating at a low cost, and, generally, achieving an allocation of resources closer to that suggested by an ideal of perfect coordination

## **Non-Market Decision Making**

than does an unfettered market. In short, *many mainstream economists working within the framework of perfect competition now argue that intervention is warranted only when they allegedly totally default, not when they allegedly marginally default.*

The notion of perfect competition does, in emphasizing ease of entry into and exit from the market, serve as a reminder that *any alliance between government and any set of market participants, union or business, is anathema, jeopardizing freedom of market entry.* The maximum wage laws that cursed the political economy called mercantilism, and the minimum wage laws cursing most Western nations today, are cases of such an alliance. So are tariffs, quotas, price-maintenance schemes, subsidies, laws dictating shopping hours, price controls, and the plethora of regulations today fettering most Western economies. That the market continues to operate when so bound and burdened is testimony to its hardiness. How long it can continue to operate when its nervous system—changing relative money prices—is subject to ever-increasing distortion, is not, however, clear.

One thing, however, *is* clear. Antagonism to large corporations based upon the disparity between the actual operation of market economies and the defining characteristics of perfectly competitive or perfectly contestable markets is misguided and misplaced.

## “Late Capitalism”

**D**uring the late 1950s, Ludwig von Mises delivered a series of lectures on economic topics to Argentinean audiences, subsequently published as *Economic Policy*. He did what only a master of any academic discipline can do: simplify complex issues without distortion. He commenced his first lecture thus:

Descriptive terms which people use are often quite misleading. In talking about modern captains of industry and leaders of big business, for instance, they call a man a “chocolate king” or a “cotton king” or an “automobile king.” [Yet] . . . a chocolate king does not rule at all; he *serves*. He does not reign over conquered territory, independent of the market, independent of his customers. The chocolate king—or the steel king or the automobile king or any other king of modern industry—depends on the industry he operates and the customers he serves. This “king” must stay in the good graces of his subjects, the customers; he loses his “kingdom” as soon as he is no longer in a position to give his customers better service and provide it at lower cost than others with whom he must compete.

The vision is clear. Consumers, by their decisions to buy or abstain from buying, determine what is produced and in what quantities. Ultimately they determine the prices at which goods are sold, the choice of means whereby goods are produced, and the remuneration received by all participants in the productive process.

Such, say many contemporary critics of market capitalism, was once the ideal and perhaps once was the reality. But no more. Large corporations have dethroned the consumer. These critics range from socialist politician Michael Harrington to Marxist-Leninist economist Paul Sweezy. But perhaps John Kenneth Galbraith best reflects the general attitude.

Writes Galbraith: “So far from being the controlling power in the

economy, markets [are] more and more accommodated to the needs and convenience of business corporations." Corporations are controlled not by consumers, but by the faceless, anonymous "experts" constituting what Galbraith calls the *technostructure*, people possessing the information and expertise necessary to design a product, to acquire capital, to modify people's taste, and so on. Informed by this technostructure, corporations exercise an unchallenged sovereignty. The giant has flexed his muscles, freed himself of all constraints, and thus today exercises unfettered power both nationally and internationally.

Galbraith's views, eloquently expressed, brilliantly advertised, and attractively packaged, have successfully been sold to many members of the general public, and to countless "fringe" academics and influential journalists. Most economists have manifested considerable sales resistance. Professor Harold Demsetz asserts, "The only conclusion permitted by [my] investigation is that Galbraith's notions are remarkably consistent in their inability to find confirmation . . . Columbus had a great deal more corroboration for his belief that he found the Indies than Galbraith has for his discovery of the new industrial state." George J. Stigler and James Kindahl, in a major study commissioned by the National Bureau of Economic Research, conclude, after exhaustive investigation, that the claim that "prices of concentrated industries do not respond to reductions in demand" runs counter to all the evidence.

In sum, the economic attack on large corporations collapses. The desperate attempts to demonstrate that large corporations need no longer seek to serve consumers have failed and failed dismally. Indeed, as simple an exercise as the persual of the *Fortune* top 500 companies over a period of time suffices to raise a question mark against their simplistic, but widely accepted, assertions. Of the original 500, only 285 remained two decades later; 159 had merged, 50 had either gone bankrupt or shrunk, and 6 could not be classified, the data necessary for classification being unavailable. So much for the unchallengeable sovereignty of the modern corporation!

**B**ut what, it may be asked, about these malicious, monstrous corporations which feast at tables groaning under the bounty secured by global plunder: transnational corporations? Are they not, in the words of Richard Barnett and Ronald Miller, "disturbers of the peace on a global scale"? Did not the Sixth Assembly of the World Council of Churches, held during 1983 in Vancouver, declare its avowed opposition to transnational corporations, insisting that the world's "market system as a whole . . . [is] incompatible with our vision of a just, participatory and sustainable society" and rapturously applaud Jan Pronk, Deputy General Secretary of the United Nations Conference on Trade and Development, when he informed a plenary session of the Assembly that the New International Economic Order would bring to all people the advantages of "international democratic socialism"—albeit not explaining how that cabal of tyrannies could establish a democratic order of any kind whatsoever? Does not everybody *know* that transnational corporations today constitute "the spearhead of U.S. imperialism"?

Oddly, not everyone *does* know that. The Marxist-Leninist dictator

## The Transnational

of Zimbabwe, Robert Mugabe, apparently does not know how terrible transnational corporations are, for when visiting New York in August, 1980, he pleaded with the heads of transnational corporations to invest in Zimbabwe, stating, "Union Carbide has done much good for Zimbabwe. Why can't other companies as well?" John Kenneth Galbraith does not know how evil such corporations are: in an article published in 1978 in the *Harvard Business Review* he ridiculed the obloquy typifying most discussions about transnational corporations. (Such support, admittedly, is ominous: If Galbraith approves of transnational corporations there must, surely, be something suspect about them. The careful reader of Galbraith's article will observe, however, that Galbraith perceives in transnational corporations organizations large enough and powerful enough *totally* to bypass consumers and deal the *coup de grace* to whatever remains of consumer sovereignty. Since Galbraith deplores the tastes of the masses and dreams of a day when intellectuals sharing his values control socio-economic systems, the complete elimination of any vestiges of consumer sovereignty is to be desired. Galbraith fails dismally to demonstrate that transnational corporations can so defy the rule of consumers. He does demolish most of the fashionable objections to such corporations.)

Interestingly, some economists commissioned by the International Labor Office in 1975 to prepare a series of studies on transnational corporations, documented some embarrassing truths. They noted that such corporations had created two million jobs in developing nations, usually had replaced expatriate managers with host-country nationals as soon as was feasible, and scrupulously had respected the host country's social values and labor relations practices.

Indeed, transfers of wealth effected by transnational corporations have demonstrably been of more assistance to the people of developing nations than have most government to government transfers. Such private transfers are considerable. There is the transfer of capital involved in building factories and plants. There is a transfer of *human* capital, host country nationals acquiring new and valuable skills. Wages paid to employees can, given sensible taxation policies, lead to saving, capital accumulation, and the creation of local industries. Typically, when transnational corporations invest in a developing nation, schools and hospitals are erected and considerable funds are invested in infrastructure, such as roads and sewerage.

## Some Telling Arguments

Strangely, some of the most telling arguments in favor of transnational corporations are unwittingly provided by their opponents. Richard Barnett notes that the power of such corporations is a function of their capacity to internationalize planning, financing, production, and marketing. Has he not heard of comparative advantage? Is it not *desirable* that the different strengths of different nations should be linked? Is not a world of interdependent nations a safer world, as well as a wealthier world, than a world of unrelated nations desperately struggling to achieve self-sufficiency? Again, the Brandt Commission laments the "ability of [transnationals] to manipulate financial flows by use of artificial transfer prices" and notes that such corporations "have been able to race ahead in global operations and out of reach of effective controls by nation-states or international organizations."



Informing this condemnation of transnational corporations is a fiction: that the interests of rulers and the interests of the ruled invariably coincide. This is, admittedly, a useful fiction from the point of view of the rulers, but it is a fiction nonetheless. Governments busily inflating the money-supply of a nation are doubtlessly assisted in their task by stringent exchange controls. The economy of the nation—and hence the vast majority of the nation's people—does not benefit. Protectionism and the savage customs duties protectionism demand feed economic inefficiency and high prices. Do these realities benefit the people? Bluntly, *at long last governments, largely thanks to transnational corporations, are being forced to compete*. Such is cause for hope, not dismay.

Yet such hope is conditional. When governments and corporations form an unholy alliance and substitute an invisible handshake for the invisible hand of the market, mischief is afoot. Many corporations today bask in special privileges and actively enjoy an alliance with government. When such alliances exist, either in a developed or a developing nation, an obscenity has been spawned.

To suggest that an admittedly deplorable overlap between corporations and governments calls for the total subordination of a nation's economy to the state, is an obvious *non sequitur*. It also proposes as a remedy a more deadly variant of the disease from which Western nations today suffer. That remedy—and its name is socialism—has, after all, been tried. It has reduced once wealthy nations to destitution. It has transformed liberty into slavery. It has destroyed the only means a people possesses for so allocating scarce resources that food sufficient for all to eat is produced and the specter of poverty is exorcised.

“Small is beautiful.” Sometimes it is. Sometimes, however, it is disastrous. Warm-blooded animals in a cold environment must be above a certain size or they will perish. That is why there are polar bears, but no polar mice.

The same can be said about organizations and the economic environment. The free market, and that presupposes a limited but strong government respecting the autonomy of each citizen and protecting the God-given liberties of all, alone can determine what size is the “right size” for any business or industry. So long as growth enables a corporation better to serve its customers, such growth is desirable and such growth will continue. When growth lessens a corporation's capacity to serve the people, a red light is flashing. That corporation must cut back, or its days are numbered. Sadly, but understandably, the temptation is for the corporation to plead with government to save it from the unpleasant alternative of painful change or destruction.

Consistent advocates of the free market in a free and open society must say “No!” to such pleas. Neither we nor anyone else can say in advance what size is the “right size” for a particular business enterprise. Yet we can say, and say with confidence, that the free working of the market will enable that “right size” to be discovered. Hence, when corporations and the State start coyly flirting, we do well to appoint ourselves to the “spoilsport” role of chaperones. A love affair almost guaranteed to produce mutant giants or dwarfs must, in all charity, be nipped in the bud! □

## Conclusion

# Disasters Unlimited

**When disaster  
subsidy zones  
are created,  
disasters  
proliferate and  
tragedies  
continue.**

by John W. Sommer

Dr. Sommer is President of the Political Economy Research Institute in Dallas, Texas and is an Adjunct Scholar of the Cato Institute in Washington, D.C.

**A**lmost one thousand years ago in England a subtle lesson in the limits of public authority was offered by King Canute who, when implored by fawning courtiers to demonstrate his regal powers by commanding the ocean waves to halt their assault of the shores, waded into the surf, held up his hand in mock gesture, and permitted all to observe his royal drenching. Canute could not avoid the force of Nature. Today, government intrusion into these areas produces a severe loss of individual responsibility and leads to the prospect of an all-powerful government attentive to special interests.

Public actions to forestall physical events or to provide relief antedate Canute of course, stretching back to Sumerian days. Fires, floods, droughts, earthquakes, hurricanes, tidal waves, tornados and volcanic eruptions lead a list of natural disasters which has been extended in modern times to include technological hazards such as toxic wastes, nuclear reactors and other remotely plausible threats. In fact, the list is infinitely expandable, perhaps one day to include denture stains and psychological damage from viewing old reruns of "The Honeymooners." Anything is possible when individuals become convinced that the shield of the State can, and rightfully should be deployed to protect their life and property at all times, in all places of their choosing, and under any circumstance.

This belief in the function of the State as the proper intervenor in all events of calamitous consequence is promoted by a triangle of special interests: 1) Citizens who are at risk or have just experienced a disaster try to reclaim some of their taxes in the form of payment for actual losses, or in the form of localized public investment such as dams or sea walls, to forestall future losses. 2) Politicians "recognize the wisdom of the people" and even exert leadership by "helping" constituents to recognize previously unforeseen threats. Congressional representatives thrive when they deliver public works thought to be hazard mitigating (and known to be vote generating). 3) Bureaucrats seek to expand the scope of their preparedness and the size of their budgets. Each party responds to the logic of incentives. This *beneficial triangle* is a benign system when viewed from the vantage of intent, but it has a tumorous quality in terms of consequences.

The systematic consequences of the humane urge to protect or assist people, and to be protected and assisted, requires vigorous national attention to illuminate the reasons why voluntary disaster assistance is superior to public liability of current and future Americans who are placed in debt for the protection of their countrymen. Such attention may, at the least, help to stem the tide of disaster creation. The logic of the argument may help to return us to a society wherein market calculations replace the beneficial triangles and where voluntary relief organizations may flourish.

Disaster  
Subsidy Zones

In 1803 Congress gave the first disaster relief in the form of an extension of time for discharging customhouse bonds of sufferers from fire in Portsmouth, New Hampshire. It did the same for Norfolk, Virginia the next year. Over the intervening years Congress has increased the number and size of awards as well as increasing the kinds of disastrous events which qualify. From the first award in 1803 to 1953 one hundred and fifty disasters were declared—or one per year on average.<sup>1</sup> In 1953 Congress granted the President authority to declare disasters. Since then the Presidency has expanded its powers to intervene in both past and potential disasters to the degree that “acts of God” are recognized only after a declaration of disaster by the Chief Executive!

Of course, the number of disaster declarations, and the amount of the awards have risen dramatically since 1953, as may be seen in the table below:

Federal Disaster Declarations 1803–1982 <sup>1</sup>			
Period	Average Number of Awards Per Year	Average Dollar Amount of Award	Largest Award in Period and Year
1803–1952	1	Not calculable	\$ 15,000,000 (1943)
1953–1962	14	\$1,630,000	\$100,400,000 (1954)
1963–1972	28	\$5,100,000	\$351,500,000 (1972)
1973–1982	40	\$6,400,000	\$190,000,000 (1979)

Presidential perspicacity has “permitted” more disasters to be officially recognized and, in current dollars, the average awards have jumped from a little more than one-and-one-half million per disaster during the decade 1953–1962 to about six-and-one-half million per disaster from 1973–1982.

Disaster relief is extended to individual states upon application by the state. The largest awards during each period were for hurricane related damage: Maine in 1954, Pennsylvania in 1972, and Alabama in 1979. Of the many disasters declared, the most expensive have resulted from hurricanes which have wrought havoc on the Atlantic and Gulf coasts. When the Federal awards to each state are summed after a traumatic event the outlay is staggering. Hurricane Agnes, for example, evoked nearly half a billion dollars in Federal relief in five states in 1972, the greatest part of which, as is the case with most hurricanes, was damage caused by flooding. In fiscal 1985, the federal government spent about one third of a billion dollars for direct disaster relief and insurance—and there are many additional indirect outlays,

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***“Under a governmental system of public support, ‘disasters’ are unlimited.”***

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not to mention those of state and local government. Federal flood insurance, for instance, is subsidized to the extent that it costs those who qualify, by virtue of owning property in an official hazard zone and enlisting in the program, only about one-third of what private insurance premiums would be.

What we witness then is a cycle of destruction by traumatic natural events followed by a period of reconstruction underwritten by the public treasury. At the time of tragedy it appears inhumane to us as individuals to cavil over assistance to those stricken, and most Americans would choose to provide assistance to the injured and homeless. But we should expect the prudent use of that assistance, not rebuilding on the same hazard-prone sites under the protection of continued artificially low-risk premiums. That is exactly what happens with the use of public funds. *Disaster subsidy zones* are thereby created. The obvious result is that real estate investors build where otherwise they would not because the risk inherent in their locational choice is spread to all the taxpayers. This is as true of lowland riverine areas as it is of barrier islands and adjacent coastal areas. Is it a proper function of government to subsidize these individual choices?

## **Disasters Unlimited**

**I**t is in this sense of induced or subsidized settlement in these disaster-prone zones that the Federal government uses our tax monies to place individuals at risk. This seems to be unethical, as well as inefficient in an economic sense. By using the general treasury to guarantee reduced financial loss due to natural disasters, government makes known hazardous locations more inviting. Furthermore, it points to the inequity inherent in subsidizing the risks of some individuals while not recognizing those of others. Disaster subsidies are often a redistribution of income from the less wealthy to those who can afford coastal resort condominiums and homes with hillside vistas.

The vulnerability of these disaster subsidy zones is well documented. In 1900 Galveston was struck by a hurricane that killed 5,000 people. In 1983, Hurricane Alicia caused nearly \$700 million damage to Galveston and nearby areas. Today, with extensive Federal relief, the devastated areas have been rebuilt and condominium developers are advertising views of the Gulf unblocked by sea walls! This history is repeated along our coasts.

Tornadoes, earthquakes and volcanic eruptions are also dramatic and costly, but they occur with less regularity to the same site. Despite the drama of these occurrences, after flood damage the next most costly natural event is shifting or expanding soil.<sup>2</sup> Boring! No television covering of this natural disaster! Soil movement cracks foundations and walls without raising any passion or pity, yet those who live in these soil-moving areas and suffer losses might wonder why they should subsidize ocean-view condominium owners while their own

## Why the President Said No

I return without my approval House bill No. 10203, entitled "An act to enable the Commissioner of Agriculture to make a special distribution of seeds in the drought-stricken counties of Texas, and making an appropriation [of \$10,000] therefor."

It is represented that a long-continued and extensive drought has existed in certain portions of the State of Texas, resulting in a failure of crops and consequent distress and destitution.

Though there has been some difference in statements concerning the extent of the people's needs in the localities thus affected, there seems to be no doubt that there has existed a condition calling for relief; and I am willing to believe that, notwithstanding the aid already furnished, a donation of seed grain to the farmers located in this region, to enable them to put in new crops, would serve to avert a continuance or return of an unfortunate blight.

And yet I feel obliged to withhold my approval of the plan, as proposed by this bill, to indulge a benevolent and charitable sentiment through the appropriation of public funds for that purpose.

I can find no warrant for such an appropriation in the Constitution, and I do not believe that the power and duty of the General Government ought to be extended to the relief of individual suffering which is in no manner properly related to the public service or benefit. A prevalent tendency to disregard the limited mission of this power and duty should, I think, be steadily resisted, to the end that the lesson should be constantly enforced that **though the people support the Government the Government should not support the people.** [Emphasis added.]

The friendliness and charity of our countrymen can always be relied upon to relieve their fellow-citizens in misfortune. This has been repeatedly and quite lately demonstrated. Federal aid in such cases encourages the expectation of paternal care on the part of the Government and weakens the sturdiness of our national character, while it prevents the indulgence among our people of that kindly sentiment and conduct which strengthens the bonds of a common brotherhood.

— Grover Cleveland,  
February 16, 1887

"disaster" goes unrecognized. Why should their locational choice be regarded as qualitatively less worthy of protection than the choices of others?

It is only a small step to recognize that any instance of change that is inconvenient is a risk and has potential to damage, therefore to be regarded a "disaster." Once providing disaster subsidies is accepted as a proper function of government, it is intellectually unassailable to expand the list of disasters to include such non-physical misfortunes as "damages" to border firms affected by devaluation of the Mexican peso, or to states impacted by Cuban refugee settlement. It is also attractive to the citizens, politicians, and disaster-bureaucrats who

## Backout Strategies

form the beneficial triangles identified earlier. Under a governmental system of public support, "disasters" are unlimited.

Government cannot shield each of us from any unforeseen event no matter how much personal freedom of action and decision is relinquished to the State. Yet there are those who argue that disaster preparedness is a public good. On what basis then should individuals turn over to the State the authority to decide whose exposure to change shall be mitigated and whose shall not? There are sufficient off-setting public bads resulting from this process, as indicated throughout this article, to demand curtailment of these incentives before more beneficial triangles come into being.

**R**isk and change are part of the human condition; everyone seeks to reduce the former and to direct the latter. How this is achieved is an issue of moral philosophy as well as political economy. Clearly, maximum individual choice in location decisions, subject to complete responsibility for one's actions, is superior in terms of ethicality and efficiency to our present system of hazard subsidy. The market in private insurance informs one of the likely consequence of choice of place and deals efficiently with risk without its subsidy. Equally clear, in the presence of resources held in common and territorial-based political representation, market signals are garbled. We know that we live in a contentious political economy, not a flexible market economy, and there are many in this country who profit by beneficial triangles which seek to mitigate the effects of change by distributing the associated costs to the public at large. Special interest abuses are expected when government is expansive, so it is no surprise that disaster subsidies have increased in the second half of the twentieth century.

We must forestall the development of new disaster subsidy zones and design *backout strategies* from those that exist. Gradually, we can move the system toward less costly and less threatening levels by adopting "sunset laws" which announce firm termination dates for the removal of disaster subsidies. These may be subject to a steadily reducing schedule of possible payments or a variety of other stipulations, but the central feature is the certainty of the removal of public support. We can also declare that no geographical location shall be eligible for Federal disaster relief for the same kind of disaster more than once. The field is open for creative backout strategies.

In the final analysis it is the responsibility of individuals to exercise judgment in action. Acceptance of this proposition will lead to private institutions to forestall disastrous events, or to mitigate their effects. Clearly, there is much latitude for individuals to engage in collective action to help their fellows when they are stricken. Private organizations do exist, and because their appeal is to conscience, not to Congress, one can expect a wiser deployment of resources. At least, in a private arrangement we can expect to avoid a systematic increase in disasters. □

1. United States of America. *Congressional Record*. Volume 96, Part 9, August 7, 1950, Washington, DC. U.S. Government Printing Office, 1950, pp. 11900-11902; *Ibid.* 4/30/73, pp. H3166-H3170; *Ibid.* 9/5/73, pp. S15951-S15952; and Federal Emergency Management Agency.

DMIS Report 2.4. "Disasters Declared Under Public Law 93-288, April 1, 1974 to July 19, 1985."

2. D. Earl Jones, Jr., and Wesley G. Holtz, "Expansive Soils—The Hidden Disaster," *Civil Engineering* (August, 1973), p. 49.

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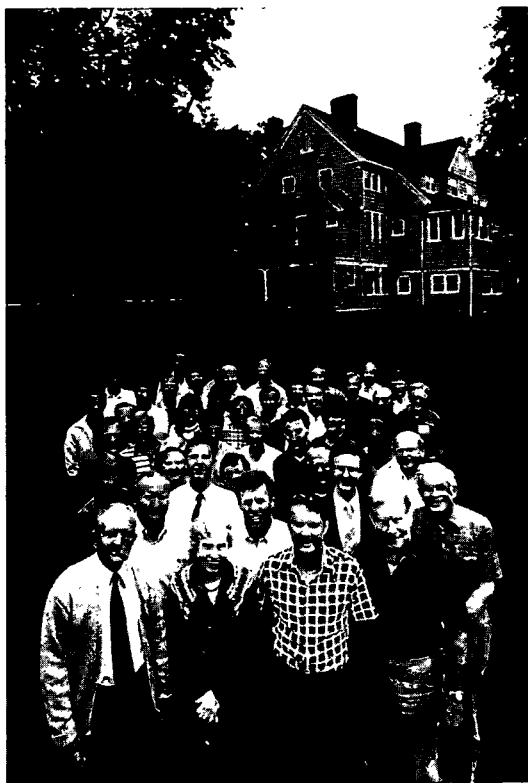
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# The Right To Stagnate

**When force is used to maintain the status quo, basic rights are violated.**

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by Frank W. Bubb

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Frank W. Bubb is an attorney residing in Swarthmore, Pennsylvania.

**E**very society operates explicitly or implicitly on some theory of rights, that is, a generally shared view of who can do what to whom under what circumstances.

Most of us still pay lip service to the traditional American theory that each person has the right to “life, liberty and the pursuit of happiness” and to the free-market economics implied by that theory—with some important qualifications. Now, however, the qualifications have become so pervasive in practice that we have backed into an entirely different theory of rights.

The new theory could be described as follows: “The members of each major group in our society have the right to be maintained at the standard of living they have come to expect. If economic change threatens this standard, it is the duty of government to help the affected group.”

For example:

- Thousands of American farmers have been facing financial ruin as their debt escalates while commodity prices remain low. Predictably, they appealed to the government for emergency low-interest loans. What is their justification? That they, the businessmen who borrowed to bid up prices of farmland in the boom years of the late 1970s, have the right to be made whole at the expense of the taxpayers, so they can live as if the boom had continued.
- American steelmakers have repeatedly brought proceedings before the U.S. International Trade Commission to prevent Americans from buying more than a certain percentage of their steel from abroad. How is the import percentage arrived at? To give U.S. steelmakers enough sales to remain profitable, so they can continue to operate as if they were the first choice of customers who would now rather buy elsewhere.
- In the annual battle over budget cuts, many politicians refuse to eliminate programs, instead favoring an across the board freeze so the pain is “shared equally.” Why? Because every interest group that once mustered enough political power to obtain



a subsidy is deemed entitled to that subsidy forevermore, regardless of its current merit.

- And what about those cost of living allowances on Social Security and government pensions? The purpose of a cost of living allowance is to make recipients whole after inflation. But inflation is a hidden tax, a way for the government to take additional resources out of the private economy. If some are allowed to live under the illusion that inflation is not a burden, then the burden on others is increased.

- My favorite example of our new theory of rights is tobacco farmers. Here is a group of people whose particular product is, in effect, a poison. Yet at the same time the federal government spends billions to counter tobacco's harm, it continues to subsidize tobacco farmers, apparently on the theory that it is "not their fault" that their product has been found dangerous.

We have traded "the right to life, liberty and the pursuit of happiness" for "the right to stagnate."

In these cases and countless others, politically cohesive groups use the power of government—the power to tax, the power to stop imports at the border, and so on—to shift the burden of coping with economic change to the unorganized mass of taxpayers and consumers.

The right to stagnate is nice, for those who have it. Unfortunately, it is not available to everyone. Since "change is the only constant," people must constantly adapt to it, whether they live alone or in groups.

A person who proclaimed his right to stagnate while living alone on a desert island would find his error quickly corrected by reality. In society, some people can live under the illusion that change can be stopped as long as they can find victims to bear its less desirable consequences.

The right to stagnate must be rationed, and the ration card is political power. Those groups which can organize most easily and whose members have the most to gain from government favors can always outmaneuver larger, less organized groups whose members have relatively little to gain or lose on any particular issue.

In *The Rise and Decline of Nations*, economist Mancur Olson details the correlation between economic stagnation and the power of special interest groups. Those societies which enjoyed long periods of stability—India and China through the ages, and in the last half-century Great Britain—have been choked by the accretion of interest group power. But those societies whose interest groups have been destroyed by war or revolution, such as Japan, Korea, and West Germany, or whose interest groups have been unable to keep pace with a rapid expansion of political borders, such as 19th-century America or the European Common Market in the 1950s, have had extraordinary economic growth.

Olson's analysis is basically pessimistic. Do we need war or revolution to unfasten the hold of special interest groups on the throat of our body politic?

Maybe, just maybe, a moral revolution might be enough. If enough people could recognize the right to stagnate for what it is, and start treating its proponents with the scorn they reserve for common thieves, we might yet realize the American Dream. □

# Cyclical Unemployment

**In the final analysis, government is solely responsible for the business cycle and the unemployment that results.**

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by Hans F. Sennholz

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Dr. Sennholz heads the Department of Economics at Grove City College in Pennsylvania. He is a noted writer and lecturer on economic, political, and monetary affairs. His most recent book is *Money and Freedom*.

**E**mployment is an essential source of happiness and enjoyment. No man, properly occupied, can be miserable for long. To enjoy life, man must employ life, which ought to be his aim and aspiration. To be unemployed is to waste life and invite evil. And yet, millions of people who would like to be employed in the market for goods and services, are sporadically unemployed. They are the primary victims of business cycles.

Economic instability has been the lot of man since the beginning of time. Whether he made his living by hunting or fishing, by cultivating the land, or engaging in industry, commerce or finance, man always faced the vicissitudes of economic life. There were good times and bad times, but these changes were caused by such extraneous influences as crop failures, epidemics, civil strife, or war. Business cycles are modern phenomena—products of the modern economic order with its political conditions and institutions. The first business cycles in the modern sense were recorded in England during the second half of the eighteenth century. The first American depression is known to have taken place in 1819. In many parts of Europe, cycles did not appear until the middle of the nineteenth century, in Russia and Japan not until the end of the century.

Business cycles are visible changes that take place in business conditions over periods of time. Boom conditions are followed by spectacular crises and painful readjustments commonly called depressions. During the course of a cycle the factors of production are subjected to radical changes in demand; they may work overtime during the boom phase and be idle during the crisis. They may enjoy rising prices and incomes during the boom, and suffer staggering losses in the depression. Labor may reap rising wages and benefits during the boom and face unemployment during the depression.

Observers of the economic enigma readily offer their explanations. One group attributes the cycle chiefly to other than economic occurrences such as political incidents, to conflicts and wars, or to changes

in the growth rate of population or international and intranational migration. Economists are quick to discard such “outside factors” because they are not inherent to the economic process.

Some economists attribute business cycles to accidental combinations of unfavorable economic circumstances. They are convinced that each depression has its own particular origins such as inadequacy in the stock of money, hoarding and scarcity of credit, over-investment in industry, new technology or real estate. “Practically every economic fluctuation,” Joseph A. Schumpeter explained, “must be a historic individual and cannot be made amenable to explanation but by minute historical analysis of the innumerable factors actually at work in each case.”<sup>1</sup>

Most students of the business cycle question the accidental-combinations theory. They are convinced that a single cause affects the economic system and generates the cyclical fluctuations. But they differ widely on the nature of the cause. The different explanations offered by distinct schools of thought may be classified according to the causative factors they emphasize:

- I. The complexities of division of labor
- II. The capitalistic system
- III. Government intervention

**M**any economists point at an “anarchy of production” resulting from the division of the production process as the cause of crises and the unemployment they engender. It is difficult, they assert, for businessmen with limited knowledge of the demand for their products to maintain equilibrium. Entrepreneurs and capitalists face great uncertainties that spring from the roundaboutness of time-consuming processes of production. Moreover, economic goods are produced to be exchanged, which invites errors of judgment that tend to develop cumulatively either toward optimism or pessimism.

A.C. Pigou, reflecting on the economic stagnation of the early 1920s, explained that two businessmen make “at the same time now an exaggerated, now an inadequate estimate of the other’s prospective real demand for his stuff. No study of trade cycles can be adequate in which this point is misunderstood.”<sup>2</sup> Professor Taussig, the foremost American economist of his time, pointed at different stages in the production process that invite errors in entrepreneurial judgment leading to overproduction. “There is overproduction, stoppage, and shut-down, reaction in turn on the making of plant and materials, cessation in the industries which will produce these, and general depression. The recurrence of commercial crises in this way is to be ascribed in the main to overproduction.”<sup>3</sup>

More than 200 years ago Adam Smith viewed man’s division of labor as the most beneficial factor of economic improvement. In the very first sentence of *The Wealth of Nations* Smith rejoiced about the division of labor. “The greatest improvement in the productive powers of labour, and the greater part of the skill, dexterity, and judgment with which it is anywhere directed, or applied, seem to have been the effects of the division of labour.” In contrast to Smith, many modern writers are alarmed about the complexities and difficulties of finance

## The Complexities of Division of Labor

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***“The capitalistic mode of distribution allocates to every participant the market value of his contribution to production: the businessman his profit, the investor his interest, the manager his salary, and the worker his wage.”***

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and management that spring from the division of labor. At a loss for an explanation of depression and unemployment, they point at the separation of work into many different component operations through specialization. But no one concludes that man should return to less specialization, which would mean lower labor productivity and lower wage rates.

If improvements in the division of labor actually caused depression and unemployment, the business cycle in the most productive countries, with the most advanced division of labor, would have to be most severe and painful. Feverish booms would be followed by deep depressions. Americans would be affected more severely than Mexicans and Bolivians. In reality, depressions and unemployment are worse by far in Mexico and Bolivia than in the U.S. This is because the follies of government intervention are generally greater in Mexico and Bolivia than in the U.S.

If improvements in the division of labor actually caused depressions, business cycles should have grown worse in recent decades that witnessed world-wide improvements in the division of labor. In reality, recent recessions were demonstrably milder than the Great Depression of the 1930s. Moreover, every improvement in technology, every new instrument of production, which are the fruits of the division of labor, should usher in a new depression and mass unemployment. Every improvement in American computer technology, for example, should breed another cycle. It is obvious that economic reality differs from such conjectures.

To point at “overproduction” as a cause of business cycles is to ignore the unlimited needs and wants of most individuals. While millions of people are starving and thousands are perishing from hunger and want, it is insensible to speak of overproduction. Of course, it is understandable that the socialistic world that is chronically lingering in poverty and despair likes to point at capitalistic countries and charge them with “overproduction.”

## **The Capitalistic System**

**M**any writers in search of an explanation of the business cycle limit their indictment to the capitalistic system that permits private ownership of the means of production. One group finds fault with capitalistic modes of income distribution; another group centers its attention on the capitalistic process of production.

The capitalistic mode of distribution allocates to every participant the market value of his contribution to production: the businessman his profit, the investor his interest, the manager his salary, and the worker his wage. Some earn high incomes because they make great

contributions to the economic well-being of their fellowmen; others earn little because they contribute little. The critics generally prefer a more equal distribution of income and wealth which, in their belief, would assure economic stability and full employment.

Lord Lauderdale (1759-1839) first pointed to consumption as the decisive factor for the quantity of labor that can be employed. "Forced parsimony" reduces the funds allotted to consumption and employment of labor.<sup>4</sup> Similarly, Thomas Robert Malthus (1766-1834) warned against the over-accumulation of capital. A more equal distribution of wealth would alleviate economic stagnation and decline. He favored public works as a means of employment and relief for the working classes: ". . . to assist the working classes in a period like the present, it is desirable to employ them in unproductive labors, or at least in labor, the results of which do not come for sale into the market, such as roads and public works."<sup>5</sup>

The business cycle theory of Lauderdale and Malthus, faulting the manner in which income is distributed, evoked answers by Jean Baptiste Say, David Ricardo and John Stuart Mill. They developed the so-called *law of markets*, which in essence denies that business cycles spring from "over-accumulation" and the manner in which income is distributed. By the end of the nineteenth century they reigned supreme in the economic world, which caused the critics to shift from the side of distribution to the side of production. The material conditions in the modern capitalistic order, in particular the roundabout methods of production, now came under attack for causing the business cycle.

Karl Marx in the main echoed the Lauderdale-Malthus explanation, but the thrust of his argument was "exploitation" rather than accumulation and inequality of incomes. Business crises are periodic climaxes of the conflicts inherent in the capitalistic system. Conflicts arise from the accumulation of capital and the growing proportion of fixed capital, which causes a decline in the consuming power of workers. The capitalists "exploit" labor and apply their ill-gotten gains, which they call "savings," to increase production. In short, they destroy their own markets by reducing "wage capital," the consuming power of laborers. Depressions temporarily restore the equilibrium between production and consumption.

Marx managed to present yet another explanation for business crises based on the life cycle of business capital. Because capitalists invest in spurts and bursts for various periods of time, "business undergoes successive periods of depression, medium activity, precipitancy, crisis. . . . A crisis always forms a starting point of large new investments."<sup>6</sup> In short, businessmen not only exploit their workers but also invest erratically and capriciously, which adds instability to exploitation. Their notorious behavior inevitably causes depression and unemployment.

A century after Marx, his countless followers throughout the world continue to explain business cycles as characteristics of capitalism. Total consumption, they propound as revealed truth, lags behind total production because of labor exploitation, which is robbery. Wherever Marxians come to power they summarily abolish private property in the means of production. Wherever they lack political power they openly advocate its abolition.

Throughout the free world the Marxian explanation contends against other explanations, the most popular of which is that of John Maynard Keynes (1883-1946). This British economist was to become the economic patriarch of the free world. The foundation of the Keynesian structure is the Malthusian concept of effective demand which Keynes defines as "the aggregate income (or proceeds) which the entrepreneurs expect to receive . . . from the amount of current employment which they decide to give."<sup>7</sup> Professor Keynes made consumption the primary element of his economic order. Consumption limits production, not the other way around as the Classical economists had seen it. The "propensity to consume" becomes a basic independent variable. It brings into existence both production and capital as factors of production. Consumption, along with investment, is the basis of "effective demand."

Conceived during the Great Depression and resting on the idea of secular stagnation, Keynes' theory is a scheme of escape from depression by way of a planned or managed economy and socialized demand. The Classical economists built on the assumption of harmony or similarity of interests. In the footsteps of Karl Marx, Professor Keynes built on disharmony and conflict. The interests of savers and investors do not match, which in turn clash with the interests of consumers. Private capitalists are apt to be greedy exploiters or inefficient bunglers, or both, and do not require the rich rewards they usually pocket. To restore and maintain more desirable economic conditions, Professor Keynes recommended central control by politicians and officials. He called upon the state for protection from foreign competition and internal regulation to assure "equitable distribution of wealth and income" and "full employment."

Keynesian doctrines came to exercise great effect upon government policies throughout the world. The doctrines were not new; there were no new elements in the system, and no new proposals of policy. But the combination of elements, policies, and terminology was new. J.M. Keynes rebuilt an old machine and made it look new. And yet, despite its new appearance it was akin to the appointments of eighteenth century Mercantilists and Physiocrats, and related to the thought which the Classical economists meant to expose and explode.

Thus, most contemporary writers point at one or several features of the capitalistic order as the disturbing factors that are said to upset the economic equilibrium and thus create the business cycle. While they engage in heated debates about the particular feature or features that presumably cause the evil, they leave no doubt that the private property order is ever breeding instability and unemployment. This is why they are demanding that government, the political apparatus of coercion, remedy the stated defects or abolish the system.

## Government Intervention

Only a few members of the Austrian school, in particular Ludwig von Mises and other writers in his footsteps, have drawn the extraordinary conclusion that, in the final analysis, government, as the creator of the monetary order and the monopolist of legal-tender currency, is solely responsible for the cycle. These economists deplore all notions and doctrines that place politicians and government officials in charge of the people's money and cause them to print ever more for the sake of economic "growth"



Unemployment office, Pittsburgh, Pennsylvania, 1938.

ARTHUR ROTHSTEIN

and full employment. In the judgment of these economists, the people must be liberated from the money monopoly and all politicians be banned from monetary matters.

In his explanation of the business cycle Professor von Mises combined given knowledge with new insights. He built on the Ricardian analysis of the effects of currency and credit expansion, on Böhm-Bawerk's theory of capital and interest, and on Wicksell's explanation of the potential gap between the "natural" rate of interest and the hampered market rate. Mises concluded that central banks tend to orchestrate processes of money and credit expansion that falsify interest rates. They create and emit new funds which lower interest rates and thereby entice businessmen to embark upon expansion and modernization. A feverish boom is created; wages and other business costs tend to rise.<sup>8</sup>

Drawing on the monetary theory of Mises, his teacher, Friedrich A. Hayek developed a theory that explains how monetary disruption al-

ters relative prices by falsifying interest rates and the pattern of investment. The creation of money and credit generates a new source of demand of goods and resources to which business will react. At first, it generates a shift of spending in favor of future rather than current consumption. That is, it kindles an "investment boom" with rising employment by attracting resources that otherwise would have been consumed. The resources will remain so employed as long as the creation of money continues. It must be continued at accelerating rates in order to maintain the boom employment. If it is discontinued for fear of run-away price inflation, a readjustment commences in the form of depression. If, on the other hand, the monetary expansion continues at accelerating rates, it must ultimately lead to the breakdown of order and production, to disintegration of the division of labor and mass unemployment. A government that, for any reason, embarks upon such policies, holds a tiger by the tail that in the end will devour its keeper.<sup>9</sup>

## The Austrian View

**A**ustrian economists see eye to eye about the cyclical movements of economic activity. They agree that employment moves strongly with the basic changes in activity but typically is slower than other features of the cycle. In reaction to declining interest rates, activities preparatory to investment expenditure lead the way—such as incorporations, corporate appropriations for capital expenditures, issuance of building permits, contracts for construction, orders for machinery and equipment, rising commercial debt, and new equity issues. Employment together with general output and consumer prices are slower to react to the new situation. The reason is obvious: it is less onerous and exacting financially to seek a building permit or secure a line of bank credit than to engage and train human labor. Moreover, the building permit may be allowed to expire, the bank credit may remain unused, the equipment order may be shelved, but human labor cannot, with good conscience, be readily hired and then dismissed.

Labor costs per unit of output tend to lag behind other cycle phenomena. Labor contracts usually extend over lengthy periods of time, which keep total labor costs relatively constant but impose great variations in unit costs depending on the level of output. During the early boom when unit costs fall, the demand for labor tends to rise and wage rates and fringe benefits follow suit. When, later in the cycle, business activity slows down and unit labor costs soar, it is rather difficult to reduce wage rates and fringe benefits. Labor contracts may impose long-term commitments; but even if they do not, it is more difficult psychologically and more troublesome to labor relations to reduce wage rates and moderate labor conditions than simply dismiss labor. It is simpler to dismiss a worker than to reduce his wage rate because he can readily understand and accept unemployment, without lasting damage to his self-esteem, being dismissed for reasons of "lack of work"; it is more difficult by far to accept wage reductions because of "rising unit costs." Unemployment due to "lack of work" obviously places the responsibility on some mysterious factors over which the unemployed worker has no influence. But to be unemployed for reasons of "excessive labor costs" allocates some responsibility not only to the monetary authorities generating the cycle but also to the



***“All depressions in American history have had their beginning in a boom that was bred by government intervention.”***

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unemployed themselves who may have contributed to the boost in costs and then refuse to suffer wage and benefit reductions.

Fluctuations in the number of employed workers are larger in capital goods and commodity-producing industries than in the service trades. After all, the cyclical fluctuations originate in the capital-goods and commodity-producing industries that readily respond to the currency and credit expansion. Businessmen embark upon construction that exhilarates all industries catering to business, that is, tools and dies, computers, steel, copper, lumber, and the like. It also explains why these industries are the first to suffer the fevers and chills of the business cycle. Moreover, the decision to expand or modernize a business is always entrepreneurial; it rests on the perception of the future which is uncertain. Businessmen are quick to change their construction orders when their outlook changes.

Wage disbursements fluctuate within a wider range than salary payments. In business usage, salary refers to a fixed monthly rate of pay, wage to an hourly rate. It is difficult for psychological reasons to reduce any rate of pay when business conditions deteriorate and labor productivity declines. But when labor costs must be reduced because business survival is at stake, employers are likely to begin their layoffs with hourly labor. In most cases this is unskilled or semi-skilled labor and requires very little training. It can be replaced readily and recalled easily without much training expense. On the other hand, employers generally are reluctant to dismiss salaried personnel, which is skilled labor, requiring lengthy schooling, training or apprenticeship before it can be employed productively. Moreover, generous employment compensation paid to unskilled labor tends to immobilize it, keeping it at company gates and waiting to be recalled. Unemployment compensation for skilled or professional labor loses its paralyzing effects when it becomes insignificant relative to the income that can be earned elsewhere. Skilled labor is quick to move on in search of other employment as soon as it is laid off, which makes employers rather reluctant to release it even temporarily.

**T**his sketch of the nature of business cycles rests on the common cause of all cycles: the money and credit expansion. Government, or its monetary authorities, may conduct it willfully and purposely in order to pursue some other objective, such as full employment, economic redistribution, or its own power and growth. Or, government may monopolize the issue of legal tender money and impose an institutional setting that is bound to disrupt the economic order. American history discloses no cycle that did not spring from this common cause. All depressions had their beginning in a boom that was bred intentionally or inadvertently by government intervention. The political powers to be who brought forth the first depression of 1819 also begot the depressions of 1839-1843,

## **A Common Cause**

1873-1879, 1895-1897, 1920-1921, 1929-1938, 1949-1950, 1953-1954, 1957-1958, 1960-1961, 1966-1968, 1973-1975, 1981-1983. The unemployment that accompanied these depressions must be charged to the same political powers.

Some business cycles were merely disruptions of domestic activity; others encompassed trade and commerce throughout the world. The depression of 1920-1921 attained international scope; the depression of the 1930s assumed catastrophic proportions around the globe. Under the influence of like beliefs and doctrines, governments the world over conducted similar policies that bore similar fruit. Moreover, international interdependence and division of labor cause business cycles to spread from country to country. In small countries, especially, foreign trade and commerce may comprise the lion's share of economic activity, and foreign conditions may have a decisive influence on domestic matters. Foreign exports and imports, world commodity prices and interest rates usually play a vital role in the process of cycle transmission.

In recent years business cycles have become global disruptions that emanate from the U.S. In 1971, under U.S. leadership, all governments summarily abolished the last vestiges of the gold standard and enthroned the U.S. dollar as world money. They made the U.S. government and its Federal Reserve System the central banker of the world. This banker obviously may expand or contract his accommodations, dispense or withhold his favors and thereby determine the liquidity or illiquidity of the world. He may kindle a world boom or squash it with deflation and depression; the world depends on his discretion and wisdom.

## Automatic Stabilizers

**T**he new monetary order seems to aggravate the severity of the business cycle. The 1981-1983 depression proved to be immeasurably more painful and potentially more destructive than the depression of 1973-1975, which in turn was the worst since the Great Depression. And yet, despite the visible recurrence of painful cycles and in spite of their growing severity, many American economists point with confidence to the "automatic stabilizers" that are said to alleviate the disruptions. They derive comfort and confidence from the vast expansion of government, the "stabilizing influence" of the income tax, the growth of unemployment insurance and programs of social security. As a result of these changes, personal income has lost its direct link with the fluctuations of production. In fact, when industrial production falls significantly, total output may decline very little, and the aggregate of personal income, especially after-tax income, may not decline at all because government collects much less in taxes from corporations and individuals, but spends much more on unemployment insurance and social security payments.<sup>10</sup>

Unfortunately, all these "instruments of stability" are merely contemporary manifestations of the sovereign power over money and the right of government to inflate and depreciate the money. If it were not for this power and the ever-active printing presses that seek to stimulate and energize the sagging "private sector," a deep depression would engulf economic production. The vast expansion of government does not impart economic stability; it imposes a crushing burden on economic life and serves to destabilize it. Boosts in social security taxes

or unemployment insurance taxes do not stimulate economic life; they depress it and create ever more unemployment.

When government resorts to inflation in order to stimulate activity and alleviate unemployment, it makes matters worse. Inflation disarranges the production process, rearranges the distribution of labor among industries, and thereby makes more and more workers dependent on the *continuation*, often even on an *acceleration*, of the rate of inflation. When, in the end, the inflation ceases or slows down, labor must scramble to readjust and return to more productive employment as prescribed by consumer choices and orders. The readjustment process may be slow and painful, the unemployment severe and prolonged.

Many economists rejoice about the visible shift of employment from basic industries to service industries, which affords new hope for more stable conditions. Manufacturing, mining, construction, and transportation are the most volatile industries; service industries such as health care and education are said to be more stable. But such hopes, too, are built on the power of government to engage in currency and credit expansion in order to finance the steady employment in the service industries, several of which, after all, either are owned outright by government or heavily subsidized by government. The steady employment of many doctors and teachers squarely rests on the taxing power of government and the effectiveness of its printing presses. It will draw to a close as soon as government loses some of its power either through tax rebellion or hyperinflation, or both.

**T**he old hazards of cyclical unemployment continue to loom on many labor markets. After more than fifty years of strenuous contracyclical effort at all levels of government and nearly forty years of a congressional mandate articulated as the Employment Act of 1946, the forces that create cyclical movements have not vanished. In fact, they are growing in strength especially in those industries that rely on government favors. While the forces of depression are gaining, many Americans continue to cling to the expectation that the federal government will intervene with vigorous monetary, fiscal, and regulatory actions in order to check any depression that develops. But events are beginning to shake this confidence in political wisdom; they are likely to weaken it further in the years to come.

There is new hope. To distrust party politics and government coercion in economic matters is the beginning of economic knowledge and wisdom. □

## Old Hazards and New Hope

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# Don't Sell America Short

**We have much to accomplish and much to be proud of in America.**

by Robert Awenius

Mr. Awenius is a retired attorney and free-lance writer in Tulsa, Oklahoma.

**T**oo many persons take a dim view of the problems that America has faced and solved—and in a negative manner disparage America and its future. They say that the glorious days of our country are over and will not be repeated in the future. Some even contend that we are no longer the world's leader; that Russia has supplanted the United States as a world power. Some of these prognosticators even say that we are through as a nation.

To many foreign nations, America has seemed to be an implausibility—but an actuality, a reality. Our coins contain the motto: *e pluribus unum*, meaning one out of many. But it takes more than a phrase to give unity to 235 million Americans, composed of adolescents and adults, men and women, whites, yellows and blacks, city dwellers, farmers and ranchers, liberals and conservatives, protestants and catholics, Jews and gentiles, factory workers and shop owners, public employees and private employees, and retired persons and workers. A foreigner looking on this melting pot of mixed human elements would expect to hear jeremiads and witness untold trouble, rather than to see the harmony that arises in this nation. Instead of wrenching disharmony, the republic proceeds on a note of unity.

Three centuries ago—1651 to be exact—Thomas Hobbes in England wrote a book entitled *Leviathan*, advocating the doctrine of sovereignty, setting forth the theory that all men fear each other and hence must submit themselves to the supremacy of the state in all secular and religious matters. In Hobbes' time that meant the King. Hobbes would have had considerable trouble accepting the fact of the American experiment of self-government outlasting many kingdoms, dictatorships and assorted despots.

America has thrived in an arena of free enterprise, where the self-regulating free market economy maximizes the free choice of our citizens. Here private entrepreneurs are relatively free to start a business—any business they wish—without obtaining permission of an official; and they can set their own prices and locate in any place in the country. This is in contrast to the authoritarian practices in much of today's world where centralized planning is the motif. Such planning is much akin to the mercantilist regulations of European economies in the seventeenth century. In this country the invisible hand of the market place can better organize an economy than the command economies of autocratic nations.

Yes sir, under our form of limited government and free enterprise, America is in good hands. Don't sell America short. □

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# Morality of the Market

by John Chamberlain

**T**he Fraser Institute of Canada had a grand idea when it invited more than two dozen people of varying persuasions and expertise to talk about the morality of the market. The idea was to bring theologians together with economists of a predominantly secularist bias to discuss values as they may affect the ways of men and women who have their livings to make. The results of the Fraser symposium have been collected in a book called *Morality of the Market: Religious and Economic Perspectives*, edited by Walter Block, Geoffrey Brennan, and Kenneth Elzinga (The Fraser Institute, Vancouver, British Columbia, 601 pp.).

Frankly, the book has given me a bad time. I found it utterly fascinating in detail, but it is quite literally all over the place. The participants all had their say, with comments piled on comments, but, in the words of *The Rubaiyat of Omar Khayyam*, they come out as individuals by the same door that in they went.

Not that there is any basic disagreement between Milton Friedman on the one hand and the Reverend James M. Wall of the *Christian Century* magazine on the other about the role that fundamental religious convictions may play in economic affairs. Value assumptions cannot be avoided. The trouble comes from the inability of twenty-eight participants to reach any consensus about the will of God. The general assumption is that the

Creator has endowed human beings with a moral sense, but does this mean that we must all be socialists in order to make human brotherhood a reality? The Catholic bishops come up with one set of answers when they say the decisions of the marketplace must be corrected if there is to be justice to the poor, but they may be missing the forest for the trees. So may certain spokesmen for Protestant Christianity, such as the contributors to the *Christian Century* that Edmund Opitz quotes in his paper about a magazine that he began to read in his school years.

J. Philip Wogaman, a professor of Christian Social Ethics, makes the point that a good economic system should allow for the concepts of stewardship, vocation and charity. He condemns laissez-faire economics for its alleged failure to protect the weaker members of the community and the common environmental inheritance of everybody. He likes the New Deal because it "worked" to bring about "beneficent" social change.

Wogaman is not quite a socialist, for he says there "may well be a need for private centers of economic power." But he is oblivious to the claims of the Vienna and Chicago economic schools that when government intervenes in the disposition of wealth there will be less money in the end available to care for the needs of growing populations. The paradox here is that welfare depends on capital earnings, but the earnings must fall

short if the state takes more than a minimal percentage of the capital usufruct for its own purposes, whether beneficent or not. Wogaman is a clear thinker in his own realm, but it is fairly obvious that he has never seriously studied economics.

In his "overview" paper, John C. Bennett of the Union Theological Seminary explains his own evolution. He was originally influenced by the so-called Social Gospel, and by the Christian realism of Reinhold Niebuhr, which made him a Christian Socialist. But since 1950 he has, as he says, lost his dogmatism. Now he gives "weight" to "the pluralism and the incentives for efficiency and productivity" which are "characteristic" of capitalism. But in conceding that the market has its virtues Bennett has not really changed his mind. "One general conclusion that can be drawn," he says, "is that Christian teaching about finiteness and sin provide warnings against both a consistent socialism and a consistent faith in the market economy."

This sort of talk leaves me floundering. The Twentieth Century offers ample proof that socialism can't feed its own people. The private plots are what keep Russian peasants going. Collectivist agriculture in Africa has starved its millions. In Red China they are now turning to enterprise zones in an effort to restore the productivity that Maoism killed. Sweden's vaunted Middle Way struggles along by tolerating capitalist enterprise, but the boredom that comes with leveling incomes has resulted in a high suicide rate. Ludwig von Mises proved long ago that the problem of calculation is insoluble under complete socialism. Without a price system nobody would know how much wheat to plant, how much fertilizer to produce, or how many widgets to make.

In short, faith in a market system is a *sine qua non* if the human race is to endure and proliferate. Where people have lost their faith in the market,

production has faltered, and the worst, as Hayek has said, have risen to the top to make slaves of the rest. It is an insult to God's intelligence to argue that Christian teaching about sin demands an equal amount of skepticism of both socialism and the free market. The latter lets more people live, which is in full accord with the Biblical injunction to increase and multiply.

Michael Novak's overview paper takes direct issue with Bennett's. Novak has no hesitation in saying that the market is far more concordant with the Christian vision of the human being than any system of production and distribution by political command. Voluntary exchange and autonomous choice, he says, are critical both for religious liberty and for freedom to preach the Word.

There is most certainly a lot to life besides economics. Edmund Opitz quotes Matthew Arnold on the instinct for intellect and knowledge, the instinct for beauty and poetry, the instinct for social life and manners, and the instinct for religion and morals. These demand expression just as much as the instinct for accumulation and expansion. But if there is no accumulation and expansion, there will be fewer people around to seek knowledge and beauty.

Ed Opitz, commenting on Ezra Mishan's paper, says there is a great deal of truth in Mishan's contention that economics and politics have usurped a position in our lives that their intrinsic merit does not deserve. But without science, technology and large-scale production four-and-a-half billion people would have little energy left to cultivate the non-economic values. The big question posed by this book is whether a market system or a command system is more compatible with finding scope for expressing the Arnoldian instincts. The answer should be the market system, but the babel of voices in this book is more confusing than clarifying. □

**Essays in the History of Liberty: Selected Writings of Lord Acton**

edited by J. Rufus Fears

Liberty Classics, 7440 N. Shadeland, Indianapolis, IN 46250 • 558 pages, \$15.00 cloth; \$7.50 paperback

*Reviewed by Tommy W. Rogers*

**L**ord Acton (John Emerich Edward Dalberg-Acton), 1834–1902, was a major figure in the Liberal Catholic Movement, and was instrumental in transforming the writing of English history into a rigorously scientific discipline based on the model of German scholarship. The themes Acton expounded in his philosophic and journalistic activities as essayist, lecturer, and reviewer were those of individual liberty, political self-government, and unfettered scientific research.

The book opens with Acton's celebrated 1877 lectures on the history of freedom in antiquity and in Christianity. Acton argued that Christian civilization emphasized the dignity of the individual and offered him a gift of freedom beyond anything offered by Greece or Rome. He viewed the church as a force in society capable of limiting the power of the state; and "it is only by abridging the authority of states that the liberty of churches can be assured." By the same token, Acton condemned any effort by the church to wield secular power, as being the "absolute power which corrupts absolutely."

Here also are the essays on the Puritan Revolution and the rise of the Whigs. But of more interest to us are the essays on the colonies and on the American Revolution. A society emerged on these shores, Acton wrote, "more powerful, more prosperous, more intelligent, and more free than any other that the world has seen."

Acton analyzes the philosophic issues underlying the Civil War in America, declaring that "the one rul-

ing element in the American war, which reduces all others to comparative insignificance, is the defense of the rights of self-government against the theory that there is a supreme, irresistible, and irresponsible power." Slavery, in his view, was not so much the cause of secession as the reason for the failure of secession and of the Confederacy. Acton felt that the Confederacy, apart from slavery, and viewing the Confederate Constitution as a political document, justified saying that "history can show no instance of so great an effort made by republicans to remedy the faults of that form of government (republican). Had they . . . called on Negroes to be partners with them . . . I believe that generous resolution would have conferred in all future ages incalculable blessing on the human race." In a letter to General Lee, Acton wrote: "I mourn for the stake which was lost at Richmond more deeply than I rejoice over that which was saved at Waterloo."

Acton's consistent rebel sympathies, which he extended to the Boers in South Africa, shaped his understanding of the issues at stake in the great struggle between Union and Confederation. Northern victory in the American Civil War, he argues, represented the triumph of political centralization over principles of federalism, self-government, and liberty under the law.

When Acton wrote that "Power tends to corrupt and absolute power corrupts absolutely," he spoke to generations past and future. How often has this phrase, this principle, been aptly descriptive of contemporary affairs! In an era when the state intrudes increasingly into the domain of the personal, the private and the spontaneous, Acton's insight into the meaning of human liberty and the dynamics which threaten its promise and exercise, remains salient and timely.



## Rivalry and Central Planning: The Socialist Calculation Debate Reconsidered

by Don Lavoie

Cambridge University Press, 32 E. 57th St., NY 10022  
• 208 pages, \$34.50

## National Economic Planning: What is Left?

by Don Lavoie

Ballinger Publishing Co., Cambridge, MA 02138 • 291  
pages, \$25.00 cloth; Cato Institute, 224 Second Street,  
SE, Washington, D.C. 20003, \$9.95 paper

*Reviewed by Bettina Bien Greaves*

Ever since the days of Karl Marx, opponents of the "establishment" have argued that socialism is the answer to all social ills. But Marx gave few clues as to the precise form that socialist society would take, and he attacked as "utopians" any who sought to describe it. Nevertheless, the inevitable inference to be drawn from his writings is that socialism would substitute central planning for the capitalist "anarchy of production" and for the isolated mercantilist interventions against which Adam Smith (1776) had directed his barbs.

After World War I, Marxian socialists gained control in several European nations. They set up commissions to study how to implement central planning, but they had no clear idea how to go about it and, except in Russia, the power of the central planners waned.

Into this controversy in 1920 ventured the late Ludwig von Mises, then a rising young economist in Vienna, Austria. Mises pointed out that if the factors of production were owned and controlled by a central planning authority there would be no markets for them. With no market for the factors of production, there would be no market prices for them. And without market prices, the planners would have no guideposts to help them decide what, when, where, how or how much to produce.

Mises' position that central plan-

ning couldn't be made to work with any degree of efficiency was largely ignored by the would-be planners. Thus Lenin tried to introduce Marxian planning in Russia in one fell swoop after the 1917 Communist Revolution. The attempt proved a disaster. The country was thrown into utter chaos. Lenin was forced to retreat and in 1921 introduced his New Economic Policy, which restored some function to the market. This Russian experience lent support to Mises' thesis that central planning couldn't be made to work.

In the 1930s, the economic calculation debate was revived. F. A. Hayek and the late Lord Lionel Robbins, especially, made important contributions, supporting, elaborating and helping to clarify Mises' reasoning. A number of Marxian socialists attempted to respond. Dr. Don Lavoie reviews the controversy anew in *Rivalry and Central Planning*, originally his doctoral dissertation

Lavoie begins with Marx's writings, extracting from them Marx's prescription for socialism, a painstaking process for it must be inferred from Marx's negative remarks about capitalism. Then Lavoie shows that all attempts to respond to Mises' 1920 challenge have failed to answer his critique of economic planning. Socialists over the years who have tried to answer Mises still do not realize that the central planning they advocate means state ownership and control of the factors of production, which precludes the development of market prices, disrupts the vital transmission of knowledge through the price system and, therefore, makes realistic economic calculation impossible. Mises' fundamental critique still stands.

\* \* \*

The title of Lavoie's second book is *National Economic Planning: What is Left?*, a double entendre. In the first place, Lavoie asks, is anything to the ideological "left" of national eco-

conomic planning? And secondly, he speculates, now that all serious attempts to introduce economic planning on a national scale have been abandoned, just what is left of them?

Lavoie begins by discussing three systems through which social activities may be coordinated—tradition, the market and planning. Tradition is admittedly suitable only as a means for coordinating activities in simple societies. The market, on the other hand, has led to the coordination of extensive and complex social activities. It has facilitated rapid experimentation and the development of countless new productive techniques. Impartial observers must admit that the extent of social cooperation and specialization under market coordination and the increase in production it has brought with it are remarkable. Lavoie then discusses the third possibility: economic planning. He concludes it has two fatal flaws.

The first flaw inherent in national planning is the totalitarian threat, the danger that a Hitler or a Stalin will gain control.

The second flaw is due to the knowledge problem, expertly developed by Lavoie in Chapter 3. How, Lavoie asks, will the central planners obtain the tremendous amount of widely dispersed information they need to coordinate successfully the complex activities of an entire economy, especially since much of this knowledge is unarticulated, existing only in the minds of scattered persons, in the form of ideas, plans or dreams?

The crux of Mises, and Lavoie's thesis, is that property should be privately owned and production planned by the private property owners. With free markets and competition among them, prices develop for goods, services and factors of production, indicating their relative value to consumers. For instance, as F. A. Hayek points out in "The Use of Knowledge in Society":

Assume that somewhere in the world a new opportunity for the use of some raw material, say, tin, has arisen, or that one of the sources of supply of tin has been eliminated. It does not matter . . . which of these two causes has made tin more scarce [and thus more expensive]. . . . All that the users of tin need to know is that . . . they must economize tin.

Free and flexible market prices furnish private entrepreneurs with almost instantaneous knowledge about consumer wishes and also about the constantly changing supply of, and demand for, resources. When production is centrally planned, there are no market prices for the factors of production. Thus, national economic planning must inevitably founder for lack of the knowledge entrepreneurs obtain on the market from instant to instant through the medium of constantly fluctuating free competitive prices.

Lavoie's critique of *National Economic Planning* is masterful! It is also pertinent to the 1980s. Lavoie extends his analysis to many post-Marxian schemes, including such recent schemes as those of Wassily W. Leontief, Felix Rohatyn, Robert Reich and even Tom Hayden. Let's hope these recent planners read not only the few pages devoted to them but also earlier portions of the book where Lavoie demolishes the theory of planning.

\* \* \*

I have two bones to pick with Lavoie. The first concerns his use of the labels "radical" and "reactionary." These words have no clear ideological meaning in themselves. A "radical" change in politics, according to Webster, is a sweeping or fundamental change in law or method of government. But the word itself does not specify the direction the change should take. Similarly, to advocate a policy of "reaction" gives no indication in

itself as to what political or social condition one wishes to return to. Lavoie could have avoided confusion by using more descriptive terms such as "classical liberal" or "free trade internationalist" for "radical," and "interventionist," "statist," "militant nationalist" or "socialist" for "reactionary."

Secondly, I was most disappointed to find a scholar and economist of Lavoie's understanding and stature revealing such historical naivete as to attribute the *idea* of protectionist legislation to special groups of businessmen, bankers and industrialists. According to Lavoie, "the origins of planning in practice constituted nothing more nor less than governmentally sanctioned moves by leaders of the major industries to insulate themselves from risk and from the vicissitudes of market competition."

The responsibility for our present hodgepodge of interventionist programs that help some and hurt others must be laid at the door of well meaning if misguided voters and politicians, misled by mistaken intellectuals—"economists," professors, journalists and others—who believe that the remedy for almost any economic problem is a law. Businessmen, bankers and industrialists were not

generally the culprits. Before the enactment of protectionist legislation, their interests are diverse; they are competitors. It is only *after* government grants them special favors that they acquire interests in common and form combinations to sponsor more legislation. To be sure, once protectionist legislation is in place many of them profit in the short run. Also many now seek continued government protection, privileges and benefits. This is not surprising, for once a program is established and businessmen have adjusted to it, they have a special interest in keeping that legislation in force. However, special interest groups are products of intervention, not vice versa.

\* \* \*

Both these books make important contributions to economic understanding. It is Lavoie's hope that his *Rivalry and Central Planning*, which deals with the classical argument over economic calculation under socialism, will stimulate renewed discussion of this debate. *National Economic Planning*, which analyzes partial as well as total planning, should lead some modern-day advocates of government controls and regulations to question their own proposals. □

## **In Future Issues . . .**

### **May**

- "The Continuing Plight of Agriculture" by Dennis Bechara
- "Unemployment Compensation" by Hans F. Sennholz
- "Hostile Acquisitions and the Restructuring of Corporate America" by Frank W. Bubb

### **June**

- "Deregulation of the Natural Gas Industry" by J. D. Steelman, Jr.
- "It's Not Our Money" by James L. Payne

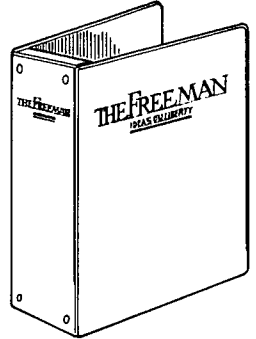
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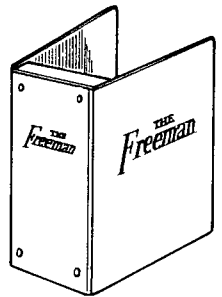
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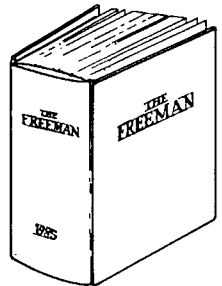


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# THE FREEMAN

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*The Freeman* considers unsolicited editorial submissions, but they must be accompanied by a stamped, self-addressed envelope. Our author's guide is available on request.

### New Cars, Used Buyers

For the sixth straight year, Japan has bowed to U.S. political pressure and imposed quotas on its auto exports. What will this mean for American consumers?

First, less competition. With fewer Japanese imports, consumers will have fewer cars from which to choose.

Second, higher prices. By restricting competition, the quotas have raised the prices of both Japanese imports and American-made cars. Estimates of these price increases run into the hundreds and thousands of dollars. By any estimate, the quotas have cost U.S. consumers billions of dollars.

Third, fewer U.S. exports. The fewer dollars we spend overseas, the fewer dollars foreigners will have to buy American goods. By restricting imports, we also restrict exports.

Fourth, no net saving in jobs. As Professor Hans F. Sennholz has demonstrated in his series of articles on the labor market (see page 186 for this month's article), unemployment is primarily a wage-rate phenomenon. To the extent that quotas enable U.S. auto workers to raise union wage-rates above market-clearing levels, unemployment actually rises.

### No Peanuts

With the plight of American farmers so much in the news, we welcome this month's article from attorney Dennis Bechara, "The Continuing Plight of Agriculture." In seeking the causes of the farm crisis, Bechara found a maze of regulations which waste scarce resources, raise consumer prices, and harm the very farmers they are supposed to help. For example:

"In 1949, Congress granted the then existing peanut farmers an allotment,

or a license, to grow peanuts and thereby closed the doors to others. Thereafter, nobody without such a license could grow peanuts. At the present time, about half of all peanut growers rent their allotments from the owners of such licenses. The cost of such rental payments is then calculated into the price support system, which in turn, raises the subsidy to the peanut grower. In addition, since 1977 the amount of peanuts that may be marketed domestically has been artificially limited, so that the price of peanuts has increased. In 1981, the program was amended to allow anyone to harvest 'additional' peanuts so long as these are destined either for export or for oil or meal uses.

"The domestic price of peanuts is much higher than the world price. This, in turn, has led to import and export controls. For example, 'additional' peanuts may be exported, but peanut butter made from these additional peanuts cannot be exported. On the other hand, foreign manufacturers can use these additional peanuts to make peanut butter, and then export it back to the United States. The peanut program costs American consumers approximately \$250 to \$300 million a year in higher prices."

Mr. Bechara's article begins on page 178.

## Thirty Years Ago

In the May 1956 *Freeman*, financial consultant Anthony M. Reinach provided a clear illustration of the costs of government intervention:

"There was once a time when the Czechoslovakians were the most efficient makers of shoes. They traded their shoes to Americans for automobiles, farm equipment, and other things which we produced more efficiently than they or our competitors.

Our own shoe manufacturers were therefore faced with converting their production to something wherein they, too, would be competitively productive. But they feared change. So, cloaking their fear in a worthy cause, they sought government 'protection.' Aid was forthcoming in the form of a tariff on Czech shoes.

"Prices of shoes went up. A few wealthy citizens felt that they could no longer afford as many shoes as they once had, and the less wealthy were obliged to own fewer shoes or deprive themselves of something else they may have wanted. Some, who could afford to wear shoes at Czech prices, now chose to go shoeless rather than pay the new 'protected' prices.

"Although we are mainly concerned with the consumer, it can also be seen that government interference affects others. For example, some marginal retail shoe stores were now forced out of business, and more prosperous stores found themselves less prosperous through loss of trade. The same holds true for the shoe importers, wholesalers, jobbers, and others. The Czechs, of course, have had their shoe market curtailed. And the manufacturers of those items which had been used in trade for the Czech shoes were injured in proportion. This is only part of the picture, but it does serve to illustrate the endless harm generated when government enters the market place."

---

## End Notes

- We're pleased to announce the winners and runners-up in FEE's first student essay contest. See page 177 for details.
- Limited space is still available in our week-long summer seminars (June 15-21, July 13-19, and August 3-9). Call Greg Rehmke here at FEE (914) 591-7230 ☐

# Liberties Lost in the Balance

**Government intervention leads to irreconcilable differences.**

---

by Joseph S. Fulda

---

Joseph S. Fulda is Assistant Professor of Computer Science at Hofstra University and resides in Manhattan.

One of today's major functions of the Supreme Court is to decide between competing claims based on the rights of the parties to the dispute. In balancing the parties' rights at least one side and often both sides find their rights circumscribed.

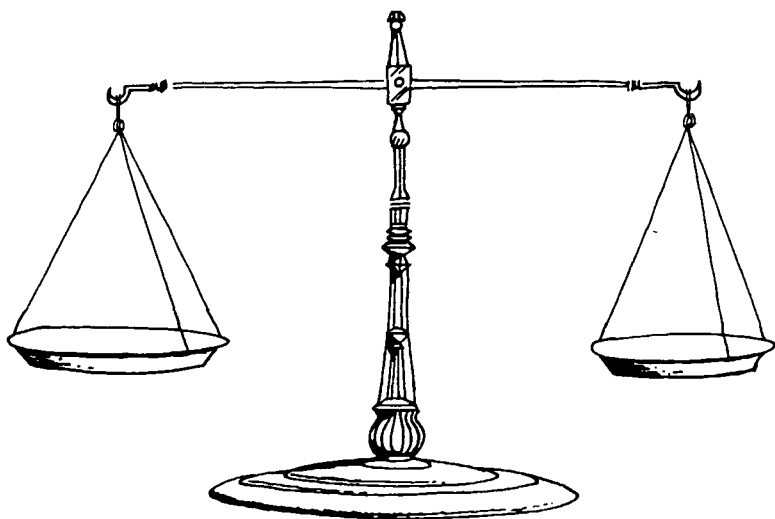
As we shall show by means of several well-chosen examples, this function of the High Court (and for that matter, lower courts and legislators as well) would be rendered nugatory in a libertarian society. In each case there is some underlying government intervention which forces the conflict between the liberties of the parties and makes a choice between them inevitable.

Consider for example the issue of prayer in the public schools. Proponents say, correctly, that the founders of the Republic never meant to exclude God from the classroom, that prayer has never harmed a soul, that it remains voluntary. Opponents argue, correctly, that students who are "different" and don't pray with the group will be singled out for unpopularity and that a child under such undue pressure has no volition to speak of. They add, correctly, that parents, not schools, should minister to the religious needs and beliefs of children.

And so the issue is left to the Supreme Court to decide. An unending stream of cases: Moments of silence, student-led prayer groups, prayer after school hours but on school property, and the like, is the result. Whatever the court decides, however, and no matter how carefully or idiosyncratically it draws the line between the religious liberty and educational freedom of the various constituencies, someone must surrender a piece of his freedom.

When I am asked whether I favor prayer in the public schools, however, the answer is quite a bit simpler. No lines to be drawn, no careful circumscriptions of rights, and no balancing of one man's liberty against that of another man. "I do not favor public schools," I reply, "and therefore do not reach your question." The key to the controversy is not "prayer" but "public." It is the underlying government





intervention of compulsory schooling and tax-financed, government schools which forces the competing claims to a head. Were the schools to be all private, there would be no problem, as each parent selected the school which best meets the interests of his or her child as the parent defines it.

As another example, consider the demonstrations led by neo-Nazis in Jewish areas. Opponents say, correctly, that hatred has no place in a society of refugees, diverse ethnic groups, and freedom. They add, correctly, that such “speech” was never intended to be free by the Founders, who made a careful distinction between freedom and license. Proponents say, correctly, that the test of free speech in a free society is only met when that which is spoken is repugnant to the great majority of people. They add, correctly, that truth is best served by an unbridled freedom of expression and that hatred is unlikely to take root in today’s benevolent America.

Again, however, someone must surrender his liberty, no matter how the question is decided. Were streets to be private property, as libertarians have proposed, the owners would determine what may or may not take place on their property and the government would not be called on to choose between its citizens. With public ownership of the streets and by-ways of America there is simply no way for the government to accommodate both the claims of those who wish a public forum and those who do not want their sensibilities lacerated by the promulgation of such vicious, vituperative, empty speech.

Most controversies of the day can be reduced to an underlying government intervention. Thus, similar to our first example, we have the furor over sex education, phonics and reading, values clarification, evolution and Creation, and the like. Likewise, public religious displays, smoking in the streets, and soliciting of funds by religious groups in public areas are all similar to our second example. In each case the controversy would disappear with privatization and the rights of *all* parties would be respected. ☐

# Hostile Acquisitions and the Restructuring of Corporate America

**A free market for corporate control tends to protect shareholders and promote economic health.**

by Frank W. Bubb

Frank W. Bubb is a corporate securities lawyer residing in Swarthmore, Pennsylvania.

**“I** think it is time for Congress to send a clear signal to corporate America that we will no longer tolerate unrestrained warfare between top managements for control of corporate assets,” said Representative Peter Rodino (D-NJ). “They [hostile corporate takeovers] do not create jobs. They do not add to the national wealth. They merely rearrange ownership interests and shift risk from shareholders to creditors,” according to Martin Lipton, a Wall Street attorney specializing in takeover defense.

As the wave of highly publicized mergers, acquisitions, buyouts, and divestitures soared to new records in 1984 and 1985, reactions like these became commonplace. Even *Forbes* magazine headlined a feature article on the subject with the following: “As the American economic environment changed, predators emerged from under rocks and began to prey on healthy businesses. Is there no stopping them? Will they devour us all?”

In 1985, some 50 bills were introduced in Congress to regulate corporate acquisitions, primarily to protect target companies. Among other things, such bills would:

- impose additional requirements on tender offerers;
- give the independent (non-employee) directors of a target company the right to veto a tender offer or the acquisition of a controlling interest, subject to reversal by a shareholder vote;
- require tender offerers to file “community impact statements”;
- prohibit open market purchases by one corporation of more than 20 per cent of another’s stock;
- deny successful acquirers a tax deduction for interest on debt incurred to finance their acquisitions.

Although none of the 50 bills made it out of committee, legislative pressure to protect corporations from hostile takeovers will undoubtedly continue.

## Important Principles at Stake

**T**hrough the sensationalism that has surrounded the wave of corporate deals, two important principles have received too little attention: (1) hostile corporate acquisitions play a crucial role in preserving the private property rights of shareholders, helping to maintain large corporations as private—rather than quasi-governmental—institutions, and (2) the ability freely to trade *businesses*, not just goods and services, is an integral part of the right to private property.

In addition, a free market for corporate control and a free market for ongoing businesses are both vital to a society's economic health. Both tend continually to reshuffle assets into the hands of those who can manage them more efficiently.

In their 1932 classic, *The Modern Corporation and Private Property*, Adolph Berle and Gardiner Means observed that control of large, widely owned corporations was becoming separated from their ownership. When a corporation's ownership is dispersed among a large number of shareholders, its current managers usually have effective control because they can use the corporate election process to perpetuate their position.

The dispersion of corporate ownership gives rise to a classic "free rider" problem. If a corporation's managers are not acting in the best interests of its owners, each shareholder has an interest in replacing them. Yet the costs to each shareholder of communicating with other shareholders, or of becoming adequately informed about issues presented by other shareholders, are substantial. In most cases, they are so high in comparison to a given shareholder's expected gain from acting that it is virtually impossible for shareholders to act in concert to oust incumbent managers.

There are solid economic reasons why the separation of ownership and control evolved during the first part of this century and continues to flourish. It permits a division of labor between investors and managers: a person can invest in an enterprise without bringing along the ability or desire to manage it, and a talented person can manage a large organization without being wealthy enough to own it. Unbundling investment capital from management skills also permits investors to reduce their risk by diversifying investments.

However, the separation of ownership and control creates two sorts of risks: (1) managers may act in their own interests as opposed to those of the firm's owners, and (2) incompetent managers may remain in charge, even though it would be in the interests of the owners to hire new ones. These problems are not insignificant. In the extreme case, if shareholders had no control over the firms they own, their property rights as shareowners would be expropriated, as it were, by self-perpetuating oligarchies.

Economically, giving hired managers unfettered control over assets they do not own would lead to some combination of two unpleasant alternatives: (1) the economy would be populated by lethargic behemoths akin to the "firms" of a socialist economy, run by well-paid insulated managements with little personal stake in the firms' performance or (2) people would simply refuse to invest in corporations, thereby eliminating the potentially huge economic benefits of letting investors not manage and letting managers not invest.

Politically, the prospect of huge blocs of productive assets in the

hands of self-perpetuating groups accountable to no one would lead inevitably to making such groups accountable to the "public," i.e., the government. Demands for this sort of solution were heard frequently as late as a few years ago, when Ralph Nader's "corporate accountability" movement sought to require Federal incorporation as a means of regulating the internal workings of large corporations. We know this system by another name: fascism. It has not been noted for its success.

The critical question is this: How can the rules be structured to capture the benefits of separating ownership from control without suffering its disadvantages? How can managers be given the incentive to act in the interests of shareholders?

This question underlies most of the development of corporate law, especially since the time of Berle and Means. The law and most legal scholars have given two answers: impose certain "fiduciary duties" on corporate managers, and implement "shareholder democracy" through rules governing the solicitation of proxies.

Unfortunately, while the imposition of fiduciary duties is able to prevent most overt conflicts of interest, it is almost totally unable to prevent management incompetence. And as Joseph Flom, a New York takeover attorney, said at a recent Corporate Counsel Institute meeting, the notion that proxy contests can discipline management is "off the wall." A proxy contest for control of a large corporation costs between \$5 and \$10 million. Without an enormous investment in stock, he reasoned, there is no motivation to mount a challenge to incumbent management. "It is an ineffective, costly way that is beyond the reach of most stockholders."<sup>2</sup> There is no better proof of the unworkability of shareholder democracy than the almost total absence of proxy contests in corporate America.

### The "Market for Corporate Control"



While legal scholars and jurists were busy pursuing the blind alley of rules and regulations, a far more effective way of aligning management with shareholder interests evolved, unbidden, out of the marketplace. During the 1960s, the "market for corporate control" sprang on corporate America with the advent of the hostile takeover bid.

No planner sat down in advance and said, "let's make managers *bid* for the privilege of managing assets owned by others," but that is how the process works. If someone thinks he can manage a corporation better than its current managers, he can offer to buy out some or all of its shareholders at a premium over the current market price.

Note how this mechanism solves the free rider problem described above. Instead of attempting to mount an expensive, time consuming challenge on his own or wading through reams of boilerplate to ascertain which of two groups of proxy contestants is better qualified to run the corporation, each shareholder is now confronted with a much simpler choice: Am I better off with what I've got or with what the bidder is offering me? Just as market prices operate as "aids to the mind," to use Ludwig von Mises' phrase, by conveying huge quantities of information in a simple form, a bidder's offer is his most effective way of communicating with the target firm's shareholders.

How can incumbent management maintain control? By doing a good enough job that investors drive the corporation's stock price higher

than any potentially competing group of managers would pay. The price of the corporation's stock is management's ongoing bid for the privilege of continuing to run it.

In the last couple of years, the market has developed a second way for incumbent managers to bid: the leveraged buyout. If managers facing an actual or potential challenge think they can outperform the challengers, but if the market (as reflected by the price of the company's shares) doesn't agree, they are free to outbid the challengers for ownership of the company—if they can raise sufficient funds from lenders and other equity investors.

While potential challengers are not infallible, their actions tend to be economically rational because they face the same economic constraints as incumbent managers. Except for the handful of wealthy individuals who play the takeover game, challengers are also corporate managers. If they make an improvidently high offer for another company, the price of their own company's stock will tend to fall.

In sum, the prospect of having their corporations yanked out from under them provides incumbent managers with a powerful, direct incentive to maximize returns to shareholders. It has often been noted, even before the market for corporate control evolved, that managers are affected by the price of their corporation's stock. The lower a corporation's stock price, the more costly it is to raise equity capital. The less equity capital a corporation has raised, the less it can support a given level of debt. Therefore, poor management effectively limits a corporation's growth. In addition, management compensation is often tied to the price of the corporation's stock through the issuance of stock options. However, for managers willing to be big fish in a small pond and to compensate themselves other than through stock options (not a difficult task!), a low stock price, by itself, is not a strong incentive to act in the interests of shareholders.

A common objection to the recent wave of corporate takeover battles is that they divert management from running the business. "Rather than planning new products or considering new markets, many executives are spending their time looking around at whom they might take over or who may try to take them over."<sup>3</sup>

This objection is just one step more sophisticated than the old socialist slogan, "production for use, not profit." It is based on the implicit assumption that value is created only by activities directly related to the production and distribution of goods and services. It does not grasp the importance of activities which tend to allocate capital to higher-value uses. Since the market for corporate control tends to move assets into the hands of those who can manage them more efficiently, the "diversion" of management effort is no diversion at all, but an input for a highly productive process.

Another objection to corporate takeover battles is that they divert bank loans and other capital from productive activities. This objection seems to assume that money lent to finance a takeover is sucked into a black hole. In fact, the money is paid out to shareholders who use it to make other investments or to repay loans.

While this discussion shows the importance of a free market for corporate control, it is not meant to endorse all the specific tactics employed by hostile acquirers or to condemn the tactics employed by defending managements. Such tactics (invariably termed "abusive"

## The Restructuring of Corporate America

by opponents), which often relate to the treatment of non-tendering shareholders after a successful takeover, involve complicated legal and moral issues well beyond the scope of this article.

**H**ostile takeovers to replace incompetent managers or to spur greater management efficiency are only part of a much larger picture. Even hostile takeovers of well-run enterprises perform other valuable functions to enhance shareholder returns and promote economic efficiency. It is possible that a corporation's incumbent managers are the most efficient managers of its particular bundle of assets and liabilities, but that such managers could be outbid for control of the corporation by people who realize that:

- the assets would be worth more if they were transferred to another corporation, perhaps because such a transfer would result in economies of scale;
- the assets would be worth more in total if some were split off, either to be merged into other firms or to be managed as smaller firms by people with more expertise in that "niche" and more incentive because they can be given a larger personal stake in a small firm;
- the assets would be worth more if some parts of the business were shut down, enabling management to concentrate on the rest;
- the assets include a disproportionate amount of cash, which could be used more efficiently if it were transferred to the shareholders through dividends or share repurchases;
- the corporation could reduce its tax bill by issuing tax deductible debt to retire shares.

In addition, hostile takeovers are a relatively small part of the total "corporate restructuring" picture. The vast majority of mergers, acquisitions, buyouts and divestitures occur in nominally "friendly" transactions, either because managements are acting on their own to maximize shareholder returns or because they fear that a hostile acquirer will implement an obviously sensible restructuring.

The restructuring of corporate America has two basic components, both of which are often part of the same transaction: (1) reshuffling assets into more efficient combinations, and (2) increasing the ratio of debt to equity on corporate balance sheets.

A record \$180 billion of mergers, acquisitions, buyouts and divestitures occurred in 1985, easily topping the previous record of \$122 billion set in 1984. Firms acquired in 1985 included such corporate giants as General Foods, Shell Oil, Hughes Aircraft, Signal, Nabisco Brands, American Hospital Supply, American Broadcasting, Carnation, G.D. Searle, American Natural Resources, Houston Natural Gas and Revlon. The trend has rolled on into 1986 with General Electric's acquisition of RCA.

The steady drumbeat of mega-deal announcements seems to have created the impression that all of corporate America is about to be swallowed up into a handful of super-conglomerates. This view, implied by scare stories in much of the popular press, is distressingly wide of the mark.

In fact, the past few years have witnessed an unprecedented phenomenon: a "riot of voluntary restructuring" and the creation of "a giant auction market in which almost every dollar of corporate assets seems to be on the block."<sup>4</sup> The most significant fact about this entire trend is that fully one-third of all inter-corporate transactions are divestitures.

Among the largest are General Electric's sale of Utah International; R.J. Reynolds' sale of Aminoil; RCA's sale of CIT Financial; Texaco's sale of Employers Reinsurance; Gulf & Western's sale of several businesses, including Simmons and Kayser-Roth; United Technologies' sale of Inmont; City Investing's divestiture of Uarco, Rheem Manufacturing, World Color Press and Motel 6; ITT's sale of numerous businesses, including Continental Baking; and Continental Group's sale of most of its containerboard and kraft paper operations. In 1984, U.S. corporations sold some 900 divisions and subsidiaries, up 40 per cent over 1980.

Divestitures and acquisitions are not two unrelated phenomena, one to be applauded and the other condemned. One company's divestiture is often another's acquisition. In addition, divestitures play an integral role in the acquisition process as acquirers sort through what they need and what would have more value in the hands of others. "Asset stripping," as it is pejoratively termed, is frequently used by acquirers to pay down debt incurred to finance their acquisitions, as in the case of Allied's takeover of Bendix or Avco's acquisition of Textron.

**T**he substantial removal of three legal roadblocks in the early 1980s set the stage for this "riot of voluntary restructuring":

(1) The Justice Department significantly relaxed antitrust restrictions based on size. In the 1960s, for example, the Justice Department blocked the merger of two Los Angeles grocery chains because they had a combined total of 5 per cent of the market. Today, acquisitions that result in 20 per cent market shares routinely go unchallenged.

(2) State antitakeover statutes, once a mainstay of corporate defense strategies, have fallen by the score on the grounds that they conflict with the tender offer provisions of the Securities Exchange Act of 1934.

(3) The phased decontrol of crude oil, as well as the partial deregulation of banking, finance, insurance, transportation and brokerage created opportunities for economies of scale through mergers and acquisitions.

The relaxation of antitrust enforcement has permitted a merger wave that is economically more sound than the conglomerate wave of the late 1960s and early 1970s. With the Justice Department blocking most horizontal and vertical mergers during that period, the only way for aggressive corporations to expand was by taking on unrelated businesses. The *ex post* theory that was used to justify the conglomerate trend was that good managers could run any combination of businesses, and that conglomerates perform a valuable function for investors by diversifying.

Now, however, corporations are being permitted to grow through acquisitions more closely related to their core businesses. To finance these acquisitions, many—especially conglomerates—are unloading

## Legal Causes

***It is hardly an exaggeration to say that without a Stock Exchange there can be no market economy. What really distinguishes the latter from a socialist economy is not the size of the "private sector" of the economy, but the ability of the individual freely to buy and sell shares in the material resources of production.***

—LUDWIG LACHMANN

businesses that are healthy but extraneous. Divesting such businesses has in turn become more attractive because the companies to which they are most valuable—those in the divested units' industries—are now permitted to bid for them. "As the game rolls on, the business landscape of the U.S. ends up with more and more 'pure' companies concentrating on just one or two fields they know best."<sup>5</sup>

## Economic Causes

**T**he three legal factors mentioned above caused this massive reshuffling of assets only in the sense that they reduced governmental barriers to the free interplay of a number of economic forces:

(1) Mergers in the same or closely related fields often yield significant economies of scale, whether in production, distribution, technological development, or management. This is especially true for firms in recently deregulated industries where regulations either directly prohibited mergers or kept profits artificially high so that management's incentive to search for savings was dulled.

(2) Management skill is not unlimited. Just as central planners cannot manage an entire economy, a corporate management team cannot efficiently handle two dozen disparate businesses. The only way out of this dilemma is to expand the management team by creating new layers of management—a sure recipe for burying valuable assets in a bureaucratic maze. As economist Frederick M. Scherer concluded from his extensive study of the conglomerate merger movement, "We typically found management failure. The acquirers didn't know how to manage their acquisitions."<sup>6</sup>

(3) Contrary to the diversification rationale for conglomerates, investors may prefer a different mix of investments than that assembled by corporate managers. While small investors managing their own portfolios may have some desire for management-assembled packages, the rise of mutual funds and pension funds has tilted the balance in the other direction. "Increasingly, professional portfolio managers prefer to trust their own skill at picking industries to invest in, rather than letting corporate managers offer them a packaged smorgasbord."<sup>7</sup>

(4) Information in securities markets is not costless. Investors and investment analysts find it easier to understand companies that are in a handful of businesses than those with scores of extraneous assets.

(5) The inflation of the 1970s increased the market value of certain assets held by corporations, but accounting rules prevented corporate



balance sheets from reflecting this appreciation. It became increasingly difficult for investors to understand the value of assets held by corporations, especially complex ones with diverse and far-flung assets.

For all but the first of these reasons, corporate managers are finding that, contrary to the received wisdom of the past, the parts may be worth more than the whole and that a simplified, slimmed-down business may result in a higher stock price. Unearthing a business buried deep in a complex corporate structure may allow both that business and the remainder of the corporation to be managed more effectively, and may allow the market to better evaluate both businesses. But—and this is a critical point—unearthing such businesses would be substantially less profitable if the antitrust laws blocked their acquisition by other corporations in the same line.

**W**hile the relaxation of antitrust enforcement and the partial deregulation of certain industries were necessary for consenting managements to undertake this massive restructuring, the process was greatly accelerated by the hostile takeovers unleashed by all three of the legal changes described above. A process that might have been undertaken in a leisurely fashion by many managements assumed new urgency when they felt the hot breath of corporate raiders on their necks. “With each attack by corporate raiders, ‘people are becoming aware’ of hidden value, says [raider Irwin L.] Jacobs. So, lest they fall prey to the raiders, managers are digging up and cashing in on the buried assets themselves.”<sup>8</sup>

“Earnings—what most investors react to—were worth less [after the inflation of the 1970s], while the underlying assets were worth more. The situation was ready-made for raiders and liquidators who knew how to buy on the basis of earnings and how to sell on the basis of assets.”<sup>9</sup> If their corporations did not sell assets, there was no way for shareholders to capture their value in the form of higher stock prices. Asset sales by successful acquirers—and then by incumbent managers seeking to deter acquisitions—provided the vehicle by which shareholders could capture this hidden value. Raiders forced an earnings-oriented marketplace to take asset values into account.

The most prominent example of the power of hostile acquisitions to accelerate an economically desirable restructuring is T. Boone Pickens, whose Mesa Petroleum tried and failed to take over several major oil companies. His raids forced target companies to merge into “white knights,” divest extraneous assets, reduce their top-heavy management bureaucracies and pay cash to shareholders through share buybacks. According to economists Harold Demsetz and Michael Jensen, speaking at a Securities and Exchange Commission forum, the oil market has undergone massive changes in the past decade, making it inevitable that there would be fewer oil companies.<sup>10</sup> Realizing this fact before most oil company executives, Pickens acted as an arbitrageur, forcing them to adjust to a reality they had not yet grasped.

**W**e have already seen that a good deal of the popular fear of corporations gobbling each other up until only a few are left is unfounded. A similar but more subtle objection to the restructuring of American corporations is that, as firms concentrate their resources in one or two core businesses, there will be fewer

### Hostile Acquisitions Accelerate the Asset Reshuffling

### Objections to the Asset Reshuffling

competitors left in each market, thus increasing their monopoly power.

The weak link in this argument is the jump from the fact of fewer competitors to the conclusion that monopoly power is increased. This argument is reminiscent of the era when the United States was virtually a self-contained economic unit, when all the relevant firms in an industry were American. In the last two decades, foreign trade has expanded from roughly one-twentieth of America's economic activity to roughly one-sixth. Most major American firms face significant competition from abroad. The best way to ensure that the restructuring of American corporations does not increase their monopoly power is to lower trade barriers.

This argument also underestimates the role of potential competition in deterring large companies from charging "monopolistic" prices. Such potential competition is enhanced by a robust market for businesses. A potential competitor, which may lack expertise in a given industry, can short-circuit an arduous learning process by acquiring a small firm in the target industry. Thus, the same wide-open process that often reduces the number of competitors in a field also enhances the ability of others to enter it.

Another frequently voiced objection to hostile acquisitions is that they "cause" plant shutdowns and layoffs, disrupting people's lives. This objection confuses the messenger with the message. Acquirers do not shut down plants or pare staff out of spite, but to increase their economic returns. In most cases, such actions should have been undertaken by prior managements to adjust to a changing economic reality.

In any event, the highly visible plant closings following on the heels of takeovers do not appear to be more frequent than plant closings generally. At the SEC forum mentioned above, economist Michael Jensen "said there is no evidence that takeovers are associated with a higher than average number of plant closings. What tends to get closed down, he said, are redundant corporate headquarters, suggesting that the pleas for protection are coming from top executives who fear for their jobs."<sup>11</sup>

## Leveraging Corporate Balance Sheets

**S**o far, we have focused on the reshuffling of assets among corporations, or the left-hand side of corporate balance sheets. However, virtually every transaction has also involved the right-hand side of corporate balance sheets, invariably by increasing the ratio of debt to equity.

A major question facing every potential acquirer is how to finance its acquisition. Since most acquirers do not have sufficient cash sitting in their corporate treasuries, they must either issue additional stock or borrow. For reasons explained below, they almost always borrow, either from bank syndicates or by issuing bonds directly to the public. Until recently, it was difficult for acquirers to borrow from the public because the level of debt required for many acquisitions was so high that rating agencies refused to give it an "investment grade" rating.

Enter the "junk bond," an unrated, high-risk, high-yield bond. A couple of years ago, enterprising investment bankers discovered that there is a substantial market for such securities, especially among investors large enough to reduce their risk by diversifying. Junk bonds

## HOSTILE ACQUISITIONS

have become a powerful tool in the hands of potential acquirers by permitting them to issue large quantities of debt backed by the assets of the acquired company.

While the quantity of junk bonds issued in hostile acquisitions has been relatively small, the availability of junk bond financing has made it possible for small raiders to threaten much larger target companies. Even though Mesa Petroleum failed to take over a single major oil company, its access to such financing made its raids more credible.

The lesson of junk bonds has not been lost on managements of potential targets. Now that takeover defenses based on the antitrust laws or state antitakeover statutes have become largely ineffective, such managements have discovered the "financial defense." If raiders believe that the target has sufficient cash flow to support a much higher level of debt, target managements can pre-empt this cash flow by issuing debt, using the proceeds to raise their stock prices by repurchasing shares.

In the last couple of years, a trickle of share repurchases has turned into a torrent, as such major firms as Unocal, Phillips Petroleum, Atlantic Richfield, Exxon, Union Carbide, Ford, CBS, Litton Industries, and Revlon instituted major buyback programs, often financed with debt. Debt is often used to finance selective share buybacks from raiders, a process pejoratively termed "greenmail."

In addition, debt is the *sine qua non* of another recently perfected defensive technique, the leveraged buyout, in which the managers of a target company outbid or pre-empt a raider by borrowing enough to buy out the company's existing shareholders.

In sum, just as hostile acquisitions have served as a powerful lever to force the reshuffling of assets among corporations, they have also directly or indirectly caused a great many corporations to increase their ratio of debt to equity. New debt issuances less repayments totaled \$164 billion in 1984, while shares retired in buybacks, mergers and leveraged buyouts exceeded new issuances by \$72 billion in 1984 and \$65 billion in 1985.

What has made this stampede into debt work? Why can raiders make a profit acquiring much larger companies entirely with debt? Why do share repurchase programs raise stock prices instead of causing shareholders to flee from corporations with more fragile financial structures? Why does everyone seem to win from a leveraged buyout?

The answer is that the tax law discriminates against equity financing and artificially encourages debt. Interest on debt is fully tax deductible, while dividends are not. Dividends are taxed twice, first when the corporation is taxed on its net income, and again at the shareholder level.

Given the huge tax advantage conferred on debt, why do corporations issue any equity securities (above a nominal level) at all? Debt is risky for a corporation because interest payments are fixed legal obligations independent of its changing financial fortunes. By participating in the company's risk, equity investors give it more flexibility and resilience. Corporate managers usually seek a debt to equity ratio which they consider optimal, in light of the corporation's tax status, the riskiness of its business, and the extent to which they are averse to risk.

Since the tax bias against equity financing has existed for years, why



T. Boone Pickens of  
Mesa Petroleum

MESA PETROLEUM

has such a massive move from equity to debt occurred only in the past few years? It appears that two factors contributed to this change.

First, the removal of legal barriers to hostile acquisitions allowed risk-oriented raiders to impose their risk preferences on more conservative incumbent managements, either by replacing them or causing them to "leverage up" as a defensive tactic.

Second, the Economic Recovery Tax Act of 1981 increased corporate cash flows by permitting accelerated depreciation, but did not increase the book earnings which tend to be the focus of investor attention. Raiders were among the first to understand that the larger cash flows enhanced the ability of corporations to repay debt. By bidding for companies on the basis of cash flow, raiders forced the market to take it into account in valuing companies.

## Conclusion

**T**he partial removal of key legal restraints in the early 1980s has permitted the flowering of the market for corporate control, helping to align corporate managements with the interests of shareholders and creating a giant auction market which tends to reshuffle assets into more efficient combinations. Interwoven with this process has been a dramatic increase in corporate debt, largely brought on by the tax bias against equity financing, making many American corporations more vulnerable to an economic downturn.

The latter trend has evoked a great deal of adverse commentary and numerous legislative attempts to curb hostile acquisitions. While halting takeovers would undoubtedly slow any further erosion of corporate balance sheets, it would also deny us the benefits of the market for corporate control. The artificial expansion of corporate debt is best remedied by ending the tax bias against equity financing. □

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6. "Bigger Yes, But Better?" *Time*, August 12, 1985, pp. 34-35.

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# Winners of the 1985-1986 Freedom Essay Contest "The Foundations of a Free Society"

## College Division

- First Prize:** Peter S. Heinecke, Princeton University  
"The Fallacy of Comparable Worth"
- Second Prize:** John Majewski, University of Texas at Austin  
"The Industrial Revolution: Working Class  
Poverty or Prosperity?"
- Runners-up:** Terence B. Byrne, McNeese State University  
"An Old Hostage Crisis: America's 'Free'  
Farm Markets"
- Jay Habegger, University of Colorado at Boulder  
"Inflation, Money, and Freedom"
- Brent M. Johnstone, University of Texas at Austin  
"Information and the Economic Problem"

## High School Division

- First Prize:** Sarah H. Lindsey, Yardley, Pennsylvania  
"Educational Freedom"
- Second Prize:** Mary Jane Massey, Daytona Beach, Florida  
"George Mason: Framers of Liberty"
- Runners-up:** Tim Lawrie, Fairfax Station, Virginia  
"‘Liberation’ Theology: A Policy of Slavery"
- Gavin Marshall, Oakville, Ontario, Canada  
"Majority Rule vs. Individual Rights"
- Bobby Taylor, Kingsport, Tennessee  
"A Proposal for Educational Reform"

Look for the winning essays in forthcoming issues of *The Freeman*.

# The Continuing Plight of Agriculture

## Why Federal farm policy fails.

by Dennis Bechara

Mr. Bechara, an attorney, is a frequent contributor to *The Freeman*. This article is based on a lecture which he delivered in November, 1985, during a FEE seminar held in the Washington, D.C. area.

On December 23, 1985, President Reagan signed into law the Food Security Act of 1985, commonly known as the "farm bill." This statute will affect the state of American agriculture for the next five years. During the past year, the precarious condition of the agricultural sector has been a hotly debated issue. Although the enactment of the 1985 farm bill is designed to confront and resolve the crisis, the unfortunate fact remains that the same failed tools which were utilized in the past will continue to be used in the future. It should not surprise us if more surpluses and low farm prices continue to plague the farm sector in the immediate future.

Why is our agricultural sector in such a precarious state? Is more government intervention the answer to the problem? Before analyzing our current crisis, it will be instructive to review our past agricultural policies, for our present attitudes toward the farm sector may be explained by our historical development as a country. Only if we fully understand the root of our policies will we be in a position to improve the lot of agriculture.

One of the fundamental differences between the development of the United States and the evolution of Europe is the abundance of land in this country. As the government acquired more land rights in the West, it became the national policy to settle the West and actually to give land to those who were willing to carve a family farm out of the wilderness. The Homestead Act of 1862 is perhaps the watershed of this era of open lands. It has been estimated that over one billion acres of land were thus given to farmers during the settlement of the West.

Although most of the family-size farms essentially provided sustenance to the families that operated them, farmers were able to grow enough crops out of which they hoped to acquire other goods that they needed. The problem, however, was that as a result of the Federal farm policies, which encouraged anyone who wanted to enter farming to do so, a perennial surplus of production always loomed on the horizon.

As the newly settled farmers attempted to set up their operations, they faced innumerable obstacles. A significant one was the need for capital to finance their operations. Consequently, farmers, in general, became a debtor class. Politically, this meant that traditionally they

favored a policy of easy credit and easy money. Perhaps because of the dispersed land ownership pattern that evolved as the West was settled, farmers also tended to regard any concentration of economic power with suspicion. They therefore generally favored both the regulation of railroads and the dismantling of large corporate utilities. Granges were partly responsible for the regulation of railroads on a state-by-state basis. These state laws, in turn, prompted Congress to enact the Interstate Commerce Act in 1887 which regulated railroads on a national scale.

Prior to the First World War, there was a farm surplus problem. However, as a result of the outbreak of the war, and the subsequent American participation in it, the federal government encouraged further agricultural production. Easy credit policies were enacted, and the justification for the overproduction was epitomized in the slogan "Food Will Win the War." Predictably, at the end of the war, farm prices fell, reflecting the government-encouraged surplus production. As protection to the farmers, Congress proceeded to enact higher tariffs on farm commodities through the McCumber Act of 1922. But farm prices remained low. Farming was perhaps the one bleak point in the economic boom of the 1920s. No matter what the government did, farm prices remained low.



**T**he year 1922 saw the birth of the concept of "parity." This concept first appeared in a booklet written that year by George N. Peek and Hugh S. Johnson entitled "Equality for Agriculture." The thesis of this booklet was that farmers were entitled to receive a "fair" price for their commodities. The fairness of the price was connected to the level of prices received during the golden era of agriculture, which were the ten years that preceded the First World War.

Congress, reflecting the thinking of the farm sector, enacted a proposal which embodied these ideas. The proposals were known as the McNary-Haugen bills. These bills would have restructured domestic distribution of farm commodities, so as to raise the prices to the much-heralded "parity" level. The excess which could not be marketed domestically, however, would have, in effect, been dumped on the international market while the U.S. consumer would have paid for this subsidy. These bills did not become law, and in 1927, when President Coolidge vetoed the latest version of these bills, he justified his veto utilizing rather prophetic language. In his veto message, the President said:

## The Birth of "Parity"

Government price-fixing, once started, has alike no justice and no end. It is an economic folly from which this country has every right to be spared . . . There is no reason why other industries—copper, coal, lumber, textiles, and others—in every occasional difficulty should not receive the same treatment by the government. Such action would establish bureaucracy on such a scale as to dominate not only the economic life but the moral, social, and political future of our people. The main policy of this bill runs counter to the well-considered principle, that a healthy economic condition is best maintained through a free play of competition, by undertaking to permit a legalized restraint of trade



Current attitudes toward the farm sector may be explained by our historical development as a country.

AMERICAN FARM  
BUREAU FEDERATION

in these commodities and establish a species of monopoly under government protection, supported by the unlimited power of the farm board to levy fees and enter into contracts. For many generations such practices have been denounced by law as repugnant to the public welfare. It cannot be that they would now be found to be beneficial to agriculture.

Agriculture in the 1920s experienced an unsurpassed productive capacity as the result of both technological advances and governmental policies. Naturally, farm prices fell due to this surge in productivity, and the signals that the low prices communicated to society were that there were too many resources invested in agriculture. The adjustment process has proven painful to many farmers. In 1790, 96 per cent of the population was engaged in farming. By 1927, the farming sector had decreased to 27 per cent. The farming sector is now one-tenth of what it was 50 years ago—2.5 per cent. Low farm prices were a symptom that indicated to society that its resources were misallocated and that a migration away from agriculture was the desired goal. In spite of all the government policies enacted to halt this migration, the trend has continued.

During Herbert Hoover's administration, prices received by farmers fell to historically depressed proportions. Farm income fell by more than half between 1929 and 1932. As a palliative, a new government agency was organized to take care of falling prices. This was the Federal Farm Board which was organized as a result of the Agricultural Marketing Act of 1929. Endowed with a revolving fund of \$500 mil-



## THE CONTINUING PLIGHT OF AGRICULTURE

lion, the Federal Farm Board set about to stabilize the prices of wheat and cotton. The price of a bushel of wheat was \$1.04 in 1929, but in spite of the purchasing activities of this agency, the price of wheat fell to 39 cents per bushel by 1931. The Board accumulated such large stocks of wheat, that at one point it controlled 80 per cent of the country's supply. Cotton fared no better. After having incurred heavy losses, Congress refused the agency any further funds and it ceased operations. Protectionism, however, seemed to be the course of action to follow, and the Smoot-Hawley Tariff of 1930 only succeeded in engendering further retaliatory tariffs that impeded world trade.

With the advent of the Roosevelt administration, a host of new statutes were enacted which were designed to treat the economic emergency caused by the Great Depression. Each sector of the economy provided its own explanation for the cause of the crisis. Agriculture too had an explanation for its problems: there was just too much production. So the Agricultural Adjustment Act of 1933 was enacted. This is the prototype of the legislation that in many ways is still in effect today.

**T**he cornerstone of the Agricultural Adjustment Act of 1933 was to raise farm income by reducing production. Farmers were paid to reduce the acreage under cultivation and were guaranteed a minimum price on certain commodities. The crops that were to be controlled by this statute were the so-called "basic" commodities: wheat, corn, cotton, peanuts, rice, and tobacco. Although these commodities generated about one-fifth of farm income, they earned the lion's share of government funds spent in order to support prices.

One of the oddities of the price support system has been that it is designed to subsidize the volume of production, not the farmers' needs. Thus, small farmers have consistently received very few benefits from the price support system, whereas large farmers have benefited proportionally more. At the present time, one-third of all farms in the United States produce approximately 85 per cent of all farm sales. Therefore, two-thirds of all farmers receive insignificant government assistance from the price support system.

The implementation of the farm policy of the New Deal was mainly based on acreage reductions rather than on price supports, since these supports were set at a low level. However, with time, the support prices began to be increased to reach levels above the market-clearing point, so that stocks of surplus commodities began to appear. Land which produced subsidized crops was cultivated more intensely to increase the yield per acre. Other land that would have produced subsidized crops had it not been for the acre reduction requirement was cultivated for various additional crops. This, in turn, created surpluses in other areas.

The mechanics of the price support system have not changed very much since their inception in 1933. The Department of Agriculture, through an agency called the Commodity Credit Corporation (CCC), issues nonrecourse loans to farmers who produce the subsidized commodities. If the price of the commodity rises above the loan rate, the farmer is free to sell the commodity and is obligated to repay the loan. Therefore, the loan rate becomes a minimum price. If, on the other

## Raising Income by Reducing Production

hand, the price of the commodity falls below the loan rate, the farmer simply relinquishes the commodity over to the CCC and the loan is considered paid in full. Thus, whenever the loan rate is set above market-clearing levels, the CCC ends up holding the surplus production.

The Agriculture and Consumer Protection Act of 1973 introduced the concept of "deficiency payments," which consists of an additional subsidy representing the difference between the lower loan rate and the higher price support or price target. Farmers are entitled to a deficiency payment whenever the selling price of the regulated commodity falls below the price support point. Although designed to avert the chronic overproduction of agricultural commodities, this mechanism has proven ineffective in reaching its goals.

The 1985 farm bill has continued the use of both nonrecourse loans and deficiency payments. The only change is that the loan rate has been lowered in an attempt to control chronic overproduction. The purpose of the lower loan rate is to encourage farmers to sell their products in the marketplace, rather than forfeiting them to the CCC. The anticipated lower farm income is supposed to be offset, however, by the deficiency payment. Therefore, since the farmer will still receive a subsidy, regardless of the market price of the commodity, it is doubtful that surpluses will be eliminated.

The export boom of the 1970s once more temporarily eliminated the perennial surplus problem. The government relaxed all production controls, and 55 million acres of cropland were added to production in order to meet this demand. Financial institutions, in turn, issued credit based on the assumption that land prices, which were increasing, provided sufficient collateral. Farm debt, which stood at \$50 billion in 1970, increased to \$214 billion by 1985. But after 1981 several factors radically altered the picture. Interest rates increased, a world recession reduced exports and other countries began to increase their productive capacity. In addition to this, the value of the dollar increased, making farm products even more expensive in world markets.

## The Present Crisis

**N**otwithstanding the massive subsidies farmers receive from the federal government, the farm economy is presently facing a severe crisis. Farm income has decreased by about a third during the past four years. In spite of this, the costs of the price support and market subsidies that form part of our national farm policy have ballooned to unprecedented levels. When the 1981 farm bill was enacted, it was expected to cost the taxpayers no more than \$12 billion. Instead, the actual costs incurred amounted to over \$60 billion. Similarly, in 1981, farm exports reached the unprecedented height of \$44 billion, which represented approximately 60 per cent of the world's agricultural market. Our share of the market has subsequently declined to approximately 50 per cent and our exports were \$32 billion in 1984.

The 1981 price support legislation enacted rigid and high price supports which only encouraged other countries to further increase their production. Therefore, land values began to decline. Since the value of the collateral no longer supported more credit, financial institutions have reduced lending. Since 1981, around 200,000 farmers have gone out of business.

Because Federal price supports have been above market clearing

levels, the government has acquired large stocks of surplus production. As a temporary solution, in 1983 the "Payment in Kind" (PIK) program was designed. Farmers who participated in the scheme were given comparable amounts of crops. Eighty-three million acres of cropland were idled, and the government surplus disappeared. But sales of fertilizer, machinery, feed and other products necessary for farming were reduced. Experts at Georgia State University estimated that the PIK program cost 200,000 jobs. This estimate does not include the actual amount of crops given away, worth approximately \$10 billion.

The 1985 farm bill continues substantially the policies of the past. The outcome of these past policies has consistently been overproduction. In response to the surplus problem, Congress has established four mechanisms to combat surpluses. These are the acreage reduction programs, marketing agreements, voluntary land retirement, and import quotas. The 1985 bill continues this trend.

The acreage reduction program goes hand-in-hand with the price support mechanism. Essentially, if a farmer wishes to participate in the subsidy program, he or she is required to limit the acreage apportioned to the cultivation of the subsidized commodities.

**M**arketing orders represent another mechanism for dealing with the recurrent surplus problem. The marketing order scheme has its origins in the Capper-Volstead Act of 1922 which allowed the formation of agricultural cooperatives. This statute exempted agricultural cooperatives from the coverage of antitrust legislation. Even though the cooperatives were free to cartelize production, they were never able to effectively influence prices because not all producers agreed to join them. In other words, the forces of the market prevented the formation of monopolies. Therefore, further statutory intervention was required, which culminated in the Agricultural Marketing Agreement Act of 1937.

This statute authorized the Secretary of Agriculture to set up marketing orders for milk, vegetables, fruits and other minor products. Presently, there are 47 marketing orders in effect, covering a variety of crops worth around \$5 billion a year. After a marketing order is adopted by the Secretary of Agriculture, a referendum of producers is held. If the order is ratified, it then comes into effect. The order may be amended from time to time by the Secretary, who usually follows the recommendation of producer administrative committees. Some of the marketing orders are not particularly important. For example, the market-support variety requires producers to contribute to an advertising fund. However, most of the marketing orders are designed to restrict supply in various ways. Some are concerned with setting quality standards. Others restrict the amount of products the farmer may bring to market, or determine how much fresh produce handlers may ship, or require producers to put part of their crop in storage until market conditions improve so as not to lower the market price. Any excess must be diverted for other uses, or simply left to waste.

Predictably, the effect of marketing orders is to increase prices. In addition, resources are misallocated since supply-control orders, by raising prices, encourage more production of the commodity. This, in turn, produces more waste, since more commodities are then diverted

## Marketing Orders



to other uses or left to rot. It has been estimated, for example, that up to 30 per cent fewer acres would be needed to produce the amount of California and Arizona oranges which ultimately are marketed. Innovation is also reduced, since there is no incentive to reduce costs of production because a producer's sales are limited by the orders. An example of an innovation that has been frustrated is the development of a special shrink wrap that would allow lemons to be wrapped fresh for periods of about six months. It has also been estimated that 25 per cent of the lemon crop is wasted.

Voluntary land retirement has been a traditional method whose purpose has been to reduce agricultural production. In many instances, the additional purpose of fostering soil conservation has also been utilized as a means of limiting farm acreage. By the 1960s, 60 million acres had been removed from production. Ironically, the price support system and the disaster payment programs have encouraged farming in areas that have been subject to unusual environmental risks. For example, in the semi-arid climate of the Great Plains, ranchers may be tempted to cultivate some of the subsidized crops. After the prairie grasses are eliminated and a crop cultivated, the rancher may be required to set aside part of his land in order to receive the subsidies. This only exposes that soil to the dangers of erosion. The 1985 farm bill has recognized the deleterious effect of the price support system to certain erodible lands, and the eligibility of those lands in the subsidy program has been restricted.

## Import Quotas

Import quotas are the fourth method which has traditionally been used to combat surpluses. Sugar is one of the products that has consistently been protected from foreign competition. The domestic price of sugar is approximately four times the world price. Foreign-grown sugar may only be imported in limited quantities and from certain countries. The sugar quota allowed from foreign countries has decreased significantly over the past four years. In 1981 we imported 5 million tons of sugar, whereas by 1985 the amount was decreased to 1 million. This has foreign policy repercussions, since most sugar-producing countries are less-developed countries that urgently need foreign exchange to support their economies.

In spite of these four methods of reducing surplus production, high price supports have consistently provided the incentive to engage in overproduction. If the price supports did not exist, farmers would guide production based upon market prices. When market prices are low, the signal communicated to producers is that production should be reduced, and farmers will act accordingly. With the present system, however, farmers can disregard the market signals and overproduce, confident that the government will guarantee a support price. The surplus production only succeeds in lowering market prices, which, in turn, becomes the political justification for keeping the price support system in effect.

One of the justifications for price supports and marketing orders is that agriculture is a different type of industry. There are many aspects of the agricultural cycle that are beyond the control of farmers. Natural disasters, insect infestations and droughts are examples of the difficulties with which farmers have to contend. But there is a large segment of agriculture, over half of the sector, which operates without

the benefit of price supports. Livestock, as well as many fruits and vegetables, have successfully operated without these supports.

The free market has the capability of protecting farmers against unforeseen price fluctuations through the trading of agricultural options. This system enables farmers to sell a commodity sometime in the future at a predetermined price. Since 1936, however, this system had not been allowed to operate in most of the major domestic commodities. But as a result of the enactment of the Futures Trading Act in 1982, the trading of agricultural options in the regulated commodities has been allowed. The first trading of these contracts began in October of 1984. It should be pointed out, however, that with the price support system in place, the prospects of these contracts are limited.

The current agricultural programs have inconsistent and conflicting effects. Some of the programs—like easy credit to buy and operate a farm, or research activities or irrigation projects—lower the costs of production. Other programs—some of the ones discussed in this article—tend to increase prices. Our legislated programs are encouraging overproduction, which has the unwanted effect of decreasing prices and reducing farm income. The surplus production which the federal government normally holds has been partially sold in the international markets. Foreign countries have increased their productive capacity, and this alternative no longer is viable in the long run. Our farm policy should not be based on sheer hope that some future event will take care of overproduction.

Circumstances have changed over the past fifty years. Farm income, as a percentage of the income generated in urban areas, has increased. The farm sector, on the average, earns about four-fifths of the earnings in the non-rural sector. Politics should be eliminated from our farm policy. It is not unknown for politicians to encourage the raising of price supports at strategically convenient times in order to gain votes. It is time we stop the present contradictory and negative farm programs. The longer we hesitate in embracing the free market, the worse it will be for all. □

## **In Future Issues . . .**

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- "Inflation and Unemployment" by Hans F. Sennholz
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- "The Political Economy of Education Vouchers" by Dwight R. Lee

# Unemployment Compensation

**Unemployment compensation harms everyone—including those it is supposed to help.**

by Hans F. Sennholz

Dr. Sennholz heads the department of economics at Grove City College in Pennsylvania. He is a noted writer and lecturer on economic, political, and monetary affairs. His latest book is *Money and Freedom*.

**T**o compensate workers for wages lost during periods of unemployment, most countries have systems of unemployment insurance. They are compulsory, in the sense that government enforces coverage and uses the taxing power to finance the expenditures. Previous contributions by or on behalf of the workers largely determine benefit eligibility and amounts according to formulas stipulated by law.

The primary purpose of the system is economic assistance and compensation of employees for wage loss during periods of economic decline and depression. The economic effects of such periods are compounded by sociological effects that are reflected in physical and mental ill health, rising crime rates, divorce rates, and even suicide rates. Unemployment compensation seeks to alleviate the ill effects.

The American system is a federal-state system that was forced upon the states by the Social Security Act of 1935. The Act levied an unemployment tax on employers, but offered a 90 per cent offset (1) for employer payments of state payroll taxes for unemployment benefits or (2) for reductions in such state taxation under a program of experience ratings. The law left the states free to determine their own benefit levels and duration of benefits. Consequently, benefit provisions and tax rates differ widely among the states.

The system is a form of public charity that springs from a new conception of social welfare. The public now accepts the concept that government must bear the ultimate responsibility for public relief, including unemployment assistance. This new attitude brought forth extensive social legislation and led the way to the "welfare" or "social service" state. The American system followed in the footsteps of earlier systems in Scandinavian countries, some Commonwealth countries and Great Britain, which in turn were influenced by the labor legislation of Bismarck Germany in the 1870s.<sup>1</sup>

The social service state has few genuine critics. Its countless supporters are guided by a great number of motives that continue to lend intellectual support to the system. Their first and foremost motive, we are led to believe, is *charity* toward their fellow men. They wax eloquent about their feelings of benevolence, good will and affection,

indulgence and forbearance. In the name of charity they call upon government to cater to the needs of the people. Government is to assure a system of social assistance, to grant every citizen the right to extensive welfare benefits, unemployment compensation being just one of them, so that everyone may achieve maximum cultural and even spiritual well-being.

A few critics are highly suspicious of this attitude that makes government the guardian of charity and welfare. Some are guided by Judeo-Christian principles that make charity a responsibility of each and every individual. To them, private initiative and charity are the keys to American progress and prosperity, having led to unprecedented improvements in working and living conditions. They look upon private charity as an important bulwark against complete state control and the political command system, which they abhor for many reasons.

The welfare state as a transfer state is an early form of the command system, appealing to envy and covetousness and, by creating classes of beneficiaries and victims, continuously breeds social conflict and strife. It is driven by government coercion and guided by majority vote. It is never fair, but always political. It is cumbersome and slow, unable to act promptly and efficiently.

**T**he Judeo-Christian command of charity is no call for politics. Unemployment compensation is the product of politics. Its supporters may concede the point, but they hasten to defend the system on grounds that it is a desirable economic stabilizer that moderates the business cycle. They applaud it as an important countercyclical force that injects purchasing power when unemployment rises and absorbs it when unemployment falls again. It is said to stabilize the propensity to consume and thereby acts in a countercyclical, stabilizing way.<sup>2</sup>

In his popular textbook, *Economics*, Paul A. Samuelson applauds unemployment insurance and other welfare transfers as "a first line of defense" that goes into action automatically to counteract a recession. "Unemployment insurance pumps funds into or out of the economy in a countercyclical, stabilizing way. Similar features are seen in many income support programs. Food stamps, aid to families with dependent children, and early retirement on Social Security are examples of public transfer payments that help to shave the highs and lows from the business cycle."<sup>3</sup>

It is difficult to fathom the operation of the Samuelson pump that moves funds into and out of the economy. Unemployment tax revenues do not move in and out of the economy. They are levies imposed by politicians and collected by internal revenue agents, exacted from employers who in turn obtain them from the productive labors of their employees. Civil servants then disburse the funds to some unemployed workers. If there should be a temporary surplus, the U.S. Treasury spends it, issuing IOU's in the form of U.S. Treasury bills and notes. If there should be a shortfall, the taxes are likely to be raised to the level of expenditures. One searches in vain for the pumping action that causes the funds to exit from the economy, remain hidden for a while and then to return to active duty.

The only pump at work is a transfer pump that reduces the paychecks of working employees while it yields benefits to unemployed

## **An Automatic Economic Stabilizer**

workers and salaries to civil servants who operate the pump. Contrary to popular belief, payroll taxes do not seize employer income. They do not reduce entrepreneurial profits or capital interest or managerial remuneration. Every penny exacted on behalf of employees is taken from employees through lower take-home pay. Lower take-home pay offsets the unemployment tax. The levy does not cause unemployment, but it continues to prevent saving and investing, which would raise labor productivity, bolster the demand for labor, and reduce unemployment.

No pump on earth can prevent the business cycle or moderate its effects. No food stamps, no aid to dependent children, no early retirement on Social Security can prevent the cycle once it has been set into motion through inflation or credit expansion. No matter what else government may contrive or attempt, easy-money policies bring about economic booms that cause business misjudgments and maladjustments. Once a boom has run its course it necessitates and brings forth a depression which is a period of readjustment. There are no miracle cures for business cycles, no recipes for full employment. Government cannot "fight" depressions through more easy money and more transfer payments. It can, however, prevent them by abstaining from the policy that causes them: inflation and credit expansion.

To embark upon pumping action at any stage of the cycle is to make matters worse. During the boom it may add to the maladjustment, during the recession it may delay the readjustment. Unemployment taxation, like any other taxation and government intervention, does not counteract the business cycle. It aggravates the disorder.

New unemployment levies are forced exactions to which the labor market has not yet adjusted. They boost labor costs and temporarily reduce employer income. Governments usually impose new levies either through higher rates or higher bases, or both, at the very moment of business difficulties, during the depth of depression. The exactions compound the situation by lowering the productivity of labor even further, thus reducing the demand for labor and boosting unemployment. They continue to have a painfully contracting effect until the take-home pay has fallen by the amount of the new tax exactions. Unfortunately, organized labor tends to resist the reduction, which aggravates the unemployment. Workers are led to lay the blame for rising unemployment on employer greed and the private property order rather than on the tax boosts and their own reluctance to adjust to the boosts.

## Skills and Training

Unemployment taxation and compensation may not encourage capital formation, but they are said to promote the preservation of skills and training. With their eyes glued on the output of the transfer pump, and completely ignoring the pump input, as well as the energy it takes to operate the pump, the popular champions of unemployment compensation view it as an auspicious outpouring that preserves given skills and training and thereby safeguards labor productivity. They favor generous compensation because it reduces the financial pressures on the unemployed to accept different or lower-level jobs.<sup>4</sup>

Surely, it is a grievous fallacy to contend that unemployment is more conducive to maintaining skills and training than work on any level;



that it is more beneficial to finance idleness than to encourage the unemployed to accept lower-level jobs; that society is better served by mass unemployment than lower-level production. Work on any level usually broadens skill and ability and adds valuable experience that improves individual productivity. It is presumptuous to contend that there is no learning except on one's own level of skill and expertise.

The skill- and-training argument completely ignores a fundamental characteristic of the private property order, which is continuous change and readjustment of production to the wishes of consumers and to the ever-changing state of technological knowledge. Capital and labor must adjust continuously; failure to adjust inflicts losses and causes unemployment. The chronic unemployment of some eight million Americans, which most observers are quick to place on the doorsteps of the business cycle, must be charged primarily to the very policies that prevent and discourage change and readjustment, from minimum wage legislation to the legal privileges of labor unions. Unemployment compensation that encourages preservation of old skills and discourages new learning and new skills aggravates and prolongs the chronic unemployment.

The reluctance to adjust to changes and acquire new skills may rest on individual apathy, sloth or just fatigue. But it may also spring from the notion that many unemployed workers have great skills and training that need to be preserved with the help of generous unemployment compensation. This is a popular error. The pains of unemployment are felt most frequently by the least productive members of society; they suffer a common fate because government or labor unions, endeavoring to raise their pay and benefits, manage to price them out of their jobs. Surely, the unemployment rate among minimum wage workers, steel workers and automotive workers, most of whom have minimal skills, training and education, is measurably higher than in any other vocation.

**I**n the United States the existence of separate state systems makes for competition that reveals some startling contrasts. The high-benefit states are the high-unemployment states. The low-benefit states are the low-unemployment states. Low benefits, severe conditions and disqualifications, and the resulting low tax rates, seem to attract new industry and promote economic expansion, which provide new opportunities for employment. High benefits call for high taxation which, going higher and higher, may hamper business and breed unemployment.

The trends of unemployment are predictable, being subject to various influences and controls. Monetary, fiscal and foreign-trade policies affect the productivity of labor and consequently the demand for labor. The level of unemployment benefits has a significant impact on worker incentives and the supply of labor. Recent growth of the benefit provisions of the unemployment compensation system as well as public assistance benefits has significantly reduced the supply of labor. It subsidizes unemployment and thereby breeds more unemployment.

Acting man always faces a choice in allocating his resources among alternative uses. In this case he must allocate his time among alternative uses. He may use it in production (work) or in consumption (leisure). The mode of allocation generally depends on the relative

## Employee Disincentives



prices of both: a rise in the price of one relative to the price of the other tends to lead to a decrease in its consumption; a falling price tends to increase consumption.

Unemployment benefits reduce the cost of leisure and encourage the withdrawal of some labor from the labor market. New benefits and extensions of old benefits reinforce the withdrawal, which is hidden in the thicket of rules and regulations that seek to deny workers the freedom to choose between work and leisure. Withdrawal from the labor market obviously assumes freedom of action and voluntary reaction to changes in the relative prices of labor and leisure. Unfortunately, institutional restriction and prohibition often deny individuals the freedom to choose. Many individuals are barred from participation in production and exchange by such barriers as minimum wage legislation and license and permit requirements, which causes some workers to seek refuge in the underground economy. But most workers still have the choice between labor, which is regulated and taxed severely, and leisure, which is subsidized generously with unemployment compensation and other benefits of the transfer system. It cannot be surprising that many workers prefer the joys of leisure over the disutilities of labor.

Over the long run, aggregate unemployment rates have been rising in the United States. They have been increasing almost exclusively among unskilled or semiskilled laborers for whom the difference between the market wage of labor and the unemployment compensation and other benefits is minimal. A worker who earns \$200 net per week for his labor exertion and \$200 in the form of unemployment compensation and many other subsidies from food-stamps to Medicaid, lacks any pecuniary incentive to labor. He lacks the incentive to accept employment at a market rate of wage that may be lower than his compensation rate. He may prefer to remain unemployed until the benefits run out.

According to Department of Labor statistics, some seven to eight million Americans are unemployed. More than thirty million live in retirement and receive Social Security benefits. More than nine million depend on survivor benefits. Over six million live on public assistance or supplemental income. Altogether more than fifty million non-working Americans depend on transfer payments for their support. Surely, their number significantly reduces the supply of labor throughout the American labor market and renders the remaining labor more expensive. Not only does it deprive working people of the transfer income that is forcibly taken from them, but it also denies them the productive contribution many transfer beneficiaries could be making.

Society is substantially poorer because millions of able people no longer contribute to economic production. In recent decades American society has grown visibly poorer in the services which unskilled and semiskilled workers usually render. Many are idle, living on unemployment compensation and public assistance.

## An Invitation to Deceit and Fraud

**T**o limit the demand for its offerings, the system imposes benefit conditions that are designed to deny the leisure option. To be entitled to benefits, a person must be ready, willing and able to work. He must be unemployed through no fault of his own. Benefits are denied if he quits his job without a valid

reason, is discharged for willful misconduct, refuses to apply for or accept any suitable work within a reasonable distance of his home, or attends a school or training course. The amount of benefits may be reduced if he is self-employed or has any type of earning.<sup>5</sup> Unfortunately, the conditions are rather ineffective, and breed deceit and fraud on a massive scale.

For example, it is difficult to estimate the number of beneficiaries who labor in the underground economy and who blithely forget to report their earnings. But failure to report is tantamount to fraud, which is deception practiced deliberately in order to secure unlawful gain. The unemployment compensation laws call for prosecution of anyone making false statements or knowingly withholding information to obtain benefits illegally. But few such cases appear in court and even fewer judges are prepared to impose the penalties.

Beneficiaries are expected to apply for and accept any suitable work within a reasonable distance of their homes. But many who prefer leisure over work use imagination and ingenuity, resorting to clever tricks and artful dodges that meet the requirements of application but avoid being offered a job.

Similarly, to quit a job without valid reason or to be dismissed for willful misconduct means forfeiture of benefits—at least, the law so stipulates. In reality, unemployed workers may cite a great many reasons that may be true, imagined, or even manufactured. The system officials passing judgment on the valid reason or willful misconduct usually concur with the workers and dispense the benefits. Employer efforts to protest and appeal the decision are so costly it is often easier to accept the decision, right or wrong.

Some states deny unemployment compensation to strikers on the assumption that strikers voluntarily leave their jobs and are unavailable for work. However, other states, especially in the Northeast where the labor union ideology is dominant, manage to pay strikers on grounds that they do not leave voluntarily, but are driven out or locked out. When the United Steelworkers struck Wheeling-Pittsburgh Steel Corporation, operating under Chapter 11 of the Federal Bankruptcy Code in an effort to reorganize \$514 million in debt, Ohio's Bureau of Employment Services ruled that Ohio strikers were locked out and, therefore, entitled to benefits.<sup>6</sup>

The effects of this policy are clear. Workers throughout the state suffer reductions in take-home pay so that the United Steelworkers of America, who earn nearly twice the rate of the average worker, can exact more income and wealth from company creditors and stockholders. The subsidy aggravates the strike and magnifies the company losses, which consume business capital, reduce the demand for labor and cause more unemployment.

Moreover, the benefits may necessitate boosts in unemployment taxation, which raise labor costs and reduce the demand for labor throughout the state. Unemployment is bound to go higher throughout the Buckeye State. The payment of benefits to strikers makes a farce of the provision that workers must be unemployed through no fault of their own. If strikers who are noisily manning picket lines and forcibly barring other workers from going to work, are said to be unemployed "through no fault of their own," then worker fault has practically been eliminated and all fault been placed either on the doorsteps of employers or the economic system itself.

## Conclusion

**T**he high unemployment that is persisting in the United States has given rise to a vigorous debate as to its causes and potential cures. On the one hand are those observers who argue that the high level of unemployment reflects primarily a deficiency of aggregate demand. In the footsteps of John Maynard Keynes, they contend that higher and more rapidly rising levels of spending, including unemployment compensation and public assistance, supported by appropriate monetary and fiscal policies, can bring unemployment down to a satisfactory rate of four per cent or less.

Opposing this orthodox view is the economic argument that there is no lack of jobs in an unhampered labor market. Unemployment springs from extraneous force, in particular, by government and labor unions raising the cost of labor above its productivity. Numerous laws and regulations seek to bestow popular benefits, reduce effort and output, and erect obstacles to labor adjustments to changing costs and opportunities. Government and labor unions make the labor market a long obstacle course for unskilled and semiskilled workers. Unemployment compensation is one such obstacle. □

1. Ludwig von Mises, *Omnipotent Government* (Spring Mills, Pa.: Libertarian Press, 1985), p. 158 *et seq.*

2. *Unemployment Compensation in Pennsylvania*, Commonwealth of Pennsylvania, Department of Labor and Industry, UCP-19, REV 6-84.

3. Paul A. Samuelson and William D. Nordhaus, *Economics*, 12th edition (New York: McGraw-Hill Book Co., 1983), p. 175.

4. William Haber and Merrill G. Murray, *Unemployment Insurance in the American Economy: An Historical Review and Analysis* (Homewood, Ill.: Irwin, 1966).

5. *Pennsylvania Unemployment Compensation Handbook*, Commonwealth of Pennsylvania, Department of Labor and Industry, Office of Employment Security, UCP-1, REV 11-80, p. 2.

6. *The Wall Street Journal*, September 3, 1985, p. 14; 4.

**New!**

## Money and Freedom

### by Hans F. Sennholz

***Money and Freedom*** is a remarkable study of money and some fateful errors of popular monetary doctrines. It explodes the widespread notion that money cannot be left to "vagaries" of the market order and therefore must be controlled by government. Professor Sennholz argues forcefully and convincingly that such control, which amounts to a money monopoly, causes monetary destruction. Money is inflated, depreciated, and ultimately destroyed whenever politicians and officials hold monopolistic power over it.

***Money and Freedom*** is published by Libertarian Press and is also available from The Foundation for Economic Education.

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# Teaching Economics

**P**rogress toward a free society and a free economy cannot be made until a substantial part of the population understands the operations of the market. What constitutes a “substantial portion” is not a scientific matter. Perhaps only 15 or 20 per cent is enough to make the difference when votes are counted. One of the problems, however, is the very fundamental deficiency in the notion that “votes” are a satisfactory method of determining the future of a society.

Without belaboring the question of how depth and breadth of education can be achieved, it certainly can be concluded that almost as important as the basic concepts themselves, for the achievement of these ultimate goals, is the effectiveness of the teaching. After teaching students who have not previously been exposed to economics, I have gradually come to some conclusions as to what fascinates young people and what approach draws them to economics and might hopefully convince them to maintain a lifetime interest in the subject.

First, students must be persuaded that they will never understand the world around them, including occurrences in their daily lives, without understanding economics. Students are fascinated when their attention is called to the “spontaneous order” of the market. Easily found examples in the environment are the similarity of prices asked for the same commodities uptown and downtown, in-state and out-of-state, and at even greater distances if we ignore transportation time and costs. Another simple example is the remarkable phenomenon that the retail outlets we patronize tend to have just the right amount of goods for the people who come in to buy. All this happens without a central planning system. On further thought, it could not, does not, happen with a central planning system.

The equity of the spontaneous order of the market is further underscored when the students consider the varied tastes, goals, attitudes, means, and values of their acquaintances. Given the heterogeneity of human beings, the accomplishments of the market appear quite remarkable. In economics as I teach it, the students learn that the spontaneous order is achieved as trades take place among individuals with differing interests and wants. When transactions take place

**How best to present economic principles.**

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by Ronald S. Hertz

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Mr. Hertz was a CPA and a partner in a leading accounting firm. For many years he taught a course in economic theory at the New York Institute of Credit. Shortly before his death in 1985, he set down these thoughts.



Ronald S. Hertz (1926–1985)

at the margin, heterogeneous individuals become compatible and mutually satisfactory transactions are consummated.

Economic theory may then be put into the context of the “invisible hand” or “spontaneous order.” My course then concentrates on the processes or “forces” of the market. To appreciate their importance, the students must gain some understanding of what might be called the philosophical context of economic theory. They must realize, for example, that economics deals with *human actions* in the face of a *scarce environment*. They must come to understand how *deductive reasoning*, on the basis of fundamental axioms, leads to conclusions, economic laws or principles, which are incontrovertible unless the original premises are repudiated or the reasoning is unsound. Regardless of what appears to the senses in the environment, therefore, the laws of economics are not reversed or refuted, but merely obscured from the casual observer by the infinite number of forces working at all times in the real world.

I also introduce the thesis that economics is a science of means. Economics is described as “value-free.” Personal tastes and other factors entering into an individual’s goals, are *givens* and not the subject matter of economics per se. Economics is non-judgmental, in the sense that it scrupulously avoids making value judgments about the ends or goals of human action. Rather it focuses on the means for achieving those ends.

Hopefully, at the end of a brief introduction of this sort, the student’s appetite has been whetted. By that time, he or she will understand the basic, self-evident axioms and can reason with the teacher from then on—from these axioms to the laws of economics, from the elementary to the more complicated, and then on to the “sponta-

***“After teaching students who have not previously been exposed to economics, I have gradually come to some conclusions as to what fascinates young people and what approach draws them to economics and convinces them to maintain a lifetime interest in the subject.”***

---

neous” introduction of money, which makes complex transactions possible.

The market then, overall, is seen as the structure of voluntary, purposeful human actions, based on private property, governed only by principles of peace and social cooperation. Private property is the necessary concomitant of a voluntary society. Explained in this manner, the economy is shown to evolve solely from the actions of individuals, only voluntarily collectivized, and the forces of nature.

Our present system is riddled with government intervention of various sorts, the effects of which are disruptive. However, the system is still primarily the outcome of individual actions, not of overall coercion. All systems, whether theoretically “pure” market or “pure” socialist, are subject to the kind of analysis which only an understanding of market theory enables one to make.

**T**he next step in teaching economics is to introduce non-market forces, as they are superimposed step by step upon the market. Such non-market forces always turn out to be forms of coercion, political superimpositions, either direct or indirect. Key examples are explored in detail—government control over money leading to inflation, artificially stimulated bank credit expansion and its inevitable consequences, the effects of price and wage controls, regulation of business, and so forth. International trade is shown to become an economic problem only as a result of the political establishment of national borders and the institution of various government interventions within those national boundaries. Finally, totalitarian socialism is described in depth as the consequence of government interventionism carried to its extreme. Reference is made to the Soviet Union and other socialist countries, as well as to the “ideal” socialist state, if such can be conceived. The fundamental flaws of socialism are addressed and the students examine and compare both ends of the spectrum of economic systems—the market and socialism.

In this way, in accordance with my profound conviction, I try to project the urgent need for people to understand economic theory and the market. Only with an understanding of market theory can anyone recognize “order” in a world in which heterogeneous individuals conduct their daily affairs without supervision superimposed by government or a higher authority. Only with an understanding of theory, can one expect to pierce the mysteries which the economy presents to uninformed laymen. □

## **Non-Market Forces**

# Choosing the Right Pond

by John Chamberlain

Robert H. Frank's *Choosing the Right Pond* (Oxford, 306 pp., \$22.95) is, paragraph by paragraph, often a delight to read, but in addressing one-thousand-and-one topics in no particular sequential order it leaves one with the impression of a most confusing eclecticism.

Frank believes in what he calls a "libertarian welfare state," which in itself is a contradiction in any meaningful terms. He thinks we have an adaptive society and can have most anything. "Ours," he says, "for the taking is a society that is not only more efficient, but also more equitable and less restrictive than the one we have today." He hints that we could get it by taxing consumption instead of income.

Frank believes, very roughly, in marginal utility economics, but he has an incurable itch to qualify all statements. It is quickly apparent that he thinks people can be paid in many other things than money. People work for cash incomes, yes. But they also work for status, which can take many forms. The mixture plays hob with any theory of collective or individual bargaining.

The question of whether a worker is paid the economic value of his contribution might, says Frank, "have

been settled long ago if there existed simple, unequivocal measures of the economic value of what people produce." Unfortunately, most modern production is done by teams. This makes it difficult to define, much less measure, what one worker contributes to what the team as a whole produces.

The fact that the output of the team as a whole can be measured, where the individual contribution cannot, means that guesswork will tend to equalize individual wage rates. The quest for status muddies all the waters. Individuals may actually prefer working for less productive teams as a means of escaping what they regard as a de-meaning treadmill.

The anti-rat-race proclivities of individual workers have a general effect on all wages. "There occurs," says Frank, "a reduction in the reward workers receive for making extra contributions to their group's output." There is thus a "flattening" of the "slopes" of incentive pay schedules, which may account for much of the American productivity decline of recent years.

The quest for status means that many individuals will be content with titles. Being vice president of a company used to mean being next in line for the presidency. But Frank knows



about a large advertising agency in New York City that has 150 vice presidents and, above these, eleven executive vice presidents. Firms with multiple vice presidents will pay these executives less, and their lower staffs more.

Within the framework of traditional marginal productivity wage theory Frank finds lots of things that are "completely incoherent." There is a large literature that "discusses the widespread practice, in both union and non-union firms, by which workers impose strong sanctions against their co-workers who exceed informal production quotas. Instances are even reported in which firms themselves take steps to limit the amount workers produce. McKersie, for example, reports the case of a General Electric plant that abandoned an incentive pay experiment despite its strong effect on productivity, because it caused some production workers to earn more than their superiors."

In the oil business a good geologist may be able to indicate fields and methods of extraction that pay huge dividends to the lucky company for which he works. The problem here is that the geologist may be worth more to the company than its chief executive officer. The only way to handle such a situation is to pay the geologist fees outside the company. In many industries the practice of paying high consultant fees enables companies to avoid embarrassing comparisons.

The disconcerting thing about Frank's book is his tendency to take things back. He likes Milton Friedman's voucher plan for education. Vouchers offer greater possibilities for diversification than is now possible under state-provided education. The incentives for schools to recruit and retain the best possible teachers would be stronger under a voucher system. But Frank suggests that "an educational rat race of unprecedented pro-

portions might be unleashed if we were to switch to the voucher method of financing education." The current system, says Frank, "provides substantial insulation from . . . pressures for most middle- and low-income parents." After reading five pages of Frank's seesaw discussion of the Friedman voucher proposal I am at a loss to know just where we come out.

I have the same sort of trouble with Frank's supposedly clinching chapter of the "Libertarian Welfare State." After reading Frank's fascinating analyses on how the quest for status modifies the quest for contract, with "flattened" incentive pay slopes resulting, what is one to make of the Frank statement that "firms do in fact compete vigorously with one another, both in product and in labor markets"? Is Frank taking his whole book back? No, for Frank has a final reiterative switch to make. "The wage structure we see within private firms," he says, "is not one in which workers are paid the value of their marginal products. Nor are the goods and services we buy in open markets the ones that best service the needs of our communities."

Frank reconciles the disparity between his statements about competition by saying that the "products we buy and the terms under which we work are at least in rough harmony with the demands we express as individuals." The "rough harmony" he speaks of goes with his theory of tensions. The Libertarian welfare state, he says, is "riddled with tension and trade-offs" that "come with the territory." He expects that the "haves" will naturally be for lower taxes while the "have-nots" will struggle for greater benefits. Some will want "greater standardization of the labor contract, while others will push for greater latitude to negotiate on an individual basis."

So it's a matter of pushing and hauling. Does this mean that Frank is willing to settle for the status quo? Not

quite. "The great trade-offs between liberty, efficiency, and equality will again confront us in the future," he says, "but for now we can have more of *all* of these things." I don't know what he means by italicizing the word "*all*." Does he mean there is no need for trade-offs in the present?

Frank illustrates his book with cartoons, many of which are taken from *The New Yorker*. The cartoons play up anomalies and are a lot of fun. They are quite in spirit with the Frank text. But the fun does not make for coherence. A book that sees there are three sides to every question is no book at all. □

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**Takings: Private Property and the Power of Eminent Domain**

by Richard A. Epstein

Harvard University Press, Cambridge, Massachusetts and London, England • 362 pages, \$25.00 cloth

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*Reviewed by Joan Kennedy Taylor*

**E**minent domain is generally regarded as a power of government, not as a limitation on government. But this brilliant new book has the intriguing thesis that the eminent domain or ("takings") clause of the United States Constitution, properly understood, provides clear limits to government power, protects private property, and forbids any legislation that has the effect of redistributing wealth.

In English common law, according to Blackstone's *Commentaries* (1765), every Englishman had an "absolute right . . . of property, which consists in the free use, enjoyment, and disposal of all his acquisitions." Richard Epstein, an eminent law professor whose main interest is the common law, proposes that this legal definition, when incorporated into the eminent domain clause ("nor shall private property be taken for public use,

without just compensation"), forms the vital link between the individual's bundle of rights and a government that is limited by those rights.

Although he is himself a Lockean, Professor Epstein disputes John Locke's concept that by living in a civil society men give "tacit consent" to its laws and are therefore contractually obligated to obey them. This concept has been the thin edge of the wedge of escalating government power. "In its place belongs an explicit and rigorous theory of forced exchanges between the sovereign and the individual that can account both for the monopoly of force and for the preservation of liberty and property. The bulwark of the individual is no longer the absolute protection of his property. Now it is that whenever any portion of it is taken from him, he must receive from the state (that is, from the persons who take it) some equivalent or greater benefit as part of the same transaction. The categorical command that property shall not be taken without tacit consent must therefore be rewritten to provide that property may be taken upon provision of just compensation."

And so it was, in the eminent domain clause that was put in the Bill of Rights and also appears in some version in all state constitutions. It is this clause that, because it presupposes the Lockean theory of the relationship of the individual to government, brings that theory into the Constitution.

In evaluating any government action, then, there are four questions that must be asked: 1. Is there a taking? 2. Is there justification? 3. Is it for public use? and 4. Is there compensation? These questions appear at the end of Part I, and are explored throughout the rest of the book.

Part II lays out the argument that if any of the common law conditions for private taking are present, then the plaintiff is entitled to some recovery, and the partial nature of the taking only effects the amount and nature of

the compensation, and not whether compensation is due. In constitutional law, this would mean that partial takings are takings, that destruction of property is a taking, that interfering with the "use and enjoyment" of property is a taking (one case allowed compensation because smoke driven out of a tunnel by an exhaust fan went across the plaintiff's property), and that consequential damages (like the loss of goodwill when a business is forced to move) are also takings. In other words, since under both common and civil law ownership is a *set* of rights—"possession, use, and disposition"—infringement on any of these rights diminishes property value and is a taking. Further, the analysis of takings has equal force whether when the taking is from many people at once, or from a single owner at a time. "The modern effort to distance the taking clause from general laws cannot be maintained. *All* regulations, *all* taxes, and *all* modifications of liability rules are takings of private property *prima facie* compensable by the state." (Emphasis in original.)

Having established the range of takings, what justifications make takings legitimate actions of government? Essentially there are three categories: the police power, consent, and compensation. The police power allows the state to take without compensation in response to a private taking. (The present day Supreme Court, says Epstein, impermissibly confuses the police power, which can act only to right a wrong, with public use, which allows actions to confer a public benefit upon payment of compensation.) The category of consent is a narrow one; an instance would be the ending by government of grazing rights on federal lands, when it was clearly understood that the government had the right to terminate at any time: no compensation is due for the termination.

Once it has been established that

partial takings from the many are still takings for which compensation must be paid, the question of compensation becomes much more complex than is currently viewed. Much explicit compensation can be found to be inadequate or defective. Large-number takings are usually in the form of regulations, taxation, and modification of liability rules. These are not explicitly compensated for because it is assumed that the affected parties are both "benefited and burdened" by the same rule, and that therefore the affected parties receive implicit in-kind compensation.

An example of such a rule would be bankruptcy laws that assure that all creditors get something because any single creditor is barred from seizing the debtor's assets. Such a rule can pass the three tests that Epstein applies in order to detect a mismatch of benefits and burdens—the economic theory of property rights, the lack of partisan motive, and the lack of disproportionate impact. Much legislation and regulation that now passes judicial scrutiny, Epstein argues, would not pass if subjected to these tests. He applies the tests to show that most contemporary economic legislation—price controls, minimum wage laws, windfall profit taxes, state severance taxes, estate and gift taxation, even the progressive income tax—are unconstitutional.

Sweeping as this conclusion is, Epstein goes further. He finds that the entire concept of transfer payments underlying welfare checks, social security legislation, unemployment benefits, food stamps, farm subsidies, indeed, most of our contemporary budget, is unconstitutional by this analysis. But being a real-world thinker, he then questions whether it is possible to undo such programs now that people have been led to rely on them, and ends by proposing a practical sequence of reforms that would start to reverse the damage. Overhaul the tax system, invalidate the mini-



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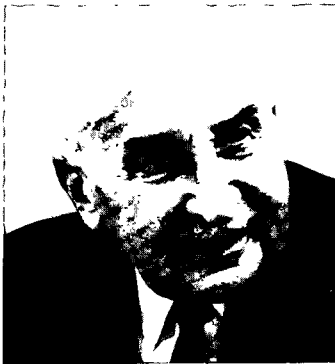
mum wage, strike down the National Labor Relations Board (NLRB), lift price controls on oil and gas, revise and rollback much zoning. As a result, "Production will rise; taxes will in general fall; the tradeoff between welfare and productive labor will shift in a favorable direction so that even if benefit levels remain the same, fewer people will demand them. That result in turn will reduce the taxes needed to fund them, which implies greater levels of productivity." He warns that we do not yet have the will as a people to make these reforms, because the intellectual climate is so hostile to them. But a proper legal theory, if widely accepted, will lead to changes in the proper direction.

It would be hard to overestimate the importance of this book. Not the least of that importance is the stature of the man who has written it. Richard Epstein is a professor at the University of Chicago Law School who has already been offered a federal judgeship and has even been mentioned by legal reporters as a possible Reagan nomi-

nee to the Supreme Court. The power of his interpretation lies in the fact that, although no one before him mounted his specific argument about the eminent domain linkage between private property and public law, "[t]he received judicial wisdom about the linkage recognizes all the important parts of the picture." In other words, he has taken theories that the legal community accepts separately but combines in other ways, and shown how much better his theory fits them together. It's as if he found the pieces of a complicated jigsaw puzzle that no one else had completed, and was able to put them together into a coherent whole. The instant recognizability of the picture that emerges, together with the identification of the pieces that everyone has been playing with, offers a strong presumption that Epstein has indeed found the solution to the puzzle. □

(Joan Kennedy Taylor is the editor of FEE's latest anthology, *Free Trade: The Necessary Foundation for World Peace*.)

## LIBERALISM: IN THE CLASSICAL TRADITION



Ludwig von Mises

**LIBERALISM: In The Classical Tradition** by Ludwig von Mises is a book-length essay that sums up the ideas and principles of classical liberalism as they apply to the twentieth century. First published in Germany in 1927, it was published in the United States under the title *The Free and Prosperous Commonwealth* in 1962 and reissued in the mid-seventies by The Institute for Humane Studies. It has just been republished by The Foundation for Economic Education in association with the Cobden Press.

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# THE FREEMAN

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*The Freeman* considers unsolicited editorial submissions, but they must be accompanied by a stamped, self-addressed envelope. Our author's guide is available on request.

### Essay Contest Winners

FEE has long been dedicated to helping people improve their understanding of the freedom philosophy, and their ability to express it in the modern idiom. In this issue of *The Freeman*, we are proud to present the first fruits of a new endeavor to this end—the first-place essays from the 1985-86 FEE student essay contest, "Foundations of a Free Society."

Contestants were asked to "present the positive case for individual liberty and responsibility in a free economy," choosing whatever subject matter they wished within that concept. Accordingly they addressed a wide variety of topics, from abstract themes such as the proper role of government, the meaning of freedom, and the morality of capitalism, to such topical issues as private vs. "public" charity, the problems with American agriculture, and international trade.

The contest drew 184 entries from 36 states, Canada, Argentina, and South Africa. California, Florida, Texas, and Virginia were most heavily represented (thanks, in part, to the promotion efforts of FEE supporters there). Of these papers, 110 came from high school students; 74 from college undergraduates. They were carefully judged by the FEE senior staff.

The main value of such a contest is to provide students with the opportunity and incentive to discipline their thoughts on liberty into written form. Also it helps FEE identify bright young people with a commitment to liberty, whose development we can assist. We have invited the five top entrants from each division to FEE summer seminars at our expense. For the award winners, of course, there is also the benefit of the awards themselves: \$1000 to Sarah Lindsey in the high school division, and \$500 to second-place winner Mary Jane Massey and \$2000 to Peter Heinecke in the college division, and \$1000 to second-place

winner John Majewski. A particular benefit for *The Freeman* is that the contest has been a source of fine articles. We hope our readers will enjoy the work of Sarah Lindsey and Peter Heinecke published herein, and a number of other excellent articles to be published in forthcoming issues.

—HB

## A Little Trust

According to newspaper reports, the Greek economy is in a shambles. The government is spending beyond its means, inflating the currency, and borrowing overseas to pay its bills. Prices are rising about 20 per cent each year. Socialist Prime Minister Andreas Papandreu professes to favor "reasonable" profits, but businessmen don't trust him.

Businessmen who want to expand their enterprises hesitate because of state control of some industries, state support of others, and the ever-present threat of increased state regulation. One successful Greek businessman has rejected the prospect of expanding, saying: "If you expand, you hire more people and you have less control over your business. You can't give your people raises and you can't fire them." (*Wall Street Journal*, March 28, 1986)

When government policies lead to economic stagnation, critics blame it on the people, saying they lack energy, initiative, and skills. However, a successful Greek manufacturer of farm machinery, who has turned down the thought of expanding because of the prospects of direct state competition, has a different interpretation: "People say there's no money in Greece. I disagree. People say there's no management skills. I disagree. People say there's no initiative here. I disagree. There's only one thing lacking here, and that's trust."

Many countries now suffer from the same "disease" as Greece—economic stagnation, government intervention,

and inflation. It's not that the people lack energy, ingenuity, or skills, but that they lack the confidence which comes from knowing that government will not place obstacles in their way.

—BBG

## Let's Pretend

It's a Barnum and Bailey world. At least it is in New York City's South Bronx, where local officials have pasted decals over the windows of abandoned apartments. The decals, paid for by a \$300,000 Federal grant, depict curtains, shades, shutters, and flower pots. To a passerby, it almost looks as if the buildings are inhabited.

But, tragically, these buildings aren't inhabited. Forty years of rent control, combined with escalating taxes, have forced New York landlords to abandon thousands of apartments. In the real world, landlords respond to economic incentives—a fact which no amount of decals can paste over.

## FEE Columns

In the past few years, articles and reviews by FEE staff members have appeared in *The Wall Street Journal*, *Barron's*, *New York Tribune*, *The Indianapolis Star*, *The Register*, and dozens of other newspapers around the country. In coming months, we will be circulating articles from *The Freeman* and other FEE publications on a more regular basis. If you see one of our articles in your local paper, we would appreciate it if you would send us a clipping.

## Reprints Available

We are pleased to offer reprints of John W. Sommer's article, "Disasters Unlimited," which appeared in the April *Freeman*. We also have reprints of James L. Payne's "It's Not Our Money," which appears on page 213 of this issue. Prices are 50¢ each or 25¢ each on orders for 10 or more.

# The Fallacy of Comparable Worth

**Why the market best determines wages.**

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by Peter S. Heinecke

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**P**ersonal freedom forms the basis of the American political system. Since the founding of our nation, politicians and activists have valiantly fought for freedom of speech, the press, and religion. Yet, one freedom, economic freedom, has been consistently ignored or underestimated. Particularly in recent years, those in power have been willing to abridge economic liberty in attempts to remold society in their vision.

These attempts are dangerous because the free market is essential for both prosperity and true freedom. Attempts to alter the market continually fail because their proponents do not understand the workings of the market. They do not believe people can act beneficially unless coerced by government. They are wrong. America's wealth was not planned by government but created by individual effort. The ability to buy and sell goods and services freely is all that Americans have needed to create a great nation:

A doctrine called comparable worth would end this success. It would have the government tell an employer and an employee engaged in a mutually beneficial relationship that their relationship was illegal. It would have the government prescribe under what terms one person could hire another. It would replace our current successful system of supply and demand with a dangerously unworkable system based on pseudo-scientific studies. It would destroy not only our prosperity but also our liberty.

Proponents of comparable worth claim that it will end a particularly insidious form of discrimination. They claim that the market systematically discriminates against women. They prove this by studying "all" the factors which comprise a job—working conditions, skills needed, and so on—and awarding a certain number of points for each. The sum of these points is the value of the job. Studies of this sort have shown that workers in female-dominated jobs are paid significantly less than workers in male-dominated jobs for work which is of the same "value." For example, in a Minnesota study the job of registered nurse garnered 275 points while that of painter received only 185. The fact that the state of Minnesota paid both equally was seen by comparable worth advocates as *prima facie* evidence of discrimination.



Peter S. Heinecke is the first-prize winner in the college division of FEE's 1985-1986 Freedom Essay Contest. He is a junior at Princeton University, majoring in politics.

Following graduation, Peter plans to pursue a career in business, and perhaps eventually enter elective politics. His family resides in San Anselmo, California.



The solution offered to such "discrimination" is alluringly simple: make it the law of the land that all employers must follow these "objectively," determined worths when creating their pay scales. In the same way that companies are now required to pay men and women equally for the same work, comparable worth advocates would have companies pay workers the same amount if their jobs have the same "economic value."

The essential problem with comparable worth is that its proponents do not understand the relationship between liberty and the market. Wages are not set randomly. Rather, individual choice determines both the supply of and demand for employment. The interaction between supply and demand determines wages. The number of factors in these determinations is infinite because it is based on the personal decisions of all Americans in the workforce. This collective exercise of individual liberty can neither be quantified nor controlled.

Because proponents of comparable worth do not understand this fact, their proposal is plagued by severe logical and implementational flaws. First, the premise that the entire difference in earnings between men and women is due to discrimination is demonstrably false. Second, all extant means of determining the correct pay are hopelessly and inevitably inadequate for such a complex task. Finally, the proposed means of implementing a solution, governmental action, would lead to market chaos and economic fascism. In short, the doctrine of comparable worth is based on faulty assumptions, poor analysis, and unworkable solutions.

Though the feminist movement almost automatically concludes that the disparity between male and female earnings is due to discrimination, the causal link is in fact not so clear. To begin with, studies have determined that between a third and a half of the difference in wages can be directly attributed to differences in education, experience and job tenure. Another important factor is that men and women have different goals and make different career choices. For example, female doctors tend to gravitate toward salaried positions, which allow them more flexibility to raise a family, while male doctors are drawn toward less flexible, but more lucrative private practice. In contrast the wages of presumably career-oriented groups of both sexes are virtually equal. Never-married women with continuous labor force participation receive roughly the same pay for their work as do married, full-time

working men. And the difference in pay between single men and single women is only 15 per cent. While discrimination may exist, such factors as education, experience, and individual choice are more important in determining wages. Thus, comparable worth is a repressive system which does not address a real problem.

## The Willis Scale

Perhaps the best known comparable worth scale is the Willis scale. It was created in 1973 when the state of Washington commissioned the firm of Norman D. Willis and Associates to determine whether the state was paying equal amounts of money to women and men whose jobs required "a comparable level" of skill. It was the basis of a one-billion-dollar court decision against the state.

If the state of Washington is going to pay 1 billion dollars to implement a pay scale according to Willis's guidelines, one would expect those guidelines to be extremely accurate. But they aren't. In quantifying the worth of a job Willis identifies four factors: knowledge and skill required, mental demands, accountability, and working conditions. Each of these factors is divided into two or three sub-categories. For example, under accountability one of the categories is the impact of one's work. Consultants using Willis's manual are advised to award points according to whether the job "impacts on something *big* or *little*, or on something *in between*." It is frightening to think that the state of Washington is preparing to spend 1 billion dollars to implement a pay scale based on one consultant's, or even a group of consultants', inherently subjective interpretation of "*big, little, or in between*."

Furthermore, the study uses the demands of the job to determine a *monetary* basis for its worth. Yet, many jobs offer intangible benefits which are ignored by the study. For example, such subjective factors as prestige, job security, and opportunity for advancement are often as crucial as monetary remuneration in a person's decision to accept a job. Obviously, it is impossible to quantify these factors and include them in a system. However, to consider money as the only form of remuneration is to subscribe to a fallacious theory of economic determinism. It is to say that employees are only motivated by money. But most employees are smarter than that. Most look beyond salary and enjoy the flexibility of receiving nonmonetary compensation. Comparable worth systems ignore this fact and would invalidate mutually agreeable contracts solely because of salary considerations. Such results demonstrate the unworkable and tyrannical nature of comparable worth.

Another flaw in Willis's study is the equal weighting given to each category. How can anyone say that the education required of a computer programmer is of the same value as the extreme danger faced by a prison guard? Or that the accountability of a high level bureaucrat deserves the same compensation as the mental demands on an air traffic controller? Individuals, of course, make these determinations for themselves when they choose careers. There is no need for the government to do it again. Comparable worth systems would supersede individual preferences and rigidly weigh each consideration equally. That those weightings have no correlation to the reality of individual choice does not seem to bother advocates.

***“Consider a person who has developed the ability to juggle running chain saws. . . . According to any comparable worth scale, this man should be paid as much as a CEO or nuclear engineer.”***

Thus, at the most basic technical level comparable worth systems are doomed to failure because they are unable to judge accurately those few factors concerning a job which they can identify. This, however, is the least of their problems. There are a multitude of variables which any system is inherently incapable of taking into consideration. The first of these is quality, which the study is forced to neglect because quality can only be applied to a specific person's work performance. The guidelines formed by Willis make no attempt to differentiate between a slovenly, rude, inefficient secretary and a dynamic, innovative, pleasant one. Worse, the competent secretary will always be considered worth less than any third-rate lawyer.

**T**he root cause of the above perversions is comparable worth's abysmal inability to consider the most crucial factors in determining the value of anything—supply and demand. No matter how dangerous a job is, no matter how many years of training are required to acquire the skills for it, the job is totally devoid of value if there isn't someone willing to employ a person trained for that job. Consider a person who has developed the ability to juggle running chainsaws. (There is such a person in Venice Beach, California.) Clearly his job requires a great deal of skill, is mentally demanding, is done in varying work conditions, and if there is a crowd around, demands a certain amount of accountability. According to any comparable worth scale, this man should be paid as much as a CEO or nuclear engineer. Yet he survives only on the meager amounts people are willing to toss in his hat. Why? Because there is almost no demand for his services. He performs an almost entirely useless function. But he continues to do it, presumably because he enjoys it. Job satisfaction is another factor which comparable worth scales are inherently unable to measure.

Lest this example seem so extreme as to be a mere aberration, let us look at a more mainstream occupation which pays very little. Buggy whip making was once an extremely valuable skill but you won't find people paid much to do it currently. Why? Because it is no longer needed. Modern technology has made such a skill useless and thus one cannot make a decent wage doing it. Comparable worth, however, does not have any ability to adjust for change. Once a job is determined to have a certain value, it will always have the same value regardless of whether it serves a useful function. To deny employers the right to adjust wages according to changing circumstances will doom our economy to noncompetitiveness in the world market.

A more current example is the pay scale at Weyerhaeuser, a major lumbering firm in the Northwest. A comparable worth survey done by Willis rated the job of personnel manager at 916 and that of a pulp

## **Supply and Demand**

mill superintendent at 760. Yet pulp mill superintendents make more money. Why? Because it is difficult to find competent, reliable pulp mill superintendents. Thus Weyerhaeuser pays them a high wage to attract qualified people to that line of work. If the government imposes the wage for pulp mill superintendents, Weyerhaeuser will not be able to function.

Herein lies the basic problem with a government-imposed comparable worth scale: Government-dictated wages will distort and eventually destroy the market. Consider what would happen if the federal government mandated wage increases for workers in female-dominated jobs. First, there would be a flood of people, both males and females, who would be attracted to the lucrative wages in these jobs. Most would end up in the unemployment lines because currently there is no shortage of legal secretaries, librarians, or nurses. Second, the courts would be engulfed with suits claiming discrimination according to the new standards. Because every corporation is different, each suit would require an exhaustive study. The cost of the studies, restraining orders, and retroactive pay increases alone would be a serious drag on the economy.

## Scarcities and Surpluses

It would not end there. Eventually someone would realize that if it is unjust to pay women less than their comparable worth, it is undoubtedly unjust and unconstitutional to pay *anyone* less than that person is "worth." Soon the government would mandate every wage paid to every person in the United States. Since there would no longer be any correlation between one's wages and the demand for one's skills, labor would be distributed ineffectively. There would be scarcities of engineers, who don't rate particularly well on Willis's scale yet are in great demand, and surpluses in the suddenly high-paying previously female-dominated fields. Weyerhaeuser would be facing a massive shortage of pulp mill superintendents.

This combination of widespread unemployment and labor shortages in critical positions would result in extreme economic stagnation. Obviously the government would be called upon to resolve such a dire economic crisis. Yet officials would have only two choices: repeal comparable worth laws or coerce people into those areas where workers are needed. It is frightening to think they might choose the latter.

The same market factors which are the nemesis of the advocates of comparable worth are also the solution to the problems they seek to solve. A recent study by the Rand Corporation revealed that in past years women have made great gains with relationship to men in terms of wages. Interestingly, the study indicated that Federal laws prohibiting discrimination were not a major factor in the gains. Rather, as women acquired education, skills, and experience which were in demand, they received commensurate rewards. Furthermore, the study concluded that women would increase their gains in the future for the very same reasons. In other words, women entering the work force today are assessing the situation and, not surprisingly, are acquiring the skills necessary to obtain more lucrative wages. Currently, women have the opportunity to earn as much as men, but because of different goals and values, generally do not. Comparable worth would destroy both their freedom to make choices and their economic opportunity.

Comparable worth derives its political strength from a variety of

***“To impose a price for anything, whether it be a product, a service, or a job, is to suppress people’s right to free and mutually agreeable exchange.”***

emotional, but in the final analysis, irrational arguments. For example, one union official has argued, “When a person whose job requires a college education makes less than a common laborer there’s something wrong.” Is there necessarily something wrong? Does spending four years of one’s life reading books entitle one to a standard of living higher than that of a person who is willing to get his hands dirty and his muscles sore? The answer is yes, if and only if there is a greater demand for, or a smaller supply of, those skills acquired during four years in an ivory tower than there is for the brute force of a common laborer.

The union official’s complaint is indicative of comparable worth advocates’ inability to grasp one incontrovertible fact: There is no such thing as intrinsic economic value. Money is merely a convenient unit of measurement. Price is merely a reflection of what people engaged in free exchange believe something is worth. To impose a price for anything, whether it be a product, a service, or a job, is to suppress people’s right to free and mutually agreeable exchange. Comparable worth, in its attempt to impose an arbitrary and inaccurate notion of justice on the market, denies both men and women the right to exchange freely their goods and services. A woman will not be helped if she is left unemployed because she is barred by the law from taking a job at a wage which she, but not the government, feels is just. The greatest and most tragic irony of comparable worth will be the huge number of people left unemployed because their employers are unwilling or unable to pay artificially high, government-imposed wages.

To sacrifice liberty in a misguided attempt to achieve equality is foolhardy. Governmental determination of wages destroys the source of both America’s economic strength and a sense of justice. The free market is not only a tremendous force against discrimination but also the ultimate bastion of individual liberty. It would be a grave mistake to subvert it. It would be folly to think that the federal government once given the power to determine the wage of every worker in this nation would use that power either wisely or effectively. Comparable worth, under the guise of justice, offers us tyranny and economic disaster. We must reject it. □

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# Educational Freedom

**Only the free market can provide high quality and efficient schooling services.**

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by Sarah H. Lindsey

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**T**he necessity of education, especially in today's rapidly changing society, is still recognized as being of the utmost importance. Yet neither those concerned with the quality of schooling, nor those concerned with individual liberty are satisfied with the current system. It could be argued that the present educational system is inefficient, immoral, and inconsistent with the principles of a free society. In the area of public education, we have failed to separate financing from the production of schooling services. The government, in addition to providing financial aid to education, has also taken on the responsibility for producing educational services. Two things keep the current system working: (1) financing it by compulsory tax payments and (2) the willingness of Americans to accept the belief that there is no alternative to government production of schooling.

Much of the failure in the field of education may be traced to government intervention. One of the first errors was the system's failure to recognize that compulsory attendance would lead to many problems. More specifically, compulsory attendance policies have failed to recognize that some students don't belong—much less want to be—in the classroom. It's assumed that all wants and needs of a student are met by the present educational system. Some students, however, do not want to learn and have no intention of letting others do so. Consequently, they create a disruptive atmosphere for other students and teachers. It is also assumed that all students receive benefits in excess of the costs to taxpayers. To the extent this is not true, compulsory attendance wastes both society's resources and the student's time and is therefore inefficient.

Second, compulsory attendance has lowered the overall standards and quality of today's educational system. The present system is supposedly trying to be fair and equal in its treatment of each student. Yet equality never raises standards; it lowers them to the lowest denominator. This allows even the poorest student to pass graduation requirements. Lower standards restrict ambitious students and high achievers by not presenting a challenge.

Third, through compulsory attendance the State forces parents to have their children associate with uneducable children, juvenile delinquents, and the like. Those who can't afford private schooling or tutors are "locked into" an unsatisfactory situation.

Sarah H. Lindsey is the first-prize winner in the high school division of FEE's 1985-1986 Freedom Essay Contest. Sarah is a senior at Pennsbury Senior High School in Fairless Hills, Pennsylvania, where she is a member of the National Honor Society. She plans to attend college and will major in either economics or biological sciences.

Sarah has won numerous other awards for her writing and leadership talents. Her non-academic interests include drawing, painting, sculpting, and field hockey.



This leads us to an interesting question: "Does the parent or the State know better the educational needs of a child?" Parents are bound to their children with ties fostered by love and responsibility. Obviously, the parents know better than the State bureaucracy the wants and needs of their child—and should be able to choose the schooling that best suits their child. Yet public schooling deprives parents of this opportunity. The government taxes away parents' income and proceeds to operate the school system as it sees fit.

"As it sees fit" usually includes suppressing the diversity that exists among individuals. A uniform code is imposed on all students, which ignores individual interests and abilities. If the government did not impose a uniform set of rules, however, people would charge discrimination. All people are not alike. Different people have different wants and public school officials cannot please everyone. There will be some parents and students who will not be satisfied with the type of education they receive. Hence, conflict arises between citizens and school boards, between parents and administrators. It is the inevitable result of government decisions rather than private ones.

The last and most powerful argument against the present public school system is that only the free market can provide high quality and efficient schooling services. Letting the market function unhampered in the production of education would likely produce an explosive growth in the number of private voluntary schools. Parents would be free to send their children to trade schools, religious schools, progressive schools, or whatever type for which there was a demand.

Those schools which meet the desires of the customer-parents would flourish. With parents making the choices, schools would have to deliver the kind of education the consumer-parents demand. It would be impossible for a school to avoid the discipline of the marketplace. Schools would be selected on the basis of performance and reputation. Any school that fails to offer what the parents and students want would have to close. If schools had to design their programs with an eye toward the market, society could be assured that everyone's freedom would be broadened by the many new choices that would become available.



This freedom of choice for parents would also provide real academic freedom for teachers. The market would encourage teachers to improve their professional skills and would stimulate creative persons outside the present system to enter the profession. Teachers would be motivated to improve because they would face competition, not protection through tenure and seniority rules and regulations emanating from the vast, complex government educational bureaucracy. Outstanding teachers would be rewarded with raises if the present employer did not want to risk losing those teachers to another firm. Ideally, teachers' raises would result from quality performance and not from demonstrations or picket-line participation. Those teachers who are incompetent would be either less successful in a market system, or would be "reallocated" by the market to another occupation.

The present public schooling system is clearly inconsistent with the principles of individual liberty and responsibility in a free society. Instead of raising the quality of education, it has resulted in lower standards, conflict, and inefficient use of resources. What the market has accomplished in the production of other goods and services can be realized also for educational services. □

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**W**e need not wait for institutional reform if we wish substantially to improve the education of our young. Not all education occurs in the school. Education, like charity, begins at home. If the task of reforming a giant educational structure serving millions of children seems too large, could each of us at least assume responsibility for the proper mental and moral development of a single child? The individual need not feel impotent when he has before him a task on a scale which he *can* comprehend as an individual, especially when that task is the development of human personality, surely the single most important undertaking in the world.

GEORGE CHARLES ROCHE III  
*Education in America*



# “It’s Not Our Money”

**F**rom time to time the United States House of Representatives lays aside its usual duties to memorialize certain of its members. The tribute is in the form of legislation. A bill is introduced placing the fallen congressman’s name on a Federal structure such as a post office or a courthouse, then congressmen rise to speak, extolling the virtues of the deceased and praising his accomplishments.

A harmless ceremony, I thought, as I came across it the other day in the *Congressional Record*. But then something attracted my notice. The representative was praising a former colleague, telling how he had served in Congress with distinction for more than twenty years. The eulogist continued: “As [the congressman’s city] grew, he was cognizant of the associated Federal presence which would be required. He continually fought for Federal dollars and was responsible for the construction of the Federal Office Building and Courthouse, the Post Office Terminal Annex, the Air Force Accounting and Finance Center, . . .”

Do you wonder why Federal spending is out of control and deficits drain the economic vitality of the country? You have just seen an important part of the explanation in the words our speaker chose to eulogize his colleague. They betray a distinctive approach to the job of congressman, a view rooted in what may be called the “philanthropic fallacy.”

This fallacy makes the assumption that government is a philanthropic institution not fundamentally different from such private benevolent organizations as foundations, churches, or the Salvation Army. Under this view, the representatives are charged with the mission of doing good by spending government funds. The congressman who “continually fought for Federal dollars” is a hero.

Our speaker, eulogizing a different colleague, gave a fuller statement of this misconception, stating that his fellow legislator “always served the people, and his long record in this body indicates clearly the contribution he made for people in the fields of social welfare, housing, and urban development. He worked hard and successfully to use the vast resources of the Federal Government to serve the most in need and to correct injustice.”

**Is government a charitable institution?**

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by James L. Payne

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Dr. Payne is on leave as Professor of Political Economy at Texas A&M University.

The congressman is seen as a philanthropist, using the "vast resources of the Federal Government" for charitable purposes.

It is easy to see that once this view becomes prevalent, holding back government spending becomes next to impossible. For the philanthropist, the only reason to stop spending is to be out of cash, and to have no way of raising more. To have money and yet to refuse to give it to worthy causes marks one as "insensitive" and "hard-hearted." For those in the grip of the philanthropic fallacy, the operative principle for government spending is "more"—no matter how high the level of spending already is.

## A Popular View

Congressmen are not alone in holding this view of government as a charitable institution. To a considerable degree, they absorb it from the culture that surrounds them. In our media, we refer to politicians who favor greater public spending on good causes as "compassionate," while those who urge cutbacks are called "heartless." Even our fiction encourages the philanthropic fallacy. Almost by definition, the "good" kings and queens of fairy tales gave large sums to the poor. No mention is made of how they acquired these sums.

In dealing with the philanthropic fallacy, the problem lies not in understanding why it is believed—for it surrounds us practically as the air we breathe—but in reminding ourselves that it *is* a fallacy. The government is *not* a philanthropic institution. It is not even an ordinary agency of production or distribution like a business or a store. It does not create goods and services that citizens voluntarily exchange for their wealth. A government, by definition, is an organization that deploys public force. It deals with pushing and shoving, with coercion.

The dollars a government commands are obtained through the use of force, direct or indirect.

When the government taxes, the use of force is direct: If you refuse to part with the funds the government official demands, he will have you thrown in jail. When the government borrows money, it is still relying on its taxing power. Lenders are reassured by the government's promise to use force to collect the repayment. When the government prints money—thus devaluing the dollars citizens hold—it relies on its ability to outlaw other currencies and force everyone to accept its paper as "legal tender."

Many people find this view unfamiliar, because they fail to inquire where public funds come from. Where, for example, did good kings of old get the resources they were so generous with? Kings didn't *earn* their money. They didn't shoe horses or tend pigs for a living. They sat in castles while their soldiers collected taxes. It was these taxes, taken by force from others, that rulers "gave" away.

Once the proper connections are made, the role of the congressman ceases to appear so philanthropic. Instead it takes on the character of a difficult balancing act. In this light, a congressman's fully translated epitaph might be far from flattering.

"He continually fought to have money taken from his fellow citizens by force for the construction of a Federal Office Building in his district."

This is not to say that appropriations of public funds are necessarily wrong. Some may be of sufficient benefit to outweigh their coercive

aspect. A congressman would be entitled to say in good conscience, “I support this appropriation because I feel that the value of these funds for X service outweighs the harm of taking these monies by force from our fellow citizens.” If X were “national defense,” for example, most of us would agree, albeit hesitantly, with the statement.

The philanthropic fallacy is further encouraged by the beneficiaries of public spending. None of these recipients mentions the coercion and injury involved in *raising* public money. Instead, they stress the good that the congressman can do by *spending* it on them. They present their case exactly as they would if appealing to a private individual, inviting the congressman to play the role of a voluntary donor generously giving of his own wealth.

“We thank you for your support in the past,” the supplicants say, in closing their testimony, “and look forward to it in the future.” What the congressmen should answer is, “Don’t thank us; it’s not our money.” □

## LEGAL PLUNDER

**T**he war against illegal plunder has been fought since the beginning of the world. The law itself conducts this war, and it is my wish and opinion that the law should always maintain this attitude toward plunder.

But it does not always do this. Sometimes the law defends plunder and participates in it. Thus the beneficiaries are spared the shame, danger, and scruple which their acts would otherwise involve. Sometimes the law places the whole apparatus of judges, police, prisons, and gendarmes at the service of the plunderers, and treats the victim—when he defends himself—as a criminal. In short, there is *legal plunder*.

This legal plunder may be only an isolated stain among the legislative measures of the people. If so, it is best to wipe it out with a minimum of speeches and denunciations—and in spite of the uproar of the vested interests.

But how is this legal plunder to be identified? Quite simply. See if the law takes from some persons what belongs to them, and gives it to other persons to whom it does not belong. See if the law benefits one citizen at the expense of another by doing what the citizen himself cannot do without committing a crime.

Then abolish this law without delay, for it is not only an evil itself, but also it is a fertile source for further evils because it invites reprisals. If such a law—which may be an isolated case—is not abolished immediately, it will spread, multiply, and develop into a system.

FREDERIC BASTIAT  
*The Law*

IDEAS  
ON  
LIBERTY



# Deregulation of the Natural Gas Industry

**How the free market efficiently allocates energy resources.**

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by J.D. Steelman, Jr.

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Mr. Steelman practices corporate and commercial law in Tulsa, Oklahoma. He has particular experience in oil, gas, and mineral rights.

**N**o industry has been more heavily regulated than the natural gas industry. From the wellhead to the burner tip virtually every level and aspect of the industry is regulated in minute detail by the state and federal government. Today the industry, like other previously regulated industries such as transportation and finance, is being deregulated and thrust into the competitive marketplace. The result, not surprisingly, is lower gas prices.

In 1848 John Stuart Mill first applied the concept of "natural" monopoly to the gas industry of the City of London and thus began more than a century of gas industry regulation in the English-speaking world. As pointed out by the late Ludwig von Mises and by Murray Rothbard, a "natural" monopoly is merely a limited-space monopoly.<sup>1</sup>

A gas company desiring to commence service to a local market must reach agreement with the owners of the streets and the subsoil for the installation of pipelines and meters. In most instances this means the gas company has to contract for an easement or the purchase of real estate with the local authorities who own or control the streets and real estate through which the gas company must lay its lines. Given the limited supply of land through which the gas company must lay its lines, the local authorities of necessity have to allocate the available supply of real estate which is to be used for the pipeline easements. Thus only one or a few gas companies is normally allocated the land rights within a city in which to lay pipelines. This right is frequently called a franchise.

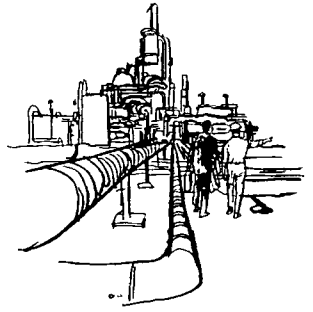
Local authorities reasoned that granting the gas company or companies a natural monopoly would result in "monopoly" prices. Thus, the local politicians felt compelled to protect the consumers of natural gas by insuring that the gas company's rates were "just and reasonable," a common euphemism for price controls. Controlled prices are not market prices since the dynamics of the marketplace will always tend to make the controlled price higher or lower than the market price, thereby resulting in surpluses or shortages.

As Rothbard points out, every business has a monopoly on the space occupied by that business. Since consumers utilize many subjective factors, including the location of a business, in valuing goods and

services, it is impossible to determine whether a price premium is due to the spatial monopoly of the business. Monopoly price cannot be conceptually distinguished from competitive price and thus as Rothbard says, "All prices on the free market are 'competitive'."

In 1877 the United States Supreme Court, in a decision extending beyond a mere spatial monopoly, held that a business (grain elevators) could be so affected with a public interest that the state could grant a monopoly to that business and thereby limit competition.<sup>2</sup> This established the philosophical and legal framework for subsequent regulation of American business, including the extensive regulation of the natural gas industry in the thirties.

Until the passage of the Federal natural gas legislation, regulation of the gas industry was purely a matter of local and state concern. It was limited primarily to the granting of franchises and the local regulation of rates. Federal regulation extended only to oil pipelines, and the Supreme Court expressly precluded regulation of interstate natural gas pipelines.<sup>3</sup>



**T**he regulation of the interstate natural gas industry had its beginnings in the early 1920s as a result of alleged abuses by public utility companies. The "abuses" alleged were control of the interstate pipeline systems by a few holding companies, resulting in high prices to the consumer, and domination of the purchase of gas, resulting in low prices to producers.

In 1928 Congress passed a resolution directing the Federal Trade Commission (FTC) to investigate and report on these allegations of public utility "abuses" and to recommend legislation to remedy the "abuses." The FTC found a number of "abuses." The most important ones were (a) the concentration in purchasing and transportation of natural gas, (b) discrimination in the purchases of natural gas from producers, (c) the unregulated competition in construction of natural gas pipelines, (d) costly competition among pipelines and holding companies, and (e) excessive variations in wholesale natural gas rates.

The natural gas industry was experiencing a tremendous expansion during the period covered by the FTC investigation. Large discoveries of natural gas were found in Louisiana, Texas, Oklahoma, and Kansas. At the same time as the natural gas fields were undergoing development, major oil fields having substantial quantities of natural gas were also being developed. The end result of such discoveries was a substantial increase in natural gas supplies in the local and regional marketplace. Prices fell and gas production was shut-in for lack of markets.

As a result of the low prices for natural gas, long-distance transmission line companies saw an opportunity to sell gas in markets that were great distances from the producing fields. At the same time, construction and operating costs for such pipelines were declining due to improved technologies (such as seamless steel pipe which enabled gas to be transported long distances at high pressures), and other efficiencies, while prices for competing fuels were beginning to rise. Thus transmission companies began to purchase the surplus natural gas and transport it to the more distant markets. The natural gas market in the 1920s and 1930s had all the ingredients required for a profitable undertaking in the long distance transmission of natural gas.

## Alleged Abuses

## Affected with a Public Interest

Unfortunately, the FTC investigation resulted in Congressional action. In 1935 the Federal Power Act and the Public Utility Company Holding Act were passed into law. Then in 1938 the Natural Gas Act was enacted. The interstate natural gas industry was deemed to be affected with a "public interest" and therefore became a fully regulated industry. Natural gas companies are granted exclusive service areas and market entry is subject to approval of the regulators through issuance of certificates of public convenience and necessity. In exchange the regulators require rates to be "just and reasonable."

The Natural Gas Act, which was administered by the Federal Power Commission (FPC), extended to the transportation and sale of natural gas by natural gas companies. In 1954 the Supreme Court extended regulation to the prices paid by interstate pipelines to independent natural gas producers.<sup>4</sup> Gas being sold in the interstate market was controlled at what proved to be below market prices. Not surprisingly shortages developed in that market. At the same time, the intrastate natural gas market which was not Federally regulated had an abundance of gas.

Under the Natural Gas Act, virtually every aspect of the interstate transportation and sale of natural gas is regulated by the Federal Energy Regulatory Commission (FERC), successor to the FPC. Rates are set on a cost-plus basis. The rate of return is calculated as a percentage of invested capital and is virtually guaranteed once set. Expenses are reimbursed, as are the costs of natural gas supplies, the largest component of a pipeline's costs. In order to increase a pipeline's rates the company must file a rate case. A hearing is held in which customers, suppliers, regulators, and any other interested party may participate. As one might expect, the issues become complex. Resolution of the issues is often difficult, expensive, and time-consuming.

The price disparities between interstate gas and intrastate gas which developed in the mid-1970s and resulted in shortages in the interstate market pointed out the below-market pricing of interstate gas by the Federal regulators. To avoid the loss of sales due to the shortage of natural gas and the increased risk of underrecovery of their fixed costs, pipeline companies actively sought new sources of gas supplies. A favorite inducement to natural gas producers during this period of shortage was the take-or-pay provision in long-term supply contracts in which the purchasers agreed to pay for gas even if they did not take it. Later when the market changed from shortage to a surplus supply of gas, pipeline companies were saddled with this liability under their take-or-pay contracts.

While these unrecovered fixed costs could be theoretically recovered in the next rate case filed by the company, regulators were reluctant to pass on to consumers the take-or-pay liabilities which amounted to tens of billions of dollars. Since industrial and commercial consumers were switching to alternative energy supplies such as residual fuel oil and coal, the pass-on of the take-or-pay liability would only increase substitution of energy alternatives resulting in what became known in the industry as "the deathspiral" which would ultimately lead to receivership. Thus producers and pipeline companies were encouraged to renegotiate their contractual arrangements to reduce the take-or-pay liability.

**I**n response to the natural gas shortages which developed during the period 1975 to 1977 in the interstate market the Natural Gas Policy Act was enacted in 1978 for the purpose of gradually deregulating the prices paid by the pipelines for gas (significant deregulation did not start until 1985), thereby encouraging development and production of gas.

In early 1981 the Reagan administration deregulated oil prices. The result was an immediate and sharp increase in prices followed by a dramatic decrease. Fuel oil became extremely competitive with gas. As pipeline companies scrambled to meet the competition of fuel oil they curtailed purchases of gas from producers and other suppliers and renegotiated contracts. This created a surplus of natural gas. The pipeline companies and distributors initiated a number of programs to make natural gas more competitive with fuel oil.

Rather than buy the gas and resell it to industrial consumers, pipeline companies began to transport gas for the producer or industrial consumer. Due to the FERC rate regulations, this means of doing business was not as profitable to the pipeline companies; but because such transportation would help to reduce take-or-pay liability to producers and prevent further sales losses, it became attractive to some companies. Thus by 1984 many companies and producers had voluntarily readjusted contractual relations, and pipeline companies were beginning to carry more gas from producers to industrial consumers. However, producers continued to have a surplus of natural gas.

The Natural Gas Policy Act deregulated approximately 40 per cent to 60 per cent of the natural gas in the United States as of January 1, 1985. The United States Department of Energy's new Import Guidelines of February 1984 and the new Canadian Natural Gas Export Pricing Policy implemented in the fall of 1984 reduced the price of imported Canadian gas by 30 per cent. In the summer of 1984, FERC further deregulated the gas industry by reducing take-or-pay liability between pipelines in what are called minimum bill contracts.<sup>5</sup>

Then in early 1985 the FERC began to advocate substantial deregulation of the natural gas industry to encourage companies to assume greater risks and have the opportunity for greater returns. In the fall of 1985 the FERC formally implemented its deregulation policy and the Department of Energy filed with the FERC to deregulate the remaining categories of natural gas still under price controls.<sup>6</sup>

Industrial consumers began to search in earnest for cheaper gas which more producers were willing to sell. Brokers and marketers, neither of whom are regulated by the FERC, saw the profit potential to be gained from matching producers and industrial consumers. A national clearinghouse developed to broker gas as more pipelines began to carry gas and soon a national spot market began to emerge as the industry became more competitive.

**I**n this new era of deregulation, the name of the game in the natural gas industry is marketing and competition. Producers, pipelines and distribution companies are all beginning to respond to the demands of the consumer, especially the large industrial consumers. As in the transportation (rail<sup>7</sup> and air) and financial industries, competition is transforming the way in which the natural gas industry does business and is making it more efficient.

## The Move Toward Competition

## The Competitive Marketplace

***“The future holds the promise of an industry free at the wellhead, free at the gathering line, generally free and competitive at the transmission line, and much less restricted at the distribution end.”***

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As one industry executive has said, “The future holds the promise of an industry free at the wellhead, free at the gathering line, generally free and competitive at the transmission line, and much less restricted at the distribution end.”<sup>8</sup>

Pipelines are beginning to position themselves to be primarily transporters of natural gas rather than merchants. In 1985 a number of interstate pipelines merged in order to expand their markets from regional to multi-regional or national transportation markets. In addition to expanding their markets, the mergers have enabled pipelines to enlarge their supply sources. The natural gas market is becoming a nationwide market for the first time in its history.

Not only have pipelines begun to compete with each other, they also have found themselves competing with national brokers and national marketers. In order to meet this competition, marketing companies have been created by the pipeline companies. The result has been new alternatives for the large industrial and commercial consumer and the distribution companies supplying the residential user.

A new and thriving spot market in which gas is bought and sold on short-term contracts at prices reflecting current market conditions has come into play. The California spot market which has developed into one of the most competitive is just one example. In the words of the president of a large interstate pipeline company, “The spot market is growing by leaps and bounds. There are virtually no barriers to where you can sell gas today.”<sup>9</sup>

The future, says another industry executive, “is full of growth opportunities for nimble firms, intensely competitive at the burner tip, and unforgiving of ponderous bureaucracies or strategic errors. The business prizes will go to those who can shed their past intellectual baggage and embrace the new world of natural gas entrepreneurship.”<sup>10</sup>

Competition and lower prices eventually would have come to the natural gas industry as a result of lower prices for competing energy products even if the regulators and the legislators had not moved to deregulate the industry. For even regulated companies having exclusive market areas, dedicated supply sources, and guaranteed rates of return are not guaranteed customers or immunity from competition when the prices of competitive products drop significantly below the price of the product of the regulated company.

The marketplace ultimately removes price disparities between competitive products in an effort to efficiently allocate resources. It subjects regulated companies to the laws of economics and the rigors of the market. Absent deregulation, the marketplace would have caused the regulated companies to compete or go out of business. Thus the



## DEREGULATION OF THE NATURAL GAS INDUSTRY

best role for regulators and legislators to play in such a dynamic environment is to encourage maximum flexibility, freedom, and competition by deregulating as quickly as possible, since the most effective and efficient allocation of natural gas resources is through a competitive and free market. □

1. Ludwig von Mises, *Human Action* (Chicago: Henry Regnery Co., 1966), p. 375. Murray Rothbard, *Man, Economy and State* (Los Angeles: Nash Publishing, 1970), pp. 619-620.

2. *Munn v. Illinois* 94 U.S. 113 (1877).

3. 49 U.S.C. § 1(1)(6) (1976); *Public Utilities Commission of Rhode Island v. Attleboro Steam & Electric Co.* 273 U.S. 83 (1927); *Missouri v. Kansas Natural Gas Co.* 265 U.S. 298 (1924); See Garfield and Lovejoy, *Public Utility Economics*, (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1964) pp. 294-350.

4. *Phillips Petroleum Company v. Wisconsin*, et. al. 347 U.S. 672 (1954).

5. FERC Order No. 380.

6. FERC Order No. 436; Notice of Proposed

Rulemaking Docket No. RM86-3-000. In late February 1986 the Reagan administration circulated for consideration by Congress proposed legislation to deregulate the remaining categories of natural gas prices which are still regulated under the Natural Gas Policy Act.

7. Henry W. Vanderleest and Karoline Bota, "Railroad Deregulation," *The Freeman*, October 1985, pp. 610-617.

8. Vinod K. Dar, "Resolve Conflicting Interests," *Oil & Gas Journal* (July 1, 1985), p. 24.

9. Robert D. Hershey, Jr., "Scrambling for Profits in a Gas Glut," *New York Times*, December 30, 1984, Section 3 p. 1.

10. Dar, *op cit*.

## SOCIALIZED OIL

Government intervention in the energy industry has taken a heavy toll in the Soviet Union, Mexico, and other nations. Russia's thriving petroleum industry, rivaling that of the United States at the turn of the century, was devastated by nationalization and Marxist reform. Writing in *Nation's Business* (August 1941), Thomas Read noted: "As to the effect of government control on potential supply, the record shows 20 years of experience with government control in Russia, which in 1900 produced the same amount of oil as the United States, in 1916 produced one-fifth as much, and in 1929 less than a tenth as much."

The promising growth of Mexico's oil industry was hampered by high production taxes and export taxes, and severely arrested by nationalization in 1938. Over the next decade not one new field was discovered, and new development wells failed to keep pace with retired wells. In 1947, for example, 20 wells were drilled in Mexico compared to 9000 in Texas. In the 1950s, U.S. know-how and capital came to the rescue, but large-scale corruption and such inefficiencies as overhiring prevented the great potential wealth of the Mexican petroleum industry from eradicating the country's chronic poverty problem.

In the late 1970s, prolific discoveries confirmed Mexico as potentially a major oil power, but what was hailed as a new era of abundance quickly collapsed because of corruption and inefficiency, high debt, declining world prices, inflation and peso devaluations, and petrodollars misspent on prestigious industrial projects. Excruciating poverty remains.

ROBERT BRADLEY, JR.

(from his forthcoming Cato Institute book,  
*Oil, Gas, and Government: The U.S. Experience*)

IDEAS  
ON  
LIBERTY



# Why Regulators Can't Regulate Effectively

**Government regulators face insurmountable knowledge and incentive barriers.**

by E. C. Pasour, Jr.

Dr. Pasour is a professor of economics at North Carolina State University at Raleigh.

**T**here is widespread agreement that government price regulation is not achieving its objective—whether the product is milk or electricity. However, there is no consensus as to *why* the results of price regulation are so unsatisfactory. Ralph Nader and consumer groups typically place the blame on the regulators. Others, including some economists, attribute the poor results to lack of resources devoted to regulation. There is a great deal of evidence, however, that larger expenditures by regulatory agencies will not solve the problems of price regulation.

Problems confronting price regulators are similar to those facing central planners of all types. This paper discusses the problems innate in central direction and describes the implications for two types of price regulation.

Economic planners are doomed to disappointment because of incentive problems and information problems.<sup>1</sup> Incentive problems are inherent in the political process because of the separation of power and responsibility. That is, political actors do not bear the major responsibility for the outcomes of their decisions. The incentive problem arises whether decision-makers are elected or appointed.

For the elected official, the next election is a primary concern and actions taken are heavily influenced by re-election considerations. Indeed, political incumbents have manipulated Social Security payments, agricultural price supports, and other government programs in attempts to affect upcoming elections. Politicians generally favor policies where the benefits are immediate and the costs are delayed. This short-run bias in the political process has contributed to the growth of government deficits in the United States during the past fifteen years. Budget-balancing is politically unpopular because the costs to the public are immediate but the benefits occur in the long run when current legislators may be out of office.

Non-elected public officials also have incentives to use the regulatory process to their own advantage. There is no single goal of bureaucrats, but salary, public reputation, and patronage are all associated with size of budget.<sup>2</sup> Thus, it is no accident that government agencies once established tend to grow regardless of changes in economic conditions.

Information problems also prevent regulators from regulating effectively. These information problems are rooted in the separation of knowledge and power. That is, individuals with decision-making power in the political process do not have and cannot obtain the specialized information about demand and supply conditions known by producers, consumers, and resource owners. Thus, even if government employees were all selfless public servants totally dedicated to the public weal, regulators would be unable to regulate effectively because of information problems.

**C**onsider the problem that arises when regulators attempt to set utility prices on the basis of costs. The decision-maker is influenced by opportunity cost, and the opportunity cost of any action is the value of the sacrificed alternative. The cost of a vacation trip by Jones, for example, is the value he places on the refrigerator, automobile, or other good(s) or service(s) that must be given up if the trip is taken. Opportunity cost is subjective because the sacrificed alternative is not actually experienced. Thus, attempts to set prices on the basis of costs are futile because regulators cannot determine the costs that influence entrepreneurial choice.

Consider the cost of generating electricity in a nuclear power plant. Entrepreneurial expectations are always crucial in cost calculations involving depreciation, interest, and other outlays. Expectations concerning obsolescence, likelihood of closedowns, and so on, however, are likely to vary widely—especially in the case of nuclear power. Thus, the cost and revenue calculations of production processes ultimately hinge on subjective opinions.

Why not set public utility prices competitively on the basis of demand and supply conditions? Focusing on supply and demand does not avoid the problem that the relevant data are subjective. It is not a matter of discovering *the* demand or *the* supply for any particular product. Demand and supply for any product depend upon assumptions made. The amount of product consumers will purchase at any given price, for example, depends upon a number of factors including income, length of adjustment period, and expected prices of closely related products. Similarly, product supply depends upon length of run, expected input costs, expected tax policies, and so on. Thus, differences in expectations about the multitude of factors affecting demand and supply imply a difference of opinion about future product price.

Cost and revenue calculations and entrepreneurial actions ultimately hinge on subjective opinion. Furthermore, in cases in which utility commissions attempt to regulate prices, it is likely to be a matter of differences of opinion. Since entrepreneurial cost and revenue calculations are based on unique knowledge and attitudes toward risk, the validity of over-riding such calculations by the regulator is “dubious in the extreme.”<sup>3</sup> Although these theoretical problems are not widely recognized, there is growing disenchantment with the results of conventional approaches to utility regulation and increasing interest in various deregulation alternatives.<sup>4</sup>

A different problem arises when government attempts to redistribute income by *raising product price*—purporting to set product price on the basis of costs, as in farm price-support programs. During the

## Opportunity Cost and Entrepreneur- ship

Carter Administration, for example, cost of production was specified as the primary guide to be used in setting farm price supports.

However, cost of production is not feasible as a basis for price setting because cost is not independent of price. If government sets the price of (say) wheat above the competitive free market level, profit-seeking wheat growers will bid up the price of wheat land and other specialized resources required to produce wheat. Thus, competition brings about a strong tendency for prices of specialized wheat resources to increase as long as costs, including returns to entrepreneurship, are less than the expected product price. Under these conditions the best estimate of cost of production is product price. Even if the price of wheat were raised to (say) \$10 per bushel, prices of wheat land and other resources would continue to increase as long as wheat farming was unusually profitable.

A similar phenomenon occurs when product price is increased by governmental restrictions on entry through the use of land allotments, taxi medallions, and so on. In each case of restricted entry, expected benefits of increased price are incorporated into higher costs so that expected profits of new entrants are similar to those of other investments of comparable risks.

Moreover, the gains to producers arising from government largesse are transitional, accruing to the affected firms when a program is implemented (or benefit level increased). Later producers are not helped because the benefits of higher prices are offset by higher costs. Thus, government programs of this type result in a "transitional gains trap."<sup>5</sup> Once a government program is instituted and the expected benefits incorporated into higher input prices, *all* producers incur windfall losses if the program is terminated.

The preceding scenario is important in explaining the financial plight today of many farmers who purchased land in the late 1970s when agricultural product prices were high. Owners of farm assets generally received transitional gains during this period because of the government's inflationary monetary and fiscal policies. In the heady economic environment of the late 1970s, farmers and other investors recklessly bid up prices of land and other farm assets because of expected favorable product prices and continued increases in prices of farm real estate. As the rate of inflation plummeted during the early 1980s, prices of farm land, buildings and other specialized agricultural resources also decreased dramatically. Once inflationary expectations are incorporated into higher resource prices, government policies that reduce inflation expectations impose windfall losses on owners of specialized resources, just as do reductions in price supports.

Farm programs affect farm asset owners and farm operators differently. Owners of farm assets receive short-run gains either if farm programs are implemented or if benefit levels are increased. However, farmers in their roles as farm operators or farm laborers receive little or no long-run benefits from farm programs. The benefits to farm operators are offset by increased costs. Farm programs also have little effect on returns to farm labor because farm labor readily moves in and out of agriculture. Since competition for labor and entrepreneurial skills tends to equate returns throughout the labor market, the return to labor in the rest of the economy (not farm programs) is the main determinant of farm incomes in the long run.<sup>6</sup>

## Conclusions and Implications

Two reasons have been discussed as to why regulators cannot regulate prices effectively. First, neither the costs nor benefits of regulatory actions are borne mainly by the regulators. Second, even if there were no incentive problem, information prevents public utility commissions and other regulatory agencies from setting price on the basis of cost. Thus, even if regulators have the proper incentives, they cannot obtain the required information to regulate in the "public interest." The highly specialized information of consumers and producers will be most fully utilized in decentralized competitive markets.

Regulators cannot regulate effectively either when they attempt to set price at the competitive level, or when they attempt to redistribute income by raising prices. In the latter case, benefits are incorporated into input prices raising costs to all producers. Thus, gains from government programs to assist producers are transitional and short lived. Moreover, when a price is arbitrarily increased, there is no economic basis for determining what the price *should* be. That is, if a policy benefits some people at the expense of others, there is no objective procedure to weigh the gains and losses in determining whether the policy is beneficial to the public at large. Thus, public policy recommendations ultimately involve value judgments.

The conclusion is that public policy cannot be prescribed on the basis of economic rules. Economic efficiency rules are beneficial to individual decision-makers but these rules, as Hayek emphasizes, are *not* the answer to public policy problems.<sup>7</sup> The data necessary to use economic efficiency rules for policy purposes cannot be obtained by government planners—whatever the policy at stake.

The analysis of public policy issues appears in a different light when incentive and information problems are taken into account and the subjectivity of costs and benefits is recognized. The focus of attention shifts from economic efficiency rules to the institutional framework that provides the greatest opportunity for individuals to cooperate in pursuing their own ends through decentralized coordination of their activities. Much work remains to be done in increasing understanding of the operation of the competitive market process where entrepreneurial activity is fueled by subjectivist expectations. However, no further work is required to show why price regulation invariably fails to achieve its purpose. □

1. Many of the points of this paper are discussed in more detail in the author's paper "Information, Incentives, and Regulation" in *Electric Power: Deregulation and the Public Interest*, John C. Moorhouse, ed. (San Francisco, CA.: Pacific Institute for Public Policy Research, forthcoming).

2. See William A. Niskanen, Jr. *Bureaucracy and Representative Government* (Chicago: Aldine, 1971).

3. G.F. Thirlby, "Economists' Cost Rules and Equilibrium Theory," Ch. 11 in *L.S.E. Essays on Cost*, J.M. Buchanan and G.F. Thirlby, eds. (London: Weidenfeld and Nicolson, 1973), p. 281.

4. A number of regulatory reform proposals are

discussed in *Electric Power: Deregulation and the Public Interest*, John C. Moorhouse, ed. (San Francisco, CA.: Pacific Institute for Public Policy Research, forthcoming).

5. Gordon Tullock, "The Transitional Gains Trap," *Bell Journal of Economics* 6 (1975): 671-678.

6. D. Gale Johnson, "The Performance of Past Policies: A Critique," Ch. 2 in *Alternative Agricultural and Food Policies and the 1985 Bill*, Gordon C. Rausser and K.R. Farrell, eds. (Berkeley, CA.: Giannini Foundation, 1985).

7. F.A. Hayek, "The Use of Knowledge in Society," pp. 77-91 in *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948).

# Inflation and Unemployment

**How inflation reduces labor productivity and produces unemployment.**

by Hans F. Sennholz

Dr. Sennholz heads the department of economics at Grove City College in Pennsylvania. He is a noted writer and lecturer on economic, political, and monetary affairs. His latest book is *Money and Freedom*.

**T**here are many great truths which we do not question every day; we accept them as a measure of knowledge, translate them into action, and pay homage to them by using them. For centuries economists accepted as truth that man's income and wealth are strictly limited by his ability to produce. Economists reflected, not about man's capacity to consume, but about his ability to produce.

Classical economists liked to cite Say's law named after the French economist, Jean-Baptiste Say (1767-1832), who taught that economic production itself generates an income equal to the value of goods produced. There is no reason for fearing surpluses and unemployment because supply generates its own demand. And neither supply nor demand were thought of being capable of causing inflation or deflation. Inflation was attributed exclusively to coin debasement and paper money creation by government during periods of war and civil strife. Once peace was restored inflation was expected to come to an end.

In his *General Theory of Employment, Interest and Money* (1936) John Maynard Keynes rejected this very foundation of Classical economics. He indicted the market order for breeding mass unemployment, and appealed to government for creating conditions of full employment. Demand may fall below supply, which calls for increased government spending, to make up for the lack of demand, or for lower taxes or increases in the stock of money, or a combination of all three.

Keynesian economics postulates a definite relationship between unemployment and inflation. Goods prices remain stable, according to Keynesian theory, as long as there is some unemployment. Inflation raises its head only beyond the full employment mark when demand exceeds supply and no idle resources are available to increase output (demand-pull inflation). The relationship is said to be illustrated by the Phillips curve named after A. W. Phillips, a British economist. As unemployment increases, the rate of inflation decreases; as unemployment decreases, the rate of inflation rises. Conversely, as the rate of inflation is made to fall, unemployment rises; as the rate of inflation rises, unemployment is said to fall. The relationship presents an unfortunate trade-off in which unemployment is the cost of price stability, and inflation the cost of full employment.

**T**here is nothing so elastic as the human mind. Lord Keynes and his followers press it and stress it in order to develop intricate trade-offs and other formulas that indict the unhampered market order and call for government intervention. Surely, politicians and government officials the world over can be expected not only to hail Keynesian recipes for government power as the ultimate revelation of economic wisdom, but also proclaim and celebrate its champions as the thought leaders of our age.

Politicians and government officials depend on Keynesian economists to provide the doctrines of governmental function and power; Keynesian economists in turn can rely on politicians and government officials to bestow prestige, position, and income on their intellectual defenders. As so often in human history, the men of power and the official cast of political thought leaders are led to cooperate for the sake of mutual benefit.

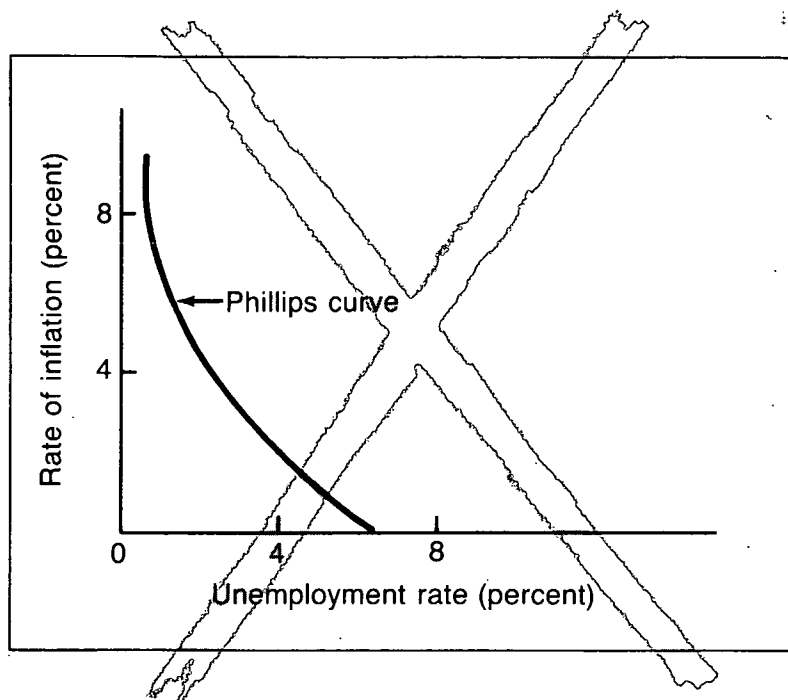
The doctrine of an inverse relationship between inflation and unemployment is a crude generalization of fictitious interaction between inflation and unemployment. It denies basic economic principles, obscures economic knowledge, and contradicts economic reality. Many Keynesians themselves are beginning to wonder whether the Phillips curve really exists.

Actually, the curve contradicts economic thought and experience. Economic records clearly reveal that the age of the classical gold standard was an age of unprecedented monetary stability together with full employment. Goods prices in Great Britain were approximately the same in 1914 as they were in 1851, without the evils of chronic unemployment or much cyclical unemployment. Our 19th-century forebears worked from dawn to dusk and yet enjoyed stable prices and hard money. There was no inverse relationship between inflation and unemployment; no one charted a Phillips curve.

Also, recent experience casts doubts on the existence of a Phillips-curve relationship. A chart drawn for the 1960s differs substantially from one for the 1970s, which again differs from one for the 1980s. The upward shift in the curves indicates that the "trade-off" varies greatly—that is, for a given inflation or unemployment rate the corresponding unemployment and inflation rate is much higher on later charts. In 1963, 1972, and 1974, the unemployment rate was nearly the same, but the inflation rates were 1.6 per cent, 3.4 per cent and 12.2 per cent respectively. Which one is the Phillips relationship? The chartists cannot answer this question because there is no causal relationship between inflation and unemployment that can be charted in any way or form. There is no Phillips curve in real life.

But even if there were such a curve, it would not explain the relations between inflation and unemployment. The chartist who gathers the data and plots the curves would still need to explain the causal relationship. In particular, he would need to answer the question of why there is a trade-off and why it varies continuously, which contradicts the regularity of the relationship. He fails to provide an answer by adding a distinction between unemployment that is frictional, structural, and cyclical. Frictional unemployment is said to arise from voluntary worker movement between jobs. The unemployment that is called structural and cyclical is said to spring from a mismatch between the supply of and demand for labor, especially when total spending

## There is No Phillips Curve



and output fall and the over-all demand for labor declines. The mismatch is to be corrected by governmental intervention of one form or another.

All types of unemployment are said to be subject to the trade-off depicted by the Phillips curve. Most Keynesians are quick to describe and illustrate it; a few try to explain it with vague generalities and references to inflationary forces. During periods of low unemployment when the demand for labor is high, we are told, wage rates are forced up causing goods prices to rise, that is, generating inflation. Conversely, when unemployment rises, wage rates cannot be raised so easily, which causes production costs and goods prices to remain relatively stable.

Such an explanation either fails to explain the relationship or explains it incorrectly. It does not discuss the force that causes wage rates to rise and produce inflation. If there is such a force it needs to be analyzed in all detail so that we may understand it and correct it. Merely to chart it and describe its effects and then recommend a dose of inflation and credit expansion is to escape economic reasoning. It also avoids the important questions of why and how a wage force of any kind can cause all goods prices to rise and inflation to raise its head. Can workers actually bring about inflation that depreciates the monetary unit year after year until nothing is left? Keynesians refuse to answer; in fact, they seek to escape economics by pointing at totally unrelated factors for the changing trade-off, such as a worker's age and sex.

Why is the unemployment rate corresponding to a given inflation rate much higher today than in the past? We are told there are more women and teenagers in the labor force, experiencing discrimination and suffering more unemployment. Moreover, having experienced more inflation during the 1970s people have come to expect more inflation during the 1980s. The Keynesian thus beats a hasty retreat from



***Inflation breeds economic evil and social disorder, and generally erodes the moral and social fabric of a free society—and all this for the sake of deceiving some workers.***

the abstract world of economics to the safe ground of psychological and sociological understanding to rejoin politicians and officials for further deliberation on legislation and regulation. He places his trust in political force rather than economic principle.<sup>1</sup>

If Keynesians were more receptive to orthodox economic knowledge they would know of the direct relationship between the demand for labor and its cost, between unemployment and gross wage rates. Employment is a function of labor cost and labor productivity. Unemployment always appears when labor cost exceeds labor productivity, creating an excess supply of labor over demand for labor.

Unemployment is a pricing phenomenon as is the surplus of any other economic good. There is no direct relationship between inflation and unemployment. Inflation willfully conducted by monetary authorities causes a rise in the prices of all products and services. If, at times, the rise in labor cost lags behind the rise in product prices, real wage rates decline, which causes the demand for labor to rise and institutional unemployment to fall. This is why Lord Keynes and his followers favor inflation and credit expansion as a suitable method for reducing unemployment. In the Keynesian system workers hopelessly do not realize that their wages are reduced and, therefore, in Keynes' own words, do not resist "a gradual and automatic lowering of real wages as a result of rising prices."<sup>2</sup>

A government that practices concealment or deceit in matters that should be fair and open as day destroys public confidence and trust. Deceit is a false road to anything, including full employment. It does not work, especially not in such plain matters as the cost of living which every housewife is watching and appraising every day. Workers who are determined not to suffer reductions in their real wages cannot be led to suffer reductions through deceit. In fact, it is easier by far for government to deceive itself without perceiving it, then to deceive the people without their finding it out.

To practice a little deceit, which works only on simpletons and fools, the Keynesians propose to resort to inflation which is one of the worst economic calamities and social evils. Its effects are ominous and calamitous. Inflation benefits politicians, officials and entitlement grantees at the expense of producers, and enriches debtors at the expense of creditors; it creates a massive flow of unearned income and inflicts undeserved losses.

Inflation consumes productive capital, lowers labor productivity and wage rates, and destroys the middle class that saves and invests in monetary instruments. It generates the business cycle, the stop-and-go, boom-and-bust reactions of business. It invites government controls over prices and wages and other restrictive policies. In short, inflation breeds economic evil and social disorder, and generally erodes

## **Deceit Is a False Road**

the moral and social fabric of a free society—and all this for the sake of deceiving some workers.

Economists do not invoke inflation in order to alleviate some unemployment. They go directly to the cause and seek to eradicate it or at least reduce it. Shunning such metaphoric terms borrowed from physics as frictional and structural, they distinguish between voluntary joblessness and institutional unemployment. The former may reflect a voluntary, temporary withdrawal of a worker from the labor market or result from changes in the market process to which he needs to adjust. This kind of unemployment may occur especially in a productive, prosperous society in which the individual may be able to unwind occasionally and take a vacation before he embarks upon new opportunities.

## Extraneous Force

**I**nstitutional unemployment is involuntary unemployment. Its proviso and requisite is extraneous force that creates an excess of labor over the demand for labor. It is impossible and inconceivable in an unhampered labor market. But it appears wherever extraneous force disrupts the smooth functioning of labor markets. By rendering some labor uneconomical, force makes it unemployable.

In final analysis, government is the only extraneous force that can interfere with the purchase and sale of labor. It does so through labor laws and regulations, taxes, levies, and other exactions; through permits, licenses, and franchises; through deficit spending, inflation, and credit expansion; it may even impose price and wage controls. Politicians prescribe the intervention, judges confirm it, and armed policemen enforce it.

In recent decades governments the world over have delegated some of their coercive powers to labor unions. Labor law and regulation tolerate union violence within broad limits. They permit unions to inflict bodily harm on strikebreakers and employees who engage them, to damage their property, and even injure customers who patronize them. The police rarely interfere with the offenders, public prosecutors do not charge them, and judges do not judge them. In general, government is unwilling to interfere with the actions of labor unions, which grants them coercive powers over large segments of the labor market.<sup>3</sup>

Institutional unemployment may spring from two basic sorts of intervention. Force may be used to *raise labor costs* above the rates an unhampered market would establish. Or it may be used to *lower the productivity of labor* through taxation, regulation, and inflation. Both government and unions freely resort to both forms of restraint in countless different ways. Workers who refuse to concede to prompt wage reductions face unemployment.

Most politicians and government officials actually believe that they have the power to raise wage rates and confer fringe benefits. Trusting in the might of the courts and police they mandate minimum wages that exceed unhampered market rates, grant social security benefits and impose numerous other costs that mean to benefit workers. In boom and recession politicians foist themselves upon the labor market, raising the cost of labor by boosting unemployment compensation, liberalizing worker's compensation, and passing the costs on to employers. In many industries fringe benefits now equal or even exceed the cost of payroll. Unfortunately, to force a worker's cost above the

value of his contribution is to render him uneconomical and, therefore, unemployable. Every time government mandates higher labor costs it renders some labor "unproductive" and causes it to be unemployed.

The effects are similar when the productivity of labor declines for any reason and workers refuse to suffer instant reductions in pay. Reduction in labor productivity, after all, raises the unit cost of production in the same way as a mandated boost in cost. It may result from any number of government interventions, union actions, worker attitudes, and even public choices and preferences. It may be inflicted by politicians and government officials who render labor less productive through onerous taxation and myriad regulations. It may be the intentional objective of the workers themselves who, acting in concert as a union, choose to work less and demand more, who impose more work rules that boost costs, or even halt operations by calling a strike. And finally, labor productivity may decline due to changing aspirations, values, and customs on part of the public.

A society that chooses to live beyond its means, that consumes more than it saves and invests and, therefore, reduces the amount of business capital invested per worker, causes labor productivity to decline. Inevitably, it experiences reductions in labor conditions and standards of living and, if wage rates are not permitted to adjust promptly to the decline, is liable to suffer mass unemployment. Unproductive labor tends to be unemployed no matter how it became unproductive.

**A**mong the many stratagems of government intervention that reduce labor productivity and produce unemployment, inflation is one of the most harmful. It is so potent that, in the end, it may play havoc with labor markets, shatter labor productivity, and destroy millions of jobs. Indeed, there is nothing more conducive to unemployment than a policy of willful inflation.

Inflation erodes and consumes capital and hampers its productive employment. It falsifies economic calculation and accounting and causes businessmen to make costly mistakes. Inflation permits government to exact more taxes from business, especially by denying inflation adjustments. When businessmen are forced to ignore inflation, to depreciate plant and equipment only on the basis of past cost rather than current cost, they are made to understate production costs, overstate business profits, and pay higher taxes. In fact, they may be forced to show profits where there are none, and pay income taxes without income—even on losses.

Inflation tends to create illusions of income and wealth that tempt people to raise their levels of consumption. When stock and real estate prices soar a feeling of success and prosperity may seize investors and induce them to buy expensive automobiles, build beautiful mansions, patronize the arts, contribute more to charities, or seek more recreation and pleasure. Blinded by soaring prices and deluded by inflation profits, they are actually consuming their capital.

Similarly, employers are likely to yield readily to unionized labor routinely demanding more pay for less work. After all, the income statement supports the illusion of rising profits and growing wealth, and reinforces the expectation that rising prices will soon cover union demands. This management attitude, especially with "professional management" that lacks ownership interests, may explain the fact that

## **Inflation Lowers Labor Productivity**

***Monopoly power over money conceives the power to inflate, which gives rise to the power to boost wages, grant fringe benefits, reduce labor productivity, and cause unemployment, which in turn reinforces the power to inflate.***

wage rates in unionized industries, such as steel and automobiles, exceed by far the rates in open labor markets. When the inflation finally comes to an end, at least temporarily, and a recession settles over commerce and industry, disaster is bound to happen. Unionized industries suffer staggering losses, and millions of faithful union members lose their jobs.

## **Redirecting Business Capital**

**F**ree and open industries cope with inflation more smoothly and efficiently without suffering the pains of crisis and unemployment. When labor productivity declines real wage rates are quickly reduced. Surely, this may be hidden by the veil of inflation that causes all prices to rise. But prices do not rise evenly and simultaneously; wage adjustments tend to limp behind the rise in goods prices, causing real wages to fall. For example, when goods prices rise by ten per cent, wages may be raised by five per cent, which reflects a real pay cut and prompts adjustment to falling labor productivity. Workers suffer reductions in real income, but need not worry about the readjustment crisis and loss of jobs that characterize unionized industries.

Many writers are convinced that a little inflation is beneficial not only to business but also the public at large. They argue that wage rates tend to rise more slowly than goods prices, which shifts income from workers to employers and turns wages into profits. In time, the profits are said to be invested in business capital, bringing improvements to labor productivity and worker income. Unfortunately, economic reality differs materially from this version of inflation theory. The reduction in labor costs may be offset by boosts in capital costs as interest rates are likely to rise; it may be offset by a rise in the cost of material and supply and, last but not least, by new exactions of government. Surely, there are many businessmen who hope to profit from inflation, but very few actually do.

Chronic inflation discourages saving and investing and, in the end, may generate a "flight into real values." It may cause commerce and industry to redirect their efforts from consumer service and satisfaction to personal survival. Working capital may be turned into gold, silver, or other precious metals; money and claims to money may be exchanged for machinery and equipment that are not needed but hopefully retain their value. Businessmen may invest in land, which may be illiquid and rather unproductive.

Such a redirection of business capital, which may prove to be highly productive for purposes of survival, usually takes the form of withdrawal from production for the market. Or, it may mean redirection

of facilities from more efficient uses for which they were meant, to less efficient uses made advisable by the inflation. In every case it lowers labor productivity; in situations of hyperinflation it virtually destroys it. If in such situations the cost of labor is prevented from adjusting to the fall in labor productivity, institutional unemployment is bound to follow.<sup>4</sup>

The productivity of labor may be depressed further by the workers themselves. Undoubtedly, they resent the economic stagnation and decline in income, although they themselves may favor the inflationary policies that prompt the decline; as voters they may cast their votes for politicians who promise yet easier money and credit. Workers may not understand the significance of such policies and their effects on labor productivity and income. Under the influence of popular notions and union dogma, they are quick to ascribe any reduction in pay to employer greed and management incompetence, which does not make for amicable labor relations.

In frustration and anger, some workers may loiter, hold back production, resort to sabotage, or walk off their jobs. Their reaction may be instinctive and understandable; nevertheless, it compounds the fall in labor productivity and aggravates the pains of unemployment. In the end, inflation causes millions of workers to be unemployed, and more millions to be alienated, angrily protesting against the stagnation and deterioration of conditions and marching in picket lines that add to the unemployment lines.

Inflation is a primary cause of unemployment. And yet, learned men and reputable advisers prescribe it, and powerful politicians and officials apply it as a cure for unemployment. In the name of "full employment" they create money and credit that generate the business cycle, misdirect human labor, reduce the productivity of labor, and create mass unemployment.

Inflation is a primeval evil that breeds many other evils. Springing from government power over money and credit and from legal-tender force, it breeds ever more government power that is to alleviate the evil consequences of earlier power. Monopoly power over money conceives the power to inflate, which gives rise to the power to boost wages, grant fringe benefits, reduce labor productivity, and cause unemployment, which in turn reinforces the power to inflate. The consequences lend new strength and support to the cause, in a vicious circle of inflation and unemployment. The circle will end when man rejects all such powers and proclaims his freedom. Man is in the best condition when he is free. ☐

1. Cf. Lewis C. Solmon, *Economics*, 3rd ed. (Reading, Mass.: Addison-Wesley Publishing Co., 1980), p. 323 *et seq.*

2. John Maynard Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt, Brace and Co., 1936), p. 264.

3. W. H. Hutt, *The Strike-Threat System* (New Rochelle, N.Y.: Arlington House, 1973), p. 252 *et seq.*; Patrick M. Boarman, *Union Monopolies*

and *Antitrust Restraints* (Washington, D.C.: Labor Policy Association, 1963), p. 64 *et seq.*; Edwin Vieira, Jr., *Of Syndicalism, Slavery and the Thirteenth Amendment* (reprinted from *The Wake Forest Law Review*, Vol. 12, No. 3, Fall 1976).

4. Hans F. Sennholz, *Age of Inflation* (Belmont, Mass.: Western Islands, 1979), pp. 33-39.

# Privatization Further Down the Road

**A new era of private roads may be close at hand.**

by Daniel Klein

Daniel Klein is a fellow of the Austrian Economics Program at New York University.

**P**rivate ownership of "public" resources may be an idea whose time has come. There are proposals for the privatization of Grand Coulee Dam, National and Dulles airports, Conrail, and Amtrak. State and local governments are studying private urban transit, garbage collection, and prisons. If privatization maintains its momentum, we will have to consider a logical candidate: the roads.

The best way to understand the notion of private roads is to examine the literature on America's own era of private turnpikes. In 1821 there were over 4,000 miles of private roadway in the state of New York. Between 1792 and 1840, some 230 New England turnpike companies built and operated 3,800 miles of road. It was private enterprise that really got the show on the road in America.

In early America, routes had not been beaten through the wilderness, and roads were sorely needed. People wanted to move westward, and commercial interests in the coastal cities sought to tap the trade of distant areas. State and local governments instituted feeble systems of mandatory labor and taxation to provide roads, but their failures were manifest.

In the 1790s, the road business was opened up to private enterprises throughout New England and the mid-Atlantic region. Private turnpike companies constructed and operated their own roads. They were equity financed and operated for profit. User payment was made at tollgates along the route. No government financial assistance was made, except in Pennsylvania (where 30 per cent of total turnpike stock was held by the state) and in New Jersey (where a small amount of aid was given to the Newark Turnpike Company).

Between 1795 and 1830 turnpike construction was brisk, crisscrossing the Northeast with private roads. During the same period, public construction virtually ceased. In New York between 1790 and 1821, for example, the state's expenditure of \$622,000 on the construction of roads and bridges is dwarfed by the investment in similar private concerns: \$11 million in turnpike companies and \$850,000 in bridge companies. A mixed system of private and public roads emerged.

Not only did private enterprise boost road mileage in America, it

greatly improved the qualities of the country's roads as well. As the leading transportation historian B. H. Meyer stated, "It is evident that the turnpike movement resulted in a very general and decided betterment of roads."

Although the turnpikes were private, the government maintained tight control through heavy regulation. Most important were the limits on tollrates and the restrictions on the placement of tollgates. These regulations made turnpike profits practically nonexistent. It wasn't long before everyone knew that there was no money to be had by way of turnpike dividends.

Despite the poor direct returns that resulted from government interference, turnpikes still found enthusiastic support for the indirect benefits they conferred. Local merchants, farmers, and landowners bought turnpike stock because the turnpike would make their businesses, produce, and holdings more valuable through improved transportation.

During the mid-1800s the state governments brought the era of private roads to a close by gradually reclaiming control of the roads, although a few private turnpikes survived into the 20th century.

**W**hat lessons can we draw from America's experience with private roads? Clearly, with today's technology, road provision through private enterprise could be even more successful. Electronic metering devices could make stopping at tollbooths obsolete. In Hong Kong, Japan, and elsewhere authorities are experimenting with tamper-proof electronic plates, the size of cassette tapes, which are placed on cars. The plates interact with equipment built into the road surface to register the driver's toll, which he pays through the mail. If this system is feasible, private enterprise could provide roads as easily as it does movie theaters.

Think about recent advances in technology: personal computers are quickly becoming household items, as are laser compact disc units; supermarket cash registers now speak to us; automatic teller machines handle our banking; innovation in motion pictures and television is rampant; Blue Cross now issues credit card-sized "Lifecards" that can contain the equivalent of 800 pages of medical information; air travel has become a casual matter for the middle class; new automotive dashboards look like something from outer space.

Now think about the roads you drive on: How much improvement have you seen in the past fifteen years? How much to you expect to see in the next fifteen? Nil, in both cases. The reason: government control.

Private roads may sound far-fetched, but a familiarity with American history casts the idea in a different light. There was a period when private enterprise was able to provide such "public goods." Private turnpikes engendered important social benefits even though returns on investment were small, primarily due to legal restrictions on toll rates and on the placement of toll houses.

The idea of privatizing the roads is beginning to be taken seriously. Even the federal government's National Research Council is holding a conference this summer on "Roles of Private Enterprise and Market Processes in the Financing and Provision of Road Services." The future may be closer than we think. □

## Technological Advances

# Mariano Moreno of Buenos Aires

by John Chamberlain

What do we know about Latin American history? Maybe a thing or two about Simon Bolivar and San Martin, the generals who led the forces that freed much of South America from Spain in the early Nineteenth Century. Bolivar might be called the Latin George Washington, and San Martin the equivalent, say, of General Nathanael Greene. But who were the Latin American James Madisons, John Jays, and Alexander Hamiltons? If they left any Latin version of the Federalist Papers we in North America don't know of it.

Ellen Garwood, the daughter of Will Clayton, the cotton broker who was primarily responsible for the Marshall Plan, has done something to dispel our general ignorance of the Latin American past in a first-rate biography of Mariano Moreno, who was Secretary of Government and of War in the 1810 revolutionary junta in Buenos Aires. Moreno, a passionate believer in free markets, had worked for free trade on behalf of the Argentine gauchos before he himself became a revolutionary.

Ellen Garwood calls her biography *The Undying Flame: Mariano Moreno of Buenos Aires* (Washington, D.C.: American Studies Center, 229

pp., \$14.95). It is noteworthy that Mrs. Garwood's extensive bibliography contains the merest smattering of Anglo-Saxon names. Mariano Moreno has no entry in my *Encyclopedia Britannica*, which speaks of a "creole" junta in the La Plata region of Argentina. "Creole" was the accepted word for anyone of Spanish extraction who happened to be born on the American side of the Atlantic.

Moreno resented the implication that "creoles" were less deserving of high office in the colonial governments than the Spaniards who went out from Spain to enforce strict mercantilist regulations. (Gaucho hides, tallow, and meat had to be sent to Cadiz and traded for Spanish goods or Spanish coin.) But, like all the early seekers for a relaxation of the mercantilist rules that kept British ships and British goods out of Latin ports (and incidentally set things up for smugglers), Moreno was at first loath to cut completely free of the ties to Madrid.

The Latins faced a situation that was a bit different from the one confronting George Washington, Thomas Jefferson, and John and Samuel Adams in North America. There was the special problem of the captive King in Spain. Napoleon had taken Ferdi-



nand VII captive. The creoles had ideas about bargaining with Ferdinand, and some of them hoped that a restoration in Spain, once Napoleon was out of the way, would let the new principles of Adam Smith take over.

### Ideas of Rousseau

Moreno was the first to discard the "mask of Ferdinand" in the La Plata region. In his *Gaceta*, or gazette, he pushed the ideas of Rousseau, who believed in the social contract. He argued that the authority of the Monarch had been returned to the peoples of both Spain and the colonies through the captivity of Ferdinand.

"The people can," he said, "modify or reduce . . . authority to the form most agreeable to them in the act of entrusting it to a new representative . . . the Laws of the Indies were not made for a State and already we are forming one."

The Argentineans of the La Plata region, in response to Moreno's urgings, opted for a constitution. His trust in the Rousseauistic "general Will" assumed a consensus throughout the whole back country of the Argentine pampas. He had gone to the university in Chuquisaca, where he took degrees in both canonical and civil law. Chuquisaca was leagues away from Buenos Aires, and Moreno was sure that the country he had passed through by foot, horseback, and coach to go to school was with him in wanting a constitution. He sent troops to the back country not as conquerors, but as persuaders.

He did, however, feel constrained to order the execution of a handful of dissenters including a former viceroy, the Frenchman Liniers. This was one of the hardest things that Moreno, a peace-loving man who had been destined for the church before shifting to the law, ever had to do. It brought him the entirely false reputation of being a "Jacobin," which provided a handle for those in the junta who wanted

more pomp and ceremony than Moreno felt was compatible with true democracy. Eventually the junta became the creature of its president, Colonel Saavedra, who liked to ape a viceroy's manners even though he stood by the revolution in the end. The Saavedra partisans ultimately pushed Moreno into undertaking a mission to England which was a thinly disguised way of sending him into exile. Worn out by his efforts to prepare the way for the coming of General San Martin, who put the necessary military muscle into the freeing of Argentina and Chile, Moreno fell sick at sea and had to be buried beneath the waves in his early thirties.

Moreno, on Mrs. Garwood's showing, was a truly selfless man. He took legal cases, including one for the gauchos of the pampas, with no thought of personal emolument. He founded the Public Library of Buenos Aires. Public hygiene was one of his preoccupations: he started what became a permanent establishment for the propagation of vaccine. He ordered police patrols in dangerous vicinities, and he insisted on the elimination of potholes in the streets. He was a very practical man.

As a publisher of Rousseau's *Social Contract*, Moreno eliminated the last chapter for reasons of religious scruples. He thought Rousseau had gone astray in religious matters. He seems to have been unacquainted with Rousseau's compatriot Montesquieu. Maybe it was Moreno's cardinal error to have gone to Rousseau for his inspiration instead of Montesquieu, who subordinated the general will to the separation of powers. There admittedly must be some consensus in government, but the gateway to tyranny is opened when there is no provision for vetoes and the constitutional protection of minorities.

With no checks and balances in government it is all too easy for a strong man to assume that he is the embodiment of the general will. □

**Democratick Editorials: Essays in  
Jacksonian Political Economy**

by William Leggett

compiled, edited, and with a foreword by Lawrence H. White  
 Liberty Press, 7440 North Shadeland, Indianapolis,  
 IN 46250 • 1984 • 412 + xx pages, \$12.00 cloth; \$6.00  
 paperback

*Reviewed by Arthur A. Ekirch, Jr.*

**W**illiam Leggett, spokesman of the radical, laissez-faire wing of Jacksonian democracy, deservedly continues to attract the attention of modern libertarians. Less than forty years of age at the time of his death in 1839, Leggett in the last decade of his short life became a free-wheeling journalist and newspaper editor, serving from 1829 to 1836 as William Cullen Bryant's assistant, and then partner, on the New York *Evening Post*. Leggett's own forthright editorials in support of equal rights and minimal government caused his newspaper to lose most of its political patronage advertising. Although Leggett therefore, not surprisingly, left the *Post*, he continued to write in two new periodicals of his own, which he promptly established, the New York *Examiner* and the *Plaindealer*.

Lawrence H. White's new Leggett collection draws much of its material from those *Plaindealer* editorials which were not included in the original *Collection of the Political Writings of William Leggett*, published in 1840. White's selections accordingly provide a fuller account of Leggett's running literary battle against all economic monopolies, his support of the divorce of government and banking, and his advocacy of free trade. These causes reflected in large part the national policies of the Jacksonians. And one of Leggett's key editorials, "True Functions of Government," appropriately began with a quote from the President's message, vetoing the recharter of the Bank of the United

States: "There are no necessary evils in Government. Its evils exist only in its abuses. If it would confine itself to *equal protection*, and, as heaven does its rains, shower its favors alike on the high and the low, the rich and the poor, it would be an unqualified blessing." "Governments have no right," Leggett added, "to interfere with the pursuits of individuals, as guaranteed by those general laws, by offering encouragements and granting privileges to any particular class of industry or any select bodies of men, inasmuch as all classes of industry and all men are equally important to the general welfare and equally entitled to protection."

On the state level, Leggett's considerable influence among his fellow New York democrats left a legacy of free banking legislation and a general incorporation law. As a follower of the Jeffersonian agrarian or Jacksonian small capitalist philosophy, Leggett believed in the natural right to property, not its abolition. Equal rights for all, within the limits of the General Law, and laissez-faire were the best guarantee of personal liberty. Experience taught that strong governments used their powers to enact special legislation in order to reward the wealthy and take away from the poor. "The remedy," Leggett wrote, "is easy. It is to confine government within the narrowest limits of necessary duties."

No less important to Leggett than equal opportunity in the sphere of political economy were the rights of free speech and free discussion. Here he believed government had the duty to protect such unpopular minorities as the abolitionists in their crusade against slavery. And he also espoused the right of the laboring classes to combine against the power of corporate privilege and monopoly. For the immigrants coming to America, "as the boasted asylum of the oppressed to all the world," Leggett urged a

warm welcome rather than hostility and intolerance. Ever consistent in his attacks upon special privilege, Leggett opposed government subsidies for public works, including education, roads, and canals, as well as the protection of authors and inventors via copyright and patent laws.

White's compilation offers an attractive, readable account of Leggett's vigorous libertarian philosophy. His foreword tells the story of a brief career for which Leggett's own clear prose is the best epitaph. □

(Arthur Ekirch teaches history at the State University of New York at Albany.)

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**The Economist of the Country:  
Ludwig von Mises in the History of  
Monetary Thought**

by James Rolph Edwards

Carlton Press, 11 W. 32nd St., New York, N.Y. 10001  
• 143 pages, \$7.95

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*Reviewed by José Italo Stelle*

**Y**oung scholars intent on communicating the history and ideas of the "Austrian" school of economics to a wider audience could learn a great deal from James Rolph Edwards, Ludwig von Mises Assistant Professor of Economics at Hillsdale College.

This book deals with some crucial and forgotten aspects of monetary thought advanced early in this century by Mises. Edwards disproves the contention of some economists "that Mises made no contributions worthy of note to monetary theory and related topics which have not already been recognized by orthodox western economists and credited in their histories of monetary thought or general doctrinal histories."

Professor Edwards stresses that most mainstream economists and economic historians fail to recognize the importance of Mises as a monetary

theorist because they neglect his early writings. There was a time in the 1920's when Mises was known in Vienna as "the economist of the country"—a man whose advice was sought by business and government leaders in his native Austria. But the climate of opinion shifted in the 1930's.

Mises had warned that every inflationary boom would be followed by economic collapse, but when the Great Depression came, nations turned to economic planning and Mises' work was ignored. Mises' business-cycle theory, for instance, "has been virtually forgotten, until just recently." The same has happened to his application of marginal analysis to the demand for money, one of his greatest contributions. Worse, perhaps, is the widespread belief that monetary theory "was not fully integrated with value theory until 1956," although Mises had accomplished this in 1912.

Edwards attributes "the relative obscurity" of Mises partly "... to the fact that *The Theory of Money and Credit* and certain of his other early works were unavailable in English translations for some decades following their initial publication."

In Edwards' technical discussion of the nature of money, the regression theorem, the value of money, and so on, he makes it clear that most critics of Mises failed to spend the time required to understand him. Their conclusions result from too hasty a consideration of the ideas of this unique "Austrian." Edwards probes the critics' half-truths, the superficially-obvious certainties, showing their logical mistakes in contrast to the truth of Mises' position.

Vindication of Mises against this background of ignorance and forgetfulness makes *The Economist of the Country* worthy of notice. □

(José I. Stelle is a free-lance writer, editor, and translator.)

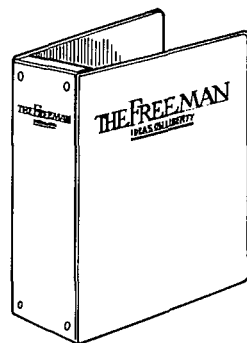
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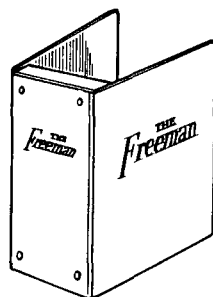
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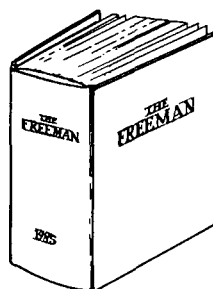


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*The Freeman* considers unsolicited editorial submissions, but they must be accompanied by a stamped, self-addressed envelope. Our author's guide is available on request.

### On Savings

Men can produce very little with physical labor alone. Only when they begin to use their minds to make tools does their labor become more productive. And the development of tools starts with "rainy-day savings," that is, by consuming less than is produced and setting aside some food, clothing, and shelter to tide the toolmaker over while he invents and produces.

Improving production is a very slow process. However, the productivity-increasing tools of inventors make it somewhat easier to consume less than is produced. Little by little producers were able to increase their savings. Instead of accumulating only "rainy-day savings," such as excess supplies of food, clothing, and shelter, they began in time to produce *capitalist savings*—extra tools and machines to be used later in production. In this way our ancestors created the vast accumulations of capitalist savings on which we all rely: huge power projects, automobile plants, coal and iron mines, oil tankers and pipelines, carefully cultivated farmland, textile mills, and so on. Most of our material welfare is the outcome of the ingenuity and thrift of our ancestors.

—From Bettina Greaves' *Economics II course at the New York Institute of Credit*

### Tangled Web

"O, what a tangled web we weave, when first we practice to deceive." In *Marmion*, Walter Scott wasn't writing about economics. Nevertheless, deceit in market pricing has certainly led to "a tangled web" of waste and malproduction.

The modern economy is rife with examples of production gone awry when market prices are artificially held down or artificially supported. Wartime price controls led to empty grocery shelves and black markets. Tenants in rent-controlled apartments

enjoy housing and a privileged position, while would-be tenants face a severe shortage of apartments.

Price supports, on the other hand, lead to the production of unwanted commodities. For example, the Swiss and Austrian governments pay farmers to grow wheat on the slopes of the Alps for esthetic reasons. The wheat never matures in that cold environment, but presumably tourists enjoy the fields of waving grain. In this country, we support the production of commodities that cannot be sold at the subsidized prices. Recently, when surplus dairy products became an embarrassment, our government began slaughtering 1.6 million dairy cattle. Among the latest disclosures of an artificially subsidized surplus was a wheat glut in Saudi Arabia, where the government has been paying wheat farmers almost five times the world price.

If production were left for entrepreneurs to plan, to serve consumers on the basis of free market prices, supply and demand would always tend to balance. There would then be no serious shortages of rental housing or gluts of wheat or dairy products. Those who try to deceive the pricing system fail to appreciate the valuable knowledge to be gained from freely fluctuating market prices.

—BBG

## Air Traffic Control

*Economic Outlook*, published by the Chamber of Commerce of the United States, offers an interesting comparison of private versus public management of air traffic control:

"Air traffic control in the U.S. is provided by both the Federal Aviation Administration (FAA) and by private contractors at smaller airports. For the smallest FAA tower authorization, the FAA spends about \$1 million to install and about \$275,000 a year to operate and maintain a tower. Pri-

vate firms provide the same services for about \$120,000 per year, including amortization of their original capital investment. When a private operator assumed the responsibility for operating the Farmington, New Mexico, tower, its contract was for \$99,000 per year compared to the \$287,000 that it had cost the FAA."

For further insights into private versus public management, see Dale M. Haywood's article on page 274 and Tibor R. Machan's article on page 270.

## FEE Columns

*Freeman* articles are reaching a growing audience of newspaper readers around the country. John W. Sommer's "Disasters Unlimited" (April *Freeman*) has been reprinted by the *Houston Chronicle*, *The Washington Times*, and the Waterbury (Connecticut) *American*. An adaptation of Dennis Bechara's "The Continuing Plight of Agriculture" (May *Freeman*) has appeared in the *Waterbury Republican* and *Pacific Business News*.

In Brazil, interviews and stories about FEE are becoming almost a regular feature in the popular news magazine, *Visao*. Latest to appear is a reprinting of William S. Kern's "Catholic Social Teaching and the U.S. Economy" (December 1985 *Freeman*).

As FEE expands its publishing program, we would appreciate it if you would call our attention to any of our articles you may see. We would especially appreciate it if you would send us a clipping.

## Reprints Available

We are pleased to offer reprints of James L. Payne's "It's Not Our Money," which appeared on page 213 in our June issue. Prices are 50¢ each or 25¢ each on orders for 10 or more.

# The Political Economy of Educational Vouchers

**Public financing of education means political control.**

by Dwight R. Lee

Dr. Lee is a professor of economics at the University of Georgia, where he holds the Ramsey Chair of Private Enterprise.

**T**he crisis in public education is real. As judged by any reasonable measure, the quality of public education is declining as the cost of public education is increasing. The desire for reform in public education is genuine. Parents want a good education for their children, and taxpayers want an honest return for their dollars. Unfortunately, a realistic appraisal of why meaningful reform in public education is so badly needed also points to why meaningful reform is so unlikely to occur.

The underlying problem with public education is, quite simply, that it is public. As long as education is provided publicly, it will be controlled by, and for the benefit of, public education professionals. The reason for this is straightforward.

As opposed to market decisions where each consumer exerts direct and decisive control over the services he chooses to purchase, no one individual has decisive control over the political decisions which determine the publicly provided services all consumers are required to "purchase." Seeing no advantage in becoming informed and active in pursuit of objectives over which he has no direct control, the typical citizen-consumer quite rationally devotes little effort to influence public education policy. In contrast, suppliers of public education have significant political influence over public education policy by virtue of the fact that they are organized through professional associations, have a concentrated interest in decisions affecting public education, and are widely perceived as education experts. The political dominance of supplier interests over consumer interests gives public education professionals the opportunity to control the policy of the public schools. The special interests that comprise the public school lobby have taken full advantage of this opportunity to promote their private purposes while neglecting the public's desire for the efficient provision of quality education.

The implication here appears to be clear. Achieving genuine educational reform would seem to require a policy which shifted control of education from suppliers of education to consumers of education. It is this view of the crisis in public education that has motivated the call for educational vouchers.<sup>1</sup> The idea behind educational vouchers



is straightforward. Instead of government financing education by actually supplying educational services, publicly funded vouchers would be given to the parents of school-age children to spend at the school of their choice (as long as the choice is approved by government). As envisioned by its proponents, this voucher system would transfer control to the consumers of education. Educators would be forced to compete for the consumers' educational vouchers and therefore cater to the consumers' educational demands. Only those schools providing quality education, as determined by the consumer, at low cost would survive. It is also predicted that the variety of educational approaches would increase to reflect the range of educational preferences among the public. Also, with diversity replacing uniformity in education, market choice would replace political combat as the means of expressing educational preferences.<sup>2</sup>

**T**his case for educational vouchers would be sound if it were indeed true that the root of the problem lay in the control of public school policy by professional educators. But this is not the case. Educator control of public education policy is a symptom of a more fundamental problem: the public funding of education. The flaw with the voucher system is that it attacks the symptom of the problem without addressing the source of the problem. Under the voucher system public education remains public education, and nothing fundamental has changed.

Proponents of educational vouchers have assumed a benign political setting for their proposal—one which if it indeed existed would largely eliminate the need for vouchers in the first place. Once vouchers were issued by government, consumers would supposedly be in complete control, as the public school lobby would somehow have been politically neutered. The only political influence that would be in evidence is the restriction that vouchers be used to purchase education only from approved schools. And presumably this influence would be exercised in a politically impartial way. The political arena would suddenly become a setting in which the education consumer is in control; the public school lobby is dormant; and quality education is provided efficiently because it is in the public interest to do so. Obviously in such a political setting educational vouchers would perform as advertised.

The prognosis for vouchers is completely different, however, when a realistic view of politics is accepted. As long as education is funded publicly, decisions on educational policy will be made politically. As long as decisions on educational policy are made politically, the interests of consumers will remain diffused and unorganized, and dominated by the focused and organized interests of the public school professionals. Given this fact of political life there are only two possibilities for educational vouchers. The first possibility is that educational vouchers will be benign because they never will be considered seriously. The second possibility is that educational vouchers will become politically acceptable—in which case they will be no better, and probably worse, than the educational approach they replace.

Consider a voucher proposal which, if enacted, would indeed be in the best interest of the public as consumers of education. In other words, the voucher proposal would accomplish exactly what propo-

## **Educational Vouchers and Political Realism**



nents of educational vouchers envision: the transfer of control over education to consumers from suppliers. One does not have to be clairvoyant to predict how the public school lobby would respond to such a proposal. They would oppose it for the obvious reason that their power and privileges would be undermined by a voucher system which worked the way it is supposed to work. This opposition is sure to be effective for the same reason that lies behind the case being made for vouchers—the ability of education professionals to control education policy when that policy is determined through the political process. What the voucher proponents have not yet recognized is that they are confronted with a Catch-22. They want an effective voucher system for the very reason that it is impossible to have one.

Unfortunately, this is not the end of the story. If it were, the idea of educational vouchers would be a rather harmless one. The problem is that there is a real danger that educational vouchers will become politically acceptable.

How will vouchers become politically acceptable if they pose such a threat to the professional educators who control the political agenda on educational policy? It has to be recognized that the public school lobby faces a second threat. That threat is public education's inferiority to the private education alternative, but this is a threat that the public school lobby can neutralize with the creative use of educational vouchers.

Compelling evidence of the inferiority of the public schools is found in the fact that private schools, charging full price for their services, are competing successfully against the fully subsidized public schools. And the number of parents who remove their children from the public school system is likely to increase. The public schools are surely not going to get better, and are very likely to get worse. The recent call for "reform" and the political rhetoric about "excellence in education" will do nothing to improve public education. Indeed, the pretense of reform has satisfied the political demand that something be done while leaving such educationally destructive forces as the National Education Association with more control than ever. On the other hand, the private demand that something be done will continue to find expression in parents' rejection of public schools. This rejection will surely increase as per capita incomes increase, even if the decline in the quality of public education is somehow arrested.<sup>3</sup>

## The Response of the Public School Lobby

**T**he public school lobby will respond to this threat of consumer rejection, but how? It will not, indeed cannot, respond by improving the quality of education and becoming competitive with private schools. This is not to be taken as a criticism of the individuals who teach in our public schools. Many of these individuals are competent, hard working, and personally dedicated to educational excellence. The problem is one of the flawed incentive structure that plagues the provision of all publicly financed goods and services.

If suppliers are to direct their efforts efficiently and persistently to the satisfaction of consumer demands, they require accurate information on what those demands are, and compelling motivation to respond to this information. There is only one arrangement whereby this information and motivation can be provided. That arrangement

***“As long as education is funded publicly, decisions on educational policy will be made politically.”***

is the private market where consumers, by virtue of the fact that they are spending their own money as they see fit, communicate their preferences through changes in prices and patronage in a way that conveys wealth gains to those suppliers who respond appropriately, and imposes wealth losses on those who do not. By breaking the connection between the demand for education and the ability of consumers to control their own money in expressing that demand, public education has made it impossible for the public schools to provide quality education efficiently.

But the public school lobby does not have to concern itself with providing better education at lower costs in order to beat back the threat it faces from the private school option. If the move to purely private schools begins to accelerate, the public school lobby can, and surely will, protect its privileged position against this competition by embracing educational vouchers. As strange as it will sound to advocates of educational vouchers, if the voucher approach to education ever becomes a serious political possibility, it will be as a means of reducing competition in education, not increasing it.<sup>4</sup>

The advantage the public school lobby will see in educational vouchers comes from the ability of vouchers to entice students back into publicly financed education. Consider the situation in which a large number of parents have taken their children out of the public schools. These parents will have the control over their children's education that can come only from private education, but they will be paying dearly for the privilege; paying for both the private education they have chosen and the public education they have rejected. Given this burden, parents of children in private schools will be susceptible to a proposal for educational vouchers. As presented by the advocates of vouchers, which will now include public school professionals, the promise will be continued freedom of choice in education without the obligation to pay twice. Such a voucher proposal will also sound appealing to the proprietors of private schools, who will mistakenly see it as a way of expanding the demand for their product by eliminating the discriminatory financial burden being placed on their customers.

Unfortunately, the reality of educational vouchers will be far different from their promise. Vouchers or no vouchers, as long as education is financed publicly, control over education will be exerted through political power, not through consumer choice. Educational vouchers may, for a time, give the appearance that consumers are exercising genuine choice. But consumer choice can, and will, be circumscribed by restrictions on the vouchers; restrictions that will reflect the interests of the politically organized public school lobby, not the interests of the politically unorganized public. One can predict with confidence that the choices educational consumers will have under any voucher system that is politically acceptable will in no way threaten the privileged position of the public school establishment.



This conclusion is based on more than just idle theorizing. We have experience with Federally funded educational vouchers at the experimental level. The Federally funded voucher experiment that ran the longest and has been deemed most successful was conducted in Alum Rock, California. As one would predict, restrictions were placed on these vouchers which minimized the competitive pressures they imposed on public school professionals, and which attempted to promote social objectives that had little to do with education. Teachers, for example, did not have to worry about loss of income if their enrollments declined. They were given priority in teaching jobs at other schools and were paid for makeshift work until such jobs became available. On the other hand, teachers who succeeded in attracting additional students were not rewarded with higher salaries. Those schools which parents preferred were not able to expand to meet the extra demand. Those students who did not get their first choice were simply assigned to other schools. A local employee certification council required that any private school had to satisfy a host of standards on such things as teacher education requirements, pay and fringe benefits, and faculty-student ratios. This control over entry was used to make it effectively impossible for any private school to enter into competition for the vouchers. The Alum Rock vouchers did nothing to threaten the suppliers of public education by passing genuine control to the consumers of education.

If educational vouchers become politically viable it will be because they can be used to reverse the expansion in genuinely private education. The public school lobby will see educational vouchers as the means to entice those who are attending private schools back into a public education system that will be no better than the one which they have rejected.

## Conclusion

The special interests that comprise the public school lobby have been able to subvert educational policy to their narrow advantages with the same political influence that will be used to frustrate any reform that threatens those advantages. These special interests would be emasculated by a system of educational vouchers that worked in the way envisioned by the advocates of vouchers. It is for this reason that we will never get a voucher system that is worth having. If educational vouchers are in our future it will be because the public school lobby will see them as the best vehicle for maintaining or enlarging their special interest advantages. Educational vouchers will never serve to increase the range of freedom in education, and may do much to restrict it. □

1. For the purpose of this paper there is no advantage in distinguishing between educational vouchers and educational tax credits, and henceforth we will refer only to vouchers.

2. Milton Friedman, the leading proponent of educational vouchers, first made the case for vouchers in "The Role of Government in Education," in Robert Solow, ed. *Education and the Public Interest*, New Brunswick: Rutgers University Press, 1955.

3. It should not go unnoticed that increased

wealth represents a major threat to the public education establishment. The wealthier parents become, the greater their demand for quality education for their children, i.e., private education for their children. The NEA's advocacy of economic policies calling for economically stifling regulations and taxes is not completely irrational from their perspective.

4. This point was first recognized by Gary North in his article, "Educational Vouchers: The Double Tax," *The Freeman*, (May 1976): 259-75.

# Taxes and Unemployment

**T**ax exactions, in recent decades, have risen to heights that would have seemed incredible to our forebears. They have become a big, often the biggest, item of a family budget. To business, taxes now are an important determinant of decision making; they circumscribe the production process, specify the nature of business activity, direct its location, and signal failure or success. In the U.S., total tax exactions now exceed one trillion dollars in a three-trillion dollar economy. It is inevitable that, in such magnitude, taxes vitally affect many aspects of our economic, social, and political lives.

A tax is a compulsory payment by individuals to government. It differs from all other payments in its basic characteristics: (1) compulsion, (2) apportionment without close reference to individual benefits, (3) use of the proceeds by politicians and government officials. The intent of a tax levy may be *fiscal*, to raise revenue and defray the expenses and expenditures of politicians and officials, or it may be *economic*, to effect economic changes. It may be to effect changes in consumption patterns, stimulate business spending, provide jobs for the unemployed, redistribute income and wealth, or even reshape the economic system. But no matter what the intent may be, all taxes have economic effects; there are no neutral taxes.

Every tax that touches business tends to "regulate" business. Every business tax—whether it is a corporate income tax, a supplementary tax on undistributed corporate income, a capital stock tax, an excess profits tax, a severance tax, an unincorporated business tax, or a property tax—affects business activity. Similarly, personal taxes, such as payroll taxes, poll taxes, gift taxes, death taxes, commodity taxes, transfer taxes, sales taxes, motor vehicle taxes, fuel taxes, or taxes on imports, all leave their marks on economic production and distribution.

Under the influence of popular economic thought, governments now raise or lower taxes in order to prevent inflation, check business recessions, and promote economic activity and growth. When economic output is approaching the limits of capacity and people want to spend more than is offered at stable prices, taxes are supposed to exert a powerful restraining force and close the "inflationary gap." In the opposite situation, when a recession is threatening to paralyze economic activity and unemployment is descending on many labor mar-

**How do rising levels of taxation affect the rate of unemployment?**

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by Hans F. Sennholz

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Dr. Sennholz heads the Department of Economics at Grove City College in Pennsylvania. He is a noted writer and lecturer on economic, political, and monetary affairs. This essay is a chapter from his forthcoming book on unemployment.

kets, government is supposed to lower taxes while maintaining or even increasing spending. Government is to create deficits and finance them by borrowing, which is said to add to the people's disposable income and propensity to consume. In short, taxation together with deficit spending and credit expansion are supposed to be a powerful force for full employment.

Economic reality differs radically from such crude notions of taxing and spending. Ever since governments the world over sought to close the "inflationary gap" and practiced contracyclical policies, the rates of inflation have soared and the cyclical movements of business have become more numerous and severe. Taxation obviously cannot alleviate inflation as long as government engages in money creation and credit expansion; but it may aggravate the rise in prices by exacting and consuming business capital and thereby reducing the supply of available goods.

Similarly, taxation is utterly incapable of alleviating the business cycle. Once economic production is disoriented and maladjusted due to inflation and credit expansion, the readjustment, which is the recession, must run its course. To prescribe tax boosts in such situations is to make matters worse. To increase government spending and suffer yet larger deficits is to deprive business of urgently needed capital, prolong the recession, and cause more unemployment.

## Improper Means to Dubious Ends

Few legislators are knowledgeable in economic matters, which explains why tax legislation may bring forth more unintentional than desired effects. A levy may fall far short in revenue or surpass all expectations. It may be designed to equalize income and wealth, but actually create more inequality. It may seek to provide equal opportunities, but actually prevent changes and bar opportunity. A tax may be imposed to improve the economic conditions of working people, but actually make them worse. It may be intended to fight inflation, but actually aggravate it, to overcome the business cycle, only to exacerbate it. It may be inflicted to alleviate poverty, but actually worsen it. It may be foisted on business in order to stimulate activity and employment, but actually bring forth economic stagnation and unemployment.

Surely, there is no tax purposely and willfully designed to cause economic stagnation or unemployment. But whatever their objectives may be, the levies imposed rarely are the proper means for the chosen ends. In particular, taxes imposed for the purpose of economic stimulation and full employment actually bring about stagnation and unemployment.

Students of labor and labor markets judge a particular levy according to its effect on the demand for and supply of labor. A tax levy, or changes thereof, may affect the demand for labor, influence the quantity and quality offered, or act on both. Like any other obstacle to production it may cause economic stagnation and breed unemployment. Taxation has such consequences whenever it renders human labor uneconomical. It may do so by raising the cost of labor above its marginal productivity, that is, above the addition to output attributable to the last worker employed whose cost equals the value of his output. Above this point, the loss incurred from the employment of labor forces employers to discharge workers.

Fiscal theory distinguishes between two modes of taxation bringing forth unemployment:

(1) Taxes, levies and fees that directly raise the cost of labor, such as Social Security payroll taxes, unemployment compensation taxes, workman's compensation assessments, and so on. They are called "employment taxes."

2) Taxes, levies and fees that lower the productivity of labor by preventing capital formation or consuming capital outright, such as steeply progressive corporate and personal income taxes, capital stock taxes, business license taxes, death and gift taxes, and other levies on capital. We may call them "business taxes."

For a tax to bring forth unemployment it must raise the cost of labor above the value of its productive contribution. If, for any reason, it fails to do so because other factors oppose and offset it, the unemployment may not materialize. Inflation, for instance, may temporarily erode real wages while eager legislators are adding costs. Rampant inflation throughout the 1970s facilitated prompt downward readjustments of real wages, at least in nonunionized industries, although government was continually boosting employment taxes.<sup>1</sup> In unionized industries, inflation usually triggers additional wage demands that prevent the offsetting adjustment. The boosts in employment taxes together with new demands for higher pay and less work bring about mass unemployment.

In a free society institutional unemployment is an alien, unnatural phenomenon. The market order, which forces capital and labor to adjust continually to consumer demand, offers employment opportunities to everyone willing to work. Free prices, which reflect consumer values and choices, guide the adjustment process. At the free market rate of labor there can be neither surplus nor shortage of labor. Chronic unemployment always indicates extraneous intervention that makes labor uneconomical. It hints at permanent barriers such as minimum wage legislation, union wage rates and work rules, government rules and regulations, and last but not least, prohibitive taxation. Both government and labor unions are laboring diligently to maintain and even raise the barriers.

**T**o help finance Social Security benefits, the federal government imposes a series of payroll taxes that now yield almost \$300 billion a year. Taxes in such magnitude obviously are an important element in the cost of labor affecting the demand for labor. They usually consist of two sets of levies—one claims a share of employee income, the other a share of employer profits. The former is deducted from a worker's pay and remitted by the employer to the Internal Revenue Service, which credits it to his account. It reduces a worker's take-home pay and net income; it is a part of labor cost borne directly by the worker. The employer's share, too, constitutes a part of labor cost, but differs from employee withholding in that a boost directly and immediately raises total labor costs and thus exerts an influence on the demand for labor. To the employer levy must be added the employer's cost of collection, remission, and compliance. Every employer report on earnings in covered employment, every labor questionnaire, adds to labor cost.

## Employment Taxes

Many politicians and officials are ever anxious to boost employee benefits and increase employer obligations. To analyze their motives is to reach into the haze of politics. Some lawmakers may actually believe that they, in Congress assembled, wield the power to exact income and benefits from employers and bestow them on workers. They depend on tax collectors, judges, juries, and police to enforce the laws they devise. Other politicians whose paramount concern is re-election, usually promise anything and everything the electorate may want to hear. But no matter what the motivation may be, every new levy raises the cost of labor and causes some unemployment.

The magnitude of the unemployment depends on the size of the exaction and the adaptability of labor. A quick downward adjustment of other labor costs—wages, fringes, or both—offsetting the new exaction, may keep unemployment at a minimum. To resist the adjustment, however, is to let the consequences run their course. The loss-inflicting submarginal labor is laid off, suffers the pain and agony of joblessness, and in time searches for other employment.

The competition of the unemployed creates a tendency for wage rates to decline to the point where the reduction offsets the new exaction. In the end, the worker pays for every penny of fringe benefit exaction no matter how it is labeled or packaged. When seen in this light, the Social Security system and all the other labor benefit systems merely are mandated schemes of wage redistribution that permit politicians and government officials to manage and redistribute labor income. The workers bear all costs of wage withholding, accounting, and remission to the Social Security Administration.

## The Impact of Benefit Mandates

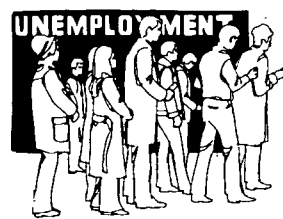
**I**n a labor-intensive industry in which labor costs comprise a large share of production cost, the impact of benefit mandates is likely to be painful and severe. If labor costs are made to rise by one per cent, unemployment may rise by two or three per cent. In a capital-intensive industry in which the payroll represents a small share of production cost, the effect of a benefit boost will be less pronounced. A one per cent rise may boost production costs by a small fraction of one per cent and unemployment by a lesser amount. In every case, labor is rendered unemployable whenever its cost is boosted forcibly above its productivity rate.

Unemployment compensation taxes by both federal and state governments are classic examples. When general business activity declines, unemployment benefits, which are state expenditures, tend to increase automatically. State governments promptly react by boosting employer exactions, which in turn boost the unemployment rates. Moreover, unemployment compensation undoubtedly affects the supply of labor as any subsidy sustains that which it subsidizes. Higher benefits tend to reduce incentives to effort; since some states have removed most restrictions on benefits to strikers, the benefits invite and encourage strikes, which raise labor costs and create more unemployment. The strongholds of labor unions are the centers of unemployment.

Labor is rendered unemployable whenever government forcibly raises its cost. The Occupational Safety and Health Act of 1970 (OSHA) is estimated to have added tens of billions of dollars to the cost of labor. It contributed significantly not only to rising unem-



ployment, but also to the economic stagnation of the 1970s, the visible decline in American ability to compete in world markets, and the extraordinary rise in goods prices. Similarly, the Employee Retirement Income Security Act of 1974 (ERISA), which made it easier to qualify for pensions, substantially raised the costs of private pension plans. The Equal Employment Opportunity legislation of 1964 and 1967, which forced employers to engage workers according to racial criteria rather than considerations of suitability and productivity, raised the cost of some labor. In every case the new legislation brought some unemployment to the very labor it meant to benefit.



**T**he Federal tax system relies primarily on payroll and income taxes. Boosts in payroll taxes bring forth unemployment directly and immediately, provided other cost reduction does not mitigate the tax boosts. Income taxes have similar results whenever they consume savings and prevent capital formation. In particular, steeply progressive rates retard economic development and produce unemployment by discouraging saving, investment in business expansion, and work effort, especially on the part of capitalists and entrepreneurs. In 1986 income taxes paid by individuals and corporations are estimated at \$433 billion, or 54.5 per cent of estimated budget receipts. Social insurance taxes consisting primarily of payroll taxes levied on wages and salaries are estimated to yield some \$289.4 billion, or 36.5 per cent of total income. Excise taxes on products and services are expected to provide \$35 billion, or 4.4 per cent of the total, and estate and gift taxes, customs duties and miscellaneous receipts \$36.3 billion, the remaining 4.6 per cent of budget receipts (*Budget of the United States Government*, Fiscal Year 1986, p. 4-3).

For many Americans steep tax progression is a maxim of "social justice" that renders to every man his due. Although men are by nature unequal in talent, labor, and virtue, many dream about equality of economic and social conditions. They would, in the name of social justice, reduce society to an average level, using the political process and government, the apparatus of force. Fiscal and budgetary objectives take second place to social and economic considerations that make government apportion its levies according to the principle of "ability to pay" and allocate the benefits according to political need and merit. Government seizes income and wealth from individuals who own and earn more than the average, from taxpayers known to save and invest their savings. Unfortunately, government consumption of the funds reduces the amount of capital invested per worker employed, lowers the productivity of labor and depresses wage rates. Workers resisting the reduction face disemployment. They may encounter yet greater difficulties if taxpayers, instead of meekly suffering the confiscatory levies, decide to enjoy and consume their capital. The consumption breeds waste and invites mismanagement—dissipating more capital, depressing wage rates further, and causing more unemployment.

Business taxes are rising continuously. The windfall oil profit tax of 1980, the largest single tax ever imposed on an industry, is estimated to yield \$5 billion in 1986.<sup>2</sup> Boosts in excise taxes on airport and airway users and telephone service are estimated to yield \$2.4 billion. A 5 cent per gallon increase in the excise tax on gasoline and diesel fuel, and other provisions of the Highway Revenue Act of 1982 are expected to

## Business Taxes

raise business costs by more than \$6 billion (*Budget of the United States*, Fiscal Year 1986, p. 4-18).

Federal estate and gift taxes are estimated to yield \$5.3 billion dollars in 1986. There are few taxes that are more destructive to labor income and employment than such levies. They expropriate economic wealth that is employed almost exclusively in the production of goods and services for the people, giving them employment and consumer products. Death duties force the heirs to sell parts or all of the testator's estate. Of course, the business they must sell or the stock they must liquidate are not consumed; they merely change ownership. But the liquid capital received for the property is surrendered to tax collectors and consumed by government. The consumption reduces the amount of capital invested per worker, lowers the productivity of labor and depresses wage rates. If the workers resist the necessary wage adjustment they face unemployment.<sup>3</sup>

## Fiscal Justice

**M**ost Americans applaud the new levies on business. They look upon business capital as evidence of unearned personal wealth that should be seized and distributed. Why should anyone be richer than the average wage earner? Viewing business capital with unveiled envy, they do not understand that capital is a requisite of all production, a tool that renders human labor more productive.

They do not know that capital is not a gift of nature, but the product of individual saving and investing. To seize it and consume it is to impair labor productivity, reduce wage rates, and destroy jobs. To distribute it among workers or hand it to politicians and government officials amounts to the same. And yet in politics, envy that covets another's income and hates the wealth it cannot reach, is setting society on fire and destroying the people it possesses. The common cry of "social justice" is but the smoke of envy; it pollutes the moral fiber of society.

It is difficult to argue about justice in fiscal matters, for it is doubtful that any exaction that depends on brute force, that apportions without reference to individual benefits and that delivers the proceeds to politicians and government officials, can ever be morally right and equitable. Justice consists in doing no injury to men. How can a confiscatory income tax or estate tax be called "just" when it inflicts great injury on taxpayers? Justice is depicted as blind; taxes exact income and wealth from some people for the benefit of others. Legislators aim their levies at certain groups and classes of taxpayers. They target their levies at producers, distributors, banks, chain stores, and many other classes of taxpayers. Surely, neither a corporate income tax nor a "windfall profits tax" on petroleum production can be said to be blind. The essence of justice is impartiality; the substance of taxation is partiality and partisanship. Justice gives to every man his own; taxation takes from some to give to others.

Taxation is a simple business. Anyone can devise new levies and add to the old. He may receive support from lobbyists who would use the instruments of government to promote their own interests by hampering and hurting others. Lobbyists for independent retailers argue for higher taxes on chain stores, coal miners plead for higher taxes on oil producers, American oil men for higher taxes on foreign producers,

and so on. The tax boosters in turn depend on the support of the reformers who wax eloquent on equality and justice.

Oppression and rebellion are never far apart. When the burdens reach confiscatory levels the public may unite and demand tax reductions. As long as the number of taxpayers exceeds the number of tax boosters, and taxpayers organize as effectively as the boosters normally do, a tax rebellion may succeed in lowering particular levies.

Most of the time, however, the public is divided on the issues. The tax boosters thus may turn a tax rebellion into a tax reform movement. They may divide the public and turn its attention from the oppression to the distribution of the burden. They may succeed in turning a rebellion against government into a taxpayer feud that must be settled by government. In short, the people are persuaded to seek "new justice" by assigning "fair shares" and "closing loopholes."

The tax reform battle is akin to the entitlement battle. Springing from the same ideological and philosophical roots, both signal the growing role of government in our lives. Taxation and unemployment are painful symptoms of this role. □

1. Maximum Social Security levies on employers since 1970 (\$):

1970 - 374	1976 - 895	1982 - 2,171
1971 - 405	1977 - 965	1983 - 2,392
1972 - 468	1978 - 1,071	1984 - 2,532
1973 - 632	1979 - 1,404	1985 - 2,792
1974 - 772	1980 - 1,588	
1975 - 825	1981 - 1,975	

Source: William H. Hoffman, Jr. and Eugene Willis, eds., *West's Federal Taxation: Comprehensive Volume*, 1986 Annual Edition (New York: West Publishing, 1986), p. 1-18; also *Budget of the United States Government*, Fiscal Year 1986, p. 4-16.

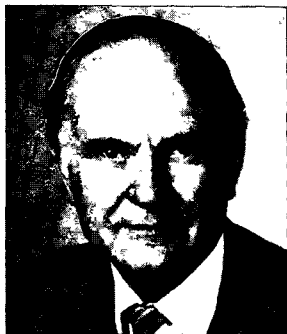
2. Although the tax is called a "windfall profits

tax" the exaction actually applies to the price increases above the 1979 controlled prices, not to profits. For many years Federal controls kept oil prices far below market prices. When oil production and distribution came to grief, sinking into stagnation and shortages, the controls were lifted reluctantly and markets were permitted to function again. But the difference between the controlled price and the free market price was expropriated by the windfall profits tax. If there were truth in politics, the tax would probably be called "a double-header exaction," at first by controls and then by taxation.

3. Cf. Sennholz, *Death and Taxes*, 2nd ed. (Cedar Falls, Iowa: Center For Futures Education, 1982), p. 48 et seq.

## Money and Freedom

### by Hans F. Sennholz



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# The Industrial Revolution: Working Class Poverty or Prosperity?

**How the industrial revolution raised the quality of life for workers and their families.**

by John Majewski

John Majewski is an economics major at the University of Texas at Austin. He is currently serving as a summer intern with the Institute for Humane Studies. Following graduation in 1988, John hopes to pursue a Ph.D. in economics. This paper was awarded second prize, college division, in FEE's Freedom Essay Contest.

Since it began approximately two centuries ago, the industrial revolution has captured the minds of an endless number of historians and economists. An era of relatively laissez faire economics, the period between 1760-1850 is for many academics the key to unlocking the secrets of economic growth, technological change, and economic development. But, for defenders of the classical liberal tradition of free enterprise, the industrial revolution is important for more insidious reasons. Writers such as Dickens, Engels, and the Hammonds have made the terms industrial revolution and capitalism synonymous with degradation of the working class. Pessimistic interpretations of the industrial revolution have led to the popular acceptance of what R.M. Hartwell terms the "theory of immiseration"—a belief that unrestrained capitalism was making the rich richer and the poor poorer during the industrial revolution (Hartwell, 1974). For the general public, the horrors of the industrial revolution prove the horrors of capitalism.

But it is not only laymen who perceive the industrial revolution in terms of "dark, satanic mills." A brief glance at almost any university history or English textbook reveals that most academics who do not specifically study the industrial revolution accept without reservation the view that capitalism led to a deterioration of living conditions for the working class. For example, a text commonly used in college British literature classes describes the industrial revolution in these terms:

For the great majority of the laboring class the results of the policy (of laissez faire) were inadequate wages, long hours of work under sordid conditions, and the large-scale employment of women and children for tasks which destroy body and soul. Reports from investigating committees on coal mines found male and female children ten or even five years of age harnessed to heavy coal-sledges which they dragged crawling on their hands and knees . . . (Norton Anthology, p. 3).

Such harsh interpretation of the industrial revolution has directly affected public policy. The industrial revolution has become a successful battle cry for detractors of capitalism. The specter of working-

class poverty and misery during the industrial revolution has been and still remains an important justification for government intervention into social and economic affairs. A vast amount of legislation, from minimum wage to antitrust laws, owes its existence to the anticapitalist mentality created by pessimistic views of the industrial revolution. As Nobel laureate F.A. Hayek pointedly argues, the industrial revolution portrayed by the pessimists is the “one supreme myth which more than any other has served to discredit the economic system to which we owe our modern day civilization” (Hayek, pp. 9-10).

This paper will attempt to show that the pessimistic interpretations, however popular, are unfounded. It will be argued that the quantitative (material) standard of living improved as real wages rose, while falling mortality rates indicate that the qualitative (sociological) standard of living also improved. Although there was considerable social and economic disruption throughout the revolution, this paper will try to show that these problems were caused by various government interventions, especially the Napoleonic Wars. Far from being a cause of misery and despair, this essay concludes, capitalism in the early nineteenth century improved the standard of living and set the stage for the modern comforts that we enjoy today.

**A**s noted above, the pessimistic case is widely accepted by both the general public and academia. However, it is fair to say that the majority of modern economic historians who study the industrial revolution believe that at least a slight increase in the material standard of living occurred. Since the introduction of reliable statistical evidence in Sir John Clapham's *An Economic History of Modern Britain* in 1926, it has become increasingly obvious that real wages rose. The evidence is now so conclusive that one historian has confidently declared that “unless new errors are discovered, the debate over real wages in the early nineteenth century is over: the average worker was much better off in any decade from the 1830s on than any decade before 1820” (Williamson, p. 18).

The evidence vindicates such confidence. Although money wages remained stable, the prices of manufactured and agricultural goods plummeted as entrepreneurs struggled to deliver consumers low-priced goods and services (Hartwell, 1971, pp. 326-27). Although the extent of the increase in real wages is hotly debated, the most recent evidence suggests that blue-collar real wages doubled between 1810 and 1850 (Williamson, p. 18). McCloskey, although emphasizing a much longer period of time, also concludes that real wages increased significantly. He argues that real wages rose from an average of £11 per capita in 1780 to £28 per capita in 1860 (McCloskey, p. 108).

As one can imagine, the increase in real wages resulted in significant improvements in the standard of living. An excellent example is the changes in diet that occurred. Per capita consumption of meat, sugar, tea, beer, and eggs all increased. An even better indication of the rising affluence was the great increase of imported foods. Per capita consumption of foreign cocoa, cheese, coffee, rice, sugar, and tobacco increased. Meanwhile, meat, vegetables, and fruits, long considered luxuries, were by 1850 eaten regularly (Hartwell, 1971, pp. 328-29). In fact, the average weekly English diet of 1850—five ounces of butter, thirty ounces of meat, fifty-six ounces of potatoes, and sixteen ounces

## An Increase in Real Wages

of fruits and vegetables—is quite similar to the English diet of today (Hartwell, 1971, p. 330).

Although such improvements obviously are important, they take on added significance when considering the large population increase that took place during the industrial revolution. Because of a fall in the death rate, the population of England and Wales rose 1.25 per cent per year between 1780 and 1860, an annual expansion that translates into an unprecedented threefold increase (McCloskey, pp. 105-108). Rising real wages (and consequent increases in food consumption) coupled with a rapidly rising population was a first in European history. The Malthusian trap of geometrically increasing populations outstripping arithmetically increasing food supplies had finally been broken. Whereas more people invariably resulted in less food per person throughout earlier European history, the industrial revolution provided more food per person. Breaking the bonds of Malthus is perhaps the crowning accomplishment of capitalism in general and the industrial revolution in particular.

## Untenable Arguments

Considering the preponderance of evidence indicating substantial improvement in real wages, it is clear that the arguments of early pessimists, such as Engels, have become untenable. Clearly, the material standard of living did not plummet. With the advent of reliable statistical evidence supporting real wage increases, sophisticated pessimists began to emphasize the qualitative effects of industrialization. Openly admitting that the working class enjoyed higher wages, more food, and better clothing, these pessimists argue that the cost for such gains in material wealth was dear. They contend that the evils of child labor, sordid working conditions, increased pollution, and various other discomforts outweighed any progress due to increasing real wages. E.P. Thompson, in his influential book *The Making of the English Working Class*, succinctly summarizes this new pessimistic position, arguing that, “By 1840 most people were ‘better off’ than their forerunners, but they suffered and continued to suffer this slight improvement as a catastrophic experience” (Rude, p. 67-68).

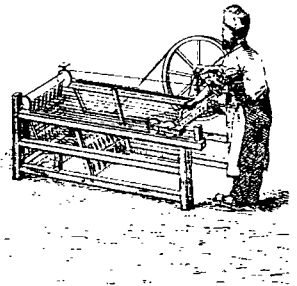
The pessimistic quantitative versus qualitative position is open to considerable criticism. For example, many of the poor conditions cited by the pessimists existed well before the industrial revolution. Pre-industrial society was very static and often cruel—child labor, dirty living conditions, long working hours, and a host of other ills associated with nineteenth century capitalism were just as prevalent before the industrial revolution. Although by today’s standard conditions were indeed poor, they were no worse than living conditions before the revolution (Hartwell, 1971, pp. 339-341).

A second general problem with the new pessimistic position is that it fails to take into account the significant improvement in life expectancy that took place. The great population explosion that happened during the industrial revolution was fueled by a steep fall in death rates. Even in cities, where living conditions are said to have been the worst, mortality rates improved somewhat (McCloskey, pp. 105-106). Deteriorating living conditions and longer life spans are difficult positions to reconcile. Clearly, improving mortality rates indicate that the standard of living rose during the industrial revolution.

Besides the two general arguments outlined above, the qualitative pessimistic position can be refuted by a close look at its specific charges.

**Technological unemployment and underemployment.** It has been long held by many pessimists that the wage increases of the industrial revolution were eroded away by extremely high unemployment and underemployment rates caused by the introduction of labor-saving technology. Although there were some pockets of technological unemployment, the calculations of Williamson suggest that the unemployment rate was at most eight per cent per year, and was probably far lower (Williamson, p. 22). Furthermore, the stable money wages between 1820 and 1850 indicate that there was little competition from unemployed workers that would have lowered wages (Hartwell, 1971, pp. 318-319). As for underemployment, the tremendous shift from agriculture, which provided only seasonal employment, to the more stable manufacturing sector, led to decreasing underemployment (Hartwell 1971, p. 323).

**Pollution and Urban Conditions.** Another popular argument of the pessimists is that the real wage increases were merely "bribes" to workers forced to endure polluted and unsanitary urban conditions. According to this line of reasoning, the gain in real wages was simply a means of luring workers to the horrid working conditions of the cities, and did not constitute a net gain in wealth. Although it is certainly true that urban conditions during the industrial revolution were appalling, the aforementioned improvement in mortality rates indicates that conditions were not bad enough to grievously affect the health of the city dwellers. Secondly, the workers voluntarily moved into urban areas, suggesting that the "opportunity cost" of pollution and various other urban discomforts *did not* outweigh the gains in real wages.



**Child Labor.** Another qualitative argument brought forth by the pessimists is that children were forced to endure long hours of work in unhealthy conditions. Although the existence of child labor cannot be denied, it is clear that most pessimists have overstated both its magnitude and the effects on the health of the children involved. In fact, much of the evidence for the pessimist's case comes from the very famous, yet very inaccurate, reports from the government committees investigating the factory system. Almost all of the "condition of England" novels by Dickens, as well as the works of Engels and the Hammonds, have been in large part based on these committee reports (Jefferson, p. 189). Politically motivated and seriously defective, the evidence in these reports is marred by the fact that the doctors who testified against child labor in the factories had not even been in a factory and refused to testify under oath (Hutt, pp. 161-167). Moreover, the great improvement in mortality rates seems to indicate that either child labor was not extensive as before or was less harmful. Indeed, it was the great improvement in productivity instigated by the industrial revolution that has enabled Western societies to banish child labor.

**Capitalism and "the spirit of the age."** Perhaps the most common yet most difficult to define charge made against capitalism and the industrial revolution is that the working class was filled with "spiri-

tual" loss. According to this argument, rural farm workers were torn from their roots and thrust into the industrial towns and cities, thus losing sense of their heritage and individualism. However, the very fact that workers moved voluntarily from rural to urban areas once again suggests that the advantages of more material wealth outweighed the "opportunity cost" incurred from the move. Moreover, many friendly societies, workers' societies, and voluntary organizations developed during this time, throwing the whole notion of "isolation of the individual" into dispute (Ashton, p. 137).

Any sociological costs endured during the industrial revolution must be counterbalanced against the many sociological benefits. For the first time, there was a sense of hope and optimism. The industrial revolution spawned the attitude that progress could be made and problems could be solved. Perhaps it is worth quoting Hartwell at length on this point:

The new attitude to social problems that emerged with the industrial revolution was that ills should be identified, examined, analyzed, publicized, and remedied, either by voluntary or legislative action. Thus evils that had long existed—child labor, for instance—and had long been accepted as inevitable, were regarded as new ills to be remedied rather than old ills to be endured (Hartwell, 1971, p. 343).

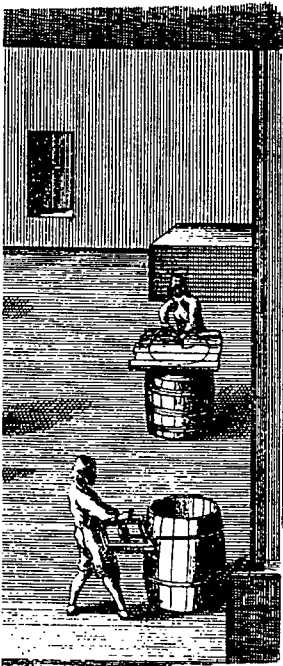
## Government Intervenes

**A**s the above analysis demonstrates, the industrial revolution resulted in a significant improvement in the quality of life for the working class. However, progress was slow, uneven, and sometimes nonexistent during many periods. For example, in the early stages of the revolution growth was minimal, resulting in little or no improvement for the working class (Williamson, p. 162). Is capitalism to blame for this slow rate of progress? To the contrary, it was the many forms of government intervention, not capitalism, which slowed British economic growth during the industrial revolution.

Perhaps the most important of these many interventions that hindered progress was the long period of intense war during the early years of the revolution. From 1760 to 1815, Britain was constantly engaged in war, either against France or the American Colonies. In fact, between 1780 and 1810, England was in the midst of a massive military build-up that was unmatched until World War I (Williamson, p. 163). Early commentators were quick to recognize the debilitating effects of this military build-up on the English economy. The historian J.E. Thorold Rogers, for instance, observed that the cost of the Napoleonic Wars was high indeed:

Thousands of homes were starved in order to find the means for the great war . . . the resources on which the struggle was based, and without which it would have speedily collapsed, were the stint and starvation of labor, the overtaxed and underfed toils of childhood, and the underpaid and uncertain unemployment of men (Rogers, 1891, quoted in Hartwell, 1971, p. 326).

Modern statistical evidence and economic theory lends support to such observations. Government war spending and borrowing increased interest rates, thus "crowding out" private investors who des-





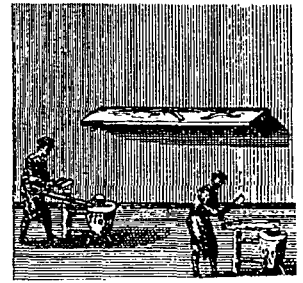
perately needed capital to construct new factories, build better canals, and design new inventions. Growth was present during the war, but it was excruciatingly small. In the long run, this meant fewer jobs and lower wages for the working class.

But, for the common man, the war had more painful and immediate consequences than slowing the rate of economic growth. Various government schemes to finance the war debt led to monetary instability and uncertainty. This monetary instability, coupled with severe harvest failures, led to rapidly increasing food prices throughout the Napoleonic Wars (Redford, pp. 89-93). In fact, food prices soared upward by more than twenty-five per cent (Williamson, p. 187). Considering that the British working class then only earned on the average little more than £11 per year, it is no wonder how these developments led to hardships and deprivation that invariably resulted in social unrest.

Although decidedly the most important, war was not the only form of government intervention that decreased the quality of life. Government monopolies, such as the East India Company and Cutler's Company, served to lessen economic efficiency and growth. The entire area of foreign commerce and trade was forced to contend with massive government regulation (Ashton, pp. 138-39).

Notwithstanding the popularity of pessimistic interpretations, the evidence of increasing real incomes and improving mortality rates indicates that significant improvement took place in the standard of living of the working class. These factors and other evidence also suggest that most qualitative aspects of the quality of life at least remained stable, and probably improved. This progress took place despite constant warfare and other counterproductive forms of government intervention that significantly hindered improvement.

While these immediate effects should not be overlooked, the real benefits of the industrial revolution are enjoyed by those living in today's world of comparative luxury and splendor. The industrial revolution was the "great discontinuity" that built the foundations for our modern society (Hartwell, 1971). It has led us into an age without the famines, epidemics, and other disasters that continually plagued preindustrial societies. Perhaps the only way to fully appreciate the impact of the industrial revolution is to look at those in the modern world who have yet to undergo industrialization. The fate of the hungry and disease-ridden peasants in such areas as Africa and India is perhaps the most forceful and convincing argument in favor of capitalism's industrial revolution. □



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# Toward Free Banking

**Moving toward  
a fully  
deregulated  
financial system.**

by Donald R. Wells  
and L.S. Scruggs

Dr. Wells teaches in the Department of Economics and Dr. Scruggs in the Department of Finance at Memphis State University, Memphis, Tennessee. This article is based on a paper presented to the Southwestern Economics Association in San Antonio, Texas, on March 20, 1986.

**M**ost economists consider money to be a special good that should be controlled by the national government. But advocates of free banking consider money a private good which, as any other good, must meet the market test of acceptability. Let us consider the advantages of free banking, and see how such a system might be implemented in the United States.

Under free banking, no government agency would grant a charter to allow a bank to operate. Banks would be free to begin operations as they saw fit, just as other businesses. They could acquire funds from any source: equity, deposits, banknotes, or other liabilities such as debentures; and pay whatever market conditions dictated on these sources. They could then use these funds in the manner most profitable to the bank as long as they avoided deception or fraud. They would hold whatever reserve they wanted—cash, securities or claims on a clearinghouse—wherever they wanted to hold it. Loans and securities would not be subjected to interest controls, nor would investment in any particular industry be mandated or forbidden. If so desired, banks could even acquire equity positions in other firms. The only role for government would be to prosecute fraud and enforce contracts, including settling disputes in court. Banks would not be subjected to government audits or made to pay any special taxes not levied on other businesses.

Money did not originate through some governmental body authorizing its use, but rather by the public and the market deciding what was mutually acceptable. Free banks could continue to offer to exchange their recognized and highly tradeable liabilities for the less well-known and less marketable liabilities of others. Traditionally, banks have persuaded the public to use banknotes and checkable deposits as money. The right to issue these notes and deposits was never a government prerogative, but the common right of all (Breckenridge 1895, p. 196). In the quasi-free-banking systems of the past, banknotes and deposits were normally convertible; that is, redeemable on demand in some reserve asset that the bank could not create, such as gold or silver. Central banks entered the picture and eventually monopolized the issuance of currency, leaving deposit creation to commercial banks.

Since currency became an outside money which banks could no longer issue, they could not exchange one liability for another—deposits for banknotes—as the public desired, but instead were forced to use up reserves or borrow from the central bank to placate public demand for currency. The ability to issue their own notes permitted banks to ease public fears about bank runs and to reduce funds tied up in till money, since unissued banknotes were not a liability on the bank's balance sheet, but were instantly available. This was especially helpful to Canadian and Scottish banks in minimizing the cost of operating branch offices (Breckenridge, p. 387; Beckhart 1929, p. 377; White 1984, p. 40).

Banks in an unregulated system would be free to open and close branches wherever they wanted. Branching allows banks to diversify their loans geographically and industrially, since banks would be in a position to acquire loan customers all over the country. An increased need for banking services in a particular area of a nation is met more readily by a new branch of an existing bank than by a new unit bank, which requires new directors and managers. Furthermore, within a given financial center, reserves can be moved among branches of one institution more quickly and cheaply than among institutions.

Branching would not be required, of course, but would face the test of the market. Experience from both Scotland and Canada shows that unit banks found it difficult to compete with larger branch banks and were frequently absorbed by them (Breckenridge, p. 146; White 1984, p. 36).

Many specialized thrift institutions, such as savings banks, savings and loan associations, credit unions, and trust companies, originated because commercial banks were legally barred from, or voluntarily eschewed, a particular field of lending. Free banking implies no restrictions on bank lending or investing; hence specialized thrifts would be necessary only for loan categories systematically shunned by banks.

**U**nlike the current arrangement, whereby the central bank controls the ultimate expansion of the money supply through its control of the money base, bank loan expansion under free banking would be controlled by the exchange of notes and deposits through clearinghouses. Banks that expanded their lending more rapidly than others would face adverse clearings and would be forced to curtail their lending unless they possessed more cash reserves than their rivals. These reserve assets could be deposits in the clearinghouse, gold, silver or some other “outside” money, such as Federal Reserve Notes (FRNs), which would be frozen in supply as were Greenbacks after the Civil War. If the Federal Reserve (Fed) were abolished, existing FRNs could serve as base money in a free banking system.

An individual bank could increase its reserves by a lending policy more restrictive than that of its rivals. The expanding bank would find its notes and deposits presented for redemption in reserve money; the more restrictive bank would gain reserves, as a smaller volume of its liabilities would be presented, by other banks, for payment through the clearinghouse.

However, the reserve base in an entirely free banking system could expand only if new reserve money entered from the outside. Since no

## Limit on Credit Expansion

FRNs would ever again be printed, the only avenue open would be an influx of gold or silver from other areas or from mining. But no central bank could expand the money base at will, imparting monetary disturbances to the economy.

Since no bank would be legally required to maintain any specific reserves, each bank would hold only the amount of the reserve assets indicated by its experience and liquidity preferences. Thus, if all banks in the system were to expand their lending by the same percentage, the check on them would *not* be adverse clearings, since each would be receiving from every other roughly the same amount of notes and deposits. Instead the expansion would be checked by each bank's desired holding of reserves plus the public's desired ratio of base money to notes and deposits. If the public trusted banks it would be unlikely to convert notes and deposits to specie or FRNs, but such a conversion would act as a brake on bank expansion.

White (1984, p. 44n) found that Scottish banks, during the late 1700s and early 1800s, were able to reduce their average gold reserves from 10 per cent and higher to 3.2 per cent as these banks gained more public confidence. In any case, credit expansion is limited in a free banking system, since the public will hold only a finite amount of any issuer's distinctive notes and deposits. But under our current system, there is no limit to expansion by the central bank, because the supply of its monopoly money will create its own demand, as the public has no choice but to hold whatever amount is created to support a higher level of nominal income and prices (Yeager, p. 42).

## Transition to a Free Banking System

**T**he first step to achieve a free banking system is to remove all legal obstacles to the production of "outside" base money plus all restrictions on private banking. The legal impediments to the production of outside money, according to White (1984a, pp. 297-98), include: (1) a prohibition on the minting of private coins; (2) a sales tax on the purchase of commodity monies; (3) a capital-gains tax on the holding of non-dollar currencies; and (4) uncertainty regarding the upholding by courts of the payment of a contract in anything but dollars, even when gold is specified. Removal of these barriers would signify that the field is open to any type of innovation that might seem profitable to undertake.

Simultaneously, Congress would have to abolish the Fed, freeing the existing supply of FRNs (the Bureau of Engraving can replace worn bills). The Fed would dispose of its assets, after buying back its stock from the member banks. Termination of the Fed could proceed as follows: (1) cease open-market operations and discounting; (2) require the Fed to buy back its stock from member banks by crediting their reserve accounts; (3) send all government securities and gold certificates to the Treasury for cancellation; (4) move the Treasury account to the commercial banking system; (5) let foreign central banks move their accounts wherever they wish; (6) phase out the Fed's check-clearing system, perhaps over one year, as deregulated commercial banks establish branches nationwide and assume the clearing function.

**Private Banking.** Equally important, however, would be total deregulation of private banking, concurrent with dismantling of the Fed. The immediate steps should be: (1) allow free entry with no charter needed from any governmental agency; (2) grant freedom to branch

anywhere; (3) abolish reserve requirements; (4) remove restrictions on the type of assets held; (5) abolish limits on interest rates paid or charged; and (6) allow banks to issue distinctive banknotes or even fractional token coins.

The freedom to enter without charter should reduce the forced difference between banks and thrift institutions. The unlimited branching will further erode this distinction as mergers occur between banks and thrifts. In addition, unrestricted branching will expedite the replacement of Fed check-clearing with private clearing. Unlimited branching will also lead to the end of correspondent relationships among banks and the holding of interbank deposits, a feature peculiar to the unit banking system. When allowed to branch, as in Canada and Scotland, banks hold insignificant amounts of the liabilities of other banks, and are insulated from contagious bank runs.

The abolition of reserve requirements would permit banks to escape the implicit tax with which they have been burdened since the beginning of the National Bank System during the Civil War; they could then earn profits on all of their assets, rather than about 90 per cent of them. A fixed percentage required reserve is the least liquid asset a bank has. When banks are permitted to hold any amount of reserve they want, their anticipated liquidity needs are the sole determinant of the amount and location of those reserves.

As an example, before the Bank of Canada was founded in 1935, Canadian banks faced no reserve requirements but held as desired reserves: outside money, call loans in New York and London, securities and commercial paper, and deposits in foreign banks (Beckhart, p. 430). Cash reserves were normally 10 per cent of total liabilities, but fluctuated between 8 per cent and 15 per cent. Banks watched the balance sheets of their rivals: the stronger ones kept the weaker in line by refusing to take checks drawn on them or refusing to lend to them in a crisis (Breckenridge, p. 433; Beckhart, p. 485). Most of the outside money (specie and Dominion Notes) was kept at the financial centers; the branches used mostly unissued banknotes as their till money. Since unissued banknotes are costless, this economy measure helped subsidize some of the branches in remote areas.

A similar situation could evolve in the U.S. under free banking. The cash reserves of banks would probably consist of FRNs at first, and then specie if the public displayed a preference for convertible banknotes and deposits. But secondary reserves would undoubtedly be invested in short term securities (such as Treasury bills, commercial paper, and bankers' acceptances) and call loans. No longer could banks consider themselves liquid merely because they could borrow outside money from a lender of last resort. Each would be responsible for its own liquidity, and any borrowing would have to meet the standards of the market.

It is also very important that banks again be allowed to issue banknotes if unregulated banking is to succeed. This enables banks to exchange one liability for another—deposits for notes—at the demand of the public, without disturbing the bank's reserves, or any other asset. In addition, these banknotes should be distinctive, not uniform as were the National Banknotes, and issued without pledging any specific asset, such as government bonds. Distinctive banknotes would meet the daily test of convertibility: Each bank would be anxious to



issue its own notes; upon receiving notes issued by others, it would return them to their issuers through a clearinghouse. To pay out the notes of another bank would be acting as a broker without fee; to hold them would be lending to the issuer without interest (Breckenridge, p. 407). Therefore, note exchanges act as a check on expansion just as check clearings do.

Allowing an unrestricted issue of banknotes, with no requirement to pledge certain assets such as government bonds, permits banks to supply the exact amount of currency that the public demands at the instant they demand it. Panics and bank runs can be avoided if the public is allowed to exchange one type of money—deposits for banknotes—when it wants. The panics of 1873, 1893, and 1907 in the U.S. resulted when the public could not convert their deposits to currency (Canadian depositors experienced no such difficulty). Many national banks in the U.S. found it unprofitable to hold the 2 per cent government bonds that were required to back their notes, thus were unable to issue enough notes to satisfy the panicky demand for currency. When banks tried to satisfy this demand by paying out their cash reserve (gold certificates, greenbacks, and other Treasury currency), they depleted their required reserves, and were forced to suspend payment.

**Deposit Insurance.** Another important step in achieving free banking is terminating the Federal deposit insurance that has existed since 1934. Deposit insurance was part of a system of strict regulation designed to save the unit bank system during the credit implosion of the early 1930s. It is rarely found in nations with a small number of large branch banks, even though Canada adopted a plan in 1967. But it is totally incompatible with free banking and thus would have to be phased out.

There are private options to government deposit insurance that should be explored. One such option could lie with the individual depositor. If uneasy about banking, this person could approach an insurance company about insuring his deposit. The insurer could diversify its risk by covering accounts up to a specified maximum in any particular bank, and then asking future clients to deposit in other banks where the insurer is covering smaller deposit volumes.

Another option lies with the banks themselves. They could alleviate public concern over safety by offering low-interest accounts with preferred claims on bank assets in case of liquidation. Another alternative, similar to the existing tax-and-loan account, would be to offer low-interest accounts backed by pledged securities. Other depositors would receive market rates but would have no special protection.

**Banknotes vs. Deposits.** Holding private banknotes rather than government fiat money would be a new experience for the current generation. Many may be reluctant to accept “funny money” at first, especially since holders of banknotes, unlike depositors, may not be customers of the issuing bank, but merely recipients of its notes in the course of business.

But banks could overcome the aversion to private banknotes in several ways. Banks could assume the risk for counterfeit notes. Scottish banks honored forgeries presented over the counter by innocent persons, but not those accepted by other banks and returned through clearings. This put the burden on rival banks to be on the alert for counterfeit notes. At any rate, counterfeiting is much more tempting

in a fiat-money system than in a free-banking system, in which the notes return quickly to the issuer (White 1984, p. 40). Banks could also offer to pay interest on any note not immediately redeemed in base money on demand.

Free banks could voluntarily offer multiple liability for stockholders if such proved reassuring to depositors and noteholders. Scottish banks operated with unlimited liability for their owners; Canadian banks and National banks in the U.S. formerly imposed double liability on their stockholders. The market might compel smaller, newer banks, but not large, well-established institutions, to impose multiple liability.

Banks could offer a mutual note guarantee exemplified by the Bank Circulation Redemption Fund (BCRF) that protected Canadian banknotes from 1891 until they were replaced by Bank of Canada currency. Banks contributed to a fund to redeem the notes of any failed bank, which notes were to earn interest until redeemed (Beckhart, p. 302). While this measure was successful in that the notes of even weak banks circulated at par all over the country, it put the depositor in a position inferior to that of the noteholder. In addition, this was not a voluntary arrangement but was mandated by the Bank Act of 1891. But in Scotland, when the Ayr Bank failed, other banks voluntarily advertised that they would accept Ayr notes, thereby bolstering confidence and gaining customers (White 1984, p. 32). A similar offer under free banking could include depositors as well as noteholders.

**W**hen a free banking system is established, reliance on a governmental lender of last resort should be avoided, even on a temporary basis. With the Fed abolished, it might be tempting to permit banks to borrow fiat money from the Treasury for a few years during the phasing out of the FDIC. Canadian banks were allowed to borrow Dominion Notes from the Minister of Finance in 1914 as a wartime measure, but this practice was not terminated when the war ended in 1918; it continued until the Bank of Canada began in 1935. Canada did not return to the gold standard until 1926, but this borrowing of base money from the government was incompatible with the gold standard, and the latter was abandoned in 1929 (Curtis 1932, p. 322).

A government lender of last resort is also incompatible with a free banking system, wherein each bank is to be responsible for its own liquidity. Free banks can borrow from one another at market rates, but a lender of last resort is needed only when one bank holds all of the outside money, as did the Bank of England during the 1800s (White 1984, p. 145). Under free banking, no bank would incur liabilities in some money that it could not issue.

**Coinage.** In addition to banknotes, private banks would also be responsible for new coins: full-bodied coins for reserves, and fractional, token coins for making change. The market gradually developed coins to expedite the assessment of the value of varying amounts of commodity money. Governments intervened to monopolize coinage to extract a profit for themselves. Coinage could have remained private, with inferior coins circulating at a discount (Selgin & White 1985, pp. 4-5). Private mints, faced with existing and potential competition, would have much less incentive to debase coins than would a state with a monopoly on coinage.

## A Temporary Lender of Last Resort?

Establishment of a free banking system requires that the Treasury cease minting its token coins, just as the Fed must stop issuing currency. However, the Treasury could be allowed one last profit by selling all its gold at Ft. Knox at market prices, ending any conceivable government role in money creation. This seems easier than the Timberlake (1984, p. 189) proposal to give everyone in the country an equal share. The existing quantity of Treasury coins would be frozen, joining the existing FRNs as part of the base, and still used as a medium of exchange. Banks, however, would issue new fractional coins, as well as banknotes. Professor Hayek has hypothesized that local merchants might collaborate to sell through banks a set of uniform coins or tokens to be used in vending machines, perhaps replacing metallic coins with plastic ones bearing electronic markings discernible to cash registers and slot machines (Hayek 1978, p. 48n). If the many U.S. railroads could agree on a standard gauge for tracks, banks and retailers can agree on a substitute for Treasury coins.

## Possible Concerns over Free Banking

**T**o those who have experienced only a government monopoly of base money, and central bank manipulation of that base, free banking may seem too radical, even though the inflationary record of central banking must inspire a search for alternatives. If money creation were divorced from the government, politicians would have to pay for their spending with taxes or real borrowing, but not by government monetization of deficits.

Critics may fear free banking would be deflationary, as the money base could grow only through additions to the gold or silver stock, since the FRN quantity would be frozen. But this ignores the possibilities of financial innovations to economize on base money, higher money turnover rates, and increasing confidence in the ability of banks to honor redemptions by the public. One Scottish bank in the early 1800s was able to operate with specie reserves of only 0.5 per cent of assets, revealing that the public may not demand specie when assured of its availability (White 1984, p. 141). Each competitive issuer can observe the demand for his money and adjust the supply thereto, a task no monopoly issuer can accomplish. Each bank must balance the desires of its depositors, who fear a depreciating money, with those of its borrowers, who would object to an appreciating money. But free banking does promise to end the inflationary bias that has crept into most wage negotiations and other long-term contracting. It is a system that would be consistent with more flexibility of prices and wages.

Other qualms about free banking may afflict bankers themselves who have spent their entire careers in a regulated environment. Older bankers may resist the adjustment; but younger, perhaps better educated ones might find a new, unregulated setting to be a stimulating challenge. Many large retailers and brokerage houses already have in place nationwide offices from which a new type of banking business may be conducted. The field may become dominated by those who were not bankers prior to free banking.

Because the U.S. system currently has no nationwide banks, as other countries do, growth in the number of banks to a competitive level may take longer than it would under unlimited branching. However, the system is not burdened with governmentally encouraged banking cartels that would stifle competition, and most interest ceilings have



been abolished. But American banks are still subjected to governmental insuring and auditing, practices incompatible with free banking.

Fortunately, no private U.S. bank is a government pet, like the Bank of Montreal (BOM) or the Bank of England (BOE). No American bank would be the government's fiscal agent: Over 11,000 banks currently hold tax-and-loan accounts of the Treasury; if the Treasury closed its account at the Fed, no single private institution would play the role of the BOM or BOE. Vis-à-vis the banking system, the U.S. government would be neutral, having no independent Treasury funds to deposit at various times, as was the case before 1914.

Finally, free banking is most likely the system that would have emerged from normal market forces, had governments not interfered with banks and money by imposing specific bond-holding for note issue, mandating fixed percentage reserve requirements, forbidding branching across state lines, and creating a central bank to expedite inflationary governmental finance. □

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## LIBERALISM: IN THE CLASSICAL TRADITION



Ludwig von Mises

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# The Ethics of Privatization

**Without a firm moral defense, the move to privatize may founder.**

by Tibor R. Machan

Dr. Tibor R. Machan is Professor of Philosophy at Auburn University, Auburn, Alabama, and Senior Fellow of the Reason Foundation and author, among other works, of *Human Rights and Human Liberties*. The book he edited for Random House, *The Main Debate: Communism versus Capitalism*, will appear in 1987.

This essay is based on a talk delivered February 19, 1986, before a Symposium on Privatization organized by the International Chamber of Commerce and the Institut Économique de Paris, in Paris, France.

Privatization springs from our Western liberal political vision, two-and-a-half centuries old. This vision conceives individuals and their voluntary institutions—churches, corporations, professional associations, labor unions, and the like—as the source of the values of civilization. The economy is capitalistic, based on the right to private property. The State is a supporting mechanism, as referees are to sporting events. The work of living and developing life's values are tasks for free human beings. The State serves them when conflicts arise.

But this Western liberal vision has lacked a moral defense. It has had the backing of experience and common sense, and has led to greater prosperity than alternative visions. However, the righteousness of Western prosperity—that it is deserved, not in need of apology—is felt to be uncertain. Thus the system to which prosperity is linked by common sense—capitalism—is generally left undefended, constantly called into doubt, never praised as is socialism in various intellectual circles, despite socialism's undeniable record of failure.

The relatively free portion of the globe could be even more prosperous, as the privatization movement has demonstrated. But again the case for this is made only pragmatically. Even the politicians are persuaded, temporarily, that the business of keeping nations reasonably wealthy should be left to the private sector. But because their belief rests on the view that making an economy more free will enhance the general welfare, there persists doubt about the more basic question: Is privatization a morally worthwhile, respectable idea?

The pragmatic case resting on successful production of riches is not the central defense of the West. Privatization itself must be embraced not merely as an efficient means to rescue economies but as a return to the West's initial commitment to set people free of each other's and their governments' oppressive actions.

It is vital to understand the moral case for freedom and privatization also for the practical value of it. Privatization entails some upheavals for various people. What of the employment dislocation involved in privatization? Vested interests are not sitting by without protests and arguments invoking compassion and equity. They charge privatization advocates of thinking only of the bottom line, the financial concerns

involved. Is that not ethically objectionable? Should some people be sacrificed to the advantages of privatization? Does not the state's involvement ensure more concern with fairness and justice? Sometimes it is argued that removing some service from the sphere of the state will mean that only where a profit can be made will the service be available. Is it right to neglect those who may not help to make a profit for the private business that takes over the service?

The idea that freedom of enterprise might again attain public respectability instills fear in the hearts of many spokesmen in newspapers, magazines, books, and radio or television talk programs. And their skepticism—whether sincere or malicious—can be extremely debilitating, unless their arguments are faced by a morally sound defense. The only thing that can accomplish this is a confident and intelligent moral defense of privatization.

Free trade needs to be shown as a noble, not just useful, policy. If the newest aspect of capitalism, privatization, is to remain a sustained public policy in the non-communist world and manage eventually to attract the thawing Soviet bloc as well, it must be shown to be morally justified. To win men's minds *and* souls, their concern with the basic question of whether some act or policy is consistent with how human beings *ought to live their lives*, in addition to efficiency considerations, must be addressed.

**I** will start with the elementary observation that commerce is an aspect of life by which men and women aim at improving their and their loved ones' well-being here on earth. Commerce is the institutional expression of the virtue of prudence in human life.

A prudent person takes care of his economic requirements. It probably will not be his main goal in life, and prudence is by no means the highest human virtue: But it's clearly virtuous to attend to one's economic existence. And it is thus proper, also, to have this attention develop into an institution among human beings within their variously sized communities.

Any effort then to thwart commerce is open to serious moral question. When done by force, however, there is no doubt that something evil is being done. Prudence is a genuine, bona fide human virtue in almost every major moral system on earth. Furthermore, in any bona fide moral system the freedom to choose between right and wrong is an essential ingredient in the moral life of a person. If not free, a person cannot be held morally responsible.

Of course, prudence is not the only virtue. Many others, such as courage, honor, honesty, justice, generosity, moderation, and the like, are of equal or higher moral significance. Yet those, too, can be practiced only in a genuine free society. The freer the society, the greater one's opportunity to live in the way appropriate to a moral agent. The more the society allows some people to dictate to others how they must conduct themselves—including in the economic sphere—the more it limits human dignity, the range of a person's sphere of individual responsibility.

But this is not all there is to the story. What we have is sound, but there is not enough moral punch to it: It is all true but not sufficiently inspiring. We need to point out that the kind of life associated with commerce is not just permissible, but often honorable, even noble.

## Prudence

Adam Smith provided the clue in the following remarks:

Ancient moral philosophy proposed to investigate wherein consisted the happiness and perfection of a man, considered not only as an individual, but as the member of a family, of a state, and of the great society of mankind. In that philosophy the duties of human life were treated of as subservient to the happiness and perfection of human life. But when moral, as well as natural philosophy, came to be taught only as subservient to theology, the duties of human life were treated of as chiefly subservient to the happiness of a life to come. In the ancient philosophy the perfection of virtue was represented as necessarily productive to the person who possessed it, of the most perfect happiness in this life. In the modern philosophy it was frequently represented as almost always inconsistent with any degree of happiness in this life, and heaven was to be earned by penance and mortification, not by the liberal, generous, and spirited conduct of a man. By far the most important of all the different branches of philosophy became in this manner by far the most corrupted.

Smith's remarks suggest that the ethics that supports capitalism and its current offspring, privatization, may be found in the U.S. Declaration of Independence. There the rights to life and liberty are linked with the right to the pursuit of happiness. To pursue human happiness in a diligent, conscientious, honest, and courageous manner, men and women everywhere require political and economic liberty. What must be stressed is, in Smith's words, that "virtue [must be] necessarily productive to the person who possessed it, of the most perfect happiness in this life."

That is the point of an ethical system, namely, to give a person meaningful, principled guidance in his life. And it is once such an ethics is identified that we learn it does not support socialism, fascism, communism, or some other collectivist system, but the free society with its legal system that protects freedom of thought, freedom of religion, freedom of trade, freedom of contract, and freedom of enterprise.

## Economic Egoism?

Of course, capitalism has often been linked with the idea that men are selfish and that it is the only economic system that properly accommodates this fact. The cruder renditions of Adam Smith so interpret him. Most notably, of course, it was Karl Marx who linked the system of private property rights with callous selfishness, when he noted that "the right of man to property is the right to enjoy his possessions and dispose of the same arbitrarily, without regard for other men, independently from society, the right of selfishness." And many modern economists, too, link the system with this kind of crude, narrow egoism which they have inherited from the English philosopher Thomas Hobbes. They often do this in a desperate effort to make capitalism scientific, to pretend that some pure, normatively neutral, value-free analysis commands us to choose the system.

But, the narrow economic idea of egoism is false: People do not in fact automatically seek out what is best for them—if it were only so, we would live in a wonderful world. Nor do they always know what is best for them—that too would be very helpful if it were so. Rather,

people must work very hard to learn what is best for them and then try hard to obtain it. But this philosophy of humanist selfishness or individual happiness is something very different from what most people link with capitalism. It is demanding. Again, Adam Smith noted its nature quite clearly when he wrote that "It is not the love of our neighbour, it is not the love of mankind, which upon many occasions prompts us to the practice of . . . virtues. It is a stronger love, a more powerful affection, which generally takes place upon such an occasion, the love of what is honourable and noble, of the grandeur, and dignity, and superiority of our own character." As Smith shows, a genuine concern for ourselves is a demanding and indeed noble pursuit. Our task in life is to seek human excellence.

Here we get a clue to the answers to the several moral questions generated by privatization. Free trade is a necessary requirement of a dignified human life. We cannot justify compromising it even for such good causes as employment security, guaranteed welfare, concern with the possibly neglected minority whom it may not be profitable to serve, and so on. Such a compromise may appear to be appealing when one considers only the plight of the few who do not immediately benefit from privatization. But when we realize that a political-economic system must serve the morality of individual self-development, not of self-sacrifice, then clearly privatization is on sound moral grounds and its detractors must attempt to solve the few problems associated with it without compromising it.

**I**t is those who are doing the work within the free sectors of the world, including the newly privatized regions, who must defend it in our time. We cannot count on intellectuals—most of whom live off the state and are convinced that the state is superior in its intentions and capabilities to the agents in the free market.

The defense of the free society, including its newest manifestation, privatization, must be conducted on the philosophical front first. It need not exclude mention of the material benefits such a system tends to bring to people in any society. But what is more important is that it affords the freedom for everyone to make moral choices in life, including one's commercial endeavors, and that such choices are rightfully aimed at enhancing the welfare of the economic agents and those to whom they stand closest in society—family, friends, colleagues, neighbors, roughly in that order of importance.

Humanity is not some one body, one large person, whose welfare we must serve the way our livers and hearts serve the welfare of their owners. Humanity is you and me. If we are not free to do the most with ourselves, if we cannot be left to ourselves to seek human excellence in life, that task is not going to be achieved by anyone. Any contrary message rests on dreams, not on a clear awareness of the facts.

The privatization movement has a lot of promise and must go much further than it has already toward freeing up the economic lives of human beings. It should avoid promising panacea, however—it should not fall prey to the temptation of the utopians who think some system alone will solve all our societal problems. And most of all, the movement must stress its own moral legitimacy. Without that it will be a mere passing fancy. □

## Defending the Free Society

# We Would Be Wise To . . .

**How best to  
supply the  
goods and  
services  
consumers value  
most.**

by Dale M. Haywood

Dr. Haywood teaches economics  
at Northwood Institute, Midland,  
Michigan.

**D**uring the past several decades, government has become a primary provider of education, mass transit, fire protection, garbage collection, road repair, and park maintenance. We may have been lulled into thinking that government is the *best* provider for such services. What's more we may have almost unconsciously come to believe that government can be the *only* provider of some of these goods and services.

But does government perform these economic roles as we assume it does? In those instances where government *is* doing the jobs, is it doing them at the lowest possible cost?

To answer our questions, we will examine two government-provided services: restaurant food preparation standards and air traffic safety. These services affect us all. They are also representative of most other government-supplied goods and services.

Federal, state, and local governments traditionally have sought to insure that employees in restaurants and other public eating places prepare and serve food at least as hygienically as the codes require. Governments employ a swarm of inspectors to enforce their complex web of regulations. Underlying this regulation/inspection system is the premise that if there were no regulations and inspectors, unscrupulous restaurateurs would harm unwary customers by preparing and serving food under unsanitary conditions. In theory, the regulation/inspection arrangement insures that this won't happen.

There is some evidence, however, that this is not the actual practice.

*The Mirage.* After years of complaints by owners of small businesses in Chicago of the day-to-day corruption they endured, *The Chicago Sun-Times* decided to investigate. The Better Government Association joined with the *Sun-Times* in its investigation. The strategy these two organizations chose was to buy a bar and restaurant and run it themselves. The newspaper's reporters became "waiters." Its photographers became "plumbers," who periodically visited the restaurant to make "repairs." They called their restaurant *Mirage*.

The *Sun-Times* people deliberately created health and safety hazards—and waited to see what would happen.

In four months of operation, they found themselves encountering:

- Payoffs of \$10 to \$100 grabbed by city inspectors who ignore health and safety hazards when the price is right.
- Shakedowns by state liquor inspectors who demand whatever is in a tavern's cash register for their silence about liquor violations.
- Tax fraud by accountants who conspire with taverns to cheat on state and federal taxes in a practice so widespread it may be costing Illinois \$20 to \$50 million in sales taxes alone.
- Misconduct and negligence by public employees who loaf on the job, use city equipment for private gain and routinely demand cash under the table for what should be public services.
- Illegal kickbacks, tax skimming and offers of political fixes from jukebox and pinball machine operators—including one former policeman who alone may be failing to report a half million dollars a year in taxable income.

City inspectors marched through the Mirage, hands out and eyes averted, ignoring city code violations for \$10, \$50, \$100 on the side. It was the payoff parade come to call (*Detroit Free Press*, January 15, 1978).

Yes, there probably are some unscrupulous restaurateurs. But the *Sun-Times'* experience with the Mirage proves that there are some unscrupulous health and safety inspectors, too. Such experiences may quite rightly cause us to doubt if *any* of governments' regulation/inspection systems do in fact accomplish what many of us assume they accomplish.

Is another layer of regulations and inspectors the answer? That's doubtful. Almost certainly there would be some dishonest inspectors among this group also. So a second group of "policemen" to police the first group of "policemen" probably wouldn't get us closer to our goal of hygienically prepared food in public eating places—or to any of the other goals of governments' regulation/inspection systems.

Indeed, one can't help but wonder which is the more dangerous situation: (A) patronizing a restaurant with no suspicion about its sanitation practices because you believe that governments' regulations and inspectors are looking out for you, when in fact they are not, or (B) patronizing all restaurants with skepticism, because there is *no* effort by government to protect you. Mightn't consumers with attitude A be the more vulnerable?

**S**o how are we going to realize our goal of healthful food preparation in public eating places? Let's consider some voluntary, free market responses to John Q. Public's demand for safe restaurant food.

*Bill Knapp's.* Bill Knapp's is a chain of sixty restaurants that serve moderately priced food. The restaurants are located primarily in Michigan and Ohio. The owners of this chain have responded in various ways to the concern they believe their customers have for wholesome food. One of those responses is in the physical configuration of the restaurants.

The sixty stores have an identical floor plan. It's a huge T. Every diner enters at the base of the T. The host then ushers patrons to

## Voluntary Market Responses



Interior of Bill Knapp's shows T-shaped design.

seating in one of three areas: the base of the T, in a separate dining room that forms the left half of the top of the T, or in another dining room that forms the right half of the top of the T.

The kitchen is located at the junction of the base of the T and the top of the T. And it is largely exposed. Thus, irrespective of which of the three dining areas they are seated in, all guests get a good look at the kitchen en route to their tables.

It's impossible to say what portion of Bill Knapp's thirty-eight years of success is due to this kitchen-disclosure feature of the chain's restaurants. But it seems likely that this device is a significant factor.

*The Embers.* In Mt. Pleasant, Michigan there is a fine restaurant that's been satisfying its customers since 1958. It's called *The Embers*. At this restaurant, meals are moderately expensive. The owner of *The Embers* caters to a different segment of the market than Bill Knapp's.

The ambiance at *The Embers* contrasts sharply with the atmosphere at Bill Knapp's. Where at Bill Knapp's there is an openness, there is an intimacy at *The Embers*, with its numerous alcoves separating the diners from each other and giving them a sense of privacy. The kitchen is unobtrusive. Management seeks to make the preparation and handling of most of the food about as *inconspicuous* as possible.

So what's the free market mechanism protecting diners at *The Embers*? A simple invitation printed on the menu, an invitation to each guest to inspect the kitchen personally.

My wife and I had patronized *The Embers* several times. Each time, after reading the invitation to inspect the kitchen, I kept saying, "We ought to do that sometime." It was on our fourth or fifth visit that I overcame my inertia. As we were exiting, I asked the hostess when we might take the owner up on his invitation. She responded, "How about right now?"

The message in her response was, "We are proud of our kitchen at *all* times. It's not something we get in shape only when company is coming."



We took the on-the-spot tour and were favorably impressed. Obviously, there's no paying off the "inspector" under this arrangement.

**L**et's consider another economic service we all value, air traffic safety.

When commercial aviation was in its infancy, the private, for-profit airlines set up Air Route Traffic Control Centers in major cities in the eastern and northeastern regions of the United States. These facilities, basically control towers, provided a modest degree of air traffic control within a fairly short radius of the cities where they were located. This was a reasonable system for its time.

But when the federal government offered, shortly after the Great Depression, to take over the system and operate it for "free," the airlines quickly accepted. Since then, the Federal Aviation Administration (FAA) has assumed, among other duties, the major responsibility for air traffic control. In an article in *Private Pilot* (October 1984), Kevin Murphy reported: "From the rather primitive early efforts at control, air traffic control sprang into the full-fledged, all-encompassing system we have today, with control towers, air route traffic control centers, flight service stations and controlled airspace from top to bottom. No reasonable pilot can argue today that the modern ATC (air traffic control) system does wonders for collision avoidance, but they can argue about one thing: cost."

Just how costly is the air traffic control we are getting from FAA? Because there are a few privately owned, for-profit firms operating airport control towers in the United States we can answer this question. According to Murphy: "Private operators spend an average of \$96,000 a year to staff and maintain a small airport tower, one third of the average FAA cost of \$294,000 per year." Of course, price is just one dimension of an economic good. What about the quality of service provided by private firms such as Barton ATC and Midwest ATC?

"We're very happy with our control-tower service," says the manager of the airport in New Iberia, Louisiana. "The folks here always have acted and conducted themselves in a very professional manner. They're very easy to work with, and their level of performance is very adequate."

A Frontier Airlines pilot reports, "These are good people to work with. They'll give you anything you want. I've never had a problem with any of them."

No private firm has a government-guaranteed monopoly at any airport it serves. The manager of the airport in Enid, Oklahoma observes that the threat of being fired is a powerful stimulus to private air traffic controllers: "If controllers . . . don't do a good job, they won't be around next year."

Perhaps a still more significant tribute to the private ATC firms comes from the government itself. In 1983, the federal government sent a team to evaluate the Farmington, New Mexico tower operated by Midwest ATC. The team reported: "Midwest ATC is providing satisfactory ATC service and has an excellent working relationship with users and airport personnel, as well as other FAA facilities. The relationship between controllers and pilots is the best it has ever been."

The evidence is clear. Private, profit-seeking air traffic controllers do at least as good a job of providing safety in air traffic as their FAA

## Air Traffic Safety

counterparts. And private firms can do it at a fraction of the cost. Wouldn't it make good sense to have the private firms, as the proven superior providers of air traffic control, operate *all* of this nation's control towers? According to a report cited in *Reason* magazine several years ago, the nationwide replacement of FAA towers with private towers would save United States taxpayers about \$25 million per year!

## Conclusion

**A**re governments always providing the economic goods and services we assume they're providing? If the service in question is sanitary food preparation, the answer is "no." The experience of *The Chicago Sun-Times* and the Better Government Association with the Mirage is proof of that.

Can the private sector provide this service? The answer is "yes." And when it is provided as Bill Knapp's and The Embers have provided it, it can contribute to the growth and longevity of those restaurants that deliver it.

*One Principle.* Where there is a free market, there is competition. The employees in competitive enterprises have to woo customers. In order to do so, they must be attentive to their customers' wishes. There are no exceptions.

So if the business is a restaurant and the wish is for hygienically prepared food, it is in the self-interest of the owner and employees of that restaurant to prepare food hygienically. And if customers want the same amount of hygiene, restaurants will provide basically the same standards of hygiene. If customers want different amounts of hygiene, restaurants will have different standards of hygiene.

Perhaps we would be wise to take a closer look at *all* the goods and services we are supposed to be getting from government. Maybe we're not getting what we assume we are in education, mass transit, fire protection, garbage collection, road repair, park maintenance, and so on. Maybe politicians, bureaucrats, inspectors, and other government employees are arbitrarily determining what we're getting, because they are shielded from the wishes of consumers.

In those cases where government is providing a valued service, is it doing so at the lowest possible cost? By contrasting FAA-supplied air traffic control with air traffic control supplied by private, for-profit firms such as Barton ATC and Midwest ATC, we discover the answer is definitely "no." There is a simple explanation for this.

*A Second Principle.* Whenever a job is done by a profit-seeking firm, there is someone who stands to gain if the firm makes a profit. That someone can improve the firm's chances of making a profit if he can hold down or cut costs. When someone is motivated to hold costs down, it's more likely that they will be held down. That motivation is stronger among the people who own and work at Barton ATC and Midwest ATC. Because the FAA is not a private, profit-seeking organization, that motivation is weaker among FAA employees.

Perhaps we would be wise to rely more on private, profit-seeking firms if we want to get the goods and services consumers most highly value—and be more certain of getting them at the lowest possible prices. □

# How the West Grew Rich

by John Chamberlain

Students of Hayek, Mises, and Milton Friedman will find much that is an old story in *How the West Grew Rich* (351 pp., Basic Books, \$19.95), but Nathan Rosenberg, a Stanford professor of the history of technology, and L.E. Birdzell, a lawyer, have collaborated to produce a book with certain subtle differences.

To begin, Rosenberg and Birdzell stress the geographical factors. The Europeans often trailed the Chinese in inventiveness, but the Chinese mandarin was self-satisfied, thinking China, as the center of the world, had all it needed without building up foreign commerce.

Europe, on the other hand, was fragmented, a big peninsula that had its own smaller Scandinavian, Greek, Italian, and Spanish peninsulas, plus the British Isles just off the northwest coast. Water travel by sea and river between the fragments was easy. After the collapse of the western Roman Empire nobody, not even Charlemagne, was able to put the fragments together politically.

The feudal system resulted in attempts to sustain local autarchies, with all production centered on the manor, but there was always the question of the need for raw materials (iron for the soldier's armor, for instance), which meant that there had to be

trade. The disintegration of political authority into the hands of often quarreling local barons resulted in many modes of travel and warfare. European pluralism came before capitalism. The necessity for trade called forth the early towns, a prerequisite for supplying needy barons and kings. The medieval church frowned on interest and had ideas about the "just price," but the traders in the towns were irked by limitations that affected their buying and selling. So the market system came into being, with free pricing replacing the fixed "just price."

## Fad, Fashion, and Fascination

The market called for inventiveness. But Rosenberg and Birdzell warn their readers to beware of any direct causal relationship here. Their point is that man is curious and seeks knowledge for its own sake. In a time when agriculture was the occupation of the great majority, there was no special need for clocks. Planting and reaping were done by the sun. Nevertheless, horology became an early medieval fad. The making of clocks and watches, status symbols at the beginning, called for extreme mechanical ingenuity, which came long before the industrial revolution. One must allow economic need to include fad, fashion, and fascination with

complex mechanisms if one is to sustain the ordinary pattern of causal relationship of economic need to technological response.

Marx and Engels saw history as the displacement of one class by another. There is truth in this, but Rosenberg and Birdzell offer proof that the process is normally devoid of revolutionary sharpness. In England the landed aristocrats, who often had coal beneath their sheep runs, simply became part of a new *haute bourgeoisie*. And, working backward, the self-made bourgeois manufacturer often used his profits to buy his way into the landed classes. Where there is such an interchange, and with labor getting eighty or even ninety per cent of the gross national income anyway, there isn't much likelihood of sharp changes in modes of governing.

The steam engine made a great difference in modes of production, however. But even here Rosenberg and Birdzell insist there was a cushioning process. They tell us that the shift from cottage industry to factory production did not require the accumulation of vast quantities of capital. Arkwright's first Cromford mill was insured for only 1,500 pounds. Multi-

story spinning mills were to come in due time, but the early factory owners had twenty years of often big profits behind them and hence no need for savings squeezed out of reduced consumption to extend their investments. It was true that consumption suffered in the early years of the industrial revolution, but this was because of the Napoleonic wars. The early factory workers in England had to scratch for housing because timber couldn't be imported from Scandinavia.

Rosenberg and Birdzell find it peculiar that some two hundred years elapsed between the time of Galileo and the full use of advanced scientific knowledge by industry. Most of the inventiveness of industry before 1880 came from skilled artisans who often lacked college educations. Henry Ford and Thomas Edison were simply inspired amateurs from the orthodox scientific point of view. Today, of course, industry is always ready to hire inventive scientists away from their universities.

When it comes to opening new perspectives *How the West Grew Rich* is a first-rate job. But it would have benefited from good editing of its often extremely redundant style. □

## Ways to Save “The Permanent Things”

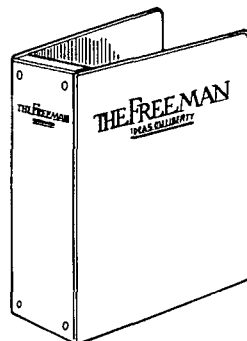
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# THE FREEMAN

## IDEAS ON LIBERTY

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## PERSPECTIVE

### Seize the High Ground

If liberty is to prevail in its intellectual struggle with socialism, its friends must *seize the high ground of morality*. The free market, private property, minimal government approach to society is right morally. All the varieties of socialism, interventionism, forced welfare, redistribution, and so on—any interferences with the peaceful pursuit of happiness—are wrong. Over and over again, friends of liberty must point out, politely but steadfastly, that all interventionist schemes are wrong because they require a gun to be pulled on peaceful people. The socialists have had the high moral ground too long, because no one has opposed them. They cannot hold it in the face of reason and clearly articulated principle.

The principle of liberty and property—the right of all people to use their own lives and possessions in peaceful pursuit of the good as they see it—is a sacred principle not to be compromised. It is the foundation on which the just and happy society is built. We must stress its importance, and the disasters that occur when we tamper with it.

One Sunday morning last year, when the *New York Times* carried its heart-wrenching, front page picture of Ethiopian refugees trudging across baked wastes toward the Sudan, a friend asked if I would not justify taxation for such a good cause as the relief of those emaciated souls. Shouldn't the right to property come second to relieving suffering of that magnitude?

I replied that the Ethiopians were starving precisely because their right to property had been put second. To endorse taxation for the relief of the starving Ethiopians would be to endorse the essential moral wrong that underlies their starvation.

Any person who proposes government force against peaceful people

should be reminded politely but firmly that the principle is wrong. The means are wrong. They are not allowable, whatever the ends. Eventually those means lead to destruction.

—HB

## Inflation in Brazil

Brazil attracted worldwide attention several years ago when it adopted “indexation” in the attempt to make inflation tolerable for the masses. This scheme provided for wages, salaries, rents, and mortgage payments to rise automatically each month to compensate for the inflation. However, the government did not halt the monetary expansion via the printing press or bank credit. Thus the economic crisis continued, with the irregularities and inequities inflation always brings.

To alleviate the developing crisis, the Brazilian government has now adopted new measures to freeze prices and control salaries. And it has introduced a new currency, the “cruzado.” However, according to *Visão*, a leading Brazilian news magazine, “The real cause of inflation—excessive expenditures by the Government financed by the printing of new money—is not even considered.” *Visão* goes on to say that “The official position . . . gives no assurances that the Government will cease its inflationary tactics while the prices are being frozen. So, what we have is ‘repressed inflation,’ . . . which only helps to camouflage the present crisis.”

*Visão* compares the situation in Brazil to that in Chile under the Marxist regime of Allende. “A feeling of general animosity has been raised against the business community and the supermarkets and department stores have been the targets of mob violence.” *Visão* equates the Brazilian government’s economic package with “a leftist coup . . . an extreme case of

State intervention in the economy and an assault on individual rights.”

—BBG

## The Tin Cartel

The tin cartel recently collapsed—under the weight of human ingenuity. The International Tin Council (ITC), which consisted of 22 member nations, worked to hold the price of tin above market-clearing levels. The ITC relied on a “buffer stock” of tin purchased or contracted for to smooth out fluctuations in tin prices and to hold prices up. But artificially high prices proved to be the cartel’s undoing.

In addition to calling forth new supplies of tin from previously undeveloped sources, higher prices spurred changes on the demand side. Every increase in the price of tin brought new minds to bear on the “tin problem,” searching for ways to use less and to substitute alternate materials.

High prices led to so many innovations in the use of tin substitutes that tin deposits are now less valuable than they otherwise would have been. As a recent *Wall Street Journal* article pointed out, tin cans have lost their place as the primary container for beverages, and that change probably is irreversible.

Human ingenuity created the myriad uses for tin, and this same ingenuity has discovered substitutes for tin. The rate of discovery and substitution is related to the price of tin and the prices of substitute materials. If prices are held artificially high, as was done by the ITC, they convey false information about the availability and mining costs of tin.

Thanks to the International Tin Council, and the entrepreneurs who reacted to higher prices, there are now fewer uses for tin, and more for aluminum, plastic, and paper.

—GFR

# A Christian Speaks Up for Capitalism

**Christianity and capitalism as allies rather than enemies.**

by James D. Gwartney

James D. Gwartney is Professor of Economics at Florida State University and an Associate of the Political Economy Research Center.

**M**any Christian leaders—evangelical, mainline Protestant, and Roman Catholic—appear to have a feeling that capitalism is unfair and needs more government intervention to keep it humane. While many of us who are both Christians and economists consider this view misguided, we sometimes lack arguments to help change this view. I'd like to offer a few.

What I am defending when I speak of capitalism is a social order that provides for the protection of one's possessions as long as they are acquired without the use of violence, theft, or fraud; and that relies primarily on free-market prices to allocate goods and services—the fundamental social system of the United States. Here are some reasons why Christians might think more charitably about it:

***Capitalism rewards and reinforces service to others.*** Under capitalism, a person's income is directly related to his or her ability to provide goods and services that enhance the welfare of others. Business winners are those who figure out what customers want and offer them a better deal than they can get elsewhere.

Moreover, such enterprises put pressure on other businesses to serve customers better—as you know if you have observed how retailers respond to the opening of a new discount store. Of course, people in business do not have to care about other people, as Christians are directed to do. But if they want to succeed, they must serve their customers better than the competition. In essence, competition forces business people to act *as if* they care about others.

***Capitalism provides for the masses, not just the elite.*** To succeed in a big way under capitalism, you have to produce something that appeals to many people. Henry Ford became a multi-millionaire by bringing a low-cost automobile within the budget of mass consumers. In contrast, Sir Henry Royce died a man of modest wealth. He engineered a far superior car to Ford, the Rolls Royce, but he designed it for the rich. The market rewarded him accordingly.

***Capitalism provides opportunity for achievers of all socio-economic backgrounds to move up the economic ladder.*** It is no coincidence that poor people around the world flow toward capitalist countries rather than away from them. Poor Mexican laborers risk their lives for work opportunities in the U.S. In Europe, the Soviets built a wall to keep people from the capitalist West. In Southeast Asia, people are drawn to Hong Kong, Taiwan, Thailand, and other capitalist countries. Why?



Because capitalism provides opportunity for those who want to achieve.

In the U.S., previously poverty-stricken refugees are succeeding as restaurant operators, taxicab drivers, and business entrepreneurs. A recent study found that nearly half of the families in the bottom one-fifth of the U.S. income distribution in 1971 made significant moves up the income ladder by 1978. No other system provides more opportunity for advancement, with fewer built-in social rigidities.

Downward movement takes place, too: Riches today do not guarantee success tomorrow. Like the God of Christianity, capitalism is "no respecter of persons."

*Capitalism provides for minority views.* When decisions are made politically, minority views are often suppressed. For example, in a public school system the political majority decides whether prayer will be allowed, whether sex education will be taught, and how much emphasis to give to basic skills. Those who do not like the decision must either give in or pay for education twice, once as a taxpayer and once in the form of private tuition.

A market system would allow each minority to get its way. For example, without interfering with others' freedom, some parents could send their children to schools that allow prayer. Committed Christians, who often find themselves in the minority, should appreciate this aspect of capitalism, which permits people to pursue divergent goals without conflict or rancor.

Even those who accept these strengths may still feel that capitalism is too materialistic. It is true that this system enables people to attain prosperity, and some people get caught up in the pursuit of wealth. But capitalism does not force individuals to worship "the almighty dollar." A person is as free to be an ascetic Christian as to be a hedonist.

Christians sometimes argue that capitalism promotes inequality, working to the advantage of the rich. Yet inequality is present under all economic systems. The people with better ideas, more creative minds, and more energy will tend to rise to the top in a socialist bureaucracy just as they will in a capitalistic system.

However, elites in a capitalistic system actually have less power than elites in a system where the government predominates. Even in a democracy, elected officials have more power over the lives of others than the wealthiest individuals do. Members of Congress have the power to take a portion of our earnings without our consent, something that David Rockefeller or the Hunt brothers cannot do, no matter how rich they are. Furthermore, if wealthy individuals use their wealth unproductively—that is, for consumption rather than investment or to supply things other people reject—their wealth will shrink over time. Even a "fat cat" living off stock dividends receives those dividends only if the business provides things that people want.

Of course, capitalism does not impose the moral demands that Christianity does. But economic systems seeking to perfect human nature have more often led to tyranny than to bettering the human race. Christians would do well to settle for an economic system that reinforces Christian virtues, improves living standards, and provides for minority views. Capitalism is such a system. □

# Churches and the Social Order

**The church plays an important role in human life.**

by Edmund A. Opitz

The Reverend Mr. Opitz is a member of the staff of The Foundation for Economic Education, a seminar lecturer, and author of the book, *Religion and Capitalism: Allies, Not Enemies*.

**I**t was once the unwritten rule in polite society that two topics have no place in civilized conversation; religion and politics. It was ill-bred to discuss religion; it was gauche to talk politics. But times have changed. We live in a different and more open age. Now we discuss religion for political reasons, and we talk politics for religious reasons! The Bishops issue a Letter; the highest dignitaries of the various denominations pronounce on matters of government and business. The people behind these proclamations represent only a tiny minority of the total church membership, but they presume to speak for everyone. What they say is, in effect, the Socialist Party platform in ecclesiastical drag.

These ecclesiastical documents focus on an economic malaise, poverty; the poverty of the masses, especially the masses of the Third World. Churchmen profess to know the cause of this poverty. Third World poverty is caused by the wealth of the capitalistic nations; *they* are poor because *we*, in becoming wealthy, have pauperized them. Likewise, within our own nation the wealth of those who are better off is gained at the expense of those who are made worse off in the process. These are the typical allegations: the rich get richer by making the poor poorer.

Ecclesiastical myopia views the market economy—or capitalism—as an evil system which, by its very nature impoverishes the many as the means by which the few are enriched. The suggested cure for these differentials in wealth is to use government's power to tax to exact tribute from the rich, and then distribute the proceeds to the poor—minus the cost to the nation of these wealth transfers. Robin Hood robs the rich to pay the poor, but Robin takes his cut!

It is as if these churchmen had swallowed the current secular agenda to which they have merely added oil and unction; as if social reform were the end, religion the mere means; as if religion has little more to offer modern men and women beyond what they can get from contemporary liberalism or socialism. The church has a more important

role to play in human life, as I shall suggest in the course of this article.

One of my favorite modern theologians is the late William Ralph Inge. Inge was the Dean of St. Paul's Cathedral in London, the scholar's pulpit of the Church of England. Dean Inge wrote some notable books in theology, philosophy, and social theory, but he was also a newspaper columnist during the 1920s where his hard-nosed comments on the passing scene earned him the nickname, "the gloomy Dean."

Christian Socialism was strong within the church of England, with some churchmen going so far as to declare that for a Christian not to be a socialist was to be guilty of heresy. A popular slogan was "Christianity is the religion of which Socialism is the practice." Dean Inge would have none of this, so he waged a perpetual war of words against the socialists, especially against socialists of the Christian variety. "I do not like to see the clergy," he wrote, "who were monarchists under a strong monarchy, and oligarchs under the oligarchy, tumbling over each other in their eagerness to become court chaplains to King Demos. The black coated advocates of spoliation are not a nice lot!"

It was not that Dean Inge was a defender of the *status quo*; far from it. Inge was a severe critic of many features of the modern western world. He argued that socialism is little more than a logical extension of many of the worst features of the modern temper, derived from the French Revolution, with its inveterate faith that man is a good animal by nature, but corrupted by his institutions; "Man is born free, but is everywhere in chains," as Rousseau put it. This being the case, said the socialists, all we have to do is change our institutions in order to produce an improved society out of unimproved men and women.

Dean Inge foresaw a tendency within this mind-set toward "a reversion to a political and external religion, the very thing against which the Gospel waged relentless war." It is not that Christianity regards social progress as unimportant, Inge goes on to say; it is a question of how genuine improvement may occur. "The true answer," he wrote, "though it is not a very popular one, is that the advance of civilization is in truth a sort of by-product of Christianity, not its chief aim; but we can appeal to history to support us that [the advance of civilization] is most stable and genuine when it is the by-product of a lofty and unworldly idealism."

Churchmen in every age are tempted to adopt the protective coloration of their time; like all intellectuals, churchmen are verbalists and wordsmiths; they are powerfully swayed by the printed page, by catch words, slick phrases, slogans, and bumper stickers. In consequence, they are pulled first this way then that by whatever currents of public opinion happen at the moment to exert the greatest power over their emotions and imagination. Today, it is the powerful gravitational pull of "environmentalism."

I'm using the word environmentalism as a label for the belief that the human species is nothing but what external conditions have made us, that we are the victims of circumstances, that our lives are determined by forces we can barely understand, let alone control. Random chemical and physical interactions produced mankind in the first place. Then this raw material—mankind as it comes from nature—is shaped into various forms by the particular society in which we find ourselves. The social class to which we belong determines, finally, what we are

## The Pull of Public Opinion

and how we view the world and ourselves. Environmentalism exerts a powerful attraction today over intellectuals of all creeds. It is the ideology of Marxists and non-Marxists alike that men and women are the mere end products of nature and society—responsible men and women no longer—and that social engineering can construct a perfect society out of defective human units. Environmentalism has the cart before the horse; it is dehumanizing.

If there is disorder in our society it follows that there is disorder within our very selves, in our faulty thinking and erroneous beliefs, in our misplaced loyalties and misguided affections. Disharmony in our personal lives will result in conflict and frictions in society. This is why serious religion has traditionally focused on the inward and the spiritual, on the mind and conscience of individual persons, to make them responsible individuals. The premise is that only right beliefs rightly held can produce right action. The good society emerges only if there is a significant number of people of intellect and character; and the elevation of character is the perennial concern of genuine religion, in league with education and art.

But the modern world views the matter differently. The modern world assumes that the human species is the mere end product of external forces; a product, first of all, of physics and chemistry—our natural environment; and a product, secondly, of the particular society in which an individual happens to live. The basic assumption is that man's character is made *for* him, by others; no individual is really responsible for himself. It is only necessary, then, for "the others" to acquire political power and use it to create social structures designed to produce a new humanity. Transform external arrangements and—according to this ideology—it matters little if men and women remain unregenerate; they will behave correctly because their institutions have programmed them to act according to the blueprint. This is the modern heresy.

Christianity, rightly understood, stands for a society with such basic features as personal responsibility, equal justice under the law, and maximum freedom for every person—the kind of society envisioned by the 18th-century Whigs like Burke, Madison, and Jefferson. Such a social and political order as the Whigs had in mind lays down the conditions in a nation which permit the operation of one kind of an economic order only, the free market economy—later nicknamed capitalism—the thing described by Adam Smith.



Adam Smith

**T**he economic order which Adam Smith challenged was called Mercantilism. Mercantilism was the communism or socialism or planned economy of the 17th and 18th centuries. The nation was covered with a network of minute regulations controlling every stage of manufacture and exchange, and the controls were brutally enforced, as they must be in every planned economy; in a 73-year period in France, 1686 to 1759, approximately 16,000 people were put to death for some infraction of the government regulations over the economy.

Adam Smith set out to free the economy with what he referred to as his "liberal plan of liberty, equality, and justice." (p. 628) It is more than a coincidence that *The Wealth of Nations* and the Declaration of Independence appeared within a few months of each other, in the

## CHURCHES AND THE SOCIAL ORDER



year 1776. The Declaration endorses the Whig political vision whose main features were voiced by Jefferson in his First Inaugural: "Equal and exact justice to all men, of whatever state or persuasion, religious or political; peace, commerce, and honest friendship with all nations—entangling alliances with none . . . freedom of religion, freedom of the press, freedom of the person under the protection of the habeas corpus," and so on. This was the political and legal framework laid down by the Whig theorists, within which Adam Smith's free market economy, or capitalism, had the freedom necessary if it was to function—his "liberal plan of liberty, equality and justice."

Millions of people during the 20th century have turned away from the traditional religious faiths of the West—Christianity and Judaism—to embrace some form of secular religion, such as communism or socialism. The prevailing world view in our time is not Theism—the belief that mind and spirit are rock-bottom realities in the universe; it is Materialism—the belief that basic reality is composed of nothing else but particles of matter.

Materialism is explicit wherever Marxism is the official creed, but it is implicit almost everywhere else. Begin with the Marxist premise of Dialectical Materialism—or any other variety of Materialism—and some form of totalitarianism logically follows. Such a society reduces human persons to minions of the state, to be used and used up in the utopian endeavor to bring about the classless society of the communist pipe dream. Christian doctrine, by contrast, makes the individual person central. His role in life is to serve the highest value he can conceive—God; the modest role of the political order is to provide maximum freedom for all persons in order that we, as created beings, may achieve our proper destiny.

**I**n the free society, church and state are independent of one another, as set forth in the First Amendment. But there is, historically, a perennial temptation for church and state to join forces and form a theocracy—an alliance which tends to divinize politics and depreciate genuine religion. We are moving in that direction.

The church has been allied with the state ever since the fourth century, and this church-state combination has often been less than Christian in its treatment of Christians, and others. Edward Gibbon, the 18th-century historian, is only one of the many scholars who have chastised the official church for its misdeeds. But listen to Gibbon when he refers to original Gospel Christianity; he speaks of ". . . those benevolent principles of Christianity, which inculcate the natural freedom of mankind." (Vol. I, p. 661)

The idea of Christian freedom came into sharp focus in the preaching of 18th-century clergymen in New England. F. P. Cole, an historian of the period, writes: "There is probably no group of men in history, living in a particular area at a given time, who can speak as forcibly on the subject of liberty as the Congregational ministers of New England between 1750 and 1785."

It was the custom of the New England clergy to preach twice a year on some theme having to do with the secular order, the Artillery Day Sermon and the Election Day Sermon. These scholarly sermons were published by the Massachusetts General Court, as the legislature was then called, and they have provided the raw material for many a doc-

## The Theocratic Temptation

## Religion and the Founders



Alexis de Tocqueville

toral dissertation. Let me offer a typical statement by one of the ablest of these preachers, Jonathan Mayhew of Boston, in 1752. "Having been initiated in youth in the doctrines of civil liberty, as they were taught by such men as Plato, Demosthenes, Cicero, and other renowned persons among the ancients; and such as Sydney and Milton, Locke and Hoadley among the moderns, I liked them; they seemed rational. And having learnt from the Holy Scriptures that wise, brave, and virtuous men were always friends of liberty,—that God gave the Israelites a king in His anger, because they had not the sense and virtue enough to be a free commonwealth,—and that 'where the spirit of the Lord is, there is liberty'—this made me conclude that freedom was a great blessing."

Most of the men we refer to as our Founding Fathers were not active churchmen, for one reason or another, but they were men of strong religious convictions. Norman Cousins has compiled a 450-page anthology of the religious beliefs and ideas of eight of these men in their own words. (*In God We Trust*, 1958) Those quoted are Franklin, Washington, Jefferson, Madison, the two Adamses, Hamilton, and Jay. There's also a section devoted to Tom Paine. A familiar statement of Jefferson pretty well summarizes the outlook of this remarkable group of men. "The God who gave us life, gave us liberty at the same time."

Tom Paine authored some influential political pamphlets, and he also wrote a great deal on the subject of religion, much of it critical—which is all right, because there is much about the ecclesiastical life of any period which deserves criticism. But when it was a matter of Christian liberty, Paine was on target. Cousins, for some reason, does not quote a surprising statement by Paine: "Wherefore, political as well as spiritual liberty, is the gift of God, through Christ." (From his essay "Thoughts on Defensive War")

What was the situation in the 19th century? Let me offer a few remarks by one of the keenest foreign observers ever to visit this nation, Alexis de Tocqueville. Tocqueville landed in New York in May, 1831. Nine months and seven thousand miles later he returned to France and wrote his great book, *Democracy in America*, with special attention being given to religion and the churches. "The Americans combine the notions of Christianity and of liberty so intimately in their minds," he wrote, "that it is impossible to make them conceive the one without the other . . . Religion in America takes no direct part in the government of society, but it must be regarded as the first of their political institutions . . . They hold it to be indispensable to the maintenance of republican institutions."

"Despotism may govern without faith," he continues, "but liberty cannot . . . [for] how is it possible that society should escape destruction if the moral tie is not strengthened in proportion as the political tie is relaxed?"

Tocqueville observed that the clergy stayed away from politics. The clergy, he observed, "keep aloof from parties and public affairs . . . In the United States religion exercises but little direct influence upon the laws and upon the details of public opinion; but [religion] directs the customs of the community, and, by regulating everyday life it regulates the state."

## A Spotty Record

**T**he history of the church during the past two thousand years is a spotty record, with many ups and some downs. There have been glorious epochs, and there have been periods which make for melancholy reading. Occasionally, the church has sanctioned tyrannous political rule; from time to time it has lent its support to persecutions, inquisitions, and crusades. As an arm of the state, or as a tool of the state, it has betrayed its sacred task while it pursued secular goals like wealth and power.

In the 20th century segments of ecclesiastical officialdom and councils of churches demand legislation to transfer wealth from one group of citizens to another. They work for a collectivist economic order planned, controlled, and regulated by government. The intended aim is to overcome poverty and feed the hungry; the means is the planned economy, otherwise labeled socialism, collectivism, the new deal, or whatever. Whatever the label, the planned economy puts the nation in a strait jacket; the planned economy, however noble the intentions of the planners, is the road to serfdom, as F. A. Hayek demonstrated in a landmark book written some forty years ago.

A planned economy forcibly directs the lives of individual men and women, and to do so the state must deprive people of their earnings which they would otherwise use to direct their own lives. Nation after nation during the 20th century has gone in for political planning of the economy and the results have been disastrous; where the planning has been strictly enforced, as in communist nations, the result has been a nation ill housed, ill fed, and ill clothed. It is a sad paradox indeed that the secular program, promoted by church hierarchies to alleviate poverty, has caused poverty in every society which has tried it. The only way to alleviate poverty in a nation is to increase productivity; and increased productivity is generated only by an economy of free men and women. Freedom is an essential part of the church's business. Freedom is a blessing in itself, and it's a double blessing, for prosperity follows freedom.

The socialists, until recently, have claimed the high moral ground. Their boast is that only socialists—or liberals—really care about people. What nonsense! Every person of good will wants to see other people better off; better housed, better fed, better clothed, healthier, better educated, with finer medical care, and all the rest. The dispute between socialists and believers in the free economy is not so much over the goals as over the means by which these goals may be met. The socialist's means—his command economy—will not achieve the goals he says he wants to reach; socialism makes the nation worse off; poorer in material wealth, and poorer in every other respect as well.

There is another route for churchmen to take, a way that leads to more freedom for people in society, rather than less freedom. Freedom is at the heart of the gospel message, and the true genius of our religion was proudly proclaimed by our forebears, some of whose words I have quoted.

Man's will is uniquely free; that's the way God made us. We are free beings precisely in order that each person shall be responsible for his own life and therefore accountable for his actions. It is by acts of will, acts of choice, exercised daily over the course of a lifetime that each of us becomes the person we have the potential to be. Each person is by nature self-controlling; each person is in charge of his own life.

## The Productivity of Capitalism

The free society, then, is our natural habitat; freedom in the relations of persons to each other accords with human nature. The tactic of freedom in the business and industrial sectors is the free market economy; the free choice economic system corresponds to the freely choosing creature that each of us is.

Animals, unlike us humans, have a finely tuned set of instincts which infallibly guides each creature according to its species. We humans do not have such elaborate instinctual equipment; instead of instincts we are given a moral code, which we are free to obey or not. Anyone can figure out for himself that no kind of society is possible unless most people most of the time do not murder, steal, assault, or lie. Thus we have commandments that say Thou shalt not murder, Thou shalt not steal, Thou shalt not bear false witness, and so on. These and other commands compose the basic moral code which is the foundation of our law.

Because we are flawed creatures as well as free, we occasionally break the law, and so we need an umpire to interpret and, if necessary, enforce the rules. We refer to this umpire function as the political order—government, the police power, the law. And we have the courts, where honest differences of opinion may be examined and resolved.

**T**he free market economy, or private property order, or capitalism—if you like—is, by common agreement, the most productive economic order. In fact, it's the *only* productive economic order. Socialism in a given country lives by exploiting the previous productive economy of that country, and when that gives out, socialist nations live on largess from capitalist nations.

The incredible productivity of capitalism is generally admitted, even by its critics; it's the way the wealth gets distributed that they complain about. What's wrong about capitalism, the critics charge, is that some people in our society have enormous incomes while other people have to get by on a mere pittance. Disparities in income show up most vividly in the sports and entertainment industries. Take basketball players, for instance. Basketball is a fun game which thousands play for pleasure and recreation. But many professional players make more money in a year than any six of us will make in a lifetime of hard work. Baseball is almost as grotesque, and then the players threaten to strike for more pay! A rock singer gives what is laughably called a concert and more money changes hands in one evening than the Seattle Symphony sees in a year. Supply your own examples. The question is: How can any person with even a modicum of intelligence and refinement condone such grotesqueries? How do we respond to such a critic?

Part of the answer is that in a free society—a social order characterized by equal freedom under the law—the market place becomes a showcase for popular folly, ignorance, superstition, bad taste, and stupidity. The market, in other words, is individual free choice in action, and no one is pleased with everyone else's choices. But our displeasure is a price we must learn to pay if we are to enjoy the blessings of liberty. We must stand firmly behind the processes of freedom, even though we can barely stand some of the products of freedom. So let's stop wringing our hands; let's try to be tolerant, and let's get on with our lifelong task of setting a better example of what freedom means.



Remember that no one is *forced* to pay over good money to watch a sporting event; no one *has* to listen to some hyperkinetic young man howl and gyrate in public places to the accompaniment of amplified sound. You and I might not pay money for such a performance, and if everyone were just like us, those who now make millions playing games would have to go back to sport for its own sake, just like the rest of us. And if a miraculous change in musical taste should occur, there'd be crowds attending Bach recitals every Sunday afternoon on your local church organ.

Turn from the sports and entertainment field to the business and industry sector. Here, too, there are wide variations in wages, income and wealth. How does this come about?

Here's a person with a knack for manufacturing a better mousetrap, which turns out to be just what millions of consumers have been waiting for. They are willing to pay handsomely for this better mousetrap, and so the manufacturer becomes wealthy. His employees also benefit. Our entrepreneur's wealth is voluntarily conferred upon him by consumers who aren't forced to buy the product, but who find that these new mousetraps make their lives safer, better, and more enjoyable. Every step in this procedure—manufacturing, marketing, exchanging—is free and fair, and when this is the case the resulting distribution of rewards is also fair. It is only when someone profits and becomes rich because government gives him a subsidy or provides him with some advantage over his rivals and his customers that there is maldistribution and unfairness in the final result.

**L**et me emphasize the fact that the free market economy rewards each participant according to the value willing consumers attach to his offering of goods and services. Why does a rock singer make millions while your fine church organist makes hundreds? The answer is obvious; crowds of people would rather pay a lot of money to hear rock than to listen to Bach for free. We may find this intellectual and esthetic wasteland repugnant to our refined sensibilities. But what an opportunity this situation presents to every teacher. I refer not only to full time professors, preachers, and writers. Most anyone can be a teacher. Nearly everyone, in other words, has the capacity to convey a new idea to some other person, to instill a nobler sentiment, a superior value, a higher moral tone. More persuasive than any of these, we can set a good example.

It is a solid truth, I believe, that you cannot build a free society out of just any old kind of people. A free society is built around a nucleus of people of superior intellect and integrity who are, at the same time, cognizant of economic and political reality. You need people who love God and their neighbor; people of understanding and compassion; people with enduring family ties. Our schools and our churches should be producing people of this caliber, for it is the function of education and religion—in the broad sense of both terms—to make us better and wiser men and women. When we have a significant number of wise and good people living lives of a quality high enough to deserve a free society we'll *have* a free society. All the rest of us, riding on their coattails, will reap the rich blessings of liberty. □

## Setting a Good Example

# Farming Is a Business

**The rules of economy apply to farming as much as they do to any other business.**

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by Clarence B. Carson

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Dr. Carson has written and taught extensively, specializing in American intellectual history. He is the author of several books, and has just completed the last of a five-volume text, *A Basic History of the United States*.

**T**he plight of service station operators does not appear to ever have caught the public fancy. Not once in all my years as a diligent TV watcher can I recall having seen a special on the subject, or even a segment on the evening news about the disappearance of the family-operated service station. The television cameras have not focused on any sheriff's bankruptcy sale of some service stations, with the sheriff surrounded by a bunch of surly service station operators protesting the sale. No legislatures or courts have declared a moratorium on foreclosures on service stations, to my knowledge. There are no Federal Service Station Banks to provide easy credit to go into the service station business. And, in all my years of perusing textbooks on American history, I have never encountered even a sentence about "The Service Station Problem," much less a paragraph or a whole section of a chapter.

By contrast—and what makes the above so remarkable—I have seen reams of material over the years dealing with "The Farm Problem." No presidential administration since that of Rutherford B. Hayes, at the latest, has managed to get by without some sort of "Farm Crisis." Every sort of scheme, crackpot or otherwise, to deal with the farm problem has had its advocates, and many a bill has made its way through state legislatures and Congress that was supposed to address the problems of farmers. For more than a hundred years now those who claimed to speak for farmers have proclaimed the responsibility of government to help farmers, and for nearly as long governments have been passing legislation of one sort or another that was supposed to do just that. Inflation—back in the days when everyone understood that meant an increase in the money supply—was once considered to be the panacea for farm problems. Then it was regulation of rail rates, government-sponsored loan programs to provide easy credit, government-sponsored cooperative storage and crop loan facilities, parity payments, subsidies, and so on. No history book worthy of the name is minus sections planted here and there through the accounts of the last hundred years detailing the plight of the farmers. And, according to spokesmen for farmers, the problem is apparently as urgent today as ever, what with declining foreign markets, drops in the prices of farm lands, and widespread farm foreclosures.

It is not my point, of course, that farmers have not had and do not have problems. As far back as my information goes, farmers have always had problems of one sort or another. They have ever been

hampered in their enterprise by droughts, floods, plagues, disease, fat years when prices fell and lean years when prices might rise but they produced much less. Farmers have been going into debt ever since merchants, factors, or bankers could be found to extend credit, many of them going deeper in debt from year to year in the vain hope that bumper crops could be sold at high prices to rescue them. Anyone who doubts this should study the accounts of American farmers and planters in our own colonial history. There have been many changes in technology and farming methods over the years, but the sort of financial problems encountered by commercial farmers have not changed much.

My point, rather, is that it is not all that clear that farmers differ that much in having problems from the rest of us who are exposed to the exigencies of the market—which is to say all of us, to greater or lesser extent. Even government workers sometimes lose their jobs, and politicians do not always get re-elected. But I started out to contrast farmers with service station operators, so allow me to stick with that for a bit. The woes of service stations over the years must often have been as great as those of farmers. True, many have left farming for other fields, especially over the past fifty years. But the number of service stations that have gone out of business during the same period must be very large, in view of the many abandoned businesses which dot the countryside. Service stations that remain in business also change hands or come under new management from time to time. One of the complaints about farming is that the family farm is disappearing, but service stations may also be operated by families. Whether service station operators are as prone to bankruptcy as farmers, I have no information, but undoubtedly many service station operators do not make a go of the business for one reason or another.

**T**he central point I wish to make, however, is that farming is a business. In this crucial respect, it is like a host of other businesses. It has been contrasted with operating a service station not because farming is essentially different but because a great deal of political attention and a large number of political programs have been enacted that were supposed to aid farmers. By contrast, very little notice has been paid to service stations, and except for an occasional piece of legislation dealing with the treatment of independents by suppliers, service stations have rarely been singled out except for restrictive legislation. There are many other businesses for which there are no specific government aid programs: toymakers, for example, candy manufacturers, makers of cereals, and so on. Some businesses have been the objects of government programs which were supposed to aid them, of course, but none so massively, I think, nor over so long a period of time. Certainly businesses, in general, have not usually enjoyed public sympathy in this century; they have much more often been the subject of punitive regulation. Moreover, public opposition to and criticism of aiding other businesses has usually been vigorous.

Thus, it is important to emphasize that farming is a business. This is important for two reasons. First, it brings it into the correct framework for considering the appropriateness of providing aid. Second, it helps to cut away the alleged differences from other businesses. Farm-

## **Farming as a Business**

**The American farmer is in a situation today that can be solved. The solution is not one of governmental policies that create short-term “fixes” for the farmer. The best method to let the farmer prosper is the same solution that would let the other parts of the economy prosper. Government must remove the burdens placed upon the individual. The individual must be allowed to compete on an *equal basis* to become competitive with his peers.**

—Edgar Terry, a fourth-generation farmer in Ventura, California

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ing for the market is a business. It is a business in that farmers use land, labor, and capital for the produce of goods to be sold. Such farming is done in the hope and expectation of profit as are all other businesses. Farmers usually seek to use as little of the scarce elements of production as possible to produce the most of the goods that are wanted (as indicated by price in the market). They seek the widest market for their produce, and thus the highest prices available. Successful farmers keep careful accounts and plan their investments of time and capital so as to maximize their income. Theirs is in no sense more of a charitable undertaking than is operating a service station or providing hundreds of other goods or services. This is not to deny that there are public benefits from farming, but these do not appear to differ from those that attend hundreds of other enterprises.

## “The Family Farm”

**P**robably, a goodly amount of the public sympathy for farmers arises from memories that extend backward into an era when farming was often not so business-like as it has now become. The “family farm” may call up visions of small farms on which growing produce for the market was only an aspect of the undertaking. Such farms often kept a variety of animals—cows, horses, chickens, hogs, perhaps sheep or goats, geese, ducks—for family or farm use. Fruit trees would often provide fruit in season, and a variety of nuts might be produced. All sorts of crops might be grown, some for animal consumption, some for the family, and only one or a few for sale in the market. Such farms would frequently have surpluses of fruits and vegetables to be shared in season with neighbors and relatives. According to lore, and sometimes in fact, these farms were refuges for children who lived in cities and towns, to which they would be sent during summer vacation to spend some time on a farm with relatives, perhaps learning something of ancient virtues and values.

Such farms have mainly gone with the wind, so to speak nowadays. Most farming for the market, whether on family farms or on company or corporation farms, is more or less highly specialized. Many farms today have no farm animals at all. The old-fashioned barn has often

been dispensed with entirely. Vegetable gardens are probably no more common on large farms than they are in the suburbs. Machinery has long since replaced most animals for motive power on the farms, and the machinery has become much larger and usually much more highly specialized in function than it used to be. A family farm is distinguished from others, if at all, by the fact that most of the work is done by a single family and that the family lives on the land. Even when there is some diversity in the produce, it is still done on a commercial scale usually. In sum, farming for the market has become commercialized.

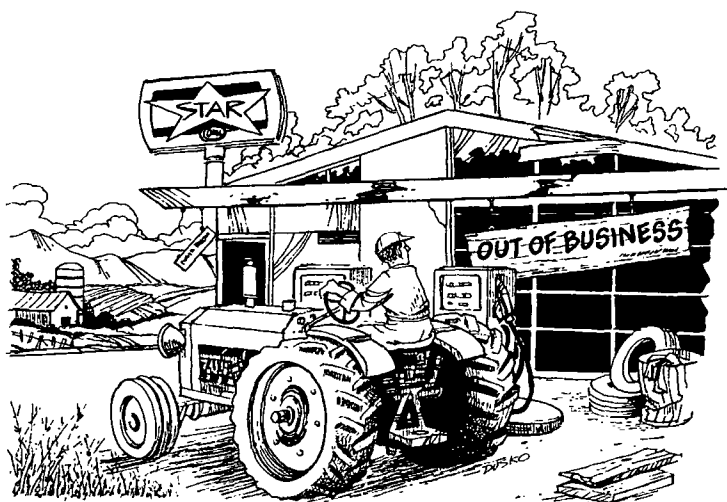
The great change in farming generally may have less bearing than might be supposed on government programs for farmers, except for its nostalgic role in promoting taxpayer support to "save the family farm." Actually, most government programs enacted over many years have been devised to affect farming for the market. Almost none of the programs has either sought or been devised to reward or restrict farm production for the family. True, some of the New Deal programs did try to encourage diversification on farms, but to the extent that they succeeded (by restricting the land planted to crops grown for the market), they usually resulted in driving people from the farms. Some loan programs, notably the Farmer's Home Administration, have enabled some people to buy houses on small plots of land, but these are rarely used for any significant farming.

**I**n any case, most of the agitation for government programs and most of the actual programs have been aimed at altering the market in some way. One of the earliest interventions was an attempt to control freight rates and the prices charged for the storage of grain. These were supposed to help farmers who shipped their goods to market or stored them in the anticipation of higher prices. Currency inflation was aimed almost exclusively at raising farm prices or providing cheaper and easier credit. Parity programs were exclusively market oriented. The same could be said for assorted price support or subsidy programs. The huge government supported loan and insurance programs have been mainly used by farmers to purchase more land, insure commercial crops, or purchase farm machinery needed for large operations. In sum, government programs have usually been for those farming for the market, not for those mainly producing food for the family on family farms.

To say that farming is a business is in no sense to downgrade its importance or to adversely criticize it. Nor do I mean to suggest that because farmers are businessmen, they are not entitled to a full measure of sympathy and understanding for the risks that they take and the benefit they provide for all of us. Farming is certainly a risky business, dependent as it is upon the elements, domestic prices, and changes in foreign markets. More risky than running a service station (or, for that matter, any number of other businesses)? That is by no means clear. Service stations have risks, some of which are different from those of farmers. For example, they are much more apt to be robbed, and location is very important. Beyond these things they are subject to all sorts of exigencies, and work always with highly explosive materials.

But to suggest that farmers deserve our understanding and appre-

## Altering the Market



ciation should not be taken to mean that government should intervene either on their behalf or to restrict them. Farming is a business, and there is an abundance of evidence which suggests that not only is government intervention often harmful to consumers (that is, all of us) but also to those engaged in the particular businesses aimed at by the intervention. That farm programs over the years have benefited farmers is hardly self-evident. Undoubtedly, *some* farmers have benefited from some farm programs. There may even have been instances when farms generally have benefited, *temporarily*, from some particular programs. But that farmers generally have benefited in the long run from government programs could hardly be maintained (leaving out of consideration the cost to the rest of the population).

## A Faulty Premise

**F**arm programs are based on a faulty premise. They are generally premised on the notion that farmers engaged primarily in producing similar sorts of goods constitute a class with common interests. This might be so if they were producing almost exclusively for their own families. But to the extent that they are producing for the market, i.e., to the extent that farming is a business, their interests crucially diverge. A farmer is in competition with all other farmers producing the same type of goods when they enter the market. Wheat farmers are in competition with one another, as are cotton farmers, cattle growers, sugar producers, chicken farmers, and so on through the whole gamut of agricultural production. Each farmer, so far as he is seeking a profit in the market, seeks to produce and sell as much as he can for the highest price at the lowest cost to himself.

Any government program premised on the notion that those farmers producing some one or combination of goods constitute a class with common interests is profoundly uneconomic. In order to work, it requires that each individual farmer act contrary to his own individual interest, that he regularly behave uneconomically. Undoubtedly, such behavior can sometimes be induced by large enough subsidies from taxpayers generally, but the program will nonetheless be a prescription for disaster. In any case, most farm programs range somewhere between subsidizing less than enough to induce uneconomic behavior and

trying to alter market conditions sufficiently to keep farmers off the backs of politicians for a season. If farmers were paid enough from government revenues to induce them to behave uneconomically as a rule, the result would be starvation and bankruptcy for citizens generally. That is, farmers would cease to produce those goods that are most wanted in sufficient supply to feed us. On the other hand, government intervention in the market to increase farm income by higher production tends to produce a glut of goods at the subsidized prices.

Most commonly, over the years, government intervention has been concerned with price manipulation: to raise the price of farm products, to raise the price, i.e., wages, of farm workers, to lower the price of shipping, storage, and farm machinery (by encouraging cooperatives), and to lower the price of money, i.e., interest. These attempts at price manipulation have sometimes been accompanied by restrictions on land planted to particular crops, on amounts farmers could sell of a crop in the market, on numbers of cows, for example, that a dairy farmer could have in production, and so on. Raising the prices of farm goods tends to encourage farmers to produce more and to draw others into growing those crops. Raising the price of farm labor tends to encourage the greater use of machinery, as does a reduction in interest rates. Restriction of acreage tends to shift farmers to efforts to produce more on less acreage, and so on. Government intervention tends to produce an ever normal "Farm Problem."

In fact, production for the market is a business. This is true whether the good produced is wheat or widgets. The rules of economy apply to farmers as much as they do to service station operators. We create the "Farm Problem" by lumping farmers together unnaturally and perpetuate it by government intervention. The solution lies in treating farming as a business and allowing those who can do it effectively to do so without interference. □

## FREEDOM AND SECURITY

**W**hen a man's property rights are protected, he is able to retain and enjoy in peace the fruits of his labor. This security is his main incentive, if not his only incentive, to labor creatively. If anyone were free to confiscate what the farmer had sown, fertilized, cultivated and raised, he would no longer have any incentive to sow or to reap.

Profit is the life blood of a free economy. The opportunity to make a profit (or the opposite, the discipline of possible loss) is the invisible hand, as it were, that guides production and distribution. And in guiding the economy to the satisfaction of society's needs, the profit system does what no central authority is capable of doing as well—even granting that the authority might be staffed by the most brilliant planners.

It is said at times that many are willing to trade freedom for security. Even if they were to receive that for which they traded, it would be a bad bargain. But the sad and frightening fact is that when a people seek to obtain security by turning over power and responsibility to government, they lose both freedom and security.

ED GRADY

IDEAS  
ON  
LIBERTY



# Information and the Economic Problem

**Information is an invaluable tool in promoting social cooperation.**

by Brent M. Johnstone

Mr. Johnstone graduated from the University of Texas at Austin in May of this year with a major in economics. He was editor-in-chief of *The Texas Review*, a conservative student journal of opinion.

This essay was a runner-up in The Foundation for Economic Education's 1985-1986 Freedom Essay Contest.

**I**nformation is the most precious good in the economy. Scarcer than platinum, more valuable than gold, it is one item of value to all participants in the marketplace. Buyers, conscious of limited budgets, search for information about low prices and high quality. Workers, wanting to support themselves and their families, search for information about jobs where their productivity, and thus their income, will be the highest. Entrepreneurs, in pursuit of profits, look for market opportunities where they can best satisfy people's needs and wants. Firms, seeking to maximize profits, search for the cheapest inputs of production and the most efficient production techniques.

Information, it will be seen, is the key to solving the economic problem. That problem is this: How do you get people to cooperate in the production of goods and services necessary to society? No one person or family can, beyond a bare subsistence level, produce everything it needs. People must rely on outsiders to help them get what they want: individuals who may very well live in different lands, worship different gods, speak different languages, and who may have very different goals, values, needs, and desires. These different people may very well even hate each other. How, then, can we get them to cooperate?

The obvious solution springs to mind: you *command* them to cooperate. A central board is set up to determine the needs of society and the best way to achieve them. Orders are given out and enforced; production is planned from the top down. It is, after all, the most obviously logical and efficient way to organize the efforts of individuals—is it not?—much as you might organize an army to conquer a city or ants organize themselves in the mound.

The economy of the Soviet Union is the best example of such a centralized state. All capital and all natural resources are owned by the state. The government plans all production as if the economy were one big firm. Through a plethora of plans, regulations, and directives, the state specifies how much will be produced—how many tons of steel, how many yards of cloth—and how much will be used in production: quantities of capital and labor to be deployed when, where, and how.



There is little need to repeat the dismal record of the Soviet economy. The stories of chronic shortages of meat, dairy products, fruits, and many vegetables; of bribery, black markets, and corruption; of low productivity and slipshod labor have been well-reported. Soviet productivity is only 40 per cent of that in the United States. The typical worker in Moscow must work 53.5 hours a week just to provide a family of four with basic groceries—as opposed to 18.6 hours in a week in Washington or 24.7 hours in London. The Soviet press itself abounds with stories of new buildings which rapidly deteriorate or actually fall apart due to substandard construction.<sup>1</sup> The Soviets, living in one of the richest and potentially most productive agricultural areas in the world, must import grain from the West simply to feed themselves. As one student of the Soviet economy concluded, “Soviet planning has not proved seductive. No electorate has freely chosen a system like it, and none is likely to do so in the near future.”<sup>2</sup>

There are many reasons for this poor performance. Part of the answer lies in the absence of private property. When a man’s workshop and the fruits of his labor are not his, he is not likely to care about the quality of his work, or whether his job even gets done at all. But, if we stop our search there, we overlook another aspect: the information problem.

Very simply, it is beyond the capacity of one man, or even a board of men, to specify how much firms should produce or what they need in order to do so—to determine how many pigs are to be raised, how many buses to be run, how many mines to be dug, how many pairs of shoes to be sold. The amount of information needed to answer these questions—much less the foresight and logic to rationally reconcile competing interests and goals—is simply staggering. True, our board may, after much deliberation, devise an answer. But there is no guarantee (witness the Soviet example) that their plan will assemble the inputs of production in the most efficient way possible, or that the plan will provide the most efficient combination of outputs to satisfy consumers. If the Soviet model is any example, the result is likely to be very *inefficient*. The breadth and complexity of data are so great that no computer can successfully tackle it.

**Y**et the economic problem does get solved—efficiently, productively—every day without active government guidance and regulation. Pause for a moment and consider, as French economist Frederic Bastiat did a century ago, the enormous range of commodities that a major metropolitan city consumes in a single day—many of which, like food, are not produced in the city itself. The city’s survival literally depends on the uninterrupted flow of such goods into the city. And yet no man or agency gives orders or even consciously plans to insure that enough food or clothes or gasoline will make it to the city that day. Nonetheless, these goods arrive daily in the approximately correct quantities—and the city survives.

“Imagination is baffled,” wrote Bastiat, contemplating the Paris of his day, “when it tries to appreciate the vast multiplicity of commodities which must enter tomorrow in order to preserve the inhabitants from falling prey to the convulsions of famine, rebellion, and pillage. Yet all sleep, and their slumbers are not disturbed for a

## Solving the Problem

single minute by the prospect of such a frightful catastrophe.”<sup>3</sup>

No one plans; no one calculates; no one consciously tries to solve the economic problem for society—and yet the problem is solved. The relevant information is transmitted to the essential parties, and the necessary goods are produced and distributed. How can this happen?

Forty years ago Nobel laureate economist F. A. Hayek considered the problem. His insights are crucial to understanding how society may best solve the information problem.<sup>4</sup>

Hayek began by redefining the economic problem. *If* we possessed all the relevant information; *if* we had a given set of priorities and preferences; *if* we knew the full range of options before us, the economic problem would simply be one of logic. Given these facts, the answers would flow out inevitably and ineluctably: Who says A must say B.

The difficulty is, of course, that this is *not* the economic problem—at least as we face it in the real world. We do not have perfect information about our options or the means to achieve them. The knowledge which we need does not exist in a single mind; it is not even found in a single coherent and integrated form. It is only found in the dispersed bits of incomplete (and often contradictory) knowledge possessed by all the participants in the economy.

So, Hayek writes, “The economic problem of society is thus not merely a problem of how to allocate ‘given’ resources. . . . It is rather the problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to put it briefly, it is a problem of the utilization of knowledge not given to anyone in its totality.”<sup>5</sup>

The question is not whether there will be planning in an economy. The question is *who* will do it. Should it be done centrally by one agency for the whole economy, or by the individuals themselves by the processes of a free market? That question turns, from our perspective, on who is more likely to have the necessary and relevant knowledge (and who thus is better able to act on it): the state or the individual.

## Time, Place, and Change

**C**lassical liberalism argues that man is a rational and competent decision-maker, and that as such, in Adam Smith’s words, “every individual, it is evident, can, in his local situation, judge much better than any statesman or lawgiver can do for him.”<sup>6</sup> Each individual has his own set of priorities; each knows, better than anyone else, his individual capacities and talents. He knows what he is and is not capable of. He alone knows the particular circumstances of his time and place.

Then there is the problem of change. To think of the economic problem in terms of allocating “given” resources is to assume that the world is static and unchanging. The cardinal fallacy implied in statist schemes of control, regulation, and planning, wrote Austrian economist Ludwig von Mises,

is that they look at the economic problem from the perspective of the subaltern clerk whose intellectual horizon does not extend beyond subordinate tasks. They consider the structure of industrial production and the allocation of capital to the various branches and production aggregates as rigid, and do not take

into account the necessity of altering this structure in order to adjust it to changes in conditions. What they have in mind is a world in which no further changes occur and economic history has reached its final stage.<sup>7</sup>

Technology, the availability of natural resources, consumer tastes and preferences: all these things are constantly in flux. Change—intangible as it is—cannot be captured in statistical aggregates and computed. It cannot be predicted, and thus we cannot make accurate and reliable forecasts. No one knows when the next technological breakthrough, the next scientific discovery, the next consumer fad will strike. But just because we cannot predict such events does not mean that we can simply disregard them. On the contrary, the ability of the economy to generate new scientific and technological advances is crucial to economic progress. The ability of entrepreneurs to take advantage of new opportunities as they emerge, quickly and efficiently, is crucial.

**T**he economic problem, then, takes on another dimension. Its solution requires rapid adaptation to change. The world is not static. The reports which greet the central planning committee in the morning may be obsolete by noon. In a world of change, it only follows that the ultimate decisions are best left to those familiar with the particular circumstances of time and place: those who know of the changes and of the resources available to meet them. Such problems by their nature cannot be solved by a central board which ponders for weeks and makes a decision. The answer is decentralization: decisions made not by the state but by individuals themselves.

But the decentralization of decision-making, Hayek points out, only solves part of the problem. It means only that the knowledge of the particular circumstances of time and place will be used. But our “man on the spot” has only his own limited but intimate knowledge of the facts of his immediate surroundings. How can information about *other* changes in *other* areas be communicated to him?<sup>8</sup>

One answer is the price system. In a free economy the price system serves as a means of communicating information to all parties in the marketplace about opportunity costs and the relative scarcity of goods and services. Prices are easy to understand and readily available. Buyers can efficiently use them to adjust to complex events a continent away.<sup>9</sup> Hayek explains:

Assume that somewhere in the world a new opportunity for the use of some raw material, say tin, has arisen, or that one of the sources of supply of tin has been eliminated. It does not matter for our purpose—and it is very significant that it does not matter—which of these two causes has made tin more scarce. All that the users of the tin need to know is that some of the tin they used to consume is now more profitably employed elsewhere, and that in consequence they must economize tin. There is no need for the great majority of them even to know where the more urgent need has arisen, or in favor of what other needs they ought to husband the supply. If only some of them know directly of the new demand, and switch resources over to it, and if the people who are aware of the new gap thus created in turn

## A World of Change

fill it from still other sources, the effect will rapidly spread throughout the whole economic system and influence not only the uses of tin, but also those of its substitutes and the substitutes of these substitutes, the supply of the things made of tin, and their substitutes, and so on, and all this without the great majority of those instrumental in bringing about these substitutes knowing anything at all about the original cause of these changes. The whole acts as one market, not because any of its members survey the whole field, but because their limited individual fields of vision sufficiently overlap so that through many intermediaries the relevant information is communicated to all.<sup>10</sup>

## The Function of Prices

**P**rices inform people about the relative value and scarcity of literally hundreds of thousands of products and, in so doing, reduce decision-making down to the level of the syllogism. By observing market prices and adding to them their personal knowledge of circumstances and events, individuals can make competent decisions about the costs and benefits of alternative actions.<sup>11</sup>

The remarkable thing about this process is that people need to know very little—just the relative changes in the prices of the commodities themselves—in order to make the correct choice. A good becomes scarce and its price increases. Without any directives or regulations being passed—indeed, without any need for people to know the reason for the scarcity—people, because of the higher price, will take the right action: they will consume less of the good. And yet the solution is not produced by the judgment of one man with perfect knowledge of all the facts, but by the natural interaction of many individuals, each of whom has only partial knowledge. The price system, writes Hayek, “brings about the solution which . . . might have been arrived at by one single mind possessing all the information which is in fact dispersed among all the people involved in the process.”<sup>12</sup>

The misfortune of this system is that it works so subtly and so well that people forget its existence, if they were aware of it at all. Thus, they are quick to replace the invisible hand of the marketplace with the visible hand of government trying to redirect the actions of people via regulation, tax policy, directives, plans, and orders: trying, as it were, to reinvent the wheel. Some of the best economic minds of this century—Oskar Lange and Abba Lerner, among others—have spent years trying to solve the economic problem with the visible hand of central planning, unaware that the problem already has been solved by the market. Indeed, the advocates of government planning are not only trying to solve a problem whose answer is already known, but their “solution” is necessarily an inferior one. As Hayek writes: “The problem is precisely how to extend the span of our utilization of resources beyond the span of the control of any one mind; and, therefore, how to dispense with the need of conscious control and how to provide inducements which will make the individual do the desirable things without anyone having to tell him what to do.”<sup>13</sup>

The late G. Warren Nutter told this story: Suppose you have a sack of potatoes and want to make that sack as compact as possible. One way is to examine the size and shape of each potato, measure its dimensions, put those measurements into a computer, and try to deter-

mine mathematically how to fit the potatoes together in the smallest possible space. Anyone familiar with higher mathematics will realize the enormous complexity of this problem.

Another way to solve the problem is to give the sack a couple of shakes and let the potatoes settle in by themselves.<sup>14</sup>

There are many lessons in this parable. But the most important is probably this: Information is costly, and economic efficiency requires that we, as a society, economize on our use of knowledge. The great virtue of a market economy, as Nutter reminds us, is that "it mobilizes knowledge for the benefit of society far more cheaply and effectively than any conscious effort can."<sup>15</sup>

Perhaps in the static and ideal world of the economic theorist, government coercion can effectively organize the activities of society. But in the real world—a world in which we do not have perfect knowledge and where change is our only guarantee—government planning necessarily leads to failure. Only in an economy where individuals are free to make their own choices and where markets, and not governments, organize and coordinate the production of goods and services can the economic problem be successfully solved. In contrast to the airy dreams of the central planners, the marketplace really works, really helps live people with real-life problems. □

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4. F. A. Hayek, "The Use of Knowledge in Society," *The American Economic Review* 35, September 1945, pp. 519–530.
5. Hayek, op cit., pp 519–520.
6. Adam Smith, *The Wealth of Nations* (New York: Modern Library), 1937, p. 423.
7. Ludwig von Mises, *Human Action* (Chicago: Contemporary Books), 3rd ed., 1963, p. 707.
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10. Hayek, op cit., p. 526.
11. Dolan, op cit., p. 29.
12. Hayek, op cit., p. 526.
13. Hayek, op cit., p. 527.
14. Nutter, op cit., p. 115.
15. Nutter, op cit., pp. 115–116.

## In Future Issues . . .

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- "The Selling of Freedom" by Dennis L. Peterson
- "Lessons From Socialist Tanzania" by Sven Rydenfelt
- "To Deal With a Crisis: Government Program or Free Market?" by Robert Higgs

### October

- "The Seven Deadly Fallacies of Bad Economics" by John K. Williams
- "Protectionism: The Myths" by J.R. Kearn
- "Protectionism and Agricultural Price Supports" by E.C. Pasour, Jr.

# The Failure of the “Middle Way”

**The search for a  
“middle way”  
between the free  
market and  
socialism leads  
to the erosion  
of freedom.**

by José Ítalo Stelle

José Stelle is a free-lance writer, editor, and translator, residing in Verona, New Jersey. This article is abridged from an essay, titled “Are Liberal Principles Still Relevant?”

**T**he “middle way” between socialism and the free market is put forward as a “third system” that retains the virtues of both, but discards the disadvantages of each. It promises to replace “outmoded” liberal freedom by a new freedom under planning: freedom from want, poverty, and insecurity. In this “third system,” civil and political freedom will be respected, but economic action will be subjected to intervention and control by government in order to “discipline” the prodigious forces of capitalism and to promote “social justice” by what is termed “a better distribution of income.”

“Planning” in the strict sense of total control of society by the government has lost much of its appeal and has been rejected even by many of its former supporters. But in the second sense of a “middle way” between the free market and socialism it rules all contemporary democracies. Depending for much of its success on the remaining faith in “outmoded” liberal values such as even-handedness and fair play, its insidious plausibility and seeming avoidance of extremes has transformed it into an unassailable creed. Yet this creed, which rejects traditional liberal principles and proclaims its “scientific” pragmatism which would fashion a new and just society by a judicious combination of the best elements of the two opposing systems, has failed to deliver on its promise of political freedom, increased productivity and wealth, and greater peace and justice, and today poses a threat to the very survival of freedom and democracy.

The weakness of the “middle way” lies in the fact that regardless of the intentions of its advocates, principles have a way of making themselves felt. The “middle way” has been unable to combine freedom with planning because planning undermines the chief safeguard of liberty—the rule of law. Planning aims at particular results and must therefore reject general and permanent rules of law in favor of particular and ever-changing commands enforced by a bureaucracy with wide discretionary powers. It is unreasonable to suppose that such powers can be controlled when the success of the plan depends on their full exercise.

The hope that excesses of authority could be checked by the electoral process has proved futile. Planning requires detailed and expert knowledge of particular questions, a knowledge that politicians do not and cannot have. The result has been that in the “middle way” countries

planning has passed into the hands of experts and that political power has shifted from elected Assemblies to unelected bureaucracies. “Middle way” planning has thus acquired the essential characteristics of the totalitarian planning, precisely what the advocates of “freedom under planning” wished to avoid.

In a free market, economic decisions are largely based on prices which reflect the underlying forces of supply and demand. Prices function as signals informing both producers and consumers where best to employ their industry and capital. Price competition becomes a vital element of economic efficiency, adaptation to changed events is quick, the relationship of effort to reward is close, and economic order is insured.

Planning, however, does away with free prices, imposes wage and price controls, and determines production. Economic decisions are made without reference to efficiency or to consumer demand. This results in misallocation of resources, falling production, reduced wages and revenues, unemployment, and a lower standard of living.

The most serious failure of “the middle way” has been its inability to promote peace and justice. For the sake of “social justice,” central planning must also determine the “just” relationship of effort to reward, that is, incomes in general. Individuals no longer control their standard of living. Worse, with a less productive economy and incomes that are increasingly determined by political power, energies previously devoted to economic pursuits become progressively employed in political action aiming at control of public resources.

This is both unjust and less conducive to peace. Special interest groups and lobbies will seek an unjust structure of privilege, ruling at the expense of society. Such a situation produces dissatisfaction and social conflict, as the belief in the possibility of justice perishes. Where no principles exist, force will eventually appear as the only road to order and justice.

In all democracies the attempt to tread a pragmatic way between liberalism and socialism has given rise, on the one hand, to calls for tougher socialist measures and, on the other (at least in most Latin American countries, but apparently also in France and the United States), to a reviling of both liberalism and socialism and an extolling of a “new” spiritual socialism, a “new” mystic order. The re-emergence of totalitarian or authoritarian regimes cannot be brushed aside.

**A**s many historians remind us, freedom has endured only when liberal principles have governed public opinion. The guiding force of principles and free institutions allows for both freedom and order—that is, for infinite variability within a legal structure, making it possible for people to pursue their disparate goals with a minimum of friction.

The liberal principles of “law, liberty, and property” are not old-fashioned remnants of an earlier era. They are vital elements by which the nations that have practiced them, however imperfectly, achieved their present wealth and relative freedom.

Casting aside liberal principles in favor of a “middle way” can only lead to a gradual dissolution of the rule of law—the first step toward despotism. □

## The Guiding Function of Principles

# Air Transportation: More Government = Less Safety

**How the profit  
motive  
promotes  
safety.**

by Harry P. Wolfe  
and  
John Semmens

Mr. Semmens is an economist for the Arizona Department of Transportation. The views expressed here are those of the author and do not necessarily reflect Departmental policy.

Mr. Wolfe is co-author of *Aviation Industry Regulation*, a recently published text in the field of air transportation.

**M**ore than 1900 people died in airline crashes in 1985. This "worst year" in civil aviation history has spawned strident demands for reregulation and more government involvement in the airline industry.

The notion that government involvement assures safety should have been eliminated by the Challenger Space Shuttle tragedy. The Space Shuttle program is a totally government controlled, multi-billion dollar undertaking. If bureaucracy and big spending could guarantee safety, this tragedy would not have happened.

Contrary to much of the current discussion which hints at the modest reduction of government controls over the airline industry as the source of increased accidents, the history of aviation demonstrates that government has more frequently created problems than solved them. The rather sorry record of government's role in aviation began before the first aircraft got off the ground.

As nearly everyone knows, the Wright brothers invented the first controllable airplane. Many people may be vaguely aware that this feat was accomplished without benefit of Federal aid. Few, however, are aware that government-funded efforts to develop a heavier-than-air flying machine prior to the Wright brothers' venture were a total failure.

In the period preceding the December 17, 1903 Wright brothers' triumph at Kitty Hawk, North Carolina, the U.S. government spent \$70,000 on a grant to Dr. Samuel Langley to develop a heavier-than-air flying machine. The award of this grant followed standard bureaucratic procedures. Dr. Langley, director of the Smithsonian Institution, was one of the most renowned scientists of the time. When Dr. Langley became interested in investigating flight he was able to marshal tremendous technical and financial resources.

The selection of Langley as the recipient of government funding was technically unassailable. It was the type of decision that a well motivated government bureaucracy would make time and again. The credentials were impressive. The funding was more than adequate. Yet, despite the head start and more lavish budget enjoyed by Dr. Langley, it was the Wrights who succeeded.

On October 7, 1903, the aircraft developed by Dr. Langley's team was deemed ready for a test flight. The aircraft was to be launched



from a catapult on a houseboat in the Potomac River, with Charles Manly serving as pilot. Excitement filled the air as the houseboat reached the launch site. A large crowd gathered, fireworks were set off, and newspapermen jockeyed for position in the hope of witnessing the momentous occasion of man's first flight.

Hopes were raised and hearts quickened as the aircraft's engine roared to life. At full throttle the craft was released from restraint and lunged along the catapult track toward launch. A few seconds of glorious acceleration were followed by an unceremonious plunge into the Potomac by the would-be airplane.

The pilot and aircraft were salvaged and preparations were made for another flight. On December 8, 1903, with diminished fanfare, another test flight was attempted. Unfortunately the aircraft became entangled in the launching mechanism, was severely damaged, and toppled into the river.

Little more than a week later the Wright brothers successfully flew a heavier-than-air machine. Disappointed at being bested in the effort to develop an airplane, Dr. Langley, in a fashion that has come to characterize the persistent failure of government undertakings, laid much of the blame on "inadequate" Federal funding.

While Dr. Langley was engaged in epitomizing the typical government approach to problem solving, two young entrepreneurs were experimenting with their own airplane. The Wright brothers had no Federal money to support their research. Instead they used \$2,000 of the money they earned from their bicycle business to develop their flyer. They worked on the flyer in their spare time while managing their bicycle shop. On numerous occasions the Wright brothers actually refused financial assistance from private contributors for fear that it would take them away from their business and make them complacent. Wilbur Wright told his father that the demands of his business forced him to be more cautious about the use of his time, and to carry out his experiments in the most expeditious manner possible.

If lavish Federal subsidies had been unable to buy Dr. Langley success, what chance would the Wright brothers' unfunded venture expect to have? Surprisingly, their chances were a lot better than might be imagined. Freed from the subsidy-induced waste and indolence that plagues government funded operations, the Wright brothers' limited financial resources actually contributed to their success. Because they could not afford the costs associated with repeated flight tests of their airplane, they developed a wind tunnel to test aerodynamic designs. This saved them a great deal of time. The Wright brothers were the first men to compile data from which an airplane could be designed. With limited finances, it was far easier to correct errors on paper than to continually rebuild a test model that was improperly designed.

The Wright brothers' use of the wind tunnel not only saved them time, but also their lives. Other airmen of the day were quick to flight-test inoperable aircraft, and lost their lives in the process. Orville and Wilbur Wright, on the other hand, did not believe in taking unnecessary risks. Wilbur Wright conducted his glider flights close to the ground in case an accident occurred. He didn't want to get hurt since a fall would interrupt his experimenting.

## NO BALLOON ATTACHED TO AID IT

Three Years of Hard, Secret  
Work by Two Ohio Brothers  
Crowned With Success

ACCOMPLISHED WHAT  
LANGLEY FAILED AT

With Man as Passenger Huge  
Machine Flew Like Bird  
Under Perfect Control

BOX KITE PRINCIPLE  
WITH TWO PROPELLERS

Headline from the *Virginian-Pilot*, December 18, 1903.

## Conserving Limited Resources

## The Pursuit of Profit

On December 17, 1903, only nine days after Langley's unsuccessful venture on the Potomac, the Wright brothers successfully launched their flyer from the dunes of Kitty Hawk, North Carolina. The longest flight lasted 59 seconds, traveled 852 feet, and ushered in the era of manned flight.

The contrast between the efforts of Dr. Samuel Langley and the Wright brothers is thought-provoking. Orville and Wilbur Wright spent \$2,000 of their own funds and succeeded. Dr. Langley spent \$70,000 in Federal funds and failed. Why were the Wright brothers successful, especially when they spent far less money than their government counterparts?

**T**he answer lies in part in the motivating force behind the Wright brothers' and Langley's efforts. The Wright brothers were motivated by the pursuit of profit. Langley was attempting to advance the "public welfare." While the profit motive suffers much derision at the hands of the economically ignorant, it is mankind's best known means of promoting productive use of resources. In contrast, the use of collective force in the name of altruistic goals has compiled a sorry record of waste, stagnation, and oppression.

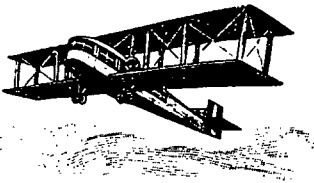
The profit motive caused the Wright brothers to place a premium on minimizing the costs of their experiments, eliminating waste, and making the best use of their time. Langley, as a beneficiary of Federal largesse, had no real incentive to minimize his costs. In fact, the mark of success for a government research program is often measured in terms of the amount of money expended on the effort.

A few examples of the contrasting attitudes toward incurring expenses are indicative. No government undertaking can be expected to function without a staff of administrators. Dr. Langley, naturally, hired such a staff. The Wright brothers conducted their own research and hired no administrators. Dr. Langley spent a considerable sum on his houseboat launch facilities. The Wright brothers launched their airplane from a 60-foot track that cost \$4 to construct.

It wasn't only the profit motive that made the Wrights cautious about the expenditure of funds. It was the fact that they were using their own money. People will be more careful when they are spending or investing their own hard-earned wealth. Wasting the "free money" from government grants is a lot easier. Using their own funds inspired the Wright brothers to be much more systematic in their experiments. For example, the Wrights perfected their aircraft's control system through hundreds of glider flights before they ever affixed a motor to the contrivance. Langley, on the other hand, attempted to master control over the machine and powered flight simultaneously.

Another reason that the Wright brothers' decision to use their own money contributed to their success was that it enabled them to maintain their independence. When money is bestowed, there are generally conditions attached. Many times, scientific curiosity must be sacrificed to fulfill the expectations of the government bureaucracy. Many of the unconventional theories and experiments carried out by the Wright brothers might never have been tolerated if they had been conducted under the eye of government administrators.

The sorry results of its early attempt to promote aviation have not



deterred government from subsequent meddling. Effective utilization of the technology of air travel is still retarded by government ownership and operation of the air traffic control network and the vast majority of airports. In addition to this direct interference, government imposes complicated regulations on air carrier operations.

These continued interventions of government in the aviation industry create red tape and divert scarce resources from more productive uses. Airlines, instead of being able to focus on efficiently providing air transportation, are forced to adhere to rigid bureaucratic rules.

Recent problems with airline safety, contrary to much of the media debate, have nothing to do with the 1978 deregulation of air routes and fare. Few media accounts accurately portray precisely what was and wasn't deregulated. Safety regulation was *not* changed by the 1978 Act. Any deficiencies in the area of airline safety are deficiencies under the *continued* government regulation of safety.

**L**et us compare the relative performances of the airline industry in the categories that were deregulated vs. those that were not. The deregulation of fares brought lower prices for consumers. The deregulation of routes brought more frequent and convenient service. It is safety—the one key aspect of air service that was retained under governmental authority—that appears to be underperforming.

This comparison of relative performances of fares and convenience (both deregulated) vs. safety (regulated) supports a conclusion directly opposite to that which is currently touted in fashionable circles. Namely, it is clear that discarding the benefits of deregulation by reintroducing government controls over fares and routes would do nothing for airline safety. To the contrary, it is becoming more obvious that the 1978 deregulation did not go far enough. If safety were also deregulated we would have the opportunity to enjoy the same kind of improved results that we've seen in fares and schedules.

Proponents of expanded government controls and coercion as the only reliable approach to improved safety scoff at the idea that a profit-hungry industry could monitor its own safety. But as we have seen from the earliest example contrasting public sector and private sector approaches, pursuit of profit is not in conflict with promotion of safety. After all, it was the non-profit motivated, government-funded Langley plane that crashed. It was the profit-seeking, privately funded Wright plane that safely achieved man's first flight.

That the profit motive would be a more effective means of promoting safety than an army of bureaucrats should be self-evident. Crashes cost money and drive up operating expenses—either to pay for damage and its consequences or to pay insurance premiums that will rise with a poor safety record. Crashes also disrupt business and scare away passengers. Profits will be hurt by either rising expenses or falling passenger revenues. Obviously, then, profit-seeking airlines have very strong economic incentives to conduct safe operations.

If we are to learn a lesson from the “worst year” in aviation history, let it be the right lesson. The air disasters of 1985 are evidence for less, not more, government involvement in aviation. □

## Fares, Routes, Safety

# Privatization: The Rediscovery of Entrepreneurship

**Responding to market incentives, rather than political pressures.**

by William H. Peterson

Dr. Peterson is director of the Center for Economic Education and holds the Scott L. Probasco Jr. Chair of Free Enterprise at the University of Tennessee at Chattanooga.

This article is adapted from a lecture given at a conference on entrepreneurship at McNeese State University, Lake Charles, Louisiana. It is used with permission of the Intercollegiate Studies Institute, Inc., the sponsor of the conference.

**L**ast February I participated in a conference on international privatization in Washington, along with some 500 others, mostly officials from the Third World. Perhaps surprisingly, the conference buzz-words turned out to be privatization and entrepreneurship.

I was struck by this seeming rediscovery of the world of Adam Smith and John Stuart Mill, and the fading from view of the world of Karl Marx and John Maynard Keynes. The trend is commendable, and I applaud it. But, alas, trends are reversible. And what irony, the trend seems more pronounced abroad than it does here in America. So the role of the private sector and the entrepreneur in preserving and expanding all over the world freedom and free enterprise, including the art of wealth-creation, has to be redefined and reaffirmed, in my judgment. To reassert an old homily, the price of freedom is eternal vigilance.

What is privatization? Privatization is a means of getting goods and services produced privately that were previously produced publicly. Sometimes it means the government will continue to finance the production of a good or service but with the private sector actually producing the good or service. One such practice is contracting out. Another such practice is giving individuals vouchers with which to purchase the good or service from private suppliers. Sometimes privatization involves the outright sale of state-owned enterprises to private investors. Sometimes it involves deregulation, the removal of legal restrictions on private provision of goods and services, and hence the allowing of a transition from a public or quasi-public to an unhampered private supply. A city's cancellation of a limited number of taxi licenses to open the cab business to all comers is a case in point.

What is entrepreneurship? While it is possible to think of public entrepreneurship (such as the conceptualization and establishment of Social Security and Medicare), to me entrepreneurship is a strictly private matter. It is the risk-assuming organization and management of an enterprise. It is the ever-present fourth and most indispensable factor of production beyond the other three of land, labor, and capital. Its quality makes or breaks the enterprise. It exists under the sover-

eignty and suffrage of the consumer who has a life-and-death vote in the marketplace over the fate and viability of every enterprise. It is at the heart of productivity improvement, of getting more out of less. It is the *sine qua non* of freedom and free enterprise, of what Adam Smith called "the wealth of nations," of the manifestation of his famous "invisible hand" in action—of self-interest harnessed to the public interest, the common good.

At the Washington meeting, Secretary of State George Shultz told the group that privatization and entrepreneurship are indeed ideas whose time has come, that success in economic development is at base a matter of choice of competing economic philosophies, that Third World debt has to be increasingly replaced by Third World equity, that with private enterprise, with the emergence of private savings, private investment and the ubiquitous private entrepreneur, comes industrial efficiency, economic growth and rising living standards. Said Agency for International Development administrator Peter McPherson to the conferees: "Interest in reducing the public sector is a new phenomenon. It results from the pragmatic realization that statism has failed in most parts of the world."

**T**hat failure is seen in the dashed hopes in state-owned enterprises and services around the globe. Guarded horror stories on state economic incompetency abounded at the conference, leading to the conclusion that state operation of enterprises leads to mismanagement of resources, low quality of products and services, reduced economic growth and even negative growth, capital flight to safer havens (most notably to Switzerland), forced migration of peoples (such as the waves of Mexicans and Central Americans across the U.S. border with Mexico), and frequent staggering financial losses. These losses have compounded the growing and precarious external debt load of developing nations at a magnitude currently estimated at \$1 trillion.

(As Ludwig von Mises had long demonstrated, government intervention into peaceful private activity tends to make things worse rather than better. Adam Smith also would have been critical of the postwar worldwide splurge on the part of political leaders in nationalizing industries from communications to medicine, while admonishing citizens to curb their predilection for "private affluence" in the face of "a starved public sector"—to quote the verbiage of John Kenneth Galbraith. As Smith wrote in *The Wealth of Nations*:

It is the highest impertinence and presumption . . . in kings and ministers, to pretend to watch over the economy of private people, and to restrain their expense, either by sumptuary laws, or by prohibiting the importation of foreign luxuries. They are themselves always, and without any exception, the greatest spendthrifts in the society. Let them look well after their own expense, and they may safely trust private people with theirs. If their own extravagance does not ruin the state, that of their subjects never will.)

At the Washington conference, I soon gathered that the solution to what I label "intervention failures" has increasingly been privatization—the return to private entrepreneurship, to what Hayek calls

## The Failure of State Ownership

"spontaneous order." Countries around the globe are finding out anew that the production of government-provided goods and services can be well shifted to the private sector, with a practically immediate upgrade of quality and a reduction of cost, apart from other desirable results. I found that privatization—the re-emergence of the entrepreneur—has become a worldwide movement, with even communist countries along with socialist governments in places like Spain, Italy, France, and Sweden getting into the swing.

The People's Republic of China, for example, under the leadership of Vice-Chairman Deng Xiaopeng, has opened its economy to foreign investors through the aegis of joint ventures, with guarantees against expropriation of property and for repatriation of earnings. It has permitted its collective farmers to sell their "surplus," i.e., over-quota, produce in the cities and to keep the proceeds. It has permitted more than ten million small entrepreneurs to run restaurants, boutiques, repair shops, street stalls, and so on. Cuba is selling state-owned houses and apartments to tenants. Hungary, in the vanguard of privatization among communist states as well as its most affluent member, concedes the right of private entrepreneurs and capitalists to bid to the government to operate their own businesses, with the bidding falling on receptive ears. Poland authorizes more private farming, now around 40 per cent of the total.

Other privatization stories also abounded at the Washington conference. Pedro Pablo Kuczynski, formerly Peru's minister of energy and mines and now managing director of the First Boston Corporation, told the conferees how his company assisted Spain's socialist government to sell off more than 40 state-owned hotels. Canada plans to sell to private investors its two loss-making state-owned airframe manufacturers, Canadair and de Havilland, along with government mining businesses, including Eldorado Nuclear, a producer of uranium oxide. Also on the Ottawa government's for-sale list are Canadian Arsenal, an arms producer, and Teleglobe Canada, a firm handling overseas telephone calls. Said Robert R. De Cotret, chairman of Canada's Ministerial Task Force on Privatization, in announcing these privatizing moves (in a bit of understatement): "A key element of the government's commitment to good management is our policy for the privatization of commercial crown corporations which no longer fulfill a specific public policy purpose."

## Privatization in Britain

**T**he biggest privatizer of all countries, though, is Britain, home of a number of socialist governments, especially since the end of World War II. In his paper, *Privatization around the Globe: Lessons for the Reagan Administration*, conferee Peter Young of the Washington-based Adam Smith Institute-USA and the Dallas-based National Center for Policy Analysis, the publisher of the paper, reported that a "privatization revolution of enormous proportion" is taking place in Britain, transforming virtually the entire British economy. Last November, for example, British Telecom, a vast state-owned telephone and telegraph firm, was sold to the private sector in the largest public offering in history. Two million Britons snapped up shares. Jaguar, Britain's state-owned auto manufacturer, was also sold to the public. The Thatcher government has sold 100 per cent of its stock in British Sugar, 51 per cent of its stock in Britoil (North Sea

*It is important to bear in mind that true privatization reaches beyond achieving efficiency and coping with deficit spending. It reaches into the nature of man, of human incentive.*

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oil exploration), 51 per cent of British Aerospace, about 40 per cent of its stock in British Petroleum, and has sold off subsidiary operations of British Steel, British Rail and British Airways. In addition, the British government has sold 873,000 public housing units—13 per cent of all British housing—to tenants. To date more than 400,000 jobs—almost one-third of the total in nationalized industries—have been shifted to the private sector.

While not so pronounced, similar privatization moves have been made in France, Italy, the Netherlands, West Germany, Sweden, Denmark, and Portugal. Turkey has sold off its Bosphorus Bridge and the Keban hydroelectric dam. It is also planning to privatize more than 30 state-owned companies, including the state airline, THY.

In Africa, Kenya sold off its national fisheries. Somalia eliminated price controls and turned over its grain marketing facilities to private enterprise. Mozambique privatized its radiator factory and truck and railroad parts plant. Togo's minister of industry told me of his initial plans to privatize 12 of 70 state enterprises, including a steel mill capable of producing 50,000 tons of steel a year (with a local market of only 8,000 tons).

Japan is divesting itself of government-owned telephone, airline, and railroad systems. Already the partial sale of giant Nippon Telephone and Telegraph has brought billions of yen into the Japanese treasury. South Korea has unloaded onto the private sector many government banks and heavy-industry plants. Pakistan and Bangladesh are returning nationalized rice, flour, jute, and textile mills to their former proprietors. India and Malaysia are privatizing their highways. Sri Lanka has put up its telecommunications system for sale, and has sold off its bus system, once a monopoly of the Ceylon Transport Board.

In America, as I noted earlier, privatization has further to go than it has abroad, especially at the central government level. Even so, 35 per cent of all local governments now contract out residential garbage collection, 42 per cent contract out the operation and maintenance of their bus systems, and 80 per cent contract out vehicle towing and storage. Louisville, Kentucky sold its money-losing teaching hospital to a private hospital company in 1983, with the hospital today not only operating in the black but furnishing better patient care. Knoxville, Tennessee has privatized its residential garbage collection, with its mayor boasting of savings of around \$1 million a year. Hamilton County, Tennessee has privatized its Silverdale prison, with

## Progress in America

the operator, the Corrections Corporation of America, charging Hamilton County \$21 per prisoner per day instead of the \$28 a day which the county had been incurring on its own. Scottsdale, Arizona has effected savings of around 50 per cent in fire-fighting costs through its contract with Rural Metro Fire Department, Inc.

And so it goes in municipal America. Private companies have contracted with city governments to control traffic, repair streets, provide ambulance service, effect crime control, maintain and clean public buildings, furnish water service, manage cemeteries, parks, museums, tennis courts, golf courses, liquor stores, auditoriums, hospitals, arts and cultural centers, and even entire city governments. The town of La Mirada, California, for example, has utilized the private sector for virtually all its key services, including social welfare, public works, and police and fire protection.

Privatization at the municipal level, and recent proposals to privatize state and Federal services, can be viewed as an encouraging move toward the free market. But a few words of caution may be in order. Much of what is being touted as privatization may, in time, extend the powers of government.

Consider, for example, the contracting out of "public" services. When a privately owned firm, which previously served only the private sector, receives a government contract, its relationship with the government necessarily changes. This is especially true if the firm receives a franchise—a monopoly privilege. Government funding brings government control, and the government contractor may soon find himself responding to political pressures, rather than market incentives.

It is important to bear in mind that true privatization reaches beyond achieving efficiency and coping with deficit spending. It reaches into the nature of man, of human incentive. As Peter Drucker noted in his new book, *Innovation and Entrepreneurship*:

The most entrepreneurial, innovative people behave like the worst time-serving bureaucrats or power-hungry politicians six months after they have taken over the management of the public service institution, particularly if it is a government agency. The forces that impede innovation in a public service institution are inherent in and integral to it and inseparable from it.

Ludwig von Mises put the matter even more forcefully, tying the issue to human liberty, in his 1944 classic, *Bureaucracy*:

There are two methods for the conduct of human affairs within the frame of human society. One is bureaucratic management, the other is profit management. . . . The main issue in present-day social and political conflicts is whether or not man should give away freedom, private initiative, and individual responsibility and surrender to the guardianship of a gigantic apparatus of compulsion and coercion, the socialist state. Should authoritarian totalitarianism be substituted for individualism and democracy? Should the citizen be transformed into a subject, a subordinate in an all-embracing army of conscripted labor, bound to obey unconditionally the orders of his superiors? Should he be deprived of his most precious privilege to choose means and ends and to shape his own life? □



# Witnesses at the Creation

by John Chamberlain

**T**he 200th anniversary of the writing of the Constitution in 1787 is almost upon us. With its checks and balances, its provision for the minority rights of states and individuals, as well as for a protection of the whole when it comes to defending the Federal borders, the document has lasted longer than any other written constitution of our time.

What makes the Constitution unique is fully explained by Richard B. Morris of Columbia University in *Witnesses at the Creation: Hamilton, Madison, Jay, and the Constitution* (New York: Holt, Rinehart and Winston, 279 pp., \$16.95). The document was the handiwork of fifty-five men who, in the steaming hot summer of 1787, met in the State House of Philadelphia in secret sessions behind closed doors. Exceeding their instructions to do nothing more than amend the Articles of Confederation that bound in loose embrace the thirteen states that had fought the revolution, the fifty-five delegates came up with something that was part nationalistic, part federative, and part a defense of the inalienable rights of individual citizens.

Fortunately James Madison of Virginia kept a meticulous record of deliberations that went on for four

months. It was Madison who, as a bait for acceptance by the states, promised the Bill of Rights that defined freedom of the press and religion and guaranteed life, liberty, and property (the traditional "rights of Englishmen") to anybody who was free born. (The founders had to get around the issue of slavery somehow, which they did by postponing the abolition of the slave trade and leaving black manumission up to the states.)

In 1787 the thirteen states, stretched out along the Atlantic seaboard, were struggling with depression. The farmers of the back country, oppressed by their debts, had taken to open rebellion. States were printing their own paper money, which quickly became worthless. There was no uniformity of import duties, and the states were setting tariffs against each other. John Jay of New York had negotiated a good treaty of peace with Britain, which extended the so-called Northwest Territories to the banks of the Mississippi. But the British were slow to evacuate territory beyond the Appalachians. Meanwhile the Barbary Pirates of North Africa, the Qaddafis of their day, were seizing American ships and holding their crews for ransom.

The times were ripe for a government that would be empowered to col-

lect the taxes needed to pay for an army and to build a navy capable of dealing with pirates. There were plenty to believe, with Alexander Hamilton, that a federal government should assume the debts of the states and take responsibility for a national currency. And the abolition of internal tariffs seemed as necessary to commerce as the building of bridges across rivers that obstructed north-south travel. But, though all the objective circumstances favored the quick ratification of the Constitution, which gave small states such as Delaware equal representation in the upper legislative chamber with the big states of New York and Pennsylvania, there was a considerable ground swell in favor of sticking to the old Articles of Confederation.

It was to combat the ground swell that Hamilton, Madison, and Jay undertook to write the Federalist Papers, which were presented to newspaper readers as the works of "Publius." Thomas Jefferson, writing to Madison, praised the Federalist Papers as "the best commentary on the principles of government which ever was written." Much of Morris' book is devoted to sustaining Jefferson's judgment. The portraits and life stories of Madison, Hamilton, and Jay are excellent.

### Modern Applications

Our Secretary of Education, William Bennett, has been making it a practice of giving lectures to students on the Federalist Papers. Their importance to American history is obvious. But who, in our political science faculties, has seen fit to apply the thinking of Hamilton, Madison, and Jay to the struggles of the outer world to achieve nationhoods that might solve their economic problems without infringing the rights of individuals?

The question of South Africa leaps immediately to mind. Here we have a

collection of tribes, including the white tribe of the descendants of the Boer trekkers. The Zulus, 6 million strong, are one of the biggest tribes. They don't want to entrust their fortunes to any "one man-one vote" majority of lesser tribes any more than the white tribe of President Botha wants to submit property and business rights to the whims of 51 per cent of a black vote bent on expropriation.

If there were a South African James Madison, he would be counseling his countrymen, black and white, to regard the separate tribes as the equivalent of the thirteen states of federalist America. There would be "one man-one vote" for taxation and foreign policy purposes, and for the election of a president. But property rights would remain vested with tribes and individuals.

The genius of Hamilton, Madison, and Jay resided in their ability to limit "one man-one vote" democracy to such things as funding the national debt, building forts on borders, paying the army, regulating internal commerce, levying tariffs, and providing for a court system and the election of representatives. But "life, liberty, and the pursuit of happiness" were beyond the vote, and property could not be taken without "due process."

There is no reason why this way of thinking can't be applied everywhere. Let the year 1987 be given over to it.

□

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### Audio Classics—The Wealth of Nations

Script by George H. Smith

Knowledge Products, 120 Tremont Street, Boston, Massachusetts 02108; toll free, 800-453-9000, ext. 400  
4 cassettes, \$39.95; \$170 prepaid for 24 cassette series

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*Reviewed by Howard Baetjer Jr.*

Cassettes will not replace books, but they give the literature of liberty an exciting new dimension. Scholarly discussions of classic works of political philosophy are now

available on tape. "Audio classics" is a professionally produced, attractively packaged series of 24 cassettes presenting the ideas of thinkers whose books have shaped the modern world. If the four tapes on Adam Smith's *Wealth of Nations* are representative, the series is a worthwhile investment for anyone who would like to supplement the printed page.

The *Wealth of Nations* tapes begin with a biographical sketch of Smith, the historical context in which he wrote, and the influence of his experience and acquaintances. The narrator outlines the structure, major points and purposes of the book. George Smith's elegant script is written in accessible language, which clarifies difficult points without being patronizing or oversimplified. This is important for tape format, in which rereading is impossible. (Rewinding is, of course, but I rarely needed to do that.)

The presentations are clearly organized. Different sections are separated by music, and the script contains transition passages describing the relation of one section to another. The narrator reads in a slow, clear, expressive voice. A helpful and entertaining aspect is the use of voice characterizations for quotations from Smith and other historical figures (including Samuel Johnson, James Boswell, David Hume, Adam Ferguson, Jean Baptiste Say, and others). Not only do these characterizations give the listener a feeling of "being there," but also they obviate any confusion as to what is narration and what is quotation.

The content is interesting and admirably complete. The four tapes, each between sixty and eighty minutes in length, provide about five hours of detailed and varied listening.

The tapes effectively debunk the criticisms that have been leveled at Adam Smith, especially that he was an apologist for exploitative big business. They make clear that while

Smith was an advocate of capitalism, he was a severe critic of some contemporary businessmen. That is, he was dedicated to the truly free economy, which leads to the well-being and prosperity of all people. Smith criticized those capitalists who pursued government privileges for themselves at the expense of consumers and their competitors.

In his book, Adam Smith strongly criticizes mercantilism, that system of bounties, monopolies and restrictions on trade which beset Britain at the time. Smith intended *The Wealth of Nations* to guide public policy away from mercantilism and toward free trade. The tapes distinguish Smith's view of national wealth as the real income of all the people of the nation, which increases under a policy of free trade, from the mercantilist view of national wealth as the riches of the state or government, toward which mercantilism was directed.

Smith's concern for the common man, who has no access to political power and privilege, informs the whole presentation. Smith was a professor of moral philosophy; his primary concerns were justice and fairness. He advocates the free market chiefly in concern for justice to the common man and equality under the law.

Listening to these tapes is no substitute for reading *The Wealth of Nations*, but for those who don't have the time to read it, they are a wonderful second choice. They provide instruction while one is restricted to one's car or otherwise unable to read. And when one returns to the original, he will find it much more accessible after hearing this fine introduction. The listener will delight in Smith's language, the clarity of his insights, and the pertinence of his thought to the present day. Hearing Smith's own words, read in an engaging Scottish brogue, one is reminded that classics are classics not because they are old, but because they are great. □

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# The Farm Problem

20 chapters—17 authors

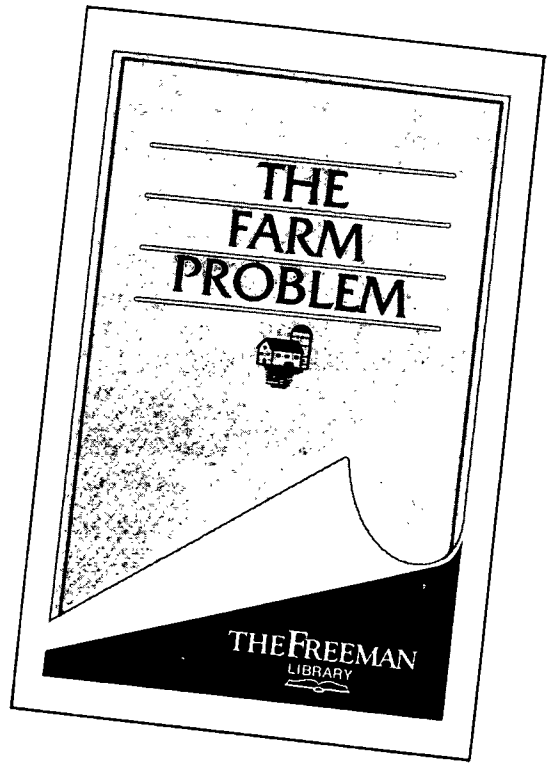
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# THE FREEMAN

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*The Freeman* considers unsolicited editorial submissions, but they must be accompanied by a stamped, self-addressed envelope. Our author's guide is available on request.

## PERSPECTIVE

### Spirit of Liberty

Since the spectacular July 4th week-end celebrating the 100th anniversary of the Statue of Liberty, America has been enjoying a period of euphoria. With much flag waving we have rejoiced in the remarkable way people from all parts of the world have melded into a single nation. Race, color, or creed offer no serious barrier to becoming a successful scientist, business owner, shopkeeper, teacher, or entertainer.

The spirit of liberty, as epitomized in the Statue, has been responsible for this record of achievement. That spirit of liberty offers opportunity to any who dare to try, to struggle, and to work. However, the spirit of liberty can be snuffed out by well-meant attempts to protect the "tired, the poor, the huddled masses."

Tax funds that finance "safety nets" can discourage the incentives of those who are less fortunate to improve their own situations. And the collection of taxes from those who must pay the costs hamper the efforts of those who could contribute the very most.

The market economy is remarkably resilient. In spite of the many obstacles that have been placed in the path of entrepreneurs over the years, they continue to show energy and initiative. And so long as freedom of entry into various occupations and businesses is not seriously restricted, so long as producers are not discouraged by high taxes and rigid regulations, newcomers will always be welcome for the contributions they can make. There is no limit to the number of new arrivals who can be accommodated in such a free market economy. However, if people come here because of the "welfare state," because of government-financed "safety nets," there is a limit to the number of people who can live within our borders. Production and living standards would then decline and newcomers would find

themselves in constant conflict with those who came here before.

Disillusionment with some of our socialistic experiments has developed, and tentative attempts have been made to limit government, reduce taxes, deregulate, and privatize. If these attempts eventually do succeed, it will be a sign that perhaps the Statue of Liberty is not 100 years old, but 100 years young. Its torch will then continue to shine as a beacon of hope to persons throughout the world. It will tell them that here they can find, not security, but what is more important, liberty and freedom of opportunity.

—BBG

## If Men Could Fly

We tend to ask questions only about the unusual event. The everyday happening rarely excites our curiosity. We see a bird in flight and yawn. Were we to see a man flying unaided through the air we would immediately start an investigation.

This poses a problem for the student of liberty. Our children, beneficiaries of the free market in a free society, take prosperity for granted. The laden shelves and burgeoning freezers in the local supermarket stimulate no questions. Bare shelves and empty freezers might.

Yet "bare shelves and empty freezers" historically are the norm! The vast majority of men and women who have walked this planet have spent their every waking hour in a struggle to keep destitution at bay. The puzzling exception which cries out for explanation is the plenty enjoyed by the beneficiaries of economic and personal liberty. If we teach our children the lessons of history, we may elicit the questions only free market economics can answer.

—John K. Williams  
Visiting Scholar

## Op-Ed Update

*The Freeman's* op-ed newspaper program, in which we send *Freeman* articles to a select group of newspapers for use on their editorial or commentary pages, continues to expand. Sarah H. Lindsey's "Educational Freedom" (June *Freeman*) has appeared in *The Augusta Chronicle*, *The Anchorage Times*, *Fort Walton Beach Daily News*, *The Phoenix Gazette*, and *The Orange County Register*. Peter S. Heinecke's "The Fallacy of Comparable Worth" (June *Freeman*) has been published by the *Gettysburg Times*, *Chicago Sun-Times*, and *Long Island Newsday*. James L. Payne's "It's Not Our Money" (June *Freeman*) has been used by the *Chicago Tribune*. And Dennis Bechara's "The Continuing Plight of Agriculture" (May *Freeman*) continues to be reprinted, most recently by the *North Fort Myers Lee Constitution*.

If you see one of our articles, we would appreciate it if you would send us a clipping.

## Spanish Books from FEE

For readers of Spanish—Hispanic newcomers to these shores and students of the language—it is difficult to obtain books which explain the free market, private property, limited government system. To fill this need, The Foundation has stocked books from Spanish language publishers in Central America and Spain. Titles include *The Law* by Frederic Bastiat, *The Incredible Bread Machine* by Susan Love Brown and others, *Economics in One Lesson* by Henry Hazlitt, *Planning for Freedom*, *Liberalism*, *Economic Policy*, and *Human Action* by Ludwig von Mises, and *The Essential von Mises* by Murray Rothbard.

Write Bettina Bien Greaves for information and a price list.

# The Selling of Freedom

by Dennis L. Peterson

**E**ntrepreneur and multimillionaire W. Clement Stone wrote, "Whatever your profession, you are selling something: ideas, concepts, goals, beliefs, values. While many persons think of selling only as offering a product or service for profit, you begin to sell the day you were born and will continue to sell throughout your life."

That statement is especially true in regard to the freedom philosophy. Although many people assume that this philosophy is passed on merely through tradition or in the formal, organized economics and government courses of certain schools, it is primarily transmitted by individuals through a daily selling process. And this process goes on not simply in classrooms but throughout the nation with the countless interactions of individuals during their everyday lives. We are constantly selling our ideas, goals, beliefs, and values.

Every believer and practitioner of the freedom philosophy is, whether or not he or she recognizes the fact, a salesman for those beliefs. Some individuals are good salesmen, some are mediocre salesmen, and others are downright poor salesmen. Those of us who sincerely want to be "supersalesmen" for freedom would do well to periodically review our sales strategies and practices. The effective selling of freedom requires that we develop and incorporate certain essential sales qualities. The degree of our success is determined by how closely we follow these time-tested qualities.

## Methodology

The most lasting method of selling the ideas of freedom is through positive education. As the editors of *The Freeman* have stated, "Though a necessary part of the literature of freedom is the exposure of collectivistic clichés

and fallacies, our aim is to emphasize and explain the positive case for individual responsibility and choice in a free economy. Especially important, we believe, is the methodology of freedom: self-improvement, offered to others who are interested. We try to avoid name-calling and personality clashes and find satire of little use as an educational tool."

The freedom philosophy cannot be forced on anyone. Others must recognize for themselves the advantages of freedom and choose it voluntarily. As the late Leonard E. Read wrote in his essay "On Improving the World" (reprinted in *The Freeman*, November 1983), "... the practice of freedom cannot depend on coercion. When it comes to influencing another to think and act creatively, to help advance another's understanding, one is limited to the power of attraction."

Many well-intentioned freedom-lovers are too impatient, however, to wait for this "positive attraction" strategy to bring results. Like their socialist opponents, they want immediate results. Consequently, they sometimes turn to political actions that bring either short-term solutions or—far worse—total disillusionment among the waverers. Their "action strategy" tends to lead to confrontation and alienation rather than to conversion, acceptance, and positive long-lasting change. As William Penn wrote in *Fruits of Solitude* (1693), "Truth often suffers more by the heat of its defenders than from the arguments of its opposers."

## Tolerance

One characteristic which should always distinguish the salesman of freedom from the spokesman for socialism is a tolerance of and respect for contrary views and opinions. It is this quality which enables one to debate an opponent without "losing his cool" and without fear that the truth will lose its credibility.

*Mr. Peterson is a free-lance writer in East Greenville, Pennsylvania.*



Thomas Jefferson recognized the power and resilience of truth and the need for tolerance of opposing and even false views. "Error of opinion may be tolerated," he said, "where reason is left free to combat it."

The need for such tolerance does not diminish if only a few people—even seemingly insignificant and noninfluential ones—hold a minority viewpoint. "If all mankind minus one were of one opinion and only one person were of the contrary opinion," John Stuart Mill argued in his essay *On Liberty*, "mankind would be no more justified in silencing that one person, than he, if he had the power, would be justified in silencing mankind."

## Example

In the world of business, consumers are more easily convinced to buy a product if the seller uses it himself. The satisfaction evident from the use of his own product will often produce the enthusiasm and conviction required for him to close the sale.

In our attempts to sell freedom, we should consistently practice the principles we espouse and defend. If we say we believe in a balanced budget and fiscal responsibility for government, we should insist on such practices in our own finances. If we preach rule by law, we should obey the law. Our primary task as salesmen of freedom is to persuade, not by conflict or coercion but by precept and example. As Leonard Read wrote in *The Path of Duty*, "Let each become an exemplar of freedom."

## Knowledge

Every effective salesman knows his product like the back of his hand. He knows its weaknesses as well as its strengths, its limitations as well as its capabilities. He will anticipate both the reactions and the objections of his prospects. And, most important of all, he will never stop learning about his product, his customers, and his strategies.

Similarly, we proponents of freedom must be perpetual students of our philosophy. Rather than claiming to be the sole possessors of truth, we should readily admit our relative ignorance and eagerly seek to learn more. Anything we

might know about the theory and practice of freedom is infinitesimal in comparison to the vast amount out there yet to be known.

## Repetition

As a teacher I learned that one cannot expect all students to grasp a fact or concept when it is initially presented. Information must be repeated until the student understands. But the student's ability to regurgitate a fact or concept does not mean that he or she has "learned." The information must be acted upon and become a part of each individual's life.

The salesmen of freedom cannot afford to be satisfied with giving their "sales pitch" just once. In order for it to be accepted and applied, it must be repeated to each new generation. And even those who have already heard it need to be reminded every so often. Statist propaganda so dominates the media today that we sometimes begin either to believe it ourselves or to think that we are the sole surviving freedom-lovers.

## Optimism

Lord Beaverbrook wrote in *The Three Keys to Success*, "... salesmanship requires, above all, the spirit of optimism."

Perhaps one of the greatest weaknesses of those who oppose statism in favor of individualism is the tendency to be pessimistic concerning the prospects for a return to freedom. I must admit that I, too, at times succumb to this temptation. What we must remember, however, is that few people are willing to embrace as their own any philosophy whose advocates are pessimistic or unenthusiastic. They choose rather to follow a path of optimism, a way that is promising and hope-inspiring.

In their attempts to alert others to the dangers of statism, many freedom-lovers unwittingly exude an air of doom, despair, and depression. Of all people, it is we—those who have experienced, both personally and vicariously, the promise and prosperity of freedom and individualism—who should be spreading such hope and positive expectation that others are magnetically attracted to freedom's way.

Jesse Stuart, famous writer and teacher from the hills and one-room schoolhouses of Ken-



Exchanging ideas on the freedom philosophy during a FEE seminar.

tucky, recognized the infectious nature of enthusiasm in his teaching. He wrote in *The Thread That Runs So True*, "... when I am enthusiastic about my teaching, (the students) are enthusiastic. When I am depressed, they seem to be that way, too. Their feelings seem to rise as high as my feelings are high or as low as mine are low. Therefore I have tried to be as enthusiastic as I can about any subject I teach."

## Moral Principles

No theory or doctrine long survives unless it has as its foundation sound moral principles and absolute truth. Possession of correct economic or governmental principles, in particular, is practically impossible without first having a firm foundation of morality.

During the past two decades, a philosophy of *amorality* has gained wide acceptance. This erroneous philosophy holds that there are no absolute moral values or principles. The only morality is that held by each individual, and since each individual views things differently, no single moral value can be the same for everyone. This amorality promotes a hedonistic, end-justifies-the-means way of life. It leads eventually to both economic and political as well as moral decay.

In a nation with a diversity of moral and religious views, where guarantees against the establishment of a single state religion are built into the political structure, it is impossible to

dictate matters of conscience. But there are nonetheless certain principles of morality that are generally held by all reasonable citizens. Most religions of the world, for example, teach the sanctity of human life, therefore we have laws against murder. Private property is another widely accepted principle, therefore we have laws against burglary, theft, and embezzlement.

Perhaps the two greatest statements of moral principle are the Ten Commandments and the Golden Rule. While these are generally associated with the Judeo-Christian heritage, they are applicable to and effective in *all* societies willing to test them. It is significant that throughout human history there has always been a close association in economically and politically free nations between their commitment to these moral principles and their economic, cultural, and political success and prosperity.

Among the salesmen of freedom, this promotion of morality is best accomplished by the exemplary life of each individual. Actions truly speak louder than words. As someone once wrote, "I'd rather *see* a sermon than *hear* one any day."

Students of liberty have an excellent "product": personal, economic, and political freedom. Our methods are time-tested and effective: positive education and worthy examples. The only thing we need is more good salesmen.

Are you such a person? Will you do your part to fill this need? □

# Memories of the 1923 German Inflation

by Edgar Bissantz

**F**or decades prior to World War I, the German mark enjoyed a relatively stable exchange rate of about 24 cents against the U.S. dollar. However, during the war, the German government paid its bills by printing large quantities of marks. Because of the resulting inflation, by the war's end in 1918 the mark had fallen to about six cents against the dollar.

Few people today remember that immediately after the war, many U.S. citizens, often at the urging of their bankers, purchased German marks as investments. The bankers pointed out that, although Germany was being asked to pay the Allies huge reparations, the country's land and buildings were essentially intact. Thus, many investors reasoned, the economy would be quickly restored by her industrious people. The mark would regain its "normal" value of 24 cents, which would yield a potential 300 per cent profit to investors. Unfortunately, the bankers did not take into account the fact that the German printing presses were continuing to turn out paper marks, and that the value of the mark was still falling.

My father's banker in Wichita persuaded him to buy \$1,000 worth of marks to remain on deposit in a German bank in the seaport of Bremen. My father soon received a bank statement crediting him with what was then a substantial number of marks. After that, other statements arrived at regular intervals, their balances always listing certain deductions for the cost of postage, carrying charges, and letters written.

At the same time, the value of the marks was

being eroded by the continuing inflation. But American investors were scarcely aware of that. Finally, in 1923, the value of my father's account had become so small that it was a nuisance for the bank. My father was asked to withdraw his balance in full.

As I was about to depart on a student tour of Europe, my father forwarded the statements to me. He asked me to visit the bank on my stop-over in Bremen, close out the account, and take the money to use on my tour. Little did my father realize what was going on.

By the time I checked into my hotel in Bremen, the collapse of the German currency was in full swing. The existing currency had been overprinted to raise their denominations by millions or billions of marks. Cities and towns were printing their own paper money, of value only locally and momentarily. Merchants refused to give up their wares for the German paper money that was losing value from minute to minute. Few pedestrians were to be seen, and there was no vehicular traffic at all. The streets of the great seaport were practically deserted. One could walk without fear right down the middle of the street. Business had come to a standstill.

I found the bank, closed my father's account, and received in settlement a few paper notes—then practically worthless. I placed them in a letter to my father and went to the post office. Several women, each seated behind a large basket of paper money, were officiating. One took my letter, weighed it, and wrote in pencil the amount of postage in the corner of the envelope—by that time postage stamps were a thing of the past—and gave me three bills from her basket in change. The postage to mail the letter to my father cost more than the marks in the envelope! Alas, my father's thousand dollar bank account had disappeared with the inflation.

Those three mark notes that I received from the Bremen postmistress many years ago—a million mark bill issued by the Freie Hansestadt Bremen, a ten million mark bill, and a thousand mark bill overprinted for one billion marks—have been framed and still hang over my desk, as a reminder that only where government can print paper money, without regard for anything of value, can such a thing happen. □

# Inflation, Money, and Freedom

by Jay Habegger

**I**t is widely believed that the coining of money is a proper function of government. In reality, however, state control of the money supply leads to a destructive inflationary spiral. All those who hold cash, especially those on fixed incomes, ultimately bear the economic burden of state-sponsored inflation. Inflation reduces real wages, diminishes living standards, and destroys investment opportunities.

The state can offer no solution to these problems. Only by allowing the market to operate unfettered with regard to money can there be an assurance of a stable, noninflationary currency. Only freely acting individuals can provide the consumer with an alternative to the inflation and uncertainty of the present government monopoly over money.

Inflation is caused by a government-sponsored expansion of the money supply. Only fiat currencies—backed by nothing more than a government decree, and not by a fixed resource such as gold—can be rapidly expanded, and thus produce high rates of inflation. Due to the limited availability of gold, currencies fully backed by gold are susceptible to only a negligible rate of inflation. As long as the state possesses control over the money supply, however, the potential for rampant inflation remains.

Even a “gold standard” is no guarantee

against government-sponsored inflation. Adam Smith recognized this as early as 1776, and wrote in the *Wealth of Nations*, “. . . the avarice and injustice of princes and sovereign states, abusing the confidence of their subjects, have, by degrees, diminished the real quantity of metal, which had been originally contained in their coins.”<sup>1</sup> Economic distress, coupled with political opportunism, will lure the state and its agents to abandon the gold standard and institute fiat paper in its place.

Governments have shown time and again that they are unable to maintain the political discipline needed to avoid fiat money inflation. Even the institution of legal barriers to monetary growth have had little effect. During the French Revolution of the 1790s, legal limits on the amount of currency in circulation were repeatedly made by the French Assembly with little success.<sup>2</sup> The limits on inflation were consistently broken, which led to new legislated limits, which in time were also ignored. Short term political benefits such as re-election or national prestige usually take priority over monetary sanity.

Indeed, even the economic knowledge and experience available in our time have not prevented modern politicians from following the siren call of fiat paper. While some measure of monetary stability was attained prior to World War II, when most nations maintained a token adherence to the gold standard, the gold standard was abandoned by almost all countries after the war. The resulting age of floating exchange rates, rampant inflation, and general

*Jay Habegger is a sophomore at the University of Colorado at Boulder. He was an intern at FEE this past summer, preparing research materials for the 1986-87 high school debate topic.*

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economic uncertainty offers evidence that politicians are unable, or unwilling, to follow a path of long-term monetary discipline in the face of short-term political gains.

Inflation can be a seductive tool for politicians facing a political or economic crisis. For the politician facing a large public debt, for example, state control of fiat paper makes inflation seem like a practical alternative to reducing spending. Inflating the money supply increases the nominal value of an individual's wages and assets, while reducing their purchasing power. If progressive tax rates are left unadjusted for inflation, the increased face value of the wage earner's income and assets will place him in a higher tax bracket, where the state receives a greater portion of his income and assets. Thus, while the individual is actually earning less, the state demands a higher share, and uses the additional revenue to pay its debts. Inflation, in this case, amounts to a subtle form of taxation.

Inflation has other political uses. The politician facing re-election, or otherwise seeking popular support, often uses inflation to bring temporary economic prosperity. Rapidly inflating the money supply may induce increased economic activity, which results in greater employment and more consumer goods. It should be emphasized, however, that these politically desirable effects of inflation are temporary, often lasting just long enough to overcome the current political crisis.

## Effect on Savings

Inflation is a subtle form of thievery. Even while assets sit seemingly safe in a bank vault, their purchasing power is steadily eroded, no less so than if one's pocket had been picked. The difference in the two crimes, however, is that the state is committing the crime in the former case, and a single criminal commits the crime in the latter.

Inflation makes long-term saving nearly impossible. An individual may watch his life's savings be inflated away through no fault of his own. The solution soon becomes apparent: spend one's money on real estate, gold, and other hard assets because they possess lasting value in comparison with a depreciating currency. In fact, inflation in our time can be

traced in the price of gold. Since the complete abandonment of the gold standard in 1971, the price of gold has risen from \$35 an ounce to over \$320 an ounce—an 800 per cent increase.<sup>3</sup> The purchase of gold and other assets is often made by going into debt, which is desirable in an inflationary period because payment will be made with currency worth less than it was when the debt was assumed. Inflation favors debtors at the expense of creditors.

A society preoccupied with obtaining as much debt as possible, and purchasing goods and services for immediate gratification, leaves little capital for business investment. Eventually, business becomes unable to find the necessary capital for further expansion or increased production. The production of consumer goods falls, and an afterburner is ignited on already soaring prices. As prices rise, people save even less and spend even more, which only accelerates the spiral. For example, during the post-World War I German inflation, workers eventually demanded that their wages be paid in cash so they could immediately purchase any available goods.<sup>4</sup>

The State may try to stop the inflationary spiral by introducing more currency into the economy or passing legislation designed to control prices. This also fails. The infusion of more currency only accelerates the inflation while price controls drive goods off the market.

The inflationary spiral during the French Revolution provides a striking example. On September 29, 1793, the French Assembly introduced the Law of the Maximum, which was designed to limit rising prices.<sup>5</sup> It failed miserably, and businesses closed their doors in droves. The French Assembly chose to ignore the laws of economics, and legislated more restrictions on the market. When these also failed, the Assembly imposed the death penalty for committing economic crimes, such as raising prices or asking what currency one was to receive. The economic chaos in France shows the final fate of the individual in a state-sponsored inflationary spiral.

Prevention of inflation and the economic trauma it brings can be accomplished only by removing the money supply from state control—abolishing the state monopoly on the coining of money. As Ludwig von Mises made clear,



The Gold Room (New York) 1869.

money is a commodity, the value of which lies in its utility as a medium of exchange.<sup>6</sup> There is no reason to believe that the market would handle the production of money in a fundamentally different way than it handles the production of any other commodity—the coinage of money simply would be another business. As with any other business, the private coiners' goal will be to best satisfy the consumers' desires in order to achieve the maximum profit.

## Private Coinage

The private coiner will provide the type of money in greatest demand. Since most individuals desire a stable currency with lasting value, this is what the coiner will provide; there will be no demand for inflationary fiat money. While a stable currency can be backed by almost any resource, history has shown gold to be the metal of choice. Coiners will provide coins stamped with a guarantee of their weight and fineness.

While the possibility of fraud in the coin industry will always exist, it will be held in check by the forces of competition.<sup>7</sup> We find examples of this when we study the history of private mints. Before private coinage was completely prohibited by the United States government in 1864, there were competing private mints in Georgia, North Carolina, and the gold-

producing Western territories. These private mints provided honest and reliable service. The chronicler of one such mint operating in the early 1860s, Clark, Gruber and Company in Denver, Colorado, wrote that "Their business transactions were honest and above any reproach; they always dealt fairly with their customers, giving them full value for all their gold."<sup>8</sup>

It is, however, very inconvenient to carry gold coins when one wants to make a purchase. Undoubtedly, the market would also provide a solution to this problem. A warehouse system might develop where one could store his gold and then be issued a receipt.<sup>9</sup> Instead of carrying gold coins, one could simply carry the warehouse receipts and make purchases with them. These receipts would be the equivalent of paper money; they would represent a certain amount of gold held in reserve.

Indeed, some consumers might even find this method of purchasing items too cumbersome. The use of debit cards would allow one to transfer gold from one account to another without ever seeing the gold or warehouse receipts. Computer and communications technology offers almost unlimited possibilities for money services. A merchant could check the quality of a currency before accepting it by using a computer network much like those used today to clear checks and credit cards. Warehouse receipts could be electronically transferred across the globe by computer.

A multitude of consumer choices is the beauty of the free market. Where people are free to choose, they select a noninflationary currency. Private enterprise must be free to coin money if inflation and its accompanying ills are to be stopped. □

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6. Mises, Ludwig von, *The Theory of Money and Credit* (Foundation for Economic Education, 1971).

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# To Deal With A Crisis: Governmental Program or Free Market?

by Robert Higgs

**E**mergencies are inevitable. History is replete with them, and the future will certainly bring new ones. During the past century, Americans have suffered the unanticipated shocks of great strikes, wars, depressions, and various lesser crises. It is instructive to consider now, while relative calm prevails, how past crises have been dealt with.

In the twentieth century the usual method by which Americans (and many others) have dealt with crises, namely, by creating emergency governmental programs, has resulted in permanent losses of economic freedoms and permanent impairments of economic institutions. If we can learn from our past mistakes, perhaps we can avoid such unfortunate developments when we must cope with a crisis again.

Above all, we need to understand that the choice is not between a governmental program and an unchecked calamity. Rather, the choice is between remedial actions taken by governmental officials, who can wield coercive powers, and remedial actions taken by private citizens, who must confine themselves to voluntarily accepted arrangements. In either case, something will be done. The critical questions have to do with the effectiveness and long-run consequences of the actions taken.

Suppose a crisis strikes: for example, foreign

supplies of oil are drastically reduced. Industries using oil as a raw material must reduce their rates of production. Workers are laid off; their earnings decline or disappear. Oil-related industries and businesses dependent on the patronage of the laid-off workers feel the impact. They too must cut back. Economic decline spreads like ripples from a stone tossed into calm water. Something must be done. But what should it be?

Some are likely to propose, indeed to insist, that the government "do something." An emergency program could assign the available supplies to the users governmental officials consider most important, perhaps hospitals, police, fire departments, farmers. The authorities could undertake to restore the domestic equilibrium upset by the foreign shortfall. They might, for example, compel refiners using domestic oil to give up some of their supplies to refiners dependent on foreign sources. Of course, some method of compensation would have to be devised; someone would have to administer the rules to insure compliance; and someone would have to make adjustments to unforeseen changes in domestic patterns of demand and supply. In short, a governmental program to "do something" about the import cutback would probably lead to the creation of pervasive rules, a large administrative corps, and a suppression of free-market arrangements over a substantial part of the economy.

But what choice do we have? Given the dire consequences of the import shortfall, how

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*Robert Higgs is the William E. Simon Professor of Political Economy at Lafayette College, Easton, Pennsylvania. He is the author of three books and a number of articles in the professional journals of economics, history, and economic history.*

could we refuse to acknowledge the need for a governmental program? Is there really any workable alternative? Would not catastrophe result from the absence of an emergency governmental response? The short answers to these questions are: There is an alternative way to deal with the crisis; a governmental program may not be needed; a market-oriented response probably will work; and people left to work out their own salvation will not simply surrender to despair and disaster.

The essence of many crises is shortage: the quantity supplied of something—oil, opportunities for employment, soldiers—falls short of the quantity demanded at the prices prevailing in the market. But markets, if prices are free to adjust, naturally tend to eliminate shortages. In fact, the very existence of a shortage tells us that the prevailing price is too low. When the price rises, two things happen. First, demanders reduce the amounts they want to buy. Second, suppliers increase the amounts they want to sell. Given a sufficiently large price increase, a new equilibrium results in which the quantities demanded and supplied are the same. The shortage disappears. This adjustment process is exactly what is meant by “the workings of the laws of demand and supply.”

Sometimes, however, the process does not appear to be working. Prices quickly rise, but little else seems to happen. Complaints arise that sellers are enriching themselves by “ripping off” the buyers. Political pressures may be exerted to keep the prices from rising further or to force them back to previous levels, on the grounds that price increases, even if they eliminate the shortage, only transfer income from buyers to sellers while doing nothing to restore the amounts of the good previously available in the market. But wait.

## Laws of Demand and Supply

The laws of demand and supply have two parts. The first law of demand says that, other things being equal, people want to buy less when the price is higher. The second law of demand says that the longer the time for adjustment, the greater is the reduction in quantity demanded for a given increase in price. Similarly with supply. The first law of supply says that,

other things being equal, people want to sell more when the price is higher. The second law of supply says that the longer the time for adjustment, the greater is the increase in quantity supplied for a given increase in price.

The message is clear: be patient. The market will restore an equilibrium, and conditions will steadily improve. With sufficient time, suppliers will bring forth more of the good in short supply or good substitutes for it. Demanders will find increasingly satisfactory ways to do without the good in reduced supply, often by substituting other goods for it.

In an emergency, however, many people do not want to wait for the second laws of demand and supply to come into play. Markets, we are often told, work too slowly. An emergency governmental program is said to have the important attribute of speeding the process of adjustment. Undeniably, coercive programs often work more quickly. But is this aspect of their operation, really an advantage?

Unfortunately, coercive programs “save time” only because they compel wastefully hasty adjustments. They do not save valuable resources. Rather, they redistribute the costs of adjustment in comparison with the responses determined by voluntary arrangements in free markets.

Suppose, for example, that in an oil crisis created by an import shortfall the government orders domestic oil producers to bring forth immediately larger deliveries of oil than they would supply voluntarily in response to the higher price of oil (assuming the government allows the price to rise freely in the market). Does not the government’s order hasten the process of adjustment, and is not such a speed-up desirable?

To see what happens, consider why the oil producers do not supply the governmentally ordered amount voluntarily. When the price rises, they of course want to increase the amounts they supply. But an increase of amounts supplied can be brought about by various means, for example, by drawing down on inventories stored in tanks, by increasing the rate of pumping from established wells, by drilling more wells on known underground reservoirs of oil, by searching for new oil fields, by extracting oil from shale, and so forth. Each source can be



tapped, but in the short run it is wasteful to draw on those that require more costly development, that is, more research, planning, reorganization of facilities, and reallocation of resources. It may make good economic sense to proceed with additional exploration and the development of new oil fields, for example, but to make these options yield oil quickly is possible only at extraordinarily high costs—for hiring and training inexperienced workers, bidding the use of materials and equipment away from other industries, paying employees higher wages to get them to work overtime. In the very short run it is economically justifiable to bring forth only the extra oil available in existing inventories in storage tanks. Later the other sources of additional supply can be tapped at a measured, and therefore cheaper pace.

Coerced haste only makes waste. *Faster adjustments are more costly, and someone must bear the additional costs.* The government can compel a faster adjustment, to be sure, but no valuable resources are saved because of the compulsion. Rather, someone is compelled to bear costs of adjustment that are not worthwhile. To satisfy the government's requirement, resources are shifted from socially more valuable uses to socially less valuable uses. The government gets a faster reallocation of resources not because its emergency programs "save" anything but only because its coercive power allows it to impose wasteful reallocations on the private owners of labor and capital. Society makes a faster adjustment at the cost of becoming, all values considered, worse off.

Emergency governmental programs, then, offer exceptional opportunities for those who would substitute their own values for those ordinarily guiding the allocation of resources in the market. When the cry of emergency goes up, the public's resistance to governmental takeovers comes down. Hence, aspiring redistributors of income, collectivist planners, and do-gooders at other people's expense all rush in to exploit the unusual opportunity for replacing market processes with governmental controls. But whatever one may think about the *immediate* desirability of an emergency governmental program, one must recognize that the program is almost certainly only a beginning; and what follows in its train may be far less desirable.

## Unintended Consequences

At the very start one often gets something he doesn't want along with something he does. Because governmental programs are created by politicians who seldom give their assent gratuitously, proponents of a governmental program of type X may be able to marshal a majority in favor of it only by adding a governmental program of type Y. For example, when Congress passed the National Industrial Recovery Act—a paradigmatic emergency program—in 1933 to restore business profits by establishing cartels in every industry, provisions were included to promote collective bargaining and establish wage-and-hour rules in the labor markets. The labor provisions bought the acceptance of the act by congressmen responsive to the interests of labor unionists and thereby insured its passage. When the Supreme Court overthrew the NIRA in 1935, Congress immediately re-established (and even strengthened) its labor provisions by passage of the Wagner Act. In this instance, as often happens, the original emergency program had attached to it, as the outcome of a political "horse trade," a governmental program that persisted long after the original program had disappeared.

Emergency programs frequently don't work as they are intended to. Governmental officials attempting to control the market discover that it is a moving target. As George Shultz and Kenneth Dam have written, "To every government action the private sector reacts or accommodates, and the government further reacts as the private economy 'talks back' to the government."<sup>1</sup> The government tries harder and harder to outwit the people subject to its controls. The people try harder and harder to anticipate what the controllers will do next. Although the process may result in a stand-off, it consumes ever more resources on both sides. For example, when the Reagan administration in 1984 announced new import restrictions on steel, "steel-making nations around the world began shipping more steel to the United States to establish higher benchmarks from which their steel export limits would be set," thereby bringing about the opposite of what the program was designed to achieve.<sup>2</sup> Naturally, domestic steel producers and labor organizations called

for a stronger program to deal with this unforeseen development. American farmers subject to acreage controls have been playing a similar game since 1933.

Creation of an emergency program usually leads to the entrenchment of the connected special interests, both governmental and private. Everyone knows that "infant industries" granted tariff protection never mature to the point where they are willing to give up the "temporary" protection they sought in the beginning. Truckers who got protection from free-market competition during the Great Depression are still fighting to maintain their privileges against those who seek to deregulate the industry. Farmers are perhaps the most notorious. While the number of farmers has declined greatly and the typical farmer's income has risen dramatically since the 1930's the bureaucracy at the U.S. Department of Agriculture has become vastly larger. And the farm "crisis" seems ever with us, no matter how often the government undertakes to deal with it.

The farm programs also illustrate how emergency governmental programs, when maintained long after the events that prompted them, can lock the government into an almost inescapable position. The benefit of governmental subsidies comes to be expected by all parties. Hence it is "capitalized" into the value of farm land. Current farmers, who must bear the higher cost of land use, get no extra benefit by operating land subject to the subsidies—all the benefits were captured by those who owned the land at the time the new subsidies were first announced. But should the government discontinue the subsidies, current farmers would be hurt; the value of their wealth would fall. Naturally they fight to maintain the existing programs. The only way the government can rectify its initially bad choice of policies is by harming innocent parties, which seems manifestly unfair. Thus the programs go on and on even after almost everyone has recognized their ineffectiveness, inequity, and waste of resources.

Of course, no matter how the programs work out, the administrative corps tends to grow. If there are far fewer farms to serve, well, the people at the Agriculture Department can find other things to do, like operating the food stamp

program or distributing pamphlets to urban gardeners or studying the international commodity markets. The U.S. Department of Energy grew out of a so-called energy crisis in the 1970s, yet today, when oil prices have plummeted and no one even claims the existence of an energy crises, the Energy Department thrives with thousands of employees and a budget of billions of dollars.<sup>3</sup>

## Suppressing Flexibility

Ultimately the most unfortunate aspect of emergency governmental programs is that they suppress or crowd out flexible, creative, voluntary market responses to the crisis. When the energy programs of the 1970s controlled the prices of petroleum products and allocated the products among different classes of users and different areas of the country, the market could not work. Indeed, every aspect of the controls, especially the so-called entitlements program that was developed to make the controls "fair" to different classes of refiners, was socially perverse. Consumption and imports were encouraged; domestic production was discouraged. William E. Simon, the famous energy "czar" of the early crisis period, later declared that "There is nothing like becoming an economic planner oneself to learn what is desperately, stupidly wrong with such a system."<sup>4</sup> Economic history is full of successful market adjustments to shortages of all kinds: coal was substituted for wood; steam engines for animal and water power; an ingenious assortment of machinery for human labor; the list is virtually limitless. Yet such adjustments hinge on the presence of market incentives and the economic liberties that permit voluntary rearrangements to emerge.

The first and second laws of demand and supply cannot come into play unless shortages are allowed to express themselves in the form of price increases and surpluses are allowed to express themselves in the form of price decreases. Ultimately the most damaging aspect of emergency governmental programs is that they prevent the fundamental forces of the price system from doing the job that they, and only they, can do while preserving our economic freedoms.

Having witnessed decades of episodic crises,

Calvin Hoover wrote: "At the time of economic crisis . . . critical extensions of governmental power are likely to occur. . . . [T]here is likely to be an insistent demand for emergency action of some sort and relatively little consideration of what the permanent effect will be."<sup>5</sup> The outcome is almost always the same. As Clinton Rossiter observed, "No constitutional government ever passed through a period in which emergency powers were used without undergoing some degree of permanent alteration, always in the direction of an aggrandizement of the power of the state."<sup>6</sup> In American history these observations are undoubtedly valid.<sup>7</sup>

Yet the pleas persist. Even in the early 1980s, hardly a time of genuine national emergency, there have been calls for emergency governmental programs to deal with unemployment, mortgage interest rates, re-regulation of the air-

lines, oil, and of course, the farmers.<sup>8</sup> Apparently the rhetoric of crisis still promises a positive political payoff, no matter how visibly grasping the special interests who mouth it.

The government will be less likely to use its powers in the service of these special interests if the general public keeps calm. When we hear the claim that a crisis is upon us, we are justified in remaining skeptical, for the serviceability of a genuine crisis to those who would set aside the free market has led them to attach the crisis label to almost all their pleas. Even when a genuine crisis occurs, we might well consider whether the best way to deal with it is simply to let the market work. By considering all costs and benefits and all consequences in the long run as well as the short run, we shall be less inclined to place our trust in emergency governmental programs. □

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## Dangerous Experimentation

Only if we understand why and how certain kinds of economic controls tend to paralyze the driving forces of a free society, and which kinds of measures are particularly dangerous in this respect, can we hope that social experimentation will not lead us into situations none of us want.

F.A. HAYEK

IDEAS  
ON  
LIBERTY



# Lilacs

by Jack Schwartzman

**W**e were fleeing the land of my birth, and my spirits sank low as I saw for the last time the old familiar sights. The stars were shining brightly that night; the fragrant aroma of Spring caused my youthful heart to beat fast; and I desperately longed to stay there forever.

Everywhere, the smell of lilacs was in the air. Everywhere, there were lilacs, lilacs, lilacs. It seemed as if the entire town was permeated with the scent of lilacs.

To this day, I cannot think of Russia without smelling lilacs; to this day, I cannot catch a whiff of lilacs without thinking of my native land.

My parents, my younger brother, and I were hurrying to the "contraband" carriage. We entered in silence, and huddled in the darkness. The driver whipped the air above the horses, and suddenly, we were off . . . off to a land uncertain . . . off to a destiny unknown. Our hearts were melancholy; our thoughts were bitter.

And everywhere, the smell of lilacs reached us, and the fragrance was intoxicating.

On flew the horses, on, on, onwards through the night. Backwards slid the houses, the trees, the river; backwards rushed the dreams, the memories, the hopes, the yearnings of youth. On sped the future; backwards fled the past.

How I longed to seize the escaping vistas; how I desired to hold on to the vanishing views of my childhood! The stars were resplendently bright and glimmering; the chirping noises of the night were symphonic and melodious. I



have never before—nor ever since—felt such a deep "belonging," such a feeling of being part of God's universe, such a "responding to" the music of the night. As we drove on, I saw grandeur disappearing before my eyes. I felt sadness rushing in to fill the vacuum of my heart.

And everywhere, the everlasting scent of lilacs greeted us, and the aroma was overwhelming.

*Dr. Jack Schwartzman fled from his native Russia in the 1920s, and lived in different parts of Europe before coming to the United States.*

*He is an attorney, professor of English, and editor-in-chief of Fragments.*

And I thought to myself: How is it possible, in Russia, a land celebrated for its dreamers of liberty—Pushkin, Lermontov, Gogol, Turgenyev, Dostoyevsky, Tolstoy—that such a terrible enslavement should exist? How is it possible that in the birthplace of Moussorgsky and Tchaikovsky, where once strummed the plaintive balalaika, now whined unceasingly the shrill bullets; where once gaily tiptoed the lovely ballerina, now grimly trod the heavy boot of the Red conqueror?

And I thought to myself: Every nation on earth has produced its poets and dreamers and musicians; every nation on earth has spat forth its demagogues and debauchers and destroyers. On the same spot, the sun may shine brightly; on the same spot, the skies may pour forth a deluge of hail and devastation.

And I thought to myself: Whether under the tyranny of the Tsar or the dictatorship of the Commissar, the voice of liberty will, nevertheless, always be heard. In camps, in prisons, in hovels, in trenches, in palaces, in hospitals, in offices, in mansions, in fields, in towns, in “contraband” carriages, and in all the Siberias of the world—the song of freedom can never be silenced; the spark of hope can never be extinguished.

And I thought to myself: Men are men the world over, be they black or white or yellow or brown or red; be they Christians or Jews or Moslems or Hindus or Confucianists; be they royalists or anarchists or revolutionists or humanists or Communists; be they Frenchmen or Americans or Indians or Tartars or Russians; be they poets or soldiers or prisoners or musicians or politicians.

And I thought to myself: How wonderful it

would be if the world of men were to accept diversity, and to welcome it! The earth is ablaze with the colors of flowers and fruits and foods and customs and languages and men. All things are different; therefore, all things are alike in their various magnificence.

And I thought to myself: The salvation of man lies in his ability to harness his dreams; in his capacity to capture the stars; in his endeavor to hear the eternal music of the spheres.

And I thought to myself: Someday, the land of Russia will be free: free, not because of the hocus-pocus of some political manifestation or some economic transmutation or some ritualistic-religious hodge-podge—but free because of the innermost ability of man to see the visage of God, and to understand the reason for man’s own existence on earth. When the land of Russia—and the entire earth for that matter—shall be genuinely free, it shall be free because man is able to understand that his destiny lies in himself.

And I leaned out of the carriage, and took a deep breath. The breeze that greeted me was full of the promise of Spring; the stars shone brightly—more brightly than I had ever seen them shine before; the sound of horses’ hoofs was rhythmic and lulling; the night was cloaked with the sparkling splendor of God.

And as the horses, the carriage, and the people in it drove on to their destiny, I stole a glance at my mother. Sitting next to me, she too was staring into the night. Even in the darkness, I could see her face—and I saw that her eyes were bright with tears.

On flew the carriage, on, on, onwards through the night. The scent of lilacs was intoxicating. □

## IDEAS ON LIBERTY



**T**he Achilles Heel of the socialist theory is that the more intensively it is applied the more the human being loses his options. Without the free interplay of the forces of the free marketplace the greater must be the centralization of planning and authority, and the greater the role of coercion.

JENKIN LLOYD JONES

# Pollution Control and Biblical Justice

by Gary North

*If a man shall cause a field or vineyard to be eaten, and shall put in his beast, and shall feed in another man's field; of the best of his own field, and of the best of his own vineyard, shall he make restitution. If fire break out, and catch in thorns, so that the stacks of corn, or the standing corn, or the field, be consumed therewith; he that kindled the fire shall surely make restitution.* (Ex. 22:5-6)

**T**hese verses make plain at least three facts. First, the Bible affirms the moral and legal legitimacy of the private ownership of the means of production. Fields and cattle and crops are owned by private individuals. Second, private property rights are to be defended by the civil government. The State can and must require those people whose activities injure their neighbors or their neighbor's property to make restitution payments to those injured. Third, owners are therefore responsible for their own actions, and also for the actions of their subordinates, including wandering beasts.

This combination of privately owned property, personal liability, and court enforcement of private property rights is the foundation of capitalism. It is surely the foundation of long-term economic growth. This property ownership arrangement is also important for the reduction and allocation of pollution. Initially,

these verses may seem self-explanatory. Nevertheless, when we consider them in the light of the many intellectual and institutional problems related to the whole question of pollution, their application in society becomes an enormously complex task. Without these legal guidelines, however, we could not deal effectively with the pollution problem.

Contrary to many of the twentieth-century critiques of both capitalism and pollution, socialist commonwealths have not produced reasonable, cost-effective, workable solutions to the pollution problem. More than this: such solutions cannot be implemented in socialist societies, for it is the private ownership of the means of production which is the basis for a successful program of pollution control. In fact, it is common ownership—bureaucratic ownership—which creates most of the economic incentives to pollute and exploit the environment.

## The "Tragedy of the Commons"

A fundamental economic problem in any system of common ownership is the problem of assessing true costs and benefits. Historically, one of the most familiar of these systems of common ownership has been commonly held land. From the Middle Ages through at least the late seventeenth century, these property units were known as "the commons," and the term still persists in some regions of the United States, referring usually to city parks.

Where the community allows citizens to place their grazing animals on the commons, a

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Dr. North is President of the Institute for Christian Economics. For a free six-month subscription to *Biblical Economics Today*, write Subscription Office, ICE, P.O. Box 8000, Tyler, Texas 75711.

whole series of difficulties emerges. The economic benefits accrue directly to the man who places his animal on the "free" land, but the costs are borne by everyone in the community who would like to use the property for any other purpose. In Puritan New England in the seventeenth century, roaming animals uprooted plants and over-grazed pastures. Townspeople cut down trees in the night for firewood or fencing.<sup>1</sup> Similar problems have plagued the commons in every culture. This is the direct result of a system of ownership in which *economic gains go to individual users and costs are borne by non-users*.

Such a system inevitably produces economic waste and personal disputes over the proper use of the common property. Those who benefit directly from their personal use of the commons have few direct economic incentives to conserve the commons' scarce economic resources, for these resources are obtained at nearly zero cost to the private users. The cost of running one additional animal on the commons is minutely felt by any single taxpayer-owner; he receives the benefits immediately. There is every incentive to over-graze the commons, for economic restraints are minimal, while benefits are direct. This creates a system of "positive economic feedback" rather than "negative feedback." It leads to a situation described by some scholars as "the tragedy of the commons."<sup>2</sup> It involves such phenomena as over-grazing, soil exhaustion, and pollution. J.H. Dales writes: "the economic effect of making common property available for use on a no-rule basis, so that it may be freely used by anyone for any purpose at any time, is crystal clear. Common property will be over-used relative to both private property and to public property that is subject to charges for its use or to rules about its use; and if the unrestricted common property is depletable, over-use will in time lead to its depletion and therefore to the destruction of the property."<sup>3</sup>

**Private Ownership:** The private ownership of property drastically reduces these problems. Private costs are more readily, accurately, and inexpensively assessed than public or social costs, precisely because *private owners directly face the effects of their own economic deci-*

*sions*. The cost of adding another animal to the land is borne directly by the man who expects to profit from the decision, if the owner of the animal is also the owner of the land.<sup>4</sup> When the private costs of adding one more animal to the land exceed expected future benefits, owners will stop adding new animals. *Private costs and private benefits tend to balance over the long run*. The better the knowledge that owners have about costs and benefits, the more rapidly the two will be equated. Resources are thereby conserved.

Nevertheless, men are continually tempted to pass on costs to their neighbors, while retaining benefits personally. One man may sneak his animals into another man's field. The other man is harmed economically—robbed. The injured party has an immediate economic incentive to put a stop to his neighbor's practice of transferring production costs to him. His incentive as an injured private owner to stop the practice is far greater than it would be in a system of common ownership, where the injury is spread over the entire population of so-called owners. (Do we really own common property? If a man cannot *disown* a piece of property, it is difficult to see how he can be said to own it.<sup>5</sup> At best, the costs of "disownership" are high; they involve political mobilization, not simply a private offer to sell.) The desire to reduce costs is strongly felt on both sides of the fence which separates privately owned properties. In fact, *the very existence of the fence testifies to a man's desire to keep outsiders from transferring their costs to him*. Of course, a fence also testifies to people's desire to avoid having their "benefits" wander off, especially if they might cause damage to another person's property, assuming restitution is the law of the land.

**Fences Reduce Conflicts:** The Bible affirms that those who violate fences or property lines must make full restitution to the economically injured neighbor. The assessment of harm is easier to make than under common ownership. "*His cows ate this row of corn in my cornfield.*" The owner of the damage-producing animals is responsible. Responsibility and ownership are directly linked under a system of private property rights. Under a system of private ownership, *property lines* are in effect

*cost-cutting devices*, for they serve as *cost-assessing devices*. Without clearly defined property rights for men, and therefore clearly defined responsibilities, the rights of "property"—God's living creatures and a created environment under man's dominion (Gen. 9:1-17)<sup>6</sup>—will be sacrificed.

Carefully defined property rights also help to reduce social conflicts. Dales writes: "Unrestricted common property rights are bound to lead to all sorts of social, political, and economic friction, especially as population pressure increases, because, in the nature of the case, individuals have no legal rights with respect to the property when its government owner follows a policy of 'anything goes.' Notice, too, that such a policy, though apparently neutral as between conflicting interests, in fact always favours one party against the other. Technologically, swimmers cannot harm the polluters, but the polluters can harm the swimmers; when property rights are undefined, those who wish to use the property in ways that deteriorate it will inevitably triumph every time over those who wish to use it in ways that do not deteriorate it."<sup>7</sup>

In questions of pollution and environmental quality, there can be no neutrality. There are winners and losers, although net winners may suffer some losses (air polluters breathe, too), and net losers may gain some benefits (asthmatics may earn high incomes by working for firms that sell raw materials to local polluting factories). It is the task of biblical exegesis to establish the ethical and legal foundations that enable judges: 1) to identify the winners and the losers; 2) to enable them to adjudicate cases properly; and 3) to determine what is fair compensation to the losers from any unauthorized winners.

## Fire and Pollution

Each owner is also responsible for what any animate or inanimate objects under his control do to injure others. A fire kindled on the land of one man must be kept restrained to his property. If the fire spreads to his neighbor's field, he is fully accountable for all the damages. Men therefore have an incentive to take greater care when using potentially dangerous tools or techniques.

The problem of pollution should be subsumed under the general principle of responsibility for fire. A fire is a physical cause of physical damage. From the case-law example in Exodus 22:5, it is clear that the fire which one man starts is his responsibility. *He cannot legally transfer risks to his neighbor without his neighbor's consent.*

The Bible is not talking here about some shared project in which both men expect to profit, such as burning fields to get rid of weeds or unwanted grass. In such a mutually shared project, the case-law example of the man who rents his work animal to a neighbor, but who stays with the animal the whole time, is applicable. The neighbor is not required to pay anything beyond the hiring fee to the owner (Ex. 22:14-15). If the animal is hurt or killed, the neighbor owes nothing.

There is no doubt that the fire-starter is responsible for all subsequent fires that he starts. Sparks from a fire can spread anywhere. A fire beginning on one man's farm can spread over thousands or even tens of thousands of acres. Fire is therefore essentially unpredictable. Its effects on specific people living nearby cannot be known with precision. It is this factor of *uncertainty* and *unpredictability* of the specific, individual consequences which governs the rule of restitution for damage-producing fires, as well as laws relating to the regulation of fire hazards.

What about pollution? Specifically, what about the uncertainty aspect of pollution? A Christian economist should argue that a man must not pollute his neighbor's property without making restitution to him for any *new* damaging effects. If some form of pollution is discovered to be more harmful medically or ecologically than understood before, the polluter should be required to reimburse those who are *subsequently* affected adversely by the pollutant, after the information concerning the danger is made public by the State, or becomes known within the polluting industry.

But what if the complaining neighbor had purchased his land knowing all about present *nuisance effects* (as distinguished from subsequently discovered effects) of the pollution process which was going on next door? Does he now have the legal right to sue his neighbor,





who is doing exactly what he was doing before the property was sold? After all, the buyer bought the property at a *discount*, because of the depressing effect on land prices caused by the pollution. There is no doubt that there is an inverse relationship between pollution and land rents (and therefore the market price of land): the greater the pollution, the lower the rents.<sup>8</sup> The market reveals this inverse relationship.

## Land Discounts: Restitution in Advance

Economic analysis informs us about the costs and benefits of biblical morality, and biblical law tells us who should bear these costs and receive these benefits. As potential buyers, we look at the discount in the purchase price of the land next door to a polluting production process, and we can conclude that this discount serves as an *advance payment of restitution to the buyer for specified, known kinds of future "spillovers."* The nuisance effects of these spillovers from the property next door are implicitly agreed to by the buyer when he receives

his discount from the seller. Any subsequent attempt by the buyer to demand financial compensation from the polluter under such circumstances is simply a demand for a statist, compulsory redistribution of private property. So is any legislation that would force the polluter to reduce pollution, unless new information regarding the dangers of the pollution is discovered. It would be a demand for restitution in addition to the discount already received by the buyer when he bought the property.

Murray Rothbard has used the concept of the "homesteading principle" to defend the legal right of a polluter to continue to pollute. By developing a previously unused piece of land, he has created an *easement right* to whatever polluting processes he adopts, so long as these processes do no physical harm to those people who owned nearby property when he bought or discovered his land. He "owns the right" to emit noise or other forms of pollution, assuming his original neighbors were unaffected. In the case of pollution, he calls this a *pollution easement*.<sup>9</sup>

The Christian economist could also argue that a protesting "pro-environmentalist" who de-

mands that the civil government put a stop to his neighbor's pollution is seeking to achieve a less polluted life-style at his neighbor's expense, despite the fact that he bought the property at a discount because of the pollution. Would he be willing to pass on to the polluter any increase in the value of his property that results from the reduction of pollution, to help defray the costs of reducing the pollution? If not, why not? Economically speaking, he is demanding that a third party, the polluter, return the discount to the buyer which was forfeited by the seller. The polluter loses, and so does the seller who was forced to accept less money for his property.

**Public Utilities:** Perhaps we can better understand the economics involved by examining the installation of water or sewer lines in a region of a town which had previously been dependent on wells and septic tanks. The municipal government could make an offer to local residents who are about to see their property values rise as a result of the new municipal service. The city says: "If you want to hook up to the new lines, you must pay a high hook-up fee to the municipal water company—a fee closer to the full value of the resulting increase in your property's value." In short, the resident who receives the increase in the value of his capital must pay for this appreciated value. This is the way that new sewer projects should be financed, not by assessing all taxpayers in the community. Those who benefit directly and immediately should bear the full costs of the project, or at the minimum, should be required to pay the equivalent of the immediate increase in the value of the property, perhaps in the form of higher assessments per month for a fixed period of time. If sewers were financed this way, there would probably be less political resistance by overburdened taxpayers to urban development.

What is the economic principle involved? Simple: *one person should not be compelled by the State to pay for the increase in value of another person's property.* The taxpayer whose property is unaffected by the increased benefits associated with a new water or sewer line should not suffer economic losses (higher property taxes or water bills) because he has to pay for another resident's economic windfall (wa-

terfall?). The beneficiary should pay for the benefit.

So it is with pollution. The beneficiary of the improved environment—a benefit extracted through compulsion by the civil-government—should pay for this improvement. He should compensate the neighbor for the costs borne by the neighbor in reducing the prior level of pollution.

## Private Contracts

This raises a very interesting point. Why should the civil government get involved at all? Why shouldn't the benefit-seeker approach the polluter directly and offer him direct compensation? The beneficiary knows approximately what it would be worth to him to escape from the pollutant. The polluter knows approximately what the value of being able to pollute means to him. If the benefit-seeker's price is high enough, he can sign a contract guaranteeing to reduce or eliminate the polluting activity. In effect, the benefit-seeker pays the discount he received from the seller to the polluter.

The polluter may reject the offer. That is his legal privilege. But it costs him to reject it. He forfeits the economic benefit offered by the benefit-seeker. His cost of continuing to pollute has just risen appreciably. He can no longer pollute at zero cost. He has an economic incentive to stop polluting the environment.

Bear in mind that we are speaking here of pollution which was known in advance, and for which the buyer of the adjacent property received a discount. We are not speaking of new pollution, or an older pollution process which, through improved scientific knowledge, is now understood to be more of a physical hazard than had been understood before.

## Pollution and the Costs of Knowledge

If pollution is really equivalent to fire's damaging effects, and we see that the Bible makes all fire-starters legally liable for damages, then is this economic analysis of pollution and damages—the concept of the purchase price discount as a form of restitution payment—

ethically biblical? Shouldn't all damage-inflicting pollution be banned, whether or not the buyer next door knew in advance about it? After all, he may also have known that the man next door started fires regularly, but he would also know in a biblical commonwealth that the fire-starter is personally liable for all future damages that their fires might cause. Why should the polluter be allowed to go on with his polluting without paying damages, yet the fire-starter be required to pay for all damages, irrespective of the neighbor's discount? Are the two cases ethically the same or different?

**The Economics of Uncertainty:** They are the same in principle, but different in application. To understand the differences in application, we must discuss the issue of *uncertainty*. The specific effects of noise or smoke are known. They are nuisance effects. They are effects that buyers can estimate, at least to the extent that discounts are offered by sellers to buyers for agreeing to live next door to smoke and noise pollution. In contrast to the known effects of a familiar form of pollution, the specific effects of any given fire are uncertain. They can be negligible or catastrophic. A fire may affect people far distant from the point of origin. Thus, the fire-starter is warned: be extremely careful. Biblical law warns all fire-starters: "You are legally responsible for all damages caused by your actions. We all know how dangerous fires are; do not attempt to transfer the side-effects to a neighbor." Under biblical law, society is partially protected from essentially unpredictable catastrophes; for those who light the fires are restrained by the threat of full financial responsibility for damages that their fires inflict.

The difference between "traditional" polluters—smoke, noise, smells—and fire-starters is primarily *a difference in men's knowledge of each action's future effects*. The specific local effects of a familiar form of pollution are approximately known in advance to those who choose to live near pollution. The specific effects of specific fires caused by local fire-starters are not well known to nearby residents. Whether specific sparks from a specific fire will be harmless, or will ignite this or that field, or this or that neighborhood, cannot be

known in advance. We must focus our exegetical attention on these specific effects.

**Insurable Risk:** The existence of fire insurance does not invalidate this analysis of "the economics of specific effects." While it is sometimes possible for a person to buy fire insurance, the reason why fire insurance is available at all is because companies insure many different regions, thereby taking advantage of "the law of large numbers." They can insure specific properties economically only because fires have known effects in the aggregate. If there were no known statistical pattern to fires in general, insurers would not insure specific properties against fire damage.

This is not to say that the following arrangement should be prohibited by law. A person who wishes to begin a business which is known to be dangerous approaches others who could be affected. "I'll make you a deal," he says. "I will pay for all increases in your insurance coverage if you let me begin this business in the neighborhood." If they agree, and if the insurance companies agree to write the policies, then he has met his obligations. He has made himself responsible for damages. Instead of paying for damages after the fact, he has paid in advance, through the existence of insurance.

What if some resident says "no"? The prospective producer of danger can then offer to buy him out. If the offer is accepted, the prospective danger-producer can then sell the property to someone who is willing to live with the risk, if the discount on the land is sufficiently large. But if the original owner refuses to sell, and also refuses to accept the offer regarding insurance premiums, then the first man should not be allowed to force out the original owner. If he begins the dangerous production process, the owner can legitimately sue for damages. But he faces a risk: the court may require a money payment to the victim. The court need not necessarily prohibit the activity altogether.

This decision by the judges requires that judges do the best they can in estimating the costs and benefits to the community, *including the perceived value to citizens everywhere of the preservation by the State of private property rights*. They cannot estimate perfectly, for they cannot know the psychic costs and benefits in-

volved in the minds of the conflicting parties. But they can make general, "unscientific" estimations, given the image of God in all men, and given the created environment in which all men live.

This is an important application of biblical revelation to economics: if there is no universal humanity—no universal human nature—and no Creator who serves as the basis for man's image, and no creation governed by the Creator in terms of His value and His laws, then it is impossible for the judges legitimately to have confidence in their estimation of social costs, social benefits, private costs, and private benefits. Without our knowledge of objective economic value provided by God's plan and His image in man, objective economic value becomes epistemologically impossible.<sup>10</sup> Judges would then be blind in a sea of subjective economic value, in which it is philosophically impossible for men to make interpersonal comparisons of subjective utility.

## Conclusion

Attempts by humanistic economists to come up with an approach to the problem of pollution have not been intellectually successful. Because humanists deny that God is Creator and that men are made in His image, they are incapable of solving the problem of objective knowledge vs. subjective knowledge. They have not been able to solve the problem raised by Lionel Robbins, the impossibility of making interpersonal

comparisons of subjective utility. Thus, we must turn to the Bible for a solution to the nagging problem of the economic effects of pollution. We must use Bible principles of justice to begin to devise political and economic sanctions against polluters—sanctions that do not inherently destroy the case for freedom. The basic solution to pollution is *restitution*, either after the act or in advance (discounts). □

1. Gary North, "The Puritan Experiment in Common Ownership," *The Freeman* (April 1974).

2. Garrett Hardin, "The Tragedy of the Commons," *Science* (13 Dec. 1968); reprinted in Garrett de Bell (ed.), *The Environmental Handbook* (New York: Ballentine, 1970). Hardin calls for greater government intervention rather than an expansion of private property rights. A solid refutation of Hardin is C. R. Batten's "The Tragedy of the Commons," *The Freeman* (Oct. 1970).

3. J. H. Dales, *Pollution, Property, and Prices: An Essay in Policy-Making and Economics* (Toronto: University of Toronto Press, 1968), p. 63.

4. In the case of land which is rented or leased, the renter may attempt to pass some of these costs to the owner. He may allow his animals to overgraze, or he may allow the soil to be depleted or damaged in other ways. Profit-seeking owners need to consider these costs when they draw up the terms of the lease. The original lease contract may impose penalties on renters who damage the property, or it may include incentives so that they will care for it.

5. "The corollary of the right of ownership is the right of disownership. So if I cannot sell a thing, it is evident that I do not really own it." F. A. Harper, *Liberty: A Path to Its Recovery* (Irvington-on-Hudson, New York: Foundation for Economic Education, 1949), p. 106.

6. See "The Ecological Covenant," in Gary North, *The Dominion Covenant: Genesis* (Tyler, Texas: Institute for Christian Economics, 1982), ch. 14.

7. Dales, *Pollution*, p. 67.

8. T. D. Crocker, "Externalities, Property Rights, and Transaction Costs: An Empirical Study," *The Journal of Law and Economics*, XIV (Oct. 1971), p. 452.

9. Murray N. Rothbard, "Law, Property Rights, and Air Pollution," *Cato Journal*, II (Spring 1982), p. 77.

10. Gary North, *Genesis*, ch. 4: "Economic Value: Objective and Subjective."

## In Future Issues . . .

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# On Building Codes

by Nils McGeorge

**H**as government regulation improved the quality of life? In the case of housing, I think not.

Uniform building codes, planning and zoning ordinances, along with subdivision laws, provide a blueprint for land use. It seems to make sense on paper—nice, broad, well-lit streets with middle and upper income houses in logical relationship to services such as schools, shopping malls, and recreation areas. But something happens along the way.

Imagine you are driving along the beautiful California valley of my father's youth. The rich diversity he once knew now has been replaced by row upon row of pink, blue, and brown tract houses crowded into the valley.

Why are there no houses in the surrounding hills? Because the local government *prevents* that—citing steep terrain, difficult drainage, and the expense of providing services. Why are the houses in the valley so close together? With the upgraded requirements for sewers, streets, wiring, and so on, the houses had to be close together to make building economically possible.

What do the residents do as a relief from the uniformity and blandness of their environment? Aside from watching TV, they can drive over the mountains to Solvang, an imitation Danish town with narrow, winding streets, sidewalk cafes (prohibited by the health department of my father's home town) and the diverse charms that tourists love.

And what about people who can't afford the well-built houses in the valley? Do the poor live



Solvang, California

in smaller, less well-built homes? No, they don't. There is no way to build houses they can afford and still meet the requirements of the building department. The very poor wind up living on the streets, in the culverts, and under the overpasses.

Are such regulations improving the quality of life for all levels of society? Unfortunately, they are not.

When we speak of freedom of speech or religion it is generally understood that the American way will not tolerate dictation from the state. In the instance of property rights, however, we let the state—and by the state I mean city, county, state, and federal governments—assume socialistic powers. We have done this in the hope that our lives would be better. We have given up our freedom hoping to reap the benefits of regulation. We have lost on both counts.

Let's combine Adam Smith's idea—open competition among free individuals—with Alexis de Tocqueville's idea—the moral development of these free individuals. Let open competition among free individuals do the regulating, and we can regain our freedom and our prosperity. □

*Mr. McGeorge is an eleventh grade student at Hellgate High School, Missoula, Montana. This article is adapted from his winning essay in a contest sponsored by the Montana Council of Organizations, on the relationship between land-use regulations and private property rights.*

# Deregulate the Utilities

by Howard Baetjer Jr.

**G**overnment regulates utilities by granting them monopoly privileges, and then controlling their prices. I contend that such government intervention is wrong. It is unnecessary, inefficient, and in the final analysis, immoral. Utilities should be completely deregulated.

In particular, government should remove all its monopoly privileges and allow anyone to try to compete with existing utilities, in any market or location. Government should repeal the privileges it has conferred on various gas and electric companies, cable television companies, water companies, and so on. Let established firms try to expand into one another's territory; let new companies try to develop in any area.

At the same time, government should deregulate the pricing of utility goods and services. Presently, the rates or prices charged by most utilities are set by the political process, via public utility commissions. This practice should be abandoned. Utilities and their customers should be allowed to determine prices by voluntary agreement. Government should stop guaranteeing rates of return to the utilities, with no regard as to whether the companies are efficient or serve their customers well.

The first reason I offer for total deregulation is that utility regulation is unnecessary. It is based on the theory that utilities are "natural

monopolies"—the sorts of industries in which monopolies naturally develop.

The theory holds that a natural monopoly will develop when, in a given market, there are great economies of scale. That is, fixed costs for machinery and equipment are very high—such as the cost of an electrical generating plant. At the same time, the marginal cost—the additional cost of producing one more unit—is very low. For more electricity, just turn up the generators a little. This means, according to the natural monopoly theory, that it is uneconomical for more than one firm to operate in a given market. Competition sooner or later will drive out all but one firm, leaving the consumer at its mercy.

The public policy response to this idea has been to establish monopolies by law, since they are inevitable anyway, and then regulate them "in the public interest." But natural monopoly theory is wrong. Hence the regulation based on it is just extra baggage burdening the economy.

Natural monopoly theory breaks down because it treats the world as fixed, unchanging, and mechanical. It assumes "a given market," isolated from other markets. But there are no isolated markets in the real world. All markets overlap and interact. At present, markets for electrical power in North America are expanding, despite regulation, with power being "wheeled" or transmitted over long distances. San Diego Gas and Electric Co., for example, has long term contracts to wheel in power from as far away as Oregon.<sup>1</sup>

*Howard Baetjer is a member of the staff at FEE. This article is adapted from a speech he gave earlier this year at Marymount College, Tarrytown, New York, as part of a debate on utility regulation.*

Another problem with natural monopoly theory is that it doesn't allow for changes in technology. In assuming that there are fixed costs for machinery and equipment, which any competitor will have to purchase, it fails to account for the development of new technology which will allow newcomers to compete successfully. High-voltage, direct current technology is revolutionizing electrical transmission, especially between separate operating systems. Some companies now generate competitively priced electricity using biomass, wood waste, and even garbage as fuel.<sup>2</sup> A rapidly increasing amount of electric power is produced not by utilities at all, but by private industries which generate power for their own use, and sell a surplus to other users. This process is known as cogeneration. As the technology develops, large-scale electrical utilities might possibly become obsolete, if regulation does not stifle the competitive process.

## Economies of Scale?

Natural monopoly theory is also flawed in overstating the importance of economies of scale. There is no doubt that large industries, with scale economies and lower unit costs, can operate more efficiently than small ones, if other factors are equal. But there are many other factors, and they are rarely equal. An important factor is the efficiency that is spurred by the very existence of competition. University of Illinois professor Walter Primeaux has done extensive studies of the electrical power industry. He reasons that where competition exists, it "could lead to lower costs than a monopoly in any business by improving incentives to operate efficiently. Moreover, to the extent that inefficiency exists in a monopoly electric utility firm, the inefficiency may be so large as to overcome or offset any economies of scale gained from monopoly."<sup>3</sup>

According to a recent survey, there are 32 communities in the United States that have competing electrical utility companies.<sup>4</sup> Professor Primeaux compared 23 of these communities with others of similar size in the same states served by monopoly electrical utilities. The results are striking. Notwithstanding economy of scale advantages of the monopolies, com-

munities with competing electric companies had average prices for residential sales that were 33 per cent lower.<sup>5</sup> Residents of towns served by two companies, such as Lubbock, Texas, consistently favor the better service resulting from competition. Though state regulatory commissions are usually hostile to competition, "residents who have a choice always vote for competition."<sup>6</sup>

The second reason for deregulating utilities is that deregulation fosters competition, which keeps prices down and quality up. The central problem is the restraint on entry—the granting of monopoly status, by law, to some politically favored businesses, keeping everybody else out. Regulated industries typically gain control of the rate-setting process and thus can award themselves "profits" regardless of their performance. Their customers, legally prevented from turning to other providers, must endure or do without. Thus the process of government regulation gets abused. The only dependable regulator for the public interest is the competitive market process.

Consider the experience of the airline industry. Under regulation, a few favored companies were protected from competition—granted legal monopolies or oligopolies on particular routes. Existing airlines influenced the Civil Aeronautics Board to maintain prices at a high level. Then came deregulation. Along came People Express, New York Air, and a rash of new services, especially in small, commuter airlines. Prices have tumbled, and the consumer has benefited.

Partial deregulation of the telecommunications utilities is having similar beneficial effects. Once AT&T's legal monopoly was ended after many decades, MCI, Sprint, Allnet and a host of other lower-cost competitors appeared. Cellular telephones, satellite communications, and fiber optics all are providing further choices with astonishing rapidity. This blessing of competition should be extended to all industries.

While these economic arguments are important, the most fundamental reason for deregulating utilities is the principle of free choice. In a good society, which prides itself on freedom, the government should protect free choice, not obstruct it. People who think they can provide electric power, telecommunications, television,

gas, or any other good or service should be free to take a crack at it. What right does government have to obstruct their creative endeavors, thereby protecting the monopoly privileges of other people?

Consumers likewise should be free to reject the services of companies that are inefficient, expensive, or unresponsive to their needs, and patronize other companies that promise to serve them better. What right does government have to deny consumers a choice of utilities? Is it not absurd that such denial of choice is called regulation "in the public interest"?

Government regulation of utilities lacks a theoretical base, brings about higher costs and

lower quality, and violates the principles of a free society. Government should deregulate the utilities, and let the competitive market process do the regulating, the cost-cutting, the improving of quality, and the innovating that characterize economic free choice wherever it exists. □

1. "Electrical Utilities Find Market Forces Taking More Important Role." *Wall Street Journal*, February 26, 1986.

2. *Ibid.*

3. Walter Primeaux, "Total Deregulation of Electrical Utilities: A Viable Policy Choice," *Unnatural Monopolies*, Robert W. Poole, ed. (Lexington Books, Lexington, Massachusetts, 1985) p. 128.

4. "Power Stations: Some Like Them Competitive," *Reason*, November, 1985, p. 18.

5. Primeaux, *op. cit.*, p. 136.

6. Jan Bellamy, "Two Utilities Are Better Than One," *Reason*, October, 1981, p. 28.

The Foundation for Economic Education

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# Lessons from Socialist Tanzania

by Sven Rydenfelt

**T**anzania in eastern Africa became an independent nation in 1961, when it was known as Tanganyika. Its political leader Julius Nyerere, a confirmed socialist, was elected president in 1962. In his Inaugural Address to Parliament he declared:

"When we were in the midst of our struggle for independence, I promised that after we had won our freedom, we would try to achieve in ten years most of the things which our colonial rulers had failed to achieve during the whole of the time they had governed our country. Today I want to renew that promise . . . All of us have agreed that we must establish a true socialist society in Tanganyika."<sup>1</sup>

Of course, the President believed in his optimistic vision, and fully intended to realize it. Good intentions, however, are not enough. If you want to implement your vision, you have to start with a realistic blueprint. And, as experience later proved, Nyerere's socialist blueprint was a dream far removed from reality.

During its first years, Nyerere's government was occupied with transforming the country from a colonial area under British hegemony into a fully independent nation. Not until 1967 did the government feel strong enough to issue the Arusha Declaration, which implemented a comprehensive socialization program. All important industrial enterprises, including banks, insurance companies, export trade companies,

and even most of the larger plantations, were placed under government control.

In Tanzania, however, the great majority of the population earned their livelihood as smallholders in scattered settlements. Of course, such a "primitive" agriculture had to be socialized, too. And so the Tanzanian government—following the Soviet model—decided to concentrate the multitude of small farms into large collectives called *ujamaa* villages.

President Nyerere was well aware of the importance of these small farmers. In a 1964 speech, he stated:

"Our future, in every respect, depends on our farmers more than on any other single group of citizens. They are the people responsible for using our one great national asset—our land. They constitute more than 90 per cent of our people."

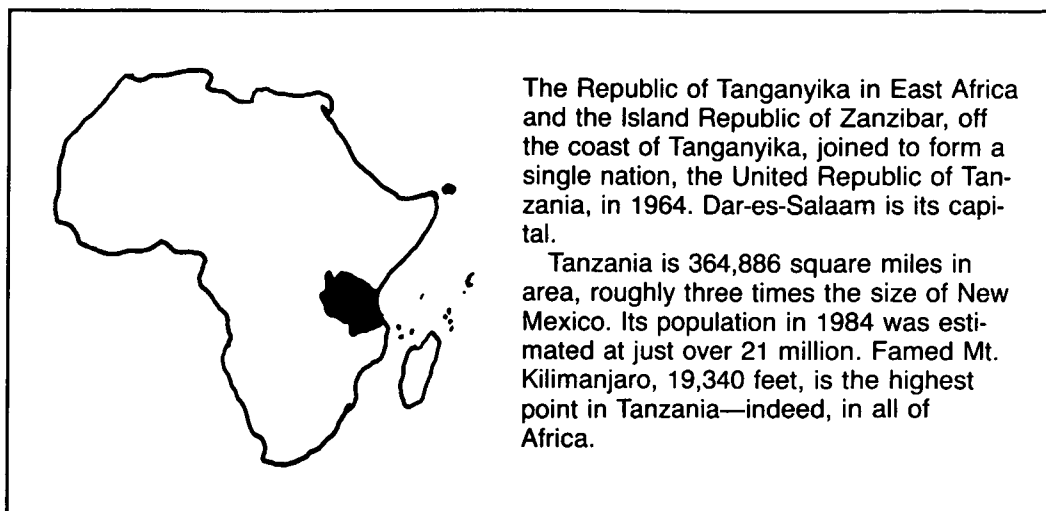
Some months after the Arusha Declaration, President Nyerere published *Socialism and Rural Development*, in which he spelled out his agricultural program. Among his promises to the nation's small farmers, the following are significant:

- Respect for the individual.
- Voluntary migration into the collectives.
- The transition into collective production was to be effected gradually and quietly.
- The ultimate stage—a collective large-scale agriculture—was to be achieved by persuasion, not by force. Private plots were to be allowed.

Although the peasants were enticed with

*Dr. Rydenfelt is a professor of economics at the University of Lund in Sweden.*

*This article is an updating of a chapter in Dr. Rydenfelt's book, A Pattern for Failure: Socialist Economies in Crisis.*



schools, shops, medical care, and drilled wells in all the ujamaa villages, the voluntary resettlement made only slow progress. In order to speed up migration, the government made further offers: free transportation to the collectives, free building materials, free food until the first crop was harvested, free agricultural machinery, and access to credit on favorable terms.

But in spite of the government's enticements and intensified propaganda campaigns, the peasants were reluctant to move into the collectives. By 1974 only 2.5 million people had settled in the ujamaa villages. The government had to choose between accepting a situation in which only 20 per cent of the resettlement program had been carried out, or abandoning the principle of voluntarism. The Tanzanian government chose to apply brute force—the same policy that all socialist governments have used against their peasant populations. During the two following years, more than 10 million peasants were forcibly moved into the ujamaa villages. In order to prevent peasants from returning to their homes, many of their old settlements were burned.

Despite the fact that fully 90 per cent of Tanzania's farmers were moved to collectives, the plans for agricultural socialism remain only dreams. Today perhaps a dozen of the 8,000 ujamaa villages function more or less in accordance with the original plan. In the others, most of the land has been divided up, and each family now cultivates its own fields as if they were

private property. This total collapse of the socialist plans in many ways corresponds to similar retreats in China and Vietnam.

The forced collectivization engendered distrust and bitterness among the peasants, which led to a sharp decline in workers' morale. When the government further mistreated the peasants by instituting price controls on agricultural products, most peasants reacted by producing only for their own needs. Those peasants with surpluses tried to sell them on the black market. Such illegal markets, where consumers have to pay substantial premiums to compensate sellers for the risks of punishment, are the inevitable result of price controls. As Ludwig von Mises wrote: "Economics does not say that isolated government interference with the prices of only one commodity or a few commodities is unfair, bad, or unfeasible. It says that such interference produces results contrary to its purpose, that it makes conditions worse, not better, *from the point of view of the government and those backing its interference.*"<sup>12</sup>

Price controls also led to smuggling. Peasants living near the border tried to smuggle their surpluses into neighboring countries, where prices usually were many times higher than the controlled domestic prices. In its efforts to stop the smuggling, the Tanzanian government closed the border to Kenya in 1977 (it was partly reopened in 1983). As a result, Tanzania lost a large part of its tourist trade.

Tanzania has a soil and climate extremely favorable for agriculture, and in 1961 the country

was the greatest food exporter in Africa. The forced collectivization, completed in 1976, was a mortal blow to production. By 1980 Tanzania had to import no less than half its food. In a few years the country had gone from the greatest exporter to the greatest importer of food in Africa. (Similarly, Russia before the socialist revolution was the greatest exporter of food in the world; now it is the greatest importer.)

Tanzania's socialist policies took a particularly heavy toll on its ability to produce export commodities. The production of sisal (a fiber used in twine) shrank from 226,000 tons in 1970 to 47,000 tons in 1983. Because of shrinking export incomes, and the need to import food, very little foreign exchange was left to pay for other needed imports—raw materials, machinery, fuel, spare parts. As a result of these shortages, only 25 per cent of industrial capacity could be used, and the lack of fuel and spare parts for motor vehicles caused a virtual breakdown in transportation. Without transportation, food surpluses produced in the countryside very often were left to rot. Electricity production, railway transportation, and telephone communications were also hard hit.

By the 1980s, the Tanzanian economy had collapsed. After a visit to Tanzania in 1982, a Norwegian radio commentator offered the following description:

"On days when bread was delivered to the stores, people had to line up for hours. Even commodities like soap, toothpaste, salt, flour, cooking oil, batteries and bandages were lacking. People starve, and starving people get desperate. When I visited Tanzania in 1974 many things were lacking, too, but people still had optimism and enthusiasm. They listened to President Nyerere: If they worked harder, the future would be better. Now the President's calls have lost their magic; people are resigned. The brutal truth is that the policy of President Nyerere has completely failed . . . The Tanzanians are unable to manage the many state enterprises, and today production is only 30 per cent of its volume a few years ago."<sup>3</sup>

Seldom has the gap between rosy dreams and dismal realities been wider than in socialist Tanzania. For example, in the Arusha Declaration of 1967, President Nyerere proclaimed:

"In order to maintain our independence and

our people's freedom we ought to be self-reliant in every possible way and avoid depending upon other countries for assistance . . . Because the economy of Tanzania depends and will continue to depend on agriculture and animal husbandry, Tanzanians can live well without depending on help from outside if they use their land properly."

The truth is that no country ever has received more aid per capita than Tanzania. In the economic bankruptcy brought on by socialism, national begging had to be substituted for national pride.

Socialist governments everywhere build their power upon support from the industrial and urban populations—a support that often is paid for with the promise of cheap food. And food prices are held down by price controls, which oppress and exploit the peasants, and lead to eventual shortages. These agricultural policies in socialist states have been analyzed and described by economists like Michael Lipton and Theodore Schultz.<sup>4</sup>

Leaders in all socialist states maintain that their chief objective is to help and support the poor. In Tanzania this message was given special emphasis by President Nyerere.

In reality, however, socialists everywhere have pursued an opposite policy, favoring the prosperous and strong—the industrial workers, the police, the soldiers, the bureaucracy—and oppressing and plundering the poorest and weakest members of the population, the peasants. □

1. Julius Nyerere, Inaugural Address to Parliament on December 10, 1962. Quotations from Julius K. Nyerere, *Freedom and Unity: A Selection from Writings and Speeches 1952-1965* (London: Oxford University Press, 1967.)

2. Ludwig von Mises: *Human Action: A Treatise on Economics* (New Haven: Yale University Press, 1949, p.758).

3. Svein Wiel Jorgensen, *Ökonomisk Rapport*, October 1982.

4. Michael Lipton, *Why Poor People Stay Poor: Urban Bias in World Development* (London: Temple Smith, 1977) and Theodore Schultz, *Economic Growth and Agriculture* (New York: McGraw Hill, 1968).

Copies of Professor Rydenfelt's **A Pattern for Failure: Socialist Economies in Crisis**, are available from The Foundation for Economic Education, 30 South Broadway, Irvington-on-Hudson, New York 10533 at \$9.95 each.

# Insolvency and Bankruptcy Law

by Dennis Bechara

**A**t one time in history, society regarded those who applied for bankruptcy relief as defrauders, and, in some instances, as criminals. Bankrupts were the object of social sanctions, and in many cases they had to leave their area of employment for fear of further societal punishments. The origin of the word bankruptcy itself is indicative of the attitude toward bankrupts. In medieval Venice, merchants conducted their business affairs in public places, and they usually brought their own benches where they could rest during the course of the day. If a merchant were unable to pay his debts, his creditors would proceed to break down his bench, symbolizing the bankrupt's exclusion from the business community. The word bankrupt comes from the Italian *banca rotta*, or broken bench.

Governmental attitude toward bankruptcy has evolved over the years to the point where today many no longer consider it a socially objectionable form of behavior. Perhaps reflecting America's more permissive values, filing for bankruptcy protection has become a growth industry. Consumers and corporations have discovered the advantages of bankruptcy relief. Many individuals who overextended their credit and no longer can meet their obligations have filed bankruptcy petitions. Some corporations have also obtained bankruptcy protection as a means of unilaterally breaking executory contracts or of dealing with a variety of pending lawsuits.

Recent developments in the area of bankruptcy, however, indicate that the boom in bankruptcy filings may already have reached its limits. Before analyzing the nature of these changes, however, it will be instructive to take a brief look at the development of bankruptcy in the United States.

At the time the Constitution of the United States was adopted, bankruptcy law differed among the various states. The framers of the Constitution felt that it would benefit the country if these differences were eliminated, so they inserted in section 8 of Article I of the Constitution a clause granting Congress the power to establish "uniform laws on the subject of bankruptcies throughout the United States." This delegation of authority to Congress, however, did not require the enactment of a bankruptcy code nor the discharge of debts. In fact, although having the power to enact a bankruptcy statute, Congress did so only sporadically during the nineteenth century. Most of the bankruptcy statutes enacted during this time were motivated by financial panics. After the effects of these business cycles had subsided, the statutes usually were repealed. Overall, prior to 1898, Federal bankruptcy statutes were in effect for less than a total of twenty years.

It has been said that the Panic of 1893 was ultimately responsible for the enactment of the Bankruptcy Act of 1898. This statute dealt with liquidations, and provided the mechanism for bankrupts to place their nonexempt assets in the hands of a trustee who, in turn, was charged with liquidating them and paying off the debts

in accordance with a priority schedule. The 1898 Act, in turn, was amended in 1938 by the Chandler Act, which introduced the reorganization aspect to bankruptcy. Reorganization is the method by which a going concern restructures itself so as to continue in business after the closing of the bankruptcy case. This bankruptcy statute was left in effect until the Bankruptcy Reform Act of 1978.

During the 1960s and 1970s a number of factors led Congress to conclude that the existing Bankruptcy Code was inadequate to meet the needs of the country. The growth in consumer credit had led to an increase in bankruptcy filings. To grasp the magnitude of this expansion, one should consider that in 1960 total consumer credit was \$56 billion, whereas by 1977 it had increased to \$289 billion. This expansion was partly responsible for a record 224,354 consumer bankruptcy filings in 1975. The increase in the number of bankruptcies tested the ability of the bankruptcy court system as it was then organized.

As a result of these developments, Congress enacted the Bankruptcy Reform Act of 1978. This statute restructured the organization of bankruptcy courts, and contained substantive amendments which liberalized the ability of consumers and corporations to file for bankruptcy relief. Perhaps symbolic of the changing attitude toward bankruptcy, the new statute referred to bankrupts as debtors, in an attempt to remove part of the stigma of being a bankrupt.

## An Increase in Bankruptcies

There is considerable controversy over the effects of the 1978 amendments. There is no argument, however, that after enactment of the Bankruptcy Reform Act of 1978, the country experienced an increase of bankruptcy filings of historic proportions. The number of consumer bankruptcies, in particular, mushroomed. In fiscal 1980, the first year the 1978 statute was in effect, there was a 60 per cent increase of filings over the previous year, to a total of 314,856. By 1982, the number of individual bankruptcy cases exceeded 500,000.

The credit industry, alarmed at this development, commissioned a study of consumer bankruptcy. The study, commonly referred to as the

Purdue Study, concluded that a significant number of consumers who had filed for bankruptcy relief could repay part of their debt out of future earnings. The study estimated that the amount of repayable debt discharged by the Bankruptcy Courts exceeded \$1 billion per year. The credit industry faulted the 1978 amendments because of the newly acquired ability of many debtors to choose a no-asset Chapter 7 liquidation.

It is no secret that the vast majority of consumer bankruptcies are "no-asset" cases. This means that after all property that is exempt from liquidation is accounted for, there usually are no assets remaining for the benefit of creditors. In a typical Chapter 7 case, a trustee is appointed by the Bankruptcy Court to liquidate the debtor's nonexempt property and to distribute it in accordance with statutory priorities. Unsecured creditors share proportionately in the assets that may remain after the creditors who enjoy the statutory priority have received payment. In return for this, the debtor, provided he has not committed fraud or otherwise waived the right, will be discharged from most of his liabilities, even though the creditors received only a fraction of their claims. Any assets that the debtor may acquire after the filing of the bankruptcy petition, including wages, are beyond the reach of most pre-petition creditors. The Purdue study found that many of the debtors who filed for Chapter 7 liquidation were employed and could have paid off a substantial amount of their outstanding liabilities over a period of several years.

In view of the growing concern over the expansion of bankruptcy cases, Congress began to consider whether further amendments were needed. The movement toward reform, however, was delayed by another development. This was the Supreme Court's decision in the case of *Northern Pipeline Construction Co. v. Marathon Pipeline Co.*<sup>1</sup> The Supreme Court held that the 1978 amendments violated the Constitution because bankruptcy judges, while enjoying broad judicial powers, were not assured of the judicial independence mandated by the Constitution in the form of lifetime appointments and salary protection.

The controversy over the 1978 amendments was not restricted to consumer bankruptcies and judicial appointments, however. Many corpora-

tions took advantage of the new provisions of the law as well. Prior to the amendments, a company that desired to file for bankruptcy protection had to be insolvent. Finding that a showing of insolvency was too cumbersome, Congress deleted this requirement in the 1978 amendments. In addition, trustees no longer have to be appointed in every Chapter 11 case, and the management of a company that files for reorganization under Chapter 11 may remain in charge of the corporation unless it engages in reprehensible conduct. In light of these provisions, some corporations began to consider bankruptcy as a means to avoid some of their liabilities and contractual obligations.

One of the immediate effects of filing for bankruptcy is that all creditors must stop their collection actions against the debtor. If a creditor already has obtained a judgment against the debtor, the bankruptcy case prevents a creditor from enforcing this judgment. Similarly, all claims against a debtor that arose before the commencement of the bankruptcy case must be handled in accordance with the Bankruptcy Code. This is known as the automatic stay. There are exceptions to the automatic stay, however. For example, the automatic stay does not shield debtors from criminal prosecutions, from the collection of alimony maintenance and support obligations, from tax deficiencies or from the exercise of the government's police and regulatory powers.

## The Johns-Manville Case

The first company to achieve notoriety in taking advantage of the 1978 amendments was Johns-Manville Corporation. This corporation filed a petition for reorganization under Chapter 11 on August 20, 1982. At the time of filing, the corporation's net worth exceeded \$1 billion. The reason for filing for bankruptcy was that 16,500 lawsuits already had been filed against the company, alleging liability because of asbestos-related injuries. The company estimated that at the rate of 425 new lawsuits monthly, up to 52,000 lawsuits were expected to be filed, creating a potential liability of up to \$2 billion. In addition, the company may be liable for unforeseen liabilities since the victims of asbestos exposure may not develop any symp-

toms for a prolonged period of time. Since the Bankruptcy Code requires that all unmatured claims be accelerated, and that all contingent, disputed, and unliquidated claims be liquidated, the filing of the petition will aid in putting an end to the uncertainties facing the company.

Other industries also have utilized the bankruptcy route to resolve their liabilities. For example, Amatex Corporation filed for bankruptcy protection in November, 1982, in light of the fact that it was defending itself against 10,000 lawsuits. Similarly, in August, 1985, A. H. Robins filed for bankruptcy since at the time of filing there were 5,000 lawsuits pending, and the company estimated up to 300,000 claims to be filed.

Another provision of the Bankruptcy Code that aids corporations in their reorganization efforts is the ability to unilaterally reject certain executory contracts which are burdensome. Subject to court approval, it is generally left to the debtor to decide whether or not those contracts should be assumed or rejected. A lease is an example of a contract that a debtor may wish to cancel. A debtor may reduce the scope of its operations and therefore may not need as much leased space as it is obligated to pay for under the rental agreement. This provision of the Bankruptcy Code permits adjustments in these contracts.

In light of the fact that insolvency was no longer required for a business entity to file for bankruptcy protection, some corporations that were saddled with what they considered to be burdensome contracts considered the possibility of filing for bankruptcy relief in order to cancel those contracts. The one area that created the most controversy was the rejection of collective bargaining agreements. Wilson Foods Corporation, the fifth largest meat packer in the United States, filed a Chapter 11 reorganization petition on April 22, 1983. It then rejected its collective bargaining agreement which covered 6,000 employees, and reduced wages between 40 to 50 per cent. The company's net worth at the time of filing exceeded \$67 million. Similarly, on September 24, 1983, Continental Air Lines filed for bankruptcy relief, rejected its collective bargaining agreement, and laid off 12,000 employees. Two days later, 4,200 employees were reinstated at half their salaries.

The Supreme Court, in the 1984 case of *NLRB v. Bildisco & Bildisco*,<sup>2</sup> agreed with the interpretation that collective bargaining agreements may be rejected "if the debtor can show that the collective bargaining agreement burdens the estate, and that after careful scrutiny, the equities balance in favor of rejecting the labor contract."

Because of the expansion in consumer bankruptcies, the Supreme Court's decisions in *Marathon* and *Bildisco*, and the proliferation of business bankruptcies to avoid liabilities, Congress enacted the Bankruptcy Amendments and Federal Judgeship Act of 1984, which went into effect on July 10, 1984. The 1984 statute reformed some aspects of consumer and business bankruptcies, and also took care of the constitutional objections to the structure of the Bankruptcy Courts.

## Consumer Bankruptcies

One of the amendments enacted by the 1984 statute relates to consumer bankruptcies. Under the new provisions, Bankruptcy Courts are empowered to dismiss Chapter 7 petitions where the debts are primarily consumer debts if it is determined that the filing of those petitions constitutes a substantial abuse. The purpose of this new provision is to eliminate the previous unfettered discretion debtors had of filing for protection under Chapter 7, and to encourage those debtors who still want to file for bankruptcy protection to do so under Chapter 13 of the Bankruptcy Code. Under Chapter 13, the debtor must propose a debt adjustment plan under which payments out of future earnings will be made to creditors. The plan must, however, be approved by the Bankruptcy Court and the payment period may last from three to five years. The discharge of debts, after completion of the plan, is broader than under Chapter 7. The 1984 statute also requires that in making payments, a debtor must use all his disposable income, unless the unsecured creditors are paid in full. The 1984 amendments eliminate the past practice of Chapter 13 plans where debtors paid a minimal amount.

Although the thrust of the 1984 amendments is to encourage debtors to pay as much as possible, there are some troubling aspects to the law.

For example, only the court, and not the creditors, may raise the issue of whether a debtor is committing a substantial abuse in filing a Chapter 7 petition. This can deprive the court of the information creditors may be able to bring forth. In addition, given the large number of consumer bankruptcies, it is doubtful if a court always will have the time to gather the information needed to decide if Chapter 7 is the appropriate mechanism. Finally, a question may be raised as to the court's appearance of fairness, since the debtor would have to present evidence to refute the court's assertion of substantial abuse, and the court would have the power to decide the issue.

The 1984 amendments also tightened some other areas. For example, the amount of exempt property has been restricted. A waiting period has been added to prevent an immediate refiling of a petition when the previous case had been dismissed either voluntarily or by the court. Similarly, in order to prevent shopping sprees prior to the filing of a petition, no more than \$500 in credit for luxury goods and services owed to a single creditor may be incurred by debtors if such debts were incurred within 45 days before the filing of the bankruptcy petition. In addition, there are now time limits during which unexpired leases of nonresidential real property may be assumed or rejected.

Although the ability of debtors to shield themselves from lawsuits through the use of bankruptcy was left intact, the 1984 statute did limit the ability of businesses to reject collective bargaining agreements. *Bildisco* was overruled by the statute, and certain procedural and substantive standards must be met prior to a court granting approval of a rejection of a collective bargaining agreement.

Although recent developments indicate that the tide has turned against the debtors' perceived abuse of the bankruptcy system, the problems still exist. In the area of business bankruptcy, the delays in the processing of bankruptcy petitions harm creditors. It is not unusual for a reorganization plan proposed by a debtor under Chapter 11 to take one or two years before it is finally confirmed by the court. During this time, creditors cannot remove their assets or invest them in a more productive venture. Similarly, there sometimes are conflicts

## **We should reassess whether it is a proper function of government to reorganize businesses.**

between secured and unsecured creditors. A secured creditor, for example, may wish to dispose of the property in which he has a security interest in order to recover the amount owed. Unsecured creditors, however, may oppose this proposal because the disposal of the property may amount to a liquidation of the business, thereby eliminating any opportunity for recovery of their debts. Or, a secured creditor may feel that the property upon which he has a security interest is depreciating or is being consumed at a rate that will reduce the value of his security interest. Although the Bankruptcy Code allows secured creditors the opportunity to obtain "adequate protection" from some of these developments, it is not altogether clear that secured creditors are able to realize the market value of their security interest.

There is no question that bankruptcy tends to reward the irresponsible and the profligate. However, a free society must have a creditor-distribution system to take insolvency into account. When a debtor becomes insolvent, that is when liabilities exceed assets, there must be a system to treat all creditors fairly. In fact, a bankruptcy system that would concern itself with creditor distribution issues is to the benefit of creditors in general. This is because in the absence of a bankruptcy system, creditors would engage in a race to the courthouse whenever they may fear that a debtor is insolvent. A system that would allow such a race would benefit some creditors at the expense of other creditors. In addition, the race to the courthouse may prematurely terminate an ongoing business, reducing the probabilities of recovery to other creditors. The absence of a bankruptcy system would be detrimental to creditors in general and would raise the cost of credit to debtors.

The present system, however, goes beyond the distribution of debtors' assets to creditors.

The Bankruptcy Code also contains provisions aimed at fostering the reorganization of failed business enterprises. As we have seen, approval of these plans takes time, and some creditors benefit at the expense of others in reorganizations. We should reassess whether it is a proper function of government to reorganize businesses. If a business has failed to adequately meet consumer demands, it is questionable whether the government should veto the market and keep such an entity afloat. It is one thing to set up a system which liquidates assets of insolvent debtors and distributes them to their creditors. It is altogether different when the government meddles into how a business should be structured and whether or not it should be allowed to survive.

In addition, the relief sought by those who file for protection under bankruptcy may have the effects of encouraging more bankruptcies. This, in turn, raises the cost of credit for all. Although a debtor should be allowed a fresh start after bankruptcy, a discharge of debts is too strong a remedy.

The removal of the insolvency requirement in business bankruptcies has led to the inequitable result that some companies, notably those with potential liability in the billions of dollars, may successfully shield themselves from lawsuits by filing for bankruptcy. A Bankruptcy Court may place limits on a debtor's potential liability since it may be interested in preserving the business as an ongoing concern. This only injures the debtor's claimants.

The 1984 amendments reveal a trend in cutting back some of the advantages debtors obtained by filing for bankruptcy relief. There is clearly a need for further revision. In a recent case, the Supreme Court has involved itself in this trend as well. In this case, it was held that a debtor may not avail himself of the Bankruptcy Code in order to violate "a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards."<sup>3</sup> True bankruptcy reform, after all, may not be that far away. □

1. 458 U.S. 50 (1982).

2. 465 U.S. 513 (1984).

3. *Midlantic National Bank v. New Jersey Department of Environmental Protection*, 88 L. Ed. 2d 859, 869 (1986).



# Readers' Forum

## To the Editors:

J.D. Steelman's essay, "Deregulation of the Natural Gas Industry," (June 1986) interestingly describes some of the revolutionary changes taking place as the gas industry breaks out of its decades-old regulatory straitjacket. Out of the distortions of shortage and surplus that have affected the production, transmission, and distribution phases of this industry for over a decade, new institutions and business practices have been developing that seen as a whole make up what F.A. Hayek calls "spontaneous order." But unlike the impression given in this essay, there is still significant regulation and much to resolve before a free market can be said to reign in the gas industry.

In response to growing market forces and distortions requiring market solutions, the Federal Economic Regulatory Commission (FERC) has faced the age-old regulatory question—more regulation or less regulation. (This is not new; the past of industry regulation has been closing one regulatory gap after another.) Beginning with self-help transportation programs in the 1970s to move gas from surplus areas to shortage areas, the FERC has been pragmatically deregulating piecemeal to create a greater role for market forces. As competitive forces snowballed, propelled by the gas surpluses of the 1980s, the FERC was forced to overhaul the Natural Gas Act of 1938 with Order 436 of October 1985 which Mr. Steelman refers to. Importantly, this overhaul is not deregulatory although certain provisions such as relaxed certification for entry and exit tend to be. Order 436 substitutes new regulation for relaxed regu-

lation and magnifies existing industry problems.

A particularly onerous provision forces interstate pipelines to accept all transportation requests by outsiders (whether producers, brokers, pipelines, or end-users) whether or not there is capacity or whether the pipeline wishes to do so. By removing pipeline "monopoly power," it is believed, mandatory contract carriage makes the industry more competitive and lowers prices for consumers. At the same time end-user contracts are incrementally terminated (begun previously by Order 380 of May 1984 and Opinion 238 of July 1985) which leaves pipelines in the predicament of holding unmarketable high-take, high-price producer contracts entered into on the basis of voided end-user "minimum-bill" commitments. There are many distortions in the making from the new regulation of Order 436 that cannot be presented here, but let it be said that pipeline regulation (not to mention partial wellhead regulation, conservation laws, and comprehensive distribution company regulation) remains a powerful force in the natural gas business environment.

I make these points in regard to Mr. Steelman's article not as an end in itself but in the hope of interesting young "Austrian" economists (who are increasingly populating graduate economics programs around the country) to examine the insightful history of natural gas intervention to teach us more. I single out Austrianism for this topic for good reason. So far only neoclassical economists and industry-

related observers have interpreted the story. Yet there are many Austrian themes that are vital for understanding, such as the interrelationships (dynamics) of industry intervention, the development of new market institutions and spontaneous order in relation to regulatory and market changes, and the role of integration, non-access, and cooperation (as opposed to free access and rivalry) in market coordination and efficiency.

—Robert Bradley, Jr.

### Mr. Steelman replies:

Mr. Bradley's ideas were most thought provoking. I do not disagree with his proposition that the natural gas industry is still a regulated industry—so is every industry in the United States. Those industries not regulated by a commission such as the FERC, FCC, FAA or the like, are subject to antitrust laws and other laws. Although I prefer the free market approach of Mises, Hayek, and the Austrian economists the issue in today's environment is whether the regulations give one a long or short leash. Certainly regulation of the natural gas industry is being relaxed in comparison to the comprehensive wellhead to burner tip regulation that had existed. Market forces are being allowed to have much more of an impact on the industry. Meaningful deregulation is a possibility. However, neither the FERC nor the state regulations on natural gas are being relaxed rapidly enough. The concluding paragraph of my article called for acceleration of deregulation not merely a relaxation of regulations.

At the time I wrote my article, Order No. 436 had all the makings of a comprehensive deregulation order, as did Order No. 451 when it was first proposed by the Department of Energy; subsequently, the picture became muddled. In my opinion, Order Nos. 436 and 451, as now being finalized, are causing chaos in the industry and the marketplace. The result among virtually everyone I know in the industry is a preference for comprehensive legislation deregulating the industry (this in itself is a radical departure by the industry from past positions).

Not only is the natural gas industry desirous of greater flexibility within the industry, it also must have greater flexibility to compete with energy substitutes that are less regulated than natural gas. This more than anything else was the impression I meant to convey—the marketplace is de facto deregulating and beginning to operate like a competitive marketplace. Entrepreneurs and managers have acknowledged by their actions that the natural gas industry is subject to competition like any other industry and they are responding accordingly.

In summary, I believe the industry is beginning to function more like a competitive marketplace than a regulated public utility and that the industry will continue to seek the removal of marketplace barriers. Regulation will be relaxed, though it is unlikely that the FERC or state regulatory commissions will be abolished. Nor do I believe that the Natural Gas Act or even the Natural Gas Policy Act will be repealed in the foreseeable future. However, I do believe that there will be forthcoming further relaxation in regulations and perhaps some real deregulation. This will allow a more competitive and efficient natural gas market to evolve and will be healthy for both the natural gas industry and the marketplace.

—J.D. Steelman

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# Congress and the Welfare State

by John Chamberlain

**F**orty Years Against the Tide: *Congress and the Welfare State*, by Senator Carl T. Curtis and Regis Courtemanche (Chicago: Regnery Gateway, 443 pp., \$18.95), is the sort of autobiography of a public figure that Albert Jay Nock, a believer in personal privacy, would have welcomed. As co-author of this memoir, Curtis, who was a Nebraska representative in the House and Senate from 1938 to 1979, never refers to himself in the first person. There is practically nothing about his family life. In reading the book one recalls the remark made by the wife of Frederic Howe, the pre-World War I reformer, when she read the manuscript of her husband's autobiography. "But Fred," she asked, "weren't you ever married?"

Because of the lack of personal detail in this book one never really sees Carl Curtis. (Russell Kirk's introduction makes up for some of the deficiency.) What one does see is a forty-year panorama of the coming of the Welfare State. The book is certainly sound as history.

As a man of principle, Carl Curtis opposed the growth of the Welfare State philosophy at considerable danger to his own career. It was not that he was against welfare if it had been limited to succoring those who were, for one reason or another, unable to do anything for themselves. But the trouble with welfare, as it developed in a land of competing pressure groups, was that it led the politicians to flood the country with paper money that was far in excess of anything connected with natural productivity. The scramble for this inflationary



Senator Carl T. Curtis

money created most of the problems that Curtis tried, with considerable pertinacity but little success, to solve by legislation.

## Unpopular Causes

The great thing about Carl Curtis is that he was always willing to risk his neck in support of unpopular causes. Nebraska is a grain-growing state, but Curtis was an early opponent of food stamp rackets that might have benefited individual farmers at the expense of the general taxpayers. He didn't like the sacred cow of the hot lunch program. The section in this book on

"Our Daily Bread from the Government" turns into a tribute to Nebraskans, who kept returning Curtis to Washington by big majorities despite their obvious interest in disposing of the agricultural surplus at any cost.

As a member of the Select Committee that investigates labor rackets, Curtis was prominent in the movement that led to certain salutary improvements of the Taft-Hartley Act. He willingly took on the big labor bosses who wanted no truck with secret union elections. What puzzled Curtis was the selectivity of the Kennedy brothers, John and Bobby, when it came to seeking indictments of labor leaders who countenanced the use of goons in labor disputes. Bobby Kennedy, as Attorney General, was indefatigable in his pursuit of Jimmy Hoffa of the Teamsters Union. But it was a "no-no" when the Kennedys were asked to do something about the United Automobile Workers' conduct of the strike against the Kohler Company of Wisconsin. There were plenty of instances of goon-squad violence on the part of the UAW in Toledo, Ohio, Buffalo, New York, and Kohler, Wisconsin, but Walter Reuther, the boss of the UAW, led a charmed life when subjected to Curtis's questioning. The Kennedys wouldn't touch Reuther.

When Curtis took a leading part in pushing the investigations of Bobby Baker, who became incredibly rich as chief aide to Senator Lyndon Johnson, he led with his chin. For his temerity in the Baker investigations and in his role in exposing the fraudulent mortgage racket of Billie Sol Estes in Texas, Curtis was marked out for purging by Lyndon Johnson. But the Nebraska voters resisted Johnson's maneuverings to get Curtis out of Washington.

## Social Security

Curtis even survived the wrath of the elderly when he openly called Social Security funding into serious question. Curtis doubted the actuarial soundness of a system that certainly wasn't true insurance. But the young came to Curtis's rescue, giving him the votes to counteract elderly defections. The young believed him when he pointed out that there were some twenty-two million persons paying Social Security taxes who did not have enough income to pay income taxes.

As one who believed in accentuating the positive, Curtis pushed the idea of the Individual Retirement Account, or IRA. The IRA legislation should have had his name attached to it. Senator Russell Long commended Curtis for his persistence in bringing the "true savings" of IRA into existence as an "antidote to the burdens imposed by Social Security and other taxation."

Curtis was willing to go to the federal government for help in providing flood control and irrigation for his Nebraska constituency. On the value of irrigation Curtis said "we must not let our natural resources go to waste." Since the Missouri River system drains one-sixth of the United States, Curtis regarded such things as the Flood Control Act of 1944 a legitimate national concern. It can certainly be argued that support of irrigation as a national expense is not consonant with Curtis's general feeling that individuals and states should take care of themselves. But consistency here would never have sent Curtis to Washington, where for years he was such a force for good. ☐

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## PERSPECTIVE

### Food from Thought

A recent ad for a seafood restaurant noted that more than 70 per cent of the earth's surface is water which, in their words, "teems with millions and millions of lunches and dinners." But, the ad went on, "it takes genius to get them out."

What the ad didn't say is that the "geniuses" who supply consumers with seafood as well as other goods and services are entrepreneurs who hope to earn a profit. Fish and shellfish have lived in the oceans for millennia. It took profit-seeking entrepreneurs to bring them to dinner tables across the nation.

Now, as growing demand endangers some species—shrimp and Pacific salmon, for example—other entrepreneurs see the potential shortages as opportunities. One entrepreneur is raising shrimp as a commercial venture in Hawaii. Another has transported salmon eggs from the Pacific Northwest to South America, where the cold rivers of Chile offer conditions similar to those in the Columbia River. At last word, young salmon had returned up river to spawn in Chile where they had hatched.

When entrepreneurs are free to seek profits, they will risk their own resources to try to meet consumer needs. But if they are discouraged by rules, regulations, and confiscatory taxes, we consumers will be the ones to suffer.

—BBG

### A Little Doubt

Sometimes a little doubt can be the beginning of great wisdom.

Consider the case of Leszek Kolakowski, a Polish philosopher. For years he was hailed as the top Marxist theoretician of his country. But quietly seeds of doubt took root in Kolakowski's mind. He became a "revisionist Marxist," regarded with suspicion and barely tolerated by the authorities. Then came

his departure from Poland and, in time, the publication of a three-volume study tearing Marxism—classical and revisionist—to shreds. More recently, Kolakowski has been uttering sentiments to which students of the freedom philosophy can only warm. Doubt, for him, was a pathway to truth.

“The world is flat.” Copernicus dared doubt, and a new vision of our planet and solar system came to life. “No person can sail beyond narrowly determined limits!” Columbus doubted, and a new continent destined to be the home of a free people was discovered. “If one party to an economic exchange profits, the other party must have lost!” Adam Smith doubted, and an economic system capable of enriching all drew nearer to its realization. “The laws of physics have been stated once and for all by Newton!” Einstein doubted, and an exciting new understanding of energy and its transformations was born.

Hence the “doubt” the freedom philosophy applauds. We cherish the truths we have discovered—an open mind, after all, is not to be confused with an empty head! Yet equally we cherish the knowledge that further truths await discovery by those humble enough to doubt that they already know it all!

—John K. Williams

## Freedom to Fail

We Americans tend to take our liberties for granted. We have enjoyed so much liberty for so long and have been so sheltered from real oppression that we have lost to a great extent an understanding of the nature of liberty and the reverence for liberty that was so deeply rooted in our forebears. In particular, we don’t seem to appreciate as a people the trade-offs between freedom and security. We have “progressed” from seeing government as merely the securer of our basic rights to life and the liberty to

pursue happiness in our own ways so long as we respect the rights of others to a perverted perception of government as the securer of a host of new “rights” that might be lumped together as the *achievement* of happiness as opposed to the altogether different right to *pursue* happiness. These so-called rights to “decent” housing, a “decent” meal and a “decent” job at “decent” pay would readily have been seen as the insidious threats to liberty that they are by the founding fathers of this country whose philosophical insights were infinitely deeper than are those of the shallow politicians who govern today.

It is not so surprising that Americans have lost their intellectual moorings insofar as liberty is concerned. Few people understood at the time of the Great Depression that it was essentially produced by the government (the Federal Reserve had been created less than fifteen years earlier) and fewer still were able to understand that an amalgam of New Deal legislation enacted under a personally appealing President effectively dragged out an economic recovery that would doubtless have proceeded much more rapidly under a more free and efficient market. Traumatized by the prolonged economic insecurities of those times, people were willing to trade some liberty for a square meal—and the image of government as economic savior has persisted despite mounting evidence of its inability to fill that role.

—William Chidester

*Market Vantage*

July 4, 1986

(Ed. note: For further insights into the importance of the freedom to fail, see Dwight R. Lee’s “Freedom and Failure,” beginning on page 392.)

# Paying People Not to Grow

by Robert James Bidinotto

**M**OST Americans believe that the rewards of life should be individually earned. That is why few government programs have been subjected to as much public criticism as the policy of paying farmers *not* to grow crops. The very idea of rewarding non-production affronts most people's notions of justice and common sense.

This does not mean that Americans oppose all government aid or subsidy programs on principle. Confusing the functions of government with those of a private insurance firm, many believe that the state should provide a social "safety net" for those regarded as innocent victims of life's hardships.

Originally, such assistance programs were intended only for the helplessly needy: the sick and disabled, the very young and the very old, those laid low by catastrophes. The presumed beneficiaries' helpless dependency was regarded as an ethical claim upon the community—and thus a moral rationale for coercive redistribution of private wealth from the "haves" to the "have-nots."

However, even in the most severe cases of individual need, coercive redistributionism poses irreconcilable moral dilemmas. It seeks to help some people—but necessarily at the expense of others. It aims to relieve those designated as "victims"—by creating a new class of "victims": those forced to provide the relief. It

designates some people as *ends*—while it arbitrarily relegates other people to the servile status of *means*.

There is an unbridgeable gap between the moral *intentions* underlying redistributionism, and its moral *consequences*. Redistributionism is intended as a charitable "spreading of wealth"; in fact, it is a compulsory spreading of burdens. It is intended to solve individual problems; in fact, it universalizes hardships. It is intended to make men morally responsible for others; in fact, it obliterates any concept of personal responsibility.

By shifting some people's personal burdens, problems, and hardships onto the backs of others, redistributionism has corrupted and undermined the vital principle of moral self-responsibility. It encourages those with personal problems to neglect their moral responsibility to seek personal solutions; and it entices them to depend instead upon the coercive power of government to extort assistance from others. Simultaneously, it punishes with taxation those who have assumed their moral responsibility to work, solve their own problems, and support themselves.

Like the policy of paying farmers not to grow crops, redistributionism pays *people* not to grow . . . as people.

In his controversial book, *Losing Ground*, Charles Murray formulated a "Law of Unintended Rewards." It states that "any social transfer increases the net value of being in the condition that prompted the transfer." It does so "either by increasing the rewards or by reduc-

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*Mr. Bidinotto is contributing editor for On Principle, a political newsletter, and received the 1985 Mencken Award in journalism for "Best Feature Story, Essay or Review."*



ing the penalties'' normally associated with the condition, or behavior, which the government is trying to ameliorate.

For example, Social Security is intended to insure against financial problems associated with old age. But it does so by removing the need (incentive) for many people to prepare other financial options for their retirement years. In addition, Social Security taxes siphon off their means of investing in any alternative. So, instead of adding to the security of the elderly, the program encourages many of them to ignore long-term planning—hence, to increase their vulnerability to hardship—and hence, to become overly dependent upon it as an exclusive, rather than supplementary, source of income. In effect, Social Security has increased the rewards and reduced the penalties of inadequate financial planning—the very problem which the program was designed to combat.

## The Human Cost of Federal Aid

Similarly, Aid to Families with Dependent Children was intended to help widows with small children. Murray shows, with devastating examples,<sup>1</sup> how AFDC benefits encourage poor women to have more and more illegitimate children, while discouraging them from marrying their live-in lovers. The enormous proliferation of inner-city illegitimacy, generations of welfare dependents, and attendant moral problems (such as crime, drug epidemics, and the like), is a grim testament to the Law of Unintended Rewards. In other words, AFDC increases the rewards and reduces the penalties of becoming an unmarried woman with dependent children—the very problem which the program was designed to alleviate.

In the same way, Federal disaster relief is intended to compensate victims of catastrophic losses due to various disasters. Much of this Federal money goes to victims of coastal flooding during hurricanes—a phenomenon so predictable that certain areas of the country are officially designated as hazard zones. Federal flood insurance is offered to individuals living in these zones at only about a third of private insurance rates. Flood victims typically use their Federal insurance compensation for recon-

struction . . . right back in the hazardous zones. In effect, the Federal assistance increases the rewards and reduces the penalties of building and living in dangerous areas. By increasing the number of people at risk, the federal government thus increases the magnitude of future disasters—the very problem which the program was designed to relieve.<sup>2</sup>

The economic consequences of redistributionism are well known, and are not of primary concern here. What these examples illustrate is a different, and perhaps even more important point: the *human* cost of Federal "assistance." Redistributionism invariably demoralizes both its presumed beneficiaries and its involuntary benefactors. It pays people not to grow—in ability, in foresight, in productive output, in moral character.

If this is so even in extreme cases of individual hardship, what can be said of those government programs designed to assist able-bodied, normally productive people?

Because of the inverted morality of the redistributionist welfare state,<sup>3</sup> it was only a matter of time before the category of "needy" people expanded. With mounting incentives to become recipients, and massive disincentives to remain producers, the growth of the welfare state began to acquire its own momentum. More and more voters began to clamor for broader and less restrictive criteria for obtaining political assistance.

Politicians have met the demand for unearned benefits by increasing the supply of redistributionist programs. In 1950, there were 4.2 wage earners for every recipient of a Federal "transfer payment." By 1980, there were only 1.6 wage earners per recipient. Transfer payments were 3.8 per cent of the Gross National Product in 1952; by 1982, they were 12.2 per cent. They were less than half of the Federal budget in 1962; today, they amount to two-thirds of all government outlays. By 1984, the federal government was running 400 separate programs to give subsidies to individuals. And this does not even begin to count up state and local programs and outlays.<sup>4</sup>

Fueling this proliferation of programs was the addition of the "deserving" to the category of the "needy" as eligible recipients. Even considering the vagaries of terminology, "needs"

can at least be specified and somewhat delimited. But given today's ill-defined and competing standards of justice, the notion of "deserving" is utterly elastic. And it does not necessarily limit government assistance only to the helplessly dependent. Once helplessness was no longer the sole standard of determining who could receive government aid, more and more able-bodied people began to line up for unearned benefits.

## Veterans' Benefits

For example, it was first argued that military veterans "deserved" compensation for injuries and traumas sustained during service to their country (a reasonable position). But no distinction between "compensation" and "benefits" was ever drawn. So, a vast array of "veterans' benefits" has been made available to present and former military personnel—whether or not they have seen combat, sustained service-related injuries, or are even "needy."

Take medical care for veterans. The Veteran's Administration maintains its own system of 172 hospitals, 93 nursing homes, 227 outpatient clinics and a variety of other facilities—the nation's largest health care network. Its facilities are antiquated and grossly inefficient compared with those in the private sector. And though the V. A. is not obligated to do so, over 80 per cent of its care is provided for *non-service-related* disabilities.<sup>5</sup>

Obviously, veterans' benefits are not strictly limited to meeting the actual "needs" of soldiers injured in the line of duty. Rather, they are intended to express public feelings of gratitude and indebtedness to all military personnel as such. Because such feelings are intangible and unquantifiable, the public can place no objective limit on what they feel veterans "deserve."

But the unlimited largess of veterans' programs has a negative side. It fosters and perpetuates dependency among military personnel, providing them with a buffer and a refuge from civilian life and the private market. It pays veterans *not* to grow.

Similarly, Americans tend to feel that workers "deserve" government assistance in times of hardship. Just as military personnel "deserve" unlimited compensation for taking risks

for their country, unemployed workers "deserve" compensation above and beyond that which they receive for their labors alone. Evidently, they also ought to be paid for the virtues of character presumably implied in being "workers." Thus, even when they are *not* working, they "deserve" compensation . . . for their past record of hard work.

This premise seems to be a dilution of the labor theory of value into the popular notion that anyone exerting himself (regardless of how well he meets market needs) "deserves" to be compensated for his effort alone. The idea that it is not results, but mere efforts—or even mere good intentions—which merit some reward, is deeply ingrained in popular values. And it implies that if "society" (the private market) fails to give a hard-working or well-meaning person his "due," then government ought to force "society" to make amends, through various interventions.

One of those interventions, intended to alleviate the "undeserved suffering" of the unemployed, is the unemployment compensation program. Since 1935, unemployment compensation has provided jobless workers with incomes. Never mind that unemployment compensation—in effect, a subsidy for idleness—discourages workers from seeking new jobs.<sup>6</sup> The *intentions* of a government policy, as always, take precedence over its *consequences*. Thus, unemployment compensation pays workers *not* to learn new skills, to seek new opportunities, to move to better locations . . . to grow.

At least unemployment compensation retains some connection to the original rationale for redistributionist programs: the unemployed are, presumably, helplessly dependent until they find new work. But thanks to the labor theory of value, the government offers aid not only to the helpless, but to those who are merely struggling.

Consider the plight of the farmer. It is government intervention which has caused the chronic agricultural crises since the First World War.<sup>7</sup> Decades of price supports, protective tariffs, government purchases of farm surpluses, subsidies for reducing production (paying farmers *not* to grow crops), "marketing orders" to restrict supply, and low-interest loans have combined to produce an oversupply of

farm products . . . and farmers.

Beyond its economic benefits, an end to government intervention in agriculture would prompt thousands of uncompetitive farmers to abandon an anachronistic lifestyle, to learn new skills more appropriate to a modern economy, to become truly self-supporting and independent. But in response to loud cries of anguish, the current Administration is continuing the same failed policies of the past. Those policies not only pay farmers not to grow certain crops; they pay farmers not to grow . . . as self-responsible individuals.

In fact, we are facing a mounting clamor for additional government programs to shield not only farmers, but fishermen, shoemakers, garment manufacturers, oil producers, and steel workers from foreign competition or disruptive market changes. Even people who usually oppose welfare schemes are campaigning for government aid to "save the family farmer" . . . loan guarantees for troubled auto manufacturers . . . tariff protection for struggling domestic steel and shoe producers . . . intervention to "revitalize" local communities dependent upon dying technologies and industries.

In each of these cases, uncompetitive or obsolete professions are being salvaged from the economic scrap heaps by infusions of government capital . . . capital drained from more competitive and productive sectors of the economy. And in each case, the alleged "victims" are demanding their "right" to be sustained, via compulsory taxation, in lines of work which consumers are unwilling to sustain voluntarily. They are demanding, in effect, the right to be paid *not* to grow—the right to stagnate.<sup>8</sup>

## "Desirable" Causes

Now, to the categories of the "needy" and the "deserving," has been added the category of the "desirable." Federal funds are available for every conceivable cause which sounds appealing, or even merely innocuous, to those holding the Federal purse strings. There is a wry joke making the rounds, which says, "If it moves, regulate it; if it stands still, tax it"—to which we may now add: "If it sounds good, subsidize it."

Sounds good—to whom? Desirable—by

whose judgment? The free market rewards producers to the extent that they offer goods and services which appeal to a large number of people. If one wished to invent a mechanism for satisfying the broadest range of desires of the greatest number of people, one could not improve upon the market system. At best, government interventions on behalf of "desirable" enterprises would be superfluous: they would mirror those selections made by consumers, voting with their dollars.

But of course, that is *not* what advocates of Federal aid to "desirable" causes mean. They intend not to mirror the democratic selections of the people—but to override them. The only "desires" they intend to indulge and reward from the public treasury are their own. Unable to win public support in the marketplace, they mean to impose their values upon the public from the halls of Congress—or, at the very least, to compel the public to finance their self-indulgence.

This coercive elitism is most evident in government support of artists, through the National Endowment for the Arts. Those most likely to get government grants are those of high visibility—those already successful or those who learn the corridors in Washington better than they learn their own profession.

What does this mean in terms of personal growth?

It means that many commercially unsuccessful artists (whose work is frequently obscure, offensive, or of poor quality) are sustained in a profession for which they are unsuited—and are thus diverted from pursuing a more appropriate career. Commercially successful recipients, on the other hand, obtain funds they do not need, at the expense of those who do.

Meanwhile, art consumers, as taxpayers, have less to spend on the kind of art which uplifts them intellectually and spiritually. Instead, they are compelled to subsidize art they find personally unrewarding or even offensive. (The evil is compounded in the case of the National Endowment for the Humanities, where taxpayers are forced to subsidize *ideas* which they may find repugnant or evil.) This means there is less money for artists whose work is moving and accessible to greater numbers of people. And thanks to redistributionism, it is not un-



common that some struggling artists—too proud, independent, or politically unsophisticated to obtain handouts—are forced to subsidize their less scrupulous, more politically “connected” competitors.

Government support of the arts pays artists not to grow.

### “Entitlements”

Today, it is no longer helplessness . . . or need . . . or the belief that one is a “deserving” person . . . or even “social desirability” that fuels the race for government assistance. As their tax burdens mount, as programs dispensing assistance proliferate, as eligibility requirements evaporate, citizens are concluding that a life of self-responsibility is less and less rewarding. Mutual plunder has become the status quo. And, in such an atmosphere, taxpayers increasingly feel *entitled* to the benefits of programs which they are required to support.

The notion of “entitlements” is even broader than the idea of “deserving” government assistance. “Deserving” implies that the recipient is

being rewarded for an action, quality, or status that merits special treatment. There is at least a residual sense of justice involved. But the concept of “entitlements” obliterates any pretext of a standard of eligibility: one is “entitled” to benefits simply because they are available. The ubiquitous phrase of our time is: “I paid into the system, so I’m going to get my share.”

Not long ago, a book appeared by a man who runs a business to teach clients how to milk the Federal system for funds. Titled *Getting Yours*,<sup>9</sup> the book represents the zenith of the “entitlement” mentality. “If you want to build a house or a chicken coop, get a job, start a business, get a college degree, improve your neighborhood, or even build a tennis court or a golf course, it is likely you can do it with funds from the federal government,” enthuses the author. “So don’t believe all the headlines about budget cuts, because the federal government continues to give out more money than ever before.” Reassuring, isn’t it?

In an essay-review,<sup>10</sup> I outlined some examples taken from the book:

“Your taxes helped the National Endowment

for the Humanities give nine students \$10,000 to walk 412 miles, following the exact route of the historic 'Underground Railroad.' Young scholars receive an average of \$14,000 to work with Smithsonian specialists on such pathbreaking projects as 'The 1940s in New York—Radical Politics and Avant Garde Art' or the 'Socio-ecology of Venezuelan Red Howler Monkeys' . . . (or) . . . 'Feminism and Its Impact on the Premises and Goals of Current Political Theory' . . .

"A Killington, Vermont, ski lodge, hurt by the 1974 fuel crisis, was saved by a \$40,000 loan from the SBA while you waited in line for gas . . . The Agriculture Dept. poured seed money into Kinnen, Alabama, to help raise an unusual crop: tennis courts, a baseball diamond, picnic grounds and a playground. And (a famous ex-baseball star)—obviously among the nation's downtrodden—got a \$100,000 loan guarantee from the SBA to buy a Dodge dealership . . .

"You also fund cutting-edge technology . . . (T)he Dept. of Energy gave a Missouri genius \$1,200 to design and build a solar-heated out-house."

Such is the dead-end of redistributionism. All the old justifications are gone; all that is left is a feeding frenzy at the public trough.

It is common for some critics to view redistributionism on strictly economic grounds—as inefficient, as wasteful of resources, as destructive of capital. But the real price of redistributionism cannot be conveyed in macro-economic aggregates or impersonal market relationships. The real tragedy of redistributionism lies in its stultifying impact on human development.

## Full Self-Responsibility

Growth, development, maturation, self-actualization: whatever one chooses to call it, it is the essence of life. In the final analysis, it means the exercise of full self-responsibility—intellectually, morally, materially. The ancient Greeks put it more elegantly. The true end of human life, they said, was personal well-being, which they defined as "the exercise of vital powers, along lines of excellence, in a life affording them scope."

Redistributionism, in the guise of govern-

ment assistance, thwarts every element of human potential. It inhibits the exercise of vital powers, diverts them along inappropriate lines, shrinks their scope and scale.

Of course, government assistance is always promoted on the grounds that it helps recipients to grow or develop in some manner. Critics often respond that if government assistance has this effect on a given recipient, it is only at the expense of someone else, whose personal growth must be sacrificed. And, as far as it goes, this criticism is true: government-fostered "growth" is inherently parasitical, even cannibalistic. But that is not the worst of it.

The truth is that there are *no* winners under redistributionism—only losers. Everyone is diminished by the process of plunder—including the plunderer. Whatever the presumed beneficiary gains in material advantages is more than offset by the price—in lost independence and moral self-responsibility, in lost incentives to achieve, in lost self-esteem . . . in a lost legacy of personal potential.

Many observers have commented on the disappearance of heroes from the modern world. Nothing is so characteristic of this century as the ever-shrinking stature of its leaders. There are probably many reasons why towering figures no longer cast their shadows across the land. Surely one of them is that a Procrustean force has been loosed upon the world—a force that punishes those who stand too conspicuously, and rewards them for remaining bowed—a force that pays *people* not to grow. □

1. Charles Murray, *Losing Ground* (New York: Basic Books, 1984), pp. 154-166.

2. John W. Sommer, "Disasters Unlimited," *The Freeman* (April, 1986), pp. 135-36.

3. R. J. Bidinotto, "The Exploitation of the Virtuous," *The Freeman* (September, 1968), p. 568.

4. J. Peter Grace, *Burning Money* (New York: Macmillan, 1984), pp. 107-8.

5. *Ibid.* See also William R. Kennedy and Robert W. Lee, *A Taxpayer Survey of the Grace Commission Report* (Ottawa, IL: Green Hill Publishers, 1984), pp. 79-80.

6. Hans F. Sennholz, "Unemployment Compensation," *The Freeman* (May, 1986), pp. 188-89.

7. Dennis Bechara, "The Continuing Plight of Agriculture," *The Freeman* (May, 1986), pp. 178-85.

8. Frank W. Bubb, "The Right to Stagnate," *The Freeman* (April, 1986).

9. Matthew Lesko, *Getting Yours—The Complete Guide to Government Money* (New York: Viking Penguin, Inc., 1984).

10. R. J. Bidinotto, "Parasitism as a Profession," *On Principle* (April 29, 1985).

# Protectionism: The Myths

by J.R. Kearl

**F**or at least 200 years it has been clearly understood that opening an economy to trade increases real per capita income, and that this increase is larger the more open an economy becomes. In our modern age, though, almost everyone who is not an economist thinks that imports reduce profits and eliminate jobs, that an economy would best be served by exporting more and importing less, and that a trade surplus would be good while a trade deficit is most certainly bad. Each of these notions is false but very much a part of the rise of protectionism in the United States.

In perhaps no other area of social policy are there so many myths that are so demonstrably incorrect yet so persistently invoked. But this gives rise to a nice puzzle: If free trade is such a terrific thing, why do protectionist myths persist and why are we moving step by step away from an open trade environment at great costs to each of us?

The positive effects that liberal or open trade have upon economic well-being or, conversely, the negative effects that protectionist policies have on our welfare are more than abstract ideas of academic scribblers. The historical record is quite clear.

The growth and power of the American economy are a direct result of the movement away from the Articles of Confederation to a union of states within which trade between states could

not be taxed. The Constitution essentially created a free trade area among the original 13 states and ensured that the free trade area would automatically increase with the creation of new states. Your economic well-being would be substantially lower if there were now 50 separate economies in this country, each with its own protected "basic" industries, rather than the integrated and specialized economy we now have. This fact might prompt you to ask why free trade between Montana and Florida is good but open trade between Alberta and Florida is not.

Likewise, all of our real incomes are substantially higher because the city of Provo cannot impose a tariff on the importation of clothing by the citizens of Provo from the mall in Orem and because Utah cannot impose a tariff on the importation of lettuce from California. Imagine, if you can, what our economic position would be if there were a tariff wall around Provo, or any of this country's cities, so high that we had to manufacture within the city all of the typical commodities we consume—shoes, televisions, cars, refrigerators, computers, and so on. Our living standards would be much lower because economic independence produces, quite simply, economic poverty.

Britain's move toward free trade in the early part of the nineteenth century, culminating with the repeal of the Corn Laws (laws that severely restricted the importation of grains in the support of domestic agriculture), ushered in almost a century of unparalleled economic growth. Those who supported the Corn Laws argued that wages would fall if trade was not restricted.

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*J.R. Kearl is a professor of economics and law at Brigham Young University, Provo, Utah.*

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In fact, wages within Britain rose rapidly with more open trade. However, not just the British benefited from the repeal of the Corn Laws. As a consequence of this move toward freer trade, Britain was the engine of economic growth for the world in the nineteenth century. (It is useful to note that Britain did not demand reciprocal actions by her trading partners, and indeed many continued to pursue protectionist or mercantilist policies to their detriment.)

On the negative side, there is now a good deal of evidence that the severity, depth, and length of the Great Depression were directly related to the unprecedented tariffs imposed by the Smoot-Hawley Act in 1930 and to similar actions taken by other countries in reaction to this tariff.

Furthermore, following World War II, as the colonies of the European powers obtained political independence, they also pursued economic independence and sought to restrict trade. All available evidence indicates that this effort to be economically independent stunted economic growth and impoverished these economies and their citizens. By contrast, those less developed areas that pursued more open economic policies, notably Hong Kong, Singapore, Taiwan, and South Korea, have experienced remarkable economic growth. For example, 1960 per capita income in the Philippines was \$163 while it was \$139 for Taiwan. By 1980, income in the Philippines had increased to \$665, a four-fold increase, while it had increased to \$2269 in Taiwan, or by a factor of 16. While there are many differences between the Philippines and Taiwan, one of the important differences was the pursuit of more protectionist policies by the Philippines.

## The Myths of Protectionism

Despite the obvious achievements of open trade and the costs associated with restricted trade, protectionist myths persist.

**Myth #1: An economy with high labor costs must protect itself because it cannot compete with an economy benefiting from "cheap" labor.**

The benefits from trade depend only upon relative production costs, not on the level of pro-

duction costs. Every economy has a relative cost advantage in some activity. For example, if you compare U.S. production costs in each of its industries with those of a low-wage country, say South Korea, you will find that those activities with relatively high U.S. costs will mostly be undertaken in Korea, while those with relatively low U.S. costs will be undertaken here. Higher labor productivity and lower capital costs allow us to have lower relative production costs in some activities, while lower labor costs allow South Korea to have lower relative production costs in other areas.

This myth suggests that we can only benefit from trade by trading with those countries that are "similar" to us. In fact, the gains from open trade are greater the more dissimilar the economies with whom we trade—our relative cost advantages and their relative cost advantages are greater and as a consequence the positive effects on per capita income in both economies will be greater.

It should also be noted, as an empirical matter, that the U.S. is not being driven from the international market place by "low" wage competition. The vast majority of our trade occurs with Canada and the European Economic Community, both of which have wage patterns comparable to our own. Even the wage pattern in Japan, our next largest trading partner, is closer to our own than to those in the less developed areas of the world. Conversely, little trade occurs with most of Africa, an area of truly low wages.

**Myth #2: Import restrictions save American jobs.**

In fact, import restrictions destroy American jobs. Free trade will move jobs from high relative cost sectors of an economy that cannot compete to low relative cost sectors that can. This occurs because imports undermine high-cost domestic activities, but since imports are paid for with dollars, when those dollars are spent by foreigners in the U.S., they increase employment in exporting sectors. It is true that when there is protection, there will be more people employed in the protected activities, but this will be at the cost of fewer people employed elsewhere in the economy.

Moreover, because real per capita income is

higher with free trade, the average worker will have a smaller real income under protectionist policies. Indeed, estimates of the annual costs to consumers of distorting the distribution of jobs through protectionist policies are generally between \$100,000 and \$300,000 per job. More bluntly, we are paying well over \$100,000 to maintain the jobs of people earning considerably less than \$100,000.

Finally, it should be noted that the effect of trade on long-term employment is generally small when compared to other determinants of employment, even though in a protectionist environment all job losses are attributed to trade. For example, recent estimates indicate that in the steel industry, 209,000 jobs were eliminated between 1976 and 1983 because of a long-term decline in the demand for steel while only 37,000 jobs were lost (reallocated) because of import competition. The recessionary difficulties of the late 1970s and early 1980s accounted for the loss of another 27,000 jobs.

**Myth #3: Temporary protection can provide a breathing period for an industry to modernize and become more competitive.**

While temporary protection does create higher returns in activities under competitive pressure, it also reduces the incentives for adjustment. If there are technologies or organizational changes that will make an industry competitive, the expected profits will provide the necessary capital for such investments, regardless of protectionist barriers. If, on the other hand, no technology or organizational change will make an industry more competitive, then the increased income that temporary protection creates will not be reinvested by a rational manager but will be devoted to other activities. Consequently, the evidence indicates that once protection is granted, productivity and unit costs generally deteriorate even further relative to other industries. It is no surprise that the steel industry has enjoyed some form of protection for the past 15 years without notable recovery or that protectionist policies have not returned the U.S. to its once dominant position in the manufacture of televisions and footwear. Textiles have been provided temporary protection in anticipation of finally becoming viable in the international and open national market since the

1820s, giving new meaning to the word *temporary*.

However, while temporary protection does little to assist a domestic industry to adjust to international competition, many forms of protection, particularly those that currently are being employed, help foreign producers because they enable them to increase the prices they charge for imports to the United States. In both the automobile and steel industries, so-called voluntary agreements to limit exports to the United States have increased substantially the profits of foreign producers. For example, the external quotas imposed by the U.S. during the 1970s are estimated to have increased the annual profits of Japanese steel firms by about \$200 million, or about one-half of Japan's annual expenditure on research and development in steel. Our assistance to the domestic automobile industry has benefited the Japanese producers and dealers by at least \$2 billion per year. Best estimates are that the external quota arrangement with the Japanese increased the price of Japanese cars by about \$900 per car and the price of U.S. cars by about \$350 per car—a total cost to consumers of \$4.3 billion, or about \$160,000 per year per job “saved” in the automobile industry.

**Myth #4: Bilateral trade should be balanced.**

Of particular concern these days is the \$35 billion or so trade deficit with Japan. Even if one could argue that a trade deficit, per se, mattered, it certainly cannot be argued that a deficit with any particular country matters. Suppose, for example, that we purchase \$10 billion in manufactured goods from the Japanese, who purchase \$10 billion in raw materials from the Indonesians who, in turn, purchase \$10 billion in food from the United States. Each country would be running a deficit with at least one other country, but the total trade deficit for each would be zero since each is also running a surplus with at least one country. More important, our ability to run an export surplus with the Indonesians would depend fundamentally on our export deficit with the Japanese. If we eliminated trade with the Japanese in order to get rid of the bilateral trade deficit, we would make it impossible for the Indonesians to run a surplus with us. More precisely, a refusal to import



goods from Japan, demanding bilateral balanced trade, would result in a decrease in U.S. exports to other countries. It is important to understand that trade restrictions ostensibly directed at imports are always restrictions on exports as well; a tariff is always a tax on exports even though it appears to be a tax on imports alone.

It should be emphasized that where we have made large international loans (to Brazil, Mexico, South Korea, et al.), it would not be possible for those countries to pay off the loans unless we ran trade deficits with them, that is, unless they export more to us than we do to them—with the difference being equal to the payment on the loan. Part of the current international debt crisis is a direct result of our refusal to accept in payment (i.e., to import) the goods these debtor nations produce.

There is an important sense, then, in which trade is always balanced: If we import more goods than we export, we must be exporting dollars or the ownership of dollar denominated assets. This is an essential fact in understanding international trade. We can only import more goods than we export if foreigners willingly accept and hold these pieces of paper, and they can only get these pieces of paper if they exchange real goods and services for them. Except for possible adjustment costs associated with changing foreign preferences to hold these pieces of paper, this arrangement cannot possibly hurt us.

**Myth #5: The United States will one day become a debtor nation if it continues to have large trade deficits.**

This myth is true, but empty. Indeed, the U.S. became a net debtor during 1985, but here the word "debtor" gets in the way of understanding. If you incur a personal debt, you must produce income to pay off the debt. If our government runs a domestic deficit, it must also produce income to make payments on the debt. If a foreign country borrows dollars from the United States, that country must produce a dollar income to make payments on that debt. In each of these cases, domestic and foreign, the debt implies some future obligation, an IOU.

The U.S. trade deficit implies no such obligation. In the simplest case, we trade dollars for

goods. Dollars are not IOUs, and they can only be spent in one economy, our own. Moreover, we can trade dollars for goods only so long as foreigners are willing to hold dollars. When they are unwilling to do so, we will have to trade goods for goods as foreigners use the dollars they have accumulated in the only way that they can, to purchase U.S. goods. If they do not want U.S. goods and do not want U.S. dollars, then an adjustment will occur in the value of the dollars that foreigners are holding so as to limit the amount of importing the U.S. can do. This is the only potential cost—that at some point in the future we will not be able to consume more than we produce as we have been able to for the past several years because of the willingness of foreigners to hold dollars.

**Myth #6: We should protect U.S. industries from subsidized foreign goods that hurt American industries and consumers.**

While it is difficult to know when a price difference is the result of a difference in efficiency rather than an explicit subsidy by a foreign government, there is little doubt that many governments subsidize the production of goods that enter the international markets. It is important to understand what this means, however. It is simply this: A foreign government taxes its citizens, thereby cutting their consumption, so that it can subsidize the consumption of people living in the richest country in the world. While paternalistic instincts may lead us to discourage this activity, we should not do so on the grounds that this activity is hurting Americans. If the rest of the world wants to provide welfare payments to us, we probably ought to humbly accept their largess. Our real income is certainly higher as a consequence.

It should be noted, though, that we are not without dirty hands in this matter. For example, while we undoubtedly have a comparative advantage in the production of agricultural commodities, the Department of Agriculture's budget, which has fluctuated between \$18 and \$35 billion over the past several years, is almost totally a subsidy to agricultural production that we are anxious to export. This is an indirect but very large subsidy of the goods that we expect other countries to buy from us. Moreover, we have directly subsidized exports of, for exam-

ple, wheat to Egypt and shipping services. In the latter area, the U.S. merchant marine fleet, which competes in the international shipping market, stays afloat solely because of governmental subsidies.

**Myth #7: Free trade for a country can only be beneficial if it is reciprocal, that is, if others are protectionist, we should be protectionist.**

What happens if we trade freely with a country that is protectionist? If a country refuses to allow U.S. goods to penetrate domestic markets but exports aggressively to the U.S., it trades real goods (e.g. cars, televisions, clothing) for paper money (U.S. dollars). This poses no problem for the country getting the real goods; we should be concerned only if the U.S. were pursuing a policy that resulted in a long-term systematic surplus.

It is important to point out, however, that we have an interest in freer trade by our trading partners since to the degree that restrictive or mercantilist policies by others lower the amount of trade that occurs, we are not as well off as we might be. In this sense, reciprocity matters. The gains here are only on the upside, however, and a nation that is freely trading with others only hurts itself with protectionist policies. The benefits of a unilateral movement toward free trade by the British in the last century were noted earlier.

It may also be the case that reciprocity is necessary to create an open or free trade political coalition where trade liberalization is sold on the notion that with reciprocity, foreign markets will become open and that we cannot expect to export without importing. Essentially, reciprocity arguments may be used to play off the mercantilist sentiments that exports will be increased more than imports in order to create a more open trading environment.

**Myth #8: The effects of protectionism are isolated to the industry protected.**

For virtually every country except possibly the U.S. (because of our unique position as the world's banker), decreasing imports decreases exports, and a tariff, quota or voluntary agreement on imported steel, for example, is essentially a tax on all exports.

The effects are even more direct than this, however. In 1985 the U.S. steel industry felt a sense of triumph because our government had persuaded the Japanese to "voluntarily" decrease their exports of steel to the U.S. The effect of this agreement, and others like it that we have forced on virtually all the steel producing nations of the world, will be to increase the price U.S. manufacturers pay for steel. While this may be advantageous to steel producers, there is more than one way to import steel: You can either import it as steel to be used in the production of final goods here, or the final goods, embodying steel, can be produced abroad and imported. Because of the potential for this kind of substitution, all U.S. manufacturers of goods using steel are now at a competitive disadvantage with foreign producers of those same goods; and while we will import less raw steel, we will now begin to import more steel embodied in final goods. The effect of this "advantageous" agreement is to place all U.S. industries that use steel in a "disadvantageous" position.

As another example, it is clear that protectionist measures that increase the price of domestic copper relative to foreign copper will lead to the destruction of more jobs in copper fabricating industries (because products with copper will be fabricated abroad) than will be saved in the copper mining industry. It is likely that these industries will then go to the government complaining about import competition and seeking relief. Like a cancer, protectionism will then spread.

**Myth #9. Finally, it is often asserted that we must protect "basic" industries or, as a variant of this myth, those essential to national defense.**

The vitality of the economy as a whole is not linked with the prospects of any particular industry. Indeed, the hallmark of a robust and growing economy is that the basic industries change through time. Railroads and agriculture were basic industries a hundred years ago. If we had pursued more aggressively domestic and international policies that protected these industries, 80 per cent of us would still live on the farm and none of us would easily be able to drive or fly. Because of the relationship be-

tween importing and exporting, when we adopt a trade policy that preserves our historical industrial base and freezes structural change, we impede structural change, not just in the U.S. but around the globe.

There are certainly legitimate national security needs, but protectionism is the most inefficient method of providing for them.

## Kernels of Truth

Debunking these myths has been, perhaps, too much of an academic exercise, yet the central point is quite simply put: Under virtually any circumstances you can imagine, protectionism lowers our economic well-being considerably. If you look only at the costs of tariffs and domestic quotas, excluding the numerous voluntary agreements, the lower end of the estimate was \$75 billion in 1984, which is a hidden tax of almost \$1300 for each family of four. The true loss is likely several times this figure.

I am not suggesting that we pursue protectionist policies in this country because we do not understand the consequences or because the myths are convincing and we have been fooled. This would imply that a little education would stem the tide of protectionism and that ideas would triumph as we establish our trade policies. Rather, these myths are essentially the clothing for naked self-interests. A full explanation of the decline of free trade depends upon identifying both particular protectionist interests and a policy process that allows these special interests to outweigh the interests of all of us.

While each of these myths is false, each, as with most myths, contains a kernel of truth; indeed, there are three basic kernels that keep these myths alive.

### ***1. Free trade increases per capita real income, but to do so it forces adjustments in the economy.***

In practical terms, this means that while free trade creates new jobs in some sectors of the economy, it also causes unemployment in other sectors. Moving from one activity to another is not without cost, even if one's income doesn't change. Thus, to return to a specific myth, foreign subsidies are of concern not because they

undermine the U.S. economy but because if they are not permanent or if they fluctuate greatly, they impose recurring adjustment costs on U.S. industries and on the individuals employed in those industries.

### ***2. Free trade increases per capita real income, but it also changes the distribution of income within an economy.***

As a result of free trade, some people's incomes may fall, even though average individual income across the economy increases. Of course, it is little solace to unemployed steel or copper workers who have been making hourly wages well above the national industrial average that there are lower paying jobs elsewhere in the economy that they can find or that the average income for their fellow Americans is higher because theirs is now lower.

It is important to remember that protectionism, while lowering average real income, does increase someone's income. Free trade produces winners and losers, but the gains of the winners are larger than the losses of the losers, while protectionist policies produce gains for the winners that are smaller than the losses of the losers.

### ***3. Free trade increases real per capita income, but it leads to economic interdependence.***

Thus, the increase in income is associated with our linkage to other economies—our well-being, in some senses, is tied to theirs.

## Keeping the Myths Alive

These three kernels of truth give the myths their staying power. Ideas and historical evidence create no political coalitions. But adjustment costs, worries about economic interdependence, and narrowly focused losses that are only offset by broadly spread gains do create political coalitions. More precisely, a group of workers at a particular factory being forced to find work elsewhere—perhaps initially at a lower salary—forms the basis for a potent political coalition. Not surprisingly, the political system responds to such political coalitions.

Lyndon Johnson once said that a politician couldn't be for free trade because there were no votes in it. Thus, our political representatives,

while often voicing allegiance to free or open trade as a general principle, virtually always find that there are special circumstances associated with particular industries in their districts that call for protectionist responses.

While the adjustment problems associated with changes in employment opportunities and incomes of particular workers may elicit a sympathetic response, neither need be present for groups with narrow interests to seek protectionist policies. Because such policies will increase the incomes of certain individuals, the policies will always attract political interest. As a consequence of this incentive and the resistance to adjustment noted earlier, protectionism is used as a subtle private tax and transfer scheme to increase the incomes of selected individuals.

The government's intervention in the sugar market illustrates this point. The world price of sugar is between 2 and 3 cents per pound, but because of protectionist policies, the price in the United States is over 20 cents per pound. That is, each of us pays over 10 times the world price for the sugar we consume. This amounts to a little less than \$100 per year for a family of four, so it is not worth it for any of us to fight the policies that create the disparity in prices. For the small number of sugar producers in this country, however, the additional amount families spend sums to millions of dollars each year. Indeed, the annual amount spent on sugar, beyond that which would be spent if we freely traded in the commodity, is equal to half the capital value of all domestic sugar producers.

In addition, the annual expenditures per family do not fully measure the costs of protectionist policies in this area because, as noted earlier, it is not possible to isolate the effects of such policies. In particular, it is easy to import sugar in other foodstuffs, such as candy bars or pasta, but doing so places this country's producers of these products at a competitive disadvantage with foreign producers.

Where does all this lead? The government now protects us from imported chicken and turkey pot pies, lemon curd, white chocolate, chocolate sauces, sweetened cocoa, pancake mixes, sweetened flour and mousse mixes, sprinkles for ice cream and toppings for Black Forest cake, herb teas, mussel salad, Korean noodles in a soup base, and frozen kosher piz-

zas. Shipments of each of these have been prevented from entering the U.S. during the past year because they contain sugar.

The convenience of manipulating the concern over sugar importation as a lever for protectionist policies is perhaps nowhere better illustrated than by noting that the mussel salad that was prevented from entering the U.S. contained less than 1.7 per cent sugar and the Korean noodles were in a soup base with less than .02 per cent sugar.

## The "Fairness" Doctrine

All such protectionist policies are devices by which small groups, with much to gain, use the political process to force the rest of us to pay for their well-being. That the true subsidies of these protectionist policies are hidden explains their attraction to politicians and protected individuals and businesses.

Protectionist policies, then, may be appealing, but protectionist rhetoric is not. Everyone is for open trade—as a general matter. However, there has been a subtle change even in the rhetoric. In much of the debate, people no longer speak of "free trade"; instead, it is now popular to stand for "fair trade." Those interested in protectionism have used that great shibboleth of contemporary life, "fairness," to mask protectionist policies and, increasingly, the debate is between "fair" and "unfair" trade rather than between "free" trade and "protectionism." Thus, no one is in favor of "protectionism," but, increasingly, people favor "fair" (read protectionist) trade and not "free" trade.

This shift in rhetoric has accompanied a shift in the kinds of protectionist policies we pursue. Tariffs were once the common means of intervening in international trade, but, increasingly quotas and "voluntary" export restraints by our trading partners dominate our trade policy.

Part of this movement away from tariffs accompanied the development of the world trading system following World War II. The United States emerged as the dominant economy following the War and with some extraordinary guidance recognized that an open trading system was important for the future stability of the Western countries. As a consequence, the U.S.

pushed for the development of a number of international institutions that would facilitate international trade and economic development. Among them was the General Agreement on Trade and Tariffs (GATT), a treaty that committed the U.S. and the other industrial nations of the West to lowering tariffs from the historic highs reached during the Great Depression. In many respects, this treaty has been successful beyond anyone's expectations. Average tariffs on industrial products for us and our trading partners have declined through a series of negotiations from 59 per cent (following the Smoot-Hawley tariff) to less than 5 per cent today.

However, other changes have created an environment more conducive to protectionism. First, with the growth of economies elsewhere, the U.S. economy has become more integrated into the world economy and relatively less dominant. Trade from the rest of the world is now much more important to us, but, at the same time, we are now a less important trading partner for any particular country. As a consequence, goods in our economy now face direct competition from abroad, many for the first time, and we have less leverage on the trade policies of other countries.

Second, the movement toward more open trade coincided with a long-term decline in some politically important and "basic" U.S. industries, including textiles, footwear, machine tools, steel, and copper. This created hostility toward what people easily identified as the "cause" of this decline—open trade—even though most of the problems had other sources.

Third, lower tariffs did create a more open U.S. economy. However, other countries, which historically had relied more on non-tariff barriers, were less affected by these lower tariffs. These economies have become relatively less open as a consequence of the decline in tariffs. In addition, non-tariff barriers, which were made obscure and unimportant by high tariffs, have now become much more visible, important, and irritating to the U.S.

A simple example will illustrate the point. When the tide is high, it is difficult to know whether beaches are sandy or rocky and for many purposes it does not matter. Similarly, when tariffs are high, it does not matter if a country has other trade barriers. As the tide

falls, however, there is a big difference between sandy and rocky beaches because the rocks are now visible and affect the use of the beach. Likewise, a country (like the U.S.) which relied primarily on tariffs, finds itself much more open to trade when tariffs fall than a country with lots of hidden barriers that only become visible as tariffs fall.

Finally, the GATT covered primarily industrial goods. It turns out that our comparative advantage appears to lie in other areas, areas that are not covered by GATT, including services and agricultural commodities. For both services and agricultural goods, substantial barriers exist that make it difficult for the U.S. to export to other nations. Thus, while GATT was a success on one dimension, it turns out to be a dimension that matters greatly to those who would export to the U.S. but less to us.

These problems with GATT, the change in our relative economic position vis à vis the rest of the world, and the decline in domestic industries of political importance have created a very different kind of environment than that which existed just after World War II. In addition, large U.S. domestic deficits and flexible exchange rates have provided an easy means for capital flows to the U.S., flows that result in a highly valued dollar in international markets. This highly valued dollar, while accommodating the partial funding of our domestic deficit by foreigners, also makes U.S. goods relatively uncompetitive on international markets, which makes the environment even less hospitable to free or open trade. Thus, protectionism becomes a seductive option to "cure" our ills, and tariffs or non-tariff barriers seem to be the answers.

Tariffs have the nice property that they are reasonably transparent, that is, easy to detect and measure. Non-tariff barriers, like voluntary export restraints entered into by our trading partners, are not as transparent. This makes them, unfortunately, much more attractive in the current environment. I view them with great alarm because they are much more difficult to negotiate away. Their use is a confirmation to some degree of the old law of unintended consequences: GATT reductions in tariffs did not eliminate protectionist pressures, they simply forced those pressures to surface in areas where

unraveling them would be much more difficult.

Why this alarm? The history of voluntary restraints has not been encouraging. In 1955, in response to threats to impose some sort of import restrictions on the rapidly increasing imports of textiles from Japan, the Japanese government offered to voluntarily limit exports to allow U.S. textile firms to adjust to the new market conditions. The resulting higher price of textiles in the U.S. provided a powerful stimulus for other nations to enter this business, and Hong Kong soon did. Again in response to threats of direct protectionism, the temporary voluntary agreement with the Japanese was extended to Hong Kong. It was then extended to Taiwan, to South Korea, to Indonesia and to every emerging producer of textiles, including the People's Republic of China following then-President Richard Nixon's diplomatic efforts. This "temporary," "voluntary" arrangement was formalized and extended to synthetic as well as natural fabrics in the early 1970s so that 30 years after the initial "temporary" arrangement was made, it remains in place.

Now, in a major effort to tighten these restrictions, the current administration has redefined what is entailed in "fabrication," which has tightened the effective import quotas, and has thus made its foray into medieval philosophy. Only instead of asking how many angels can stand on the head of a pin, the important question now is, "When is a sweater a sweater?" This issue arises because under the textile quota agreement, some countries have quotas for exports to the U.S. but no domestic textile industry. As a consequence, there is an incentive for a textile producing country to ship its textiles to one of these countries for subsequent shipment to the U.S., thereby exceeding its quota but not the quota of the two countries combined. Since this is a bit blatant, what these countries do, instead, is to ship parts of finished clothing—say the back, two fronts, and two sleeves of a sweater—to a country without a domestic textile industry, for instance China to Panama. The parts are then assembled, labeled "Made in . . . ," and shipped to the United States.

Similar voluntary agreements have been made in a number of areas, including specialty

steel, automobiles, footwear, and that all-important domestic sector, mushroom production, which is now covered by a voluntary agreement limiting imports. The U.S. is now proceeding to force our trading partners to "voluntarily" limit carbon steel exports to the U.S.

These arrangements are neither "voluntary" nor "temporary" nor "transparent." To illustrate, consider the current war of words with Japan. This battle was initiated by a fairly dramatic increase in the announced exports of Japanese autos to the United States following the expiration of the "voluntary" Japanese arrangement limiting exports to the United States to about 1.8 million cars per year for the past four years. You would think that the expiration of the agreement between the U.S. and Japan would mean just that, that the Japanese were now free to trade in automobiles. Such, of course, was not the case. It is clear that our government and the industries involved expected a continued adherence to the arrangement by the Japanese with at most modest increases in exports to the U.S. The Japanese were still limiting exports, but apparently at higher quotas than was expected, resulting in an increase in exports to the U.S. under a supposedly open trading system that has triggered the recent attacks on Japan.

Voluntary trade agreements are attractive precisely because they are not transparent. They amount to taxes on U.S. citizens and transfers to some U.S. and foreign producers that never appear on any budget document of the U.S. government. Firms simply claim them as revenues from sales.

Because ideology and ideas matter far less in the political arena than political self-interest, I think one has to be quite pessimistic about the future of the open trading system. In fact, the subtle manner in which it is now being undermined makes even tariffs attractive by contrast. What is quite certain, though, is that we have neither a Congress nor a president with any commitment to free trade, only to "fair" trade, and that some of our private industries will continue to benefit from hidden, but nevertheless substantial, taxes on each of our incomes to support their own interests. □

# Protectionism: A Threat to Individual Freedom

by Stephen Lai

**T**he rising protectionist sentiment threatens the consumer's right to choose among competing goods and services. This basic right, along with such civil rights as freedom of speech and religion, must be defended or else the government becomes a threat to all individual liberties.

Protectionism takes several forms, all of which violate consumer freedom of choice. Tariffs are the most frequently cited example. In an effort to save Harley-Davidson, the U.S. recently raised the duty on foreign motorcycles from 4.4 per cent to 49.4 per cent.<sup>1</sup> Along with tariffs, protectionist policies have grown to include import quotas on foreign goods and government subsidies to U.S. industries. Other forms of protection include regulations and standards on foreign imports, and government procurement policies which favor the purchase of domestic products.

Protectionism has its roots in the mercantilist period of the sixteenth to eighteenth centuries. Mercantilist legislation was based on the theory that a nation gains wealth only by exporting its products. This completely overlooks consumers and their needs. In the nineteenth century, the Corn Laws of Great Britain provided a tariff barrier against foreign grains, and caused untold suffering among the poorer masses.

U.S. tariffs originally accounted for 92 per cent of Federal revenue.<sup>2</sup> In more recent years, the percentage has fallen to around 1 per cent.<sup>3</sup> The decline in percentage was caused by an increase in the sources of government revenue, not by a reduction in tariffs. The Smoot-Hawley Tariff Act of 1930 raised U.S. tariff barriers to

their highest levels, which provoked foreign retaliation resulting in a disastrous plummet in international commerce. As Ronald Reagan stated, the tariff "helped plunge this nation and the world into a decade of depression and despair."<sup>4</sup>

Currently the textile, steel, shoe, and electronics industries are petitioning the government for protection from foreign imports. U.S. producers also call for raising a protectionist wall against the "flood" of Japanese products and retaliation against Japanese protectionism. The U.S. limits Japanese car imports and still restricts carbon steel imports to one-fifth of the market, because the Japanese subsidize industries such as their machine tool manufacturers and charge a 15 per cent to 20 per cent duty on plywood imports.<sup>5</sup> About 180 trade protection bills are being considered by the House of Representatives, and over 300 in the Senate.<sup>6</sup> With more special-interest legislation interfering with the market, the forgotten consumer pays higher prices for fewer goods.

Protectionism has evolved because of the notion that exports are good and imports are bad. Many people mistakenly believe that every transaction must have a winner and loser, despite the fact that people trade because, in their own eyes at least, each expects to gain. Protectionists therefore advocate a "balance of trade" based upon equal sales to both nations.

Industries argue for protectionist policies to allegedly protect consumers from low-quality foreign items and to insure their employees' jobs. These companies disguise their true purpose of gaining security through the elimination of competition.

Many domestic companies demand trade pro-

*Stephen Lai is a senior at Wichita Collegiate School, Wichita, Kansas.*

tection because of unfair "underselling" by foreign nations. These arguments are absurd because the very nature of the market is to provide goods at a lower price than the competition. Protectionists then claim that foreigners' trade policies are restrictive and are just cause for retaliation, but such policies serve no purpose other than revenge. While retaliation could result in economic disaster like the Smoot-Hawley Tariff, a nation that chooses not to retaliate provides the consumer with the benefits of free choice, and makes a gesture that helps establish friendly relationships.

Advocates of protectionism overlook the benefits of specialization and comparative advantage. Because resources are scarce, consumers are best served when labor, capital, and raw materials are channeled toward the most productive industries. Trade barriers interrupt this process. As Ludwig von Mises stated, "All that a tariff can achieve is to divert production from those locations in which the output per unit is higher to locations in which it is lower. It does not increase production; it curtails it."<sup>7</sup> The market, and not the government, is the most efficient allocator of resources.

Competition is an incentive to adapt and create new products for the consumer, not an excuse to seek government assistance. Without competition, an industry tends to stagnate. Protectionism creates opportunities for monopolization, where prices can be maintained at artificially high levels. As foreign producers improve their products and decrease their costs, protected domestic industries become ever more dependent upon government aid.

Because protectionism raises prices, it reduces living standards. In the words of Adam Smith, "In every country it always is and must be the interest of the great body of the people to buy whatever they want of those who sell it cheapest."<sup>8</sup>

In 1984, tariffs on Japanese cars cost U.S. consumers an estimated 4.5 billion dollars, while clothing duties cost an estimated 8.5 billion dollars.<sup>9</sup> Even if employment was preserved, each job supposedly saved by protectionism cost consumers an estimated \$50,000 to \$100,000.<sup>10</sup> The consumer pays higher prices when purchasing protected goods, and loses

money that could be spent on other products.

Many protectionists contend that economic self-sufficiency is needed for national defense. This argument, however, does not justify protection of the wool industry or beekeepers. When trade is free, consumers benefit from the products of other nations, and friendship and trust develop. When nations depend on one another for trade, there is little cause for war. As Frederic Bastiat stated, "If goods do not cross frontiers, armies will."<sup>11</sup>

The United States has fought several wars related to trade issues. The Revolutionary War began because Great Britain attempted to control U.S. trade. The U.S. fought the Barbary War from 1800 to 1815 to protest the demand for tribute. The War of 1812 protested the blockade of Europe by Great Britain. Even the Civil War was related to the Southern dislike of the Tariff Act of 1828 and the fear of European retaliation.

It is difficult to assess the total cost of protectionism. But we do know that protectionism reduces consumer choices and raises the prices of protected foreign goods and competing domestic products. In addition, our tax dollars are wasted on protected industries that require government subsidies to stay in business. Finally, government procurement policies waste more money through the purchase of over-priced domestic products which could be bought at less cost from foreign suppliers.

To stop this wasting of scarce resources and the spiraling pattern of government intervention, consumers must recognize that freedom of choice is a basic human right, and demand that it be protected like all other rights. □

1. Charles P. Alexander, "The Tricks of the Trade," *Time*, 7 Oct. 1985, p. 34

2. W. M. Curtiss, *The Tariff Idea* (Irvington-on-Hudson: The Foundation for Economic Education, 1962), p. 35

3. Curtiss, p. 35

4. Richard Alm *et al.*, "Free-Trade Fight," *U.S. News & World Report*, 23 Sept. 1985, p. 49

5. Alexander, p. 34

6. Gene H. Hogberg, "Prepare for Trade War!" *The Plain Truth*, Jan. 1986, p. 3

7. Ludwig von Mises, *Human Action* (New Haven: Yale University Press, 1949), p. 737

8. Henry Hazlitt, *Economics in One Lesson* (New York: Arlington House Publishers, 1979), p. 74

9. Alm *et al.*, p. 49

10. *Ibid.*

11. Curtiss, p. 63



# Protectionism and Agricultural Price Supports

by E.C. Pasour, Jr.

**T**rade is highly important to U.S. agriculture. In recent years, export sales have represented about one-fourth of the total revenue from sales of U.S. farm products. Consequently, there is widespread concern in the agricultural sector about recent losses in markets for farm exports and about the harmful effects of trade barriers imposed by other countries. Exports of U.S. farm products in fiscal 1986 are expected to be less than \$28 billion—down about \$16 billion from the record high of \$44 billion in 1981.

Although U.S. agriculture is generally considered to be a bastion of free enterprise, the reality is quite different. Our domestic agricultural policy has been a perennial albatross in efforts by the United States to liberalize trade. As shown below, there is an inherent contradiction between domestic price supports and free international trade.<sup>1</sup>

## Price Supports and GATT

The General Agreement on Tariffs and Trade (GATT) is a multilateral treaty among more than eighty governments (including the United States) established in 1947 to liberalize and expand trade through negotiated reductions in trade barriers. The conflict between U.S. farm programs and free trade, apparent when GATT was formed, led the United States to insist on

special treatment for agricultural products. The incompatibility of current farm programs with an open economy can be traced to farm policies instituted during the Roosevelt New Deal era. The Agricultural Adjustment Act of 1933, as amended, *requires* that the U.S. Government impose quantity restrictions whenever imports would “materially interfere” with the operation of U.S. farm programs.<sup>2</sup> Consequently, agricultural and other “primary products” were not bound in the GATT treaty by the general principles that prohibit import quotas and export subsidies.

It is not difficult to see why price supports for dairy, sugar, peanuts, tobacco, and other U.S. farm products have led to protectionist policies. In recent years, for example, domestic prices of U.S. dairy products frequently have been two to three times world prices. The case of sugar, for which domestic price in mid-1986 was about four times world price, is even more dramatic. Without rigid import controls, consumers would undermine domestic price support programs by substituting lower priced imports for price-supported products including sugar, butter, cheese, and peanuts.

Although GATT permits import restraints for agricultural products, there are limits as to how far countries may legally go in restricting imports to protect domestic farm programs. Not all of the U.S. import restraints on farm products can be explained by the GATT exemption. University of Chicago economist D. Gale Johnson shows that U.S. import restrictions on

*Dr. Pasour is a professor of economics at North Carolina State University at Raleigh.*

sugar, dairy, peanuts, and beef products clearly have violated the GATT principle that import quotas should not be used to reduce imports by more than the extent to which domestic production is reduced.<sup>3</sup> Therefore, when measured against the touchstone of free trade, United States trade policies as they affect farm products fall short in both the letter and the spirit of the law.

## Export Subsidies

GATT exceptions for agricultural products are also made for export subsidies as long as a subsidy does not result in "more than an equitable share of world export trade in that product."<sup>4</sup> Even though U.S. agricultural interests are highly critical of subsidized agricultural exports by other countries, especially by members of the European Economic Community (EEC), the United States continues to subsidize the disposal of surplus farm products under the Public Law (PL) 480 ("Food for Peace") program. For example, about \$1.5 billion is budgeted for PL 480 in 1986.

The PL 480 export subsidy program, begun in 1954, was motivated in large measure by the desire to dispose of surplus agricultural products. The program ostensibly has other laudable objectives, including improvement of world diets, promotion of agricultural trade, and "food for peace." Exports of U.S. farm products have been increased through PL 480 over the years in a variety of ways, including donations of commodities, sales for local currencies, and sales at low interest rates.

The Food for Peace program, however, is not the only type of export subsidy affecting U.S. farm products. A new \$2 billion "export enhancement program" was launched in 1985 to run through fiscal 1988. The program is to be targeted to markets taken over by competing nations using "unfair trade practices." In addition, in an effort to dispose of government stocks of price-supported products, the 1985 farm bill permits farmers to redeem their price-support loans at less than the amount borrowed—another way of using the public purse to drive down price levels in international markets.<sup>5</sup>

The largest amount of expenditures on export

subsidies, however, is reserved for the target price method of price supports. In this price support system, farmers receive from the government the difference between the market price and the target price of a product as a "deficiency payment." This program permits prices received by U.S. farmers for price-supported products to exceed significantly prices in international markets—a poorly disguised export subsidy. It is estimated that these so called "deficiency payments" will total about \$10 billion for the 1986 crop year.

Regardless of type, export subsidies are inconsistent with free trade. In the case of agricultural exports, "food aid that preempts the commercial markets of third-country exporters creates an international trade problem and may in the end be deleterious to the interest not only of the international trading community but even of the recipient country itself."<sup>6</sup>

In view of the United States' history of subsidizing exports, U.S. criticism of similar policies in other countries rings hollow. Current complaints about protectionist trade policies by other countries are especially hypocritical in view of the increase in direct and indirect export subsidies under the new farm bill. Agricultural interests in the United States have long criticized the EEC for its protectionist farm policies. The new farm bill means that the United States can no longer argue that it is less dependent on export subsidies than the Europeans.<sup>7</sup>

It should be no surprise when other countries institute trade restrictions that are similar to those long used by the United States. Moreover, appeals to Japan, members of the EEC, and other countries to open their markets to U.S. products are unlikely to appear credible as long as protectionist policies are maintained for U.S. agricultural products.

In the public debate over trade policies, the United States frequently is depicted as a free trade island located in a sea of agricultural protectionism. The preceding examples show that there is a wide gap between this image and reality. Furthermore, as competitive pressures intensify in markets for farm products throughout the world, it becomes increasingly important to recognize the problems posed by U.S. domestic agricultural policies in liberalizing and expanding trade.

## Implications of Rising Agricultural Productivity

Farm productivity is increasing rapidly throughout much of the world, not only in the United States and the European Economic Community, but also in the developing countries where advances in productivity have been especially pronounced. Dennis Avery, of the U.S. Department of State, finds that during the most recent decade, developing-country farm output rose 38 per cent while that of the developed-country agricultures rose only 15 per cent.<sup>8</sup> As an economic analyst who has followed agricultural progress throughout the world since 1980, Avery concludes that future farm export trade will be "fiercely competitive" throughout the world.<sup>9</sup>

The implications of widespread technological advances in agriculture are straightforward for U.S. farm policy. Rising foreign farm productivity and increasing competition in export markets for U.S. farm products implies a progressively higher price tag for U.S. consumers and taxpayers to maintain current U.S. price support programs. Moreover, to the extent that domestic farm programs raise product prices, they provide an artificial production incentive for farmers in other countries.

The responsiveness of sales to a change in product price generally is higher in international than in domestic markets because there are more close substitutes in world markets. In view of this responsiveness and the importance of exports in the marketing of U.S. farm products, protectionism could mean less revenue for the agricultural sector, even in the short run. Of course, protectionism is harmful to the public at large even when it confers short-run benefits on groups with narrowly focused interests.

Government price support programs for farm products are clearly incompatible with an open economy. It is hypocritical for the United States to criticize other countries for using import controls, export subsidies, and other trade restrictions that this country is also using. The United States acting unilaterally cannot abolish protectionist measures in other countries. Policymakers can, however, make our domestic farm programs consistent with free trade. The phasing out of domestic price supports that raise

U.S. prices above the world level is an important first step in reducing trade restraints and in opening up world markets for U.S. products. Price supports not only are inimical to trade, they do not achieve their objective of increasing the long-run profitability of agriculture.<sup>10</sup> Measures to reduce trade barriers, on the other hand, increase both prosperity and the prospects for peace.<sup>11</sup>

The 1985 farm bill represents a continuation of the failed farm policies of the past, rather than a major change in direction. Farmers will be more dependent on government payments than ever before. Economic pressures may yet, however, bring about a reduction in agricultural trade barriers. Increasing competition in markets for U.S. farm products and budget pressures may force U.S. policymakers to do what they have heretofore been unable or unwilling to do—modify our domestic farm policies to make them compatible with the GATT objective of liberalized trade.

The harmful effects of protectionist policies are well known. The amount of damage varies with the type of trade restriction, but the effect of protectionism is always the same. It prevents farmers, other workers, and consumers throughout the world from reaping the benefits that occur when individuals are permitted to engage in those activities in which they are most productive. □

1. Some of the points of this paper are discussed in more detail in the author's paper, "Free Trade's Price" in *Choices*, Second Quarter 1986, pp. 33-35.

2. Kenneth W. Dam, *The GATT: Law and International Economic Organization* (Chicago: The University of Chicago Press, 1970).

3. D. Gale Johnson, "Domestic Agricultural Policy in an International Environment: Effects of other Countries Policies on the United States," *American Journal of Agricultural Economics* 66 (Dec. 1984): pp. 735-744.

4. Kenneth W. Dam, *op. cit.*, p. 142.

5. D. Gale Johnson, "U.S. Joins the Agricultural Subsidy Sinners," *The Wall Street Journal*, May 7, 1986, p. 30.

6. Kenneth W. Dam, *op. cit.*, p. 268.

7. D. Gale Johnson, 1986, *op. cit.*

8. Dennis Avery, "Update on Rising World Farm Output," U.S. Department of State, at the Valley National Bank Agricultural Symposium, Phoenix, Arizona, April 10, 1986, p. 1.

9. *Ibid.*, p. 7.

10. D. Gale Johnson, "The Performance of Past Policies: A Critique," Ch. 2 in *Alternative Agricultural and Food Policies and the 1985 Farm Bill*, Gordon C. Rausser and K. R. Farrell (eds.) (Berkeley, Cal.: Giannini Foundation, 1985).

11. Joan Kennedy Taylor (ed.), *Free Trade: The Necessary Foundation for World Peace* (Irvington-on-Hudson, N.Y.: The Foundation for Economic Education, Inc., 1986).

# The Seven Deadly Fallacies of Bad Economics

by John K. Williams

**I**n the sixth century of the Christian era Pope Gregory I, remembered by history as Gregory the Great, listed what became known as the "Seven Deadly Sins." Gregory's listing soon became as popular as the vices listed, and by the Middle Ages any preacher worth his salt had in his traveling bag a sermon, or a series of sermons, expounding the nature and detailing the perils of those Seven Deadly Sins.

It may seem somewhat extravagant to liken bad economic thinking to attitudes and actions which allegedly condemned the soul to hell. Yet economic errors are not to be taken lightly. The errors I call the "seven deadly fallacies of bad economics" can lead and have led to unspeakably destructive consequences. Their seriousness cannot be overstated.

## The Fallacy of Forgotten Costs

The first fallacy to be considered might be called "the fallacy of forgotten costs." This fallacy is admirably discussed by Frederic Bastiat in a pamphlet he penned in 1850 entitled, "What Is Seen and What Is Not Seen." Writes Bastiat: "Nothing is more natural than that a nation, after making sure that a great enterprise

will profit the community, should have such an enterprise carried out with funds collected from the citizenry. But I lose patience completely . . . when I hear alleged in support of such a resolution this economic fallacy: 'Besides, it is a way of creating jobs for the workers.' "

Continues Bastiat: "The state opens a road, builds a palace, repairs a street, digs a canal: with these projects it gives jobs to certain workers. That is what is seen. But it deprives other workers of employment. That is what is not seen . . . In noting what the state is going to do with the millions of francs voted, do not neglect to note also what the taxpayers would have done—and can no longer do—with these same millions."

These words, written over a century ago, could have been penned yesterday! Today's politicians are still prone to justify their high taxing, high spending policies by pointing to the employment opportunities they thereby create—indeed, Lord Keynes provided such politicians with an entire volume of incantations they can mutter when perpetrating what Bastiat called this "ruinous hoax." Strip away the new terminology, and the old fallacy so castigated by Bastiat is revealed—the deadly fallacy of the forgotten cost.

The full import of this fallacy is concealed if we think of "costs" simply in terms of "prices." A price is merely a cost expressed in monetary terms. It is extremely useful so to ex-

*The Reverend Doctor John K. Williams has been a teacher and is a free-lance writer and lecturer in North Melbourne, Victoria, Australia. He was resident scholar at FEE this past summer.*

press a cost, relative money prices being the key to economic calculation.

In truth, however, the "cost" of a good a person acquires or of a service a person enjoys or of an activity in which a person engages signifies whatever that person has spent, surrendered, or forgone in acquiring the good, in availing himself of the service, or in engaging in the activity. The cost to me of purchasing a book may be not acquiring a theater ticket. The cost to me of spending a day in a park may be my not acquiring the income I could have earned from writing. The cost to me of using some land I own to grow wheat may be not using that land to run cattle or grow vegetables. Simply, in considering the cost of acquiring some good or using some service or engaging in some activity, one must consider every thing, activity, and state of affairs surrendered or forgone in opting for one of two or more alternatives. Factors such as comfort, time, ease, anticipated future satisfactions, and the approval of other people may well be involved; indeed, any thing, activity, or state of affairs a person values can enter that person's calculation of costs.

Some extremely significant implications for sound economic thinking follow from this insight. The primary point Bastiat makes, however, should be crystal clear. The good a person chooses is seen and felt and enjoyed; the money surrendered to acquire that good, and alternative uses to which that money could have been put, are by definition not seen and felt and enjoyed, and hence are easily forgotten.

Politicians, to take but one example, can triumphantly point to the jobs they have saved in, say, the textile and clothing industries by the imposition of tariffs. Not so obvious, however, are the costs these tariffs involve. In the absence of the tariffs, men and women may well have preferred to purchase relatively cheap imported clothing for themselves and their children. They would thus have possessed additional cash to spend on goods and services they value, but rank in importance below a certain amount of clothing.

Workers would have been employed to provide these goods and services. Other workers would have been employed to produce whatever goods the overseas suppliers of textiles di-

rectly or indirectly accept in exchange for those textiles. Jobs in the textile industry are protected, but at considerable cost: The additional goods and services consumers could have enjoyed had they been able to purchase relatively cheap clothing, and the jobs in the production of these additional goods and services for home-consumption and the goods exchanged, directly or indirectly, for the imported textiles.

Add to that the even more intangible factor of forgone competition, and the forgone innovations and technological improvements that may well have characterized a threatened industry's response to competition. Throw in the reality of the forgone liberty of individuals to exchange goods with whomsoever they please and forgone bonds of interdependence forged between nations. It may be that what is surrendered and forgone is valued by many individuals less than what is realized by the imposition of tariffs, but that is not at the moment the point. The point simply is that what is forgone and surrendered is less visible than what is realized. Thus the ease with which men and women fall for the fallacy of the forgotten cost.

The truth is simple. It is summarized in the proposition, "There's no such thing as a free lunch." Every economic choice we make or politicians make for us has a cost. The cost is not obvious, being the valued opportunities forgone. The beginning of economic wisdom, however, is to keep an eye open for what is not obvious, and thereby avoid the deadly economic fallacy of forgotten costs.

## The Fallacy of Misplaced Value

In *Canterbury Tales*, Chaucer's Parson states that the Seven Deadly Sins are "all leashed together." So, it might be suggested, with the seven deadly fallacies of bad economics. They merge and overlap. It could well be claimed that the second fallacy in my list—"the fallacy of misplaced value"—and the first fallacy—"the fallacy of forgotten costs"—belong together. Yet it is useful, I think, to distinguish them.

Many medieval ethicists concerned themselves with what they called "the just price." In so speaking, they were suggesting that the money prices of economic goods should reflect

the "real" or "objective" value of these goods and services. This "real" value of an economic good was perceived as no less a quality of that good, than, say, the good's weight.

As economic thought developed, a distinction was drawn between the "use value" of a good—the good's usefulness to human beings—and the "exchange value" of the good—the alternative goods and services for which the good might be exchanged. Attention focused, however, upon the "exchange value." What, people asked, determines this value? The most promising answer seemed to be that it derived from the productive resources used in its manufacture, labor being the most significant. Thus Adam Smith in his *Wealth of Nations* wrote that, "If among a nation of hunters . . . it usually costs twice the labor to kill a beaver which it costs to kill a deer, one beaver should exchange for or be worth two deer." David Ricardo built on this foundation, and later Karl Marx, greatly indebted to Ricardo, developed his version—some would say versions—of the labor theory of value. The value of an economic good derived, insisted Marx, from only one of the productive resources embodied in that good: the "socially necessary labor time" its production involved.

In 1871, however, a radical challenge to this way of thinking appeared in the form of Carl Menger's *Principles of Economics*. Menger insisted that the idea of "value" was crucial in economics, but he went on to argue that the value of an economic good was not a mysterious quality inhering in the good. Rather, when speaking of economic value one is referring to the relationship between an appraising mind and an object appraised. Value is invariably "value to someone." Value, in other words, is subjective, varying from person to person, from time to time, and from situation to situation. Locating that value in a good rather than in the mind appraising that good is what I signify by "the fallacy of misplaced value."

One distinction must be noted. In determining the value to me of, say, a book, I am ranking the book in relation to other goods on my own value scale. I rank it, let us say, above a theater ticket, and thus acquire the book at the cost of a forgone opportunity to acquire a theater ticket. I might also, however, appraise the

purchasing power of a good—that is, estimate how much that good could be sold for. On this matter I can be correct or incorrect. Something "objective" is involved. Yet appraised purchasing power itself rests upon the countless subjective evaluations of my fellow market participants. It is from these hundreds of thousands of subjective evaluations that changing relative money prices in the market are born.

Elaborating how market prices—including the prices of the factors of production—derive from the subjective evaluations of market participants is a fascinating exercise. Linking the subjectivity of value to an understanding of costs in terms of forgone opportunities leads to some extraordinarily significant conclusions.

We are forced, for example, to assert that the cost of an economic choice—be it that of purchasing a book at the cost of the forgone opportunity to procure a theater ticket, or of producing jump ropes at the cost of the forgone opportunity of using the same productive resources in producing clotheslines—is known only to the person or group of people making the choice. We are further forced to insist that an objective measure of cost is simply not available, the individual's evaluation of a forgone opportunity being by its very nature subjective. If this be granted, talk of "social costs" becomes suspect, to put it gently.

No less fascinating is the study of the attempts of many economists to avoid these conclusions, perhaps the most significant of these being Alfred Marshall's tortuous synthesis, which featured a productive resource theory of cost on the supply side and a subjectivist analysis of cost on the demand side.

Suffice, however, that we be aware of the fallacy of misplaced value. When we hear Marxists darkly muttering of the "surplus value" expropriated by capitalists, or other economists speaking as though they could objectively compare the "value" of one distribution of economic goods to that of an alternative distribution, we should become suspicious.

The realization that all economic choices involve costs can lead, by a faulty leap of logic, to two further deadly economic fallacies that typically come together: "the fallacy of static wealth" and "the fallacy of the zero-sum game."

## The Fallacy of Static Wealth and the Fallacy of the Zero-Sum Game

These twin fallacies take the form of a sort of picture dominating the thinking of many people. Economic activity is depicted in terms of a poker game. One player's chips are observed to have increased. Immediately one concludes that some other player has lost chips. Poker is, as they say, a zero-sum game: Gains enjoyed by one party must be balanced by losses suffered by another. So it is, people embracing the fallacies of "static wealth" and "the zero-sum game" insist, with economic exchanges. "Winners" must be balanced by corresponding "losers."

Such was the "picture" held by advocates of the socio-economic system known as mercantilism, the system Adam Smith so vigorously attacked. Perhaps the word "system" is somewhat misleading, for, as Thomas Sowell has noted, "[mercantilism] is a sweeping label covering a wide range of writings, laws, and policies beginning in various European nation-states in the seventeenth century, still pervasive in the eighteenth century, and never completely extinguished till the present day." ("Adam Smith in Theory and Practice," in *Adam Smith and Modern Political Economy*, edited by Gerald P. O'Driscoll [Ames, Iowa: The Iowa State University Press, 1979] pp. 3-18) Yet crucial to the thinking of "the motley collection of businessmen, pamphleteers, and politicians" described as "mercantilists" was the perception of wealth as something static and of economies as zero-sum games.

According to the mercantilists, wealth was a constant, a given—like the chips in a poker game. If one community—and typically the mercantilists thought in terms of communities—improved its overall economic situation, another community must have lost out. That losing community, so it was claimed, must have bought more goods from the winning community than it had sold to that community, the difference having been made up in gold. As the seventeenth-century writer Thomas Mun expressed it, only "the treasure which is brought to the realm by the ballance [sic] of our

foreign trade . . . [constitutes the amount] by which we are enriched" (*England's Treasure by Forraign Trade* [1664; New York: Kelley, 1965] p. 21). To achieve an export surplus, mercantilist nations were characterized by governmental controls of a magnitude and scope which, as Sowell puts it, "probably exceeded anything seen in the twentieth century, either in capitalist economies or in most socialist economies" (*ibid.*, p. 4).

What Adam Smith perceived, essentially, was first that "wealth" was not something static and given like gold, or, indeed, poker chips, but rather consisted of goods and services that could be created, and second that both parties to an economic exchange could improve their respective situations. This second perception is sharpened if we take seriously the truth ignored by those committing the fallacy of misplaced cost, namely, that the value of an economic good is not a mysterious quality somehow residing in the good but a relationship between an appraising mind and some object appraised.

If, in the absence of coercion, two individuals exchange goods or services, it can be only because each party to the exchange values, at least at the time of the exchange, what is obtained more than what is surrendered. Each anticipates enjoying a more valued situation by making the exchange than obtained before making the exchange. There are two winners, not one. This is a positive-sum, rather than a zero-sum game.

Given that Adam Smith in 1776 exposed the twin fallacies—the fallacy of static wealth and the fallacy of the zero-sum game—and given the clinching of this exposure by the insistence of economists following the lead of Carl Menger that the "value" of a good or service signifies the value of that good or service to someone, one might have thought that the two fallacies could be exorcised from people's thinking. But not so.

Consider the following statement, taken from the published sermons of a cleric with whom I am fighting a somewhat protracted battle:

"Think of an economic system in terms of some castaways on a desert island. The castaways have brought with them some fresh water, and they find a supply of bananas and coconuts on the island. Some of the castaways have

greedily claimed that they own the water and the supply of food. They feast, but their fellow castaways starve. Some suffer, simply because others are selfish."

The key phrase in this: "Think of an economic system as . . ." The speaker is describing a static situation: an island with a given supply of food and water. And that is precisely how *not* to think of an economic system!

If an economic system is to be compared to an island, let it be a large island inhabited by active people. Some people have devised a way of distilling fresh water from sea water. Some have established banana and coconut plantations. Some have become skilled at fishing. Some have bred wild goats. Some have learned to extract iron. Even the simplest are contributing to the process of wealth creation, say by tending a fire used for the distilling of water. The moment one starts thinking not in terms of goods simply provided like manna in the wilderness, but of men and women using the skills and imagination they possess and the raw materials at their disposal to create the goods and services they want, one is beginning to approach the reality of an economic system. And one has escaped from the deadly economic fallacy of finite wealth.

Consider another quotation from the same source:

"One does not have to be a genius to realize that, if some citizens in western nations are getting richer, then other citizens of these nations—or perhaps men, women and children of the Third World—are getting poorer. One does not have to enjoy a university education to realize that, behind newspaper headlines reporting company profits, are the many helpless little people who have been forced to endure losses. If Peter prospers, somewhere there's a Paul Peter has robbed."

Frankly, one does not have to be the possessor of a university education to realize that the author of these passages is peddling the discredited economic nostrums of yesteryear. He has embraced, and is luring his listeners and readers to embrace, the twin fallacies under consideration: the fallacy of static wealth and the fallacy of the zero-sum game.

In all fairness, I should add one qualifier. The fallacy of the zero-sum game is only a fallacy if

the exchanges made by people are not coerced. The moment coercion enters the picture—be that coercion exercised by individuals who have discovered that improving their well-being by plunder is more congenial than doing so by production and voluntary exchange, or by governments using their coercive power for purposes other than the protection of citizens from such individually initiated coercion—then zero- and indeed negative-sum games abound. Sadly, however, few of those depicting economic activity in terms of zero-sum games are advocating the only economic system which avoids such "games"—the free market.

## The Fallacy of False Collectives

The fifth deadly economic fallacy I would bring to your attention is the fallacy of false collectives. All of us are familiar with collective nouns: "the community," "the state," "a society," "the working class," "aggregate demand," and even "the market." These terms can be extremely useful, functioning as a sort of shorthand whereby we refer to numerous individual human beings and particular relationships between them. Problems are created, however, when we start speaking and thinking as though these terms signify "thing-like," existing entities distinct from these individuals and relationships.

There may be some value, for example, in occasionally using such terms as "aggregate demand" and "aggregate supply." Mischief is afoot, however, when the real world that economics seeks to understand—the world of people seeking to improve their situations by using what they have to acquire what they want—is supplanted by a purely imaginary world, a sort of ballet called "the economy" starring the two dancers "aggregate demand" and "aggregate supply." Lost in that imaginary world one is tempted to get into the act, so to speak.

Why not play choreographer? Why not improve the performance by stimulating "aggregate demand"? There is nothing wrong with this fantasy if fantasy it remains, but when the real world of economic activity is subjected to governmental activities described as "stimulating aggregate demand," disaster can result.

Indeed, there are dangers inherent in aggre-



gates even if one avoids the fallacy of treating these aggregates as concrete "things." As Madsen Pirie observes in *The Logic of Economics* (London: The Adam Smith Institute, 1982), "When we use numbers we lose information." A study of "apples" dictates indifference to information about the particular weight, shape, taste, and so on of each component apple; a study of "fruit" dictates indifference to further detailed information. Yet in economics, as is the case elsewhere, truth often lies in the details.

Suppose we are thinking of the phenomenon of involuntary unemployment. We are wondering if the phenomenon is related to wage rates. We do our homework. We reach a fairly general conclusion: If men and women are to use what they have to acquire what they want, they must direct their productive efforts in a way that takes account of the changing tastes and preferences of their fellows, the changing skills and technologies available to a community, the changing relative scarcities of raw materials distributed globally, and so on. We further conclude that information about such realities is available only when it is encoded in changing relative money prices in a free market.

We note, for example, that a rise in the price of one product relative to others tells both consumers and producers what they must do to improve their situations, and constitutes an incentive for these people to act. We finally conclude that changes in the prices for various forms of labor in various activities encode the best information available in a large and complex society for what we might call the "distribution" of labor.

A downward move in the wage level available for people of certain skills in a particular industry, and an upward move in the wage level available for people of different skills in another industry, "informs" people as to what skills it is desirable to acquire and in what industry it is desirable to seek employment. We thus conclude, perhaps, that politically determined or sanctioned measures preventing wage rates from moving downward in certain industries or arbitrarily forcing them upward in other industries deprive people of the information they need if some sort of correspondence is to obtain between the distribution of various forms and

quantities of labor and the distribution of demand for these forms and quantities of labor.

Suppose, however, that we attempted to tackle the problem, thinking only of some abstraction called the "unemployment rate" and the "average wage level." There is no way that, so thinking, we would find ourselves looking askance at measures interfering with changes in relative wage rates. Inevitably, economic theorists and politicians embracing the fallacy of false collectives are destined to lead men and women to economic disaster.

## The Fallacy of Centralized Planning

The sixth deadly economic fallacy I have called "the fallacy of centralized planning."

The defining economic question can, perhaps, be expressed thus: "How are men and women to use what they have—skills, raw materials, information, and time—peacefully to acquire what they want?"

Some components of an answer are reasonably apparent. For example, the adverb "peacefully," which precludes an answer to the question in terms of the oldest labor-saving device known to humanity—the use of violence to expropriate desired goods from men and women creating these goods—demands, I suggest, some adopted practices or accepted institutions protecting people from coercive violence. Any response to the question which goes beyond the most primitive will involve, I submit, at least a rudimentary division of labor. But the activity I particularly wish to focus upon is that of coordination.

Historically, human beings have discovered but three ways to coordinate their productive efforts so that they more or less successfully use what they have to acquire what they want: coordination by tradition, coordination by political edict, and coordination by "the market"—and I am aware, incidentally, that this term "the market" is itself an abstraction or collective of sorts, pointing to individual men and women enjoying private property rights and voluntarily engaging in transactions chosen and negotiated by themselves.

Tradition is a satisfactory means of economic coordination—"planning" if you like—only for

the most primitive and static of societies. The two options today deemed viable for large and complex societies are those of coordination by political edict and coordination by the market—the “command economy” and the “market economy.”

The fallacy of centralized planning has it that while in simpler times it may have been possible to coordinate the economic activities of men and women by the market, the complexity and rapid technological changes of today’s world make such a means of coordination impossible. It is claimed that we thus require expert planners working in conjunction with politicians.

I submit that this claim is a fallacy reversing the reality. Only the market can coordinate the economic activities of hundreds of millions of men and women in a rapidly changing world.

Consider, for a moment, a simple tribal society. Assume that the wants of its members are limited, the skills possessed by the “tribe-as-a-whole” are relatively few, and the raw materials available to the tribe remain more or less the same from year to year. In such a situation we can imagine tribal elders, or even the tribe as a whole, meeting and planning the tribe’s economic activities by reference to this readily available information about what the tribe “has” and what tribe members want.

Now consider, in contrast, a large and complex society. A vast menu of possible wants is available, individuals opting for widely different “lists” of wants and diverse rank orderings of these wants. Skills are highly specialized and are diffused through millions of people, and constantly change as new technologies become available. Resources are distributed globally, and are marked by constantly changing relative scarcities. It is literally impossible for political planners, however good and wise, to collate, synthesize, and make economic decisions by reference to this totality of information.

Yet as already noted, this information is available, in an appropriately distilled form, in a market economy. Changing relative money prices, which are determined by the interactions of millions of individuals seeking to improve their situations through what they produce and the voluntary exchanges they make, “encode” this data. There is planning and coordination, but it is the planning of countless individuals

doing what they can to acquire what they want, and the coordination of these plans by what Carl Menger called the “organic phenomenon” of the market or what Friedrich Hayek called the “spontaneous order” of the market. The very complexity of modern societies, and the diffused, changing, and essentially private nature of much of the information which coordinated economic activity must utilize, combine to make central planning impossible.

It is tempting to suggest that this sixth deadly fallacy of bad economics is rooted in the first of the old Seven Deadly Sins: the sin of pride. It is humbling to acknowledge that the peaceful activities of the many can coordinate an economy with a subtlety and flexibility the deliberative planning of a super intelligent few could never realize. Perhaps it is this very pride that makes the deadly fallacy of centralized planning so attractive.

## The Fallacy of Market Mastery

The seventh and final deadly economic fallacy to which I would draw your attention I have called “the fallacy of market mastery.” This is the fallacy of those who claim that the market is a means whereby some people exercise power over others.

Consider, for example, this frequently heard statement about labor unions: “Were it not for unions, employers could set whatever wages they wished. Their economic power would be absolute!”

The model is clear. Capitalists allegedly enjoy power over those with only their labor to sell. The whim of employers would determine wages were it not for the bargaining power of unions—a power dependent upon the capacity of unions to prevent workers from accepting a wage lower than the “union wage.”

This claim could well lead us into an examination of a range of theories explaining how wages are determined: the subsistence theory of Malthus and Ricardo, the wage-fund theory of John Stuart Mill, and so on. Let us content ourselves, however, with briefly returning for a moment to the days of mercantilism—in particular, mercantilist France.

Unions as such did not exist. The government actually imposed *maximum* wage laws. Any

employer who paid wages above a legally defined ceiling was charged with an economic crime, tried, and if found guilty, may well have been sent off to be chained to an oar in one of France's sea-going galleys. The shocker is that numerous employers defied these maximum wage laws!

Why? The selfishness of employers, and the forces of even a grotesquely fettered market, led them to engage in their law-defying activities.

Suppose, for example, I am a factory owner in mercantilist France. By taking on an additional worker I can increase the hourly output of my factory by goods I can sell for \$40. The money costs of the raw materials involved in producing these additional goods, and the money costs of the additional wear and tear on my machinery, come, let us say, to \$20. The maximum wage rate the government allows me to pay each worker is \$1. Each additional worker I can put on thus yields me an additional \$19 an hour!

Now for the purposes of our discussion, let us assume the same figures apply in all industries. Each additional worker an employer takes on represents an additional \$19 in the employer's pocket. But to acquire my additional worker, I have to attract him from his present employment. To do that, I must content myself with, say, an extra \$18.50 an hour I can pocket, offering him not \$1 an hour but \$1.50 an hour.

Simply stated, employers must bid for a worker's services. In this hypothetical situation, the critical figure is \$20 an hour. At any wage rate below that figure, employers benefit by adding employees. At any wage rate above that figure, it doesn't pay to add an additional employee—hence the damage caused by minimum wage laws. Wage rates tend toward the money value of the productive output of labor, and that is increased as the capital invested per worker increases.

The economic system in mercantilist France was anything but a free market. Yet such rudimentary and fettered aspects of the market as did exist were sufficient to generate what we might call "the mystery of the inexplicably generous employers." Simply put, the market itself—the self-directed productive and exchange activities of individual market

participants—determines wage rates, just as it determines all prices. Indeed, in an unfettered market economy, the profits of the entrepreneur, the interest accruing to the owners of capital and land, and the wages of workers, are all determined in this sort of way. They reflect the relative contributions of the entrepreneur, of the owners of capital and land, and of those selling their labor, to the productive process. That is the genius and, indeed, the beauty of the market.

For our purposes, however, it is sufficient to stress that given a market economy—and that entails the rule of general principles of conduct equally applicable to all proscribing the use of violence or threatened violence by any—the price for which individuals can sell their labor is set by the same process all prices are set, a process of competitive bidding for scarce resources and goods. No person or group of people exercises mastery over the market or is in a position arbitrarily to control the price of anything. All that anyone can do is to offer to exchange goods and services with his or her fellows.

## Conclusion

Men and women once took the Seven Deadly Sins with desperate seriousness. Pride, envy, anger, sloth, covetousness, gluttony, lust: the list was familiar. Preachers, and writers such as Chaucer and Dante, depicted in considerable detail the dire consequences of actions informed by these realities.

I have referred to seven fallacies. The fallacy of the forgotten cost. The fallacy of misplaced value. The fallacy of finite wealth. The fallacy of the zero-sum game. The fallacy of false collectives. The fallacy of centralized planning. The fallacy of market mastery. There is no need for me to depict the dire consequences of actions informed by these fallacies. They are familiar to all who contemplate human history, both ancient and contemporary. Familiar also, however, are the consequences for a people who seek to use what they have to acquire what they want in ways rooted and grounded not in these fallacies but in economic truth. May the liberty and the plenty that such truth alone makes possible be enjoyed by ourselves, by our children, and by our children's children! □

# Freedom and Failure

by Dwight R. Lee

**D**uring good times and bad, the economic landscape seems always littered with firms that have failed, workers who have become unemployed, farmers who have lost their land, and the residue of entire industries in the process of withering away. The natural tendency is to see these failures, and the genuine human hardships that result, as a flaw of the economic system that produces them. Even those who consider themselves supporters of the market economy call for government action to buffer society against the harsh failures of unfettered capitalism.

It is certainly the case that when viewed in isolation the consequences of economic failure appear cruel, harsh, and unfair. Because of events over which they have little or no control, many hard-working, law-abiding citizens experience serious economic hardships in a system of free market capitalism. No one can argue with credibility that all, or even a significant minority, of these victims of economic failure are getting what they deserve in any particular instance of adversity. But economic outcomes that in isolation seem unjustified may be the necessary consequence of a system that is generating an overall, long-run pattern of outcomes that is entirely justified. As Henry Hazlitt has warned repeatedly, the major source of error in economic understanding comes from the tendency "to concentrate on . . . short-run effects

on special groups and to ignore . . . the long-run effects on the community as a whole."<sup>1</sup>

Hazlitt's warning cannot be overemphasized when considering economic failure and the fairness of free market capitalism. Each market failure is an inseparable part of a wider web of interactions and outcomes that provides everyone the maximum opportunity for success in the world of scarcity. Scarcity is an unfortunate fact of life, and it is easy to see scarcity itself as unfair. But unless one is prepared to argue that making the best of an unfortunate situation is also unfair, there can be nothing unfair about free market capitalism. And because instances of failure are necessary companions to the general success of the free market process, it would require a sharp twist of logic to characterize as unfair the failures that arise from free market activity.

Economic failure is inevitable if we are to have economic progress. One explanation for this link between failure and progress was provided by Joseph Schumpeter when he described capitalism as a "process of creative destruction."<sup>2</sup> The discovery of improved products, and better ways of producing existing products, necessarily means that many established products and technologies are valued less. Those who have committed their resources to these now obsolete products and technologies will suffer a decline in wealth as their investments turn sour and their skills become less employable. They will experience economic failure. But this destruction of wealth, or economic failure, is only part of a larger picture of wealth

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*Dr. Lee is a professor of economics at the University of Georgia, where he holds the Ramsey Chair of Private Enterprise.*

creation and economic success. The loss of wealth experienced by some is (1) a transfer of resources to those who will put them to more valuable use, and (2) a compelling incentive to redirect efforts into more productive employment. The process of "creative destruction" is our best hope for economic success.

## Entrepreneurial Freedom and Failure

There is another vital link between economic failure and progress. Economic progress that expands opportunities for all is clearly a force for fairness. Such broad-based economic progress depends on what is best described as the entrepreneurial spirit. Without those with visions of what might be, and the dedication and courage to pursue those visions, few of the technologies and products that provide the foundation for our current wealth would be available. It is only because individual entrepreneurs have had the freedom to attempt what the more "sensible" among us would never have attempted that economic development has been possible.<sup>3</sup>

This does not mean that most entrepreneurial ventures contribute to our economic well-being. Quite the opposite is true. A relatively small percentage of the projects promoted by entrepreneurs add more to our wealth than they consume in time, talent, and resources. Most entrepreneurial ventures turn out to be exactly what most of us would have predicted in advance—impractical fantasies. But, it is impossible to know in advance which entrepreneurial gambles will be an economic step forward. There is only one way to discover these economic successes, and that is by giving entrepreneurs the freedom to snub their noses at the conventional wisdom and venture forth in pursuit of their "impossible" dreams.

This freedom to attempt success in the face of daunting odds requires an accompanying freedom to fail. And the freedom to fail has to be sufficiently painful that it cannot be ignored. The entrepreneur whose project is rejected by the consumer will remain convinced that it is the consumer who is mistaken. Unless such entrepreneurial confidence is sternly subordinated to consumer preferences, the losses from the

many entrepreneurial mistakes would persist and overwhelm the gains from the relatively few entrepreneurial successes. Without the discipline of failure forcing accountability to consumer preferences, entrepreneurial ventures would be economically destructive and entrepreneurial freedom could not be tolerated. The economic system that cannot condone failure cannot risk freedom.

## Communication, Honesty, and Concern

There is only one economic system that turns failure into a force for the type of accountability that makes freedom possible. That system is free market capitalism. It is a system that allows freedom because it is a system that motivates people, both when they succeed and when they fail, to deal with each other with honesty and fairness.

Consider the characteristics of a system of human interaction that would be ideal from the perspective of economic accountability and fairness. First, this system would have each of us in constant communication with everyone else. If there is to be any hope of being accountable to the preferences of others in our use of resources, each of us will need to receive information from others on their preferences. Second, the communication that took place would be honest. Transmitting inaccurate information on the value derived from resources would make it impossible to direct resources into their highest valued uses. Third, each individual would give the preferences of others the same weight he gives his own. No matter how much an individual may desire one economic outcome, if others communicate to him that they value another outcome even more he would accommodate their preferences.

It is possible to achieve a real world approximation to this ideal system—free market capitalism. The key to understanding this approximation is in recognizing the incentives established by the private property system which forms the foundation of the market.

In the private property system, resources are transferred from one individual to another through voluntary exchanges. The market prices that arise from these exchanges are the

means by which all market participants communicate their preferences to each other. There exist strong incentives for people to communicate honestly through prices. It is in the interest of all market participants to assess carefully the value realized from different resources, and to communicate their desire for more of a particular resource only if it is honestly worth more to them than the prevailing market price. The temptation sellers would otherwise have to overstate the values of their products with excessive prices is controlled by market competition.

Finally, each market participant is motivated to act *as if* he has the same concern for the preferences of others as he has for his own. When an individual reduces his use of a product in response to a higher price, he is in effect saying, "Others are telling me that this product is worth more to them than it is to me, so I will consume less so that they can consume more." Similarly, economic failures such as bankruptcies and unemployment can be thought of as people saying, "Others are telling me that my resources would be more valuable in other activities, so I will respond to their preferences." These "failures" reflect the success of free market capitalism in getting people to cooperate with each other freely, fairly, and honestly.

## Focusing on Failure

Unfortunately, few people heed Henry Hazlitt's warning and look beyond the isolated trees of economic failure to see the overall forest of economic success. This oversight is explained in part by the fact that it is easier to concentrate on particular outcomes than to comprehend the larger pattern of which these outcomes are only a part. But this is far from a complete explanation. The fact is that there is more for people to gain as members of organized interest groups by concentrating on the isolated failures than by considering the overall success of free market capitalism.

When individuals suffer losses from the operation of free market capitalism, they are in fact making a necessary contribution to the working of an economic system that serves the long-run interest of all. From the perspective of each individual, however, the best possible situation

would be to receive protection against personal economic failure while benefiting from the contributions the failures of others make to economic progress. The fundamental fairness of the free market is that it does not provide anyone a free ride on the contributions of others. In the free market everyone has to contribute to the general economic prosperity by accepting the failures as well as the successes that come his way.

It is the legitimate function of government to enforce the private property rights upon which the fair and honest cooperation of the free market depends. When property rights are enforced no one can avoid making the cooperative adjustments required by economic failure while benefiting from the cooperative adjustments economic failures force on others.

Unfortunately, government power, though justified as a means of protecting property rights, can be destructive of these rights. This abuse of government power is sure to occur when, as has been the case in recent decades, government ceases to be viewed as a necessary evil and instead is seen as the primary source of social progress. Once it becomes widely believed that the discretionary use of government power is an acceptable means of solving particular economic problems, economic failure will become a useful justification for the politically organized to receive unfair advantages at the expense of the politically unorganized.

The negative consequences of economic failure are highly visible because at any one time they tend to be concentrated on a relatively few. The positive consequences of economic failure are largely invisible because they are indirect and spread over the entire population. When the few who experience economic failure are organized they will see it to their advantage to lobby government for relief. By granting this relief, politicians receive the gratitude of the benefiting few by imposing a diffused cost on the entire population. This imparts a clear political bias in favor of substituting unfair government force for the fairness of market cooperation. This bias, however, although generated by the political muscle of organized special interests, ultimately rests on perceptions of fairness.

If protecting a particular group against the consequences of economic failure is widely

considered to be an unjust use of government power, then politicians will be very reluctant to provide such protection. Special interest groups lobbying government for relief from an economic failure cannot rely solely on the organizational advantage they have over the general public. Success depends crucially on the perception that justice is served by indemnifying particular groups against failure. There is much to be gained by those that are, or would be, politically influential from portraying their economic failures as unfair. No one should be surprised that as government has grown, the focus on economic failures has increased, as has the perception that these failures are unfair. With government standing ready to transfer wealth to those whom the economy has treated "unfairly," the private payoff is increasingly in lamenting the "unfairness" of failure rather than celebrating the fairness of the cooperation, wealth, and freedom that this failure makes possible.

## Conclusion

The fact is that government cannot reduce economic failure. It can only protect some against failure by increasing the overall level of failure and imposing it on others. As Hayek warned over 40 years ago: "The more we try to provide full security by interfering with the market system, the greater the insecurity becomes; and, what is worse, the greater becomes the contrast between the security of those to whom it is granted as a privilege and the ever

increasing insecurity of the underprivileged."<sup>4</sup>

The special favors granted by government are not only unfair, they become the justification for yet more futile government attempts to provide security against economic failure.

Once government starts down the road of buffering people against the failures of market activity it becomes difficult to turn back. And the ultimate destination if we remain on this road is a politicized economy lacking both fairness and prosperity because it cannot provide the accountability nor tolerate the freedom which are essential for economic success and honest cooperation. The best hope for preserving the market process is by advancing public understanding of how this process works to promote a broad-based prosperity. Only through economic understanding can we pierce the rhetorical facade of fairness used by organized special interests to acquire political favors. Once this facade has been stripped away, it will be difficult for political opportunists to undermine the freedom and prosperity of all under the pretense of concern and justice. □

1. Henry Hazlitt, *Economics in One Lesson*, New York, Arlington House Publishers, 1979; p. 17.

2. Joseph A. Schumpeter, *Capitalism, Socialism and Democracy*, New York, Harper Torch Books, 1962; pp. 81-86.

3. The benefits from freedom are clearly not confined to those who choose to exercise it. As F. A. Hayek has said, "The benefits I derive from freedom are thus largely the result of the uses of freedom by others, and mostly of those uses of freedom that I could never avail myself of. It is therefore not necessarily freedom that I can exercise myself that is most important for me." See F. A. Hayek, *The Constitution of Liberty*, The University of Chicago Press, 1960; p. 32.

4. F. A. Hayek, *The Road to Serfdom*, The University of Chicago Press, 1944; p. 130.

## Subsidizing Inefficiency

**B**ECAUSE FAILURE is repugnant to a welfare-oriented society, we see continued efforts made to put a floor under everything. This includes a spreading attempt to bolster up faltering business firms or even whole areas or industries by government grants, loans, subsidies, defense contracts, and the like.

Ironically, the greatest danger to our economic system today lies not in a direct attack on profits, but in a well-meaning effort to insure everyone against failure. To put it bluntly, this means subsidizing inefficiency; it is the antithesis of the effective operation of the profit motive.

We are in danger of losing one of our greatest freedoms: the freedom to fail. Profit and loss are two sides of the same coin; take away one side and you take away the whole coin. Our greatest economic asset is the right to invest private capital in the hope of making a profit, but at the risk of losing our shirt.

—GEORGE CLINE SMITH

IDEAS  
ON  
LIBERTY



# The Start-Up Entrepreneur

by John Chamberlain

In his *Discovery and the Capitalist Process*, which was reviewed in *The Freeman* last winter, Israel Kirzner speaks of three levels of entrepreneurial endeavor. One is at the level of arbitrage, where paired buying and selling transactions are simultaneous. A second level of entrepreneurship is pure speculation on the future. This depends on alertness but without any simultaneity in the buying and selling of physically identical objects. The third level in Kirzner's triad is that of productive creativity in which the entrepreneur sees possibilities in novel forms of combination.

Though the Kirzner levels may overlap in gifted individuals, a case can be made that only the third Kirzner type of operator deserves to be called the true entrepreneur. The arbitrage dealer creates nothing by his trades as such, though he may use his profits creatively at a different time. The pure speculator may help his own bank account to grow, but it will be the bank's business to use the speculator's profits creatively. In his *The Start-Up Entrepreneur* (New York, E. P. Dutton, 306 pp., \$18.95) James R. Cook pays his respects to all types of enterprisers, including managers such as Alfred P. Sloan of General Motors who also had creative flair. But for the most part Cook is concerned with people who, perceiving market gaps and unsatisfied wants, bring improved or new products and services into existence.

There is a strong autobiographical thread to Mr. Cook's book. He had been a small-town insurance agent in Minnesota, but he yearned to start a manufacturing and servicing company of

his own. Without doing any research whatsoever in the field of water purification he plunked down some of the cash he had received from selling his insurance agency for a franchise to market "Crest Water" in the Miami-Fort Lauderdale area of Florida. The Crest Water machine that went with the franchise could really do a purifying job, but it soon became apparent that Cook and his partner Jay Anderson didn't know Florida. They thought they could sell to the restaurants. After a score of turn-downs and some unfortunate encounters with antagonistic Health Department inspectors they decided to concentrate on condominiums and apartments. When they finally made several inroads in North Miami, they discovered that the machines they sold rusted within weeks. And there was a fish taste when the deionization tanks wore out.

There had to be corrections in the machines. Before the manufacturers came through with something workable the problem of getting customers remained acute. Luckily Cook and his partner got a tip that the thoroughbred horses at the Tropical Park race track were drinking bottled water. Cook's partner made the rounds of the trainers, and in a few days he had a life-saving order. After further trials and tribulations Cook found a Key Biscayne developer who was willing to test a coin-operated machine in one of his flagship buildings. The coin-operated concept proved the breakthrough. There were still other difficulties, both of money-raising and manufacture, to survive, and the business never did become a gold mine. But



fourteen months after they had started Cook and his partner found someone to buy their business for \$120,000.

What Cook learned from his Florida experience was persistence. Back home again in Minnesota he began to keep a notebook compilation of "needs" and "errors." As a gun collector he noticed there was no market price guide for prospective gun purchasers. So he began to publish the *Blue Book of Gun Values*. He formed a group to offer insurance on safe deposit boxes after he had gone into the business of selling gold and silver to investors. Market gaps seemed to open up everywhere. He put up the capital to help start a company that sold nonalcoholic mouthwash to members of Alcoholics Anonymous. The company — Morning Magic Mouthwash of Colorado — is still prospering. During the oil crisis he beat a formidable competitor in providing wood stoves. The market gap here lasted all too short a time, but, with his Investment Rarities Incorporated, which does a lot more than buy and sell precious metals, Cook has never been at a loss for new diversified entrepreneurial ventures.

As a "how to" book as well as an autobiography *The Start-Up Entrepreneur* is filled with all sorts of valuable advice to beginners. The problem of diversification must be handled carefully. Oddly, investment capital for small enterprises never seems to depend on interest rates. If the "cut in" prospects seem good to friends and relatives of small-time enterprisers, the money comes through. This probably explains why the vast increase in jobs under Reagan has come from small companies that have not had to borrow at particularly high interest rates.

Much of Cook's advice comes in the form of quotations from the famous entrepreneurs and free market thinkers of both past and present history. Ray Kroc of McDonald's is quoted so often that he might well have been listed as a co-author. In certain sections the book reads like an anthology, with wisdom coming in short and effective spurts from Andrew Carnegie, Peter Drucker, Cyrus McCormick, J. C. Penney, Napoleon Hill, Ludwig von Mises, Leonard Read, Conrad Hilton, Henry Ford, Stanley Marcus, George Gilder, and Dale Carnegie, just to name a few of Cook's chosen mentors.

Cook seems to have done superlatively well for himself despite government regulation and the depredations of the Internal Revenue Service. He is always mindful, however, that he might have started more businesses if the State had not asked for half his profits. He surmises that if Thomas Edison had been bothered with modern taxation he would have failed to carry through on half his inventions. The paperwork involved in keeping track of the many Edison false starts would have driven the man crazy. □

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## MONEY AND FREEDOM

by Hans F. Sennholz

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*Reviewed by Richard A. White*

**M**oney is the most marketable economic good in society. Individuals attach value to money with the future expectation of obtaining with it goods and services in the market; money is valuable because of its purchasing power. Money facilitates exchange and makes possible an advanced division of labor.

Since the creation of the Federal Reserve System in 1913, the federal government has enjoyed a money monopoly. The government, which controls the Federal Reserve, may inflate the currency seemingly at will, since legal tender laws force individuals to accept the state's devalued money.

But inflation has dire consequences. As Professor Hans F. Sennholz points out in his latest, provocative book, *Money and Freedom*, inflationary booms lay the groundwork for recession and depression. With more money available on the loan market, interest rates decline, and businesses are lured into making bad capital investments. Because the investments are not accompanied by corresponding increases in savings, capital costs will rise to meet increasing demand. The boom, therefore, must lead to a bust, a time of adjustment to correct previous malinvestments. If the government continues to inflate, then hyperinflation and eventually the total destruction of the currency will follow.

In order to restore stability and integrity to money, Sennholz advocates monetary freedom, that is, the private issuing of coins and bank notes. A "parallel standard" of competing monies would replace the government monopoly. Legal tender laws would apply only to the issuers of currencies, who would be required to redeem their monies at face value. Thus, the government would be required to accept its fiat paper money at face value, but could not force it on anyone else.

A particular form of money, like any other economic good, will be driven out of the market if it fails to satisfy consumer demand. Given monetary freedom, individuals will likely choose gold as their money, as they have in the past. Gold is highly marketable, easily divisible, and cannot be "created" out of thin air by the government. Furthermore, gold does not require coercion to gain acceptance. As Sennholz states, "Gold does not need legal tender force; no honest money needs legal tender, but it needs to be free from government regulation, taxation, manipulation, intervention, and threat of confiscation." (p. 83)

In a section entitled, "False Solutions: Managed Money," Sennholz examines reform proposals of economists from the monetarist, supply side, and social credit camps. While the proposals vary widely, they all fail to take into account the main problem: the government money monopoly. Sennholz's critique of authors such as Milton Friedman, Robert Mundell, and Wickliffe B. Vennard is excellent, and though current Austrian proposals remain unmentioned, the section serves as a fine overview of the popular monetary solutions being set forth today.

Books which espouse sound economic analysis are essential if the present monetary system is to be reformed. Sennholz's *Money and Freedom* is such a book. It provides explanations of past mistakes and solutions to present problems. The clarity with which Sennholz expresses his ideas makes complicated economic ideas understandable to the reader, and even those who disagree with Sennholz will benefit from his analysis. The government money monopoly has failed. Only when freedom is restored to money will a sound currency be established. □

## DESTROYING DEMOCRACY: HOW GOVERNMENT FUNDS PARTISAN POLITICS

by James T. Bennett and Thomas J. DiLorenzo

Cato Institute, 224 Second St., SE, Washington, D.C. 20003 • 1985 • 561 pages, \$24.95 cloth, \$11.95 paperback

*Reviewed by Daniel Klein*

**D**estroying Democracy provides a detailed account of the thousands of hidden and diverse ways Federal agencies hand over billions of taxpayer dollars to special interest advocacy organizations. This practice subverts whatever fairness we may have in American politics. Moreover, it is against the law, as shown by passages from laws enacted by Congress and rulings of the Supreme Court.

Behind the facade of representative government, political bodies play a major role in shaping public opinion. They do so by funding special interests which, in turn, lobby for the handouts on which they depend. To obtain tax dollars, the special interest groups engage in a masquerade, claiming that their intent is to aid the less fortunate, advance the public interest, protect the consumer, improve the environment, uplift minorities, and so on. Actually, pressure groups use the taxpayers' money primarily to further their own interests.

"Virtually without exception, the recipients of government grants and contracts advocate greater governmental control over and intervention in the private sector, greater limitations on the right of private property, more planning by government, income redistribution, and political rather than private decision making." (The exceptions are a handful of right-wing organizations which have responded to the lure of political handouts.)

Some examples: One government agency gave a Ralph Nader "public interest research group" \$1,287,000 in the period 1979-81. Jesse Jackson's People United to Save Humanity received more than \$5 million during 1977-81 from the departments of Education, Labor, Health and Human Services, and Commerce. The National Organization of Women and its affiliates have received considerable grants, one

of which (for \$105,000) was used to finance a media campaign publicizing NOW's positions. Tom Hayden's Campaign for Economic Democracy was awarded \$500,000, and its activist training arm, The Center for New Corporate Priorities, received a separate grant of \$126,000.

This book details the realm of tax-funded politicking, and in so doing offers something much broader. Since most advocacy groups receive taxpayer support, the work serves as a handbook of hundreds of activist organizations, from the most remote grass-roots campaigns to the most prestigious Washington think tanks.

In addition to the text, there is a hundred-page appendix listing the recipient organizations, the Federal agency which gave the money, the amount, and the dates.

Before we can successfully oppose "the engineering of consent" we must identify the engineers and know how they operate. This book tells us. □

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## MAKING SENSE OF MARX

by Jon Elster

Cambridge University Press, 32 E. 57th Street, New York, NY 10022 • 1985 • 556 pages, \$15.95 paperback

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*Reviewed by John K. Williams*

**T**his volume is the second contribution to a series, *Studies in Marxism and Social Theory*, being jointly published by the Cambridge University Press and the Editions de la Maison des Sciences de l'Homme. The editors of the series hope that it will "exemplify a new paradigm in the study of Marxist social theory," liberating such theory from what they describe as "the increasingly discredited . . . presuppositions" of Marxist orthodoxy.

Jon Elster—a Professor of Political Science at the University of Chicago and research director of the prestigious Oslo-based Institute for Social Research—designates himself a Marxist, albeit noting that the sense in which he feels able to so describe himself "has undergone a change over the years." Many readers may, however, wonder precisely what Elster's radically revised "Marxism" signifies. His scholarship is awe-

some; his language is precise; his argumentation is cogent. Yet his Marxism is to the writings of Marx what the ethereal smile of the Cheshire Cat is to that enchanting creature.

"For many readers," observes Elster, "Marxist economics will be more or less synonymous with the labour theory of value." One might challenge the term "synonymous" but one both could and should be excused for suggesting that this theory is central to the economic thought of Marx. One is thus somewhat relieved to discover that Elster concedes this centrality. Yet he bluntly asserts that "the theory is useless at best, harmful and misleading at its not infrequent worst," and proceeds rigorously to defend this judgment.

Elster's unqualified rejection of both the special and general labor theory of value is extraordinarily significant. The grand old man of Marxist economics in the United States—Paul Sweezy—is indubitably correct to insist that Marxist economics without the labor theory of value and the associated concept of surplus value is *Hamlet* without the Prince. The insistence of Marx that the capitalist mode of production necessarily involves the exploitation of labor by capital depends, in his *economic writings*, utterly upon the labor theory of value. Yet Elster firmly and decisively rejects that theory.

Elster's criticisms of Marx's class analysis of capitalist society are no less stringent than his criticisms of the labor theory of value. Yet he clearly is anxious to retrieve the notion of class conflict from the dismembered cadaver left when his dissecting exercises are complete. Sadly, Elster is either unaware of, or chooses to ignore, the class (or "caste") war stressed by classically liberal thinkers, particularly such nineteenth-century French thinkers as Jean Baptiste Say, Gustave de Molinari, Charles Comte, and Alexis de Tocqueville. Indeed Thomas Paine, writing in 1792 of the United States, insisted that "[t]here are two distinct classes of men in the Nation, those who pay taxes and those who receive and live upon the taxes." As against the "high Tories," the classical liberals perceived in any government able to appropriate goods and services the root cause of social division and "class" struggle, insisting that unless structures limiting the power of government could be created, conflict between

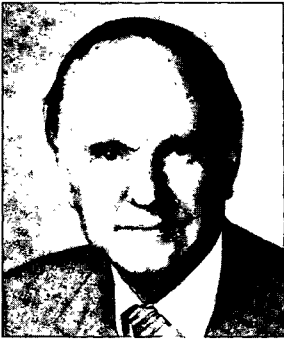
those controlling the statist apparatus and those subject to that apparatus is inevitable.

A case can be made for asserting that the insights Elster most values in Marx are remarkably familiar to students of the freedom philosophy. No student of Ludwig von Mises or reader of Joseph Schumpeter will be amazed to learn that the world studied by economists is a world of dynamic and ongoing change. No person familiar with the rich heritage of classical liberalism will find astonishing the notion that, the moment government's task is perceived as going beyond that of defending through laws equally applicable to all the equal rights of all, special interest groups seeking to forge an unholy alliance with government will emerge, each warring against the others. No reader of Adam Smith will greet the insistence that a vital

relationship exists between a nation's political and economic structures with other than a somewhat tired, "So what's new?"—for after all, the market economy rests upon precisely defined and efficiently enforced private property rights.

In short, Elster perhaps unwittingly raises the extraordinary but enchanting possibility that what the editors of the series to which his book is a singularly distinguished contribution wish to establish—namely, "what is true and important in Marxism"—might be aspects of the classical liberal heritage absorbed by the eclectic Marx. Be that as it may, Elster's volume is a work serious students of the freedom philosophy would do well carefully to read, thoughtfully to ponder, and mightily to enjoy! □

## Money and Freedom by Hans F. Sennholz



*Money and Freedom* is a remarkable study of money and some fateful errors of popular monetary doctrines. Professor Sennholz argues forcefully and convincingly that such control, which amounts to a money monopoly, causes monetary destruction.

*Money and Freedom* is published by Libertarian Press and is also available from The Foundation for Economic Education.

102 pages, paperback \$6.00

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## PERSPECTIVE

### Privatization: Two Perils

"Privatization" conjures up the picture of a shift of governmental activity into private hands. At first glance, this would seem to merit applause from those of us who favor the free market, private property, limited government system. After all, if non-coercive, creative "public" functions are transferred to the marketplace where they belong, individual liberty will flourish to the betterment of us all.

Yet those who employ the euphemism of "privatization" often use the word to mask two related ideological perils: First, the term may mean the mere "contracting out" of "public services" to private entrepreneurs as a means of carrying out activities which are not the proper function of government. Second, the doctrine may encompass the premise that the private sector—the market—will be allowed to accomplish specific "publicly necessary" functions only for as long as the government determines that those endeavors are properly performed. The State thus acts as a backstop or guarantor, a provider of last resort in the event that the market fails to supply the goods or services as directed by the government. Both of these ideological snares pose fatal pitfalls to the principled student of liberty.

Consider first the idea of "contracting out government services." This idea rests on the belief that the services provided or the goods produced constitute a necessary and proper governmental function, with the only quibble relating to the most effective means of carrying out this presumably appropriate "public service." Such a tenet violates the principles of minimal government and unrestrained individual action: the proper State exists solely to repel and deter the initiation of force and the application of fraud, and to afford a system of common justice capable of adjudicating otherwise insoluble disputes between citizens.

Sovereignty cannot tolerate the delegation of these destructive, outside-the-market powers to private citizens. The cloaking of private individuals with the compulsive powers of the State in the arena of creativity outside the narrow fences of proper governmental action cannot disguise the immorality and foolishness of the act. The State cannot delegate the monopoly of

force needed to police criminal and fraudulent conduct, nor can it "contract" for a system of justice. These are the sole responsibility of government. "Contracting out" creates a confusion of terms.

By the same token, if an activity undertaken by the State penetrates the arena of creative human conduct, liberty lessens and slavery abides. The condition does not change for the better by endowing private citizens with the powers of government.

Indeed, the "contracting out" thesis concedes the greater efficiency of the market, although it remains to be seen if contract employees retain any semblance of efficiency in non-competitive bureaucratic enterprises. And even if we assume that contract employees are more efficient, this fails to answer the pertinent inquiry: why help a tyrant become more efficient and hence prolong the agony he inflicts? Why would any honest and accountable individual strike such a bargain with the traducers of freedom, and why would any defender of the voluntary way praise such nonsense?

The "contracting out" concept assumes a number of slim disguises. It permeates the charade of "public corporations" such as the Postal Service. It appears in the euphemistic phrase, "proprietary functions of government should be operated like a business," which lies behind socialistic ventures such as the Tennessee Valley Authority. It supports the extortive process designed to buy off the beneficiaries of legal plunder. Whatever the protective garb, the theory is blatant and dangerous.

Let us now turn to the second peril of privatization: use of "privatization" to retain the State as both ultimate authority over the necessity and wisdom of a good or service and final arbitrator of the sufficiency of the good or service.

By nature, a market consists of all willing and interested participants. Each such individual "votes" in a massive "dollar democracy" for those goods, services, or ideas which most appeal to him or her. A market exists without coercion and without inflexible presuppositions of ultimate desirability; it caters to the wants of every one of us who buys and sells therein. A market flourishes precisely because of the

lack of prior restraint and pre-defined limits.

This simple description lays bare the inconsistency of those "privatizers" who see the marketplace as a handy smorgasbord for purveyors of predetermined fare. If the State decides that certain goods and services must be offered, and that the police power must pass upon the quality and quantity of those goods and services, the supposed transfer from the public coercive apparatus to the private creative process is a sham. The result—a coerced economy—does not constitute a market at all; rather, the clumsy claw of government has tinkered with the system and obliterated any semblance of true liberty.

Those who prize freedom must not waver in their devotion to principle. We ought to praise the abatement of governmental power whenever it recedes from the creative sector. And, importantly, we must not be gulled by those who contend that the enemy is capitulating when, in fact, the State and its operatives are merely employing fifth column tactics to lessen their natural bumbling and to continue fooling the foolish.

—Ridgway K. Foley, Jr.

(Mr. Foley, a partner in Schwabe, Williamson, Wyatt, Moore & Roberts, practices law in Portland, Oregon.)

## Op-Ed Update

FEE's op-ed program, inaugurated last spring, has placed adaptations of *Freeman* articles in more than 40 newspapers around the country. Dwight Lee's "The Political Economy of Educational Vouchers" (August) was reprinted in *The Anchorage Times* and the *Charleston Gazette*. Among the newspapers carrying James Gwartney's "A Christian Speaks Up for Capitalism" (August) were *The Phoenix Gazette*, *San Jose Mercury News*, and *The San Diego Union*. "Air Transportation Safety" by John Semmens and Harry Wolfe (August) appeared in *The Orange County Register*, *The Joplin Globe*, *The Dayton Daily News*, and *The Green Bay Press-Gazette*. "Lilacs" by Jack Schwartzman (September) has appeared in newspapers in Texas, Florida, California and Tennessee.

# Underground Government

by Hans F. Sennholz

**W**hen the burden of taxation becomes oppressive many taxpayers are tempted to evade their obligations by working off the books. When government regulations and license requirements make certain services exorbitantly expensive, many people may disregard the restrictions and hire unlicensed labor or learn to do it themselves. When entitlement benefits are connected with employment and income restrictions, the beneficiaries are tempted to ignore the restrictions and work off the books. In every case people react to the burdens imposed and obstacles erected by hiding from the watchful eyes of political authorities and escaping to the underground.

In a similar way, when constraints on government pose a major threat to politicians, government employees, and powerful interest groups that benefit from political largess, government goes underground. When budget cuts threaten the position and incomes of politicians and bureaucrats they react by going "off-budget." Whether they are committed philosophically to expand the political arena or just defend their economic existence and life style, off-budget operations are an important procedure for achieving their goal.

The path to underground government is rather short and direct. Government merely needs to establish independent corporations,

that is, quasi-public enterprises that are managed by politicians or their appointees and operated "off-budget." These enterprises (OBEs) may engage in any economic activity from the construction and maintenance of airports, public housing, and libraries, to the development of theaters, stadiums, and zoos. Their spending, borrowing, and other activities are deleted from any government budget. Their debt is not subject to constitutional debt limitation nor is it conditional on voter approval. Government activity may thus be made to disappear by a simple stroke of the pen that creates a corporate charter. The simple expedient of a corporate guise moves political machinations beyond the control and scrutiny of the electorate.<sup>1</sup>

An OBE is a creation of politics. It is a body or board authorized by law to enact ordinances or adopt resolutions for the purpose of acquiring, constructing, improving, maintaining, and operating "civic projects." It may borrow money and issue bonds for these purposes. It must not be confused with "taxing districts" that are subject to budgetary limitations, are endowed with taxing powers, and guided by elected directors. OBEs operate outside the governmental structure, lack taxing powers, and function under appointed directors. Except for these differences, the taxing districts and OBEs are akin in form and function.

Most politicians and officials, however, prefer OBE's. The use of OBE's allows them to spend and borrow without constraint, to dispense patronage without civil service restric-

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*Dr. Sennholz heads the department of economics at Grove City College in Pennsylvania. He is a noted writer and lecturer on economic, political, and monetary affairs.*



tions, and to bestow favors and benefits on special groups. An OBE is an anomaly of organization: a government entity unfettered by many of the statutory constraints applicable to government, a corporation without stockholders but with a board of directors consisting of politicians or their appointees, a non-profit business that competes with business or is protected from competition as an unregulated monopoly.

The pace of off-budget activity seems to vary with the imposition of tax and expenditure limitations. When tax resistance limits the scope of government revenue, politicians and bureaucrats on all levels of government learn to evade rather than accommodate. When state and local governments chafe under constitutional restrictions they go underground. Moreover, the federal government can be expected to encourage the move. It encourages off-budget activity by providing grants-in-aid and extending loans directly to OBEs, bypassing on-budget units of government. Aid may be given by an off-budget Federal enterprise to an off-budget state or municipal enterprise with a handful of politicians and officials deciding the issue. Taxpayers have no voice in such matters.

Most government entities in the United States are spawning OBEs. There are more than ten thousand OBEs raising funds by issuing tax-exempt bonds not subject to legal restrictions on public debt, conducting business in competition with individual enterprises or as monopolies sheltered by legal prohibitions, and dispensing economic favors in exchange for political support. They are masquerading under various guises such as boards, authorities, agencies, commissions, corporations, and trusts. Most of them are state and local entities; the federal government has spawned only a few as Federal spending and borrowing remain virtually unhampered by either constitutional or statutory limitation. And yet, Federal off-budget financing is growing at a remarkable rate especially through the off-budget Federal Financing Bank. Unfortunately, the American public knows little about underground government activity. In fact, there are few statistics on OBEs and the political wheeling and dealing they conceal from the public. There are few voices that warn against the consequences of such practices.

## Off-Budget Local Government

During the 1960s and 1970s local governmental bodies gave birth to thousands of independent entities that operate "off-budget." On December 31, 1984, in the Commonwealth of Pennsylvania alone, some 2,548 municipal entities were pursuing 2,896 projects, most of which were off-budget. Among others there were 37 airport authorities, 121 parking authorities, 691 sewer authorities, 298 water authorities, 97 recreation authorities, 48 solid waste authorities, 82 health authorities, 95 other single-purpose authorities, and 341 multi-purpose authorities. They are accustomed to borrowing between half a billion dollars to one and a half billion dollars every year and, on December 31, 1984, carried a debt of \$8.2 billion.<sup>2</sup> Throughout the U.S., municipal authorities owed a total long-term debt of \$271.3 billion of which \$108 billion were "full-faith-and-credit" issues and \$163.2 billion 'non-guaranteed.'<sup>3</sup>

The phenomenal growth of "off-budget" local government in recent years is clearly visible in the trend from "full-faith-and-credit debt" to "non-guaranteed" indebtedness. In 1950, the former stood at \$15.6 billion and the latter at \$2.3 billion. In 1980, for the first time, the non-guaranteed off-budget debt exceeded the full-faith-and-credit debt (\$102.2 billion versus \$100.4 billion). At the end of fiscal year 1983, the ratio was \$163.2 billion to \$108 billion.<sup>4</sup> Projecting the trend we can estimate that by now (1986) the off-budget debt amounts to twice the budget debt. In short, it took some thirty years for the former to equal the latter, but only five to six years during the 1980s to soar to twice the size of full-faith-and-credit debt. In just four years (1980-1983), full-faith-and-credit debt rose \$7.6 billion, but non-guaranteed debt soared by \$61 billion, or eight times faster.

Politicians and government officials are reacting to tax resistance by placing government debt and expenditures off-budget, moving most of local government beyond the direct control of taxpayers. They are creating OBEs that, together with their beneficiaries, can be mobilized against all future taxpayer resistance to taxing and spending. In the meantime they are building a pyramid of debt that is bound to

place a serious financial strain on local governments nationwide.

## Statewide OBEs

State governments were building their own pyramids of non-guaranteed OBE debt long before local governments joined the rush in earnest. Law makers and government officials on all levels of government like to spend large sums of money on popular projects while deferring the costs through borrowing. At the state level they succeeded in creating hundreds of statewide OBEs which now account for more than two-thirds of all state borrowing. Total state long-term non-guaranteed debt now exceeds \$109.6 billion while the full-faith-and-credit debt is \$55 billion, or just 33.4 per cent of the total.<sup>5</sup>

During the 1960s and 1970s New York State paved the way. Determined to greatly expand the state's programs in education, health care, welfare, housing, and other areas, the legislature raised taxes significantly and multiplied OBE spending. Ignoring taxpayer opposition it launched numerous OBEs and quadrupled OBE debt, which at times amounted to some four times the guaranteed voter-approved debt.

When voters rejected a \$100 million housing bond issue for the third time, the legislature created the Housing Finance Authority. The Authority issued massive amounts of non-guaranteed debt which alone at times exceeded the total full-faith-and-credit debt of New York State. When voters rejected a \$500 million higher-education bond issue for the fourth time, the legislature created the off-budget State University Construction Fund. When the voters rejected a public housing bond issue for the fifth time, the legislature reacted by creating the Urban Development Corporation. UDC was given the powers of eminent domain, to override local zoning and building code controls, and to disregard any restrictions that hamper rapid construction. When UDC fell into default in 1975 the legislature created yet another OBE, the Project Finance Agency, which issued more OBE bonds to pay the bills of the bankrupt UDC and to cover the deficits of various other OBEs.<sup>6</sup> Altogether, the people of New York State were made to shoulder the heaviest debt

among the fifty states, more than \$27 billion by the end of fiscal 1983.<sup>7</sup> More than 80 per cent of this debt is off-budget, non-guaranteed, lacking voter approval. But the creditors may rest assured: OBE bonds are "moral obligation" bonds.

## Underground Federal Government

Federal politicians and officials react to taxpayer demands for fiscal restraint in the same way as local and state politicians and officials: they go underground. The Congressional Budget and Impoundment Act of 1974, which merely announced the need for fiscal discipline without actually curbing Federal spending, produced a rush to the underground. Since then Congress has been steadily proclaiming the need for discipline and balanced budgets, but simultaneously preparing the way for placing Federal spending off-budget.

The U.S. Congress uses three avenues of escape. First, it simply deletes from the budget numerous agencies that are Federally owned and controlled. Beginning with the Export-Import Bank it subsequently removed the Postal Service Fund, the Rural Telephone Bank, the Rural Electrification and Telephone Revolving Fund, the Housing for the Elderly or Handicapped Fund, the Federal Financing Bank, the U.S. Railway Association, and the Pension Benefit Guaranty Corporation. More recently it created two off-budget entities to carry out energy programs: the Synthetic Fuels Corporation and the Strategic Petroleum Reserve Account. Total off-budget outlays by these entities are estimated at \$10 billion in fiscal year 1984 and \$12.5 billion in fiscal 1985.<sup>8</sup>

A significant factor in financing Federal off-budget activities is the Federal Financing Bank (FFB), which began operation in 1974. Although it is part of the Treasury Department, its transactions are excluded from the budget totals. Its lending is not counted as budget outlays although it finances its operations by borrowing from the Treasury Department. It performs three off-budget functions: It lends money to government agencies; it purchases guaranteed loan assets from Federal agencies; it disburses loan funds directly to borrowers when the loan

is guaranteed by a Federal agency. Total net outlays of the Federal Financing Bank are estimated at \$7.3 billion for fiscal year 1984 and \$10.4 billion for 1985; total loans outstanding are calculated at \$114.1 billion and \$124.6 billion respectively.<sup>9</sup>

The second avenue of escape to the underground leads to a number of privately owned, but government-sponsored and controlled enterprises (GSEs). They are established to carry out government programs; they redirect credit by acting as financial intermediaries to promote greater amounts of lending to certain beneficiaries, seeking to favor lenders and borrowers especially in housing, education, and agriculture. Exempt from state and local taxes and from Securities and Exchange Commission regulations and requirements, these enterprises maintain direct lines of credit to the U.S. Treasury that range up to \$4 billion.

There is the Federal Home Loan Bank System that promotes home ownership through the extension of credit to savings and other home financing institutions; the Federal Home Loan Mortgage Association that bolsters the availability of mortgage credit and liquidity in the conventional residential mortgage market; the Federal National Mortgage Association that purchases conventional and privately insured mortgages originated by mortgage bankers, savings institutions, commercial banks, and other primary lenders; the Student Loan Marketing Association that seeks to expand the amount of funds available for insured student loans; the Farm Credit System, which is a co-operative providing credit to farmers and ranchers, their cooperatives, farm-related businesses, commercial fishermen, and rural homeowners. Altogether, the government-sponsored off-budget enterprises are reported to have held \$314.1 billion in loan assets in 1984, \$360.1 billion in 1985, and \$405.9 billion in 1986.<sup>10</sup> At the present rate of growth the GSEs can be expected to achieve a trillion dollar portfolio some time in 1993.

Advancing on its third avenue of escape, making government appear smaller than it actually is or making government activity seem to disappear altogether, the federal government is conducting over 150 loan guarantee programs that affect and redirect private funds. It guaran-

tees the payment of the principal and interest of a loan in whole or in part in the event of default. It thus allocates economic resources by providing credit to borrowers who do not normally qualify or would have to pay higher rates. All such guarantees result in subsidies to the borrowers and significantly alter the allocation of credit. They channel private credit toward Federally selected uses, which reduces the quantity of credit available to those borrowers who do not receive assistance, and increases their interest costs.

Loan guarantees are not included in government outlay totals. Nevertheless, most Federal functions call for credit programs that not only grant loans but also issue loan guarantees. The loans may be off-budget, the guarantees usually are. The Federal Housing Administration guarantees home mortgages as does the Veterans Administration. The Commodity Credit Corporation provides loan guarantees for export sales. The student loan program provides guarantees of education loans to graduate and undergraduate students. Excluding the guaranteed loans disbursed by the Federal Financing Bank and other off-budget enterprises, the total volume of guaranteed loans outstanding is estimated at \$363.8 billion in 1983 and \$438.8 billion in 1986. At this rate of growth it can be expected to exceed one trillion dollars in 1994.<sup>11</sup>

## Flexibility and Innovation

Prudent politicians and OBE officials are unlikely to admit the implications. As public servants imbued with a sense of the public interest, they favor off-budget activities. In their hands OBEs are said to be more flexible, innovative, and economical than government agencies. They may even be used to circumvent voter disapproval expressed repeatedly at the ballot box.

Zeal for the public good is the characteristic of a man of honor. But is it a public good to circumvent the majority decision of voters? Is it a public good to engage in off-budget activity that benefits certain interest groups at the expense of the public? Is it in the public interest that the activities undertaken by OBEs be carried out by political institutions rather than economic organizations? Is government flexibility and innovation in economic matters really a de-

sirable feature of government or just another term for subterfuge, waste, and arbitrariness? And even if an OBE should be more flexible, innovative, and economical than a government agency, why should it be sheltered from periodic reassessment of its performance in either the political arena or the marketplace?

There are two methods for the conduct of human affairs.<sup>12</sup> One is bureaucratic management, the other is profit management. The former is suitable where services have no price on the market and therefore cannot be tested by cost and price calculations. A police department, an army regiment, or an air force squadron, no matter how valuable their services may be, cannot be operated as gainful enterprises. Bureaucratic management is the only method for their conduct. Profit management is the only economical method for enterprises that render services in the marketplace; it receives its social legitimacy from the patronage of customers who dictate the production process. Where the profit motive is the guide, business must adjust its operations to the desires of customers. Profit and loss considerations force every businessman to cater to wishes and render services the consumers deem most important. The price and cost structure guides businessmen in their task.

An OBE is an enterprise owned and operated by government. At its best it springs from the notion that private enterprise is failing to provide a desirable service or that it is providing it unsatisfactorily. At its worst it serves as the private domain of politicians and officials dispensing favors to special groups, politicking with taxpayer money, building political empires, and lining their own pockets. The public may stand idly by because it may be persuaded that individual enterprise is failing to do the job. Moreover, the public may be suspicious of the profit motive, of profit management, and the private property order. Many people are anxious to substitute political action and political authority for voluntary action and consumer supremacy. They are longing for a command system.

Whatever the motivation may be, OBEs manage to escape the strictures and constraints under which government entities usually are forced to labor. There are regulations and controls on government entities because of the open-endedness of government expenditures.

Every able manager of a government agency or enterprise knows how to improve the services of his office through additional expenditures. Every commissioner of police and commander of an army regiment or air force squadron can use more money as can every provost of a state university and director of a city hospital. Every manager of a municipal swimming pool or city park can improve the service to the public provided he is granted more money. Undisturbed by profit and loss considerations he is an ever eager spender of government money. But public funds are limited no matter how they are stretched on- and off-budget. Therefore, government must constrain and delineate the spending enthusiasm of its managers; it must prescribe many details of management, in particular, the quantity and quality of the services to be rendered, the hiring and remuneration of labor, the purchase of materials and supply, and so on. In short, where profit and loss considerations do not apply or are rejected for political reasons, the only way to make managers responsible to the public is to constrain their discretion by rules and regulations.

The flexibility which OBE managers so diligently seek is the ability to escape rules and regulations. It is cleverness to escape the traditional constraints on government. It is "government unlimited" for the construction and maintenance of public housing, libraries, theaters, stadiums, airports, and zoos. OBE flexibility not only reduces the people but also deceives them. After all, OBEs do not submit to any proof of effectiveness nor do they yield to elections and referenda. They operate under no immediate constraints of consumers and no responsibility to voters. When losses are suffered they do not cease to operate. They pursue what they call "more important tasks," "more noble objectives," allocating funds to "worthy" and "needy" causes that differ from the orders given by customers. Economic considerations give way to "social objectives" and self-serving ends.

## Winners and Losers

The "noble objectives" which its sponsors so loudly proclaim usually are economic favors to some people at the expense of others. A trans-

portation OBE may charge a low fare that subsidizes commuters. A community hospital may render services at rates that subsidize some patients at the expense of taxpayers. A city parking authority may offer "free parking" to city employees. It may do so without approval or sanction by taxpayers who are expected to bear the deficits.

Unfortunately, the "noble objectives" may be replaced by commonplace objectives on the part of those individuals who create, manage, and finance the OBEs. The altruistic motive of rendering service to the poor and underprivileged often turns into scandalous pursuit of self-interest by politicians, OBE boards and managers, employees, bankers and underwriters, attorneys, consultants, architects, engineers, and many others who profit from OBEs. The transfer benefits thus accrue to interested parties and promoters, leaving few benefits but many frustrations to the stated beneficiaries.

Politicians are the primary beneficiaries of OBEs. Fiscal limitations of any sort restrict their power to engage in transfer activity; OBEs evade the restrictions and ignore voter reluctance at the polls. By making political activity seem to disappear and permitting politicians to resume spending, OBEs enable them to preach fiscal frugality on-budget while practicing political largess off-budget.

OBEs inevitably give rise to special-interest groups that can be depended on to lend vocal support. Bankers, in particular, have a vested interest in the growth of off-budget enterprises, receiving income not only as investors in OBE projects but also as trustees on behalf of bondholders and as financial advisers to the entity. Bankers may act as underwriters of bond issues which OBEs, in contrast to government agencies, usually place on a noncompetitive basis, granting higher profit margins to underwriters. Attorneys always join the parade, acting as "bond counsels." They derive generous income from reviewing indenture specifications and issuing opinions on the deductibility of bond interest from Federal taxation. Their fees tend to rise with the volume of debt issued.

OBE managers and members of the board have a vested interest in OBE prosperity and growth. Appointed by a governor, mayor, or city council, *directors* have ample latitude to

pursue their own self-interest. They may engage in business activity that directly supplements that of the OBE. They may speculate in real estate in anticipation of OBE activity. They may manipulate OBE contracts or place supporters in patronage positions. At the least, they may guide OBE dealings in such a way that friendly politicians and their supporters derive some benefit from the enterprise.

OBE *managers* who direct the day-to-day operations usually operate in secrecy and undisturbed by audits by the government entity that created the OBE. However, the managers are ever mindful of the politicians to whom they owe their jobs and, therefore, are quick to accommodate political pressures by providing patronage positions. If an OBE succeeds in generating revenue to cover its operating costs and debt service and thus manages to be financially independent, the excess revenue is held internally to be used by management. OBEs pay no taxes or license fees, post no performance bonds, face little paperwork and regulatory tape that strangle individual enterprise. They pay no dividends to the sponsoring unit of government, but usually earn enough to grant generous fringe benefits to managers and employees.

## The Burden on Taxpayers

When OBEs fail to cover their costs, taxpayers must brace for a summons. The number of OBE bankruptcies is rather small because politicians cannot afford to let their projects fail and their artifices to become visible. They are quick to use tax revenues to provide government subsidies and grants to avoid default. Although there is no explicit commitment for government to come to the rescue, there is what politicians call a "moral commitment" to cover a shortfall. It serves to reassure investors who are urged to buy the bonds. Judging from the ready acceptance of OBE obligations, American bankers and other institutional investors continue to be reassured by such "moral commitments."

Taxpayers must bear, in one form or another, the cost of OBE loss and failure. But even when OBEs manage to operate in the black, they crowd out competing borrowers and allocate capital and labor to political uses rather than to

economic employment. They withdraw scarce economic resources from urgent want satisfaction so that political interests can be served, and channel capital from more productive to less productive employment, which depresses labor productivity and lowers labor income. No matter how efficient an OBE may be, it amounts to malinvestment and maladjustment because it is a creation of politics. After all, if an economic project is expected to be economical and profitable because consumers will patronize it, it will be developed by individual enterprises. If businessmen shun it and private investors avoid it, it is likely to be uneconomical.

A few OBEs are said to be highly profitable, which may permit their managers to embark upon other economic activities. Toll road and bridge authorities may be very profitable, charging whatever the traffic will bear. The Port Authority of New York, for instance, is using its control over airports, bridges, toll roads, and harbor facilities to build a vast business empire. But some of its revenue constitutes monopolistic gain that enriches the Port Authority and its dependents at the expense of the public. This leads to poor service and breeds political corruption. But even in service, honor, and integrity, a profitable OBE is a malformation that rests on political privilege. Exempted from taxes or license fees, and protected by regulation and restriction, it serves "higher ends" which are uneconomical ends. It receives its legitimacy from political power rather than the patronage of customers.

## Industrial Development Agencies

The businessman's "special" is the industrial development agency (IDA) that issues tax-exempt industrial revenue bonds (IRBs) and finances favorite private enterprises. IDAs are the fastest growing type of all the OBEs and are estimated to exceed \$10 billion in annual bond sales. Most of them issue obligations without the "full-faith-and-credit" of the sponsoring government; their operations are off-budget and beyond the reach of voters and taxpayers. Their obligations are non-guaranteed, that is, they depend on the credit of the private borrower and the revenue from the development project. If

the project fails, the bondholders bear the loss. If it stays alive, the private borrower pockets the difference between the tax-exempt rate and the market rate of interest. He is enjoying a privilege that is created and bestowed by politicians.

The friends of IDAs are quick to point out that the agencies are instrumental in providing financial resources to private firms, especially small businesses, that they facilitate production where there would be none otherwise, that they raise productivity and reduce unemployment. IDAs are said to confer a "public benefit" through the development of commerce and industry and the promotion of the general welfare. Of course, such rhetoric builds on the assumption that private financial institutions are failing to provide the necessary resources to many firms, especially small businesses, that private lenders fail to encourage production where it is needed, and that they do not raise productivity and do not reduce unemployment. IDA rhetoric tacitly assumes that private enterprises do not confer a "public benefit" and do not promote the general welfare.

Unfortunately, the rhetoric differs from the reality. Every businessman enjoying customer patronage, whether he be a baker, banker, or barber, is conferring a public benefit, raising production, and reducing unemployment; businessmen earn their livelihood by producing products and rendering services wherever they are needed. Countless entrepreneurs are forever searching for new opportunities to embark upon needed production. If they find none, it is likely that no economic opportunity exists. If politicians discover an "opportunity," the project is likely to be a transfer scheme that benefits some people at the expense of others. Transfer allocation replaces market allocation, serving political interests that are contrary to the interests of the general public.

IDAs often assist ailing and failing businesses that either are losing the patronage of customers or making inefficient use of their resources. In both cases IDAs not only countermand consumer sovereignty, that is, public interest and control, but also promote economic inefficiency and incompetence. Moreover, by granting tax exemptions to special-interest groups, IDAs create vocal groups of grateful supporters who

can be depended upon to defend and promote IDAs and the use of IRBs. Small businesses are not among the supporters; they are the least likely recipients of IDA largess because their voices may not be audible in the noise of corporate clamor for privilege. Giant corporations that have the labor power to deal with numerous IDAs, that enjoy expert legal assistance, and command political clout, are the primary beneficiaries of IRB financing.

Large manufacturing and retailing firms make extensive use of IRBs to finance expansion projects. In fact, because McDonald's Corporation financed the construction of hundreds of new restaurants with IRBs, IDA obligations are frequently called "burger bonds" and their beneficiaries are referred to as "burger debtors." Obviously, "burger bonds" are instrumental in destroying countless small enterprises that cannot compete with subsidized McDonald's restaurants or K-Mart stores. The voices of the businesses that perished as a result of burger-bond favors are no longer audible, but the voices of the giant corporations, investment bankers, and law firms that benefit from IRB sales, are heard clearly in the chorus of special interests.

The net effect of IRB finance is a gross distortion of American business and outright waste of productive funds. IDA projects inflict revenue losses on governmental treasuries, and lead to rising interest rates and higher borrowing costs for all borrowers, public and private. But above all, they call for further politicalization of economic life. On all levels of government, party politicians and government officials now sit in judgment of economic phenomena. Local politicians adjudge the need of a project and adjudicate the benefits to be bestowed. Federal officials, by offering or withdrawing Federal tax exemption, hold veto power over them all. The Revenue Expenditure and Control Act of 1968 provides the legal setting; it withdrew tax exemption from all IDAs except those financing air and water pollution control equipment, airports, docks, wharves, electricity, gas and water services, industrial parks, parking, mass transportation, housing, sewage, sports facilities, and trade shows and convention centers. The act offers tax exemption to all issues not exceeding \$5 million to finance plants and

equipment for industrial facilities, which was later raised to \$10 million.<sup>13</sup> It is obvious that American economic life is molded and guided by such powerful directives. But it is neither efficient nor equitable to grant tax relief to some businesses and withhold it from others.

Political power intoxicates the best hearts. No man is wise enough, nor good enough, to be trusted with much political power. Constitutional government is built on this very knowledge; it is cogent evidence of the distrust of human beings in political power. It rests on a deep conviction that individuals vested with authority must be restrained by something more than their own discretion—by bills of rights, laws, rules, regulations, and mandates by the people they govern.

Off-budget government escapes most such restraints and opens the gates of political power. It escapes the constraints because changing thoughts and values are either moderating the common distrust of political power or the distrust is failing to restrain the growing powers of government. The deep conviction that government must be restrained is giving way to the belief that government must be able to engage in any economic activity its agents deem necessary. It is yielding to the ancient notion that political rulers are endowed with extraordinary powers. Unfortunately, they are not. But they are ever eager to ignore the traditional constraints and follow their own caprice. □

1. Cf. James T. Bennett and Thomas J. DiLorenzo, *Underground Government: The Off-Budget Public Sector* (Washington, D.C.: Cato Institute, 1983), p. 4 *et seq.*

2. Pennsylvania Department of Community Affairs, *Directory of Municipal Authorities in Pennsylvania—1984* (Harrisburg: Department of Community Affairs, 1984), Statistics, pp. 9-11.

3. *Facts and Figures on Government Finance*, 23rd edition (Washington, D.C.: Tax Foundation, 1986), p. f29. Data as of the end of fiscal year 1983.

4. *Ibid.*

5. *Ibid.*, p. e61. Data as of the end of fiscal year 1983.

6. James T. Bennett and Thomas J. DiLorenzo, *ibid.*, pp. 60-68.

7. New York is followed by California with a state debt of \$12 billion, New Jersey \$10.3 billion, Illinois \$7.8 billion, Massachusetts \$7.4 billion. *Facts and Figures on Government Finance*, pp. e62, e63.

8. *Budget of the United States Government*, Fiscal Year 1986, pp. 6-11.

9. *Special Analyses, Budget of the United States Government*, Fiscal Year 1986, p. F-42.

10. *Special Analyses*, p. F-23.

11. *Special Analyses*, p. F-20.

12. Cf. Ludwig von Mises, *Bureaucracy* (Spring Mills, Pa.: Libertarian Press, 1983).

13. James T. Bennett and Thomas J. DiLorenzo, *ibid.*, p. 125.

# Socialism and Incentives

by David Osterfeld

One of the major issues of socialism is that of incentives. Critics often argue that because it "abolishes" profits and losses, socialism eliminates incentives. Defenders maintain that since it eliminates the role of capitalists and entrepreneurs, workers under socialism "produce for themselves." Therefore, it is held, socialism actually maintains or even stimulates incentives.

The issue of incentives is vitally important. But the traditional way of presenting this issue is misleading. The real issue is not the presence or absence of incentives, *per se*. Incentives cannot be eliminated. They are omnipresent. Every politico-economic system generates a set of incentives. The real issue is whether a particular set of incentives is "right" or "wrong," i.e., whether it is appropriate to attain the goals sought or claimed for it by those implementing the political and economic policies.

## The Record

The goals of both socialism and capitalism are identical: prosperity and freedom. This identity of goals makes a comparison of their performances relatively easy. The differences are indeed striking. Socialist systems have compiled an uninterrupted record of economic failure and political oppression.

The Soviet Union contains some of the most fertile agricultural land in the world. Prior to the communist revolution of 1917 Russia was

the world's largest exporter of grain. Collectivization of agriculture during the 1920s and 1930s was quickly followed by dramatic declines in agricultural output. Between five and ten million Russians died of starvation during these years with twelve to thirteen million more saved by food donated from the Western capitalist countries. Today, the Soviet Union employs nearly 25 per cent of its labor force and invests in excess of 25 per cent of its capital in agriculture, both of which are far higher than any other industrialized country. Despite its tremendous agricultural potential, the Soviet Union is now the world's largest food importer. It now imports nearly one-third of its food, and this is despite having grudgingly permitted the establishment of private mini-farms one-half to one acre in size. These private plots comprise only three per cent of the total cropland yet produce 27 per cent of the nation's food. It is unlikely that the Soviet Union could exist without these plots.<sup>1</sup>

This pattern is repeated with monotonous regularity throughout socialist countries. Most of the Eastern European nations are blessed with fertile agricultural land. The adoption of socialist policies in most of these countries has been quickly followed by declining production, food shortages, and bread lines.<sup>2</sup>

Agricultural output in China was virtually stagnant during the 25-year reign of Mao Tse-tung. The Chinese government now acknowledges that during just one three-year period, the so-called "Three Difficult Years" from 1959-62, between 20 and 30 million Chinese died of

*David Osterfeld is Associate Professor of Political Science at St. Joseph's College in Rensselaer, Indiana.*



starvation. By the time of Mao's death in the mid-1970s the average Chinese was less well fed than he was during the 1920s or even during the Japanese occupation of the 1930s. Beginning in 1977 Mao's successors abandoned his "socialist experiment." As a result, says *The Economist*, "food grain output has increased by 12 per cent a year since then, despite bad weather in 1980."<sup>3</sup>

Out of a population of only eight million, two million Cambodians died of starvation in the late 1970s after socialist measures were applied to agriculture by the Khmer Rouge.

In 1957 Ghana became the first African country to receive its independence, quickly followed by a number of others. At the time of independence famine had become a thing of the past in Africa. Yet within a few years the continent was being ravaged by perennial famines. Millions were dying from starvation or diseases associated with malnutrition. Once again, the correlation is striking.

Ghana, as Sven Rydenfelt notes, "is one of the world's best endowed countries: fertile soil, ample rainfall, and a favorable climate. . . ." At the time of independence it was the world's leading producer of cocoa. But after President Kwame Nkrumah adopted what he termed "African socialism" Ghana's cocoa production declined by 50 per cent. Similar production declines occurred in other crops such as cassava.

Like Ghana, much of Ethiopia is ideally suited for agriculture. "Ethiopia is one of those countries so richly endowed by nature," agronomist Doreen Warriner wrote in 1973, "that the agrarian structure, feudal in every sense of the term, does appear to be the only constraint on development."<sup>5</sup> In March 1975 the feudal period ended; "Ethiopian socialism" began. But instead of development, agricultural performance, poor to begin with, deteriorated rapidly. It is now well established that over one million Ethiopians have died of starvation in the most recent famine.<sup>6</sup>

And in Tanzania President Julius Nyerere began to collectivize agriculture in 1967. A food exporter in the late 1960s, Tanzania imported \$18 million worth of food in 1980 despite the fact that nearly 70 per cent of its population was engaged in agriculture.<sup>7</sup>

In marked contrast to the socialist countries

of the world which almost invariably find themselves on the verge of starvation despite employing between 25 and 90 per cent of their workforce in agriculture, the more capitalist countries of Western Europe and North America are able to produce huge food surpluses while employing only three to four per cent of their work force in agriculture.

A brief overview of the data reveals a clear correlation between economic systems and economic performances: socialist economies have performed poorly; capitalist economies have performed quite well. The correlation is much too strong to be attributed to mere chance. To understand this correlation we need to examine the very different incentives generated by the two economic systems, and then look at how individuals would be expected to respond to these different sets of incentives.

## The Incentives

Assume that an individual, Clem, is a member of a socialist commune. Assume that there are 1,000 members of the commune and that the output is divided equally among the members. (For the sake of simplicity we will ignore matters such as capital investment.) Let's say that the production of the commune totals 100,000 bushels of wheat a year, or an average of 100 bushels per member. At a price of, say, \$5.00 per bushel total receipts for the commune are \$500,000, or \$500 per member. The question is: How is Clem likely to behave? Will he work hard? Will he shirk?

Let's assume that Clem is both naturally industrious and socially conscientious. He is concerned about the overall good of the commune. As a result, Clem works very hard and increases his production from 100 to 150 bushels of wheat a year. This increases the annual output of the commune from 100,000 to 100,050 bushels. At \$5.00 per bushel the income of the commune increases from \$500,000 to \$500,250. Since total income is divided equally among the members, the income of each member rises from \$500 to \$500.25 a year. Thus, because of his extra work Clem's production increased 50 per cent. But his income increased by a mere 25¢ or by 0.05 per cent. Moreover, the income of the other 999 members also in-

creased by 25¢ even though they did not work any harder and their productivity did not increase.

Clearly, Clem's activities benefited everyone in the commune *except himself*. Everyone else had his income increase without increasing his work. But Clem's income increased only 25¢ despite increasing his work load by 50 per cent. While the *benefits* of the extra production were *diffused* throughout the commune, the *costs* were *concentrated* on Clem. Given the distributional policies of the socialist commune it is clear that Clem's decision to increase his work was "irrational," and it is highly unlikely that he would continue his Stakhanovite exertions, thereby subjecting himself to continued exploitation by the other members of the commune. In short, *the distributional policies of socialism penalize industrious behavior*.

Deeper insight into socialist incentives can be obtained by looking at the situation from a different angle. Assume that the conditions of the commune are the same as described above. But now assume that instead of increasing his production Clem begins to slough off, to shirk. Assume that he cuts his production from the average of 100 bushels a year to only 50. What are the effects? The total output of the commune drops from 100,000 bushels to 99,950 bushels. Its total receipts therefore fall from \$500,000 to \$499,750. As a result each member's income declines by 25¢, from \$500 to \$499.75. Yet, they have not, we are assuming, reduced their work loads. Clem's income is also reduced 25¢. But he has cut his work load in half. This is a great deal for Clem! He has obtained a 50 per cent increase in leisure at a cost to himself of only 25¢, or a 0.05 per cent reduction in income. In short, since the *cost* of Clem's shirking is *diffused* among all the members of the commune while the *benefits* are *channeled* to Clem, socialism creates a strong incentive to shirk. The problem, of course, is that there is no reason why this is limited to Clem. It applies with equal force to all members of the commune. But if all members shirk, little or nothing will be produced and the commune will quickly find itself in dire straits.

The basic problem of socialism is the imbalance or asymmetry it creates between costs and benefits. At times the costs are diffused

throughout the entire community while the benefits are concentrated on one or a few members. At other times it is the costs that are concentrated while the benefits are diffused. The result is that socialism, *by its very nature*, rewards sloth and indolence and penalizes diligence and hard work. It therefore establishes incentives that are incompatible with its self-proclaimed goal of material prosperity. The inherent dilemma of socialism is that individuals who respond "rationally" to the incentives confronting them will produce results that are "irrational" for the community as a whole.

## The Solution

The solution to the dilemma of socialist incentives lies in what economists call "internalizing the externalities," i.e., making sure that *both* the costs and benefits of individual actions are borne by the individual and do not spill onto "society" as a whole. There are two distinct methods by which this can be accomplished: private property or coercion.

Assume that instead of living in a commune Clem lives in a market society and owns his own farm. If Clem would increase his production, just as he did in the commune, from 100 to 150 bushels, he would receive the full benefit of the additional output. The result, again assuming \$5 per bushel, is that Clem's income would increase not by a mere 25¢ but by \$250, going from \$500 to \$750 per year. Conversely, by reducing his production from 100 to only 50 bushels, Clem's income would fall not by 25¢ but by \$250, dropping from \$500 per year to only \$250. Thus, private property automatically "internalizes the externalities," i.e., it channels both the costs and the benefits of each individual's actions onto that particular individual. In doing so it creates incentives that automatically penalize indolence and reward hard work and productivity. These are the exact opposite of the incentives generated by socialism.

To permit private property would be to acknowledge the failure of socialism. As a result, socialist systems have allowed private property only grudgingly and on a very restricted basis. Rather than admit failure socialists have usually opted for the other means to internalize externalities: coercion. To counteract the incentive

to shirk, the socialist rulers can establish production quotas for Clem and the other members of the commune and then threaten them with penalties for failure to meet the quotas. Since coercion will stimulate production only if the penalties are severe enough to counteract the incentive to shirk, socialism must reduce the population to virtual slavery. But even if coercion does stimulate production the increase will be far less than under private property. Since it insures that each producer will receive the total value of his production, private property provides the incentive to *maximize production*. Coercion, on the other hand, is only able to establish the incentive to produce the *minimum required* to avoid punishment. It is no accident that socialism ends up enslaving its workers. Nor is it an accident that free men have always been more productive than slaves.<sup>8</sup>

Socialism promises prosperity and freedom. But the incentives created by socialism place it in a dilemma. If the workers are allowed to remain "free," they will not produce. To stimulate production they must be denied their freedom. Thus, socialism cannot achieve *both* prosperity *and* freedom. Usually it results in neither. □

1. See Sven Rydenfelt, *A Pattern for Failure* (New York: Harcourt, 1983), pp. 27-45; Hedrick Smith, *The Russians* (New York: Ballantine, 1984), pp. 264-84; and Marshall Goldman, *USSR in Crisis* (New York: Norton, 1983), pp. 63-87.
2. Rydenfelt, pp. 46-79.
3. "In Praise of Peasants," *The Economist* (February 2, 1985), pp. 86-87. Also see Stephen Mosher, *Broken Earth* (New York: Free Press, 1983), pp. 28-52. Especially see pages 37-45. Mosher quotes a Chinese peasant as saying that "People aren't lazy all the time, just when they do collective labor. When they work on their private plots, they work hard. There is a saying, 'Energetic as dragons on private plots, sluggish as worms on the public fields.'" "
4. Rydenfelt, p. 113.
5. Quoted in Gene Ellis, "Land Tenancy Reform in Ethiopia: A Retrospective Analysis," *Economic Development and Cultural Change* (April, 1980), p. 526.
6. See David Osterfeld, "Famine in Africa," *The Journal of Social Political and Economic Studies* (Fall, 1985), pp. 259-74.
7. *Ibid.*, pp. 265 and 269; and Rydenfelt, pp. 117-24.
8. Two points are worthy of note. First, the reliance on devices such as "workpoints" has been ignored. To the extent that they work they constitute a clear violation of the principle of egalitarianism that permeates socialist literature. Moreover, since "workpoints" are a reflection not of the preferences of the consumers but of the socialist ruler(s)' opinion of the value of one's contribution, "workpoints" are not only economically arbitrary but also reinforce the concentration of political power in the hands of the rulers. Second, the problem of incentives is not the sole reason for the poor performance of socialist economies. The related problem of economic calculation is also vitally important. On this issue see Ludwig von Mises' classic *Socialism* (London: Jonathan Cape, 1969); Don Lavoie, *National Economic Planning: What Is Left?* (Cambridge: Ballinger, 1985); and David Osterfeld, *Freedom, Society and the State* (San Francisco: Cobden Press, 1986), pp. 221-30.

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# The Forgotten Dream

by John K. Williams

**I**n the biblical book of *Daniel* is a story about a king who dreamed a dream so disturbing that it wakened him from his sleep. Bewildered and troubled by his dream, the king decreed that his advisers be aroused and brought before him. The advisers were assembled, the signal for silence was given, and the king rose to his feet.

"I have dreamed a dream," announced the king, "and my spirit was troubled to know the interpretation." Then silence again reigned.

One person, bolder than the rest, broke the silence. Said he: "O king, live for ever! But tell thy servants the dream, that we may show the interpretation."

All eyes turned to the king. The expression on his face changed. Those present sensed that something was strangely amiss. At long last the king again spoke. "I forget," he said. "The thing has gone from me."

The king, however, soon regained his composure. He instructed his advisers first to recover the lost dream and then to interpret it!

Men and women today who are committed to liberty face a task not unlike that thrust upon those royal advisers of old: the recovery of an all-but-forgotten dream. That dream, the dream of liberty and a social order fostering liberty, is perhaps as old as humanity. It found voice in the seers of ancient Israel and the thinkers of ancient Greece. It spoke at the signing of Magna Carta which made the rights of kings subservient to law and again in 1689 when the

English Bill of Rights proclaimed that Parliament must also be so subservient. It was heard in the measured reasoning of John Locke and in the impassioned writings of the poet John Milton, who declared: "Our liberty is a blessing we have received from God himself. It is what we are born to. To lay this down at Caesar's feet were a degrading of our very nature."

The dream of liberty lured the Pilgrim Fathers to venture the Atlantic for a new and unspoiled land, placing their confidence in the dream and their own power to make that dream come true. It captured the hearts of the multitudes in this land; for years before the American Revolution was fought a veritable flood of tracts and books and letters and newspaper articles made real to the people the great principles of liberty, human rights, and limited government. It thundered in a Declaration of Independence which in its substance far exceeded its title, in a Constitution which built security amid the portents of catastrophe, and in a Bill of Rights which was the consummation of what began with Magna Carta—all men and women being perceived as the servile subjects of no one, certainly not of a government they themselves had made.

Thus a nation "conceived in liberty" was born. The dream had taken on flesh and blood, and a free people began to enjoy the material fruits of liberty.

Yet let me underscore the truth that for most of human history, liberty existed only as a dream. The free society, from the perspective of history, is an abnormality, a departure from the submission and tyranny which has been the normal lot of the human race. It is therefore, perhaps, not surprising that men and women en-

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*The Reverend Doctor John K. Williams has been a teacher and is a free-lance writer and lecturer in North Melbourne, Victoria, Australia. He was resident scholar at FEE this past summer.*

joying the reality of liberty and its fruits should revert to the old and established ways, forgetting the dream—the ideas and ideals—of which the reality was born.

Yet such has most certainly happened. Free societies have departed from the dream that gave them birth, drifting back to the old authoritarian world of caste, of legally entrenched privileges, and of an economic system coordinated by political decrees. Sadly, many who sense that a once free people have departed from the principles which secured their liberty and furthered their material well-being cannot really say what those principles are. When asked to tell of the dream enshrining those principles they can only respond as did the king of old: “I forget. The thing has gone from me.” Hence the task that is ours: recovering an all-but-lost dream.

Ideas and ideals—dreams if you will—are fragile and fleeting. It may thus sound extravagant to suggest that such down-to-earth and concrete realities as political and economic structures can be born of ideas and ideals and, indeed, be destroyed by ideas and ideals. Yet I submit that a reading of history, both of the distant past and of more recent years, substantiates such a claim. John Maynard Keynes, on this matter at least, was correct. His words warrant repetition: “The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economists. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back . . . [S]oon or late, it is ideas . . . which are dangerous for good or evil.” If we would defend liberty against its enemies, we must seek to recover for ourselves and for others the all-but-forgotten dream of which the free society was born.

## Democracy

Perhaps the most invidious expression of our forgetfulness is our equation of the “free society” with “democracy.” It is perhaps helpful to

remind ourselves of the singular lack of enthusiasm for “democracy” displayed by the Founding Fathers of this nation.

Consider the words of James Madison: “[D]emocracies have ever been spectacles of turbulence and contention; have ever been found incompatible with personal security, or the rights of property; and have in general been as short in their lives as they have been violent in their deaths.”

Samuel Adams was no less suspicious of democracy: “Remember, democracy never lasts long. It soon wastes, exhausts, and murders itself. There never was a democracy that did not commit suicide.”

Many similar statements could be cited, drawing on the words of those who made liberty a reality in this nation, and their forebears and contemporaries in the struggle for liberty from the Old World. “Democracy” was not the name of the dream they struggled to make a reality: Indeed, they perceived a very real tension between “democracy” and the goal for which they fought.

“Democracy” is a word with a long history. It looms large in *The Republic* of Plato and the political writings of Aristotle. Historically speaking, it signifies a particular answer to a very specific question: “Who shall be entrusted with the coercive power of government?” Shall that power be entrusted to an absolute monarch? To an aristocracy? To a plutocracy? To the majority of the populace? These are questions which exercised the minds of those who through the ages dreamed of liberty.

Yet such thinkers realized that these questions were secondary to the crucial question of *what power should be ascribed to government*, regardless of who exercised that power. The great cry of those who dreamed of a free society was not that majority rule was desirable, but that tyranny was intolerable, be the tyranny that of a king despotically ruling his subjects or that of an aristocratic class despotically ruling their alleged inferiors or that of a majority despotically ruling a minority.

If by “democracy” one signifies simply majority rule, there is no answer to the claim of James Madison that “on a candid examination of history” we shall find democracies characterized by “turbulence, violence, and abuse of

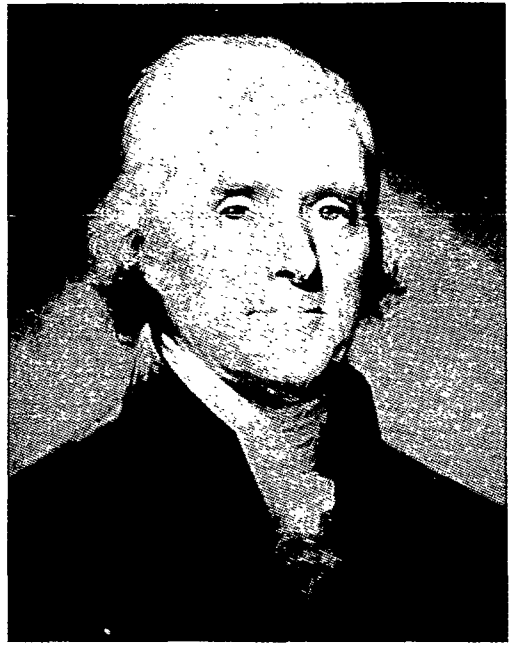
power by the majority trampling on the rights of the minority." Thus it was that Thomas Jefferson, discussing the powers of legislatures in Virginia, reminded his fellow-citizens that "[an] elective despotism was not the government we fought for." To make the same point another way, the Founding Fathers and the thinkers whose works they built upon perceived that the words "despotism" and "tyranny" can only be defined in terms of the purposes for which force and the threat of force may be used by government. Specifying the identity of those who exercise the power of government says little or nothing about the purposes for which and circumstances in which that power may legitimately be used.

Those who dreamed of liberty and sought to make that dream come true were essentially agreed as to the function of government and thus as to the proper domain of government activity. "Governments are instituted among Men" to secure the equal liberty of all to formulate and strive to realize their own visions of the "good life." The equal liberty of all precludes any attempt to realize such a vision by coercive violence. The proscription of such violence, the protection of individuals from any person or group of people initiating or threatening to initiate such violence, is the task of government. And that is all.

The seriousness with which this insistence once was taken is perhaps illustrated by Alexander Hamilton's objections to the Bill of Rights: "I . . . affirm that bills of rights, in the sense and to the extent in which they are contended for, are not only unnecessary in the proposed Constitution but would even be dangerous . . . . For why declare that things shall not be done which there is no power to do? Why, for instance, should it be said that the liberty of the press shall not be restrained, when no power is given by which restrictions may be imposed?"

## The Purpose of Government

Our forefathers in the struggle for liberty were well aware that force is the essence of government. What is distinctive about the classical liberals' understanding of government is the insistence that the sole legitimate purpose for which governments may exercise coercion



*Thomas Jefferson*

is the protection of individuals from coercion. Should any government use its powers to promote one group at the expense of another, then that government becomes, in Frederic Bastiat's words, an agency of "legal plunder." Its edicts become a perversion of law, for the law, "instead of checking injustice, becomes the invincible weapon of injustice."

Whether these edicts enjoy majority approval is irrelevant. Indeed, from the perspective of the classical liberals, to describe as "government under the law" the directives issued by elected representatives of the majority, however much these directives discriminate in favor of special interest groups, is to torture language. Such constitutes not "government under the law" but "lawless government."

When I insist that the question, "For what purpose and in what circumstances is the coercive power of government appropriately used?" is distinct from the question, "Who should exercise that power?" I am not implying that the latter question is insignificant, or that an answer to this question in terms of democracy is to be rejected. What has failed to protect the liberties of all is not democracy as such but a particular form of democracy, namely, "unlimited democracy." You may recall a much admired utterance of Sir Winston Churchill:

"Many forms of government have been tried, and will be tried in this world of sin and woe. No one pretends that democracy is perfect or all-wise; indeed it has been said that democracy is the worst form of government except all those other forms that have been tried from time to time."

That utterance troubles me. It suggests that the only choice we have is between democracy as today we know it—unlimited democracy—and no democracy at all. Yet in truth another choice is available, a choice between *different kinds of democracy*. A town-hall, participatory democracy will not generate the same rules as does a centralized, representative democracy. A democratically elected government of men and women who are, in Jefferson's phrase, "tied down from mischief by the chains of the Constitution"—a Constitution limiting the powers of government to the protection of individuals from arbitrary aggression—cannot be identified with the "unlimited democracy" of rule by whatever decrees happen to enjoy the approval of the majority.

Those of us committed to liberty can, I think, take heart from the fact that many of our fellow citizens today sense that something has gone terribly wrong with government. Numerous voices have been raised deploring the "war of all against all" that has accompanied departures from the rule of law, understood as rule by known, nonarbitrarily enforced general principles of just conduct equally applicable to all, in favor of rule by edicts advantaging some and disadvantaging others.

Ordinary people have seen the inevitable consequence of such departures. On the one hand, they see the emergence of well-organized special interest groups warring against each other in their attempts to exchange votes for legislative favors. On the other hand, they note the desperate attempts of politicians both to identify and satisfy a cluster of such groups so as to achieve re-election—and to expand the market for their services by legislative measures creating new special interest groups.

Many people likewise have sensed and resented the eroding of their individual liberty and the decline in their real standard of living that have accompanied the growth of big and intrusive government, and have unambiguously

signaled that they are tired of creating by their own efforts goods and services consumed by the beneficiaries of big government. We can take heart from this growing grassroots suspicion that big government is the cause rather than the solution of many of the problems we face, and from the growing number of economists crying out for increasing deregulation of the sadly fettered market we know today.

Yet while we can properly take heart, our task takes on an increased rather than a lessened urgency. A disquiet over symptoms must be linked to an informed perception of root causes. Anger directed at particular beneficiaries of governmental coercion must be coupled with an understanding that the moment one permits government to favor some people at the expense of others, the question of which groups are to be favored and which are to be coercively frustrated becomes a numbers game and nothing more. The only way to stop political plundering is to renounce all government favors.

Ideally, the locus of indignation should be a government interfering with the noncoercive exercise of any individual's autonomy, but maybe the more pragmatic point constitutes at least a starting point. Our task, in short, is to recover and remind both ourselves and our fellow citizens of an all but forgotten dream proclaiming that democracy is not enough, and that alongside the question as to who exercises the power of government goes the more important question as to what that power should be, regardless of who exercises it.

## Property Rights

If the most invidious departure from the dream which gave birth to the free society is the equation of the free society and a "democratic society," then the contemporary tendency to disparage and undermine both the idea and the reality of private property rights must come a close second.

The institution of private property rights was crucial in the thinking of those who for centuries kept alive the dream of a free society and of those who made the dream a reality. David Hume in his great *Treatise of Human Nature* (Book III, Part II, Section II) succinctly states what many in the classical liberal tradition said

before him and have said since: "No one can doubt, that the convention for the distinction of property, and for the stability of possession, is of all circumstances the most necessary to the establishment of human society, and that after the agreement for the fixing and observing of this rule, there remains little or nothing to be done towards settling a perfect harmony and concord."

Certainly the Founding Fathers had no doubts as to the crucial importance of private property in a free society. The Virginia Bill of Rights opens thus: "That all men are by nature equally free and independent, and have certain inherent rights, of which, when they enter into a state of society, they cannot, by any compact, deprive or divest their posterity; namely the enjoyment of life and liberty, with the means of acquiring and possessing property, and pursuing and obtaining safety and happiness."

Today the institution of private property is very much under fire. The doctrinaire socialist and, indeed, the collectivist anarchist, perceive in private property the fundamental source of all social ills, agreeing with Jean Jacques Rousseau (a thinker whose destructive influence is unwisely overlooked by many defenders of liberty) who wrote:

"The first man who, having enclosed a piece of ground, bethought himself of saying, 'This is mine,' and found people simple enough to believe him, was the real founder of civil society. From how many crimes, wars, and murders, from how many horrors and misfortunes might not anyone have saved mankind, by pulling up the stakes, or filling up the ditch, and crying to his fellows: 'Beware of listening to this impostor; you are undone if you once forget that the fruits of the earth belong to us all. . . .'" (*Discourse on Inequality*, Part II)

Yet it is not so much the doctrinaire socialist whose attitude on private property rights should most concern us. Indeed, in one way I warm to these opponents of liberty, for they correctly perceive that in opposing individual liberty and the free society they must tackle the institution of private property head on and oppose that institution utterly. In a perverse way, such thinkers can help our cause, in that they make a well argued case for holding that the abolition of individual liberty and of the free society de-

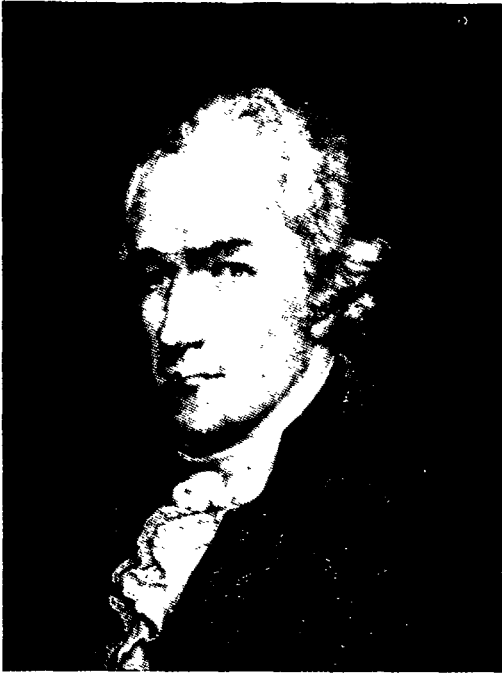
mands the abolition of private property rights.

More pernicious, in my judgment, are those who do not regard the institution of private property as important enough to warrant a head-on attack. At best, such people are prepared to acknowledge that private property rights are of limited value; for the most part they rarely think about such rights at all. This mentality displays itself in slogans slapped on cars which read, "Human rights before property rights!" and in documents such as the U.S. Catholic Bishops' pastoral letter on the U.S. economy, which in its draft form did not contain one reference to property rights, even though the word "rights" was tossed about like confetti.

In truth, however, the contrast between "human rights" and "property rights" is utterly vacuous. Property rights are human rights—the rights of men and women to determine how material things are used. The slick little slogan, "Human rights before property rights" depends for its effectiveness upon the mental picture it evokes: here are people with their hopes and fears, their loves and hates, their joys and sorrows; over there are dead and lifeless things. "Caring" human beings who speak of "human rights" concern themselves with the "people side" of the disjunction; Scrooge-like human beings who speak of "property rights" concern themselves with the "things side." A moment's thought should be sufficient to remind one that human beings are at least in part material beings whose physical survival depends on the use they make of material things, and hence that the right of people to determine the uses to which things are put is a singularly important human right.

Indeed, as Murray Rothbard has repeatedly pointed out, "human rights" unrelated to material realities signify nothing at all. For example, to be informed that one enjoys a "right" to free speech, but that one is not legally permitted to acquire a space one may fill with sound waves, is to be told one does *not* enjoy a "right" to free speech. To be told a given society respects the "right" to a free press, but that the purchase or borrowing or begging of paper, ink, or any sort of printing machine is forbidden, is to be told that the society in question does *not* respect the "right" to a free press. To proclaim that indi-





*Alexander Hamilton*

viduals have a "right" to life, but no "right" to seek and acquire food or shelter, is to proclaim that individuals do *not* have a "right" to life. "Human rights" that are not fleshed out in terms of the "rights" of people to control and use material things signify little or nothing.

Before going further, I should, perhaps, underscore that to assert that a person has a "right" to do X or to own Y, does not mean that he or she will successfully do X or successfully acquire Y. To say, for example, that someone has a "right" to own a watch is simply to say that he may engage in peaceful activities so as to acquire a watch, and that if successful, he is not obligated to surrender that watch. This "right" generates the purely negative obligation of other people to not coercively prevent this person from engaging in noncoercive actions to acquire a watch, and not coercively to make him surrender a watch so acquired. There is no "positive right" in the sense of some guarantee of being the possessor of a watch and certainly no positive obligation of someone to create a watch and surrender it to someone else. Simply, the "right" to property is negative.

The notion of some mysterious "guarantee" that all will succeed in their endeavors to acquire material goods, and the attendant obliga-

tion upon some individuals to create and surrender goods for the use of others, is no part of the age-old dream of individual liberty and the free society.

At the same time, it should be noted that a society respecting private property rights dramatically increases the probability that an individual will succeed in realizing his or her wish to use material things for some chosen purpose. The point is that some system of property rights is inescapable in any society. Given the ubiquitous reality of scarcity, someone has to decide how scarce resources are to be used. Is a particular area of land to be used to grow wheat at the cost of not growing oats? Are raw materials, labor, and time to be invested in the production of more transistor radios at the cost of not being used in the production of more pocket calculators? Are more goods to be consumed in the present at the cost of future capital, or is capital to be accumulated at the cost of present consumption? The decisions are inescapable, and must be made by some person or set of people.

## The Role of Rules

Rules specifying who this person is or people are constitute rules specifying "property rights"—indeed, even a rule to the effect that the person or gang who shoots straightest or punches hardest shall determine how material things are used is specifying "property rights"! In reality, human beings have come up with only three systems of "property rights": rules based on tradition, rules based on political edict, and rules based on private ownership and voluntary exchange. The first—tradition—may work for a small, static, almost tribal society. The second and third seem the only options available to large and complex societies.

When property is controlled by political edicts, it is highly improbable that dissidents will be granted access to material goods so as to further their views. But when property is privately owned, in contrast, the chances of someone holding unpopular views being able to use material resources to further his beliefs are still considerable. Dissidents may pay the private owners of printing presses to print their tracts, or they may purchase or rent printing presses.

The point is essentially that made by, among

others, Alexander Hamilton: "Power over a man's subsistence amounts to a power over his will." When the men and women directly and indirectly controlling political structures determine who may use what material resources for what given ends, individual liberty and the free society are no more. Indeed, the classical liberals' insistence upon limited government, and their insistence upon private property rights, go together. *Private property rights constitute the critical limitation upon government.* When all are at liberty to acquire property and enjoy security in their possession, liberty is secure. Conversely, as the "property rights" of individuals are attenuated—as the uses to which they may put their possessions are circumscribed or their freedom to dispose of what is theirs is narrowed—liberty is threatened.

Given that human beings are material creatures in a material world, liberty in any meaningful sense rests firmly on the institution of private property. Attenuate that institution, and you attenuate liberty; secure that institution, and you secure liberty. At the same time, by securing private property and thus limiting government, you make possible the emergence of the free market economy, an economic system ultimately resting upon individuals being able freely to determine, in the context of rules equally applicable to all, what they shall make of the time, skills, and material goods that are theirs, and freely exchanging the fruits of their efforts and labor.

It makes no sense to talk of the free market in the absence of private property rights—indeed, what is freely exchanged in the marketplace is not simply physical objects but sets of rights in those objects: the right to take physical possession, the right to resell, the right to consume, the right to change the physical form of the object, the right to give or to lend or to rent that object to someone else, the right to destroy the object. The entire system turns on precisely defined and efficiently enforced private property rights, and with the system comes almost as a

bonus the material plenty with which it is uniquely associated. I say "as a bonus" simply because even if it were not uniquely associated with a level of wealth creation unimaginable before the dream of liberty became a reality, I would still opt for the free market, private property system, since it alone is compatible with individual liberty and the free society.

At this juncture, it is not unreasonable to ask: What stake do the poor have in the private property system? This is being asked by many churchmen and churchwomen, who emphasize a moral imperative to consider the situation of the poorest and most vulnerable members of a community when judging an economic system.

I submit that any understanding person, who truly cares about the poor, will come out passionately in defense of private property rights. My reason is not merely the vaunted efficiency of capitalism, or the recognition that economic intervention harms the poor more than any other group. My ultimate reason, rather, is that it is the poorest and the weakest who need to have what is theirs protected from the politically powerful.

Certainly, the fight for property rights, historically speaking, was a struggle carried on by the least privileged and by those perceiving the least privileged as human beings whose "rights" were the same as anyone else's. And the enemy against which they fought was invariably powerful castes who effectively controlled the statist apparatus of their day.

The fight for limited government and property rights, in large measure, was successful. The dream of liberty, after a long struggle, became a reality. Sadly, however, many beneficiaries of liberty grew complacent and forgetful. The dream was all but forgotten as constitutional government degenerated into unlimited democracy, and private property rights were subordinated to numerous other alleged rights. Hence our task: the task of recovering, both for ourselves and for our children, the forgotten dream of liberty. □

# The Golden Age of Opportunity

by Gregory F. Rehmke

**I**t was a golden age of opportunity—a time when adversity coupled with a free economy generated a surge of human energy, productivity, and progress. Impoverished men, women, and children flowed into America by the millions, driven from their aristocratic homelands and tightly planned societies. Isaac Asimov, the well-known science and science fiction author, writes of his early days of opportunity and hard work in New York City in a recent advertisement sponsored by Panhandle Eastern Corporation:

“Everyone faces adversity from time to time. It’s a natural part of life. By itself, it’s neither good, nor bad. The important thing is how we deal with it and what we learn from it . . .

“Very early in life, poverty forced me to become quick, resourceful, and imaginative. It also forced me to accept jobs I really didn’t want but which helped me grow.”

Asimov’s family came from Russia during the early 1920s when Isaac was three. Which of his ancestors ever glimpsed opportunities such as America offered the young Isaac? Which of them even dreamed of being anything but a peasant—without secure property, without rights, without hope for a better life?

It wasn’t the adversity that was unusual for this new-generation Asimov—it was the freedom, by hard work and ingenuity, to throw off the poverty into which he was born. And Isaac Asimov became a whirlwind of action and energy. He began writing when he was eleven,

and was earning money from his writings by the time he was eighteen.

But he wasn’t making enough money to support himself, so he began teaching. He had no special credentials to teach, but in that day diplomas and certification were unnecessary. He was required only to know the course he was to teach—biochemistry—so he systematically mastered the subject, keeping just days ahead of his lectures. Within two years he was contributing to a textbook on biochemistry.

Where are such opportunities now? Where is the freedom for today’s victims of foreign tyrannies to bring their energy and genius to America? Where is the freedom to move from place to place and job to job? And what has become of the motive force of adversity?

Poverty no longer forces one “to become quick, resourceful, and imaginative.” Instead, modern poverty gives one special priorities. The certified poor can qualify for state housing, food stamps, free medical care, and other forms of aid to keep them off the streets and out of the newspapers. The energies of today’s poor concentrate on the rules and regulations which govern those who receive the dole: standing in welfare lines in grim buildings at an appointed time, waiting long hours in other lines for ten pounds of “free” cheese, hiding any unapproved earnings, living furtively under the watchful eyes of the welfare spies, rehearsing pleas of need and adversity for steely-eyed bureaucrats.

One might argue that Asimov is unusual, that his innate skills are rare. That is probably true.



PHOTO CREDIT: CULVER PICTURES

But there are millions of other people who worked their way into the middle classes before the welfare traps were laid and legal barriers erected.

Today, many entry level jobs in manufacturing, construction, and other fields are no longer open to the poor. They are reserved for workers with the proper union cards. These jobs often pass from father to son and uncle to nephew. For many high paying union and government jobs you need to know someone, maybe a relative or a friend with political connections. But the poor know only each other.

At the same time, minimum wages and licensing restrictions keep many jobs above the reach of the unskilled—condemning many to remain ever unskilled, ever underqualified, ever poor. The creative and productive energies of the poor are splintered by the subtle barriers to entry quietly guarding hundreds of enterprises that had drawn in and transformed previous generations.

The golden age of opportunity for the poor has faded. Endless regulations lock away entry-level jobs at the same time as welfare payments seduce the poor into lives of hopelessness and despair. With no means to “create themselves” through productive work, and no way to under-

stand why, they mull over the injustice of their world. The remaining currents of energy born of today's adversity are often channeled into gang warfare or playground sports or are dissolved with drugs.

How can we reanimate the stagnant world of today's poor? Rumbles are already being heard among liberals and conservatives alike. The vast scale of welfare state failures is mind-numbing to the traditional reformers. So reforms are being offered from without. More and more people, over the next few years, will consider the possibility that involuntary philanthropy does not work and that coercive regulations passed in the name of the “public good” merely guard the private good—protecting moneyed and privileged special interests from competition.

To even think that coerced (tax-supported) charity can help the poor is to accept a subtle form of slavery as just and workable. The issue of justice is perhaps buried too deep for the pragmatic politician, journalist, or layman to unearth. But the companion issue of workability is rising to the surface. Coercive programs just cannot be grafted onto the voluntary institutions of a free society. Such graftings quickly infect the institutions to which they are attached, as private philanthropy has been sullied by its bigger tax-supported companion.

Everything about Isaac Asimov's story has stamped on it “only in America.” We should be proud of our country and the principles for which it stands. It was these principles—private property, free markets, and the Rule of Law—that unleashed “an unprecedented fury of human energy, attacking the non-human world, and making this earth more habitable for human beings.” (Rose Wilder Lane, *The Discovery of Freedom*, p. viii) Millions of the world's poor were drawn into this vortex of productive activity, earning their way out of poverty as they provided goods and services which in turn improved the lot of their fellow man.

If we have any duties to the poor of the world and to the poor here in America, surely they include prying open the doors of opportunity, and restoring the free and open economy we inherited from our parents, and which should be the birthright of our children. □

# The Moral Foundations of Property Rights

by Brian Summers

**P**roperty rights are human rights. They do not belong to property; they belong to people who hold them with respect to property. Property rights include a person's rights of possession—the rights to use property peacefully, alter it, consume it, and exclude others. They further include the right to transfer possession by any peaceful means an owner sees fit—to sell, trade, mortgage, let, give, and bequeath. Taken together, these constitute the rights of full private ownership.

Why should anyone have such rights? Why should some people enjoy the possession and use of property at the seeming expense of others? These are questions on which the great debate between capitalism and socialism ultimately turns. Let us examine the answers offered by the defenders of private property.

Some defenders of property appeal to First Amendment rights. They ask, for example, how can the press be free if the government owns all the newsprint, presses, and distribution systems? How can religion be free if the government prints all the books and owns all the buildings? Similar arguments apply to freedom of speech and the right to assemble.

Such arguments, as far as they go, are compelling. But private ownership involves a lot more than the free exercise of First Amendment rights.

Other defenders of property go beyond First Amendment arguments to the assertion that property rights are essential to freedom itself. They contend that freedom—the absence of co-

ercive intervention in peaceful activities—is impossible without private ownership.

But full private ownership is not a prerequisite for many peaceful activities. For some activities, such as swimming at a public beach, the right to use property is often sufficient. The rights to alter, consume, exclude others, sell, trade, mortgage, let, give, or bequeath the beach are usually not required for such peaceful use.

Of course, one can ask whether people should be free to do such things with respect to a beach. But this is merely to rephrase our original question: Why should anyone have such property rights?

A few defenders of property base their defense on the right to life. They point out that a person cannot eat without at least implicitly establishing property rights over the food he consumes. Similarly, a person would have trouble keeping warm without some property rights with respect to clothing and shelter.

Here again is an argument that, as far as it goes, is compelling. But certainly a person can eat without the rights to sell, trade, mortgage, let, give away, or bequeath his food. In addition, this argument, on the surface at least, applies only to consumer goods. What about the main concern of socialists—the raw materials and capital goods which constitute the means of production? Why should anyone own them?

## Economic Approach: Incentives

Economics provides a comprehensive answer. When the means of production are privately owned in a market economy, businessmen seek to earn profits by cutting costs

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*Mr. Summers is a senior editor of The Freeman. An earlier version of this article appeared in the Fall 1982 issue of Lincoln Review.*

through the prudent use of scarce resources. The businessman who conserves the most resources, while giving consumers the most for their money, earns the greatest profits. Private ownership fosters efficient production.

Consider, for example, the operation of a privately owned bus company. If the operator has full private ownership—if he is free to choose his routes, adjust his fares in response to market conditions, and bargain with anyone who wishes to work for him—he has every incentive to provide cheap, efficient service. Free market competition, and the possible entry of potential competitors, supplies all the incentives needed to improve service and cut costs through conservation.

The bus owner also has every incentive to maintain his capital stock. If he ever wants to sell his company—or bequeath it to his children—he will maintain his buses in good working order.

The same incentives apply to the professional managers of a company owned by stockholders. If the managers fail to maintain the buses, the price of the company's stock will fall and the management will be replaced by stockholder vote or a corporate takeover—unless, of course, the management is bailed out by government subsidies or the takeover is prevented by threats of antitrust action.

Compare this with the operation of city-run buses. The routes and fares of city-run buses are determined by political pressure. The revenues (and subsidies) are devoured by union monopolies which threaten violence against nonunion workers. With no profit motive, and no need to keep the buses rolling past the next election, deficits soar while the buses fall into disrepair.

Incentives are the key to understanding why “publicly owned” transportation is in constant need of repair, despite huge subsidies. Similarly, incentives explain why collective farms are vastly outproduced by privately owned plots; why unowned air, land, and water are often polluted; why unowned timber, wildlife, fisheries, and grazing lands are rapidly depleted (often to extinction); and why private timber companies plant millions of saplings to try to maintain the productivity (and thus the value) of their land.

But the economic case for private property

goes beyond an analysis of incentives. Economics proves that private ownership is a prerequisite for rational economic planning.

## Economic Approach: Calculation

In any advanced society, knowledge is divided among millions of individuals, with no one knowing more than a tiny part. Because of this division of knowledge, scarce resources are often misallocated—inadvertently used in ways that fail to contribute the most to consumer welfare. A manufacturer may be unaware that a resource could contribute more if used elsewhere. Those who know of other uses may be unaware of the availability of a resource, or even of its existence.

To correct these misallocations of scarce resources, we need a system that (1) provides a means of discovering misallocations, (2) stimulates people to use the means of discovery, (3) encourages people to transfer control of resources to entrepreneurs who have discovered misallocations, and (4) rewards the correction of misallocations.

All this is accomplished by the free market profit and loss system. Any infringement on property rights reduces this system's efficiency. In particular, “public” ownership of the means of production prevents businessmen from competitively bidding for scarce resources. Without competitive bids, the “prices” of scarce resources become arbitrary, so that no one can calculate the true costs of any project.

These economic arguments relate to our previous comments about the right to life. We previously saw that human survival requires at least some property rights in consumer goods. We now see that human survival—at least as we know it—requires economic calculation based on private ownership of the means of production. Economics shows how property rights can, indeed, be based on the right to life.

Economics also sheds further light on the relationship between private property and freedom. Freedom—the absence of coercive intervention in peaceful activities—refers to the range of options (alternatives) a person may peacefully *pursue*. At any particular time in a market economy, this range is pretty much the

same for all people. Of course some people, especially the wealthy, have a greater ability to attain options (goods, services, jobs). But, in general, these options are available for all to pursue.

Thus, as a person accumulates wealth, he doesn't, as a general rule, gain more freedom. But in a market economy, as *other* people pursue wealth by offering the consumer more goods and services, the consumer's range of options expands. In terms of options, the consumer finds that he has more freedom of choice in a modern shopping center than his grandparents had in a general store.

## The Claiming of Natural Resources

Economics provides compelling arguments for the free market, private property system—based on the efficiency of the system itself. But we must still consider the justice of original claims to previously unowned natural resources. If these original claims cannot be justified, the free market forever will be plagued with charges of immorality.

Original claims to property are sometimes defended with a finder-keeper approach. According to this argument, the discoverer of say, an oil field, is its rightful owner.

But if this approach applies to oil fields, it should also apply to the discovery of a continent, planet, or galaxy. Merely being the first to observe something—or putting up the capital that leads to a discovery—seems to be insufficient grounds for full private ownership.

Other claims to property are based on first occupancy. By this argument, the first person to occupy a piece of land is its rightful owner. But merely being the first to set foot on say, Mars, doesn't seem to create a moral claim to the entire planet.

## Lockean Approach

But if the "first occupancy" takes the form of settling and working the land, a strong case can be made for private ownership. In the famous words of John Locke (*Second Treatise of Government*, paragraph 27):

Though the earth, and all inferior creatures

be common to all men, yet every man has a property in his own person. This nobody has any right to but himself. The labor of his body, and the work of his hands, we may say, are properly his. Whatsoever then he removes out of the state that nature has provided, and left it in, he has mixed his labor with, and joined to it something that is his own, and thereby makes it his property. It being by him removed from the common state nature placed it in, it has by this labor something annexed to it, that excludes the common right of other men. For this labor being the unquestionable property of the laborer, no man but he can have a right to what that is once joined to, at least where there is enough, and as good left in common for others.

The Lockean idea of acquiring property by mixing labor with unowned resources has been enormously influential, and has spawned many compelling defenses of property rights.

However, the Lockean approach is not without difficulties. For one, it includes the troublesome concept of self-ownership. Full self-ownership would imply that an individual has a complete set of property rights with respect to himself. Some such property rights are difficult to deny, such as the right to peacefully use our own faculties. But how can we consume ourselves or transfer possession?

Fortunately, the Lockean approach is more firmly based on the concept of people owning their own labor. But what does it mean to "mix one's labor" with natural resources? This metaphor has led to considerable confusion.

For instance, it is sometimes asserted that if an individual "mixes" what he owns (his labor) with what no one owns (an unowned natural resource), it doesn't necessarily follow that he owns the resource. An equally plausible conclusion, it is contended, is that he has simply "discarded" his labor—like a sailor pouring his coffee into the unowned sea.

But "he owns the resource" and "he has discarded his labor" are not the only possible conclusions. We can also conclude that because a person has mixed his labor L with an unowned resource R, he has created the "mix" LR. Thus, if he is entitled to what he has created, we can conclude that he owns LR. But the concept "LR" is, at best, vague.

## The Lockean Proviso

Another difficulty with the Lockean approach is the proviso that private ownership is justified only to the point "where there is enough, and as good left in common for others." This proviso, carried to its extremes, reduces to an absurdity.

For example, if oil companies must leave "enough and as good oil in the ground for others," where should they stop? If the last barrel of oil must be left in the ground for our children, then *our* children must leave the last barrel for *their* children, and so on. No one may ever take the last barrel. But if the last barrel is permanently off limits, then anyone taking the next to last barrel would not be leaving "enough and as good in common for others." No one may ever take the next to last barrel. Similarly with all other barrels of oil. Pushed to its limits, the Lockean proviso prohibits anyone from ever taking any nonrenewable scarce natural resource.

Many interpreters of the Lockean proviso don't go this far. However, they often demand that a first appropriator (such as an oil company) be forced to compensate all the "victims" who could have, but didn't appropriate a given resource.

But who are the victims? Anyone with an oil rig? Anyone who could have invested in oil exploration? And how much are they being "hurt"? By any amount they say?

More important, is anyone actually being hurt by the first appropriator? I, for one, am glad when someone else discovers oil. I know that, in a free market, it will eventually mean more gas for my car. In the long run, we all benefit from such competitive market processes.

Even in the short run, a potential competitor who doesn't get to the oil first is not being physically coerced by the driller who does. By what right does he demand compensation from an explorer peacefully going about his own affairs?

Some adherents to the Lockean proviso assert that private ownership is fine in principle, but as a practical matter, the "enough and as good" proviso is needed to prevent all resources from falling into private hands. Anyone coming along later, they contend, would effectively be locked out.

But as a practical matter, it is immigration laws, apartheid edicts, tariffs, and other government restrictions that lock people out. It is precisely because private owners are eager to sell and let their property that regulations are imposed by those who wish to prevent such transactions.

## Creation—Transformation Approach

These difficulties with the Lockean approach are overcome by (1) dropping the Lockean proviso and (2) replacing the "mixing" metaphor with the principle that an individual owns whatever he (or his agent) creates from an unowned resource. In this approach, the justification for first ownership is not based on the owner's labor, or on the pain and sacrifice associated with his labor. The justification for first ownership is based on the creation brought forth by the first owner.

But who creates property? In the case of physical resources, at least, no one. But to "mix labor" with an unowned resource is to transform it—to create a transformation. Any person who transforms an unowned resource owns what he creates—he owns the transformation.

Thus, the first person to transform an unowned field into a farm, owns the farm. But plowing (transforming) land doesn't, in this approach, give the farmer ownership of oil lying beneath the land. Only if he pumps the oil to the surface, or creates another transformation in the oil, can he claim to own the transformation—and thus claim full private ownership over the oil he has transformed.

If an individual owns whatever he creates from an unowned resource, he clearly owns whatever he (or his employee) creates from his property. For example, if a farmer pays an employee to transform his oranges into juice, the farmer owns the juice.

And he may sell the juice for whatever price the market will bear. If this price yields a profit, the profit belongs to him because (1) he owns the juice and (2) his decision to transform the oranges created the opportunity to discover the profit.

This last argument may appear to be nothing





**“A farmer acquires previously unowned land by transforming (clearing and plowing) a field.”**

more than the finder-keeper approach. Our farmer-entrepreneur, after all, discovers the profit (or loss) which results from his decisions—much as an explorer discovers lands as a result of his decisions. They both create their own opportunities to make discoveries.

But there is a fundamental difference. The lands exist whether or not the explorer decides to look for them. The farmer’s profit doesn’t exist without his decision to transform the oranges. His employee is needed to make the juice, but the farmer’s entrepreneurial decisions make the difference between profit and loss.

As a practical matter, the creation-transformation approach assigns property rights in much the same manner as the Lockean approach (without the “enough and as good” proviso). But there is at least one basic difference. Some people interpret the Lockean approach to mean that once labor has been “mixed” with an unowned resource, that resource forever belongs to the “mixer” and his heirs. For someone else to take the resource, he would have to “take” the mixer’s “stored up labor.” Thus, an abandoned, overgrown farm would forever belong to the farmer’s heirs.

The creation-transformation approach, however, assigns property rights only as long as a transformation exists. Our farmer acquires previously unowned land by transforming (clearing and plowing) a field. If he abandons the

field and lets it revert to a state of nature, his transformation gradually disappears. When his transformation has completely vanished, his property rights with respect to the field would also vanish.

## **The Justice of Current Property Holdings**

What do the arguments for private ownership say about the justice of current property holdings? Do they endorse the status quo? Or do they call for a massive transfer (“redistribution”) of property rights?

The economic argument supports private ownership *as an institution*. Economics tells us that private property, free trade, and peaceful cooperation promote economic efficiency and enhance human welfare. Thus, the economic approach endorses any property holding that came into being through peaceful means. Property holdings acquired through violence, however, receive no endorsement because such coercion—legal or illegal—disrupts the market process.

But economics says little about the justice of original claims to property—the holdings of those who first claim property from previously unowned resources. For this we must turn to the Lockean and creation-transformation approaches.

These two approaches provide ethical guidelines for acquiring property from a state of nature—guidelines for, in effect, creating property rights. As a corollary, they endorse voluntary transfers of justly acquired property.

But these arguments do not endorse property acquired by immoral means. Violence, conquest, and coercion may create legal “rights” to property, but they do not create moral rights.

To what extent are such immoral means the basis of current property holdings? A detailed answer is beyond the scope of this paper. There are, however, two facts we should bear in mind.

1. The original inhabitants of a territory did not necessarily have a moral claim to all its resources. First occupancy is an insufficient claim to first ownership. Claims to original ownership must be based on creatively transforming (“mixing labor with”) natural resources.

2. Most current property holdings are not in the form of raw land. Most of what we own has been *produced* since the advent of capitalism. Even if a native has a valid moral claim to the land on which a skyscraper stands, he cannot claim to have created (and thus own) the skyscraper.

Thus, in general, property holdings arising out of capitalistic (free market) activities are morally justified. And violations of these property rights are to be condemned.

## Legal Plunder

In particular, our arguments condemn the morality of all government transfer programs—subsidies, welfare, and the like. Such programs are nothing more than the indiscriminate *legal*

*plundering* of property that has been justly acquired through peaceful, mutually beneficial, market transactions.

Our arguments further condemn all interference with the peaceful exercise of justly held property rights. By what right does anyone dictate how much rent a landlord may ask for *his* apartment? Or how much an oil dealer may ask for *his* oil? Or what a farmer may grow on *his* land?

And our arguments condemn the seizure (“locking up”) of millions of acres of land by various government agencies. By what right does anyone prevent people from peacefully transforming unowned resources? By what right do government officials—who haven’t creatively transformed an acre of wilderness—claim property rights over this land?

Such ethical considerations, of course, receive little attention from men of practical affairs. Real world decisions, it is widely believed, should be made on practical grounds—with ethical arguments best left to the moral philosopher.

On practical grounds, however, those concerned with the future of the free society place themselves at a serious disadvantage by ignoring ethical arguments. The opponents of freedom can always conjure up expedient grounds for further government intervention, confident in the public’s ignorance of the economic and historic arguments against such intervention. Unless such expediency is met with compelling moral arguments against the violation of property rights, the would-be controllers will usually have their way. □

## The Right to Property

**T**he institution of property, when limited to its essential elements, consists in the recognition, in each person, of a right to the exclusive disposal of what he or she have produced by their own exertions, or received either by gift or by fair agreement, without force or fraud, from those who produced it. The foundation of the whole is, the right of producers to what they themselves have produced.

—JOHN STUART MILL

IDEAS  
ON  
LIBERTY



# Public Education: How Free?

by Rolf McEwen

Numerous virtues have been ascribed to public education, but it is certainly not free in any sense of the word. Although tuition is not paid at the classroom door, we know that taxes are taken from people-at-large to pay for public schools. Costs per pupil per year range between \$2000 and \$7000 in various states. Although we know that taxes pay for these services, there is often an illusion that schooling in America is somehow "free."

We know that education for youth in America is mandatory. During several decades of the mid-nineteenth century, it was decided in various legislatures that compulsory education was good for the people and for the nation, perhaps to ensure an educated populace capable of democratic self-government. It was thought that representative government required a level of education which could not be guaranteed without institutions mandated and financed by taxation and government promotion. It was sometimes considered a matter of national security, that a superior knowledge might be achieved in the people, providing a higher level of productivity and a competitive edge in world markets. Legislators considered it a matter of law to establish excellence in education through a public tax-supported system. Therefore, the freedom to choose *not* to go to school was removed, and compulsory attendance laws were enforced. Citizens were not free to neglect school attendance, and they were not free to neglect tuition payments through taxation.

The intentions of those promoting tax-supported public education were good. Compulsory education laws were intended to promote the general welfare and to ensure that parents would not neglect their children's education, exploit their services at home, or manage family resources so that funds were not available for tuition payments. But the good intentions of lawmakers have not brought success. Public schools are not successful in guaranteeing student proficiency or in maintaining school attendance. Only about 75 per cent of students entering high school graduate, and many of those are considered functionally illiterate. It is estimated that 20 per cent of Americans cannot write a letter or read the newspaper.

Can we say then that public schools have succeeded? Have literacy and educational proficiency improved during the century or so of public schooling? Studies have shown that literacy rates in eighteenth century America were higher than they are today. Thus, ironically, the general public was more proficient academically before the introduction of compulsory education and government support of schools.

How can this be? Why have the public schools failed to provide educational excellence? Vast amounts of money are being expended, voluminous studies have been conducted, graduate schools promote advanced programs, and yet the results are so disappointing.

Perhaps the reason lies in simple concepts such as individual initiative and freedom of choice. Do not most people find it profitable to be able to read and write? Do not most people

wish to make the most of their own lives, to compete successfully for desirable employment and higher incomes? It appears sensible that the pursuit of happiness provides sufficient incentive for people to improve themselves educationally. Thus the need for schooling is in one's self-interest, although perhaps "schooling" is not the most accurate term, for maybe it is actually learning that people seek. When schooling is mandated by law, that sense of "opportunity" which arises from free choice vanishes, and often a stubborn and uncooperative spirit finds its way into the classroom, causing disruption and hindering the learning environment for eager students. Attitude is affected by compulsion, and poor attitudes hinder education.

Likewise, the economic compulsion attached to taxation creates additional attitudinal problems. There are those who do not willingly submit thousands of dollars to the local schools, and their attitudes find expression in the surrounding culture. Often these taxpayers believe that they should have some freedom to choose their children's school. Perhaps they wish to select the teachers for their children, or the curriculum. This is not practical or possible in our public school system. Parents are unable to effect change or to choose from a variety of alternatives because the system is rigid and often controlled by district administrators or policymakers far removed from the local community. When state funds are provided to local schools, strings are often attached. It is difficult for local communities to operate schools free from bureaucratic control at state and Federal levels. It is frustrating to teachers to be manipulated and directed by restrictive policies, it is frustrating to parents to be unable to make choices of schools and teachers, and it is frustrating to students to have to submit to state-mandated coursework.

Many are persuaded that abandoning compulsory education laws and tax-support for schools would result in empty classrooms and impoverished schools, but there is little historical evidence to support this theory. If it is in the interest of people to develop knowledge and skills in order to acquire desired employment and financial success, will they neglect their education? Quite the contrary, students will yearn more eagerly for education than they do under the com-

pulsion of current law. They will perceive education not as a requirement, but as an opportunity. Administrators will not be burdened with trying to provide discipline for uninterested students, and schools would arise to meet the demands of various student interests and abilities. The market would soon be competing for students, and students would be competing for the best schools and the best teachers. The entire psychological atmosphere surrounding schools and education would be improved, would be more positive, and there would be excellence in a variety of programs. Of course, there would be some who would choose to not attend school. But those same students are not attending under the present circumstances.

## Whose Responsibility?

Is it the responsibility of government to decide that citizens should be educated? Should the state decide what is proper curriculum? I believe these matters are better left to parents and individuals. The enormous expense now placed upon society is not efficiently managed. Attitudes are not right. The bureaucracy has promoted attendance and conformity, but has failed to maintain creativity, interest, and excellence. Money has proven to be insufficient to mend the ills. The truth is that what education requires, government cannot provide. It needs freedom. Education needs a free market without government funding, direction, interference, or assistance. What the legislators intended to improve they diminished.

One might ask "You don't think you're going to abolish public schools in America, do you?" It does seem rather incredible to pose such a possibility. It's an appealing possibility, nevertheless. It's sometimes just enjoyable to pipe-dream. The sad fact is that public education has declined for the past twenty-five years. More and more money is tossed at the problem, but results are dismal. Achievement tests have recently shown some improvement, but only due to a drastic lowering of difficulty in the tests. If the 1960 editions of standardized tests were administered to students today the results would indicate inferior levels of achievement in all academic disciplines.

Private schools would take up the task of edu-

cation and provide services at a variety of locations, with varying costs, philosophies, and areas of specialization. Students and parents would select schools of their choosing, and they would examine the programs more closely than they do under current conditions. Parents would have to take more interest in their children's education because they would have to inquire into schools and teachers and curricula. The choices would promote lively debate and inquiry in the community as parents sought the best education at the lowest cost.

Teachers' salaries would be determined by market competition. Good teachers would be promoted and poor ones would be weeded out. The bureaucracy would be unable to protect jobs for poor teachers entrenched in their positions. Teachers would sense greater support from parents and greater interest from students. Stultifying regulations and controls would be lifted from their backs, and they would acquire added freedom to stimulate learning and im-

prove achievement. In short, the entire academic atmosphere would obtain a shot of vigor in the course of competition, freedom, and choice.

Now, why is all this a pipe-dream? Because people believe the experts whose self-interest is served by continuing the current system. Citizens are too busy to examine the problem and too docile to take responsibility for education themselves. The government system is easy on such people because it makes choices for them and thinks for them. We must rouse ourselves and take responsibility for our own lives rather than leaving it to government to provide for us, to educate us, and to make our decisions. If we give the government 40 per cent of our national income and tell them to spend it for us, they will. And in fact, they do. Education is a good place to begin directing our own lives by allowing people to choose their own schools, or no schools, and to see education as the opportunity and responsibility that it is. □

# Private Schools in the Inner City

by Howard Baetjer Jr.

**T**hose who believe that educational services should be provided by a totally free market, with no governmental involvement in schooling, are frequently told: "You are advocating a completely private school system, with no public schools for the poor. How can the poor possibly afford private schools?"

These are serious concerns, which need to be addressed. Thus, we welcome a recent Heartland Institute study of private schools in the poorer sections of Chicago. The study, by Joan

Davis Ratteray, president of the Institute for Independent Education, shows that demand for private schooling is high and increasing among those in the city's poorest neighborhoods.

"There are nearly fifty [independent neighborhood schools for Black and Hispanic youth] in Chicago," says Ratteray, "with most of them located in the least affluent communities." These are grade schools, for the most part, some high schools, and some schools offering grades K-12. Their total enrollment is about 2.3 per cent of the enrollment in Chicago's public schools. Annual tuition ranges from \$270 in the poorest areas to \$3000 in more af-

fluent neighborhoods. Strikingly, “. . . in the city as a whole, schools that are closest to poor neighborhoods have the highest enrollments, the longest waiting lists, and the greatest need for expanded facilities.” One grade school within walking distance of five housing projects has a waiting list of over one thousand!

Why should poorer parents be so eager to pay extra for private schools? Because leaving their children in the public schools bears an even higher cost—in their children’s education, personal development, and physical safety. Parents express deep concern about the low academic standards, the violence, and the unapproachable bureaucracy of the public schools. They want for their children discipline, safety, and a strong sense of values. “. . . [T]hey are willing to endure severe economic hardship in order to provide a better chance at learning for their children.”

They are also willing to work hard and imaginatively to keep their schools going. According to Dr. Ratteray, “[T]hese schools are the epitome of self-help, entrepreneurship, and innovation.” Parents pay tuition out of meager savings from paychecks, by help from grandparents, and by working at the schools. They frequently participate in fund-raising, which often provides a substantial portion of the schools’ budgets. One school augments income with the profits from a thrift shop operated by the parents; another “is part of an organizational structure that houses its own publishing company and bookstore . . . [O]ne-third of the school’s operating capital comes from the success of the other two enterprises.”

Some of the schools take advantage of church buildings and in-kind help from their communities. Some receive support from foundations and church congregations with which they are affiliated. A few are blessed with energetic leaders who campaign around the country to raise additional operating funds. Through such programs as “adopt-a-child,” churches and civic organizations undertake a child’s costs. And in one school, “teachers participate in a salary-sharing program that is maintained by contributions from donors outside the immediate community. In this way, the contributors maintain a personal relationship with the teachers they sponsor and come to learn a great deal about the program.”

The Chicago experience casts doubt on one of the main reasons given for public schools—that the private alternative is too expensive, especially for the poor. Certainly many of the less-affluent parents have severe difficulty making tuition payments, and the low-budget schools often do without enough textbooks and adequate facilities. Often parents must withdraw their children, and occasionally the schools fail. Nevertheless, these schools on the whole are succeeding and growing, an accomplishment the more impressive for the financial difficulties involved.

These financial difficulties would diminish in an education setting free of the government’s massive presence. Chicago will spend about \$1.84 billion on its school system next year, or \$4279 for each of the 430,000 children in it. If parents or private benefactors didn’t have to pay taxes toward this costly system, they would have more dollars to spend on schools of their choice. In the absence of competition from the tax-supported public schools, the demand for independent schools would increase—boosting the number, quality, and variety of private schools.

What is occurring in Chicago is a dramatic illustration of market response to human wants, no less impressive for its small scale. Faced with the calamity of inner-city public schools, a dedicated core of poor parents are exercising their power of choice, and private enterprise (non-profit in this case) is responding.

The tragic irony is that the very existence of public schooling restricts parents’ power of choice. It obstructs them from providing the education they want for their children. Many well-intentioned people believe that the poor have the most to gain from public schooling. In Chicago, at least, the opposite seems to be the case.

Chicago’s neighborhood schools, persevering and growing despite economic hardship, show that private, voluntary endeavor can support schooling even in the lowest-income areas.

A free society must put a premium on liberty. Parents’ freedom to choose how they will spend their education dollars, and at what schools, is paramount. The growing movement to independent neighborhood schools is a positive step toward restoring education to private endeavor and free parental choice. □

# Our School System: The Dream and the Reality

by David Smyth

**O**ne night I had a dream. I dreamed that some of us got together in our small New Jersey town and abolished its public school system. We removed the public school system's legal privileges, and ended its tax support. From then on, all schools would have to compete on an equal footing in a free and open market.

In my dream, we had to face down tremendous opposition. From traditionalists who insisted that a public school system is an integral part of the American way of life. From educational experts who told us we would raise a generation of ignorant savages. From real estate people who warned us that buyers would shun our town and that real estate values would plummet. From legal experts who told us the move was illegal and unconstitutional. From teachers and employees of the public schools who saw unemployment staring them in the face. From parents and citizens who were worried to distraction by all these objectors.

Nevertheless, we accomplished it. In my dream, our decisive weapon seemed to be the circular we sent to all the town's inhabitants. We pointed out that residents like my 75-year-old neighbor Mrs. B., now scraping by on Social Security, was paying \$1,000 a year in taxes for a school system she hadn't used since her children grew up. She would continue paying for the rest of her days although she would never again use the school system. I pointed out that I was paying \$1,800 a year to send my son

to a Catholic high school in addition to the \$1,800 that was extracted from me in taxes for a school system I wasn't using either. I asked this question: If a private organization can run a school for a yearly fee of \$1,800 per student, why does the public school system have to charge an average of \$1,500 to *every householder* in the town—not only parents of school children but also elderly people like Mrs. B.? Childless couples? Single people? None of them have any children nor get any benefits in return for their tax money.

Catholic schools can rely on the volunteer work of their brothers, priests, and nuns, and pay their lay teachers less than public school teachers, some objectors said. But this didn't convince some parents who were sending their children to private schools for a fee of \$3,000 to \$5,000 a year. They pointed out that on a per-student basis these privately run schools were still costing about the same as the per-student cost of the public school system, and providing a better education.

Anyway, the town council was planning to increase school taxes the following year, people in our town were getting tired of rising taxes, and they decided to give us a chance. In my dream, we dumped the school system.

Then the competition began. A group of public school teachers decided to form a co-operative, rent one of the elementary school buildings, and offer a primary school education for a fee. They all knew each other, they wanted to succeed, and they didn't have much trouble weeding out the incompetents in choosing their

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*Mr. Smyth is a journalist and free-lance author in New Jersey.*

co-op members. They knew they couldn't survive with a lot of dead wood in the staff.

A Protestant group that had been running a Bible-oriented school in an abandoned army barracks decided to bid for another of the school buildings and advertised for pupils among the Protestant churches.

The Catholic church already had a boys' school in the area but lacked a girls' school. It decided to rent a third school building for this purpose.

A fourth school went to a conservative Jewish group that stressed instruction in Hebrew and Jewish religion.

The remaining school, which had already been closed under the public school system due to the baby-bust that had resulted in declining enrollment, was sold to a private entrepreneur. This man rented out sections of the school to various smaller groups: One school specialized in helping retarded children, another stressed practical instructions such as carpentry, a third was oriented to technological instruction in electronics and computers.

In my dream, we now had a wide variety of schools available for all our parents. If they didn't like one they could try another. If they couldn't afford this one they could move their children to that one.

There were some poor people in town who said they could not afford any school. If they were homeowners, we asked how they had previously afforded the school taxes, which were now abolished. If they rented apartments, they should have benefited from the dramatically lower taxes paid by their landlords who, in response to competitive forces, were lowering their rents.

Nevertheless, there were people who genuinely could not afford to pay for their children's education. In my dream, we asked the churches to help these people, which they were the more willing to do now that they had more Protestant, Catholic, or Jewish schools to choose from. We asked business, social, and civic organizations to provide scholarships for needy children.

There were still a few parents—a very small, ignorant antisocial minority—who willfully and positively refused to provide their children with any education at all. I was wondering what should be done about these people—and I do

not believe in forcing anyone to do anything, but still the situation seemed unfair to their children—when I woke up.

## An Impossible Dream?

I am acquainted with the school system administrator in our town and the next time I met him I asked him whether my dream could ever become a reality. *Impossible*, he said. The laws simply will not allow the abolition of a public school system. We have to try to improve what we have.

The administrator is an amiable, harassed man who deserves a better fate. He is doing his best to run a system which relies on the political solution of school problems. The political solution means that everybody in town votes on what is to be done about the school system, the majority elects its representatives into office, and then everybody has to do what the majority wants. This means there are always minorities—some of them very vocal and indignant—who are not getting what they want, and who are therefore perpetually harassing the school administrator. There is, however, nothing we can do about it, because that is the way the system works.

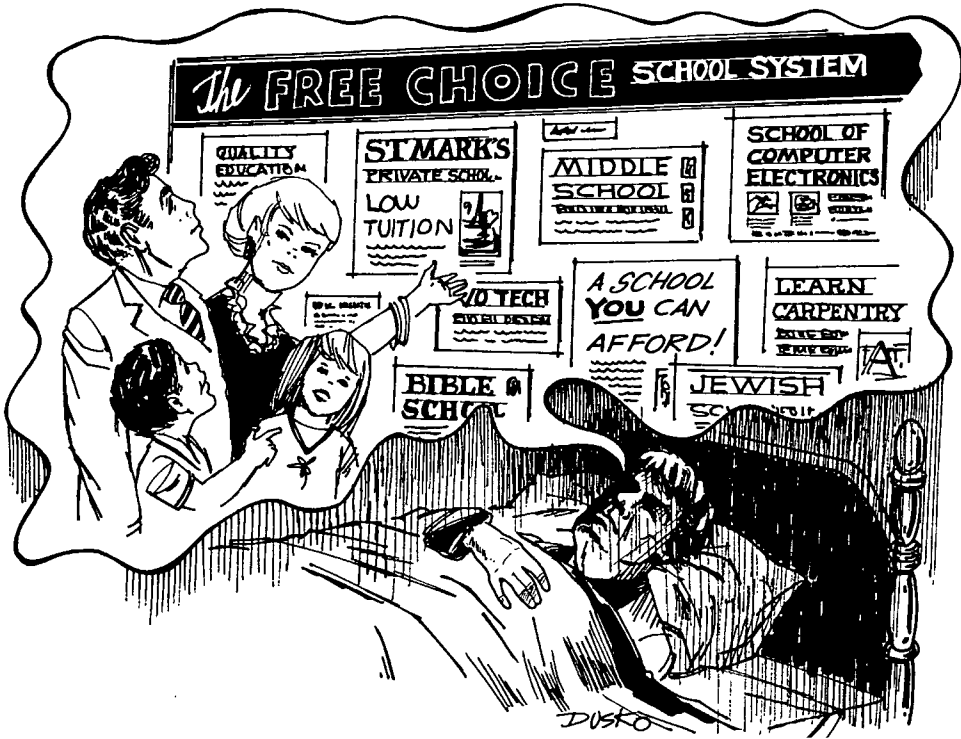
Abolish the political solution method—which means ending the public school monopoly and the forced collection of taxes needed to support it—and you let the free market work. The free market solution means that anyone who thinks he has something to offer in the education field can set up a school—religious, technical, academic, or whatever else—and see if he can get enough people to keep him going. This means that every conceivable minority can be catered to without infringing on anybody else's rights.

If parents want their children to have prayers in school, they send them to schools that have prayers in school. If they don't want that then they choose a school that has no prayers. This is simply nothing to argue about. It becomes a non-issue.

The free market solution imposes its will on nobody. There is no way that the political solution can offer any comparable richness, diversity—or I believe in the end, quality.

*Impossible*, our school administrator said. But the next night my dream returned. In my





dream, none of the predicted calamities fell on our heads when we abolished the public school system. Most of the teachers—the competent ones anyway—found jobs. Parents were more satisfied with their schools than they had ever been before. Our taxes were lower. The competition between schools raised the level of school services. Most of the needy people were helped to get an education for their children. We still don't know what to do about the half-dozen families that refuse to educate their children—but I am not sure how children from such an environment would fare in any school system. The real estate bust never came, and practically everyone stayed on to see how the new system would work out—particularly with the incentive of lower taxes.

Over a longer period of time there will be some benefits and some disadvantages. We shall have to see. There may be an influx of childless people fleeing from high school taxes in other towns. Families with a large number of children may tend to move out and seek a better deal in those school-tax-system towns. However, the variety and quality of our privately run schools should attract to our town families interested in a quality education for their children.

As neighboring towns see how we have managed to cut taxes and improve our educational system at the same time, they may follow our example.

*Impossible*—the school administrator's judgment wakes me up again. And indeed I shall have to stop dreaming. Our town's school system really isn't all that bad. There is some drug-dealing, but there are no rapes, murders, knifings, gang-fights or other murderous occurrences to speak of. Most of the students manage to graduate from high school.

But there are other towns in the United States where all these horrors are daily happenings, where the school corridors are little safer than World War I trenches, where school lavatories are unusable by decent students, where the education is so bad that a large percentage of the students graduate from high school without being able to read or write properly or even to locate where the United States is on a map of the world.

I still dream that sometime, somewhere in the United States, somebody is going to do something with the public school system that will be an example to the rest of the country. □

# Gray's Liberalism

by John Chamberlain

In his *Liberalism* (Minneapolis, the University of Minnesota Press, 106 pp., \$9.95), John Gray of Jesus College, Oxford, takes an exceedingly broad view of his subject. With him, F. A. Hayek, John Maynard Keynes, John Locke, Thomas Hobbes, even the Fabian socialists, are all liberals together. It is their common claim to individualism that binds them. The individualist asserts the moral primacy of the person against the claims of the social collectivity. Fabians who are waiting for the inevitability of gradualism to bring them to socialism are confident that the State will not interfere with their private affairs under a collectivist order, which means that they remain liberals in heart, though in a deluded sense.

Gray's definition spares him a lot of trouble when it comes to dealing with the difference between continental European liberals, who hold to the nineteenth-century classic outlook, and American and British liberals who want cradle-to-grave support in all phases of their existence. Liberalism, to Gray, constitutes a single tradition in spite of the variations that have come with what he calls the "revisionist liberalism of our own times." Personally, I find Gray's effort to stretch a rubber band around Hayek and Keynes, Tocqueville and Harold Laski, Hobbes and Mises, a bit confusing. But until he comes into really modern times, Gray is clear enough.

He begins by denying any claims to the ancients, whether Greek or Roman, to being liberals. The ancients, even Aristotle, did not grant that individuals had any immunity from

control by the community. To them, a man was free when he had an entitlement to participation in the community's deliberations, but that is as far as it went. Anti-liberal sentiment is not as virulent in Aristotle as it is in Plato, but Gray says that "nowhere in Aristotle is there any glimmering of an assertion of the negative right to individual liberty postulated by such modernists as Hobbes and Locke." The Sophists did indeed develop a doctrine of political equality that went against elitist conceptions of government, but the Western world had to wait for the seventeenth century for the first systematic expositions of the modern individualistic outlook which fathered the liberal tradition.

Hobbes began the tradition when he postulated that each man always acts with a view to his own benefit. But this, with Hobbes, did not mean that men would fight to the death for freedom. Since men, in his opinion, were compelled to avoid violent death as the greatest of evils, they were content to accept a Leviathan state with an arbitrary power to keep the peace. Hobbes may have been an individualist, but he offered no defense against the coming of the totalitarian State. Nor did Spinoza, despite his feeling that human beings aim to persist in being not only to avoid death, "but in order to assert themselves in the world as the individuals they are."

Gray says that Hobbes and Spinoza belong to "the prehistory of liberalism." The Spanish Jesuits of the School of Salamanca anticipated some of the themes of the classical liberals of

the Scottish Enlightenment when they argued that the just price of any commodity was the market price. But, as Gray puts it, "the central elements of the liberal outlook crystallized for the first time into a coherent intellectual tradition" in John Locke's *Second Treatise on Civil Government*. Locke was the first to link the rights to personal property and individual liberty. To him, the property right came from mixing one's personal labor with natural resources appropriated without theft. It was the duty of government to protect the property right under the rule of law. The acceptance of Locke's theories was essential to the full flowering of the capitalist order. The American Revolution of 1776 might be called the colonial version of the English Glorious Revolution of 1688, which Locke's theories touched off.

Classical liberalism, developed in detail by the Scottish philosophers and Adam Smith, gave a distinct character to the first half of the nineteenth century in England. The classical economists of this period subscribed to the theory that the State had only night watchman functions. But theory and practice did not always jibe. The first Factory Acts, passed in the early decades of the century, were an infringement of the laissez-faire doctrine. There came a real split with John Stuart Mill, who held that the State had rights to distribution of the capitalist product once it had come into existence. Mill was the first important revisionist liberal.

Gray is good when it comes to tracing the ramifications of revisionist liberalism in Britain and the attempts to backtrack from it to a classical stance. He is less satisfactory when it comes to a description of the American scene. The revolt against Fabian revisionism in the U.S. was considerably more than can be found in the work of Robert Nozick. Gray makes no mention of such important anti-revisionist rebels as Albert Jay Nock, Garet Garrett, Claude Robinson, Henry Hazlitt, and Leonard Read. Despite the failure to give credit where it is due on this side of the Atlantic, Gray's final defense of the free market is first-rate. □

**Editors' Note:** For another perspective on Professor Gray's *Liberalism*, we are pleased to publish the following review by Professor Richard Ebeling of the University of Dallas.

## LIBERALISM

by John Gray

Minneapolis: University of Minnesota Press • 1986 • \$9.95

Reviewed by Richard M. Ebeling

**T**he twentieth century has frequently been labeled the "age of collectivism." Since the first World War, the spirit of individual liberty and the policy of economic freedom have appeared to be irrevocably on the decline. Every conceivable form of State control and management has been tried during the past 75 years: socialism, fascism, Nazism, welfare statism, and interventionism. And each has failed, bringing nothing but tyranny, poverty, and a lost sense of hope in its wake.

But now with the twenty-first century less than 15 years away, the age of collectivism may be drawing to a close. And in its place may be coming a new liberal era. This is what makes *Liberalism* by John Gray such a valuable handbook. In a mere 100 pages, Professor Gray outlines the history of liberalism from ancient times to the present, and gives a concise and insightful analysis of the major tenets of the liberal point of view.

It is important to realize that by liberalism, Professor Gray means *classical* liberalism, i.e., the political philosophy which has emphasized that civil liberties and economic freedom are inseparable, both requiring respect for private property in a competitive, free market environment.

The historical half of the book traces the origin of liberal ideas to the ancient Greeks and Romans. But, as Professor Gray points out, the individualist foundation of liberalism only really developed in the seventeenth century in the writings of such thinkers as Benedict de Spinoza and John Locke. However, it was only in the eighteenth century that a general liberal world-view and philosophy was systematically developed by the Scottish moral philosophers, the French *philosophes*, and the American founding fathers.

While liberal ideas predominated throughout the nineteenth century, Professor Gray points out that an era of full *laissez-faire* never existed and liberal policies in general were on the decline by the 1870s. A major villain in the story

is John Stuart Mill who flirted with socialism and redefined liberalism in such a way that opened the door to the redistributive welfare state. The liberal era ended with the First World War and the growth in State power and control over economic affairs.

Now that collectivism has been tried and found wanting, there is new interest in the liberal alternative, and Professor Gray analyzes the premises of liberalism in the second half of his book. He discusses the alternative foundations that have been offered for liberalism—natural rights, utilitarianism, and contractarianism—and explains the strengths and weaknesses of each. He contrasts the alternative “negative” and “positive” meanings of freedom and their relationship to each other.

In a chapter on “Individual Liberty, Private Property and the Market Economy,” Professor Gray defends economic freedom for the protection of individual liberty by drawing upon the writings of Austrian Economists, particularly

the works of F. A. Hayek (who has defined the market economy as a “spontaneous order” of mutual and voluntary cooperation).

Professor Gray brings the book to a close with a discussion of the “legitimate” functions of the minimal, liberal State and the possibilities for classical liberalism in the future.

One of the most difficult problems in the past was to know which single book to recommend to someone interested in knowing more about the classical liberal ideal, but who was not up to reading through a half dozen lengthy works. Professor Gray has now solved that dilemma with a readable and concise volume. □

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**Freeman** readers may order copies of John Gray's **Liberalism** at \$10.95 each (includes shipping) from Laissez Faire Books, Department F, 532 Broadway, New York, NY 10012, (212) 925-8992.

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*for high school and college students*

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Cover illustration: Randolph Caldecott, from *Old Christmas, from the Sketchbook of Washington Irving*.

## PERSPECTIVE

### The Christmas Spirit

We get much more out of life than we pay for, because many people give much more than the services for which they are paid. This is the essence of the Christmas spirit, as portrayed by Charles Dickens in "A Christmas Carol."

The well-known French author, Bertrand de Jouvenel, noted that we enjoy "warm hospitality, leisured and far ranging conversation, friendly advice, voluntary and unrewarded services. Culture and civilization, indeed the very existence of society, depend upon such voluntary, unrewarded activities." But such activities very often depend on having time, money, and property. It is the freedom to use private property that enables people to give of what they own.

Dickens contrasted the Christmas spirit of giving, generosity, sociability, and cheer, with the stinginess of dour, greedy, grasping Ebenezer Scrooge. In Dickens' mind, Scrooge was a typical capitalist. But Scrooge was no more a "typical" capitalist than Dickens was a "typical" writer. Moreover, once Scrooge was converted by the Ghosts of Christmas, past, present, and future, it was his private property which enabled him to be generous.

It is ironic that the welfare state, intended to be a system where money doesn't matter, has become a system where only money matters. Many services which used to be provided by family, friends, and volunteers, with no expectation of monetary reward, now depend on taxes and bureaucratic decisions. In a welfare state, the act of "giving" is reduced to a nine-to-five government job.

The Christmas spirit of giving and sharing persists today because capitalism and private property survive. What Dickens failed to realize is that it is having private property and the freedom to use it that permits Christmas giving.

—BBG

### Efficiency Experts

Are private sector institutions more efficient than government bodies? Yes, by a long shot. At least that is the opinion in most American

households, according to a recent survey publicized in *Newsweek*. Respondents gave "high or very high" efficiency ratings in greatest proportion to competitive enterprises such as supermarkets, banks, department stores, and credit card companies. By contrast, government-provided services such as public schools, the space agency, local transport, and commuter rail generally had the lowest efficiency ratings, with Congress itself holding the dubious honor of last place.

It is no surprise to students of liberty that market enterprises are more efficient than political ones. But it is encouraging that so many Americans recognize the difference.

Logic suggests that schooling, space development, local transportation, and other socialized activities would also be more efficient if turned over to the private sector. Does this survey presage public support for such a move? Let us hope.

—HB

## Old Dutch Burying Ground

The Old Dutch Burying Ground in North Tarrytown, New York, dates from the time of the American Revolution. The tombstones of common fieldstone, granite, and slate, tilt at various angles. But many of the inscriptions are sharp and clear.

The dates on the tombstones reveal the ages of the departed. Many lived to ripe old ages, especially the men. Quite a few women died in their prime. But sprinkled among the adults are a substantial number of very young children and infants.

One stone marking the grave of a young woman reads:

Tho the Mother is Dead  
And the babe left behind  
May it truly be said

That the father proved kind.

But kindness was not enough. Next to this young mother's grave stands a small stone marking the grave of the baby, who died a mere seven months later.

The folks who lie buried in the Old Dutch Burying Ground lived and died before the capitalist "industrial revolution" and also before the "medical revolution" that followed in its wake. In the face of infectious disease, the people of that time were practically helpless; many succumbed before an epidemic ran its course. Operations, often fatal due to shock or infection, were seldom performed, but if they were, the principal method of deadening the accompanying pain was liquor.

A woman's life was especially difficult, not only because of the harsh conditions of daily living but also because of the hazards of childbirth. Men often survived several wives, sired numerous offspring, only to see many die in childhood.

It was the capitalist "industrial revolution" that wrought the difference between those times and now. With capitalist tools and machines, one worker could produce considerably more food, clothing, and shelter than before. As production increased, more people were freed for study and research. In time, their studies and experiments led to the inoculation for smallpox, safe anesthetics, and recognition of the importance of antisepsis, launching what might be called the "medical revolution."

The advancement of medical science lengthened life expectancy, and sharply reduced deaths among young people. In the more recent Sleepy Hollow Cemetery next to the Old Dutch Burying Ground, the tombstones are mostly of adults, and serve as a reminder of the lengthened life spans wrought by capitalism.

—BBG

## Freedom Essay Contest: Last Call for Entries!

Deadline for our student essay contest is January 15, 1987. All high school and college students are invited to enter the competition. Cash prizes, as well as seminar fellowships, will be awarded to winners and runnersup. Call or write The Foundation for complete details.

# Ravioli and the Economics of Trade

by James Doti

**M**emories are formed more by discontinuities than continuities in our lives. Because of this, I think, the only Christmas I remember well is a Christmas celebrated away from home, a Christmas spent in Little Italy. It is a Christmas memory whose edges take on more clarity over the passage of time.

## December 24, 1955— Christmas Eve Day

My dog Blackie and I look out of a frosted window that separates the cold and crisp Chicago winter morning from the comforting warmth of Grandma's flat. My parents, brothers, aunts, uncles, and cousins will join us tomorrow for a traditional family Christmas celebration, but for now my dog and I are here to keep Grandma company. I don't mind since Grandma and I are tight—a special closeness that comes more easily when one is the youngest of a horde of grandchildren.

Her wizened face is dark, almost swarthy. She wears spectacles with thin silver rims and all manner of long, old-fashioned dresses and shawls, usually black. Her diminutiveness emphasizes the kindly countenance of her face. Many years of dough-kneading have given her stong muscles, but she is old now and often short of breath.

She speaks with a thick Italian accent and I

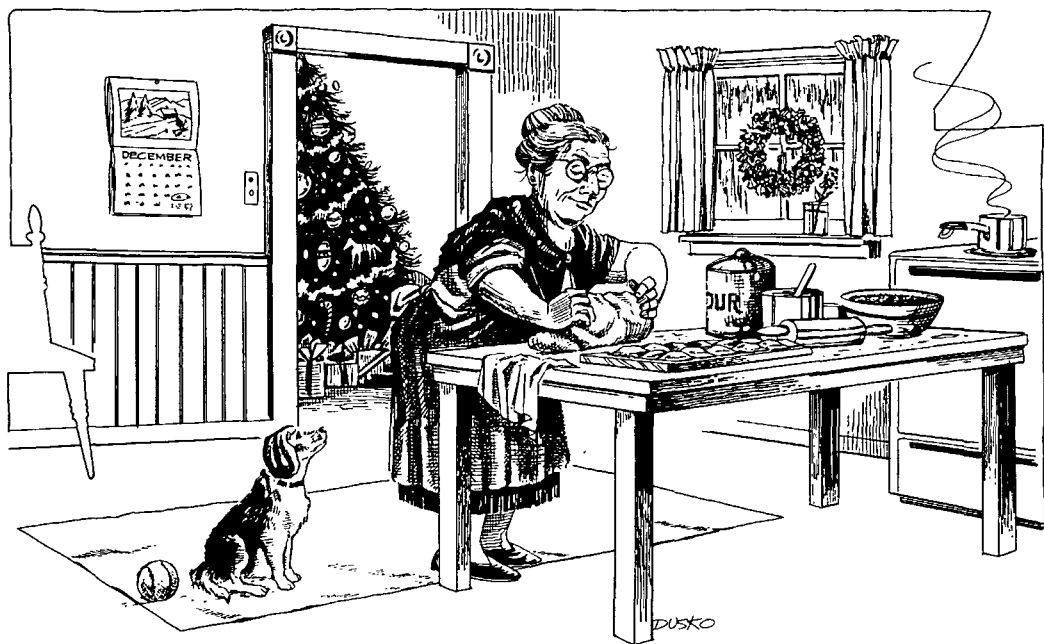
*Dr. Doti is Dean of The School of Business and Management, Chapman College, Orange, California.*

with a speech impediment that renders my English barely intelligible. Yet, we have no problem communicating; our communication does not necessarily require the spoken word. We work with silent efficiency in packing the last of the ravioli that we will bring to market. As I gather the now-dried ravioli which are spread throughout the flat, I savor the rich and sweet aroma of fresh basil and chiminelli.

It is the chiminelli seeds that give Grandma a competitive edge over the other widows in the neighborhood who are also purveyors of ravioli. The source for the seeds is a relative in Grandma's grim little home town of Brienza, Italy—the only area in the world with the proper blend of harsh climate and barren soil that allows the ugly chiminelli bush not only to survive but to thrive and prosper as well. The arrival of Grandma's annual shipment of chiminelli seeds once created quite a stir in the neighborhood when two FBI agents came to question her regarding a possible involvement in drug trafficking. The case was closed when Grandma gave each of the agents a bag of the wonderful tasting pretzel-shaped biscotti that are also distinguished by the anise-tasting seeds.

A chilled wind hits our faces as we pack the last cartons of ravioli on the two decrepit Radio Flyer wagons we use for transport. But Grandma has bundled me up, and I am dressed in galoshes, so except for my face which feels the harsh wind, the rest of me is sweaty and uncomfortably hot.





As we pull our wagons past Laflin Street and Ashland Boulevard, we make it to Halsted Avenue which will lead us to our destination—South Water Market. Tall buildings and narrow alleys cut sharp angles and make deep shadows. The vibrant and festive street life which envelops the area during summer months is absent now. Table-top Christmas trees seen in several sooty windows and cheap dime-store Christmas wreaths hanging on heavily painted gray-green doors fail to convey any Christmas cheer. Perhaps because the neighborhood is unfamiliar or perhaps because of its lifelessness, my dog, in contrast to his usual bounding ways, trails closely behind me. As our expeditionary force of three makes slow and steady progress toward our destination, I fantasize I am Captain Scott heading toward the South Pole.

But when we arrive, our hopes are dashed in much the same way I suspect Captain Scott's were when he found that the Norwegian interloper, Roald Amundsen, had beaten him. After hunting throughout various warehouses and loading bays, we find an agent who gives us the bad news. Hardly looking up from a newspaper he is reading, a gruff man with an inflated sense of self-importance exposes prodigious gaps in

his cigar-stained teeth when he tells Grandma, "We ain't buyin' anymore raviiolese from youse ladies. We're importin' 'em in frozen from Italy. We can get 'em a lot cheaper dat way." Grandma's protestations fall on deaf ears. The man whose jawline had long ago disappeared into one of his chins rises from his chair while making a lifting gesture with both arms and says, "Listen lady, I gotta make a living, too."

As we leave the building with our still heavily-laden wagons we encounter a bitter wind laced with sleet. We are preoccupied with our disappointment when a bus veers toward us and comes to a screeching halt just by the curb where we stand. The shrill sound of brakes and a fountain of slush sprayed by the huge wheels paralyzes my Grandma and me, but Blackie bolts. I turn and see him rounding a corner at breakneck speed. We desperately follow, but lose sight of him.

Lost! Lost! My dog Blackie is lost.

Tears mingle with the sleet on my face as we venture further into an unknown neighborhood. Grandma pleads with me to abandon the search, but I don't give up until she bodily drags me off. Even though I know down deep that Blackie must be hopelessly lost, I fight, scream,

and cry. It is only when I see the look on Grandma's face that I realize we too are lost. My attention turns away from dog-saving to people-saving.

As dusk settles upon us the cold turns colder and the sleet turns icier. Like Captain Scott and his men and the ill-fated trip back to base camp, our movement is painfully slow and misdirected as we trudge in circles over previously covered ground. Several children seemingly oblivious to the cold, throw snowballs at each other in a dangerously boisterous way. Grandma is too proud to ask anyone for directions. When I, risking the ridicule that usually accompanies my speech, do ask and get us back on track I feel for the first time in my life the exuberance that comes when one sheds the weakness of youth and assumes responsibility and control. I fantasize that my decision to ask a stranger for directions is one of life-saving importance and is an heroic act that is witnessed, cheered, and applauded by many.

It is not long before we see the familiar spires of Our Lady of Pompeii Church. As we enter the sturdy old church where my parents were married and my oldest brother was baptized, the redolence of incense and burning candles invades our senses. The church feels peopled and full. Sisters of Mercy, in their glory, bustle up and down marble aisles, arranging altar cloths and poinsettia plants. The warmth of the church comforts us. Grandma prays for economic survival; I pray for Blackie's survival. Before we leave, Grandma fumbles in her purse and gives me a few coins to leave in the poor box.

A block from home, we give the unsold and now-surplus ravioli to Miss Amberg, the beloved director of Madonna Center, the settlement house where my parents first met. As we pull our now-empty wagons over that last block, our slow and spiritless walk conveys Grandma's woe at failing in the marketplace, my woe at losing a dog. In contrast to the quick movements down the steps when we loaded the wagons, Grandma now negotiates the steps with resigned fatigue as she brings both of her high-laced shoes together on each level before proceeding to the next step.

At the doorway, a scratching sound from within the flat is heard. Blackie! He jumps and

slobbers on me when we open the door. A note is on the kitchen table.

Dear Ma,

When we came to bring you your Christmas present, we found Blackie yapping to get inside. The Christmas present in the back room is from all of us. See you tomorrow.

Your loving children

In the back room, rests a state-of-the-art swivel model mahogany RCA Victor black and white 21-inch television set wrapped in a large red bow.

Later that evening while watching the original Christmas episode of "The Honeymooners" on the new RCA set, I stuff pretzel-shaped biscotti in my mouth and wash it all down with cream soda. Blackie snuggles near me beside a clanging radiator.

Grandma looks outside. She hears carolers below the window from Madonna Center singing songs of Christmas celebration, celebrating her and her ravioli. She smiles a distant smile, but her eyes do not reflect contentment; they reflect apprehension. With that special sense of knowing that children sometimes feel but do not fully understand, I see a troubled woman, a woman oblivious to the joyful presence of Blackie, the RCA, the biscotti, the cream soda, and the carolers' songs.

She has no real monetary worries to speak of. Her children are all financially well-off and will gladly provide for her. But she is a fiercely independent woman. It is an independence that she may have been born with but more likely developed in the hard and brutal struggle it takes to leave one's native land, one's relatives, and one's traditions in order to emigrate to a new and strange land.

It was an emigration that allowed her to take her only possessions—her children and her values: respecting others and taking pride in one's work. She would use these values in a free land not merely to survive but to help her and her family live a fuller and more spirited life. They were strong values that she imbued in her children and her children's children.

But now she looked out the window with ap-

prehension. A heartless process in this free land, a process she did not understand, had taken away her sole means of independence and dealt her a cruel blow. She failed in the marketplace and with a fierce sense of pride, this was something she could not accept.

## The Solution?

The solution to my grandmother's difficulty would be simple today: Form a strong political action committee and lobby for a stiff tariff on Italian ravioli. If such a course of action seems improbable, consider the fact that the National Pasta Association (NPA) recently convinced the White House to slap a stiff retaliatory tariff of 40 per cent on European pasta without egg and 25 per cent tariff on pasta with egg. The retaliation was aimed at the European Economic Community (EEC) for a tariff it had imposed not on U.S. pasta but on U.S. citrus products. Evidently, the EEC was convinced by the European citrus industry that it needed protection.

Meanwhile, the NPA is lobbying to protect its tariff. Corby Kummer in *The Atlantic Monthly* states:

As soon as the tariff went into effect, it (NPA) mailed promotional literature (accompanied by packages of domestic pasta) to congressmen telling them to remember that American pasta must be protected. Before the tariff was imposed, the NPA predicted that, unchecked, Italian pasta could claim a 20 percent market share by 1988 or 1989—something extremely unlikely, given that it had only a 4.5 percent market share at the time. (*The Atlantic Monthly*, July, 1986, p. 41.)

Although the pasta tariff and most other restrictions on trade are intended to protect domestic industries, as with most well-intended governmental policies, the ultimate impact is quite different. The reason for this is straightforward: Tariffs and other restrictive policies reduce the overall benefits to be derived from trade. A corollary to this is that protected industries in the long-run generally fare poorly when they are not fully subjected to the harsh realities of a competitive environment.

Almost all economists agree that free trade is

better than protectionism. What is it that is so unmistakably good about free trade that has done the impossible—namely, get economists to agree with each other?

We can be very analytical about it and show the net benefits of trade by describing the theory of comparative advantage. Adam Smith was far too interesting a writer to get bogged down with such analytics; David Ricardo, however, had no such compunction. Ricardo rigorously showed that two nations will benefit from trade even when one of the nations is absolutely more efficient in the production of all goods.

We need not be so analytical. Actually the benefits of free trade are simple to understand within the context of a free enterprise system. Our economic system is based on greed. Of course, this is not as bad as it sounds. Thankfully, almost everyone is a profit-maximizing individual and competition among many profit-maximizers assures that prices are kept low and that goods and services are being produced that people demand.

How does free trade enter into this? Free trade simply allows more profit-maximizing producers to get in on the action and helps insure that the competitive process functions more efficiently. Looking at a concrete example, consider the impact of the 1980 automobile import quotas. Is it so surprising that U.S. automobile prices increased 50 per cent from 1980 to 1985 when overall consumer prices increased at half that rate or that automobile profits increased over 80 per cent to \$10 billion over that time period? Such a result is not surprising. It is a typical short-run outcome of protectionist policies.

## Why Erect Barriers?

If the case is so open and shut in favor of free trade, why do we erect barriers? The answer to this question, I believe, is that vocal private interest groups stand to gain much in the short-run by pushing for self-serving laws. Unfortunately, the political strength of a vocal minority is often more politically potent than that of a more disinterested majority. Case in point: As a result of steel quotas, the share of steel imports is projected to drop from 30 per cent to 18 per

cent of the U.S. market. Presumably, some domestic jobs in the steel industry will be saved in the short-run. But how many jobs will be lost in countless other industries as a result of having to pay higher prices for steel? The steel industry recognizes the short-run private gains accruing to it because of restrictive trade policies; the costs of such policies are spread too thinly and across too many industries to ferment much opposition. The fact that the costs of trade regulations far outweigh the benefits, however, should be clear. As F. Kenneth Iverson writes in *The Wall Street Journal*:

The cost to consumers is staggering. The trigger price mechanism under President Carter cost consumers an estimated \$1 billion per year for more than three years and saved, temporarily, some 12,000 steelworking jobs. That's more than \$80,000 per year per job, quite a bit more than the jobs paid.

But the delay in modernization and the cost to consumers are only two parts of the picture. The greatest hazard is the destruction protectionism causes to U.S. manufacturers for whom steel is a significant part of their costs. Because the American steel industry is sheltered, world prices on some steel items are \$100 to \$200 a ton lower than in the U.S. This enables foreign manufacturers or American companies that move abroad to undersell domestic manufacturers. Automotive parts, oil rigs, farm implements, appliances, railroad parts and numerous other products are examples of domestic products suffering under this handicap. In 1979 the imports of these downstream steel products were estimated at five million tons. In 1985 they reached an estimated 15 million tons.

One steel analyst has projected that the increased imports of such products will cause a decrease in the domestic steel market of more than 1% a year. As this occurs, our steel industry will have to shrink even further. How ironic that protectionism will accomplish the very thing it is supposed to prevent. (*The Wall Street Journal*, August 21, 1986, p. 22.)

Adam Smith understood all this as long ago as 1776:

Each nation has been made to look with an invidious eye upon the prosperity of all the

nations with which it trades, and to consider their gain as its own loss. . . .

That it was the spirit of monopoly which originally both invented and propagated this doctrine, cannot be doubted; and they who first taught it were by no means such fools as they who believed it. In every country it always is and must be the interest of the great body of the people to buy whatever they want of those who sell it cheapest. The proposition is so very manifest, that it seems ridiculous to take any pains to prove it; nor could it ever have been called in question, had not the interested sophistry of merchants and manufacturers confounded the common sense of mankind. Their interest is, in this respect, directly opposite to that of the great body of the people. As it is the interest of the freemen of a corporation to hinder the rest of the inhabitants from employing any workmen but themselves, so it is the interest of the merchants and manufacturers of every country to secure to themselves the monopoly of the home market. Hence in Great Britain, and in most other European countries, the extraordinary duties upon almost all goods imported by alien merchants. Hence the high duties and prohibitions upon all those foreign manufacturers which can come into competition with our own. (*The Wealth of Nations*, Modern Library Edition, 1937, pp. 460-61.)

In commenting on the discovery of America, Adam Smith also states:

It is not by the importation of gold and silver, that the discovery of America has enriched Europe. . . . By opening a new and inexhaustible market to all the commodities of Europe, it gave occasion to new divisions of labour and improvements of art, which, in the narrow circle of the ancient commerce, could never have taken place for want of a market to take off the greater part of their produce. The productive powers of labour were improved, and its produce increased in all the different countries of Europe, and together with it the real revenue and wealth of the inhabitants. (*Ibid*, pp. 415-16.)

Nor should it be supposed that restrictive trade policies provide long-run benefits to the protected industries. Notice that the benefits al-

luded to in the above examples were couched in terms of "short-run" benefits. Without the unbridled powers of competition present to give correct signals to an enterprise, protected industries will soon become dead industries.

After years of protection, the steel industry is ailing, and there are no immediate signs of turn-around. Indeed, the current question is whether a viable steel industry will exist in the U.S. ten years from now. Even in the case of the pasta tariff, the volume of pasta imports into the U.S. is as high as it was before the imposition of the tariff.

The fact that restrictive trade policies offer no long-run protection to beleaguered industries is even more obvious in a world of multinational enterprise. An interesting case-in-point is offered by Marc Levinson, a senior editor at *Dun's Business Month* who writes:

International Salt Company, based in Clark Summit, Pennsylvania, charged last year that dumped Canadian rock salt endangered the welfare of U.S. salt companies and of some 1,600 American workers. A Commerce Department investigation found that the salt was indeed being sold in the United States at less than its Canadian price. Low profits for U.S. salt producers in 1983, when dumping was alleged to have occurred, seemed to make International Salt's case even stronger.

But there was a twist to this otherwise mundane matter. The "U.S. company" claiming injury, International Salt, is owned by a company based in Holland. The villain alleged to be doing most of the dumping was none other than Morton Salt Company of Chicago, the largest producer of rock salt in the United States as well as a major importer. Was Morton dumping Canadian salt to injure itself? Should America's dumping laws protect a foreign firm against imports by a U.S. firm? These questions remain unresolved: In January, the ITC ruled that the domestic salt industry's problems in 1983 were due to a warm winter, not to dumping. ("Down in the Import Dumps," *Across the Board*, April, 1983, p. 57.)

The automobile, steel, salt, pasta, and all other industries do not need protection from free trade. Neither did my grandmother.

## March 18, 1956— St. Joseph's Day

I withdraw a spoonful—no more, no less—of ricotta filling and almost simultaneously place the filling onto a rolled sheet of dough. Grandma rolls another sheet of dough out of her newest capital investment, a deluxe Rolletti pasta-making machine. She ritualistically places the smooth and elastic sheet of dough onto the sheet containing twenty dollops of ricotta filling.

The final step is the most satisfying and certainly my favorite part. A newly purchased ravioli cutter allows me to cut and seal the ravioli pockets at the same time. The satisfaction of seeing the clean serrated edges left by the cutter is not unlike the sense of satisfaction one feels when correctly tying a complex knot.

The efficiency in ravioli production brought about by the recently acquired capital equipment (\$14.78), allows Grandma to make 500 ravioli in the same amount of time it took to make 100 ravioli several months ago. Moreover, she charges a lower price to compete with the frozen Italian product and still makes it all worthwhile.

Grandma may not even have to worry about the inferior Italian product much longer. It turns out that the frozen patties have a tendency to break apart in the cooking process, leaving a large quantity of naked ricotta balls and trails of pasta remnants floating in a pot of boiling water. Even those ravioli that survive the cooking process are mushy—not the requisite *al dente*.

She smiles at me while I take the tray full of ravioli to the bedroom to dry. I suddenly realize the sense of pride and satisfaction one must feel when ingenuity and hard work bring success in the marketplace.

Grandma beat the market, and that smile on her face told me she knew it. □

# Should We Organize for Liberty?

by Robert James Bidinotto

**T**he mark of the idealist is his desire to “do something,” to make over the world in the image of his ideals. But there is nothing more tragic than the idealist whose means contradict his ends.

While advocates of liberty understand the contradictions of collectivism, many have failed to recognize contradictions of ends and means within their own camp. The problem usually arises in organized, cooperative activities to promote their shared convictions.

This problem is both sad and enduring. Pro-freedom journals have long chronicled the bitter machinations of feuding factions. Cults of personality and chronic organizational rifts preoccupy many inhabitants of our ideological world. Impressive sums of time and money have been expended on bloodletting that would have been the envy of medieval physicians.

What concerns us here are not unavoidable conflicts over philosophical ends, but those *avoidable* conflicts arising from inappropriate *means*. Such unnecessary strife is diverting precious thought, energy, and resources from the battle for individual human liberty.

Some years ago, I drafted some thoughts on this subject. Recently, I was reminded of them when I read the late Leonard Read’s “How to Gain Liberty,” and found that he had anticipated many of my own conclusions:

Organization, though much used, seems to be little understood. In the field of extending

individual liberty, organization has strictly limited, technical possibilities. Unless these limitations are scrupulously observed, organization will inflict on liberty more harm than good; thwart, not abet, the spread of understanding.<sup>1</sup>

In short, Mr. Read would have asked us to consider the meaning of our principles—and then consider whether those principles really animate our organized activities.

## Individualism and Collectivism

The battle for individual liberty is rooted in the wider battle of individualism versus collectivism.

Individualism is a social philosophy prescribing full personal self-responsibility. The individualist accepts the responsibility of thinking for himself (independence), and of acting consistently on his unborrowed vision (integrity).

Collectivism is a social philosophy prescribing individual subordination to some wider collective. It requires individuals to abandon personal moral responsibility, trading their independence and integrity for unthinking obedience and helpless dependency.

To accept uncritically the ideas of others, rendering oneself blind and vulnerable, is the antithesis of independence. And to sever one’s thoughts from one’s actions, heading on an inconsistent and self-defeating course, is the antithesis of integrity.

These considerations are not irrelevant asides. They lead logically to the following

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conclusion: *No activity to establish liberty can succeed while dispensing with the moral and psychological requirements of individualism.* Phrased another way: *No activity to establish liberty can succeed which fosters authoritarian and dependent personalities.*

As Leonard Read put it:

Just as government becomes dangerous when its coercive, restrictive, and destructive powers are extended into the creative areas, so do voluntary organizations pervert and destroy the benefits of intellect when the capacity to merge is carried to the point of subjecting individual judgments to the will of the majority or group. Truth, as each person sees it, is the best that the mind of man has to offer. Its distortion, inevitable when achieving a collective chorus, does injury to understanding.

Is it possible that some groups espousing the free society are "subjecting individual judgments to the will of the majority or group"? Has a form of collectivism afflicted even pro-freedom organizations? Is it even possible to "organize individualism"?

There are several types of cooperative ideological efforts, some consistent with individualism, some not.

## I. Orthodoxies

I was once a leader in an idealistic group which promoted a systematic philosophical position. Soon my concern for the identity and integrity of the group drew me into the unwanted role of an ideological policeman of fellow members. More of my efforts became diverted into that role than in advancing the purposes of the group. Board meetings became heated shouting matches, as each of us attempted to preserve the "consistency" of the group as we individually saw it. Our common affiliation turned former friends and allies into bitter foes and rivals. Predictably, the group fell apart.

Some years later, I was hired by a decent, idealistic businessman to head a project to promote the free market system. I had assumed the two of us agreed on what "the free market system" implied. But I soon discovered that we had serious disagreements, even of thrust or emphasis. Paralyzed by competing loyalties to my job,

and to my own views, the project failed and the two of us parted company.

Both projects failed because they were structured to be *ideological orthodoxies*.

An ideological orthodoxy is any group or publication supporting a specific *system* of ideas, and permitting only *authorized* interpretations of those ideas to be advanced in the name of the group.

This last qualification is critical. *Whose* interpretation is to represent the views of all members? *Some* authority has to define the collective position of any group advancing a systematic viewpoint. If the group's position is to appear self-consistent, the implications of general principles must be decided upon for all. That is why the orthodoxy cannot tolerate dissent.

The basic problem of the orthodoxy is that of public representation. If people promote a common philosophy individually, no orthodoxy could arise: each person would be assumed to be speaking for himself. But the structure of the orthodoxy links everyone's views and reputation, making each member a *de facto* "spokesman" or "representative" of the common philosophy.

Soon, the leaders become preoccupied with being "misrepresented" by zealous followers; and they then feel impelled to restrain members from making "unauthorized" public statements. For anyone to think independently, creatively, innovatively—or even to disagree occasionally—raises the specter of public "misrepresentation." Thus conformity, usually far from the intention of the leadership, becomes the glue holding the group together.

What alternatives are left to an individual in such a structure? He may decide to impose his perspective on the group, by "taking over"—in which case he suppresses the independence of other participants. He may decide to suppress his own views and "go along," even though he may disagree in principle with some of the group's positions—in which case he undermines his personal integrity. Or he may decide to quit—in which case he preserves his own independence and integrity by undermining the group.

Hence the endless factionalism, excommunications, schisms, and heretic-burnings which have characterized orthodoxies throughout his-

tory. Hence the interminable power struggles, as competing members attempt to purify the group from what they see as heresies. And hence the unsavory behavior that too often afflicts such groups: boot-licking, back-stabbing, bullying, blindness. Authoritarianism and appeasement are the inevitable by-products of every effort to make thought a group process.

Paradoxically, the orthodoxy is spawned of two laudable impulses: the desire for cooperative ideological action, and the desire for integrity and consistency. But when the scope of agreement must include *an entire intellectual system*, the two impulses contradict each other. That is because no two minds can consistently interpret the vast implications of general principles exactly the same way.

*No mind can represent another—not systematically, not philosophically.* Total agreement can be based only upon a totally shared context of understanding. That is clearly impossible. And that is the inescapable problem of the orthodoxy. Only the illusion of harmony exists in such groups, an illusion rooted in dogmatic self-suppression, and enforced by authoritarian measures.

Among advocates of laissez-faire capitalism, relatively few orthodoxies have arisen; but those few have had explosive histories. Needless to say, they are hardly consistent with independence and integrity. Orthodox structures may indeed be appropriate to advance *collectivism*; but they have nothing in common with individualism and liberty. They “pervert and destroy the benefits of intellect”—as Mr. Read observed—by “subjecting individual judgments to the will of the majority or group.”

## II. Coalitions

In reaction, many proponents of liberty have attempted to escape from the trap of orthodoxy, via the route of *coalitions*.

Coalitions attempt to build a broad consensus around some vaguely ideological label, slogan, or premise. Common examples include the more ideological political parties, or those groups and publications bearing ambiguous designations such as liberal, conservative, libertarian, socialist, and so on. But unlike the orthodoxy, the coalition's exact ideology is never

precisely defined, unambiguously identified, or fully systematized.

Why? Because identifying such philosophical ramifications would impose “divisive” ideological requirements on members—leading them back into orthodoxy. So, ideological coalitions characteristically issue moralistic pronouncements, while cautiously tiptoeing around any rationales for such pronouncements. In the name of “tolerance,” the coalition rejects authoritarianism . . . for agnosticism.

Lacking a common theoretical base, the coalition's concerns are reduced to the lowest common denominators of agreement: usually, their common label, and some common enemy.

The common label sustains the illusion of a definite ideological position, while its undefined status permits unrestricted recruiting. Meanwhile, the common enemy cements the coalition, by diverting attention from its unresolved (and unmentionable) identity problems.

Thus the futility of the ideological coalition. It cannot offer a *fundamental* challenge to society, since it avoids any systematic theory. Eschewing theoretical roots, it cannot tell the public *why* its pronouncements should be accepted. The same agnosticism that binds the coalition, leaves acceptance of its declarations and assertions in the realm of blind faith.

This is especially apparent in the history of the more ideological political parties. As orthodoxies, such parties rarely attract a broad constituency. Broadening their base of support requires them to tolerate a wider spectrum of members; and to trade explicit, controversial doctrines for more ambiguous slogans and generalizations. But such coalition-building waters down the philosophical identity of the party. So, at some point, party “purists” decide to move in the opposite direction—toward purging heretics and reimposing strict doctrinal requirements. The resulting orthodoxy once again drastically narrows the party's public appeal.

The dilemma of the ideological political party is that it is attempting to do two competing things: change public opinion, and win public approval. The former can be done only by challenging the audience; the latter, only by resembling it.<sup>2</sup> This dilemma is shared by most coalition groups.

Many pro-freedom organizations and publi-



cations are structured as loose, eclectic coalitions. Most have proved impotent and unstable. Invariably, some members become impatient with intellectual self-suppression in the name of "unity," and try to take over. A running battle then ensues between the group's "purists" and it's "pragmatists." Members are tugged between the two sides, seldom realizing that *both* are united against the definition of individualism: the authoritarian "purists," against independent judgment; the agnostic "pragmatists," against definitions as such.

Happily, the alternatives among cooperative ideological projects are *not* limited to orthodoxies or coalitions.

### III. Forums

*Forums* are groups and publications whose participants maintain a platform to promote a range of diverging views.

The essential difference between forums, and orthodoxies or coalitions, is that forums are directed toward *the self-education of participants*, while both orthodoxies and coalitions are aimed at *educating an external audience with a (presumed) common perspective*.

There are several types of forums.

1. *Unlimited forums* are intellectual marketplaces, open to any and all ideas, with each participant given an unrestricted platform and impartial consideration. It is clearly understood that no participant necessarily represents anyone other than himself. Examples include most letters-to-the-editor columns, broadcast "talk" programs, many "think tanks," debating societies, and public speaking forums.

Any forum requires some criteria for selecting participants, of course. But in an unlimited forum, that does not include the need to hold certain ideological perspectives. Instead, the choice of participants is usually based upon their reputation, the controversy they might provoke, or the fundamental alternative that they might offer.

The most common objection to supporting an unlimited forum is that one will frequently assist the propagation of views he opposes. But the same criticism might be made of any marketplace. If one truly believes that his perspec-

tive would fare well in public competition with others, he will welcome the existence of an unlimited forum. Just as a man should welcome the existence of the economic marketplace (even though he may not like all the goods and services offered), so should he regard a marketplace of ideas as to his long-term interests.

This is especially true for those holding unpopular views in a culture where an intellectual Establishment often ignores minority perspectives. The existence of an outlet for new and unpopular ideas is in the best interests of everyone—most of all, to the world's smallest minority: the individual. *An unlimited forum facilitates innovation*, in a manner which respects the integrity and independence of all participants.

2. *Limited forums*, by contrast, allow only certain *categories* of views or subjects to be considered, but permit divergent viewpoints and interpretations within those categories. They may be limited either topically, or philosophically.

a) *Topical forums* limit participation not by ideological content, but by intellectual context. Examples: the various professional journals, each restricted in subject matter to a narrow field of concern. Within each field of study, divergent viewpoints openly compete. Nobody represents anyone but himself; innovation is encouraged; and the individualist virtues of independence and integrity are fully respected.

b) *Philosophical forums* limit participation to those sharing common philosophical premises or perspectives; but within that context, various interpretations compete. Examples: journals devoted to the study of Marxism, or Austrian economics, or Freudian psychology—in which writers sharing a common theoretical approach debate fine points and applications. Likewise, a journal or a public speaking forum might devote itself to the study of liberty, and admit a range of contesting perspectives.<sup>3</sup>

There is nothing in the structure of the philosophical forum that violates the requirements of individualism. The only danger is that a philosophical forum may drift beyond its proper lim-

its, and become instead a dogmatic orthodoxy or an agnostic coalition.

For instance, a journal which admits only those articles strictly conforming to some officially authorized "party line" is not a forum. And a journal which advocates a variety of specific political reforms, but which is incoherently eclectic in its arguments and contributors, is not philosophical.

The basic issue is the difference between *study* and *propaganda*, between personal education and public activism. A forum aims at the self-education of its *participants*; coalitions and orthodoxies aim to offer an allegedly united perspective to the *public*. The philosophical forum, focused on self-education, respects the integrity and independence of participants. The coalition and orthodoxy, requiring unified action, do not.

Those involved in a philosophical forum must be extremely careful that its activities do not cross the boundary line from self-education to public propaganda. To the extent that this occurs, the forum will find itself becoming more unstable and divided over the question: Whose interpretation of our "common" perspective are we going to promote?

The temptation to move from self-education to public activism was often addressed by Leonard Read, and never more forthrightly than in "How to Gain Liberty":

The best thing to do even in an intellectual fight for liberty, many think, is to organize—which is a form of action. Usually they think in terms of organizing someone else to do something instead of organizing their own time and energies. . . . This mania for organizing is usually little more than an effort, doubtless unwitting, to transfer responsibility from oneself to some other person or persons whose competence is often unknown. . . .

Is there any way, beyond self-education, for individualists to make common cause?

#### IV. *Ad Hoc* Projects

*Ad hoc* projects are organized with pre-defined and carefully delimited positions on predetermined issues.

Examples: A committee is formed by fans of

a book to distribute it to libraries. A film project is undertaken by those who like a particular story. A petition is circulated by those who agree with its wording. Backers of a particular political candidate work to elect him to office.

Observe that while such projects require some agreement by all participants, that agreement is specific, delimited, and *predetermined*. No *system* of abstract ideas, requiring somebody's eventual interpretation, is promoted; participants do not "represent" each other beyond the predetermined area of agreement; and thus, the independence and integrity of all is respected and maintained.

By definition, any group based upon some abstract idea(s), and which must constantly interpret or apply its doctrines to new issues, is *not* limited and is *not ad hoc*. Groups always redefining their identities with new platforms, goals, and positions are guilty of a kind of "bait-and-switch" fraud. They are not the same groups established by their founders. After joining with certain expectations, a member may be dismayed to find his group turning into something quite different.

I was once a board member of an *ad hoc* organization promoting passage of state tax-limitation laws. To this end, the group rallied broad support and was highly successful. But in time, its leaders began to plot ambitious goals beyond the realm of taxation. In addition, they proposed that all board members make their public positions conform to those of the board's majority. The combined effect was to require conformity on *unlimited* future issues. Needless to say, a number of us quit; and the "new" group has since achieved nothing.

*Ad hoc* projects bypass such problems by being structured to avoid them. They minimize discord, are flexible in what they can be designed to accomplish, focus everyone's energies on a narrow range of concerns, respect the individuality of all participants, and thus maximize the chances of success. They recognize what I shall call "Bidinotto's Law of Organizations": The narrower a group's philosophical agenda, the broader its public appeal; the broader the range of required agreement, the narrower its public appeal.

*Ad hoc* projects are the best means of engaging in political activism. Those attracted to poli-

tics should not try to "take over" the major parties—or even establish some "party of principle" of their own. For all the reasons cited above, such attempts will result either in an orthodoxy, or some unstable and ineffective coalition. Instead, would-be candidates should run either as independents, or as *nominal* members of the (non-ideological) major parties—fully recognizing that a political candidacy is not the best forum for public education.

## The Ideal Alternative

Limiting cooperative efforts to those structures consistent with individualism might seem depressingly restrictive—especially to those whose fantasy is to lead a mass crusade. Those so moved would do well to read Eric Hoffer's *The True Believer*.<sup>4</sup> Their vision might be called many things; "individualist" is not one of them.

But it is not my purpose to single out individuals and groups for criticism. Most idealistic activists are not aware that there are principles underlying organizational structures, and have simply chosen among the available options. This writer himself has learned the principles of individualist cooperation the hard way.

The greatest lesson I learned is that the ideal solution to the problems of organized individualism is the simple individualism of a personal career. The most influential and innovative ide-

alists in history have acted alone, in personal undertakings, loyal only to the inner voice of their convictions. Those at a loss for things to do, would do well to follow their example. Said Leonard Read:

Action? The casual thinker might imagine that the best course is to try to tell others what to do and how to think. But reason supplies a contrary answer. It suggests that pursuit of one's own personal understanding is the only practical action for one to take. . . . Some persons will assert . . . that this suggested student approach—this process of self-improvement—is too slow to meet the challenge of these times. . . . But, in my opinion, there is no short cut. The only way to truth—that is, to understanding—is through one's own person.

The world is stampeding toward collectivism in an orgy of organizing. Let advocates of liberty remember that in individual understanding lies our power, and in the individual life, our glory. □

1. Leonard Read, "How to Gain Liberty," a 1955 essay reprinted in *The Freeman*, January 1986. All subsequent quotations from Mr. Read are from this article.

2. Robert James Bidinotto, "Marketing the Free Market," *Notes from FEE*, January 1984. In this essay, I dealt with these two competing approaches as, respectively, the "exemplar" and the "salesman" strategies.

3. *The Freeman* has been fulfilling this role for many years.

4. Eric Hoffer, *The True Believer* (New York: Harper & Row, 1951).

## Start When Ready

**A**nyone can begin the practice of freedom whenever he chooses to do so. It is easy, and one need not wait upon other persons to agree before he begins. No committee resolutions or elections or laws are needed for a person to begin the practice of freedom. One need merely resolve not to impose his will—legally or illegally—upon his peaceful fellow men in their religions, their economic theories, their attitudes, their morals, their mores, or whatever. And then start to practice it.

—DEAN RUSSELL

IDEAS  
ON  
LIBERTY



# Deficits Do Matter

by Hans F. Sennholz

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**P**oliticians and officials in high places are telling us that government debt does not matter; after all, we owe it to ourselves. As long as government borrows funds internally and expenditures are financed from internal sources, so the notion goes, no real cost is incurred. Interest payment on debt merely represents transfers from taxpayers to bondholders. Debt to foreigners, by contrast, is seen as a wholly different matter because it necessitates interest payments to outsiders. It is analogous to private debt.

The recurrent notion that "we owe it to ourselves" springs from the doctrines of mercantilism. It was very popular with European monarchs during the 16th, 17th, and 18th centuries because it placed them in the center of economic life and made them the promoters and guardians of national prosperity. Kings and princes who looked upon the economic lives of their subjects as mere extensions of their own economic activities viewed their debts as both accounts payable and accounts receivable. After all, if the subjects belong to his lordship, also their property is his. The debt he may owe them he owes to himself.

The so-called Keynesian revolution during the 1930s revived the doctrine and promoted it

to a great principle of economic knowledge. Economists throughout the Western world accepted it almost universally. And yet, it is as fallacious today as it was when the kings and their ministers proclaimed it. It is the rationale of spendthrift governments ever eager to run into debt.

The federal government debt now exceeds \$2 trillion and is expected to reach the \$3 trillion mark by the end of the decade. We do not owe these sums to ourselves, the U.S. government owes them to individual savers and investors. Surely, in a command system such as communism or fascism, government owns and controls everything and everyone and, therefore, may be said to owe it and simultaneously own it all. But in our free order, individuals do have rights and may own property. They may own treasury bills, notes, and bonds and expect to be paid; the fact that they, too, may be taxpayers is irrelevant for the claim. They expect to be reimbursed by the debtor, the government, which in turn depends on taxpayers for payment. It does matter to every individual whether he owns such obligations or merely owes taxes that service the debt.

The core of the fallacy lies in the holistic way of equating individual action with community action as a whole. If individuals were part and parcel of the collective whole and personal property an integral part of government property, it would not matter how the credits and

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*Dr. Sennholz heads the department of economics at Grove City College in Pennsylvania. He is a noted writer and lecturer on economic, political, and monetary affairs. His latest book is Money and Freedom.*

debts are listed; they all would balance out. But in our free order, private property is not government property and government property is not private property. This is true no matter whether the individual owner is a native or foreigner. The law protects both from government infringement and transgression.

## Deficits Curtail Investments and Are Tax Liens

Government debt usually signals the consumption of individual savings and economic resources. It is a rare exception for government to invest its funds productively, applying property for future income or benefits. Politics tends to favor present use and enjoyment at the expense of the future. A huge debt signals huge consumption of economic resources for political ends, incurred in the past at the expense of the future. It speaks of factories not built, stores not opened, businesses not started, and jobs not created.

Deficits consume funds that otherwise would be available for private investment; they represent a direct transfer from investment to consumption. The deficits of the U.S. government curtail the rate of economic expansion, keep productivity and labor income lower than they otherwise would be, impede international competitiveness, and cause American levels of living to fall relative to those in other countries where people save and invest more.

It may be argued that other governments throughout the world incur similar deficits and, therefore, exert similarly restrictive effects on their countries. But such an argument is badly misleading because the savings rate is much higher in many other countries. Where the investment rate exceeds 20 to 30 per cent of income, the impact of a 5 per cent deficit is less adverse on investment than in the U.S. where the savings rate barely reaches 5 per cent. Americans cannot afford any further reduction in investment through government deficits.

Deficits and debts also signal future tax exactions. Having incurred the debt in the past, government, in order to repay the funds or just pay the interest, must levy taxes in the future. In essence, therefore, a government debt is a government claim against private property—an un-

paid tax bill so to speak—that will fall due in the future. Like all other business taxes, it is bound to depress labor productivity and the value of productive property.

To most people government spending is a panacea for all economic evils and difficulties; a cure-all for human woes. Where economic stagnation impedes progress and prosperity, government is expected to stimulate through deficit spending. Where there is unemployment, government is expected to supplement private demand and thus create jobs. Where there is poverty it is expected to provide affluence through more spending and debt. But nature forgives no debt and grants no benefit without cost.

There can be no beneficiary of government largess without a victim of exaction. Government cannot pile up debt without every paying it off; all government expenditures must ultimately be paid out of tax revenues or be repudiated through inflation, which is merely another form of taxation. Either immediately or ultimately every dollar of government spending is taken out of the pockets of taxpayers. When seen in this light, the supposed benefits of government spending are rather questionable. To build a pyramid of Federal debt is to delay the inevitable and pay interest thereon.

## Inflation Reduces Debt

Politicians point out that over the decades the Federal debt has actually declined in terms of purchasing power as well as relative value. If growing budgetary deficits are accompanied by shrinking real debt and rising ability to pay the debt, the happy spenders may indeed be right that Federal debt no longer matters.

True, the Federal debt has actually declined both in purchasing power and relative value. But this decline in itself is a great evil that is spawning many other evils. Most of it is the handiwork of inflation, the willful policy of currency debauchery, that enriches one class of people at the expense of another. It deprives creditors of their rightful claims and enriches the debtors, primarily politicians and government officials who incur the debt and place it on the people. It breeds economic and political conflict as it pits the economic interest of one



**“As budget deficits continue, the U.S. dollar must ultimately fall not only in purchasing power but also in the money markets of the world. When foreign investors finally conclude that they have enough dollar liquidity and enough investments in the U.S., the dollar must fall.”**

social class against another, jeopardizing peaceful social cooperation and endangering the democratic process. Surely, debt and depreciation do matter.

Depreciation of debt by inflation is repudiation pure and simple. It is deceit, wicked and desperate; its consequences can never be foreseen. When deceit has been practiced in matters where all should be fair, confidence cannot be easily restored. In financial terms, interest rates signal the dangers of repudiation; they cannot be expected to return to normal as long as deceit can be expected. In this sense, the deceiver is bound to pay a price for his evil ways.

The rising burden of interest on the Federal debt illustrates the point. In fiscal year 1986 the U.S. Government is estimated to pay \$196.095 billion in interest on its debt; in 1987 it is scheduled to pay \$206.855 billion. In terms of Federal revenue the interest is expected to consume some 25 per cent of estimated receipts, in terms of gross national product some 4.5 per cent, which is the highest in U.S. history. Even in 1945 when the Federal debt amounted to 133 per cent of GNP, the burden of interest consumed less than 10 per cent of net receipts and barely 2 per cent of GNP. If government expenditures on goods and services were deleted from GNP figures because government revenue merely consists of exactions from private production, the interest burden on every American

would be seen to be even greater. Surely, debt and interest do matter.

## **Deficits Disrupt Foreign Trade**

Federal budget deficits cause interest rates to be higher than they otherwise would be, which may induce the American people to save more and foreigners to move funds into the United States. The foreign investments alleviate the savings shortage, permitting the federal government to continue the deficit spending and the American people to maintain their levels of living. But the foreign investments also serve to drive up the value of the dollar, which causes American goods prices to rise in international markets and American firms to become non-competitive. In other words, the inflow of foreign capital leads to an overvalued dollar, which leads to more imports of foreign goods and to what is commonly called, balance-of-trade deficits. The imports, in turn, keep the price inflation low but also hamper American competitiveness, depressing competing industries and causing the loss of jobs in those industries.

If the budget deficits continue, American competitiveness may be damaged permanently. The consumption of capital in the U.S. and the formation of capital abroad may necessitate permanent adjustments in patterns of produc-

tion and international trade. Capital-intensive industries may contract in the U.S. but expand wherever capital continues to be formed. American wage rates may fall while some foreign rates continue to rise.

As budget deficits continue, the U.S. dollar must ultimately fall not only in purchasing power but also in the money markets of the world. When foreign investors finally conclude that they have enough dollar liquidity and enough investments in the U.S., the dollar must fall. In fact, it may plummet when foreigners lose confidence in U.S. economic and monetary policy, when willful dollar depreciation inflicts painful losses on their dollar investments, and causes them to liquidate rather than invest. When foreigners become dollar sellers rather than dollar buyers the international situation is bound to change. The American dollar will fall, American competitiveness will improve, the flood of imports will cease, competing American industries may relax, but goods prices will soar. After all, if the rising dollar stimulates foreign imports and investments, a falling dollar tends to bring forth the opposite. Smaller supplies signal higher prices. Moreover, as foreign imports decline the American firms that compete with imports can now, in turn, raise their prices. In the end, large Federal deficits are bound to generate serious inflationary pressures.

## Even Keynesians Object

Large budget deficits usually induce monetary authorities to engage in massive credit expansion in order to finance the deficits. They conduct what Keynesian economists call "an infusion of aggregate demand" which in time is said to add to inflationary pressures. The inflation effects are said to be rather slow, though, given idle plant and equipment and a high unemployment rate. Nevertheless, Keynesian economists recommend that budget deficits should be avoided as the economy approaches full employment. Federal deficits, Keynesians reassure us, are the appropriate remedy for recessions; they are inflationary at other times. If they are already very large at the beginning of a recession, public policy makers may be reluctant to pursue yet larger deficits during the recession. They may be reluctant to prescribe

Keynesian remedies so that, according to Keynesians, recessions will be deeper and larger than they otherwise would be.

One may disagree completely with the Keynesian rationale, and yet agree with the conclusion that government budgets should be balanced. In fact, they should be balanced all the time, not just during periods of "full employment," which may be slow in coming. Government deficits consume economic substance and wealth; by their very nature they depress economic activity. The stimulation that may be observed in the wake of deficit spending is the result of willful currency and credit creation; it is the effect of the injection of monetary funds that lower interest rates and misguide businessmen in their investment decisions. When interest rates are lower than market rates and goods prices are made to rise faster than wage rates and fringe costs, the demand for labor tends to rise and unemployment may fall. This morsel of economic knowledge constitutes the secret ingredient of the Keynesian recipe.

Keynesian deficit spending during recessions is destined to fail whenever goods prices don't rise faster than labor costs. Workers and their trade unions may see through the inflation machination and readjust their demands to the willful depreciation, demanding cost-of-living clauses and other compensation adjustments to offset the inflation losses. When the workers no longer can be made to suffer reductions in real income the Keynesian recipe loses its power. Moreover, when deficit spending is given in large doses in recessions after large deficits were suffered in a boom period, deficits may turn into a prescription for deep depression and mass unemployment. A twenty per cent inflation rate may cause a twenty per cent unemployment rate because productive capital may no longer function; it may join other assets in the flight into inflation hedges.

Deficit spending is the mother of debt, which is the prolific mother of folly and despair. A small debt may be cleared off in a little time, whereas a large debt may never be repaid. A debtor who owes a great deal may despair of ever being able to pay and, therefore, may be tempted to default. As the U.S. government debt soars past the \$2 trillion mark, the possibility of default looms ever larger. □

# The Illegality of Legal Tender

by Philip W. Newcomer

**T**he coming of the Civil War brought with it four years of savage fighting, resulting in an unprecedented loss of life and property. Both the Union and the Confederacy, however, failed to anticipate the sustained nature of this conflict. In fact, Northern troops, at first, were enlisted for only ninety days.<sup>1</sup> This lax attitude toward the war was shared by Lincoln's Secretary of the Treasury, Salmon P. Chase. As a result, the taxes levied at the suggestion of Chase during the beginning of the conflict provided little of the revenue needed to meet Federal expenditures. During the fiscal year ending June 30, 1862, revenues were a mere eleven per cent of the government's outlays.

To meet these growing expenses, President Lincoln signed the first Legal Tender Act on February 25, 1862. This act authorized the printing of \$150,000,000 in United States notes, that amount being increased by later legislation to \$450,000,000. These notes were declared to be "lawful money and legal tender in payment of all debts, public and private, within the United States, except duties on imports and interest on the public debt."<sup>2</sup> Because they were printed in green ink, the United States notes quickly became known as greenbacks.

As the bill made its way through Congress, it sparked considerable debate. Chase reluctantly submitted the currency scheme to a subcommittee chaired by Representative Elbridge G.

Spaulding of New York. Spaulding led the drive to pass the legislation, claiming that its acceptance was necessary for the survival of the Union.<sup>3</sup> Many congressmen, however, refused to view the bill in this light. This proposal was, after all, a "... radical departure from traditional monetary theory and practice."<sup>4</sup> Historians have indicated that the proponents of the bill did not fully explore traditional methods of public finance. Wesley Clair Mitchell noted, in his *History of the Greenbacks*, that no United States notes were issued until three months after all specie payments were suspended. Mitchell points out:

Had these three months been utilized energetically in passing a few simple sanctions of an internal revenue tax act, . . . and in organizing machinery for the sale of bonds, there seems to be slight reason for believing that the government would have failed to obtain sufficient funds, particularly when account is taken of the improvement of credit caused by the military successes of the winter and spring.<sup>5</sup>

Despite evidence that the Act wasn't needed, many political leaders, viewing it as a desirable alternative to an unpopular increase in taxes, found the measure to be warranted during this state of war. Since the Act was considered as a part of Congress' war powers, few people questioned the constitutionality of legal tender. That issue was not addressed until after the war, when controversies concerning the Legal Ten-

*Philip Newcomer is a senior at Grove City College, majoring in economics.*



der Acts reached courts throughout the nation. The opinions resulting from decisions handed down concerning greenbacks, both in favor of and against their tender status, show that the concept of legal tender is repugnant to the spirit of the Constitution of the United States.

The first cases dealing with greenbacks to reach the Federal courts did not specifically address the issue of constitutionality. These cases, however, focused attention upon the legal tender question. In *Lane County v. Oregon*, 74 U.S. 71 (1868), the Supreme Court placed a restriction upon the application of the Legal Tender Acts, holding that states may require payment of taxes to be made in specie rather than in United States notes. The power of a state government to tax was viewed as essential to the operations of that state. Federal legal tender requirements interfered with the states' ability to declare a method of payment. In the majority opinion, the Court stated, "There is nothing in the Constitution which contemplates or authorizes any direct abridgement of this power by national legislation." The principle established in *Lane County*, and later cited in *National League of Cities v. Usery*, 426 U.S. 833 (1976), proclaimed that the states were free to exercise their inherent governmental powers without fear of Congressional intervention.

This principle had a significant implication when applied to the concept of legal tender. Since Congress could not interfere with the fundamental powers of a state government, it was fair to deduce that Congress also was forbidden to tamper with constitutional restrictions upon those powers. In Article I, Section 10, Clause 1 of the Constitution, states were forbidden to "make any Thing but gold and silver coin a Tender in Payment of Debts." It was clear, therefore, that Congress could not force a state to pay its creditors in legal tender notes.<sup>6</sup> To do so would violate the constitutional legal tender disability placed upon the states. The decision of *Lane County v. Oregon*, then, opened the question of Congressional legal tender powers for further judicial review.

The constitutionality of the Legal Tender Acts was first challenged in a number of state courts. Initially, many states, including New York, Pennsylvania, and Indiana upheld the acts as a logical extension of Congressional war

powers. In 1864, however, Indiana reversed its earlier decision by declaring, in *Thayer v. Hayes*, 22 Ind. 282, that the acts were unconstitutional. The Kentucky Court of Errors also recognized the invalidity of legal tender in its decision of *Griswold v. Hepburn*, 63 Ky. 20 (1865). In this case, Griswold sued Hepburn for interest and principal due on a promissory note signed in 1860. Legal tender notes offered in payment by Hepburn had been refused by Griswold. Considering the intent of the Founding Fathers, the court's opinion stressed that, "When the people who adopted it [the Constitution] delegated to Congress exclusive power 'to coin money,' they intended that nothing else than metallic coin should be money." Despite the strength of the court's argument, it was the appeal of this case which led to the most resounding condemnation of the legal tender concept.

### *Hepburn v. Griswold*

In 1869, *Hepburn v. Griswold* came before the Supreme Court. On February 7, 1870, the Court, by a four to three vote, upheld the earlier decision of the Court of Errors of Kentucky.<sup>7</sup> In so holding, the Court clearly rejected the constitutionality of the Congressional legal tender legislation. Ironically, the majority opinion was written by Chief Justice Salmon P. Chase, who, as Lincoln's Secretary of the Treasury, originally endorsed the first Legal Tender Act. The reasoning of his argument greatly clarified the legal tender issue.

In writing his opinion, Chase searched in vain for a constitutional basis for legal tender. Clearly, Article I, Section 10 denied legal tender power to the states. Yet, this fact did not automatically imply that such power resided in the federal government. Chase found no expressed Congressional legal tender power within the text of the Constitution. He also declared that such actions cannot be reasonably implied as necessary and proper to the execution of any expressed power. John A. Sparks noted in his essay, "The Legal Standing of Gold—Contract Versus Status," that the Tenth Amendment reserved for the states powers which were not delegated to the United States. Powers denied to the states which were not del-

egated to the United States, therefore, were reserved for the people.<sup>8</sup> Since the declaration of legal tender was forbidden to states and was not delegated to Congress, the acceptability of a currency was to be determined freely in the marketplace.

After finding no constitutional basis for the legislation, Chase isolated the ill effects of these laws. The Fifth Amendment stated that the United States cannot deprive any person of "life, liberty or property, without due process of law." By requiring the repayment of debts in a depreciated medium of exchange, the Legal Tender Acts impaired the obligation of contracts. Creditors, therefore, were denied property by Congress without due process of law. Chase declared the legislation to be nothing less than a violation of the due process clause of the Fifth Amendment. This holding was in keeping with later substantive interpretation of the due process clause. Under this interpretation, a person could be denied due process even when all procedural due process requirements were met. In later cases, such as *Allgeyer v. Louisiana*, 165 U.S. 578 (1897), the Court struck down various nonmonetary economic regulations by applying this substantive approach to the due process clauses of the Fifth and Fourteenth Amendments.<sup>9</sup> Chase's opinion in *Hepburn* recognized the true nature of legal tender laws: Such legislation is an unconstitutional economic regulation.

Shortly after the *Hepburn* decision was handed down, a change in the Court's composition forever altered judicial interpretation of legal tender. On the day that *Hepburn v. Griswold* was decided, President Grant sent the names of William Strong and Joseph P. Bradley to the Senate as candidates to fill vacancies on the Supreme Court. Both men were confirmed by the Senate and appointed to their seats by March of 1870. Four days after their appointments, the Attorney General moved that the Court consider the two legal tender cases still undecided. With a five to four vote, the Court ordered re-examination of the legal tender question.<sup>10</sup> Not only did this action undermine public opinion of judicial integrity, it signaled the formation of a new majority in favor of legal tender. The Court then took up both cases, *Knox v. Lee* and *Parker v. Davis*, 79 U.S. 457

(1871), together and overturned the ruling of *Hepburn v. Griswold*.

Justice Strong, in writing his majority opinion of *Knox*, unknowingly made a powerful argument against the constitutionality of legal tender. The errors of Strong began with his concept of the role of the judiciary. He wrote that, "decent respect for a co-ordinate branch of the government demands that the judiciary should presume, until the contrary is clearly shown, that there has been no transgression of power."<sup>11</sup> Such a position was inconsistent with the traditional concept of judicial review.<sup>12</sup> This concept was defined by Chief Justice John Marshall when he stated in *Gibbons v. Ogden*, 22 U.S. 1 (1824), that the judiciary must act "with that independence which the people of the United States expect from this department of the government."<sup>13</sup> Failure to do such would result in the collapse of the Federal balance of power. Strong's defense of the actions of Congress failed to address this critical point.

## A Necessity?

In arguing for legal tender, Strong contended that the necessity of the legislation gave it merit. In fact, he did not even consider the necessity of such laws to be a questionable notion. According to Strong, the idea that the Legal Tender Acts did "save the government and the Constitution from destruction is not to be doubted."<sup>14</sup> This point, however, was questioned by Chief Justice Chase in his dissent.

Was the making of the notes a legal tender necessary to the carrying on of the war? In other words, was it necessary to the execution of the power to borrow money? . . . In their legitimate use the notes are hurt, not helped, by being made a legal tender. The legal tender quality is only valuable for the purpose of dishonesty. Every honest purpose is answered as well and better without it . . . the making of these notes a legal tender was not a necessary or proper means to the carrying on of the war or to the exercise of any express power of the government.<sup>15</sup>

Strong's necessity doctrine was also attacked in Mises' *Theory of Money and Credit*, which stated that "In order to appraise correctly the

weight of this emergency argument in favor of inflation, there is need to realize that inflation does not add anything to a nation's power of resistance, either to its material resources or to its spiritual or moral strength."<sup>16</sup> Even if the legislation were necessary, "the doctrine of 'necessity' has no logical place in constitutional law under any circumstances."<sup>17</sup> The constitutionality of legislation never should be determined solely by the apparent importance of the law in question.

Strong then searched beyond necessity for further grounds upon which he could uphold legal tender. He quickly noted that legal tender was "a power confessedly possessed by every independent sovereignty other than the United States."<sup>18</sup> Legal tender, therefore, was a right which was inherent in the sovereignty of all nations. Such reasoning, however, was not common to the Supreme Court. Except in cases of international relations, "the Court has never since suggested that the federal government enjoyed powers implied from the mere fact of its being a sovereign nation."<sup>19</sup> The Constitution, not the act of another nation, provided the foundation upon which the American government was built. The actions of that government must be judged according to the standard established by the Constitution. The alleged sovereign right to declare legal tender was not proof of constitutionality.

Continuing in his reasoning, Strong looked to the text of the Constitution to find justification for the Legal Tender Acts. At this point, Strong forged his resulting powers doctrine, which he summarized as follows:

And here it is to be observed it is not indispensable to the existence of any power claimed by the federal government that it can be found specified in the words of the Constitution, or clearly and directly traceable to some one of the specified powers . . . Powers thus exercised are what are called by Judge Story, in his *Commentaries on the Constitution*, resulting powers, arising from the aggregate powers of the government.<sup>20</sup>

Strong, when unable to find an expressed power of legal tender, dispensed with the necessity to do so. The resulting powers doctrine gave virtually limitless power to the legislature. Congress

found no need to confine its role to that for which its powers were delegated. This doctrine was clearly outside the realm of the Framers' intent. Strong's failure to find a reasonable constitutional basis for legal tender was evidence that Chase was correct in claiming that no such basis existed.

## Greenbacks Reissued

Judicial interpretation of the legal tender issue did not cease with the decision of *Knox v. Lee*. In 1878, an Act of Congress provided for the peacetime reissuing of greenbacks. Under this law, the notes retained their legal tender quality. In 1884, the validity of this reissue was challenged in *Juilliard v. Greenman*, 110 U.S. 421 (1884), which was heard by the Supreme Court on a writ of error from a Federal circuit court. With the exception of Justice Field, all the judges agreed that the greenbacks were an extension of the Congressional power to borrow money.<sup>21</sup> Using reasoning similar to that of Strong in *Knox*, Justice Gray delivered a majority opinion which was equally unconvincing.

Quoting Strong, Gray claimed that the federal government possessed the right to impair contracts. Strong had earlier cited the power to declare war and the power to make bankruptcy laws as examples of sanctioned interference with contract obligations. These powers, however, were delegated to Congress. As Chase noted in both *Hepburn* and his dissent in *Knox*, no such delegated power existed for legal tender.<sup>22</sup> Gray never commented upon Chase's assertion concerning the impairing of contracts. This interference, Chase realized, was hostile to the spirit of the Constitution.

Like Strong, Gray relied upon necessity as an argument for the validity of legal tender. With the excuse of war gone, Gray implied that the legislation was essential due to "the inadequacy of the supply of gold and silver coin to furnish the currency needed for the uses of the government and the people."<sup>23</sup> Gray, like many others, believed that a growing money supply is a prerequisite for a strong economy. In making his statement, Gray failed to realize the basic economic principle that inflation only dilutes the value of each unit of currency. The eventual result of inflation is stagnation, not economic

growth. Had Gray realized that fact, he would not have viewed the legislation as necessary.

Gray was not content to find precedent for his decision solely in *Knox v. Lee*. He also looked beyond America's borders to find aid for his reasoning. He cited a contemporary case in England which upheld the exclusive power of the Emperor of Austria to emit legal tender notes.<sup>24</sup> In doing such, Gray relied upon the same fallacy that Strong had earlier committed. In American law, English common law was only addressed when one considered the origins of the Constitution. Contemporary foreign proceedings have no bearing upon the Constitutionality of American legislation.

In upholding legal tender as a peacetime measure, Gray referred to Marshall's opinion in *McCulloch v. Maryland*, 17 U.S. 316 (1819), which stated:

We admit, as all must admit, that the powers of the government are limited, and that its limits are not to be transcended. But we think the sound construction of the constitution must allow to the national legislature that discretion, with respect to the means by which the powers it confers are to be carried into execution, which will enable that body to perform the high duty assigned to it, *in the manner most beneficial to the people*. [Emphasis mine.]<sup>25</sup>

Gray, however, wrongly applied Marshall's words to this legal tender issue. The legal tender power is not beneficial to the people. Upon that power rests the government's ability to inflate the money supply. As Dr. Hans F. Sennholz points out, "Legal tender laws permit government to take income and wealth without the people's consent . . ."<sup>26</sup> Furthermore, "Legal tender legislation is one of the great evils of our time, the necessary basis of inflation and monetary destruction. It gnaws at the moral and economic foundations of economic society, largely because it is misunderstood and ignored."<sup>27</sup> Such legislation, because of its harmful nature, could not be the proper subject for the application of Marshall's words. By quoting Marshall, Gray actually found no support for the validity of the legislation. Gray, like Strong, offered a weak defense of the concept of legal tender.

These flawed decisions upholding legal tender, when considered in conjunction with the reasoning of earlier cases, indicate that legal tender laws lack a firm basis in constitutional law. Even without that basis, the decisions of *Knox v. Lee* and *Juilliard v. Greenman* served as dangerous precedents for the government's monetary monopoly. Because of those decisions, legal tender compulsion was given the approval of this nation's judiciary. That approval began with the decision of five justices in *Knox v. Lee*. Yet, "Another day may come when five other justices will read the Constitution and arrive at a different conclusion."<sup>28</sup> Should that day come, those judges will find ample support for their actions in the reasoning of the various cases addressing the issue of greenbacks. □

1. Robert G. Athearn, *American Heritage New Illustrated History of the United States*, vol. 8 (New York: Fawcett Publications, 1971), p. 635.

2. Wesley C. Mitchell, *A History of the Greenbacks* (Chicago: University of Chicago Press, 1903), pp. 78-79.

3. *Ibid.*, p. 45.

4. Walter T.K. Nugent, *The Monetary Question During Reconstruction* (New York: W.W. Norton & Co., Inc., 1967), p. 25.

5. Mitchell, *A History of the Greenbacks*, pp. 73-74.

6. Edwin Vieira Jr., *Pieces of Eight* (Old Greenwich, Conn.: Devin-Adair Publications, 1983), p. 152.

7. Robert E. Cushman, *Leading Constitutional Decisions* (New York: F.S. Crofts & Co., 1935), p. 130.

8. John A. Sparks, "The Legal Standing of Gold—Contract Versus Status," in *Gold Is Money*, ed. by Hans F. Sennholz (Westport, Conn.: Greenwood Press, 1975), p. 85.

9. *Allgeyer v. Louisiana*, 165 U.S. 578 (1897), cited by Paul G. Kauper and Francis X. Beytagh, *Constitutional Law*, 5th ed. (Boston: Little, Brown, and Company, 1980), pp. 702-707.

10. Cushman, *Leading Constitutional Decisions*, p. 131.

11. *Knox v. Lee*, 79 U.S. 457 (1871), cited by Vieira, *Pieces of Eight*, p. 202.

12. Vieira, *Pieces of Eight*, p. 202.

13. *Gibbons v. Ogden*, 22 U.S. 1 (1824), cited by Kauper and Beytagh, *Constitutional Law*, p. 154.

14. *Knox v. Lee*, 79 U.S. 457 (1871), cited by Vieira, *Pieces of Eight*, p. 215.

15. Mitchell, *A History of the Greenbacks*, p. 71.

16. Ludwig von Mises, *Theory of Money and Credit* (Irvington, N.Y.: Foundation for Economic Education, 1971) p. 426.

17. Vieira, *Pieces of Eight*, p. 199.

18. Cushman, *Leading Constitutional Decisions*, pp. 132-133.

19. *Ibid.*

20. *Ibid.*, p. 134.

21. *Juilliard v. Greenman*, 110 U.S. 421 (1884), cited by Emlin McClain, *Cases on Constitutional Law* (Boston: Little, Brown, and Company, 1900), p. 443.

22. Sparks, "The Legal Standing of Gold . . .," pp. 89-90.

23. McClain, *Cases on Constitutional Law*, pp. 453-454.

24. Vieira, *Pieces of Eight*, p. 233.

25. McClain, *Cases on Constitutional Law*, p. 447.

26. Hans F. Sennholz, *Money and Freedom* (Spring Mills, Pa.: Libertarian Press, Inc., 1985), p. 26.

27. *Ibid.*, p. 24.

28. *Ibid.*, p. 29.

# Can “Industrial Policy” Work?

by Frank W. Bubb

**A**fter a wave of enthusiasm for “industrial policy” in 1983 and 1984, the idea now seems dormant at the national level. The advocates of industrial policy, placed on the defensive by pro-market forces and a robust economy, were compelled to back-track from their initial assertions that a government agency could successfully pick “winners” among private sector firms. Since picking winners is the core of industrial policy, its once-bold proponents were reduced to advocating a drab patchwork of reforms.

More recently, however, several state governments have jumped on the industrial policy bandwagon as if the entire national debate had never occurred. Over a dozen states, principally in the “rust belt” of the upper Midwest and the Northeast, have funded agencies whose unabashed goal is to pick winners. According to Michael Finn of the Michigan Venture Capital Fund, “What we’re trying to create is the environment for the same type of phenomenon as Silicon Valley.” In the past four years, the Michigan fund has invested \$48 million in 23 new companies.<sup>1</sup>

The amount of state activity suggests that industrial policy may be heading for a comeback at the national level. If the resurrection of industrial policy coincides with a serious recession, it may not be possible for advocates of the market to defeat it again with generalized assertions that the market can pick winners better than a government agency. Market advocates must be able to articulate precisely *why* this is true.

Any industrial policy that dispenses govern-

ment subsidies to businesses is automatically a policy of picking winners. When a government agency grants firm A’s request for a subsidy but rejects firm B’s request, it is perforce picking winners. Indeed, picking winners—in the sense of spotting “winners” ahead of the market and nurturing them—is the best result advocates of industrial policy could hope for; the only other alternatives for a subsidy program are propping up losers and random redistribution.

What exactly is a “winner”? Industrial policy advocates seem to accept a fairly conventional economic criterion: profitability. Those firms which can grow most profitably by using invested capital most efficiently should be termed “winners.” The more a subsidy program channels capital to such firms, that is, the more efficiently its subsidies are used, the better the results for the economy as a whole.

What do the advocates of industrial policy find objectionable about the market’s method of picking winners? To show that private capital markets allocate capital efficiently, it must be shown that: (1) efficiency is enhanced when firms seeking investment capital maximize their own profits, (2) private investors can effectively pursue their own self-interest, and (3) the market effectively links points (1) and (2), that is, that investors’ pursuit of their own gain channels capital to those firms that can use it most profitably.

Advocates of industrial policy seem, by and large, to accept points (1) and (2). As I understand it, their principal concern is that the market is a flawed mechanism for translating investors’ pursuit of gain into the most efficient use of capital by investees.

Much of this concern may stem from simple ignorance of how the market functions. There-

*Frank W. Bubb is a corporate securities lawyer residing in Swarthmore, Pennsylvania.*

fore, this article will first describe how the market picks winners. Then it will discuss how a government agency that is optimally structured to achieve its objective might undertake the same task.

***A variation on the debate over socialist economic calculation.*** This discussion is based in part on the insight developed by Ludwig von Mises<sup>2</sup> and Friedrich Hayek<sup>3</sup> that economic calculation is impossible under socialism. In 1920, Mises first presented his now-famous challenge to socialism. He argued that, since the socialist state would own all means of production, there could be no market on which the prices of the myriad productive inputs would be established. Without such prices, which operate as "aids to the mind" by conveying information in a highly condensed form, the managers of the socialist economy would have no way to allocate capital efficiently.

Eventually, socialist economists regrouped around "market socialism," under which managers of socialist firms would be instructed to operate *as if* they were profit-maximizing corporate managers buying and selling productive inputs. Mises and Hayek counterattacked with a variety of arguments, the most basic of which focused on the role of the central planning board, which would select firm managers and allocate capital among the competing firms.

The prescribed role of the socialists' central planning board is strikingly similar to that which industrial policy advocates wish to confer on a subsidy-granting agency. The only difference is that the former would have a monopoly on its function, while the latter would attempt to operate as an alternative to an already-existing private capital market.

***The special form of uncertainty faced by investors.*** No system can guarantee that its selection of future winners and losers is correct at any given time. But that is inherent in the situation faced by investors in any economy, whether they be private investors, a subsidy-granting agency of the sort envisioned by industrial policy advocates, or the market socialists' central planning board. As Victor Borge once put it, "Forecasts are very difficult, particularly about the future."

Uncertainty about the future is a fact of life for all participants in an economy. But the uncertainty facing investors is magnified by the nature of competition among investees. No investee walks around with the word "winner" stamped on his forehead, waiting to be discovered by investors. Rather, winners emerge from an often unpredictable evolutionary process, a process of struggle which may impel a firm which everyone thought to be a "loser" to develop a decisive innovation in technology, marketing, manufacturing, or some other field. Such a firm may in turn be overtaken by others whose innovations once again help to remake the economy.

Economic progress is utterly dependent on this unpredictable process of rivalrous competition among investees. A society seeking a method of allocating capital among investees can face this fact in one of two ways: (1) it can cover up the problem by squelching competition among investees, with stagnation as the result, or (2) it can select a capital allocation procedure that adjusts to change as rapidly as possible. Such a procedure must provide incentives for the rapid communication and use of information, and for the formation of realistic expectations in the face of risk and uncertainty.

## How the Market Picks Winners

Advocates of industrial policy often decry the lack of information about how "we" should allocate "our" capital. According to Representative Stan Lundine, "We don't even have credible information on which to base our decisions," and "You have to get down to the ball bearing industry; you can't just talk about industry in general."<sup>4</sup>

Such statements seem to assume that information doesn't exist unless it resides in written form in a central location. This assumption causes industrial policy advocates to overlook the market's largely non-written, decentralized method of storing and communicating information. Sitting in the midst of the most sophisticated capital market in the world, U.S. advocates of industrial policy fail to grasp how that market picks winners because they don't understand the signals continually transmitted among investors and investees.

**How the market stores and communicates information.** The market stores information in the form of prices, in this case, the prices of corporate equity securities.<sup>5</sup> The price of each corporation's shares tends to encapsulate the information about the corporation and its relative prospects which is widely dispersed among investors. No single investor possesses all the information extant about a particular firm, much less an industry or the entire economy. Yet the market as a whole possesses such information because it is able to draw on the knowledge and judgment of millions of investors.

For example, if a new industrial process is developed which increases demand for ball bearings, those investors who first spot the change in data and correctly evaluate its effect on the earnings of ball bearing makers will profit by buying the shares of such firms, thus driving their prices up. Sparked by the profit-seeking behavior of investors, this process of adjustment continues rapidly until the share prices of ball bearing makers fully incorporate the new data.

The crucial point is that this adjustment process operates without most investors having to learn about the new industrial process or its effect on ball bearing usage. The market gains the use of this information by, in effect, paying for it. The profit received by those who first come into possession of the information is their payment for transmitting it to other market participants.<sup>6</sup>

What information is reflected in security prices? Investors tend to bid each firm's shares to a price equal to the sum of expected future after-tax returns thereon (in the form of capital appreciation and dividends), discounted by current and anticipated interest rates, and adjusted for the investment's perceived risk.

The ability of the market to price securities correctly has led a number of academic economists to formulate the "efficient market theory," which Paul Samuelson describes as follows:

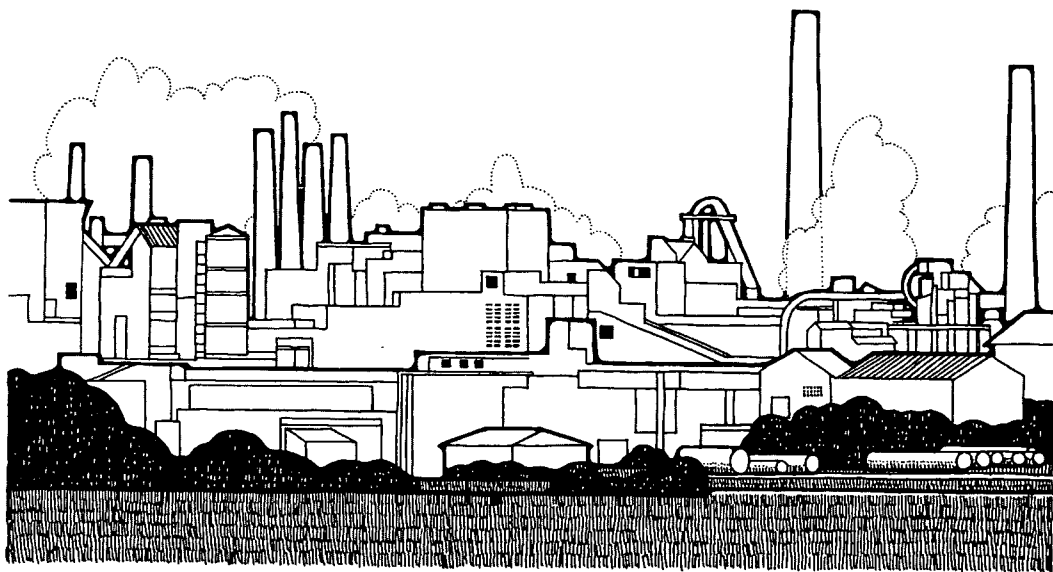
If intelligent people are constantly shopping around for good value, selling those stocks they think will turn out to be overvalued and buying those they expect are now undervalued, the result of this action by intelligent investors will be to have existing stock prices

already have discounted in them an allowance for their future prospects. Hence, to the passive investor, who does not himself search out undervalued and overvalued situations, there will be presented a pattern of stock prices that makes one stock about as good or bad a buy as another. To that passive investor, chance alone would be as good a method of selection as anything else.<sup>7</sup>

Since Samuelson's statement, some of the more enthusiastic efficient market theorists seem to have gotten carried away with the allegedly automatic, instantaneous character of market adjustment. The vital role of active investors in bringing about such adjustment is described as follows by Arlene Hershman in the October 1984 *Dun's Business Month*:

. . . academics are reexamining the role of information in an efficient market. Some economists believe that information isn't free, that it has a price that is paid for in time, money and effort; they assert, further, that market participants who dig out new information will be paid for it in stock market profits. . . . Some money managers, who also are efficient market adherents, believe that it has sectors of inefficiency and that they can outperform the market by searching out ideas that are strikingly new or different.

**Market prices as a means of communication among investors.** Samuelson's statement focuses on what market prices communicate to the *passive* investor, while Hershman's focuses on what they communicate to the *active* investor. Integrating these statements, we can see what the market, through its particular constellation of security prices, is telling each investor and potential investor at every moment: "Here, in the highly condensed form of security prices, is the sum total of all that everyone else knows and expects about the firms with shares outstanding. If you have something positive to contribute, in the form of new information or understanding, the market will tend to compensate you with profits. If you don't, you are nevertheless protected to a large degree by the fact that other, more active, investors have bid stock prices to levels which reflect their knowledge and understanding."<sup>8</sup>



Just as a scientist stands on the shoulders of all those who have gone before him, each investor stands on the shoulders of the market as a whole. Both the scientist and the investor are presented with an immense amount of information generated by others; both must be exceptionally good to improve on what they receive.

The movement of security prices through time also communicates information to each investor. The investor's profit or loss on each investment provides him with feedback on his investment decisions, and to some degree allows him to learn from his past successes and failures.

***Market prices as a means of communication by investors to investees.*** So far we have focused on security prices as a means by which investors communicate with each other. Security prices are also a means by which investors communicate with companies with securities outstanding. The higher investors bid up a firm's share price in relation to its book value (invested and reinvested capital per share), the more efficiently they expect the firm to use its capital. That is, the more the market expects the firm to be a "winner."

The higher a firm's share price, the more cheaply it can raise additional capital; that is, the smaller the percentage of the company's fu-

ture earnings that must be given up by its existing shareholders to raise a given amount of cash. Since management tends to act in the interest of existing shareholders (for reasons explained below), management is encouraged to issue more shares when investors bid up the company's share price. In effect, such investors are pre-buying the company's next stock issue.

The more cheaply a firm can raise additional capital, the greater its incentive to expand its operations. Conversely, the lower a firm's share price, the more it costs to raise new capital and expand.

In sum, relative security prices are the way millions of investors tell companies whether to expand or contract, to continue what they are doing or make changes. The market "picks winners" (and losers) every day.

***Market prices as a means of communication by investees to investors.*** The communication described so far—among investors and from investors to investees—would go for naught if investees wasted new capital. How do investors know that investees will use newly raised capital productively?

Since management tends to act in the interest of existing shareholders, it will attempt to offer securities on the market at the highest price that clears the market, that is, at a price which gives



*"The problem of economic calculation is a problem which arises in an economy which is perpetually subject to change, an economy which every day is confronted with new problems which have to be solved. Now in order to solve such problems it is above all necessary that capital should be withdrawn from particular lines of production, from particular undertakings and concerns and should be applied in other lines of production, in other undertakings and concerns. This is not a matter for the managers of joint stock companies, it is essentially a matter for the capitalists—the capitalists who buy and sell stocks and shares, who make loans and recover them, who make deposits in the banks and draw them out of the banks again, who speculate in all kinds of commodities."*

—LUDWIG VON MISES, *Socialism*

investors an expected rate of return equal to or just above the market rate (adjusted for risk). For the same reason, management will offer securities which provide such a return only if it believes it can use the invested funds to generate a greater return for the business.

By "stepping up to bat" in the securities market, management is telling investors that it believes such returns are achievable. Just as active investors adjust stock prices in a manner that tends to allow the passive investor to earn nearly a market rate of return with a minimum of investigation, the incentives faced by corporate managers *tend* to decrease the need of investors to investigate the expected returns on a corporation's proposed investments. Prices convey information in a condensed form.

**The role of selection and incentives.** The market's ability rapidly to communicate meaningful information and to put it to good use is only as good as the incentives facing market participants. So far, we have assumed that investors seek profits and corporate managers tend to serve the interest of existing shareholders. But the capital market consists of more than individual investors and ultimate investees. Capital often flows through long chains of intermediaries, each of which is subject to incentives that enhance the rapid flow and use of in-

formation. To fully understand why the market will pick winners better than a subsidy-granting agency, we must explain the incentives facing each type of market participant.

- *Individual investors*—The desire for profit gives investors a strong incentive to act competently. In addition, the market tends to select in favor of more competent investors and against the less competent by reshuffling assets from the latter to the former.

- *Managers of investees*—Corporate managers have an incentive to act in the interest of existing shareholders because their compensation tends to be tied to their company's stock price (the market has selected in favor of firms which compensate their managers in this way); because a lower stock price reduces a corporation's ability to expand, giving the manager a smaller organization to govern; and because a low stock price encourages tender offers to oust incumbent managers.

- *Managers of intermediaries*—Mutual funds, pension funds, banks, insurance companies, brokerage firms, and other intermediaries are managed by people who face similar incentives to those described above (although some intermediaries are not subject to tender offers). Often their compensation is tied to their firm's investment performance or to the dollar value of assets managed (again, because the market

has selected in favor of firms which compensate their managers in this way).

- *Managers of tender offerers and other acquirers*—Corporations which are not usually thought of as intermediaries can play that role when they buy or sell other companies, either through negotiated transactions or hostile tender offers. The managers of such firms have exactly the same incentive to keep their stock price high as do other corporate managers.

- *Employees of intermediaries*—Most intermediaries are too large for their managers to select and monitor investments personally, so they must hire others as portfolio managers, investment analysts, researchers, etc. Because managers are affected by their subordinates' performance, they have a strong incentive to select and reward competent employees.

This brief description presents a pattern. In each case, (1) a party (let's call him "A") entrusting funds to another ("B") is directly affected by B's performance, (2) B's performance can be measured by monitoring investment results, and (3) A has the power to replace B or affect B's remuneration. As we shall see below, the breaking of this pattern, this chain of accountability and control, underlies much of the explanation of why a government-created agency could not pick winners as well as the market.

## How a "Non-Political" Government Agency Would Pick Winners

It is sometimes argued that, while industrial policy works in other countries, it could not work in the United States because our political culture is different.<sup>9</sup> Jobs in government planning agencies are insufficiently "prestigious," such agencies are not given the requisite "flexibility" and are subject to too much political pressure from special interests, and so forth.

To see whether such factors are all that stand between the American people and a successful industrial policy, let's imagine how an agency could be structured to maximize its ability to pick winners. Let us assume:

- Congress creates the agency with competent, independent directors, as little Congress-

sional oversight as constitutionally permissible, and a large enough initial appropriation that it need never return to Capitol Hill for more funds;

- the agency is able to hire the most competent staffers with large salaries and performance-based bonuses, and can terminate and promote staffers without regard to civil service rules;

- the agency can spend as much as it desires on research; and

- the agency can make its investment/subsidy decisions on any basis it desires, free of any requirement to treat applicants on an equal or rational basis.

In short, the agency could be structured to look and act like a first-rate investment fund, with just two exceptions that go to its very nature and purpose:

(1) Let us recall that advocates of industrial policy seem not to contest the idea that private investors can effectively pursue their own self-interest, but rather argue that the market cannot effectively translate investors' pursuit of gain into the most efficient allocation of capital among investees. Therefore, if our hypothetical agency were to operate as a nationalized mutual fund, trying to maximize its own profit like any private investor, it would not be addressing the problem it was created to solve. Since the agency must assume the market is not allocating enough capital to winners, it would have to channel more capital to such firms than its own profit expectations could justify, thus acting at least in part for the firms' benefit. The agency must operate on the basis that the full return on its "investments" can be calculated only by including the benefits it confers on its "investees." In summary, the only way the agency could attempt to improve on the performance of the market as an institution is to operate as an alternative institution which grants subsidies to those it perceives as winners.

(2) Since the agency would be created by Congress for a public purpose, it could not be operated for the private profit of its appointed directors or anyone else to whom they would be accountable. Whatever the proponents of industrial policy want, it is clear they do not advocate conferring on any private party the economic benefit that could flow from the power to dis-

burse billions in public funds.

The agency would underperform the market in picking winners for four reasons, the first three of which arise from exception number (1) and the fourth of which arises from exception number (2).

## Why the Agency Would Underperform the Market

***Inability to use information communicated by other investors.*** As noted earlier, the market prices of equity securities serve as a highly efficient form of communication among investors, telling each investor what everyone else knows and expects about investees. Since our agency is premised on the idea that the market's selection of winners via stock prices is flawed, the agency has no choice but to disregard such prices and all the information they convey. Instead, it would have to rely entirely on the non-price information gathered by its own research department.

To pick winners better than the market, the agency's research department would have to outperform the market in quickly acquiring, evaluating, and using information. Let us assume that the agency would be able to hire "enough" researchers and that it could properly structure their incentives. The agency would still face an insurmountable problem: the larger its research department, the more its internal communications would become overloaded by the sheer mass of verbal and numerical (non-price) data. Like any intelligence agency, its problem would lie not so much in gathering data, but in getting it to the right people, integrating it, and evaluating it. By contrast, the problem of "internal" communication within the market is handled primarily by the price mechanism, with the system's participants paid (in the form of profits) for ensuring that the information encapsulated in prices is as accurate and current as possible.

It might be objected that the task faced by the agency's research department is the same as that performed every day by investment analysts and researchers for intermediaries such as mutual funds, namely, attempting to obtain information not already reflected in stock prices. This objection misconceives the role of such re-

search efforts. Such research uses current stock prices as benchmarks, continually attempting to determine whether a stock is overpriced or underpriced compared to other stocks in light of new data. By using stock prices in this way, investment analysts stand on the shoulders of the market. By contrast, the agency would be attempting to see farther by getting down from the market's shoulders and standing on its own feet.

It might also be objected that, if the agency makes favorable loans or outright grants to its "investees," its research would be comparable to that of other lenders. After all, lenders seldom make their credit decisions based on a prospective borrower's stock price. The problem with this objection is that lenders also do not pick winners; that function is performed by the *equity* markets. Therefore, the relevant comparison is between the respective information-gathering methods of the agency and the market for equity securities.

Since the agency would be making its "investments" on the basis of less complete, less current information than the market, a higher proportion of the agency's funds would be malinvested. The agency would probably earn less than passive investors, who tend to be saved from malinvestments by the price-adjusting behavior of more active investors. The agency's information-gathering handicap relative to the market would be greatest with respect to the most rapidly changing segments of the economy, which happen to be those segments disproportionately inhabited by "winners."

***Unreliability of information communicated by investees.*** As discussed above, investees communicate information to investors whenever they issue securities. New securities can be only issued if the offering price gives investors an expected rate of return (adjusted for investor-perceived risk) at least equal to the market rate. By offering securities at that price, the managers of investees communicate their expectation that the proceeds can generate greater returns for the business. This process forces corporate managers to realistically evaluate the risks of alternative strategies and investments. As anyone familiar with corporate planning could attest, projects presented to

management with a stated return of 20 per cent or 25 per cent are a dime a dozen; the real trick is for managers to reject those projects which are too risky in light of the firm's cost of capital.

Since our hypothetical agency must seek to outperform the market by subsidizing investees it perceives as winners, it must require investees to project above-market returns on its funds, while its own returns must be below-market. What happens when a corporate manager is faced with the prospect of obtaining a subsidized investment of this sort? Obviously, the manager is given the incentive (1) to seek the agency's funds for any investment which he expects to earn more than the agency's below-market rate of return, and (2) to overstate the expected return on such investments, in effect underplaying their risk.

By altering the corporate manager's incentives, the agency's investment process would reduce the reliability of information communicated by investees about their own expectations. By eschewing information contained in stock prices, the agency would be forced to substitute largely futile after-the-fact efforts to determine the investee's actual rate of return on invested funds.<sup>10</sup> The more the agency grants subsidies rather than seeking its own profit, the less it could rely on information communicated by investees, and the lower the total return on its investments is likely to be.

***Inability to calculate the return on its investments.*** So far, we have focused on two factors which suggest that, for investments made any given time,  $T_1$ , the agency is likely to underperform the market: (1) it would always be two steps behind the market in gathering information because it could not use information transmitted by other investors, and (2) the information obtained on investee expectations at  $T_1$  would be less reliable than the information such investees transmit to the market.

The agency would also underperform the market because it could not calculate the return on its investments from time  $T_1$  to any subsequent time  $T_2$ . Unlike a profit-seeking investor who can compare stock prices at  $T_1$  and  $T_2$  and add in dividends, our agency must attempt to measure its performance by factoring in the

benefit it confers on its investees.

This task would be virtually impossible. The agency could not determine whether its investees are winners by comparing the performance of their stocks against the market's. To the extent an "investment" by the agency contains a subsidy element, the subsidy constitutes found money for the shareholders of the subsidized firm and would of course raise the firm's share price. By this standard, the agency could turn a corporate "dog" into a winner by giving it a large enough subsidy.

Nor could the agency determine whether it has selected winners by reference to the return on investment of subsidized firms. A firm which has a high return can always use its next investment dollar on a low-return or high-risk project (as the agency's subsidies would encourage it to do). The agency could measure its returns only by attempting to monitor the actual returns its subsidies generate for investees, a process which, as noted above, would be fraught with error and uncertainty.

The agency's inability to measure its performance would block its access to the self-correcting mechanisms that operate in the market, in effect severing its feedback loop. Unlike a profit-seeking investor, the agency could not learn from its past successes and failures.

And unlike other intermediaries, its managers could not measure the performance of staffers hired to make or recommend investments, and those ultimately in charge of the agency could not measure the performance of its managers. As a result, agency personnel could not be compensated, promoted, or fired based on performance. Even if the agency were to start with the "best and brightest," its ability to motivate its personnel and to select in favor of the most competent and against the least competent would be substantially impaired.

***Lack of incentive.*** The fourth and final reason the agency would underperform the market in picking winners arises from the fact that it could not be operated for the private profit of those ultimately in charge of the agency. As noted earlier, the managers of investment intermediaries have a strong incentive to operate in the interests of their investors because (1) such investors can capture the benefits and detri-

ments of the managers' performance and (2) such investors have the power to replace the managers or affect their remuneration. The merciless judgment of investors is the means by which external reality impinges on managers, forcing them to be alert to opportunities for profit and to resist the natural tendency of organizations to become "fat" and to operate in set routines.<sup>11</sup>

By contrast, no one in a position to influence the agency's actions could capture the resulting benefits or detriments. Therefore, even if the performance of the agency's managers could be measured, no one would have a strong incentive to select and reward such managers based on their performance. As a result, even if all of the other objections to the agency could be overcome, its managers would have less incentive than private managers to ensure that it operates efficiently and alertly. Given enough time, our creative, high-powered agency would take on the appearance of any other government bureaucracy.

## Bringing Politics Back into the Picture

In order to focus on the economics of industrial policy, we have temporarily assumed that our hypothetical agency could be operated free of political influence. Now this assumption can be relaxed.

In fact, eliminating political considerations would be impossible, if for no other reason than that Congress would retain the power to abolish or rein in the agency if its activities become politically unacceptable. On this point, the allegedly independent Federal Reserve System's continual accommodation of political pressure is instructive. A non-political government-created agency is a bit like a square circle.

Once it becomes apparent that the politicians would function as the owners of the agency, all sorts of things fall into place. The politicians, even those who might have opposed creation of the agency, can capture the benefits of its activities by influencing it to subsidize favored constituents, receiving payment in the currency of politics: votes, contributions, and favors. The effect on the agency's already modest ability to

channel funds to winners ought to be readily apparent.

While the agency could not succeed by the market's criteria, it could succeed admirably by the very simple criterion of politics: *is the result visible to the voters?* As long as a politician can point to a government-subsidized project and say "this created (or saved) X jobs," the project's political benefits would probably outweigh its political costs. Why this is so—that is, why the political process weighs costs and benefits so much more crudely than the market—is an important and difficult subject, one that is beyond the scope of this article.

Nevertheless, the sharp divergence between political and economic criteria of success shows the principal danger of industrial policy. Once a subsidy granting agency becomes established, it will appear to be a success even as it draws resources from productive to unproductive uses, making us all poorer as a result. □

1. "States Back Risky Ventures In Effort to Create New Jobs," *New York Times*, June 23, 1986.

2. Ludwig von Mises, *Socialism: An Economic and Sociological Analysis* (London: Jonathan Cape, 1951), pp. 111-222 and especially pp. 137-142.

3. Friedrich A. Hayek, *Individualism and Economic Order* (Chicago: Henry Regnery Company, 1948), pp. 119-208.

4. *National Journal*, May 21, 1983.

5. This discussion focuses on equity securities rather than debt securities because it is by pricing the former that the market picks winners. Equity securities are residual claims against a business which can be realized only after all contractual claims, such as the obligation to pay principal and interest on debt securities, are satisfied. Because debt securities are partly insulated from the corporation's performance by a "cushion" of higher-risk equity securities, the market prices of its debt securities depend primarily on market-wide interest rates and only partly on the corporation's "downside" potential, that is, the likelihood of its default. By contrast, the price of a corporation's shares depends less on interest rates and more on expectations about its "upside" as well as "downside" potential. It is the ability of equity securities to capture the "upside" potential that makes them the market's vehicle for picking winners.

6. See Thomas Sowell, *Knowledge & Decisions* (New York: Basic Books, Inc., 1980), pp. 103-4.

7. Burton Malkiel, *A Random Walk Down Wall Street* (New York: W.W. Norton & Company, Inc., 1973), pp. 167-8.

8. There are really three broad categories of investors—active, passive, and what might be termed "pseudo-active." The third group engages in a great deal of trading activity, often on the basis of charts, but does little, if anything, to adjust prices to new information or more perceptive analysis. The third group probably creates short-term distortions in security prices which are then corrected by "true" active investors searching for profit opportunities.

9. Joseph L. Badaracco, Jr. and David B. Yoffe, "'Industrial Policy': It Can't Happen Here," *Harvard Business Review*, November-December 1983.

10. This task would be fraught with error and uncertainty. The projects funded by the agency would not necessarily be the ones so designated by the investee, but would be those which, in management's mind, would not have been undertaken but for the subsidy.

11. See Mises, *Bureaucracy* (New Rochelle, N.Y.: Arlington House, 1969).

# The Farm Problem

by John Chamberlain

**W**hen Nikita Khrushchev came to America in 1959, he visited an Iowa farm. He was well aware that American agriculture was a great success story. But he never knew why.

The magnitude of the success story is apparent in the figures that are scattered through the 20 essays taken from *The Freeman* for publication in a book called *The Farm Problem* (Foundation for Economic Education, 144 pp., \$5.95). In 1800 some 90 per cent of the U.S. population were non-city people, making their livings as farmers, hunters, or backwoodsmen. In 1960, when Karl Brandt was collecting statistics for his essay on "The Hard Core of the Farm Problem," only 10 per cent of the people were still on the farm. In 1983 Clarence B. Carson, for his essay on "The Trouble With Farming," had the 1980 census to consult. The total number of farms in the U.S. had declined from 6.1 million in 1940 to 2.8 million in 1980. Farm population had declined from 30.5 million in 1940 to 8.8 million in 1980. The number of hired farm hands, which stood at 2.6 million in 1940, had been cut in half (1.3 million) in 1980.

With fewer and fewer people farming more and more land on bigger farms, the agricultural yields were tremendous. One American farmer was feeding himself and 24 others. In Russia the collectivized farmer feeds only a total of five. The 1981 corn crop in the U.S. was the biggest ever. The 2.7 billion bushels of wheat constituted another record.

The figures representing an incredible plenty

can be spun out in all directions. George B. Mueller, in his "The New Agricultural Revolution," says that "as farmers we are presently investing twice the amount industry averages in capital tools per man." This puts food on the typical American's table for less than 17 per cent of his wages. Says Mueller, "rather than looking upon agriculture as a serious problem, we should consider it our biggest success story."

## Famine

We have had dust bowls, but never famines. It hasn't been that way throughout recorded history in other countries. Edmund Opitz, in his "The War on Poverty Revisited," tells us that a French famine wiped out a million people, five per cent of the country's population, in 1709. The potato famine in Ireland in the 1840s claimed some 1.5 million lives. A famine in China in the late 1870s killed 15 million. India is now making use of improved strains of grain, but it has only recently escaped from the condition that cost one and a half million lives in the 1943-44 Bengal famine.

If Moscow had not had oil and gold to trade for wheat, there would have been acute starvation in Russia in nine out of 20 dry years between 1963 and 1983. Sven Rydenfelt, the Swedish economist who gives us this information, thinks that it is a cop-out for the Communists to blame everything on the weather. In Czarist times they had dry weather, too, but they also had wheat in exportable quantities.

The “planning” of agriculture in socialist countries outside of Russia has, as Rydenfelt makes plain, resulted in a general impoverishment.

Africa is the worst example. David Osterfeld, in his “African Famine: The Harvest of Socialist Agriculture,” says that government marketing boards in most of the famine-threatened African countries have forced the peasants to produce without profit. Unable to get more than a fraction of his crops’ actual value, the African peasant loses all initiative. Ethiopia is particularly reprehensible—over 60 per cent of the country is arable, but only 10 per cent is cultivated. Nobody with a hoe in his hands sees the point of producing anything beyond subsistence levels.

## Technology

Statistics tell a story, all right, but there is nothing like personal experience to ram a point home. Howard Baetjer Jr., a graduate student at Boston College in 1983, took time out one summer to work as a field hand on a Nevada alfalfa ranch. They used laser beams to level the fields in the parched territory where he worked. The

laser allows the rancher to get the ground absolutely even as it drops off at exactly the right rate. The laser light, pitched at the proper angle, is read by a sensor attached to a huge machine with a scraping blade and a reservoir of topsoil. When the ground rises up, the sensor tells the blade to shave the area down. When the ground drops off, it tells the machine to dump some soil.

A laser-planed field means that irrigation will be perfectly even. The alfalfa will soak up the water without waste. A hundred years ago nothing but sagebrush would grow on an average Nevada 40-acre field that now yields enough hay to feed 70 cows for a year.

Our politicians, chivvied by the more inefficient farmers who ought to be looking for jobs in industry, try to deal with the tremendous plenty by establishing price supports and limiting the number of acres to be planted. It doesn’t work—the American farmer, with new seeds and fertilizers at his disposal, has always been able to defeat the government’s purpose by growing more and more on less and less ground. The failure of the government programs is stressed in most of the essays in this volume. □

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*Prepared by*  
*Bettina Bien Greaves*

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