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In what the *Wall Street Journal* calls “a watershed moment for government intervention in the private sector,” the Federal Reserve announced in October that it will regulate executive compensation at all banks so they will not have incentives to take on too much risk.

Meanwhile, the Obama administration said it would cut by half (on average) the compensation of the highest-paid people at the seven companies still on taxpayer life support: AIG, Bank of America, Citigroup, General Motors, Chrysler, GMAC, and Chrysler Financial.

So here’s the puzzle: Is such government intrusion into the compensation process a good or bad thing?

Before answering, let’s remember that the taxpayers have been compelled to rescue lots of companies, banking and otherwise, over the last two years. The people’s exposure is immense. Neil Barofsky, special inspector general for Treasury’s financial sector rescue, says enormous surprise bailout costs will befall the country in addition to the $159 billion the Congressional Budget Office projects TARP will lose. Barofsky was referring to the cost of government borrowing and the potential cost of rewarding risky behavior.

Besides that, the Fed has been buying up billions of dollars in “toxic” (that is, worthless) mortgage-backed and other paper with money created from thin air. The new money threatens to ignite a monster price inflation when the banks begin to lend it. The impending dissipation of the people’s wealth at the hands of the (Federal Bureau of Counterfeiting) is another cost of the bipartisan government bailout of corporate finance. It’ll be a massive tax on the middle and working classes.

Well, then, shouldn’t the government have something to say about what goes on in those companies on the dole, executive pay in particular?

It’s tempting to say yes, but I think the best answer is no. I’m not totally comfortable with that answer, but it seems better than the alternative.

First off, we must reject the propaganda that the Treasury and the Fed are acting as the taxpayers’ agents by taking control of corporate compensation. Nothing can be further from the truth. They are the taxpayers’ adversaries and are only looking out for themselves.
After all, they are the ones that exposed the taxpayers to these huge liabilities in the first place.

Moreover, it’s not really the taxpayers’ money the politicians are looking out for. In real terms, it’s now their money by virtue of legal plunder. The Bush administration tried to sell the public on the bailout by suggesting that the toxic assets (or bank shares) acquired by the government might one day be resold at a profit for the taxpayers. But if the assets do sell for more than the government paid, will taxes be cut to reflect the profit? Fat chance. Politicians tend to spend every penny they can get their hands on—and then some. It is they who would profit, not the taxpayers. They ain’t us.

Another reason to oppose government conditions on bailout money is that they are likely to make things worse. I seriously doubt whether anyone at the Fed or Treasury is qualified to design compensation packages that would encourage just the right amount of risk, not too much or too little.

A third reason to reject this government intervention is that it will serve as a justification for further intervention. Pay czar Kenneth Feinberg already says he hopes the pay scheme will become a model for the rest of Wall Street.

My final reason for saying no to the pay czar and bank regulators is that I want to make sure that such bailouts never happen again. Maybe the people will be less likely to acquiesce the next time if they see the current corporate rescue for the plunder it is.

We can’t change the past. The bailouts happened. Now we have to deal with the consequences. We should concentrate on stripping government of the power to bail out companies in the future. We should also begin to fully separate State and banking. A good start would be to abolish government deposit insurance, which only lulls depositors into a false sense of security and creates the very systemic risk the regulators say they want to avoid.

“Green jobs” are the magic words promising to bestow prosperity and environmental bliss through costless government manipulation. Do you need more reason to be skeptical? Andrew Morriss performs the debunking. Richard Fulmer adds an insight on the shortcomings of alternative energy sources.

In the mixed economy, is freedom’s glass half full or half empty? George Leef shows that this is more than a philosophical question.

Walmart inspires hisses and hosannas. Which are more deserved? Art Carden sorts it all out.

These days it’s especially popular to scapegoat anyone engaged in complex financial transactions not readily understood by laymen. Example: short sellers. They’re accused of manipulating the stock market for personal profit, so the government has its eye on them. Warren Gibson comes to the defense of this valuable yet unappreciated group.

The government’s money managers are willing to risk inflation to avoid deflation. Good idea? Steven Horwitz distinguishes good deflation from bad.

One of the great pieces of American folklore is that businessmen don’t like regulation. Bruce Yandle sets the record straight.

Here’s what our columnists have come up with this time around. Lawrence Reed declares himself a Loco-foco. Donald Boudreaux won’t let Chinese currency manipulation keep him up at night. Stephen Davies demonstrates the power of historical myth. John Stossell looks at the tax system and doesn’t like what he sees. David Henderson says don’t fear the trade deficit. And Theodore Levy, encountering the claim that markets for medical care cannot work, remonstrates, “It Just Ain’t So!”

Volumes about the alleged failure of the market, a crusty old individualist, the law, and American public policy undergo scrutiny by our reviewers.

—Sheldon Richman
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Imagining a political movement that says it’s committed to “equal rights”—and means it. Not just equality in a few cherry-picked rights but all human rights, including the most maligned, property rights. Imagine a movement whose raison d’être is to oppose any and all special privileges from government for anybody.

When it comes to political parties, most of them in recent American history like to at least say they’re for equal rights. If we’ve learned anything from politics, though, surely the first lesson is this: What the major parties say and do are two different things.

In American history no such group has ever been as colorful and as thorough in its understanding of equal rights as one that flashed briefly across the political skies in the 1830s and ’40s. They were called “Locofocos.” If I had been around back then, I would have proudly joined their illustrious ranks.

The Locofocos were a faction of the Democratic Party of President Andrew Jackson, concentrated mostly in the Northeast and New York in particular, but with notoriety and influence well beyond the region. Formally called the “Equal Rights Party,” they derived their better known sobriquet from a peculiar event on October 29, 1835. Turn On The Lights, The Party's Starting

Democrats in New York City were scrapping over how far to extend Jackson’s war against the federally chartered national bank at a convention controlled by the city’s dominant political machine, Tammany Hall. (He had killed the bank in 1832 by vetoing its renewal.) When the more conservative officiomial of the convention expelled the radical William Leggett, editor of the Evening Post, they faced a full-scale revolt by a sizable and boisterous rump. The conservatives walked out, plunging the meeting room into darkness as they left by turning off the gas lights. The radicals continued to meet by the light of candles they lit with matches called “loco focos” (Spanish for “crazy lights”).

With the Tammany conservatives gone and the room once again illuminated, the Locofocos passed a plethora of resolutions. They condemned the national bank as an unconstitutional tool of special interests and an engine of paper-money inflation. They assailed all monopolies, by which they meant firms that received some sort of privilege or immunity granted by state or federal governments. They endorsed a “strict construction” of the Constitution and demanded an end to all laws “which directly or indirectly infringe the free exercise of equal rights.” They saw themselves as the true heirs of Jefferson, unabashed advocates of laissez faire and of minimal government confined to securing equal rights for all and dispensing special privileges for none.

Three months later, in January 1836, the Locofocos held a convention to devise a platform and endorse candidates to run against the Tammany machine for city office in April. They still considered themselves Democrats, hoping to steer the party of Jefferson and Jackson to a radical reaffirmation of its principled roots rather than bolt and form a distinct opposition party. “We utterly disclaim any intention or design of instituting any new party, but declare ourselves the original Democratic party,” they announced.

The “Declaration of Principles” the Locofocos passed at that January gathering is a stirring appeal to the bedrock concept of rights, as evidenced by these excerpts:

William Leggett's expulsion from a Democratic Party meeting sparked the formation of a new faction firmly dedicated to equal rights. commons.wikimedia.org

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The true foundation of Republican Government is the equal rights of every citizen, in his person and property, and in their management. The rightful power of all legislation is to declare and enforce only our natural rights and duties, and to take none of them from us. No man has a natural right to commit aggression on the equal rights of another; and this is all the law should enforce on him. The idea is quite unfounded that on entering into society, we give up any natural right.

The convention pronounced “Hostility to any and all monopolies by legislation,” “unqualified and uncompromising hostility to paper money as a circulating medium, because gold and silver are the only safe and constitutional currency,” and “Hostility to the dangerous and unconstitutional creation of vested rights by legislation.”

These days Congress and the legislatures of our 50 states routinely bestow advantages on this or that group at the expense of those whom the same laws disadvantage—from affirmative action to business subsidies. The Locofocondemnation of such special privilege couldn’t be clearer: “We ask that our legislators will legislate for the whole people and not for favored portions of our fellow-citizens, thereby creating distinct aristocratic little communities within the great community. It is by such partial and unjust legislation that the productive classes of society are . . . not equally protected and respected as the other classes of mankind.”

William Leggett, the man whose expulsion from the October gathering by the regular Democrats of Tammany Hall sparked the Locofocondo being, was the intellectual linchpin of the whole movement. After a short stint editing a literary magazine called The Critic, he was hired as assistant to famed poet and editor William Cullen Bryant at the New York Evening Post in 1829. Declaring “no taste” for politics at first, he quickly became enamored of Bryant’s philosophy of liberty. He emerged as an eloquent agitator in the pages of the Post, especially in 1834 when he took full charge of its editorial pages while Bryant vacationed in Europe. He struck a chord with the politically unconnected and with many working men and women hit hard by the inflation of the national bank.

In the state of New York at the time, profit-making corporations could not come into being except by special dispensation from the legislature. This meant, as historian Richard Hofstadter explained in a 1943 article, that “men whose capital or influence was too small to win charters from the lawmakers were barred from such profitable lines of corporate enterprise as bridges, railroads, turnpikes and ferries, as well as banks.”

Leggett railed against such privilege: “The bargain-ing and trucking away of chartered privileges is the whole business of our lawmakers.” His remedy was “a fair field and no favor,” free market competition unfettered by favor-granting politicians. He and his Locofocond followers were not anti-wealth or antibank, but they were vociferously opposed to any unequal application of the law. To Leggett and the Locofocons, the goddess of justice really was blindfolded!

The Locofocons won some local elections in the late 1830s and exerted enough influence to see many of their ideas embraced by no less than Martin Van Buren when he ran successfully for president in 1836. By the middle of Van Buren’s single term, the Locofocond notions of equal rights and an evenhanded policy of a small federal government were reestablished as core Democratic Party principles. There they would persist through the last great Democratic president, Grover Cleveland, in the 1880s and 1890s. Sadly, those essentially libertarian roots have long since been abandoned by the party of Jefferson and Jackson.

If you’re unhappy that today’s political parties give lip service to equal rights as they busy themselves carving yours up and passing out the pieces, don’t blame me. I’m a Locofocon.
Medical Markets Can’t Work? It Just Ain’t So!

BY THEODORE LEVY

D r. Darshak Sanghavi, an academic pediatric cardiologist who (like all physicians) financially benefits from the cartelization of medicine, explains in Slate, the online magazine, that health care markets can’t work because of the information asymmetry between physician and patient (“Talk to the Invisible Hand,” www.tinyurl.com/y948v3o). So we need the cartel. This is not particularly surprising; most physicians think that. But it ain’t so.

Through several examples Sanghavi attempts to demonstrate that a medical market with the customer/patient in charge just doesn’t make sense. With the U.S. government now paying half of all medical bills and consumers paying only 10 percent out of pocket, it is not surprising that Sanghavi can show that marginal efforts to move toward a market without making any fundamental changes in the system do not always work, but let’s look at his examples:

In 2004 President Clinton developed chest pain, was diagnosed with coronary artery disease (CAD) and treated with coronary artery bypass grafting (CABG). Sanghavi notes that Clinton, savvy though we know him to be, did not study New York state’s database of hospital- and surgeon-specific death rates from heart surgery. Had he done so, he might have thought twice about having the surgery at Columbia-Presbyterian in New York City, which the database lists as having “the highest death rate of any of the 35 hospitals doing bypass surgery.” Sanghavi sees this as evidence that even savvy consumers cannot deal with the complexities of the medical marketplace. But is it?

Most doctors think that we need a cartelized health care system.

First, in a true medical marketplace, hospitals might find it profitable to advertise the results of the database, something they have little incentive to do now, when patients remain rationally ignorant of the quality of hospitals not covered by their employer-chosen insurance. More important, the database in the form developed by New York state is crude. Are you better off going to a cardiac surgeon who does 50 CABGs per year, restricting his surgery to only otherwise healthy patients with mild CAD, and has a 1 percent complication rate, or are you better off going to a cardiac surgeon who does 500 CABGs per year, takes patients refused surgery elsewhere because they’re viewed as “too risky,” and who has a 2 percent complication rate overall (but among otherwise healthy patients with mild CAD has a complication rate of 0.4 percent—though this breakdown is not in the raw data offered by the New York database)?

How can one obtain such detailed analysis of the data? One can do what Clinton did: Go with the recommendation of the cardiologists he entrusted with his care. In a true medical marketplace he’d have even more options: Businesses would develop that analyzed such data and provided their analysis for a fee (or perhaps it would be available for free on the Internet, paid for by ads, like Google searches).

Sanghavi questions whether it helps for consumers to “have skin in the game”—that is, pay some health care costs directly so they no longer treat it as essentially a free good, overusing it and driving up costs. He

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acknowledges that the famous RAND Health Insurance Study (1982) showed that when patients paid 25 percent of costs, overall medical spending dropped 20 percent.

But Sanghavi is concerned. He notes that consumers “cut back equally on highly effective and largely pointless treatments.” He fails to say this means that under the highly regulated system he defends, where medical experts are in charge of determining what is needed without worrying about patient cost concerns, “largely pointless treatments” are still available. Of the RAND results Sanghavi notes with a concern that can only be felt by physicians: “The cost savings came from mostly avoiding doctors altogether.” But most people who see doctors have transitory complaints that resolve on their own, caused by problems or pathologies that are never determined, no matter the expense of the workup (headache and back pain being the two most common complaints). So it is good that “the cost savings came from mostly avoiding doctors altogether.”

Most important, the RAND study showed, though Sanghavi didn’t mention it, that with few exceptions, seeing doctors less often and spending 20 percent less overall “had no adverse effects on participant health.”

Of course, if we had a competitive market in health care, with all its implications for easier access to information, broader advertising of various options, direct price competition, easier access to medications, and more, I would expect that consumers might better distinguish “highly effective” from “largely worthless” medical practices. They seem to make good choices now when given the opportunity, in areas like Lasik and plastic surgery.

For Sanghavi, “The usual rules of the marketplace seem not to apply to health care” because doctors apparently know more about medicine than patients do. So doctors control the interaction. So regulations are needed. So the argument goes.

But this argument proves too much. Information asymmetry is the norm not the exception. Car dealers know more about cars than consumers do. The guys behind the Genius Bar know lots more about computers than Apple customers do. Are consumers always being ripped off? Sanghavi the pediatric cardiologist claims—correctly, I’m sure—that no parents ever questioned him when he ordered a special type of color Doppler cardiac ultrasound on their child. But he unfortunately seems to believe a medical marketplace is everything we have now—all the regulatory burdens, supply restrictions, informational prohibitions—except patients will pay more out of pocket. He ignores various other innovations that may help consumers get what they need despite information asymmetry. For example, competing cardiologists trying to simplify matters for patients might offer flat fees, including labs and imaging, so the consumer could compare physician costs more easily and not need to know whether a specific lab or ultrasound was “needed.” Alternatively, consumers could go on the web and use the services of Medical Cost Advocate (www.medicalcostadvocate.com). Such services would be more commonplace in a truly free market in health care.

Some say that health care is different, and if by that they mean the health care market has been artificially restricted, segmented, regulated, and distorted by government interventions dating back more than a century, they are right. Only the educational and financial industries come close in the degree of government regulation, which doesn’t speak well of regulation’s success. But if they mean health care is more complicated than anything else offered in the marketplace or that health concerns don’t respond to supply and demand or that medical services can only be provided when medical cartels battle government payers while insulating patients from the true costs of care . . . it just ain’t so.
If you got an email offering you the chance to invest in a business that would create new profitable industries, employ millions of people, reduce energy consumption without reducing quality of life, and improve environmental quality, would you be skeptical? And if the email went on to claim that the technologies to do all this exist now and could save existing businesses billions of dollars in just a few years by reducing waste and energy use, would you wonder why no one was already implementing all these “common sense” ideas? If the email went on to promise that you could do this all at no risk by investing borrowed money, you’d likely be reaching for the delete key.

If we substitute “the federal government” or “the United Nations Environment Programme” or “the European Union” for “you” and change the email to a proposed law, however, we discover that politicians from Washington to Brussels are embracing measures to “green” the economy and create “green jobs” with an almost religious fervor, despite weak empirical support for these proposals. The Obama administration included billions of spending and tax incentives for green initiatives in its budget, and last spring’s “stimulus” bill poured $62 billion in transfers plus $20 billion in tax cuts into “green initiatives.”

Unfortunately, the rhetoric about “greening the economy” or creating “green jobs” is just political window-dressing for some of the same central-planning measures proposed by the left for years. Behind that rhetoric are proposals built around government subsidies for favored technologies, measures to limit trade, and a great deal of wishful thinking about alternative energy measures not quite ready for prime time.

What Counts as Green?

The first problem in untangling the claims made by green-economy proponents is determining what counts as a “green” job or technology. Many times no definition at all is provided; even when the term is defined, different groups pick quite different definitions. For example, the U.S. Conference of Mayors’ report Current and Potential Green Jobs in the U.S. Economy defines a green job as

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any activity that generates electricity using renewable or nuclear fuels, agriculture jobs supplying corn or soy for transportation fuels, manufacturing jobs producing goods used in renewable power generation, equipment dealers and wholesalers specializing in renewable energy or energy-efficiency products, construction and installation of energy and pollution management systems, government administration of environmental programs, and supporting jobs in the engineering, legal, research and consulting fields.

Interestingly, the mayors count jobs in existing nuclear power plants but not in new ones.

In contrast the United Nations Environment Programme’s Green Jobs: Towards Decent Work in a Sustainable, Low-Carbon World excludes all nuclear jobs, but includes all jobs said to “contribute substantially to preserving or restoring environmental quality.”

If we take politics into account we can explain these definitions. The Conference of Mayors is concerned with building a coalition for spending to benefit its members. Those mayors with nuclear power plants in their cities want to claim credit for greening their economy through nuclear plants (which also pay lots of local taxes). The U.N. report, on the other hand, was aimed at gaining support from an international environmental movement that detests nuclear power, which explains why it didn’t count any nuclear jobs.

Neither applies any objective criteria to the problem of defining which industries will gain and which will lose. For example, both define as “green” any jobs related to nonfossil-fuel technology, even if these energy sources (such as wood) release as much carbon dioxide per BTU of energy generated as fossil-fuel sources—or more. (Wood is much less efficient in terms of carbon emissions than either natural gas or gasoline on a per-BTU basis.) Moreover, burning many renewable fuels produces considerable particulate pollution, both inside homes and outside—a serious problem particularly for women and children in developing countries.

Green-economy proponents also disagree about how green hydroelectric plants are. Many who advocate government spending on alternative energy also want to dismantle existing hydro projects to restore rivers and improve fish habitats. (And many of those dams were built with subsidies by the Bureau of Reclamation and Army Corps of Engineers and would have flunked any serious cost-benefit analysis.) But small hydro, their preferred alternative, is by definition “small.” As a result, it would take quite a few small hydro plants to produce sufficient energy to replace even a single large dam or coal-fired power plant. Not surprisingly, there is no evidence of a large-scale building boom in small hydro projects or even a serious effort to identify where such projects might be located.

Even more interestingly, both definitions are expansive enough to include “supporting jobs in the engineering, legal, research, and consulting fields.” Indeed, the Conference of Mayors found that the top two U.S. jurisdictions for current green jobs are New York City and Washington, D.C., suggesting that the investment in green technology so far is producing a lot of consultants, lawyers, and lobbyists rather than engineers or factory workers. Another estimate found more secretaries, management analysts, bookkeepers, and janitors among “green jobs” than environmental scientists.

Defining terms is essential to a rational policy debate; without clarity we end up with a division between favored and disfavored technologies driven by interest groups rather than by either market forces or logical thinking. Unfortunately, so far the green-economy literature has mostly produced lists of “technologies we like” and “technologies we don’t like” based on politics. We certainly shouldn’t be spending billions of dollars promoting what we can’t define.

Where Do Estimates Come From?

Even if we don’t quite know what a green economy looks like, its advocates assure us there will be lots of jobs and other benefits from converting to it. Not surprisingly, most green-economy proposals predict...
huge benefits at low cost, making them politically appealing. Jobs will appear in economically depressed areas, and energy efficiency will soar, saving firms, consumers, and governments billions. Unfortunately these benefits are largely due to inappropriate economic forecasting methods. In particular, most estimates are produced via “input-output analysis,” the same technique used to produce outlandish claims for the benefits of municipal stadium projects.

In an input-output analysis a vast matrix is calculated from economic data as they exist today, tracing connections between firms in different industries. For example, an automobile plant uses steel, aluminum, plastic, batteries, paint, tires, and other materials to produce cars with a particular amount of labor per car under current technology. If we thought that the plant would begin producing more cars, the input-output matrix could be used to calculate how much more steel, aluminum, and other inputs would be demanded by the car industry and how many more workers would be hired to work in it.

There is a role for such calculations in industry forecasts (predicting steel demand from auto production helps steel plants decide about investing in new capacity, for example). But using them to predict the impact of government programs to green the economy is problematic because the method rests on two assumptions that green proposals violate: constant prices and constant technology.

By definition, efforts to change energy technology are going to change technology and prices. The relationships in an input-output matrix based on using coal to generate electricity and gasoline to fuel cars simply aren’t applicable to an economy where substantial amounts of energy come from high-cost sources like wind and solar and the cars are hybrids or run on ethanol.

Worse, the green-economy predictions rest on extremely optimistic estimates of the impact of spending on new technologies. Almost no advocates of these policies deduct the jobs lost from replacing existing technologies with the new, green ones. Refinery workers, coal miners, fossil-fuel power plant workers, and many others will all lose their jobs if the proposed shift to nonfossil fuels takes place. Some of those workers may find jobs insulating public buildings or bolting together windmills, but many will not. Because all that public spending to produce these new technologies comes from taxes (whether today or in the future), it reduces private spending and so eliminates the jobs that would have been created by the higher private spending displaced by the taxes.

Any estimates of major changes are likely to be imprecise even if all these factors are taken into account because of the considerable uncertainty surrounding these relationships. Ignoring all the downsides, as green-economy proponents do, suggests that they are less interested in accurate predictions than in creating political pressure for policies regardless of their impact.

**Labor Productivity**

Even if we set aside these technical issues, however, there are still some serious problems with green-economy plans. Perhaps most important, the literature mistakenly glorifies low-productivity jobs on grounds that more employment is better. For example, the UN Environment Programme criticizes modern agriculture because “labor is extruded from all points in the system,” argues wind and solar are better technologies because producing each BTU of energy requires more labor than in fossil-fuel industries, and argues that the steel industry has evolved to use too little labor.

To see why this is a problem, let’s consider ethanol. Although even many environmentalists now recognize ethanol’s problems, it was the darling of alternative-energy proponents for many years, and hundreds of millions of dollars in subsidies have produced a substantial corn-based ethanol industry in the United States. (Despite these subsidies, the fuel remains uncompetitive with gasoline at current gas prices.) Corn-based ethanol requires more labor to produce
than gasoline does, largely because growing and processing corn is more labor-intensive than pumping and refining oil. As a result, green-economy advocates score ethanol higher than gasoline since each BTU of energy in ethanol takes more labor to make than a BTU of gasoline.

But lower labor productivity is a bad thing not a benefit. Not only does more labor mean higher costs, but higher-productivity jobs (generally those that involve working with greater amounts of capital) can pay higher wages precisely because they are more productive. Low-productivity jobs are low-paying jobs because employers cannot afford to pay their employees more than the employees generate. If more labor were the metric, we’d all be better off using quills and parchment in place of computers.

**Rejecting Trade**

The advocates for greening the economy reject more than basic labor economics. They also believe that a green economy is one with relatively little trade. The literature emphasizes buying locally produced goods over those from other areas, both to save the transportation costs and to promote self-sufficiency. Not surprisingly, the UN Environment Programme criticizes Walmart for its global supply chain:

Companies like Wal-Mart (with its policy of global sourcing and especially its policy of searching for cheap products, with potential negative impacts for labor and the environment) are major drivers and symptoms of [increased global trade]. . . . Ultimately a more sustainable economic system will have to be based on shorter distances and thus reduced transportation needs. This is not so much a technical challenge as a fundamental systemic challenge.

To be fair, the benefits of trade are sometimes hard to understand. Nobel Prize-winner Paul Samuelson said the theory of comparative advantage was a contribution of economic theory that was both “nonobvious and nontrivial,” and generations of Econ 101 instructors have proved his point by struggling to get students to understand it. But the libertarian case for trade is remarkably simple and clear: Voluntary exchanges must make people better off or they wouldn’t occur, so a world with more voluntary exchange is preferable to one with less. Even the person most confused by trade theory can understand that autarky (producing everything locally) is a recipe for disaster by examining the record of Albania under communist dictator Enver Hoxha or North Korea today, two examples of societies where the rulers reject virtually all trade.

Moreover, the idea of locally grown food (a key component of the green economy) is hard to accept for those of us living far enough north to lack a year-round growing season. From my home in rural Illinois, I can see miles of soybean and corn fields. I am delighted that my neighbors can trade their corn and soybeans to people living elsewhere and that people in countries from France to Honduras to Israel to New Zealand send agricultural products here in return. I can buy French wine, Honduran bananas, Israeli citrus, and New Zealand lamb in my local grocery store because of trade, enriching both the variety and healthfulness of my diet. Even if it didn’t make us better off, the freedom to trade would be an important liberty. Since it does, it is indispensable to the vastly better lives we live today compared to our ancestors.

**Ignoring Incentives**

Those advocating for a green economy often appear to believe that no one will undertake any measures to improve environmental quality or conserve resources without a government program to show them the way. We know this is false because we have over a hundred years of experience with market incentives for both providing environmental quality and reducing resource use.

Studies of income levels and environmental quality have found what is termed the “environmental Kuznets curve,” a U-shaped relationship between national
income and environmental quality. As very poor countries begin to develop, environmental quality often falls as energy production and use increase, factories appear, and people begin to consume more. But once per capita gross domestic product (GDP) reaches about $5,000, people can afford to spend more on improving the environment. Not surprisingly they do, and environmental quality improves after that point with respect to most pollutants for which we have data. In short, richer is greener.

Environmental quality also improves because market incentives spur firms to reduce energy and resource use. Any firm that cuts its energy use can devote the savings to undercutting its competitors’ prices. This has happened on an economy-wide basis. For example, from the 1970s to 2000, energy use per dollar of real GDP fell by 36 percent as firms economized on energy without reducing output. Each unit of energy input yielded four times as much useful heat, moved people 550 times farther, provided 50 times more illumination, and produced 12 times as much electricity in 2000 compared to 1900—a stunning success story. Major energy-using industries like steel, aluminum, and paper have all become more energy- and resource-efficient, while consumer goods like refrigerators have become larger, more feature-rich, and cheaper to operate. It doesn’t take a government program to make firms more efficient, but it does take a market economy.

According to its proponents, the green economy will run on biofuels, wind, and solar power, ushering in a new age of clean energy. Unfortunately, this is mostly wishful thinking. The Department of Energy (DOE) says wind currently contributes less than 0.6 percent of total U.S. energy production. (Usually green-energy advocates note that it contributes 7 percent of renewable electricity generation, ignoring the less flattering total energy numbers.) Moreover, wind is both expensive and unreliable, as wind turbines produce energy only when the wind blows. Plus the massive wind farms green-energy advocates envision would require building what DOE estimates are $60 billion of new transmission lines (which many environmentalists oppose) and offshore wind farms like the Cape Wind project (blocked for years by the late Sen. Ted Kennedy, who objected to its impact on the view from his sailboat). There are also important questions about wind turbines’ effects on bird populations and the impact of “shadow flicker” from the turbine blades on neighbors. Similarly, solar power (mostly solar thermal and hot-water production) currently produces only 0.05 percent of U.S. energy consumption and is projected by DOE to rise to just 0.13 percent by 2030. Solar panel arrays take a great deal of land, usually in sensitive desert environments where endangered-species issues have already blocked some proposed photovoltaic sites. And both solar and wind power require expensive backup plants for when weather conditions aren’t right (such as at night and on days without wind).

None of these problems are insurmountable, and it is quite possible (and perhaps likely) that as the prices of natural gas and oil rise in the future, an entrepreneurial inventor will find ways to make these technologies viable. The problem is that they are not viable today and will not become so in an environment of subsidies.
How Dense Can They Get? The Fallacy of Alternative Fuels

BY RICHARD W. FULMER

When it comes to power, energy density is the key. Solar power, wind power, and ethanol are so expensive because they are derived from very diffuse energy sources. It takes a lot of energy collectors such as solar cells, wind turbines, or corn stalks covering many square miles to produce the same amount of power that traditional coal, natural gas, or nuclear plants can on just a few acres.

Each of these alternative energy sources is based on mature technology. Agriculture and fermentation have their roots in prehistory; windmills date back at least to 65 B.C.; the photovoltaic effect was discovered in 1839. Yet nowhere in the world are these technologies serving as primary energy sources without significant government subsidies. While incremental improvements can be expected, it would take an order-of-magnitude increase in productivity for them to become viable. As old and as well-researched as the technologies are, such improvements are possible but unlikely. As significant future energy sources, these technologies are dead ends, which is why the government, and not the private sector, is funding them.

Industry is more than willing to risk research dollars on technologies that show real promise, but it is not willing to flush shareholder money down a rat hole. Politicians, however, operate from different incentives. When a crisis, real or imagined, makes headlines, they want voters to see them “doing something” about it, and they must move quickly because election cycles and constituent attention spans are short. Funding long-term research in promising technologies doesn’t meet politicians’ needs. Solar panels, wind turbines, and ethanol refineries are all current technology and can be erected quickly with fanfare and photo ops. By the time these alternative power sources prove to be financial and, possibly, environmental busts, the politicians will have been reelected and voters’ attention will have shifted to the next crisis.

Another benefit of subsidizing “shovel ready” solutions is that existing technologies have existing supporters who can provide campaign funds. Such supporters, however, constitute a well-financed status quo that will make government funding, once started, difficult to end. For example, even though corn-based ethanol has driven up food and fuel prices, increased auto emissions, raised atmospheric carbon dioxide concentrations (by causing additional acreage to be tilled), and possibly resulted in net energy losses, the government is still subsidizing the industry and still requiring that the fuel be added to gasoline.

Wind energy, for its part, has been “just a few years away” from being economically competitive with conventional power for at least the last 25 years, and this will not change any time soon. The Energy Information Agency predicts that in 2016 wind power will still be 49 percent to 77 percent more expensive than electricity from either coal or natural gas. Furthermore, because wind turbines work only when the wind blows, wind farms cannot replace conventional plants. Backup power from conventional sources, usually gas turbines, must be ready to come on line the moment the wind fails. Despite these fundamental problems, subsidies continue to flow thanks to an entrenched lobby.

By contrast, consider the significant oil-industry investments in researching biofuels made from algae. Unlike ethanol, biofuels are chemically similar to fuel made from petroleum and, like petroleum-based fuels, have a significantly higher energy content than ethanol. Biofuels can also be handled by current fuel distribution systems and can be burned in today’s vehicles.

Algae can be grown in brackish water on desert land and, with today’s technology, can produce over 2,000 gallons of fuel per acre each year. This compares favorably with the approximately 250 gallons of ethanol that can be produced from an acre of corn—a ratio of 8 to 1. Accounting for the differences in BTU content, the ratio jumps to over 12 to 1. It may even be possible to boost productivity to 100,000 gallons per acre per year, raising algae’s potential to over 600 times that of corn-based ethanol!

Biofuels are carbon-neutral because the carbon dioxide released when they are burned is extracted from the atmosphere by the algae. Unlike burning petroleum-based fuels, then, burning biofuels will not result in a net increase in atmospheric CO₂ levels.

With algae’s vast potential, it is easy to understand why private industry is interested and why no government subsidies are needed to encourage investment. Moreover, if algae-based fuels do not prove viable, the companies now researching them will have no “status quo” problems with ending their investments and shifting scarce resources to more promising technologies—where “promise” is measured in density.

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Freedom in America: Is the Glass Half-full or Half-empty?

BY GEORGE LEEF

I
t is an age-old question of perception. Show a person a glass with some liquid in it and ask, “Is it half-full or half-empty?”

The importance of the answer depends on the interests of the person asking the question. If you owned a restaurant and wanted to skimp on the wine, you would rather your customers focused on what they are getting and not on what they aren’t. You won’t get many complaints if your patrons think that half a glass of wine is normal.

We are facing exactly that problem in America with respect to freedom. “Half-empty” people notice that a lot of freedom is missing. They are aware that they’re prevented by force of law from doing many things they would like to do, and compelled by force of law to do many others that they would prefer not to do. Most of those people also know that in the past there were far fewer restrictions on freedom than today; they sense that with each passing year, the glasses contain less and less wine.

Looking on the Bright Side

“Half-full” people, in contrast, rarely think about the government’s innumerable laws and taxes as deprivations of their freedom. They focus on what freedom they still have and regard it as enough.

Just as restaurateurs prefer customers who see half-full glasses and are content with that, so rulers prefer citizens who are content with whatever freedom they choose to permit. For that reason, crafty rulers—and the form of government doesn’t matter—try to condition the people to think that they are enjoying the best possible state of affairs. Rulers want the people to believe that all the state’s numerous mandates, prohibitions, and confiscations are actually good; they’re done not to take away freedom but only to improve society. If you can get your citizens to look at things that way, they will be as docile as sheep.

A survey by George Mason University economics professor Daniel Klein helped me (a half-empty person) to see what’s going on. Klein had written critically about minimum-wage legislation, mentioning that such laws not only have adverse economic consequences but also abridge freedom—namely, freedom of contract. Imposing a minimum wage commands employers: Either pay each employee at least the legal minimum or else face prosecution. To Klein’s surprise a number of economists responded that they did not think that law has any important impact on freedom. Klein subsequently conducted a poll asking economists if they felt that minimum-wage laws were an attack on freedom. A majority of those who responded said that they regarded them as having little or no impact on freedom.

So here is a government mandate—do this or you’ll be punished—yet a majority of economists see no loss

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of freedom. An obvious explanation is that the minimum wage simply has no effect on professors. They don’t hire low-wage workers and therefore feel no sting from the law. But even when people are directly affected by government actions that restrict their freedom, they’re apt to shrug it off as “just one of those things.” They still have a lot of other freedoms, after all. Why get upset over the part of the glass that’s empty? Enjoy the part that’s full.

Most people view taxation like that. For working, successful Americans, federal, state, and local taxes take about half their income. If it weren’t for those exactions, they would be able to spend, invest, and donate to charities much more than they now can. True, the tax system is cleverly designed to hide the impact of taxes through another piece of coercion— withholding. Nevertheless, intelligent people know that a great deal of their money is confiscated by the government. Few complain. In fact, many support political candidates who have pledged to increase their taxes. How do we explain that? The “half-full” mentality does it. The glass may be down to 49 percent, but that’s enough.

Freedom of contract gives us another illustration. Government has steadily whittled away at it over the last several decades but few people seem to care. The minimum wage is just one aspect of the attack on freedom of contract; there are many others. Employers may not “discriminate” when hiring workers, meaning that they are subject to legal action by the government if they allegedly decline to hire an applicant because of his race or some other immutable characteristic (“forbidden grounds,” as legal scholar Richard Epstein puts it). Do Americans regard “affirmative action” laws as an abridgement of freedom? Mostly, no. It’s not just that most of us don’t hire any workers, but also that freedom to choose with whom to contract has been tarred with the pejorative “discrimination,” and therefore laws taking away that freedom are actually applauded. Why should people be free to do something that’s bad?

Medicine is another part of life where our freedom has been trimmed. We are not allowed, for example, to purchase any medicine that hasn’t been approved by the Food and Drug Administration. A concerted effort to overturn that law on constitutional grounds failed recently. This can be a matter of life and death for a few people, but the court held that the government was doing nothing wrong in making it illegal for sick people to use unapproved medicines. There was almost no protest. Apparently, Americans are so used to government agencies regulating their lives that freedom to decide which medicines to take is now in that unobserved empty part of the glass.

Too Much Freedom?

Many people support political candidates who have promised to increase their taxes. How do we explain that?

If a law or regulation seems to take away some freedom, “half-full” people think, “It’s not that we’re now less free but that we had too much freedom before. The government is giving us a better balance.”

Let’s look at a few more examples. The government punishes merchants if they increase prices “too much” following a natural disaster (“price gouging”). Hardly any Americans object that this deprives merchants (not to mention consumers) of freedom.

The government dictates that only certain kinds of light bulbs may be used in the future. Americans offer hardly a peep of protest.

The government makes it illegal to drive a car unless the driver and passengers are buckled in. Are any of the politicians who supported the law voted out of office? No.

The government forces banks to make mortgage loans to people who would not qualify for one under prudent lending standards. No complaints about that attack on freedom, although some Americans are now unhappy that it helped catalyze the mortgage crisis.

The government requires people to buy official stamps for all documents to make them legal. Do the people care? Well, this one’s a trick. It’s the Stamp Act, imposed in 1765 by the British government. The law sent a great many Americans into the streets to protest
and threaten the officials charged with enforcing the law. Most Americans were not “half-full” people back then. If a similar law were passed today, people would meekly obey, saying to themselves, “Well, the government needs more money for all the good things it does.”

Skeptics may be thinking, “Okay, some peripheral bits of freedom may have been whittled away over the years, but the government would never deprive the people of any really important aspect of freedom.” Put aside the riposte that what one person thinks peripheral may be extremely important to another. I think that the “glass half-full” view most people apparently have puts all of our freedom at risk. Could we lose, say, freedom of the press the way we have lost other, “peripheral” freedoms? I think so. Here’s a hypothetical case to make my point.

Suppose that a new law were proposed, the “National Truth and Civility in Publishing Act.” It would establish a federal agency with authority to punish anyone who published a book, magazine, newspaper, blog, or anything else that was adjudged to be either false or potentially harmful to the feelings of a reader. Would Americans tolerate a law like that? It tears the heart out of the First Amendment. But I think most Americans would be assuaged if the political spin doctors said, “Look, people are still free to write what they want. The law merely tells them that they need to get their facts straight and not write in a way that could be demeaning or offensive. The government has a compelling interest in promoting truthful and respectful writing, doesn’t it? What good ever comes from lies or disrespectful writing? Freedom of the press has never been absolute and we are merely refining it a little to make life better.”

“Half-full” people would probably fall for that since they focus on the freedom that’s left, not that which has been taken away. They’d never give a thought to the consequences of putting federal officials in a position to harass those who write what the government does not want the public to read. With a law like that in place, the baseline concept of what freedom means would adjust downward again. No, the freedoms protected by the First Amendment are not secure. Nothing is if people only look at the freedom that’s left, not that which is being taken away.

Frédéric Bastiat taught that people’s thinking is usually influenced by what they see, not what they do not see. His point is at the root of the slow death of freedom in America.
Americans are importing more from China. Protectionists abhor this fact.

Explaining that American imports from China reflect nothing more sinister than the voluntary choices of American consumers does not satisfy simple-minded protectionists. It is sufficient that these imports take business away from some American producers. In the minds of simple-minded protectionists, international trade is harmful whenever it causes domestic business to lose market share to foreign rivals.

Not all protectionists, though, are this simple-minded. Some of them understand that resources have alternative uses and that prosperity is enhanced when each specific resource is used to produce that good or service that consumers value more highly than any other good or service that that resource can be used to produce. The “sophisticated” protectionist (if we may call him that) also understands the argument based on comparative advantage—namely, free trade encourages resources to be used in their most efficient ways.

But the sophisticated protectionist is still a protectionist. He cannot shake off his uneasy sense that imports somehow harm his country’s prosperity. So he eagerly latches onto almost any excuse to proclaim that he supports free trade “but not when foreigners do” this, that, or the other thing.

The length of the list is limited only by protectionists’ fertile imaginations: Foreign governments subsidize exporters; taxes and regulations in foreign jurisdictions are less burdensome than taxes and regulations in the home jurisdiction; foreign governments don’t have as much respect for human rights as the home government does; foreign industries are older and more experienced and hence have an unfair advantage over domestic industries; imports are sold by their foreign producers at unfairly low prices; capital can freely move from one country to another. . . . Truly, the list is long and ever-growing.

An Idea With No Currency

An idea requires more space than is available here. (Suffice it for now to say that none of these alleged exceptions to the case for free trade withstands careful scrutiny.) So let’s focus on just one such reason heard frequently now for why free trade is unwise: undervalued foreign currency.

The protectionist complaint about undervalued foreign currency rests on the indisputable argument that the lower the price of a foreign currency—for example, the Chinese yuan—the greater the quantities of this currency that will be bought. Just as a lower price for apples makes apples a more attractive purchase for consumers, a lower price for a currency makes it more attractive.

If the price of the yuan falls—that is, if it takes fewer dollars today than it did yesterday to buy yuan—people with dollars will buy more yuan.

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Yuan, like dollars, are not themselves consumable but instead can be exchanged for goods, services, and assets. In the case of yuan, the goods, services, and assets that they can be directly exchanged for are supplied by the Chinese. So the greater the number of yuan that can be bought for a dollar, the less expensive for Americans are Chinese products relative to American products.

Therefore, a lower-priced yuan causes Americans to buy fewer U.S. products and more Chinese products.

Governments being what they are, it’s undeniable that many of them—including the one headquartered in Beijing—intervene in their economies in countless distorting ways. Let’s assume for the remainder of this article that the Chinese government does in fact keep the price of the yuan artificially low.

Does this policy help the Chinese and harm Americans?

**False Savings**

A low-priced yuan certainly shifts business to some Chinese producers and away from American producers who compete with them, just as genuine efficiency improvements in Chinese industry take some business away from American producers who compete with Chinese producers. But contrary to protectionists’ claims, Beijing’s efforts to lower the price of the yuan *harms* the Chinese economy and benefits the economies (including that of the United States) whose people trade with the Chinese.

To see why, let’s use a close-to-home example.

When I was a child my elementary school—Immaculate Conception School (ICS)—held two fund-raising fairs each year. At these fairs we kids bought tickets that we could exchange for various trinkets and food. Of course, some items cost more than others. A big stuffed panda bear might have been priced at, say, 50 tickets, a hotdog at three tickets, and a pencil sporting the school logo at one ticket.

Using dollars, each of us students could buy as many or as few tickets as we pleased (or, more accurately, as many tickets as our parents could afford or would allow us to buy).

Suppose that ICS had undervalued its tickets. Suppose, if the “correct” price (by whatever calculus) was $1, ICS sold each ticket for 75 cents.

Undervaluing its currency in this way surely would have resulted in more sales at the fairs. A 25 percent discount on trinkets and junk food is a darned attractive deal for kids.

Would ICS have benefitted itself by such undervaluation of its medium of exchange? Some of its employees would have benefitted. The fairs would have required more clerks and food preparers to handle the larger demand. But it’s clear that undervaluing these tickets would have harmed ICS on net. Instead of raising money for its operations, ICS would have lost money. By underpricing its trinkets and junk food, it would have subsidized its students’ consumption of these things. Undervalued tickets would have enabled its customers (us students) to acquire valuable goods and food at prices below ICS’s cost of supplying them.

No student (including me) would have complained about undervalued fair tickets. Such undervaluation would have been to our benefit.

But the school principal (Sister Quentin, if I recall)—who we can imagine was the architect of this self-destructive scheme—would have realized, on coming to her senses, that artificially stimulating the school’s exports of trinkets and food on fair days is no path to long-run and widespread prosperity for ICS.

The situation with the Beijing government is identical. The real costs of the resources and outputs exported by the Chinese people are not lowered simply because Beijing keeps the price of the yuan artificially low. And the resources spent to supply the extra American demand that results from an artificially low price of yuan—even though they are unseen by the untrained eye—represent a huge cost that harms the Chinese economy.
Walmart’s Bottom Line

BY ART CARDEN

Walmart is one of the world’s largest, most successful, and most vilified corporations. It was ranked number four in the Fortune 500 from 1995 through 1998, reached number one in 2002 and stayed there until 2009, when it fell behind Exxon Mobil. It’s also the only firm in the top four of the Fortune 500 that is not an energy company.

The concentrated public-relations campaign against Walmart has been moderately successful, and the company has drawn criticism from all sides: Commentators on the left criticize the company for its alleged impact on wages and jobs; those on the right criticized its decision to join the National Gay and Lesbian Chamber of Commerce and to offer “abortion pills” in 2006. Recently, Walmart announced support for mandatory health coverage by large employers, bringing more criticism. Walmart’s handling of the attacks has been less effective than the company would have liked, and its attempts to defend itself have been a distraction.

The criticisms too often rely on anecdotes or statistical comparisons that are difficult to interpret. When one considers that Walmart is the world’s largest corporation, with revenues of about $300 billion and almost two million employees, anecdotes that cast the company in a good or bad light are not particularly surprising. Similarly, a simple comparison of employment (or wages) in a city with a Walmart to a city without one is only minimally informative because such comparisons often fail to control for other explanatory characteristics. Current research suggests that the economic, political, and social case against Walmart is exaggerated. Further, Walmart’s “Every Day Low Prices” do not come at an unacceptable social cost in the form of negative spillovers not reflected in prices. Walmart is certainly imperfect, and there are reasons to view the company with a critical eye, but the usual criticisms of the company collapse under the weight of the evidence.

Does Walmart Squeeze Workers and Suppliers?

Economists Jerry Hausman and Ephraim Leibtag argue that we systematically overstate the rate of price inflation because we don’t account for Walmart’s and other big-box companies’ impact correctly. Walmart claims to save consumers $2,500 per capita per

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year. This is probably an overestimate, but studies I have done with Charles Courtemanche of the University of North Carolina-Greensboro do suggest that Walmart increases our options.

Critics claim that Walmart can deliver low prices because it destroys jobs, lowers labor standards, and squeezes suppliers. The data, however, do not support the first two, while the third is misleading. Retail labor market studies by University of Missouri economist Emek Basker show that Walmart modestly increases retail employment. Critics are quick to counter by questioning the quality of those jobs, correctly noting that Walmart pays less than its unionized competitors. However, this should be qualified. Union pay scales restrict the labor pool from which unionized stores can hire: If the union contract specifies minimum compensation of $12 per hour, then people whose labor cannot produce at least that much in revenue will not be hired. Since Walmart is an open shop, it has no such artificial floor for the productivity of the people it can hire. Those who would not be employable under union conditions are made better off despite the illusion of exploitation.

The company’s critics correctly point out that the last several decades have seen a large gap open between manufacturing and retail wages. But these data must be interpreted with caution because immigration and changing labor participation have altered the distribution of the workforce. People who are today earning Walmart’s “Every Day Low Wages,” as the critics call them, might not have participated in the labor force several decades ago and their wages would not have appeared in the official data.

Supposedly, Walmart drives small local mom-and-pop retailers out of business, spreading economic havoc and weakening a community’s social fabric. In a paper published in Economic Inquiry, West Virginia University economists Andrea M. Dean and Russell S. Sobel fail to detect a statistically significant effect of Walmart on self-employment, the number of small businesses, or bankruptcy among small businesses. It is true that Walmart causes some businesses to close, particularly in sectors that directly compete with the company. However, these businesses can be replaced by businesses in other sectors. In a summary of their research that appeared in the Spring 2008 Regulation magazine, Dean and Sobel offer the example of Main Street in Morgantown, West Virginia, which was decimated by Walmart but which soon recovered as clothiers and electronics stores were replaced by small businesses in other industries.

They also discuss the obvious objection that perhaps Walmart’s wake leaves a swath of low-value, low-wage businesses. They show, however, that Walmart penetration does not appear to reduce the values of small businesses. Stacy Mitchell, author of The Big-Box Swindle, argues that Dean and Sobel’s result relies on an incorrect interpretation of Census data. For their part, Dean and Sobel say Mitchell misunderstands the data. If they are correct, the effects of Walmart’s penetration are consistent with what economists believe about technology and economic growth as well as with Joseph Schumpeter’s well-known concept of “creative destruction.” Walmart’s expansion allows people to produce more with fewer resources and less labor, which frees those resources and that labor to move into other occupations.

Walmart also allegedly uses its raw bargaining strength to extract concessions from suppliers. It is usually able to get lower prices, but it also provides something of great value in return: access to its supply chain and logistical support. While anecdotes of Walmart’s hard bargaining abound, a 2001 Journal of Retailing study by Paul N. Bloom and Vanessa G. Perry found that while dealing with Walmart can hurt financial performance for companies that do only a small share of business with the company, “large-share suppliers to Wal-Mart perform better than their large-share counterparts reporting retailers other than Wal-Mart as their primary customers.” Bloom and Perry note that Walmart offers access to broad markets and that companies taking advantage of this prosper as a result.

Sweatshops

Another common refrain is that Walmart and other large retailers obtain their goods from third-world
“sweatshops.” In an important 2006 study published in the *Journal of Labor Research*, economists Benjamin Powell and David Skarbek showed that “sweatshop” labor paid better than the alternatives. In a June 4, 2008, article for the Library of Economics and Liberty, Powell summarizes this research and points out that criticisms of “sweatshop wages” (like those aimed at a factory in Honduras making clothes for Kathie Lee Gifford in 1996) invariably compare the wages and working conditions to American rather than Honduran working conditions—a comparison he calls “irrelevant” because of restrictions on international labor mobility. Sweatshops are a blessing, not a burden. As Powell points out, sweatshop wages more than double the average in some countries. Unfortunately, boycotts and legislation will not improve working conditions around the world. Powell summarizes the conditions that create low wages in countries like Honduras:

Wages are low in the third world because worker productivity is low (upper bound) and workers’ alternatives are lousy (lower bound). To get sustained improvements in overall compensation, policies must raise worker productivity and/or increase alternatives available to workers. Policies that try to raise compensation but fail to move these two bounds risk raising compensation above a worker’s upper bound, resulting in his losing his job and moving to a less-desirable alternative.

Unwillingness to recognize this can lead to policies that do more harm than good. Abuses undoubtedly occur, but Walmart has the resources to be able to have an effective monitoring program—not necessarily because of explicit humanitarian impulses, but because consumers are willing to pay for the guarantees and assurances that they are not buying the products of slave labor. Since consumers demand information about the conditions in which people produce the goods they obtain from abroad.

The thesis that Walmart’s ethical-standards monitoring is an elaborate ruse is tempting, and a ruse might pay off in the short run. However, Walmart should be disciplined by the capital market. Failure to provide consumers with what they demand—guarantees about international labor conditions, for example—at the price they are willing to pay will hurt long-run profitability and, therefore, the stock price. It is wise to read with a critical eye, but if Walmart’s managers are running a systematic campaign of misinformation, then they are failing in their responsibility to shareholders.

Someone who discovered such a ruse would be in a position to profit handsomely by acquiring Walmart stock and fixing the problem.

### Walmart, Communities, and the Environment

In his 2000 book, *Bowling Alone*, political scientist Robert Putnam documented a decline in “social capital”—which he defines as “networks and norms of reciprocity” that hold communities together—in the United States since the 1950s. Walmart has been accused of contributing to this phenomenon. In a 2006 study agricultural economists Stephan Goetz and Anil Rupasingha reported evidence that Walmart reduced several measures of social capital like census participation, voting, and a measure they themselves constructed. However, in a study published in *Public Choice* in early 2009, Charles Courtemanche, Jeremy Meiners, and I use Putnam’s data to show that there is no identifiable, systematic negative relationship between increased Walmart density/longevity and measures of noneconomic “quality of life” or civic participation. As Walmart penetration increases, we cannot tell that people spend systematically less time with friends or less time civically engaged.

Others have alleged that Walmart erodes American values. *United States of Wal-Mart* author John Dicker calls the company a “conservative cultural gatekeeper.”
and right-wing critics like those who operate the Christian website www.saveWal-Mart.com took Wal-mart to task for joining the National Gay and Lesbian Chamber of Commerce. (The company discontinued this affiliation in 2007.) Using similar data and methods to those used in our study of social capital, my co-authors and I were unable to find a systematic relationship between Walmart’s penetration and individual values. It appears that while people get their groceries at Wal-mart, they get their politics and their values elsewhere. Finally, Walmart has been criticized for its alleged contributions to environmental degradation, but its cost-cutting has considerably reduced the amount of packaging manufacturers use. This was particularly important in 2008 as gas prices hit record highs. A May 29, 2008, article on CNNMoney.com used Hamburger Helper as an example: To meet Walmart’s demands, General Mills produces “denser pasta shapes” that can be put into a box that is 20 percent smaller, saving “890,000 pounds of paper and eliminating 500 trucks from the road.” Conditions create solutions: Walmart has been able to use recent increases in fuel prices to trim additional fat from the supply chain and to innovate in ways that will lead to permanent increases in productivity.

**Discrimination, Health Care, and Subsidies**

Finally, Walmart has been criticized for alleged systematic discrimination against women and for aggressive patterns of seeking local government subsidies. Walmart is the defendant in the largest class-action civil rights lawsuit in history—*Dukes versus Wal-Mart*, in which an estimated 1.6 million women allege a decades-long pattern of discrimination—but the central tenet of the case is inconsistent with Walmart’s alleged morbid obsession with profits. In spite of their incompatibility, these criticisms often appear side by side. There are conditions under which firms can maximize profits while discriminating in employment, but before we can reconcile discrimination with profit maximization we have to prove that these conditions are in place. Otherwise, the hypothesis of profit maximization works against discrimination and discrimination works against profit maximization. If an employer insisted on discriminating by refusing to hire productive women or by paying them less than they were worth, he would create profitable opportunities for competitors to scoop up members of the victim group and earn profits by paying them something closer to their market value. An employer’s ability to discriminate will be sharply limited by competitive pressure.

Walmart’s critics have also argued that the company places undue burdens on the government’s public health infrastructure. But this is a “problem” that exists because that infrastructure exists and not because of Walmart *as such*. One could argue more plausibly that by paying better than their employees’ next-best alternatives, Walmart actually relieves some of the pressure on the public health infrastructure. The critics also miss that Walmart’s existence provides a larger pool of resources that can be taxed to provide these benefits.

One robust criticism remains: Walmart has sometimes used the State to redistribute resources to itself and to cripple its competitors. Walmart is aggressive about seeking subsidies, such as acquiring properties through eminent domain, from governments eager to “attract new jobs” and new tax revenue, as critical groups like Good Jobs First, WalMartWatch.com, and WakeUpWalMart.com point out. These subsidies distort patterns of economic activity and sometimes can have the perverse effect of taxing one firm to subsidize a competitor. The problem is compounded further by the alleged need for more subsidies to redevelop areas blighted in Walmart’s wake. This issue provides a setting in which Walmart’s critics can play a constructive role.

In 2005 Walmart supported an increase in the minimum wage, and in July 2009 it earned a front-page mention in the *Wall Street Journal* for teaming up with the Service Employees International Union and the Center for American Progress to advocate mandatory employer-provided medical coverage. Walmart’s seem-
ingly counterintuitive advocacy is a classic example of what economist Bruce Yandle terms the “Baptists and Bootleggers” phenomenon. Among the supporters of Prohibition were Baptists, many of whom felt that consuming alcohol is a sin, and bootleggers, who stood to profit handsomely if the government crippled potential legitimate competition. In the health care scenario the “Baptists” are groups that believe everyone has a fundamental right to health care. The bootleggers are large firms (like Walmart) that know that mandates will hurt their smaller competitors.

There is also reason to believe that Walmart’s business model is partially underwritten by transportation subsidies. Critics often overlap with people who criticize the American “love affair” with the automobile. The two are related. While it is true that, all else equal, Walmart has been good for consumers, it is also an unintended consequence of the massive subsidies to transportation infrastructure that created today’s urban sprawl. To the degree that Walmart is undesirable, it is a symptom of a larger pattern of interventionism rather than a cause.

Perhaps most unsettlingly, Walmart’s embrace of the proposed health care mandates and advocacy of a higher minimum wage illustrates a disturbing truth about the reality of doing business in the twenty-first century. By backing President Obama’s health care proposal, Walmart might be able to use this to fend off more damaging legislation later. In short, Walmart could be aiding and abetting what Ayn Rand called “an aristocracy of pull.” A 2006 volume of critical essays called the company “the face of twenty-first-century capitalism.” If twenty-first-century capitalism means competition by politics rather than competition by production, we will see lower economic growth as a result. This does not excuse the company’s use of the coercive power of the State for its own benefit, but Walmart is an effect rather than a cause.

The economic, political, and social case against Walmart has been tried and measured against the best available data. For the most part, it has been found wanting. We are left with a rather flimsy criticism, which is that for all its virtues (or at least its non-prises), Walmart is aesthetically unappealing. This visceral reaction to capitalist aesthetics has been called “the yuck factor,” and economist Alvin Roth has argued that we have to take “repugnance” seriously as a political constraint. However, just because I find another’s choices repugnant, I don’t have the right to supplant those choices with my own. People have argued that what happens in someone’s bedroom is none of the government’s business. By the same logic, what someone puts in his or her shopping cart is none of the government’s business. Even if Walmart causes people to make bad aesthetic choices, the civility necessary for a functioning society must take over.

Walmart’s “Every Day Low Prices” policy has been alleged to reduce labor standards, to squeeze suppliers, to decimate small retailers, and to tear the social fabric. In virtually every instance, the empirical evidence available suggests that what Charles Fishman called The Walmart Effect is at best positive, at worst benign. Walmart is a retailing innovator and a force for competitors and suppliers to reckon with. As a social phenomenon, however, the alleged negative spillovers from Walmart are greatly overstated.
Short selling is a little-understood, much-maligned tactic by which traders can profit from their belief that a company's stock is overvalued.

Following the financial problems of the last two years, short selling has come under fire, with new or revived regulations proposed to curb the practice. It is unpatriotic, destructive, and destabilizing, say the critics. Such complaints are nothing new. President Hoover blamed short sellers for the continuing market declines of 1931 and 1932, threatening regulation or even outright prohibition. “Individuals who use the facilities of the [stock] Exchange for such purposes are not contributing to the recovery of the United States,” he grumbled.

Defenders say short sellers add liquidity to markets. When short sellers are present, buyers encounter a more liquid market because they face a larger pool of sellers than they would otherwise. More sellers—more liquidity—means more predictable prices and smoother price changes. Shorts can put a damper on runaway enthusiasm, and when they are right, they can hasten the demise of failed businesses.

The mechanics of short selling are simple. You borrow stock and sell it, hoping its market price will decline so you can repay your loan with stock that you buy cheaply. In the meantime, you are said to be “short” that stock, the opposite of the situation of someone who owns the shares and is “long.” For widely traded stocks, brokers can easily find shares to borrow, either from their own inventory or from customers who have agreed to make their shares available. For thinly traded stocks it may be difficult or impossible to find shares to borrow. The short seller must pay the lender the amount of any dividends that the stock pays while he is short. And most brokers require cash on deposit to cover the obligation to buy the stock later on.

Most short sellers simply think a stock is overpriced and hope to profit from a decline. But sometimes short sales are used as part of a hedging program. If you want to “hedge your bets” you can short a stock to offset possible losses in a related stock that you own. For example, if you aren’t sure where the oil industry as a whole is going but you think Chevron is overpriced relative to Exxon Mobil, you can buy XOM and sell CVX short. Or you may have shares of your employer’s stock coming to you as part of your year-end bonus but you fear a price drop before then. You can sell short and then cover your position with the shares you receive. (Hedge funds, incidentally, were originally organized to engage in hedging, but have since expanded into all sorts of exotic trading strategies.)

Since there is no limit on how high a stock price can go, short sellers who are not hedging expose themselves to unlimited potential loss. Amateur investors

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**BY WARREN C. GIBSON**

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should be very careful about selling short and should use stop orders to exit their position if the market goes against them.

Failure is an essential feature of free markets. Companies that suffer losses must be allowed to fail so that scarce capital can be redeployed into lines of business that better serve consumers. Short sellers, when they are right, hasten the necessary decline of the stock of a faltering company. In extreme cases, short sales can predict liquidation or bankruptcy. In other cases the stock of a generally sound company may have been driven to unsustainable heights by bandwagon psychology, and short sellers can help deflate those spikes and hasten a return to more realistic levels.

But the message that the short seller brings is not always popular. We don’t like to hear bad news. We may think there’s something unseemly about speculators profiting from other people’s troubles. Executives of companies whose stock is being shorted can be particularly vocal about blaming speculators for beating up their company shares when in fact their own management blunders are at fault. Almost since the beginning of organized stock trading, short sellers have been suspected of distorting markets, destroying good companies, and reaping unjust profits.

**Abusive Short Sales?**

Can speculators start a run on a stock using massive short selling? Dumping large blocks of stock could cause a price drop that would frighten many holders into selling out, driving the stock still lower—a waterfall decline. Then at just the right moment, the shorts could cover their positions (buy shares to repay their stock loans), taking a big profit. Their profit would come at the expense of other shareholders, with no fundamental developments accompanying the price swings.

Such maneuvers are possible in theory but quite difficult to pull off successfully. You have to find shares to borrow, and lots of them, if you’re going to have a noticeable impact on the share price. Then you have to get the timing just right. If you don’t and the share price rebounds before you can get out, you’re left holding the bag, with unlimited potential losses as the stock rises. If you are conspiring with others, there is always the danger that one of your group will break ranks and grab profits ahead of the others. Manipulation, therefore, is much easier said than done.

“Naked short selling” has come under scrutiny recently and has been the subject of an increasing number of lawsuits. One plaintiff’s lawyer calls the practice “the largest commercial fraud in U.S. history, involving hundreds of billions of dollars.” In a naked short sale, the seller has not borrowed the shares that he is obligated to deliver, but seems to be making them up out of thin air. Clearly this is fraudulent behavior. Clearly someone has been cheated.

Not necessarily. Sellers, short or not, are given three business days to deliver the shares they have sold. Short sellers are required to have borrowed the shares or have good reason to expect to find them by the settlement date. If that day arrives and the stock has not been delivered, a “failure to deliver” event is recorded. To see what happens next, we need to understand a little of how stocks are held and traded these days.

Stock trading has evolved into a highly efficient business. Customers can enter orders online and see the results in just seconds. Commission rates are low, often under $10, and problems are extremely rare. This happy situation has been made possible in part by the elimination of paper stock certificates. When you buy stock in today’s market, you actually acquire an entitlement to shares that are kept in the possession of an organization called the Depository Trust Co. (DTC). When you sell your stock (or, strictly speaking, when you sell your entitlement), another organization, the National Securities Clearing Corp. (NSCC), issues an order to DTC to record the new entitlement. The physical securities are not touched. Most brokers are members of the NSCC and conduct virtually all their trading by electronic transmission of orders to transfer entitlements.
Failures to deliver are rare, and the DTC and the NSCC have procedures in place to handle them when they do occur. First, the seller does not receive funds until the shares are delivered. Likewise, the buyer does not relinquish funds until the shares are delivered. If the settlement date passes and the seller has not delivered, the buyer can send a “buy-in” order to the NSCC. The seller gets two more days to deliver the shares, and after that if there has still been no delivery, the NSCC will purchase the shares and charge the account of the member who failed to deliver.

In this situation the only difference is who acts as the effective lender of the security. While this is certainly not the normal course of events, it is hard to see how the economic effect on the market as a whole is any different from the effect of a short sale completed in the normal way.

Thus naked short selling does not appear to be a major problem, nor does it have the dire consequences one might expect.

**Regulation of Short Selling**

The Securities and Exchange Commission (SEC) regulates stock trading in the United States. Regulation of short sales began in 1938, and the current “Regulation SHO” was adopted in 2005. Short sales are explicitly permitted except, according to an SEC commentary (www.tinyurl.com/adcwy), when “effected to manipulate the price of a stock.” The commentary does not state how the intent of a seller is to be determined. Presumably, an expression of satisfaction when the stock falls is not enough. Nor, one hopes, is knowledge that any sale will put at least marginal downward pressure on the price. But this is just the sort of fuzzy, non-objective law that opens the door to abusive prosecution.

The SEC commentary on regulation specifically addresses failures to deliver and naked short selling. Interestingly, it declares that naked short selling is not always a bad thing, but rather, in certain circumstances, it “contributes to market liquidity.” It cites as an example a market maker (a specialist or a broker/dealer) whose job is to offer to buy and sell a particular stock continuously even when there are no other buyers or sellers. To meet a sudden surge in buying, a market maker may sell short without having first found shares to borrow. The public benefits from a smoother market, and there is almost no risk that the market maker will be unable to net out his position in a reasonable time.

The SEC has been fielding a growing volume of complaints alleging possible market manipulation via short sales—about five thousand between January 1, 2007, and June 30, 2008. Of these, just 123 were forwarded for investigation. None were pursued. The SEC staff has downplayed the importance of naked short-selling abuses.

This has not deterred politicians from gunning for short sellers. Leading the charge is a group of six senators led by Edward Kaufman (D-Del.). So, notwithstanding its relatively benign view of short selling, even some forms of naked short selling, the SEC has decided to propose rule changes to curb short selling. Reinstatement of the “uptick rule” is one proposal, and there might also be “circuit breaker” provisions to further inhibit waterfall declines. The SEC’s recent proposal to reinstate the rule was met with mainly negative reactions from people in the securities business, and at this writing no decision has been made.

From 1938 to 2007 an uptick rule was in effect. At any given moment, a stock has “ticked up” if its last price was higher than the previous price. When a stock was declining, short sales were forbidden until an uptick occurred. This was supposed to help curb runaway declines.

A major change in trading took place a few years ago when the time-honored practice of quoting prices in dollars and eighths of a dollar (sometimes sixteenths) was abandoned in favor of decimal quotes. The economic importance of the change was that stocks now move in one-penny increments rather than eighths (12.5 cents). An uptick rule in the one-penny environment has far
less effect than under the old fractional regime simply because there are smaller and more frequent price changes, so that the tick changes direction more frequently. But reinstating the rule would let politicians take credit for pressuring the SEC into “doing something” about the nasty short sellers. And they will probably cause little damage to the markets in the process.

Circuit-breaker rules were put into effect after the crash of 1987. In case of a severe selloff, trading on the New York Stock Exchange, as measured by the Dow Jones Industrial Average, can be interrupted or halted, depending on the time of day and the magnitude of the decline. The proposed new rule would extend this idea to individual stocks, interrupting or halting short sales of stocks that have experienced rapid declines. This rule may or may not make much difference depending on how the parameters are selected. It could give an unfair advantage to sellers of a stock who already own it. With competing short sellers temporarily locked out of the market, ordinary sellers, still allowed to sell, could enjoy a price advantage. It might also be difficult for market makers to distinguish ordinary sell orders from short sales.

In the long run stock prices are determined by fundamentals. In the short run all sorts of influences drive prices. Short-term traders should be prepared for volatility.

In the long run stock prices are determined by fundamentals. In the short run all sorts of influences drive stock prices: exuberance, despair, rumors. Those who choose to engage in short-term trading should understand this and be prepared for volatility. Restraints on honest short selling can only hinder the recognition of failing companies and stymie the efforts of hedgers to reduce their risk.

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Frustrating Michael Moore

BY SHELDON RICHMAN

If Michael Moore would study a little political economy he might turn into a potent champion of individual liberty.

As we see in Moore’s new movie, Capitalism: A Love Story, Moore is offended by some truly offensive things: banks engaging in wild speculation without concern for the risk, taxpayer bailouts for banks and other businesses, cozy relations between Wall Street and Washington, politicians getting favors from companies that want benefits from government, and big institutions pushing less powerful individuals around. True, he’s offended by some inoffensive things as well, such as the cut in the 90 percent top income-tax rate years ago. But by and large, what he rails against should be railed against.

Had he called his movie State Capitalism: A Love Story, I might be applauding (with some reservations). But he’s targeting the more ambiguous “capitalism,” which he uses interchangeably with “the free market.” He can be forgiven for this, however. Most people would say that the current U.S. economic system is capitalist. Moore has probably heard that all his life. He’d hear it if he watched a Fox financial program. Would Ben Stein or Lawrence Kudlow disagree? Moore has also heard Republican politicians—George W. Bush, for example—praise the existing system, with all its deep government interventions, as capitalist. Bush did this even as he and Treasury Secretary Henry Paulson, former chief of Wall Street behemoth Goldman Sachs, stamped Congress into passing the $700 billion TARP bailout last year. Moore takes such people at their word: The free market is capitalism, and capitalism is what we have today.

Vulgar Libertarianism

Can we blame him for thinking this way?

Yes, it’s sloppy thinking, and had he been more curious and read beyond the confines of “Progressive” literature, he could have gotten the straight story. But many knowledgeable advocates of the free market contribute to the confusion by exhibiting what Kevin Carson calls “vulgar libertarianism,” or what Roderick Long describes as “the tendency to treat the case for the free market as though it justified various unlovely features of actually existing corporatist society.” How often have you heard a free-market advocate condemn pro-business intervention in one breath, then defend existing dominant corporations in the next—as though they did not arise in the interventionist environment just condemned? Pro-market is not the same as pro-business. If some market advocates don’t understand that, why should Moore?

This may go a long way in explaining Moore’s aversion to profit—at least other people’s. He associates profit with business, which he associates with (state) capitalism. So for him, profit per se is suspect. But he should see a problem here. Does he think he’s exploiting moviegoers when his production company ends up with a profit? Do the co-ops and worker-owned firms he loves exploit their customers when they sell their products for more than their money costs?

Cornered like this, Moore might say he’s only against the excessive profits that capitalist market power permits. But now we’re back where we started. To the extent that intervention hampers competition by erecting barriers to entry—which is the usual effect,
intended or not—protected firms are free to charge higher prices and reap more profits than would have been the case in an open market. Corporate power and privilege derive from political power and can’t exist without it. In contrast to existing capitalism, the truly free market would have no legal barriers to competitive entry, assuring that prices and returns are economically justified and not the fruits of privilege. Only the State permits business to make profits by withholding benefits from consumers.

But Moore doesn’t know this. What he “knows” is that the choice is between the current corrupt system—and it is corrupt—and some vaguely defined scheme of control by benevolent politicians, which he calls socialism and democracy.

In his movie Moore expresses affection for socialism, but he’s not clear what he means. He never advocates collectivization of the means of production or the abolition of markets. Instead he suggests that socialism means workers having a say in how the companies they work for are run. But why assume that’s anti-free-market? He praises worker-owned companies and notes that hundreds of them exist in the United States today. He might be surprised to learn that these things are entirely compatible with the free market. In fact, it’s a perfectly libertarian intuition to abhor being subject to the arbitrary whim of anyone—yes, even a private employer. If government regulatory and tax obstacles to new competition and self-employment did not exist, workers would have their maximum bargaining power and widest array of alternatives. I imagine we’d see more departures from the traditional firm. People used to get their “social insurance” from mutual aid societies. Maybe in a true free market, we’d see a bigger role for the employment counterpart to these public, yet not governmental, organizations.

What would Moore think about a system in which no one could collude with politicians to legally plunder the rest of us for his or her own benefit and everyone was free to enter into any cooperative arrangements to produce and offer goods to others in voluntary exchange? Michael, that’s the free market!

The Nirvana Fallacy: A Love Story

Of course, Moore naively looks to government to provide things. His movie laments that FDR died before he could see his Second Bill of Rights enacted. Roosevelt wanted government to guarantee everyone a good education, job, home, health care, and so on. Has Moore ever wondered where government would get the resources for this? He can’t really believe that somewhere there’s a massive pot of collective wealth waiting to be distributed. He must realize that the tax system would provide the money. But how can he not know that if government appears to penalize wealth creation with confiscation, less wealth will be created?

Moore is unaware that he commits the “Nirvana fallacy.” This is the erroneous idea that our choice is between the admittedly imperfect world we’re bound to live in if government leaves us alone and an imagined utopia in which benevolent and all-wise rulers oversee and regulate everything. Of course that is not the choice. Moore’s preferred system, whatever he calls it, would be run by individuals whose insights into the public interest would be no sharper and whose motives no purer than other people’s. However, since they would wield political power—which is the legal authority to compel obedience—they would be far more dangerous than anyone in a free market could ever be. He knows how corrupt politicians are. Why does he think different people would run things in his utopia? Does he really want them in charge of everyone’s job, education, health care, housing, pension, and the rest? It’s hard to understand why he isn’t uncomfortable with the idea of the people being tenants and employees of the State.

It’s hard to understand why Moore isn’t uncomfortable with the idea of the people being tenants and employees of the State.
Deflation: The Good, the Bad, and the Ugly

BY STEVEN HORWITZ

During the current recession a number of commentators have made various comparisons to the Great Depression, mostly because of the dramatic decline in the stock market and ongoing troubles in the financial industry. When oil prices also began a dramatic decline in the autumn of 2008, pulling the overall consumer price level downward for the first time in a very long time, yet another fear of the Great Depression era came to the forefront of the public’s consciousness: deflation. Many observers pointed out, quite correctly, that the deflation that followed nearly immediately after the stock market crash in 1929 was a major reason that what would have been a serious, though likely short-lived, recession was transformed into the Great Depression. With these fears of deflation, and the damage it did decades ago, now part of the discussion, it is a good idea to remind ourselves just what we should and should not fear about deflation, and how deflation can be, and was historically, a major contributor to economic catastrophe.

The key to understanding deflation is to realize that it comes in three forms: the Good, the Bad, and the Ugly. To make sense of these three forms we need to be clear on some terminology and definitions. First, the word “deflation” itself requires additional clarity. Normally, the definition is something like “a sustained decline in the average level of prices.” That definition immediately raises the question of why anyone would think deflation is bad. After all, what could be bad about things getting cheaper? For one thing, “prices” are normally understood to include “wages” (although in the Ugly version we’ll see what happens when this isn’t the case), so whatever gains one gets from lower prices are likely to be offset by lower wages. For another, that definition says nothing about whether the process by which prices fall is a painful one. (Could not one say of inflation: “What’s the big deal? Sure, prices are going up, but your wages will too, so aren’t you just even?” We know enough about the process by which prices rise to know it’s not that simple and the same is true of the process by which they fall.)

With that common definition in mind, we then need to make a further distinction about the cause of falling prices. A decline in the general level of prices can come from two broad sources: improvements in economy-wide efficiency (the decreased relative scarcity of some large number of goods) or a deficient supply of money. We might further distinguish between these two by referring to the first as “price deflation” and the latter as “monetary deflation.” Price deflation, as it turns out, is the “Good” of the Good, the Bad, and the Ugly. Monetary deflation is the “Bad” and can lead to the “Ugly.”

Price deflation, sometimes called “benign deflation” is, or at least should be, the normal by-product of a growing economy. To see why, we need one last digres-
sion, this time into monetary theory. Understanding both inflation and deflation requires that we recognize that the demand for money is a demand to hold real cash balances: We demand money when we hold balances in our wallets or our checking accounts. When we spend money we actually reduce our demand for money as we shift how we hold our wealth from money to whatever we buy. Think of a wallet or checking account as part of a larger portfolio of assets we choose to hold at any given time. We want a certain portion of our wealth in the form of housing, some in the form of food, some in the form of clothing, and some in the form of money. Thus our demand for money is a demand to hold money balances, and we care about the real purchasing power of those money balances—what they are capable of buying, not just what number is stamped on the bills.

A correct understanding of the demand for money helps us to understand why sometimes people can have either more or less money than they would prefer. For example, during inflation the monetary authority has created more money than people wish to hold at current prices, so they spend those “excess” money holdings on goods and services, driving up their prices. During a monetary deflation, as we shall see, a deficient supply of money means that people do not have large enough money balances and will act to get more.

All of this implies that a good monetary system is one that supplies exactly the amount of money the public wishes to hold at the current level of prices. It is worth noting that this view, called “monetary equilibrium theory,” implies that not every increase in the supply of money is inflationary. Should the demand for money rise, it is the appropriate response of the monetary system to increase the supply to match it. In our discussion of monetary deflation below, we will see why monetary equilibrium theorists make this argument. This argument also distinguishes those Austrian economists who work from the monetary equilibrium tradition from those who work from a more Rothbardian tradition, in which any increase in the money supply not matched by an increase in the quantity of gold is necessarily inflationary and the ideal monetary system is not one that matches changes in money demand with changes in the money supply.

The Good

If the monetary system is doing its job and matching changes in money demand with changes in supply, the long-term trend of the price level will be gently downward as economy-wide productivity rises. Put differently, increased productivity will cause benign price deflation as the real cost of goods and services falls. This sort of deflation is not only not harmful; it is beneficial because the cost of living is lower. In the United States this is precisely what happened to the price level during the last few decades of the nineteenth century, since the pre-Federal Reserve banking system based on gold was reasonably effective at getting the money supply right much of the time and productivity gains caused a steady, slow fall in the price level. Over the last few decades the same downward pressure on prices from productivity gains has been taking place, but it has been outweighed in the aggregate by the inflationary policies of the Fed, so the price level continues to climb in spite of these productivity-induced deflationary pressures.

One implication of this last observation is that consumer price index figures may well understate the real degree of monetary inflation in a given economy. For example, if productivity increases are pushing prices down 3 percent per year, but excesses in the money supply are pushing prices up by 3 percent per year, the common measures of inflation would show stable prices. However, on the monetary equilibrium view, that stable price level is disguising underlying inflation of 3 percent, as prices should have fallen by 3 percent. Austrian economists have long argued that something like this may well have been at work in the 1920s, where relatively stable prices concealed a multiyear inflationary boom that culminated in the recession and then the stock market crash of 1929.
To the extent that a fall in the overall level of prices reflects increased productivity, it is Good. Similarly, a decline in the price level caused by the decreased relative scarcity of key goods is not problematic. The dramatic fall in oil prices in the autumn of 2008 was enough to cause the average level of prices in the United States to fall, which is the source of much of the concern about deflation. However, this sort of deflation is not the type to be concerned about, and certainly does not warrant the comparisons to the Great Depression. In fact, falling oil prices in this case probably did much to prevent the early months of the recession from being any worse than they were, as lower gasoline prices eased financial pressures on many households.

The Bad

The “Bad” sort of deflation arises from an insufficient supply of money. When people do not have as much of their wealth in the form of money as they would like, they will make attempts to increase those money balances. Assuming that in the short run additional income is not possible, people have essentially only two other options: sell off other assets or reduce their expenditures. Either one will work, but selling off assets is problematic for two reasons. First, it is not totally under the individual’s control since it requires a buyer, and second, if everyone is short on money, finding a buyer will be especially difficult because everyone else is looking to sell. Therefore, the most likely result of a deficient money supply is that people will restrict their expenditures to allow more of their income to build up as checking account or currency balances.

As everyone reduces spending, firms see sales fall. This reduction in their income means that they and their employees may have less to spend, which in turn leads them to reduce their expenditures, which leads to another set of sellers seeing lower income, and so on. All these spending reductions leave firms with unsold inventories because they expected more sales than they made. Until firms recognize that this reduction in expenditures is going to be economy-wide and ongoing, they may be reluctant to lower their prices, both because they don’t realize what is going on and because they fear they will not see a reduction in their costs, which would mean losses. In general, it may take time until the downward pressure on prices caused by slackening demand is strong enough to force prices down. During the period in which prices remain too high, we will see the continuation of unsold inventories as well as rising unemployment, since wages also remain too high and declining sales reduce the demand for labor. Thus monetary deflations will produce a period, perhaps of several months or more, in which business declines and unemployment rises. Unemployment may linger longer as firms will try to sell off their accumulated inventories before they rehire labor to produce new goods. If such a deflation is also a period of recovery from an inflation-generated boom, these problems are magnified as the normal adjustments in labor and capital that are required to eliminate the errors of the boom get added on top of the deflation-generated idling of resources.

Over the course of U.S. history the economy has been subject to a number of deflationary episodes, all of which were the consequence of a variety of government interventions in the monetary system. In each of those cases before the Great Depression, policymakers largely allowed the economy to repair itself by standing by and doing little to nothing while prices and wages fell sufficiently to get the demand for money back into alignment with the supply. No doubt these were painful recessions that could have been avoided by having a banking system that responded to changes in money demand by more quickly adjusting the money supply, rather than allowing the price-level adjustment process to cause the problems noted above. However painful they were, these recessions did not become the “Ugly” version of deflation precisely because policymakers allowed the necessary downward adjustments to take place, which was the correct thing to do given the monetary system’s errors that caused the monetary deflation in the first place.
**The Ugly**

During the Great Depression, what should have just been a Bad deflation became an Ugly one. This deflation was unlike earlier ones for two reasons. First, the scale of the deflation was unmatched. The U.S. money supply fell over 30 percent between 1929 and 1933, a period in which the demand for money was actually **rising** as a consequence of the stock market crash and the bank failures that followed it. The combined effect was a massive downward pressure on prices. The Fed did not actively reduce the money supply during this period; it failed to react strongly enough to actions the public and banks were taking, such as the public’s holding more currency rather than bank deposits, which caused a multiplied reduction in the total money supply. As Milton Friedman and Anna Schwartz’s *A Monetary History of the United States* describes it, there was a great deal of internal debate within the Fed over whether it had the power to respond as we now believe it should have and whether, even if it had the power, such a response was the right one. Those who argued in favor of doing nothing won the day and substantially worsened the depression in the process.

The second difference from earlier recessions was that policymakers adopted the view that the key to recovery was to “maintain” prices and wages at their pre-deflation levels. Both Presidents Hoover and Roosevelt strong-armed business leaders into keeping prices and wages up and pushed laws that directly or indirectly did the same.

The effects of these misguided attempts at price and wage maintenance were devastating. Firms continued to pay unjustifiably high wages, while watching sales slacken because prices also stayed high; they covered their losses out of their profits, causing some firms to fail and others to see severe declines in their stock prices. This contributed to the low levels of private investment that prolonged the depression since firms did not have profits to recycle back into their own activities. More brutally, keeping wages so high led to the horrific unemployment rates of the Great Depression, which peaked at around 25 percent in 1933. Only by around 1934 did prices and wages fall enough to start bringing unemployment rates back down. However, unemployment remained at historic highs because even with the declines in prices and wages, private investors were hesitant to take risks in light of the policymakers’ earlier mistakes and the constantly shifting political environment. During the Great Depression, unemployment stayed above 14 percent from 1931 through 1940.

Current observers are quite right to point to the Great Depression as an example of what can go wrong from deflation. There is no doubt that the very large monetary deflation of the early 1930s made the recession that began in the summer of 1929 much deeper and more severe than it would have been otherwise. But even so, had prices and wages been allowed to adjust, that recession would have been Very Bad, but not Ugly. Attempting to keep prices and wages high during the monetary deflation prevented the cleansing price adjustments from taking place and forced sellers to make “quantity” adjustments in the form of reduced production and historic levels of unemployment.

**Avoiding the Last Big Mistake**

The price level declines seen in the fall of 2008 and early 2009 do not seem to be harbingers of significant deflation. As noted earlier, the decline in oil prices is the leading factor pushing down the overall price level, and this is the benign price deflation that we have labeled Good. In fact, the Fed’s initial response to the troubles in the banking system in the fall of 2008 was to flood the system with reserves, remembering the mistakes the Fed made at the onset of the Great Depression. Given the worries about a cascade of bank failures and the major deflationary effects this would have had on the money supply and the economy as a whole, injecting some additional reserves was probably the
right reaction at the time. Two key questions remain, however:

1) Did the Fed overreact and create too many reserves? A look at the Fed’s balance sheet suggests it may well have done so, especially given how many of those new reserves are just sitting in the banks right now (helped along by the Fed, now paying interest on such reserves).

2) Will the Fed be able to withdraw those reserves as the economy recovers and thereby avoid a potentially massive and damaging inflation? If it cannot do so, we will face a much bigger threat in the near future from inflation than from deflation.

All of that said, we do not know for certain what is going on with the demand for money. We know that expenditures are down, which suggests that people are quite possibly increasing their demands for money. But in the absence of the thousands of bank failures that characterized the 1930s and with evidence that banks, on the whole, are continuing to lend (despite scare-mongering media and government stories to the contrary), the concern that any increase in money demand will translate into significant monetary deflation seems remote. As Milton Friedman once said, central banks are always trying to avoid their last big mistake. In this case, that big mistake was the Great Depression, and the Fed has clearly shown a willingness to err on the side of inflation rather than deflation, even at the cost of putting itself in a difficult position once the recovery starts.

What all of this goes to show is that the best way to avoid both Bad and Ugly deflation and to generate the Good kind is to minimize the role of government intervention in both the monetary system and the regulation of prices and wages. A competitive banking system—one without a central bank but with fractional reserves—would avoid both deflation and inflation. Even under a central bank, the effects of a monetary deflation can be minimized by restricting government’s involvement in the setting of prices and wages. In a free economy the only deflation we would see is the slow, long-run decline in prices that results from the productive powers of competitive capitalism. That deflation would be just another Good produced by truly free markets.
Our Economic Past

Dangerous Historical Myths
BY STEPHEN DAVIES

One of the most powerful influences on human affairs is historical myth—beliefs about the past that are simply wrong. Some historical myths have far-reaching and baleful effects because they shape the way people understand not only the past but also the present, leading them to make harmful or even dangerous decisions. This seems to be especially so with economic history.

Take the standard account of the Great Depression and the New Deal. In many ways the New Deal itself was one result of another historical myth: the widely received account of what had happened to the German economy in the first half of the twentieth century, particularly during World War I and the Third Reich. That myth probably did more harm than almost any other in that century.

In the case of the Third Reich, the widely held perception even now is that whatever else may be said about his regime, Hitler managed to bring about a dramatic revival of the German economy. After 1933 Hitler and his finance minister Hjalmar Schacht stabilized the economy and managed to solve the huge unemployment crisis that had destroyed the Weimar Republic’s legitimacy. This was partly due to Schacht’s imaginative monetary policy and partly to massive public works programs, such as the autobahnen. There was a sharp move away from free markets to a much more interventionist economy that worked better than what had gone before. During World War II this economy was able to achieve great success in terms of war production, notably under Hitler’s armaments minister, Albert Speer.

Obviously there is some truth in this account, or else it would not be credible. There was indeed a sharp move in the direction of a more state-controlled economy. In fact few people realize just how interventionist—even socialist—the policies of the Nazi state were (although the full name of the party should give some indication of this). However, the picture overall is mostly wrong. Adam Tooze conclusively debunked this account in his masterful work, The Wages of Destruction: The Making and Breaking of the Nazi Economy. Tooze shows that the public works programs had little effect on unemployment and wasted resources; that the 1930s saw constant financial and foreign-exchange crises for the Reich; that by 1939 the condition of the German economy was desperate and that this was in fact a major factor in Hitler’s increasingly aggressive policy; that the supposed success of Speer simply did not happen; and that overall the regime was so crippled by its economic incompetence that it is nothing short of a miracle that it had as much military success as it did.

Fortunately, while Nazi Germany’s economic policy and its supposed success had some influence in the 1930s (not least among some New Dealers), it had none after 1945. However, an earlier episode in German economic history had much greater consequences and influence—both entirely malign. When war broke out in July 1914 the German government and High Command planned and hoped for a short and decisive war. Things of course did
not work out that way and by the fall of 1916 it was clear that this strategy had failed, while the British blockade grew ever more stringent. In the face of impending defeat, the German Empire’s government was effectively taken over by the military in the person of the army’s quartermaster general (and effective chief of staff) Erich Ludendorf. His thinking and policy were set out in his 1935 work and apologia, Der Töte Krieg (The Total War).

Ludendorf argued, first, that all the human and physical resources of a nation made up its military capacity, or Wehrkraft. To ensure victory and survival in the zero-sum game of nations, all these resources had to be controlled and directed to a single purpose. Who was to do this? The answer for him was simple: Since the goal was victory in conflict, it had to be the military. What this meant in practice was a form of planned economy in which all economic activity was directed by the general staff through a series of planning boards and detailed regulations and targets.

The main point was to remove the profit motive—Ludendorf never tired of ranting against unpatriotic profit seekers and selfish individualists—and replace it with structured command relations. In one sense the aim was to transform the entire economy and society into an army, with the typical command-and-control structure of the modern military. In another sense the goal was to turn German industry into one giant corporation by a process of planning and cartelization. One important aspect of the regime created by Ludendorf, just as for Nazi Germany, was a close alliance between the military, the political and bureaucratic classes, and the managerial elite of large corporations, or at least some of them.

Ludendorf’s policy was a disaster. Production actually declined or was wasted, and the financial methods led to severe inflation, which of course became even worse after the war. The policy also led to increasing resistance from the population, as his ever-more-furious outbursts revealed. Eventually the increasingly desperate situation led to the gamble of the huge spring offensive of 1918. Its failure meant the war was definitively lost.

However, the policy of Germany after 1916 was not seen at the time or for long after as the enormous mistake that it was, even from the High Command’s point of view. Instead it was thought to have been a huge success. Strangely this view became even more widespread after 1918—not least among the victorious powers. A myth took hold: that the organization of the economy under Ludendorf was a model for other nations in peacetime.

This belief had disastrous consequences. It certainly did in Germany itself since it provided much of the basis for the economic policies of the Third Reich, as well as providing yet another justification for slave labor and the systematic plunder of subject populations. In milder form this received view had a major impact in both Great Britain and the United States during the interwar years.

However, its most significant effect was felt in the east. When the Bolsheviks came to power in 1917 they had no real idea of what socialism would look like. Their initial effort, so-called war communism, proved utterly catastrophic and was reversed with the introduction of the New Economic Policy in 1921. What followed was a huge debate as to what kind of model to adopt. The “center” argument that eventually triumphed under Stalin was to adopt the supposedly successful model of the World War I German war economy. So the Soviet economy was in many ways the product of a mistaken idea about Germany’s war economy and how it had worked.

Misunderstandings of what is actually happening in economic affairs do not only have immediate consequences. When they shape the politicians’ and public’s view of history, their effects can be immense, sometimes comically, but more often tragically.
Efforts in Washington to write a major climate-change law are causing some Bootlegger/Baptist coalitions to fall apart and new ones to emerge. In late September Exelon Corporation, a major electric utility, followed industry partners Pacific Gas & Electric (PG&E) and PNM when it resigned from the U.S. Chamber of Commerce. The Chamber opposed the Waxman-Markey climate-change bill, which would sharply limit carbon emissions, raise the cost of power, and in effect impose as much as a 15 percent tax increase on each U.S. household. Exelon, PG&E, and PNM favor the law. They are also heavy nuclear-power producers.

In an earlier comment on the fracturing of the U.S. Climate Action Partnership (USCAP), an industry-environmentalist coalition pushing for cap-and-trade carbon emission controls, Environmental Defense Fund president Fred Krupp repeated a commonly held misconception about government regulation when he said: “It’s very unusual for big corporations to raise their hands and say, ‘We want to be regulated for something that we’re not regulated for now.’” Exelon, PG&E, and PNW apparently make his point.

But as a matter of fact, industry support of regulation is not rare at all; indeed, it is the norm. And in the United States it is as American as apple pie.

**Historical Examples**

A somewhat casual investigation of business history reveals that it was the U.S. Chamber of Commerce, with the special assistance of General Electric president Gerard Swope, that supported passage of President Roosevelt’s 1933 National Industrial Recovery Act. The Act, with its Blue Eagle codes affecting 2.3 million employers, attempted to place all American industry in a price-fixing cartel. But while the Chamber and many large firms supported FDR’s cartel, many other firms, including Ford Motor Company, did not.

Going back further, we are reminded by Howard Marvel, writing in the 1977 *Journal of Law of Economics*, that it was the owners of the newly built water-powered textile plants that supported the English Factory Acts (1802 and on), not the owners of older mills that used far more labor per unit of output. The legislation limited child labor and hours and conditions of work, which raised the costs of labor-intensive producers. The industrialists who joined with other crusaders to support the legislation are remembered as philanthropists.

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In 1907 it was the electric utility industry, led by Samuel Insull, that lobbied for state regulation in the hopes of escaping less predictable and intractable municipal control. In 1910 American Telephone and Telegraph Company chairman Theodore Vail successfully called for federal regulation of long-distance telephone calling just when the Bell patents were expiring and new competition was, as he put it, “skimming the cream” from the market. Even the Magna Carta (line 35) specifies a standard width for all cloth sold in the kingdom—all in the name of consumer protection, scholars tell us. The standard happened to be the width of looms operated by the London weavers. The less fortunate Bristol weavers had to break and modify their looms to compete.

A focus on environmental regulation reveals a host of Bootleggers and Baptists who have coalesced, sometimes quietly, to support output restrictions. In hearings before passage of the 1972 federal Water Pollution Control Act, industrialists located along the Ohio River argued for the law. They faced pollution controls imposed by the Ohio River Sanitation Commission and wanted a national level playing field. Only federal regulation would solve their problem, and they supported it. It was the coal interests in Ohio and West Virginia, along with environmentalists, that lobbied for the 1990 Clean Air Act amendments requiring scrubbers on newly built and modified coal-fired electric utilities. As Bruce Ackerman and William Hassler famously noted in their 1981 book, Clean Coal/Dirty Air, the scrubber requirements eliminated the clean-burn advantage of western coal and kept the eastern coal producers happily burning their higher-sulfur coal.

Yes, industry support of legislation that imposes restrictions on output is commonplace, but one begins to understand this more fully after careful scrutiny of the lobbying process. It is seldom the case that every firm in an industry supports restrictions. When John Deere petitioned the EPA (Environmental Protection Agency) to increase the stringency of the air-emission standard on small gasoline engines, it was because Deere had a patent on cleaner engines. When the Chicago meat packers lobbied Congress to pass the 1906 Meat Inspection Act, it was because of markets lost to consumer fear over Upton Sinclair’s The Jungle and Argentine beef producers who were invading the U.S. market with lower-priced food.

And when nuclear-power producers Exelon, PG&E, PNM, and others lobby for a federal statute that would impose high costs on coal-fired competitors, there should be no question why.
“T he government who robs Peter to pay Paul can always depend on the support of Paul,” George Bernard Shaw once said.

For a socialist Shaw demonstrated good sense with that quotation. Unfortunately, America has become a laboratory in which his hypothesis is being tested.

The theory of government I was taught says that government provides benefits, primarily security, to the entire population. In return we pay taxes. But lately the government has been a distributor of special privileges, taking money from some and giving it to others. America is now about evenly split between those who pay income taxes and those who consume them.

The Urban-Brookings Tax Policy Center recently disclosed that close to half of all households will pay no income tax this year. Some will pay less than zero—that is, they’ll get money from those of us who do pay taxes.

The Tax Policy Center adds that this year the average income-tax rate for the bottom 40 percent of earners will be negative and that their cash subsidy will equal 10 percent of the total amount the income tax brings in, thanks to the Earned Income Tax Credit and President Obama’s “Making Work Pay” program.

The view from the top also shows the lopsidedness of the tax system. The top 20 percent of earners make about 53 percent of the income in America but pay 91 percent of the income tax. The top 1 percent pay 36 percent. The IRS says the bottom half of earners pay less than 3 percent.

How the Other Half Votes

This presents a serious problem because government has such vast powers to dispense favors. As Shaw suggested, people who pay no tax will not hesitate to vote for politicians who promise big spending. Why not? They will get stuff without having to pay for it.

Yes, working people who pay no income tax still pay taxes: sales tax and payroll (Social Security and Medicare) taxes. But the income tax is big and visible, so it’s a problem that a growing number of people don’t pay but get benefits from those who do.

Frédéric Bastiat, the great nineteenth-century French economist, defined the State as “that great fiction by which everyone tries to live at the expense of everyone else.” I don’t know if he envisioned one half of the population living off the other half.

It’s important not to confuse the interests of the taxpayers with the interests of the politicians and other tax consumers. Yet that is done all the time. When the government bought toxic assets (of zero market value) from the banks, it said taxpayers would profit when the economy recovered and the assets once again commanded a positive price in the market. Even if we make the dubious assumption that the government is savvy enough to buy low and sell high, it’s not the taxpayers who would benefit from any.
profits. The politicians will spend every penny rather than cut taxes.

To put it bluntly, we are not the government.

The built-in unfairness of the tax system has prompted a range of tax-reform proposals, such as a flat tax and replacing the income tax with a sales tax. These alternatives are better, but they have their drawbacks, too. For that reason, there is something more urgent than tax reform: spending reform.

The true burden of government, the late Milton Friedman said, is not the tax level but the spending level. Taxation is just one way for the government to get money. The other ways—borrowing and inflation—are also burdens on the people. The best way to lighten the tax burden is to lessen the spending burden. If government spends less, it takes less. And if it takes less, the tax system will weigh less heavily on us all.

Once again, we find wisdom in Adam Smith: “Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things.”
Richard Posner’s latest book belongs to the fast-expanding cottage industry of financial crisis books. A federal judge with a grounding in economics, Posner would seem to be an ideal person to tackle this complicated subject. Alas, he provides neither fresh material nor an interesting perspective.

Posner describes well-known events—the failure of investment banks Bear Stearns and Lehman Brothers, the series of bailouts by the Treasury and the Federal Reserve, the stimulus package passed by Congress—then tries to explicate the causes of the crisis. His account, unfortunately, merely hews to current conventional wisdom.

Here’s a capsule version: Deregulation of banks combined with cheap and easy credit to cause interconnected debt and real estate bubbles. “Free market ideology” left banks and other financial firms free to take huge risky bets on mortgages, which they did. In 2007–08 the twin bubbles collapsed, resulting in a steep downturn in economic activity. The government had to shore up the system with extraordinary measures. The long-term solution is more government action to restrain and supervise financial institutions, although Posner would wait until the dust settles before reregulating.

It’s true that some household borrowing was channeled to risky instruments like adjustable-rate mortgages and much of the lending by banks was turned into complex securities backed by debt. When property prices declined and foreclosures spread, the values of these securities also declined, decimating bank balance sheets. But all that is a consequence not a cause of the trouble.

At the heart of the story is the ready availability of credit that fueled excessive borrowing and lending. Posner describes how the Fed flooded the economy with money in the early 2000s in response to the collapse of the previous bubble in stocks. However, he claims that even without the Fed’s loose monetary policy, an alleged global capital surplus brought in enough money from abroad to keep interest rates low.

That claim is dubious. Yes, Asians saved a lot, but other people, notably Americans, saved relatively little. In the world as a whole there was no surge in saving to drive down interest rates. It was the Fed’s easy money that pushed markets into a credit binge.

Posner’s line is that “Laissez-faire capitalism failed us, but government allowed the preconditions of depression to develop and wreak havoc with the economy.” He discusses the Federal Reserve’s culpability for the crisis, granting that it “would be a powerful argument against re-regulation,” but places more blame on that hobgoblin, “free market ideology.” The “free market” canard requires one to ignore that the United States hasn’t had anything close to a free financial market in a century.

Major mistakes by experts pose a challenge for Posner’s way of looking at behavior. For example, he describes Fed Chairman Ben Bernanke’s neglect of the warning signs of an impending crash as “extremely puzzling.” As a proponent of neoclassical economics, Posner assumes that people act rationally in the sense of making the best choices in view of all available information. And the Fed must be even more rational than the rest of us.

Another academic tribe, behavioral economists, attributes the crisis to human quirks like herding or imitation. Posner rejects those explanations on the ground that such behavior is not really irrational. On regulatory issues, however, he does not differ from behavioral economists who assume that government experts are trustworthy because they’re better informed than the general population.

Long before the currently fashionable behavioral school emerged, F. A. Hayek criticized the neoclassical rationality premise but came to a different conclusion.
from today’s proregulation behavioral economists. He found that government agents possess less wisdom than the market, which pools the knowledge of many individuals. The “fatal conceit” (as Hayek put it) that government knows better has resulted in economic disasters ranging from the Soviet Union to the Federal Reserve’s destabilizing policies.

Now the Fed is to become an even more powerful regulator of vaguely defined “systemic risk.” Posner grasps that “The successive Federal Reserve chairmanship of Greenspan and Bernanke must be reckoned prime causes of the financial crisis,” but even so agrees with President Obama that more government intervention is needed.

As a reform, Posner advocates the consolidation of agencies like the Securities and Exchange Commission into one top regulator along the lines of Britain’s Financial Services Authority. He appears oblivious to the fact that this authority with its overarching powers did not save Britain from financial crisis.

This highlights the book’s great flaw: Posner clings to the myth of benign government rationalism.


Unsanctioned Voice: Garet Garrett, Journalist of the Old Right
by Bruce Ramsey
Caxton Press • 2008 • 309 pages • $17.95

Reviewed by Brian Doherty

This is a curious book about a curious man. It’s not a biography in a normal sense, but a biographical essay based on the limited material left behind by Garet Garrett, the journalist, novelist, and powerful voice speaking up for individualism and free markets as the New Deal eclipsed them.

Bruce Ramsey, an editorial writer for the Seattle Times, has already edited three collections of Garrett’s journalism. But Garrett’s own papers were mostly destroyed except for one year’s worth of a journal; just one small book had been written about him in the 1960s by an author who had access to many people who knew Garrett directly. Ramsey had to go to such unobvious sources as biographical works by or about the likes of journalist Gay Talese, newspaper magnate Randolph Hearst, and financier Bernard Baruch to get much useful secondary information.

What Ramsey had access to, and condenses with skill and affection, is a lifetime of printed journalism and commentary on his times from Garrett, a clear writer and interesting thinker. From that, Ramsey paints a fascinating and complicated man who championed classic American political (and other) virtues.

Garrett is remembered by modern libertarians as one of their forefathers in the prewar “Old Right.” Garrett was a fellow traveler, friend, or mentor to many figures important in the early growth of the modern American libertarian movement, from FEE founder Leonard Read to novelist and polemicist Rose Wilder Lane to Richard Cornuelle, early functionary of the libertarian support organization the Volker Fund.

As Ramsey demonstrates, Garrett was too individual a thinker and writer to be slotted in as simply an early modern libertarian. He’s best seen as an eclectic constitutionalist, for “an America-first foreign policy, economic laissez-faire and a gold-backed dollar.” But Garrett was not categorically for free trade and had a soft spot for national autarky, which he saw as both an economic and foreign-policy good. He was against legal gambling, free banking, and free immigration (and not just prospectively—he believed the American spirit of individualism had been sullied by the pre-World War I immigration of a European proletariat).

Garrett was born in Illinois in 1878, and by age 18 (at most) had launched a lifelong career as a journalist and editorialist in the Midwest and later Washington, D.C., and New York. He got an early start studying the worlds of twentieth-century business and finance, and had a gift for winning the respect of highly placed men and difficult interview subjects such as Bernard Baruch and Henry Ford.

The most educational part of Ramsey’s book to those who only know Garrett by his later political essays
on the death of a free America (kept in print through much of the past 50 years by various libertarian and conservative publishers) consists of discussions of the series of novels Garrett wrote in the 1920s. All are set in the world of business and industry. His belief in the virtue and efficacy of individual effort was at the core of his social philosophy. He once wrote, “I have never seen a good farmer with a good wife in a state of failure,” which sums up his attitude toward how one succeeds.

Garrett’s intellectual approach differed from the systemic rationalism of such libertarian founders as Ayn Rand and Ludwig Von Mises. He once wrote to his friend the socialist Lincoln Steffens that “there is not one damned thing I am sure of . . . it is much more important to believe something than that what you believe should be right.” His shock at how quickly the individualist America he thought he knew from pre-New Deal days embraced creeping socialism led him to declare, “I am too humiliated to have an opinion about anything. Everything I believed about my own people was wrong.”

He came to think that Americans of the postwar era were, sadly, getting exactly the type of government they wanted and that the original Americans belonged to a different breed entirely. This sense of loss led to the grim mood of the early libertarian movement—the realization that believers in limited government and free markets were fighting to reverse a defeat, not preserve a system. As the title of Garrett’s most famous essay put it, “The Revolution Was.”

A major theme of Garrett’s intellectual life was especially prescient: an understanding of the importance of gold as a monetary standard, that bankers and government “must be limited by something they cannot control . . . the gold standard.”

Ramsey sums up why American, and certainly libertarian, historians should remember Garrett: “Because he stood against state dominance at home and state intervention abroad, and showed that the two are connected.” Alas for Garrett’s cause, his relevance is as strong as ever.

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Book Reviews

The Legal Foundations of Free Markets
Edited by Stephen F. Copp
Institute of Economic Affairs • 2008 • 257 pages • $34.00
Reviewed by George Leef

The Legal Foundations of Free Markets, a recent book from the veteran British free-market Institute of Economic Affairs, brings together essays by nine leading experts in law and economics that delve into the interface between the legal system and the economy. The book blends historical analysis, economics, and legal theory, yielding many penetrating insights.

Each of the ten essays is an estimable work, but some are likely to be of particular interest to Freeman readers. I’ll focus on four.

At the top of that list, I would place Peter Leeson’s essay, “Do Markets Need Government?” Most free-market advocates assume that “the rules of the game” must come from and be enforced by the government. Leeson, however, argues that market participants may do a better job than the State, writing, “The long-standing existence of vibrant markets under conditions of real or quasi-statelessness suggests that private ‘rules of the game’ must be possible without government.” In commercial transactions, he points out, the participants have a lot at stake in the performance of contractual obligations. That led them to develop commercial law completely independent of government, as well as tribunals to adjudicate disputes. Those tribunals did not have enforcement powers, but the need to maintain a good business reputation minimized flouting of their decisions. Violators were apt to face ruinous ostracism. Adam Smith’s “invisible hand” worked remarkably well.

Leeson goes on to show that the spontaneous order of the market also devised mechanisms to deal with criminal conduct. After reading his essay, it’s evident that the Hobbesian notion that society would be chaotic violence without a powerful state is untenable.

Another particularly valuable contribution is the late Norman Barry’s essay, “Economic Rights,” in which he
laments that “for most of the time, in all countries, economic rights have been at the mercy of legislatures . . . with little or no protection from the courts or written constitutions.” He attributes this unfortunate state of affairs to the abandonment of the Enlightenment concept of the unity of liberty. In this concept, economic liberty is integral to an overall concept of liberty; most modern thinkers, by contrast, conclude that some aspects of liberty are important and others are not. They say they can tell wheat from chaff, with property rights and economic liberty being chaff. “There is scarcely any recognition of the connection between economic rights and other, more fashionable notions,” Barry writes.

He concludes that nations would reap huge productivity gains if they would steer away from “welfare rights” and regulatory intervention, and instead allowed people to produce and trade as they choose.

Julian Morris also merits special mention for his essay, “Private Versus Public Regulation of the Environment.” He takes issue with the presumption that the State alone is capable of solving environmental problems: “The reader may be surprised to learn that many environmental problems have in fact been caused by governments, sometimes in spite of attempts by private industry or businesses to stop them.”

I’ll mention one more essay, Cento Veljanovski’s “The Common Law and Wealth.” In it Veljanovski looks at this intriguing question: What kind of legal system is apt to contribute more toward a nation’s ability to produce wealth—common law or civil law? He notes that Gordon Tullock, among others, has observed that common law tends to be “untidy,” with duplicative costs, inefficient methods of ascertaining facts, and great latitude for wealth-destroying judicial activism. Other scholars, however, such as Richard Posner, maintain that since common law is premised on the legality of the status quo, it places a restraint on the use of law to redistribute wealth. This is an interesting debate with no resolution in sight.

Scholars who are interested in the field of law and economics will want to have this book on their shelves, and professors teaching a variety of law, economics, and political science courses will find in it a good many supplemental readings to get sharp students thinking about questions that mainline textbooks almost always overlook.

Unmasking the Sacred Lies
by Paul A. Cleveland
Boundary Stone Publishing • 2008 • 184 pages • $25.00

Reviewed by Joseph G. Lehman

Unmasking the Sacred Lies is an excellent introduction to the major economic policies of the United States. Author and Freeman contributor Paul A. Cleveland traces the history of those policies up to 2008, explains their effects, and explores their alignment with the nation’s founding principles. The book aims to “shed light on the underlying lies which threaten the foundations upon which the nation’s achievements are based.” Cleveland succeeds with an ideal primer for college and many high school students interested in economics, political science, American history and current events.

Think of Sacred Lies as an economic history survey of American public policy. The book does not stand alone as a text on economics, history, political science, or American government, but Cleveland connects all of them. It’s easy to imagine that Cleveland wrote it to give his students at Birmingham-Southern College not just a grasp of key economic policies but also the means to evaluate them.

He devotes each of his nine chapters to one major policy area—fiscal, monetary, transportation, agriculture, education, labor, welfare, business, and environment. Two special sections bookend those topics. The first describes the role of property, trade, and human action in the exercise of freedom. The last section addresses the limitations of the law and the State as ways to solve human problems.

This last section alone, entitled “The Lawlessness of Too Many Laws,” makes the book a standout. Most textbooks that cover economics and policy seem to treat law as a force that lacks inherent limitations.
Authors may acknowledge that new laws or programs involve tradeoffs, but they seem to say, “If you can get the money and if you can get the votes, then what’s the problem?”

The problem is that the cumulative weight of multi-tudinous laws, regulations, and administrative dikats eventually undermines the workings of the law itself. Cleveland explains the burden of too many laws as a vicious circle that creates moral and practical problems. Excess law leads to ignorance of the law, which breeds disrespect for the law, which then leads to lawlessness, which must bring about ever more laws. As civilization becomes increasingly politicized, it declines.

Hidden political bias is a problem in many books aimed at students. But Cleveland shows respect for readers by forthrightly stating his perspective. The lens through which he analyzes public policy characterizes government as force. He builds his arguments from the ground up, making them accessible to those unfamiliar with the Austrian school or Public Choice.

Cleveland leads readers to understand that the common conception of government has changed. Once viewed as the institution of last resort that protected rights and punished wrongdoers, government is now widely seen as an expedient means of acquiring things for oneself.

The book shows up at just the right time. Political energy and interest in government spending have surged since the enactment of trillion-dollar “stimulus packages,” government bailouts and takeovers of major corporations, and renewed efforts to nationalize health care. A federal sprint toward Keynesian policies has reintroduced the term “paradox of thrift” to the news lexicon. Public awareness of the “housing bubble” is high. Cleveland describes Keynes’s “paradox,” as well as the history of government interference in housing markets, as if he knew what economic disasters were about to happen.

The chapter on business policy is especially good, debunking common myths. The chapter devoted to labor policy takes a complicated subject too often portrayed as merely a refereed contest between workers and owners, and shows how current law tilts the playing field decisively in favor of unions.

A strength of the book—its concise treatment of complex policies—may sometimes leave readers wishing for more thorough discussion. A more extended analysis of federalism, for example, would have fit especially well in the education chapter. And sometimes Cleveland weakens his work by departing from strict scholarly exposition. For instance, in the environmental chapter, he describes a statement by biologist David Graber as “the ravings of a morally reprehensible mad man.” Similarly, regarding fiscal policy, calling Franklin Roosevelt “either delusional, a liar, or some combination of the two” will be agreeable to FDR’s critics, but it won’t help convince students who were taught to revere Roosevelt and his New Deal.

_Sacred Lies_ is a welcome counterweight to the bias and misinformation soaked up by students who have never been exposed to a fair treatment of free-market ideas. The book will work even better for individuals predisposed to those ideas by challenging them to sharpen arguments and increase understanding of convictions they already hold. Most important, all readers will better appreciate that we have gone far beyond the proper functions of government and suffer from many laws that are destructive.

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Quick. What’s the trade deficit between California and the rest of the world? Don’t try Googling it because you won’t find an answer. No government agency—or private entity—computes the dollar value of goods that people in the rest of the world sell to or buy from Californians. Why not? Because it doesn’t matter.

Yet governments do that computation for countries. Do trade deficits between countries matter? They do, but a lot less than most people think. A high trade deficit is not a definite sign of an economy’s weakness, and a low trade deficit or high trade surplus is not a definite sign of an economy’s strength.

First, let’s define our terms. By the most comprehensive measure, there can never be a balance-of-payments deficit. If we import a higher dollar value of goods and services than we export, then the extra dollars we spend on imports balance that difference, and the net balance is zero.

Of course, when people refer to a balance-of-payments deficit they are not thinking about this comprehensive measure; they’re thinking about a narrower measure—the merchandise trade deficit. This is the difference between the dollar value of what we spend on imports and what we are paid for exports. In 2008, the latest year for which these data are available, Americans spent $840 billion more on imports than foreigners spent on U.S. exports. Offsetting this was a U.S. surplus on services of $144 billion. The net balance of trade on goods and services, therefore, was $696 billion. To put this into perspective, this was about 4.8 percent of the total U.S. gross domestic product.

Where did this $696 billion go? It went to other countries, of course, but most of it came back in one of three forms: 1) foreign purchases of American bonds, mainly government bonds; 2) foreign purchases of other assets such as stocks, land, and property; and (3) so-called direct investment whereby foreigners build plants and equipment in the United States.

Is this bad? Consider each in turn.

1) If foreigners refused to buy government bonds, the U.S. government would need to offer higher interest rates to make holding the bonds attractive to Americans. That would drive up the cost of financing the U.S. budget deficit. We can decry this deficit—and I do—but given that it exists, which is better: having the irresponsible federal government paying a higher or lower interest rate? I vote for the latter.

2) One reason foreigners invest in U.S. stocks, land, and property is that the United States is still a relatively safe haven for investment. Granted, it’s probably less safe than it was before the U.S. government changed the rules with its bailout, the so-called Troubled Asset Relief Program (TARP), and with the so-called stimulus package. But it’s still safer than investing in much of the rest of the world. So rather than being bad, the size of this investment is actually good.

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3) The same reasoning applies here. It’s good, not bad, that foreigners find it attractive to invest directly in the United States. It’s especially good for U.S. workers. The more capital there is per worker, the higher worker productivity is and, therefore, the higher are real wages.

Dollars on the Penny

What if the money doesn’t come back in any of the above three forms of investment but, instead, is held in U.S. dollars? That’s even better for Americans. Instead of giving up capital in return for merchandise, we are giving up paper money. According to the Bureau of Engraving and Printing, the average cost of a unit of paper money is 6.4 cents. Because of the production process, the cost is probably higher for a one-hundred-dollar bill, and presumably a disproportionately high number of such bills is held abroad. But it’s still likely to cost under 25 cents to print a one-hundred-dollar bill, and the bills take an average of 89 months to wear out. Getting valuable goods in return for paper money that sells for dollars on the penny is a good deal for Americans. Jay Leno, in a 1980s ad for Doritos, said “Crunch all you want. We’ll make more.” Similarly, if people in other countries hold on to their paper U.S. bills, the Federal Reserve can make more.

But aren’t we as a nation, by spending more on imports than our exporters earn, actually saving less and implicitly giving up capital for consumption goods? Yes, we are. But that’s the result of decisions that millions of us make individually. And it really doesn’t matter, at an individual level, whether we save less to buy imports or to buy domestically produced consumption goods. Either way, we’re giving up capital for consumption. Is this a bad idea? We’re showing by our actions that we think it’s not. We’re showing that many of us value those high-quality Toyotas more than we value the shares of General Motors stock or U.S. government bonds that we could have bought instead. Do you think you’re giving up too much capital for consumer goods? Then spend less and save more.

What about the danger that foreigners will own a large share of the U.S. capital stock? It’s not a danger.

I mentioned earlier that a small balance-of-payments deficit is not necessarily a sign of economic strength. Between 1980 and 2008, there have been only three years in which the United States has had a merchandise trade surplus: 1980, 1981, and 1991. Those were all years in which the U.S. economy was in recession. That is no coincidence. When economic growth is high, we tend to spend a higher share of our income on imports. The years with the highest merchandise trade deficits also tended to be the years with the highest economic growth.

What about the danger that foreigners will own a large share of the U.S. capital stock? First, it’s not a danger. Even if it happened, it would simply mean that U.S. workers would work for foreign employers. While some of these foreign owners would be worse than U.S. employers, some would be better. Incidentally, during the 1988 U.S. presidential campaign, Democratic candidate Michael Dukakis told workers at a St. Louis automotive parts plant: “Maybe the Republican ticket wants our children to work for foreign owners . . . but that’s not the kind of a future Lloyd Bentsen and I and Dick Gephardt and you want for America.” The problem? The workers he was speaking to were employed by an Italian corporation.

Second, the amount of U.S. capital owned by foreigners at the end of 2008 was $23.4 trillion. But the amount of foreign capital owned by Americans was $19.9 trillion. This difference of $3.5 trillion is only about 7 percent of the $48 trillion total value of physical assets.

To look at the $3.5 trillion another way, it is less than $70 trillion. Why is that relevant? Boston University economist Laurence Kotlikoff says that’s the amount by which the present value of the U.S. government’s future promises to spend exceeds the present value of the government’s future projected tax revenues.

Now that’s something to worry about.