THE FREEMAN

IDEAS ON LIBERTY

VOLUME 61, NO 4 MAY 2011

Features

8 **Quantitative Uneasiness** *by Ivan Pongracic, Jr.*

11 **Who Owns the Fed?** *by Warren C. Gibson*

16 **The Kid and the Benevolent Bully** *by Roger Koopman*

18 **Can Government Manage the Economy?** *by James L. Payne*

22 **Adam Smith Reveals His (Invisible) Hand** *by Mark Skousen*

25 **Roots of Egypt's Revolt** *by Nouh El Harmouzi*

29 **China: Wealth but Not Freedom** *by James A. Dorn*

31 **The Law Merchant and International Trade** *by Peter T. Leeson and Daniel J. Smith*

35 **Safe Food at Any Cost** *by Paul Schwennesen*

37 **The Ominous Expansion of Class-Action Suits: *Walmart v. Dukes*** *by Wendy McElroy*

Page 29

Columns

4 **Ideas and Consequences ~ Competition and Monopoly: A Refresher** *by Lawrence W. Reed*

14 **Thoughts on Freedom ~ Naive Keynesianism: A Failure of Imagination** *by Donald J. Boudreaux*

20 **Our Economic Past ~ The Progressive Income Tax and the Joy of Spending Other People's Money** *by Burton Folsom, Jr.*

27 **The Therapeutic State ~ Senseless** *by Thomas Szasz*

39 **Give Me a Break! ~ Spontaneous Order** *by John Stossel*

47 **The Pursuit of Happiness ~ Poverty Is Easy to Explain** *by Walter E. Williams*

Page 27

Departments

2 **Perspective ~ Wisconsin Labor Brouhaha** *by Sheldon Richman*

6 **America's Greatness Requires War and Taxes? It Just Ain't So!** *by Aeon J. Skoble*

40 **Capital Letters**

Book Reviews

42 **The New Holy Wars: Economic Religion Versus Environmental Religion in Contemporary America**
by Robert H. Nelson *Reviewed by Art Carden*

43 **Gridlock: Why We're Stuck in Traffic and What to Do About It**
by Randal O'Toole *Reviewed by Gary M. Galles*

44 **Bought and Paid For**
by Charles Gasparino *Reviewed by George Leef*

45 **Imposing Values: An Essay on Liberalism and Regulation**
by N. Scott Arnold *Reviewed by Daniel Shapiro*

Page 42

THE FREEMAN
IDEAS ON LIBERTY

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

President Lawrence W. Reed
Editor Sheldon Richman
Managing Editor Michael Nolan
Book Review Editor George C. Leef

Columnists
Charles Baird, David R. Henderson, Donald J. Boudreaux, Robert Higgs, Stephen Davies, John Stossel, Burton W. Folsom, Jr., Thomas Szasz, Walter E. Williams

Contributing Editors
Peter J. Boettke, Dwight R. Lee, James Bovard, Wendy McElroy, Thomas J. DiLorenzo, Tibor Machan, Joseph S. Fulda, Andrew P. Morriss, Bettina Bien Greaves, James L. Payne, Steven Horwitz, William H. Peterson, John Hospers, Jane S. Shaw, Raymond J. Keating, Richard H. Timberlake, Daniel B. Klein, Lawrence H. White

Foundation for Economic Education

Board of Trustees, 2010–2011
Wayne Olson, Chairman
Harry Langenberg, Walter LeCroy, William Dunn, Frayda Levy, Jeff Giesea, Kris Mauren, Ethelmae Humphreys, Roger Ream, Edward M. Kopko, Donald Smith

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

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

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

Copyright © 2011 Foundation for Economic Education, except for graphics material licensed under Creative Commons Agreement. Permission granted to reprint any article from this issue, with appropriate credit, except "Spontaneous Order."

cover background: © James Steidl

Perspective

Wisconsin Labor Brouhaha

Wisconsin's been through quite a row. The new governor, elected without the support of most government-employee unions, proposed to cut back the scope of collective bargaining for most state workers. Gov. Scott Walker says the budget measure is needed to save money as well as government jobs for the debt-ridden state.

Is the governor's proposal really an assault on human rights, as advocates of the Wisconsin state employees allege? (Their raucous protests at the state capitol were compared to rebellions in the Middle East.)

A few basics: In a *freed* market—meaning no privileges, no bailouts, no legal barriers to competition (domestic or foreign), no patents, no protected banking cartel, no regulatory impediments to self-employment, no vast tracts of government-held land—workers would be free to form voluntary associations called unions and business owners would be free to deal with them or not. If not, workers would be free to use nonviolent methods to gain recognition for their unions, including strike threats, boycotts, and sympathy strikes, as well as lesser measures. Violence by any party against any peaceful person would be illegitimate. Freedom of association would be complete, and coerced association would be beyond the pale.

Under such circumstances, everyone's demands would be tempered by two powerful factors: freedom and competition. Pay workers too little, and they would be bid away by rivals or take up self-employment. Pay them too much, and rivals would attract customers with lower prices. Demand too high a wage, and risk losing out to someone else willing to work for less. Market rivalry would protect everyone from abuse, which is why competition—endless hosannas to it notwithstanding—is usually the target of government intervention.

Regarding government workers, it is a grave mistake to treat so-called public employment like other employment. Governments are monopolies that get their revenue by force, not through voluntary exchange. Thus they don't face the market test of free competition, and they lack key price information with which to engage in economic calculation. The consequences of this difference are considerable.

As *Freeman* columnist Charles Baird notes, when government negotiates terms with employees, the parties are coconspirators in the looting of captive taxpayers. (Government employees aren't taxpayers; they are tax-consumers.) Fundamentally they are not rivals but rather accomplices with a harmony of interests contrary to those of the taxpayers. This is aggravated by the fact that those unions are powerful political actors and rich sources of campaign contributions (the ultimate source of which is the taxpayers) and manpower. A politician negotiating with a government union whose election support he seeks is unlikely to have the taxpayers' interest uppermost in mind.

Would the working conditions of state workers become intolerable if their unions were restricted? Not likely. But if they did, would it really be so bad if state governments had trouble finding employees?

So, does this mean that free-market advocates should side with the governor of Wisconsin? Actually, no. State governments are in trouble because they spent profligately when revenues were rolling in and now can't meet the pension and other obligations they've imposed on the taxpayers. As a result, they face a crisis of legitimacy. Some governors realize this and are trying to save the discredited system by trimming spending (for now) and making political hay by resisting the unions. The fiscal hawks even tout cutbacks as ways to produce *more* revenue in the future. Rarely do you hear a governor call for the shedding and demonopolization of functions like education. So this is largely a fight over how to preserve and divide the tax spoils.

⋆ ⋆ ⋆

What's the Federal Reserve up to? The business news is abuzz with insider lingo like QE2, but what does it all mean? Ivan Pongracic, Jr., has been keeping close watch on what we like to call the Bureau of Counterfeiting.

Many people think the Fed is a private bank owned by the country's bankers, who use it to profit off the American people. Hold on, Warren Gibson says. The Fed is bad enough without making up stories about it.

Imagine an honest child running a lemonade stand. Now imagine a bully who's constantly proclaiming his good intentions as he puts the screws to the first child. Roger Koopman thinks this describes much of the U.S. economy.

Believing that government can manage an economy is like believing in leprechauns and unicorns, yet despite overwhelming evidence, people continue to do it. James Payne tries to figure out why.

Adam Smith is famous for his "invisible hand" metaphor, but he mentions it *only once* in each of his books—strangely, right about in the middle of each. Is there any significance to this? Mark Skousen thinks so.

Egyptians drove a dictator from power last winter, inspiring oppressed people throughout the Middle East and North Africa. What accounts for the sudden uprising after 30 years of subjugation? Nouh El Harmouzi traces its roots.

China is growing economically but not politically. The economy has been liberalized, but the country is still in the grip of a central government run by the Chinese Communist Party. James Dorn discusses China's future in light of this contradiction.

When world trade revived after the fall of the Roman Empire, merchants from diverse cultures and countries needed a common legal system to peacefully resolve their contract disputes. What did they do? They generated their own—without government. Peter Leeson and Daniel Smith analyze the Law Merchant.

No one wants tainted food, but what's the best way to prevent it: competition or government regulation? Speaking from experience, Paul Schwennesen makes the case for competition.

A lawsuit against Walmart could dramatically and unreasonably expand the number of class-action suits unless reversed by the U.S. Supreme Court. Wendy McElroy has the details.

Our columnists provide a cornucopia of keen insights. Lawrence Reed elaborates the benefits of competition. Donald Boudreaux debunks vulgar Keynesianism. Thomas Szasz undermines the psychiatric explanation for the attempted murder of a congresswoman. Burton Folsom, Jr., reviews the history of the income tax. John Stossel celebrates spontaneous order. Walter Williams scrutinizes poverty. And Aeon Skoble, reading the claim that war and taxes make America great, protests, "It Just Ain't So!"

Our reviewers report on books covering the financial crisis, traffic jams, secular religions, and regulation.

—*Sheldon Richman*
srichman@fee.org

Competition and Monopoly: A Refresher

BY LAWRENCE W. REED

"Gym Now Stresses Cooperation, Not Competition," blared a headline in the *New York Times* a decade ago. The story was about an elementary school where "confrontational" games, team sports, and elimination rounds were changed or scrapped so that differences between students' athletic abilities would be minimized.

Perhaps this is fine for grade-school gym class, but it would make for rather boring Olympic games. And were it imposed on production and trade, it would condemn millions to poverty and early death. Let's review some fundamental principles.

In economics competition is not the antithesis of cooperation; rather, it is one of its highest and most beneficial forms. That may seem counterintuitive. Doesn't competition necessitate rivalrous or even "dog-eat-dog" behavior? Don't some competitors lose?

In my view, competition in the marketplace means nothing less than *striving for excellence in the service of others for self-benefit*. In other words, sellers cooperate with consumers by catering to their needs and preferences.

> Competition is not the antithesis of cooperation; rather, it is one of its highest and most beneficial forms.

Many people think that competition is directly related to the number of sellers in a market: The more sellers there are, or the smaller the share of the market any one of them has, the more competitive the market. But competition can be just as fierce between two or three rivals as it can be among 10 or 20.

Moreover, market share is a slippery notion. Almost any market can be defined narrowly enough to make someone look like a monopolist instead of a competitor. I have a 100 percent share of the market for articles by Lawrence Reed, for example. I have a far smaller share of the market for articles generally.

Not so long ago, XM and Sirius were the only two satellite-radio providers in the United States. For a year and a half the federal government prevented the two from merging, fearing that a harmful monopoly would result. Economists argued that XM and Sirius were competing not only with each other but as two of many companies in a huge media marketplace that includes free radio, iPods and other MP3 players, Internet radio stations, cable radio services, and even cell phones—all of which, along with likely new technologies, would continue to compete even after the merger. Ultimately, economic reasoning prevailed and the merger was allowed.

Governments don't have to decree competition; all they have to do is prevent and punish force, violence, deception, and breach of contract. Enterprising individuals will compete because it is in their financial interest to do so, even if they'd prefer not to.

Competition spurs creativity and innovation and prods producers to cut costs. You wouldn't think of stopping a horse race in the middle and complaining that one of the horses was ahead. The same should be true of free markets, where the race never ends and competitors enter and leave continuously.

Theoretically, there are two kinds of monopoly: coercive and efficiency. A coercive monopoly results from a government grant of exclusive privilege. Government, in effect, must take sides in the market to give birth to a coercive monopoly. It must make it difficult, costly, or impossible for anyone but the favored firm to do business. The U.S. Postal Service is an example. By law no one else can deliver first-class mail.

Lawrence Reed (lreed@fee.org) is the president of FEE.

In other cases the government may not ban competition outright but simply bestow privileges, immunities, or subsidies on one or more firms while imposing costly requirements on all others. Regardless of the method, a firm that enjoys a coercive monopoly is in a position to harm consumers and get away with it.

An efficiency monopoly, by contrast, earns a high share of a market because it does the best job. It receives no special favors from the law. Others are free to compete and, if consumers so will it, to grow as big as the "monopoly." Indeed, an efficiency monopoly is not much of a monopoly at all in the traditional sense. It doesn't restrict output, raise prices, and stifle innovation; it actually sells more and more by pleasing customers and attracting new ones while improving both product and service.

An efficiency monopoly has no legal power to compel people to deal with it or to protect itself from the consequences of its unethical practices. An efficiency monopoly that turns its back on the very performance which produced its success would be, in effect, posting a sign that reads, "COMPETITORS WANTED."

> From its very inception, antitrust law has been plagued by vagaries, false premises, and a stagnant conception of dynamic markets.

Antitrust Law

Where does antitrust law come into all this? From its very inception in 1890, antitrust has been plagued by vagaries, false premises, and a stagnant conception of dynamic markets.

The Sherman Antitrust Act of 1890 put the government on record as officially favoring competition and opposing monopoly without ever coming close to any solid definition of either term. It simply made it a criminal offense to "monopolize" or "attempt to monopolize" a market without ever saying what kind of actions qualified.

The first lawsuit the government filed ended disastrously for the Justice Department: The Supreme Court ruled in 1895 that the American Sugar Refining Company was *not* guilty of becoming a monopolist when it merged with the E. C. Knight Company. The evidence suggested that the merged companies would have made for a very strange monopoly indeed—one that substantially increased output and greatly cut prices to consumers.

In *The Antitrust Religion* (Cato, 2007), Edwin S. Rockefeller explains how the self-serving legal community invented sinister-sounding terms for quite natural phenomena and at the same time enjoys a feeling of self-righteousness in "protecting" the public from those evils. Such terms include "reciprocity" ("I won't buy from you unless you buy from me"); "exclusive dealing" ("I won't sell to you if you buy from anyone else"); and "bundling" ("Even though you only want Chapter One, you have to buy the whole book.") Another work I strongly recommend on this subject is a classic by economist D. T. Armentano, *The Myths of Antitrust*.

In a free market unencumbered by anticompetitive intrusions from government, these factors ensure that no firm in the long run, regardless of size, can charge and get any price it wants:

- Free entry of newcomers to the field, whether they be two guys in their garage or a giant firm that sees an opportunity to expand into a new product line.
- Foreign competition. As long as government doesn't hamper international trade, this is always a potent force.
- Competition of substitutes. People are often able to substitute a product different from yet similar to the monopolist's.
- Competition of all goods for the consumer's dollar. Every business competes with every other business for consumers' limited dollars.

Bottom line: Consider competition in a free market not as a static phenomenon but rather as a dynamic, never-ending leapfrog process in which the leader today can be the follower tomorrow. FEE

America's Greatness Requires War and Taxes? It Just Ain't So!

BY AEON J. SKOBLE

New York Times columnist David Brooks thinks America is great but in trouble, and he wants to take steps to preserve American preeminence. He's right, though not in the way he thinks. In his November 11, 2010, column Brooks argued that we need some sort of National Greatness Agenda; the problem is that his conception of what makes us great is incoherent.

Brooks does identify some real problems: for instance, that competition between the two major parties has become "fratricidal" and theatrical, and that it is creating massive budget deficits that, left unchecked, will prove catastrophic. But his diagnosis of the problem and his proposed solutions are fraught with fallacies. He thinks that a revived patriotism will "lift people out of their partisan cliques," yet the current partisan tribalism seems not to be lacking in patriotism. As is often the case, much hangs on how one understands the terms.

> America fails to be great when it violates its principles by invading foreign lands, abusing its citizens' liberties, or forbidding the free movement of people and goods.

What makes a country great? One way to answer this involves claiming that there is something special about the ethnic makeup of the people who comprise it. For Mussolini there was something great, something special, about *being* Italian; his allies in Germany and Japan had similar theories about their respective nationalities. But that approach won't quite work for America since it comprises people of many ethnicities.

Another way to understand national greatness is in terms of institutions and operating principles. But institutions and principles can change. What would make a country great on this model would be to have great institutions grounded in great principles. The Declaration of Independence is an example of this approach: Begin with a set of principles (moral equality of all persons, the natural right to live and be free, power only justified by consent) and then appeal to it when creating institutions (limited government of enumerated powers, republican structure with a democratic franchise, church-state separation, citizen militia, free trade). On this model America is great inasmuch as its institutions reflect its principles. A nation that claims to be dedicated to the principles outlined in the Declaration fails to be great when it invades foreign lands, abuses its citizens' liberties, or forbids the free movement of people and goods.

Brooks's exhortations reveal a lack of clarity about different senses of greatness, which comes out most clearly in his repeated use of false dichotomies. He asks, for example, "Do you really love your tax deduction more than America's future greatness?" This alternative presupposes that it is only through higher taxes that a nation can become great. This in turn assumes that national greatness is only measured by things done by the government. What might these be? Scholarly, artistic, and technological

Aeon Skoble (askoble@bridgew.edu) is a professor of philosophy and chairman of the philosophy department at Bridgewater State University in Massachusetts.

greatness might well be better fostered by individuals having more money and freedom.

"Are you really unwilling," he asks, "to sacrifice your Social Security cost-of-living adjustment at a time when soldiers and Marines are sacrificing their lives for their country in Afghanistan?" It's not clear that solving other countries' problems is how we measure our own greatness. In any event, this question also reveals a confusion: equating national greatness with government spending. Instead of asking whether Social Security payouts should rise with inflation, we might ask whether we would be better off as a nation of financially independent and responsible people who didn't look to the political system for retirement income. Instead of wondering how high taxes have to be to fund overseas military campaigns, we might ask whether those campaigns need to be undertaken by the government (as opposed to either being undertaken by privateers or not at all). One way to measure American greatness might be the extent to which we exemplify peace and prosperity. The best way to achieve those ends would be to limit (or even better, eliminate) coercive interference with other people's lives.

> The best way to exemplify peace and prosperity would be to limit (or even better, eliminate) coercive interference as others' lives.

Lost Preeminence

Brooks laments a lost preeminence, but it isn't clear what he means by that. He might be referring to a late-1940s preeminence, when America, having helped destroy the Nazis and their Japanese allies, led the way in rebuilding those nations and helping them become prosperous liberal democracies. But today's "nation-building" looks very different. Unlike World War II, which actually ended, the current wars of nation-building seem perpetual, which suggests that a different course of action might have better results.

Or perhaps Brooks is referring to a time when American preeminence was measured in contrast to the privations of the old Soviet Union. In that case, let's review the lessons of that contrast: Our former adversaries in the communist world were impoverished because tyranny doesn't work as well as freedom. Besides the soul-crushing dehumanization of a system that doesn't recognize fundamental liberties, the centrally planned socialist economic system turned out to be incapable of generating an abundance of goods and services. So if Brooks wants to see American preeminence regained, he might do better to promote liberalization of the world's economic systems, which, again, is best done by example.

Brooks's general rhetorical approach is to frame the debate between "liberals" and "conservatives" as a stubbornness game in which both sides must yield in order to bring about "a governing philosophy that believes in targeted federal efforts to arouse growth, social mobility and responsibility." As it happens, the free-enterprise system does precisely these things, but most politicians can't understand that this requires not action on their part, but inaction. They must stop interfering with people's lives, not look for new ways to do it; protect liberty not abridge it. Brooks fallaciously conflates subsidies with tax reductions, but this implies that people are not the owners of their property. If the government takes money from Peter and gives it to Paul, that's a subsidy to Paul. But if the government takes *less* money from Peter, that's not a subsidy to Peter, since it's Peter's property to begin with. Brooks's calls to end subsidies are correct, but the word doesn't mean what he thinks it does.

In a way, then, Brooks is right: America has lost some of its greatness and needs to take steps to regain it. But the problem isn't people who want to bring the troops home or keep more of their money. Indeed, bringing the troops home would make it easier for people to keep more of their money. So would ending drug prohibition. So would allowing free trade and free human migration. National greatness, American-style, does not consist of the storied pomp of ancient lands, but rather of the opportunities illuminated by the lamp of liberty. FEE

Quantitative Uneasiness

BY IVAN PONGRACIC, JR.

In their recent paper, "Has the Fed Been a Failure?," George A. Selgin, William D. Lastrapes, and Lawrence H. White conclude that over nearly 100 years the Federal Reserve's performance has been mostly awful (www.tinyurl.com/24znnjk). Unfortunately, the Fed is currently engaged in a policy that will likely make a nice addition to their article.

This policy, known as Quantitative Easing (QE), consists of buying longer-term financial instruments, notably U.S. Treasury bonds and private mortgage-backed securities. Since the Fed engaged in one round of quantitative easing in 2008–10, the current round (announced last November, but signaled for months prior) has been labeled QE2.

It is difficult to understand what the Fed is up to these days.
TalkMediaNews

QE2 is a departure from the Fed's usual procedures, which aim primarily to affect short-term interest rates through purchases of short-term (less than a year in maturity) Treasury bonds, or T-bills. This tool of monetary policy, known as open-market operations (OMO), has largely been on the sidelines for the past two years, since the Fed drove the key short-term rate to near zero in late 2008 and has kept it there. The Fed turned to QE that year because the Great Recession was so severe. QE1 was primarily aimed at buying up MBS, many of which were considered "toxic" due to mortgages that were unlikely to be repaid. These MBS were like albatrosses around the necks of many banks, leading the Fed to try to help by taking these liabilities off their hands. Astonishingly, through $1.75 trillion of such purchases, the Fed increased the monetary base (currency plus bank reserves) by nearly 200 percent between December 2008 and March 2010.

However, rather than stimulating the economy through increased lending, much of that new money has remained idle, locked up in vaults as banks have been unwilling and often unable to lend. (Regulators in the past two years have considerably tightened lending standards, making it much more difficult to qualify for a loan, especially in these uncertain times.) Moreover, the Fed started to pay banks interest on their reserves held at the Fed. This is why the massive increase in the monetary base has not brought about much increase in the active money supply (currency plus deposits), which is necessary to stimulate the economy. This is also why the official inflation rate has continued to stay so low.

Given the failure of QE1 to return growth and unemployment rates to normal levels, the Fed has embarked on another round. In early November it announced it aims to purchase $600 billion in long-term Treasuries to bring down their yields (which act as

Ivan Pongracic, Jr. (ipongracic@hillsdale.edu) is an associate professor of economics at Hillsdale College.

the benchmark for many long-term interest rates) and spur lending, especially in the hard-hit real-estate markets, as well as increase inflation, which, according to the Fed, is too low to be consistent with a robust rate of growth.

The announcement of QE2 was received with widespread skepticism or even outright derision—from distinguished monetary economists such as John Taylor as well as politicians like Sarah Palin. Chairman Ben Bernanke and the Fed governors have, in return, mounted a major defense, with Bernanke even appearing on *60 Minutes* in early December. But his protestations ring hollow. Every Fed chairman has sworn that he was not to blame for the economic calamities that occurred on his watch, and that without his actions things would have been much worse. It is always only years later that subsequent Fed policymakers are willing to acknowledge the Fed's previous failures.

> If Americans aren't spending or borrowing enough, the Fed will make us an offer we can't refuse.

Inflation Expectations

The critics of QE2 have pointed to two problems with the policy: First, the Fed is seemingly ignoring the key role that inflationary expectations play in its ability to effect a macroeconomic result. The Fed's actions are reminiscent of the 1960s, when the Keynesian economic mainstream relied on the now-discredited Phillips Curve theory to control the economy. The Phillips Curve purported to show a stable trade-off between inflation and unemployment; therefore the policymakers needed only to increase inflation to lower unemployment to an acceptable level. It turned out that this only worked as long as people's inflationary expectations did not change—but of course as inflation went up, inflation expectations followed, ultimately leading to increasing rather than decreasing unemployment. After the painful stagflation of the 1970s, as well as the theory's thorough drubbing by some of the most highly respected economists of the past half a century (including Milton Friedman), one would have expected the Fed to have permanently learned how difficult it is to control inflation expectations, as well as how fundamental they are to the Fed's ability to control inflation itself. However, the Fed now appears committed to be taking us down that road again. (And in fact Treasury yields went up rather than down in the first six weeks of QE2, possibly due to inflation expectations—a key component of long-term interest rates—themselves going up).

If the Fed Had a Hammer

The second problem with QE2 is that the Fed is stuck in an inappropriate economic model, which embodies the adage that when all you have is a hammer, every problem looks like a nail. The Fed really only has one policy tool: raising and lowering interest rates, whether short- or long-term. Therefore all economic problems seem solvable to the Fed through the use of this tool. The Fed has used it enthusiastically over the past ten years, bringing interest rates down to then-record levels in 2003–05, spurring a massive boom in both private and public debt and pushing the average savings rate negative for the first time in U.S. history. It is now increasingly accepted that loose monetary policy was one of the major causes—maybe even the primary one—of the Great Recession. For the past two years individuals and businesses have been slashing expenditures, increasing savings, and paying down debt—trying to get through the Keynesian hangover. But the Fed will have none of that: If Americans are not borrowing and spending enough, the Fed will lower not only the short-term rates but also long-term rates. In other words, it'll make us an offer we can't refuse—and we'll be back on that not-so-merry-go-round yet again.

In response to these and other criticisms (leveled even by some of the Fed's own, such as Kansas City Fed president Thomas Hoenig), Bernanke and other Fed officials responded in an unexpected way: They claimed the current policy isn't actually "quantitative easing," since the money used to purchase the Treasuries will not be newly created and therefore the monetary base will not increase. With QE1 the Fed "printed money" to purchase the assets, but this time it is simply "rein-

vesting" the funds that it receives from the maturing MBS in its portfolio.

This is a rather strange turn of events, as the Fed itself initially emphasized the $600 billion, making it appear that this will be a new injection and therefore a stimulus. But if the monetary base stays the same, it means only that the Fed is changing the composition of its balance sheet: fewer MBS, more Treasuries. That may have some macroeconomic effect (currently debated in the blogosphere), but certainly not very much, either on unemployment or inflation. Yet Bernanke and others have made a big deal about QE2 lowering long-term interest rates, stimulating the economy, lowering unemployment, and diminishing the danger of a deflationary spiral, something that they cannot possibly believe if QE2 isn't really a quantitative easing.

So what exactly is going on here?

It is difficult to know. Economists are increasingly noticing the inconsistencies between the Fed's words and deeds, but so far it has led mostly to head scratching. A likely explanation is that the Fed is trying to fool us—to convince us that there is an ongoing monetary stimulus, hoping that this will comfort investors and real-estate markets, while simultaneously reassuring inflation hawks that the policy will not further increase the monetary base, which has already gone up quite enough. If this conjecture turns out to be right, a notable victim of QE2 will be Bernanke's commitment to his own ideals. He has been a leading proponent of inflation targeting, which stresses the importance of continuous and thorough communication with the public for the sake of transparency and accountability. All that appears to be out the window now. Not only is the Fed failing to be transparent, it may be guilty of actively misleading us. After three decades of increasing transparency, it seems that the Fed may be returning to its old ways.

Economists are increasingly noticing the inconsistencies between the Fed's words and deeds.

It might be difficult to accept that the Fed would be willing to risk its hard-won credibility just to get some more short-term stimulus. Yet it is possible that this is all driven by a much bigger issue: U.S. fiscal policy, which has gone over the cliff in the past three years. The federal government has racked up $5 trillion in new debt in that time, with much more to come, financed through new Treasuries. Such a massive increase in supply has been driving down their price and pushing up yields—along with long-term interest rates. Given the extremely fragile real-estate market, rising long-term interest rates are the last thing the Fed wants, so it is not surprising that it would attempt to counteract them.

More problematically, the Fed may also be buying up Treasuries to keep down the financing costs of the federal government's growing debt burden. If this is indeed what has been driving QE2—which the Fed, not surprisingly, vehemently denies—it would mark a sharp break with modern history. In the Accord of 1951, the Fed reasserted its control over monetary policy after ten years of pegging bond rates very low to make it cheaper for the federal government to fight World War II. If it begins to be perceived as the Treasury's puppet again, investors could rapidly lose confidence in the prospect of both an economic recovery and low inflation, not to mention the long-term viability of the massive federal government debt.

Eventually the economy will start growing faster, likely leading to a rapid dislodging of currently idle reserves through cheap loans. As that cash starts entering the economy, inflation rates will inevitably be driven higher. The Fed may or may not keep this process under control, but it doesn't even matter all that much, as the damage will already have been done. What Bernanke and most others at the Fed clearly fail to understand is Ludwig von Mises's and F. A. Hayek's fundamental point that artificial manipulation of interest rates by a central bank distorts microeconomic reality, perverting relative prices and sending the wrong signals to both entrepreneurs and consumers. This leads to faulty decision-making, resulting in more misallocations, malinvestments, and asset bubbles. In other words, by not allowing prices to fall to correct for the past artificial stimuli, the Fed is actually preventing the economy from adjusting and beginning a true recovery. QE2 continues this error. FEE

Who Owns the Fed?

BY WARREN C. GIBSON

Have you heard? The Federal Reserve System raked in profits of $79.3 billion last year, almost triple what runner-up ExxonMobil made. The Fed's business model is a snap—just print money—and unlike poor beleaguered Exxon, the Fed has no competition to worry about. This means a gigantic windfall for the big banks because, although they don't like to admit it, they actually own the Fed.

Or not. These are all half-truths and distortions, all too easy to find on the Internet. Bloggers like to begin with the discovery that commercial banks hold shares of Fed stock and those shares pay an annual dividend. A further discovery that the Fed makes big profits is all it takes to send some of them off on a conspiracy tangent. Because shareholders in a profit-seeking corporation are its owners, so it must be with the Fed, they think. Profiteering, world-government schemes, and who knows what else, must surely follow. As I will show, these half-baked ideas are distractions from the serious issues that surround the Federal Reserve System.

> Commerical banks own shares in their local Federal Reserve branch, but these shares do not confer ownership in any meaningful sense.

Yes, commercial banks hold shares of stock in their local Federal Reserve branch, but these shares do not confer ownership in any meaningful sense. Ownership is defined as the legal and moral right to use and dispose of some asset. Ownership can be conditional or temporary, as when you lease an apartment and acquire the right to occupy it for a limited time, but not to run a business in it or do major renovations. Your purchase of shares of stock in a public corporation gives you rights to vote in shareholder elections, receive any dividends declared, and sell your shares—but that's about all. You may not walk into the corporate offices and start giving orders; on the other hand, you may not be held liable for any misdeeds of corporate officers or employees. If you acquire shares in a nonpublic company like Facebook, you accept additional restrictions on when and to whom you may sell your shares.

Member banks receive a fixed 6 percent annual dividend on their Fed stock and enjoy limited voting rights. But there the resemblance to ordinary shares ends. The banks are obliged to acquire shares when they become members of the Fed, and they may not sell their shares or pledge them as collateral. An initial issue of stock was seen as a good way to capitalize the Fed when it began, but there has been no need for additional capital and those shares are no longer significant.

Each branch has a board of directors with six members elected by local member banks and three appointed by the central board of governors. However, board members are not all bankers. Moreover, under a rule recently enacted by Congress, only nonbankers may serve on committees that select Fed bank presidents. This new rule is one way in which the ground has been shifting under the Fed recently; more about this below.

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

In the beginning the Fed was quite decentralized. A dollar bill in my wallet is imprinted "Federal Reserve Bank of San Francisco," a remnant of the formerly dispersed power. The headquarters operation was initially a modest one, operating out of an office in the Treasury Department, but it now has its own imposing building, greatly expanded powers, and a correspondingly larger staff. With so much power now centralized, the branches engage mainly in monitoring local conditions and passing recommendations up to the board of governors. They have also become known for differing interests and points of view. The St. Louis Fed, for example, has an excellent collection of data available to the public (www.tinyurl.com/52j3d). The Cleveland Fed is known for innovative research.

The Fed is a nonprofit institution, but that designation means only that profits are not its primary mission. The Red Cross is also a nonprofit, and like the Fed, it does earn a profit during any year in which gross income exceeds expenses. From an accounting point of view, such profits are essentially the same as those earned by firms in competitive markets, but not from an economic point of view. Competitive profits serve the vital function of directing scarce capital resources to the most urgent unmet demands of consumers. The Fed's profits serve no such function.

"Who owns the Fed?" is the wrong question. Instead we should ask: Who calls the Fed's tune?

Its income consists primarily of interest earned on its securities portfolio. Until recently the portfolio was made up almost entirely of Treasury securities. It has expanded greatly since 2008 to include mortgage-backed securities, loans to such pillars of the financial system as Harley-Davidson, and other assets including direct real-estate holdings. It incurs operating expenses of the usual sort: salaries, buildings, supplies, and more.

Remember that $79.3 billion profit? The 2010 figure, far higher than the $47.4 billion recorded for 2009, did not benefit the Fed's managers or member bank shareholders because the money was remitted to the Treasury. That's the law. It happens every year. If any private firm earned that much in a year it would be headline news and a boon to stockholders. For the Fed this is just an interesting statistic.

Who Calls the Tune?

The answer to the question "Who owns the Fed?" is that it's the wrong question. Instead, we should ask: Who calls the Fed's tune? That's not such an easy question, yet it's the only way to reach an understanding of why the Fed acts as it does and why it has done so much economic damage.

First and foremost, the Fed was created by Congress and can be modified or abolished by Congress. Clearly Congress is the Fed's most important constituent.

The U.S. president also holds substantial sway over the Fed. He appoints the seven-member board of governors subject to Senate confirmation. The powerful Open Market Committee, which makes monetary policy decisions, consists of those seven plus the president of the New York Fed and four seats that are rotated among the 11 regional presidents.

But even though it exercises ultimate control, Congress has given the Fed a degree of independence that no other federal agency enjoys. Although its profits are swept back to the Treasury, the Fed enjoys a sweet deal that is unavailable to ordinary Federal agencies, which must plead with Congress for an annual appropriation. The Fed spends whatever it wants on operations, constrained only by the necessity to keep up appearances—not to look like fat-cat bankers. Its profit is whatever remains after all expenses have been paid, and, in contrast to ordinary corporate accounting, after dividends have been paid.

The Fed's vaunted independence is a good thing, the thinking goes, because we don't want the stewards of our money to be caught up in the swirl of day-to-day politics. But independence trades off against accountability. After all, in a democracy the bureaucracies are supposed to be accountable to Congress. The purse strings are the primary means of accountability among the other agencies, but there are no such strings tying Congress to the Fed.

Such control as commercial banks exert is not so much a function of their nominal stockholdings as it is of their connections through the network of good ol' boys that weaves through government and "private"

financial institutions. The Fed surely looks out for the interests of major private institutions, especially big banks, insurance companies, and securities firms. It does not want big-bank failures or a stock-market crash. It must be cognizant of foreigners who hold $3 trillion in U.S. Treasury debt and are keenly aware of the Fed's actions and pronouncements.

These incentives have little to do with the Fed's official dual mandate: stable prices and high employment. That mandate was established by the Employment Act of 1946 and the Humphrey-Hawkins act of 1978. These were times when no one questioned the Keynesian idea that inflation and unemployment always trade off against each other (the Phillips curve) and that monetary and fiscal policy must steer a course between two extremes. If the proponents of the mandate could see the relatively stable prices of recent years coupled with high unemployment, they would call for major Fed "easing." If they then found out how much easing we have already had and the consequent monstrous increases in debt, they would surely be speechless.

Swift Changes

Some congressmen are calling for reassessing the dual mandate. This is just one way in which things are changing fast for the Fed. This once-staid institution is under increasing attack and is finding it necessary to defend itself, as when Chairman Ben Bernanke came out of his cloister to appear on *60 Minutes*, a decision he may regret given the reaction to his astonishing claim that further "quantitative easing" will not increase the money supply.

New rooms are being added to the Fed mansion even as the sand shifts under it. Congress has given it extensive new powers unrelated to monetary policy, most notably a new consumer protection agency. The idea is that the Fed's independence will ward off regulatory capture, something that always seems to happen to ordinary regulatory agencies. We shall see.

Rep. Ron Paul is the Fed's most prominent critic. Last year his bill to require an audit of the Fed garnered a great many cosigners in the House. He reintroduced it at the start of the 2011 session, this time with his son Rand Paul on hand in the Senate to file the same bill there.

But in some ways the Fed is already quite transparent. Its website has extensive reports, updated regularly and more detailed than any releases from commercial banks or private corporations. And while deliberations of the powerful Open Market Committee are secret, detailed minutes are now made available shortly after each meeting.

In other ways it is quite secretive. For example, the Fed refused to disclose the names of banks that got loans during April and May 2008, denying Freedom of Information Act (FOIA) requests filed by Bloomberg and Fox News. Responding to lawsuits, the Fed did *not* claim it was a private institution and therefore exempt. Instead it cited potential harm to the banks that had borrowed, but the court sensibly ruled against a "test that permits an agency to deny disclosure because the agency thinks it best to do so. . . ." The information was released.

> New rooms are being added to the Fed mansion even as the sand shifts under it.

"End the Fed" has become a rallying cry for Ron Paul and his supporters. His little book by that name will not earn any academic awards, but as a mass-market polemic it does a good job of making his case without conspiracy theories or private-ownership sideshows. There is, however, room for honest debate about fractional-reserve banking, which he opposes.

About the Fed, though, Ron Paul is right. Whatever good intentions its managers may have, the Fed, like all central banks, exists ultimately as an enabler of ever bigger government. My colleague Jeffrey Rogers Hummel may be right when he says the Fed is becoming the central planner of the U.S. economy. But when we argue for replacing the Fed with market institutions, we must take the time and effort to get our facts straight and to expose the complex network of special interests that supports the Fed. Wrongheaded and simplistic arguments only hinder the cause. FEE

Naive Keynesianism: A Failure of Imagination

BY DONALD J. BOUDREAUX

Each of us has a set of peeves—things that disproportionately irritate us.

By their nature, most peeves are small. For example, I bristle at the failure to use hyphens correctly. As my late, great teacher Fritz Machlup pointed out, a foreign exchange student is typically not a foreign-exchange student. The first is a student studying temporarily in a foreign country, while the second is a student of international currency transactions. (I can't resist recalling a classified ad whose author offered for sale a "black-man's bowling ball." I'm quite sure that this hyphen was misused.)

Some peeves, however, are large. These are ones that spark over-the-top irritation. One of my largest peeves is the frequently heard assertion that because personal consumption expenditures are currently (say) 70 percent of GDP, our standard of living will fall if personal consumption expenditures fall below that level.

This notion is Keynesianism at its most naive—Keynesianism that, though rejected or slathered with conditions by most or all Keynesians in the academy, motivates the (mis)understanding of too many reporters, pundits, and politicians who speak on economic issues.

I avoid here any discussion of the many conceptual problems involved in measuring economic output and in classifying expenditures. (Okay; I'll mention just one such problem: A large chunk of "personal consumption expenditures" in the United States is on medical care, which is financed massively by government. As Michael Mandel points out, "[I]t's misleading to say that 'consumer spending is 70 percent of GDP', when what we really mean is that 'consumer spending plus government health care spending is 70 percent of GDP.'")

The fundamental error woven throughout such naive Keynesian arguments about the importance of a particular level of consumer spending to the economy is that there is no "correct" or "optimal" level of consumer spending apart from whatever is the level that results from individuals freely choosing to spend and to save.

> There is no "correct" or "optimal" level of consumer spending aside from what individuals freely choose to spend.

The Precious Aggregate

Suppose Americans for the past several years spent 70 percent of their incomes on consumer electronics, Las Vegas vacations, and massage therapy, while saving the remaining 30 percent for retirement. There is in this pattern of spending and saving nothing inherently natural or precious. It's simply the measured aggregate result of how hundreds of millions of Americans chose to allocate their resources over the past several years.

What happens if this year Americans' preference for saving changes so that they now spend only 60 percent of their incomes on consumer electronics, Vegas vacations, and massage therapy, while saving 40 percent for retirement?

One effect is that producers and importers of consumer electronics will earn less money than before, as will masseuses and owners of Vegas hotels and casinos. Another effect is that some workers in these industries will lose their jobs.

Naive Keynesians focus like lasers on this effect. They worry that workers—some of whom are laid off and all of whom now (the naive Keynesians tell us) are

Donald Boudreaux (dboudrea@gmu.edu) is a professor of economics at George Mason University, a former FEE president, and the author of Globalization.

more anxious about their economic futures—will reduce their spending even further. And because workers reduce their spending, investors (it is alleged) will reduce their investing.

It's a spiral downward. The economic rot spreads.

And because before consumers changed their behavior, personal consumption expenditures were 70 percent of GDP, naive Keynesians—after intoning that "consumption is 70 percent" of the economy—will demand government action to restore that level of consumption.

But the fact is that, in this example, personal consumption expenditures are *not* any longer 70 percent of GDP. They are lower. And there's nothing wrong or undesirable about this fact.

When income earners change the amounts they spend relative to the amounts they save, they of course change the pattern of economic activity. One trouble with naive Keynesians is that they assume the earlier pattern of economic activity—the one that prevailed before the "disruptions" when the level of employment was high—is somehow special. They take that earlier pattern as defining some sort of standard that ought not be disrupted—and if disrupted, ought to be restored.

Naive Keynesians assume that whatever pattern prevailed before the "disruptions" is somehow special.

With people now spending only 60 percent of their incomes on consumption goods and services, while saving 40 percent, naive Keynesians assume that—in the absence of government intervention—the economy will shrink, jobs will disappear, and people will become poorer. The reason is that some chunk of necessary consumer expenditure is now going into savings.

"How can the economy recover," ask naive Keynesians, "if the 70 percent of it that is personal consumption expenditures is not all used for that purpose?"

Naive Keynesians commit too many errors even to list in the space allotted to me in this column. Perhaps foremost among these errors is their mistaken presumption that the practical imagination and initiative of entrepreneurs is as narrow and as anemic as their own in fact is.

If it were true that entrepreneurs were so dull that none of them could ever figure out how to employ a greater supply of saved resources in ways that improve the operational efficiency of a factory, increase the quality of a consumer good, and enhance worker training so that more will be produced in the future when those higher retirement savings are drawn down, then perhaps increased savings would always spell economic trouble.

Precluding Economic Change

But that would be a world in which *any* economic change spelled trouble. It would be a world in which, even if people merely changed the *kinds* of consumer goods they purchased (rather than changed the total *amount* they purchase), entrepreneurs would be unable to figure out how to adjust to such changes in consumer preferences.

Any change would spell damnation, releasing spooky animal spirits that scare everyone into withdrawing as much as possible from the economy.

Open-eyed observation of the commercial world in which we live should be sufficient to dispel these naive-Keynesian presumptions and fears. Entrepreneurs are forever on the lookout for ways to improve efficiency, to make their products more attractive to consumers, and to introduce totally new products.

Change is a natural and ever-present part of the competitive market process. So just because naive Keynesians can't imagine how increased savings might be productively employed to make the economy stronger—just because they can't imagine what capital goods the economy would produce if consumers changed their preferences and started saving more—does not mean that pattern of spending and saving which existed in the recent past is better than any one that will emerge in the future. FEE

The Kid and the Benevolent Bully

BY ROGER KOOPMAN

The kid had eighteen cents.

The benevolent bully had a buck-forty-nine.

The kid went to the corner candy store and bought a licorice pipe and a jawbreaker for two cents. He was giving serious consideration to the chewable wax lips when he overheard a big kid at the fountain ordering a large lemonade for a dime. He put back the lips and hustled down to the grocer's on the next block.

"I can make better lemonade and sell it for a nickel," the kid thought. So he bought a supply of lemons, sugar, and paper cups, then scrounged up some pitchers and a lemon squeezer from the attic and a card table and folding chair from the garage. He perched out on the corner with a cardboard sign that read, "All-American Lemonade, 5¢." It wasn't fancy, but the kid was in business.

InspirationDC [flickr.com]

Meanwhile, the benevolent bully had spent his buck-forty-nine ("borrowed" from the smaller kids) on candy, comic books, and ten-cent lemonades. He liked to give away stuff to his favorite friends. He felt popular—and important. That is, until the money ran out. Then he had to borrow more from the little kids, which was tedious work.

The kid's All-American Lemonade was a big success, and pretty soon he had expanded his line to other premium drinks—all for a nickel. After expenses he was making three cents a serving and, at 30 cups a day, had netted more than $25 the first month.

Then the kid had a brainstorm. He noticed that, for some reason, the little kids around town never had any money. So he proposed to set them up with All-American Lemonade stands in their own neighborhoods and split the profit 50-50. Within a few weeks, the kid had eight lemonade stands at strategic locations all over town. His local managers were making a phenomenal $10-$15 a month, and the kid was getting rich (by kid standards), which allowed him to open still more stands while hiring three helpers to run his own operation and keep the other stands stocked up. He kept improving his products, and the townfolks kept buying his beverages all the more. Life was good.

The kid's success did not go unnoticed by the benevolent bully who, filled with indignation and a keen sense of social justice, insisted that he and his bud-

Roger Koopman (koopman@imt.net) is the president of the Montana Conservative Alliance. This article first appeared at TheFreemanOnline.org.

dies deserved their fair share. The argument went something like this: The kid had too much money, while other deserving souls had none. To stimulate the economy the kid's excess earnings should be redistributed to worthy kids as entitlements to spend on wax lips and comic books.

The benevolent bully's ideas proved popular among the kids without lemonade franchises (most of whom had forgotten that it was the bully who had impoverished them.) Pretty soon the kid was being forced to pay a heavy "stimulus tax" to grow the economy (which, naively, he thought he had already been doing.) So he quit opening new stands. At the same time, the kid's local managers were being told that their All-American Lemonade was actually un-American, because they were making and keeping too much money. They, too, were forced to contribute to the benevolent bully's stimulus program, with a 50 percent tax on their ill-gotten gains.

Before long, all the benevolent bully's friends could be seen around town in wax lips. But there didn't seem to be as many lemonade stands as before, and people were starting to complain that the drinks tasted a bit watered down. The bully took immediate action, sensing that the capitalist-corrupted kid had compromised his product to recapture lost profits. He formed a Lemonade Quality Control Board, forcing the kid to use only premium, board-approved "green" ingredients. He levied fines on the kid and turned him in to the city for operating without a license and to the Board of Health for failure to have a State-certified kitchen.

The benevolent bully reminded people how bad things could have been if it weren't for the economic stimulus.

To make a profit the kid now had to raise the price of his lemonade to 10 cents a cup. People soon quit buying his beverages, and by the end of the summer All-American Lemonade was out of business. Coincidentally, the market for wax lips and comic books dropped off about the same time. The benevolent bully reminded people how bad things could have been if it weren't for the economic stimulus. The people were grateful.

Soon the bully had launched the Lemonade Stand Recovery Program (LSRP), paid for by the taxes extracted from the kid and his former managers. He set up stands around town, run by his friends and subsidized by the LSRP until money ran out. None of the stands made a profit (their lemonade was expensive and ordinary), but at least the benevolent bully was able to temporarily stimulate the economy while running robber barons like the kid (with his five-cent lemonade) out of business.

Many years later, the kid became a successful entrepreneur and grew a company that employed ten thousand in the manufacture of consumer goods. The economic recession, brought on by government inflation spending, borrowing, and regulation, has since forced the company to lay off three-quarters of its workforce.

The benevolent bully became a U.S. senator. He is working on the problem daily, diligently deficit-spending and redistributing wealth to stimulate the economy.

Let's pour ourselves a glass of nongovernment lemonade and learn the lessons of liberty. FEE

Can Government Manage the Economy?

BY JAMES L. PAYNE

A doctor says he can cure illness by waving birch wands over the patient. We are skeptical, but being open-minded we agree to give him a chance with ailing Uncle George. He waves a red wand and chants something. The patient shows no improvement.

"Let me try a green one," he says. We're still tolerant. The new wand is waved. Afterwards dear George is decidedly worse.

"Let me think," the healer says. "Maybe it should be a purple wand and a different chant."

For 98 years the federal government has been attempting to prevent asset bubbles, recessions, and spasms of unemployment. In 1913 Congress and Woodrow Wilson created the Federal Reserve System, the President telling the country this new institution would be "a safeguard against business depressions." In 1929, after 15 years of Fed operations, the United States plunged into a deep depression.

In the face of failure, we keep looking to government.

Okay, so maybe red wands don't work, and we should try green. Politicians of the 1930s created more bodies designed to stabilize the economy and build investor confidence: the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, the Securities and Exchange Commission, and the National Credit Union Administration. The Depression deepened, becoming by far the longest and deepest economic downturn in the history of the United States.

This is the national pattern in economic policy: In the face of failure, we keep looking to government. Since the Great Depression, we've added more units designed to curb inappropriate behavior and ward off recession, including the Commodity Futures Trading Commission (1974), the Federal Financial Institutions Examination Council (1979), the Working Group on Financial Markets (1988), and the Office of Thrift Supervision (1989). Yet in 2008 we fell into another economic downturn.

The 2008 recession was triggered by the boom and bust in the housing market. Was housing an unregulated market where government had failed to intervene? Sorry: There were seven agencies supposedly nurturing this industry:

1. Federal Housing Administration (1934)
2. Federal National Mortgage Association (Fannie Mae) (1938)
3. Government National Mortgage Association (Ginnie Mae) (1968)
4. Federal Home Loan Mortgage Corporation (Freddie Mac) (1970)
5. Neighborhood Reinvestment Corporation (1978)
6. Federal Housing Finance Board (1989)
7. Office of Federal Housing Enterprise Oversight (1992)

In sum, at the onset of the 2008 recession there were 16 units of the federal government that were supposed to manage economic life and keep us from harm, yet harm befell us. No wand-waving faith healer has ever failed so conspicuously.

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

Alas, economic policy is not a drug trial; it is politics, and politics is ruled by illusions. In June 2009 we found President Barack Obama urging the creation of yet more government units to manage the economy, promising that his reforms would "make sure that these problems are dealt with so that we're preventing crises in the future."

We can't be too critical of Obama, because many others share this confidence in government regulation. "Without intervention by the government," say economists George Akerlof and Robert Shiller in their 2009 book *Animal Spirits*, "the economy will suffer massive swings in employment. And financial markets will, from time to time, fall into chaos." It's astounding to assert that government can prevent crises, recessions, and "swings in unemployment" while being fully aware that for 98 years it has been trying and failing.

Not Learning From Experience

A powerful subconscious bias is obviously at work here, a mental distortion that prevents normal, intelligent people from being able to learn from experience. I call it the watchful-eye illusion: *the idea that government has greater knowledge and wisdom than the public*. In extreme form this illusion treats government as God, a superior being who surveys the scene from His Olympian position, controlling error and wrongdoing. Once this illusion is locked into your thinking, you remain convinced, despite any amount of failure, that government has the ability to do things right next time.

It appears that this fallacy begins in childhood. Youngsters see that their lives are guided by people who are more thoughtful and mature than they are: their parents. If they challenge the parents—asking, in effect, what gives you the right to make rules over me?—the parents say they know more. When children first learn about government, they see it as a super authority ten times more powerful than parents. Naturally, they assume it must have ten times their parents' wisdom and foresight.

Many do not outgrow this perspective; they carry into adulthood the idea that government is a superparent. Economists Akerlof and Shiller accept this view, declaring that it forms the core of Keynesian economics:

> The proper role of the parent is to set the limits so that the child does not overindulge her animal spirits. But those limits should also allow the child independence to learn and to be creative. The role of the parent is to create a *happy home,* which gives the child freedom but also protects him from his animal spirits.
>
> This happy home corresponds exactly to Keynes' position (and also our own) regarding the proper role of government.

Ordinary Beings

There are two fallacies in the Keynesian view that government can be a "parent" watchfully guarding over the national economy. First, the politicians who run government don't have superior wisdom and maturity. Government officials are ordinary, fallible human beings. They can be careless, inattentive, and shallow. They can be swayed by emotion. And sometimes they can be dishonest and corrupt.

The second fallacy is that the public is an ignorant child. The economy's millions of individual businessmen and investors have, collectively, vast wisdom about economic possibilities and trends. These individuals pour their knowledge into their market behavior, thereby setting the prices of assets, goods, and services. Left free to suffer the consequences of their decisions, investors and entrepreneurs will develop systems for managing risk and for evaluating the validity of investments. These systems won't be perfect, of course: There will be errors, bubbles, and frauds. But from these errors, the community learns to improve decisions in the future.

This system of social learning is short-circuited by government intervention, with its subsidies, bailouts, changing rules, and false promises to protect everyone. In truth, the greatest long-run threat to the health of the economy is the chaotic meddling of eager politicians whose intellectual powers have been so naively overrated by academic economists. FEE

The Progressive Income Tax and the Joy of Spending Other People's Money

BY BURTON FOLSOM, JR.

On August 31, 1910, Teddy Roosevelt traveled to Kansas to make a stirring speech in support of a federal income tax. "The really big fortune," Roosevelt said, "the swollen fortune by the mere fact of its size, acquires qualities which differentiate it in kind as well as in degree from what is possessed by men of relatively small means. Therefore, I believe in a graduated income tax on big fortunes."

Those two sentences helped focus the Progressive worldview. First, the United States needed an income tax to capture large chunks of revenue. Second, someone who had a large fortune, "by the mere fact of its size," had to be treated differently from other wealth holders. Property rights became variable. One group would be treated one way, other groups would be treated another way. Third, the nation needed a "graduated income tax" to redistribute wealth from the haves to the have-nots. The new tax slogan would be "ability to pay."

Under a progressive income tax, property rights became variable.

Author Delos Kinsman, writing while Roosevelt was president, said, "Individuals should contribute to the support of the government according to ability." And "income is the most just measure of that ability." Enlightened leaders like Teddy Roosevelt would redistribute wealth in the national interest.

Roosevelt's thinking was a profound change from the views of the Founders. To them, government existed to protect property, not redistribute it. Americans had a right to pursue life, liberty, and property, not an entitlement to it. Thus the Founders never considered raising revenue through an income tax, least of all a graduated one. They wanted consumption taxes—levies on imports or on luxury goods. Why? Because, as Alexander Hamilton said in *Federalist* 21, "The amount to be contributed by each citizen will in a degree be at his own option, and can be regulated by an attention to his resources."

Hamilton added, "If duties are too high, they lessen the consumption; the collection is eluded; and the product in the treasury is not so great. . . . This forms a complete barrier against any material oppression of the citizens by taxes of this class, and is itself a natural limitation of the power of imposing them."

American law also reinforced the use of consumption taxes. "All duties, imposts and excises shall be uniform throughout the United States," the Constitution reads. What could be more uniform than Congress's first excise tax of seven cents a gallon on all whiskey produced in the United States?

Not Good Enough

Progressives, however, disliked consumption taxes as the major source for revenue. They were too small, too cumbersome to collect, and sometimes too regressive—wealth never properly redistributed itself through consumption taxes. Taxes on whiskey, tobacco, and imported olives from Spain shifted very little, if any, wealth from rich to poor. In 1913 the House Ways and Means Committee observed that federal revenue rested "solely on consumption. The amount each citizen contributes is governed, not by his ability to pay taxes, but by his consumption of the articles needed." Swollen fortunes, as Roosevelt might say, went untaxed and became more swollen while some immigrants lived in poverty.

The Sixteenth Amendment was ratified in 1913, giving Congress the "power to lay and collect taxes on incomes from whatever source derived." It did not rule out "ability to pay" as the basis for the levy. The amend-

Burton Folsom, Jr., (bfolsom@hillsdale.edu) is a professor of history at Hillsdale College and FEE's senior historian. He is the author of New Deal or Raw Deal? *and blogs at BurtFolsom.com.*

ment became law just as Woodrow Wilson was coming into the presidency. As a Progressive, Wilson wanted to start small, establish a precedent, and then increase rates over time. Under the new tax law, exemptions were so high that few Americans earned enough to pay any tax. Rates started at 1 percent and rose slowly to a high of 7 percent on all income over $500,000.

Progressives easily sold this tax plan to the voters. Fewer than one American family in 100 paid anything, but politicians could promise audiences that they might receive benefits from the revenue. And who would dare to suggest that billionaire John D. Rockefeller did not have the ability to pay 7 percent of his huge income to the government?

Ability to Pay

Yet that raises an interesting question. At what tax rate did Rockefeller, or other wealthy men, cease to have the ability to pay? If they could pay 7 percent, could they pay 15? Apparently so, because in 1916 Wilson and Congress raised the top rate to 15 percent. Unlike with a consumption tax, under the income tax politicians judge ability to pay and they choose the rates they think rich people can afford. If politicians choose rates too high they may lose the support of the rich, but they may gain support of those larger groups receiving subsidies from the tax revenue. If wealth really needs to be redistributed, should we trust people to do it with their own money or politicians with other people's money?

Rockefeller, for example, was the best and cheapest oil refiner in the world. His charitable giving included the Erie Street Baptist Church, a cure for meningitis, and funding for Tuskegee Institute. That was how he redistributed his own wealth. Andrew Carnegie, the steel baron, built libraries, and banker Andrew Mellon built the National Gallery of Art in Washington, D.C. In the political realm, President Franklin Roosevelt supported high taxes and gave subsidies to silver miners, farmers, and the Tennessee Valley Authority to make cheap electric power.

Charitable givers and politicians both pursue their self-interest, but the politician's self-interest includes winning votes. That means, if possible, channeling subsidies to voting groups to win reelection at the expense of taxpayers in general. Rockefeller's gifts to Tuskegee did not cost anyone but him any money. FDR's subsidy to silver miners, by contrast, cost millions of taxpayers small amounts of tax revenue. It helped FDR carry several western states each time he ran for president. His redistribution efforts were essential to his being reelected.

> Charitable givers and politicians both pursue their self-interest, but the politician's self-interest includes winning votes.

Thus U.S. politicians had incentives to steadily increase the income tax in the 1900s. The top rate went from 7 to 15 percent in Wilson's first term. World War I took it over 60, then over 70 percent. It didn't drop below 50 percent until 1924, and was about 25 percent the rest of the decade. The rate rose to 63 percent in 1932 under Herbert Hoover and then 79 percent in 1935. The World War II years pushed it over 80 percent, and in 1945, FDR's last year in office, the top was 94 percent on all income over $200,000. Wealthy people apparently had a very high ability to pay, and politicians had a very high desire to fight wars and win elections. FEE

Adam Smith Reveals His (Invisible) Hand

BY MARK SKOUSEN

"Adam Smith had one overwhelmingly important triumph: he put into the *center* of economics the systematic analysis of the behavior of individuals pursuing their self-interest under conditions of competition."

—George Stigler (emphasis added)

Critics of laissez faire—from Cambridge economic historian Emma Rothschild to British Labor Party leader Gordon Brown—have recently attempted to wrestle Adam Smith out of the hands of the free-market camp and into the camp of the social democrats. According to Iain McLean, professor of politics at Oxford University, and Samuel Fleschaker, professor of philosophy at the University of Illinois at Chicago, the Scottish philosopher was a "radical egalitarian" who, while endorsing economic liberalism, had a lively appreciation of market failure and ultimately rejected "ruthless laissez-faire capitalism" in favor of "human equality" and "distributive justice."

These critics are quick to claim that Smith was no friend of rent-seeking landlords, monopolistic merchants, and conspiring businessmen, and that he advocated an active State authority in support of free education, large-scale public works, usury laws, progressive taxation, and even limits on free trade.

What about the metaphor of the "invisible hand," the famous Smithian idea that "by pursuing his own self-interest, [every individual] frequently promotes that of the society"? Free-market economists from Ludwig von Mises to Milton Friedman have regarded it as a powerful symbol of unfettered market forces, what Adam Smith called his "system of natural liberty." In rebuttal the new critics belittle Smith's metaphor as a "passing, satirical" reference and suggest that he favored more of a "helping hand." They emphasize that Smith used the phrase "invisible hand" only once in each of his two major works, *The Theory of Moral Sentiments* (1759) and *The Wealth of Nations* (1776). The references are so sparse that commentators seldom mentioned the expression by name in the nineteenth century. No notice was made of it during the celebrations of the centenary of *The Wealth of*

Mark Skousen (editor@markskousen.com) is the editor of Forecasts & Strategies, *author of* The Making of Modern Economics, *and the producer of FreedomFest (www.freedomfest.com). He is a former president of FEE. This article first appeared at TheFreemanOnline.org.*

Nations in 1876. Until well into the twentieth century, no subject index listed "invisible hand" as a separate entry. It was finally added to the index in 1937 by Max Lerner for the Modern Library edition. Clearly, it wasn't until the twentieth century that the invisible hand became a popular symbol of laissez faire.

Could the detractors be correct in their assessment of Adam Smith's sentiments? Is the metaphor central or marginal to his "system of natural liberty"?

Friedman refers to Adam Smith's symbol as a "key insight" into the cooperative, self-regulating "power of the market to produce our food, our clothing, our housing . . . without central direction." Economist George Stigler calls it the "crown jewel" of *The Wealth of Nations* and "the most important substantive proposition in all of economics."

On the other hand, economist Gavin Kennedy contended in earlier writings that the invisible hand is nothing more than an afterthought, a "casual metaphor" with limited value. Rothschild, the Harvard University economic historian, even goes so far as to declare, "What I will suggest is that Smith did not especially esteem the invisible hand. . . . It is un-Smithian and unimportant to his theory" and was nothing more than a "mildly ironic joke."

Some economists have begun to refer to the "invisible hand" reference as, at best, a "mildly ironic joke."

Who's right?

A fascinating discovery by Daniel Klein, professor of economics at George Mason University, may shed light on this debate. Based on a brief remark by Peter Minowitz, the Santa Clara University political philosopher, that the "invisible hand" phrase lies roughly in the middle of both of Smith's books, Klein made preliminary investigations. He next recruited Brandon Lucas, then a doctoral student at Mason, to investigate further. Klein and Lucas reported in *Economic Affairs* (March 2011) that they found considerable evidence that Smith "deliberately placed 'led by an invisible hand' at the centre of his tomes" and that the concept "holds special and positive significance in Smith's thought."

Klein and Lucas base their conjecture on two major points. First, the physical location of the metaphor: The single expression "led by an invisible hand" occurs almost dead center in the first and second editions of *The Wealth of Nations*. (It moves slightly away from the middle after an index and other material were added to later editions.)

Moreover, it appears again "well-nigh dead centre" in the final edition of *The Theory of Moral Sentiments*. Klein and Lucas admit that it was not in the middle of the first edition in 1759, speculating that "physical centrality was not initially a part of his intentions . . . [but that] by 1776, Smith had become intent on centrality." Indeed, Smith moved the phrase "invisible hand" closer to the center of the book, first by appending an important essay on the origin of language and finally by making substantial revisions in the final edition.

Second, they note that as a historian and moral philosopher, Adam Smith commented frequently on the importance of middleness in architecture, literature, science, and philosophy. For example:

- Smith wrote sympathetically about the Aristotelian golden mean, the idea that virtue exists "between two opposite vices." For instance, between the two extremes of cowardice and recklessness lies the central virtue of courage.
- In his essays on astronomy and ancient physics, he was captivated by Newtonian central forces and periodical revolutions.
- Klein discovered that in his lectures on rhetoric, Smith admired the poetry of the Greek poet Thucydides, who "often expresses all that he labours so much in a word or two, sometimes placed in the middle of the narration."

In sum, according to Klein and Lucas, the invisible hand represents the centrality of Smith's "system of natural liberty" and is appropriately found in the middle of his works. By this discovery, if true, one goes from one extreme to the other—from seeing the invisible hand as a marginal concept to accepting it as the touchstone of his philosophy.

Klein and Lucas's list of evidence is what a lawyer might call circumstantial, or "impressionistic," to use their own adjective. Taken as a whole, the documentation is either an ingenious breakthrough or a "remarkable coincidence," to quote Kennedy.

A few Smithian experts have warmed up to Klein and Lucas's claim. Kennedy, who previously considered the invisible hand a "casual" metaphor, now sees a "high probability" in their thesis of deliberate centrality. Others are more skeptical. "We have no direct evidence for the conjecture," states Craig Smith, an expert on Adam Smith at the University of St. Andrews. The idea that Smith deliberately hid his favorite symbol of his philosophy "strikes me . . . as very un-Smithian," he states, and runs contrary to his policy of expressing thoughts in a "neat, plain and clever manner." Placing the shorthand phrase "invisible hand" in the middle of his works may not be plain, but is it not neat and clever?

We may never know the truth, since we have no record of Smith's confession on the matter. Fortunately, one does not need to depend on the physical centrality of the "invisible hand" to recognize the doctrinal centrality of his philosophy.

There are many passages from *The Wealth of Nations* and *The Theory of Moral Sentiments* that elucidate the "invisible hand" theme, the idea that individuals acting in their own self-interest unwittingly benefit the public weal, or that eliminating restrictions on individuals' behaviors "better[s] their own condition" and makes society better off. Smith repeatedly advocated removal of trade barriers, State-granted privileges, and employment regulations so that individuals could flourish.

In *The Theory of Moral Sentiments*, Smith writes:

> The man of system . . . seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board. He does not consider that the pieces upon the chess-board have no other principle of motion besides that which the hand impresses upon them; but that, in the great chess-board of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature might chuse to impress upon it. If those two principles coincide and act in the same direction, the game of human society will go on easily and harmoniously, and is very likely to be happy and successful. If they are opposite or different, the game will go on miserably, and the society must be at all times in the highest degree of disorder.

There are many passages from Smith's works that elucidate the "invisible hand" image.

Smith's argument is comparative. To quote Klein: "Hewing to the liberty principle generally *works out better* than not doing so—in *this* respect, [Kenneth] Arrow, Joseph Stiglitz, and Frank Hahn *do* disfigure Smith when they identify the invisible hand with some rarified perfection. We need not rehearse Smith on the ignorance, folly, and presumption of political power, on the corruption and pathology of political ecology. . . . Smith sees the liberty principle as a moral, cultural, and political *focal point*, a worthy and workable principle in the otherwise dreadful fog of interventionism."

To think that Adam Smith, the renowned absent-minded professor, hid a little "invisible" secret in his tomes is indeed the ultimate irony. As Klein concludes, "That the phrase appears close to *the center*, and *but once*, in *TMS* and in *WN* might be taken as evidence that Smith did intend for us to take up the phrase."

I find Professor Klein's story compelling and have enjoyed showing copies of Smith's works with a bookmark in the key pages to students, faculty, and interested friends. FEE

Roots of Egypt's Revolt

BY NOUH EL HARMOUZI

Egypt has been a pressure cooker for decades. Like others in the region, the Mubarak regime was sitting atop a simmering political crisis, simultaneously attempting to contain rising Islamist violence and snuff out pockets of political resistance. The country has been under a continuous state of emergency since the assassination of Mubarak's predecessor, Anwar Sadat, in 1981. That state of emergency has been the foundation of a policy of "stability through continuity," which in fact has meant the monarchical exercise and transmission of power by a president backed by a military junta and with the support of the barons and apparatchiks of the hegemonic National Democratic Party. It's now all crashed down, and Mubarak is gone. How did such a "stable" regime become destabilized so fast?

Protesters in Tahrir Square, Cairo, celebrate the announcement of Hosni Mubarak's resignation on February 11.
Jonathan Rashad

One reason Egypt's political development was frozen for so long is the lasting influence of Gamal Abdel Nasser (president 1956–70), who allied the country with the Soviet Union, imposed a policy of economic nationalism and statism, and created huge loss-producing State enterprises and a bloated bureaucracy. Other reasons are Egypt's geography, geology, economy, history, and geopolitical position, each of which has stifled the generation of an open political and economic system and strengthened the country's static and authoritarian political system by providing revenue directly to the rulers, without requiring the consent of a productive population. Since the rulers don't rely mainly on taxes, they have little reason to promote good governance or to be accountable to the people.

Sources of Revenue

Geography: The Suez Canal provides a direct passage between the Red and Mediterranean Seas. As an artificial sea passage between Europe and Asia, the Canal is of major importance because it avoids the long ship passage around Africa. The Suez Canal was nationalized by Nasser in 1956. Every day nearly 40 vessels traverse the Canal, producing some $3.3 billion per year in income to the State.

Geology: The land of Egypt is blessed—or cursed—with oil reserves that provide foreign exchange earnings estimated at $1.2 billion per year. The oil industry

---

Nouh El Harmouzi (elharmouzi@gmail.com) is editor of Minbar Al Hurriyya (www.minbaralhurriyya.org), the Arabic-language news and analysis site of the Atlas Economic Research Foundation, and professor at Ibn Toufail University in Kenitra, Morocco. This article originally appeared at TheFreemanOnline.org.

was nationalized in 1962 and provides rents to the State and the bureaucracy that it has spawned.

Economy: A rigidly controlled labor market has created huge unemployment and forced many Egyptians abroad in search of work. Every year Egyptians working in North America, Europe, and the Gulf countries send an estimated $4.3 billion to their families, providing an external source of income to the country without creating wealth at home.

History: Egypt's inherited wealth of tourist sites draws some five million foreign visitors per year from the whole world. The sites are State-owned and -managed and accordingly poorly maintained, but because there are no close substitutes for seeing the Sphinx or the Pyramids, the State receives billions of dollars in foreign exchange earnings (some $5 billion in 2005).

Geopolitics: Egypt is a central hub in the chaotic politics of the Middle East, a neighbor to Libya, Sudan, Israel, Jordan, and Saudi Arabia (from which it is separated by the Sinai desert and the Red Sea). Apparently without consulting "the Egyptian street" (and the Arab street in general), the government of Egypt was the first Arab government to sign a peace treaty with Israel (the Camp David Accords of 1979). In return for being at peace, the United States has given the Egyptian government over $2.1 billion, including $1.3 billion in military aid, every year since 1980. Egypt's leaders have occupied an increasingly difficult position, as they are seen as betraying the Arab nationalist ideals of Nasser and abandoning the Palestinians.

All those "rents" were captured by the ruling coalition, which until February was increasingly controlled by President Mubarak's son Gamal. Those rents have supported a vast system of patronage through which Egyptian society has been controlled. The now-defunct National Democratic Party and the State organs it dominated controlled almost all the media, the unions, the secret services, and the political police. As a result, "democracy" was emptied of its meaning.

A "rent-seeking" political system that cemented its hold on society put Egypt in a perpetual pre-revolutionary situation and created a powerful, but quite brittle, security situation.

The demographics and economics of Egypt also have contributed to the brittleness. Egypt's statist economic system generates few opportunities to create wealth, in contrast to receiving rents through State employment. Unemployment is probably over 30 percent, and with some 600,000 young people entering the job market each year, the situation has been worsening. Moreover, Egypt's population is both rapidly growing, with some 26 million Egyptians under the age of 15, and poor, with 44 percent living on less than $2 per day.

Plutocratic Land of the Pharaohs

In short, the Land of the Pharaohs is a dual society, with a thin layer of powerful and wealthy people whose riches have largely derived from rents from the State ruling over a mass of impoverished people. The poorly managed "privatizations," undertaken in a climate of pervasive corruption and hostility to independent business, have done little to address the country's intolerable inequalities. Moreover, the country faces a total public debt above 100 percent of GDP, and public finances are taking a nose dive, resulting in delays in payment of wages to public servants, traditionally a strong base of support for such rent-seeking States. The pressure has been building for years, and the example of Tunisia accelerated the process, resulting in an explosion of anger and rage.

The desperate and left-behind have in the meantime been swelling the ranks of the more radical movements. The Salafists, Wahhabis, and more radical branches of the Muslim Brotherhood are the main beneficiaries of that process, as other avenues for political dissent have been stifled; the increasing bomb attacks and the recent uprising are the main consequences of this. But even the Muslim Brotherhood seems to have been surprised by the uprising in the streets. There is hope that perhaps something different will emerge, something that goes beyond the confrontation between a quasi-fascist one-party State and a radical Islamist movement working to take its place.

The roots of the revolt have been growing for years. It will take some time before we see what will grow from those roots: a pluralistic democracy, a renewed and even more tyrannical military State, or an intolerant Islamist tyranny. FEE

Senseless

BY THOMAS SZASZ

Do people really want to know why, on January 8, 2011, in Tucson, Arizona, a young man named Jared Lee Loughner engaged in mass murder? I submit they do not. Politicians, psychiatrists, pundits, and the press univocally assert that Loughner's deed is the "senseless" product of mental illness. This belief in a nonexistent mental disease causing mass murder is on a par with young children's belief in Santa Claus. It is false but satisfies the believers. The great French essayist Michel de Montaigne (1533–1592) sagely observed, "Nothing is so firmly believed as what is least known."

Before his shooting spree Loughner had produced a video he called "My Final Thoughts," in which he said, "All humans are in need of sleep. Jared Loughner is a human. Hence, Jared Loughner is in need of sleep." On the morning of his massacre he posted a message on his MySpace account acknowledging his sense that he was at the end of his rope and his decision to let go: "Goodbye. Dear friends . . . Please don't be mad at me."

Nobody really wants to know why Jared Lee Loughner chose to commit mass murder.
U.S. Marshals

"War is a continuation of politics by other means," said Prussian general Carl von Clausewitz (1780–1831). I suggest that, similarly, mass murder in plain sight, such as Loughner committed, is a continuation of suicide by other means. Sometimes it is called "suicide by proxy" or "suicide by cop."

Loughner, to use his metaphor, has gone to sleep. And so have we if we prefer to believe that his self-destructive and destructive act is the senseless product of his "mental illness" rather than the result of his planned, "sensible" decision. The latter view is unpopular and unacceptable because it acknowledges Loughner's humanity and free will, precisely the qualities that psychiatrists—aided and abetted by the criminal justice system—are intent on removing from persons they label "mad." This medicalized view of certain offenses—usually crimes that particularly upset people—has, for reasons I have presented elsewhere, become widely accepted in our society, embraced equally by the right and the left.

Normally, we infer the motive for an action from its consequences. For Loughner, one of the consequences of his action is that his life is over, if not biologically then socially. Loughner was well aware of his failure to transition from childhood to adulthood. After years of fruitless travail, he decided to bring his life to a dramatic end. He committed mass murder and let himself be destroyed by the society that, he felt, obstructed his efforts to succeed.

Loughner's crime, like any act, was not senseless at all, provided we are willing to put ourselves in his shoes. Of course, it makes no sense if we are unwilling to do that, denying the personhood of the actor, dismissing *a priori* his possessing free will, attributing his action to mental disease instead of personal decision.

The only thing we know with certainty about the Loughner case is the identity of the shooter. We do not know why he committed this crime. Nevertheless, commentators ritually refer to Loughner as the "alleged" assailant and confidently assert that he is crazy, deranged, lunatic, mentally ill and schizophrenic. Former Vice President Dick Cheney told NBC News,

Thomas Szasz (tszasz@aol.com) is professor of psychiatry emeritus at SUNY Upstate Medical University in Syracuse. His latest book is Antipsychiatry: Quackery Squared. *This article originally appeared at TheFreemanOnline.org.*

"We need to be a little careful about assuming that somehow the rest of society or the political class bears the responsibility for what happened here when it was the act of a deranged, crazed individual that committed a crime."

E. Fuller Torrey, a recognized expert on schizophrenic murderers, agrees. He refers to Loughner as "the alleged shooter" and states that he "is reported to have had symptoms associated with schizophrenia . . . and almost certainly was seriously mentally ill and untreated. . . . These tragedies are the inevitable outcome of five decades of failed mental-health policies."

Torrey's remedy for the problem of people being at liberty to commit crimes and suffer the consequences is intensifying the traditional legal-psychiatric practice of incarcerating innocent individuals and calling it "hospitalization" and "treatment" and even "suicide and crime prevention": "The solution to this situation is obvious—make sure individuals with serious mental illnesses are receiving treatment. The mistake was not in emptying the nation's hospitals but rather in ignoring the treatment needs of the patients being released. . . . Others are unaware they are sick and should be required by law to receive assisted outpatient treatment, including medication and counseling. . . . If they do not comply with the court-ordered treatment plan, they can and should be involuntarily admitted to a hospital."

Legally mandated and enforced confinement, even in a nominally medical institution, is imprisonment and punishment, not "hospitalization" or "treatment," for the innocent and guilty alike.

In contrast, Ashley Figueroa, a former girlfriend of Loughner, told ABC News that she remembers him as "a drug user with a grudge against the government. . . . I think he's faking everything. . . . I think that he has been planning this for some time." A writer for Salon.com adds: "Figueroa is not a doctor, and these claims conflict with the opinion of top doctors in the field of psychiatry. (Dr. E. Fuller Torrey actually told Salon that Loughner looks like a 'textbook' case of paranoid schizophrenia.)"

True, Figueroa is not a "doctor." Does having a medical degree qualify a person to diagnose someone he has never laid eyes on as a schizophrenic? Does the fact that Figueroa knew Loughner, that they had a real-life human relationship, count for nothing?

It did not take long for authorities, in Arizona as well as nationally, to heed Torrey's advice to cure would-be "schizophrenic murderers" by constricting the liberties of all Americans. On January 15, exactly one week after Loughner's rampage, one of his victims, J. Eric Fuller, 63, a military veteran, attended a televised forum on "helping the community to heal" and angrily confronted a fellow participant with the metaphor, "You're dead." Fuller's words were interpreted as a "threat," and he was involuntarily committed for a 72-hour mental-health evaluation. According to CBS News, "[Pima County sheriff's spokesman Jason] Ogan said the hospital will determine when Fuller will be released."

The war on words continued in Congress. Before Tucson, the Republicans opposed Obamacare, calling the bill "job killing." Overnight, that term vanished from the political vocabulary, replaced by "job crushing" and other metaphors. Foolishly, *Washington Post* columnist Dana Milbank hailed this piece of semantic surgery: "[House Speaker John] Boehner, in a pair of statements on his Web page, dropped the 'job-killing' phrase in favor of 'job-crushing' and 'job-destroying.' House Majority Leader Eric Cantor . . . did not allow the k-word to escape his lips at Tuesday afternoon's news conference. . . . [T]he new GOP majority generally showed a skill that had been lacking in the Republican caucus for the past two years: self-restraint."

Wedded to the idea that we have two kinds of lawbreakers in America, sane and insane, we are unable to attend to the human problems we call "mental illnesses." But not to worry: We can always operate on the vocabulary. FEE

China: Wealth but Not Freedom

BY JAMES A. DORN

When Chinese President Hu Jintao visited Washington earlier this year he received the gracious welcome and state dinner he did not get on his first visit in 2006. He also had some tough discussions on trade, foreign exchange, national security, and human rights.

China can be proud of the rapid economic progress it has made since 1978, when it was still a centrally planned economy with little foreign trade. Today, as the world's second-largest economy, the People's Republic (PRC) has gained wealth but not freedom. The Chinese people have a vastly wider range of economic and social opportunities than under the dictatorship of Mao Zedong, but their basic human rights continue to be denied by a ruling party determined to maintain its monopoly on power.

Liu Xiaobo was sentenced to 11 years in prison for supporting political freedom.
Voice of America

As head of the Chinese Communist Party (CCP), Hu has paid lip service to "putting the people first," but there has been little progress in liberalizing the political regime. The reality is that his idea of a "harmonious society" is one directed by the ruling elite, in which order emerges from the top down, not spontaneously under a constitution of liberty.

One of the CCP's long-held tenets is "to seek truth from facts." The most glaring fact is not the inequality of wealth, but the inequality of power that strips the Chinese people of their fundamental rights. Putting the people first means limiting government power and safeguarding rights to life, liberty, and property.

The great Chinese liberal Lao-Tzu understood the importance of freedom and limited government. For him and other Taoists, harmony cannot be forced; it must be natural. In the *Laozi*, also known as the *Tao Te Ching*, we read: "The more restrictions and prohibitions there are in the world, the poorer the people will be." Denying individuals the liberty to exchange ideas, to criticize the government and party, and to associate freely without the fear of repression makes people poorer by restricting the alternatives open to them.

In 2004 the National People's Congress (NPC), China's rubber-stamp parliament, amended the PRC Constitution to better protect the private sector and for the first time added the words "human rights" to the document. Article 33, section 3, reads, "The state respects and protects human rights." Such language encouraged Chinese liberals to test the waters, only to find that reality did not match the rhetoric.

The drafting of Charter 08, a manifesto for fundamental human rights, earned Liu Xiaobo the 2010 Nobel Peace Prize, the first awarded to a Chinese citizen. It also earned him 11 years in prison. The empty chair at the Nobel ceremony was yet one more iconic image of the individual versus the State. Before his sentencing in 2009 Liu stood before the court and declared, "To block freedom of speech is to

James Dorn (jdorn@cato.org) is vice president for academic affairs and a China specialist at the Cato Institute, and professor of economics at Towson University. *This article first appeared at TheFreemanOnline.org.*

trample on human rights, to strangle humanity, and to suppress the truth."

Like others before him, Liu was accused of "incitement to subvert state power." Yet the Chinese people have always believed that when government acts unjustly it loses the Mandate of Heaven. Charter 08 recognizes that "China has many laws but no rule of law." The charter, initially signed by 303 liberals, now has more than 10,000 signatories—all of whom recognize that people everywhere have the rights "to freedom, to property, and to the pursuit of happiness."

Charter 08 and Preexisting Rights

Charter 08 reveals an acute understanding of the case for limited government and the principle that the legitimate function of the State is to protect preexisting rights to life, liberty, and property, not to deny those rights. Civil society requires freedom. To achieve that freedom Charter 08 advocates a constitutional democracy with separation of powers, an independent judiciary, and a bill of rights. Freedom of expression, of religion, of association, and the protection of private property are all enshrined in the document. The hope of the Chinese framers is that Charter 08 will "bring to reality the goals and ideals that our people have incessantly been seeking for more than a hundred years, and . . . bring a brilliant new chapter to Chinese civilization."

> The peaceful development that Beijing seeks will be on shaky ground until it confronts the incompatibility of top-down order with human happiness.

The official reaction to Charter 08 and to Liu's Nobel Peace Prize was predictable: The Chinese government launched a storm of propaganda in support of the status quo. The mouthpiece of the CCP, the *People's Daily*, wrote in October 2010, "By rumor-mongering and libeling, the charter denies the people's democratic dictatorship, socialism, and the unitary state structure stipulated in the Chinese Constitution. The charter also entices people to join it, with the intent to alter the political system and overturn the government. Liu's activities have crossed the line of freedom of speech into crime."

Top-Down Order and Human Happiness

Yet as Premier Wen Jiabao noted last August in a speech in Shenzhen, "Without the safeguard of political reform, the fruits of economic reform would be lost and the goal of modernization would not materialize." And in an interview with CNN in October, he recognized that "freedom of speech is indispensable for any country."

The harmony, stability, and peaceful development that Beijing seeks will be on shaky ground until the CCP confronts the reality that top-down order is not consistent with human happiness, and that spontaneous order emerges from free markets and a genuine rule of law. Premier Wen, in his 2003 speech at Harvard, said that China has "found the right path of development" and that "the essence of this path is to . . . respect and protect the freedom of the Chinese people to pursue happiness." In 2007, following the annual session of the NPC, he encouraged people to "oversee and criticize the government," and said, "It is particularly important that we need to make justice the most important value of the socialist system."

Justice, however, requires the prevention of injustice. Liu Xiaobo, Gao Zhisheng, and others entrapped by China's jackboot justice system deserve to be heard, as do "the lost souls" of Tiananmen. FEE

The Law Merchant and International Trade

BY PETER T. LEESON AND DANIEL J. SMITH

Is the State necessary for flourishing international trade? Conventional wisdom thinks so. According to that wisdom, private international commerce would wither without intergovernmental treaties, State courts dealing with international affairs, and State-crafted legal practices for international merchants. Some commentators have gone so far as to suggest that a world legal system is needed to ensure the continual growth of international commerce.

Superficially, at least, the idea that State involvement might be indispensable for international trade seems sensible. Without it, how could merchants from different legal systems—not to mention cultures, languages, and religions—make binding contracts, providing the security they need to trade with persons beyond their nations' borders? Without a world court for private international commercial agreements, what law would take precedence in commercial disputes? Which nation's courts would handle merchants' disagreements? And how could merchants secure a fair hearing in the courts of their adversaries? Without a supranational legal system, or at least national governments' cooperation, these and myriad other potential problems stemming from commercial conflicts between parties from different countries would seem insurmountable.

> International trade first took off under a private international legal system.

Yet private parties have surmounted these problems—without government. International trade first took off under a private international legal system called the *lex mercatoria*, or Law Merchant. It continues to thrive under private legal arrangements today.

In the eleventh century Europeans discovered agricultural improvements that could sustain a larger population. The growing population increasingly migrated to urban areas. In these cities a new class of merchants was born. Merchants across Europe were separated by language, distance, and local law. To facilitate trade, they needed a common set of commercial rules. Out of that need the Law Merchant was born.

The Law Merchant was a purely informal body of law. It developed out of merchants' international commercial customs and shared legal notions. Roman law (the *ius gentium*) provided many of these notions, which merchants modified to meet their special needs, as Bruce L. Benson pointed out in "The Spontaneous Evolution of Commercial Law" (*Southern Economic Journal*, 1989.)

In its early days the Law Merchant relied entirely on private adjudication and enforcement. Merchants conducted much of early international trade at fairs throughout Europe. At these fairs local authorities performed regular activities, such as preventing violence, but they didn't normally adjudicate disputes between international traders.

Nor did authorities enforce the terms of private commercial contracts. International merchants formed their own courts for this purpose and applied their own law to these cases. Merchants' courts came to be called "dusty feet courts" because of the condition of mer-

Peter Leeson (pleeson@gmu.edu) is the BB&T Professor for the Study of Capitalism at George Mason University. Daniel Smith (dsmitf@gmu.edu) is a Ph.D. candidate in economics and the Oloffson Weaver Fellow in Political Economy at George Mason University.

chants' shoes as they busily traveled between commercial fairs. In these courts merchants acted as judges, deciding the disputes of fellow traders on the basis of shared customs. Merchant courts enforced their decisions privately by threatening noncompliant traders with a loss of reputation and merchant-community ostracism.

Advantages of the *Lex Mercatoria*

Medieval international merchants used the *lex mercatoria*'s private system of international commercial governance instead of government for several reasons. First, they desired speedy dispute resolution. Disrupting business to resolve contractual disagreements was costly. The Law Merchant minimized costs by eschewing the formality of State court proceedings. Merchant courts' flexible rules of evidence, "[o]ral proceedings, informal testimony of witnesses and unwritten judicial decision-making" hastened the judicial process for time-pressed international traders, according to Leon Trakman's *The Law Merchant: The Evolution of Commercial Law*.

Merchants couldn't rely on government legal systems to resolve trade disputes.

The Law Merchant further reduced the time required to resolve disputes by simplifying the process of international trade, limiting the kinds of conflicts that might require resolution. For example, the system dispensed with agents' need to obtain formal authorization from their principals to conduct trade with third parties, entirely eliminating a large source of potential trade-related disputes. The Law Merchant also dispensed with the need for official notarization to transfer debts between parties. This reduced the cost of international commercial transactions and precluded another important locus of potential contractual conflict.

Second, merchants used the Law Merchant's private governance system because it provided neutral third-party dispute resolution. Using one disputant's State court would've been undesirable from the other disputant's perspective. Traders would've quite reasonably feared "home-court bias" from foreign judges. By taking dispute resolution out of either disputant's home court, the Law Merchant secured international traders against this concern.

Third, unlike State courts, which were operated by bureaucrats, the Law Merchant's courts were operated predominantly by merchants themselves. This was a great benefit to international traders. Who could better understand the intricacies of international commercial contracts, correctly detect fault, and assign reasonable remedies than other merchants? International merchants demanded adjudicators with expertise in the questions before them. Merchant courts—run by and for the benefit of merchants—satisfied that demand.

Fourth, the Law Merchant's private, spontaneously evolved status permitted it to adapt rapidly to the environment of growing international trade and thus to merchants' rapidly evolving legal needs. "Strict rules lacked the flexibility to vary in response to the peculiarities of the merchants, to their trade background and to their form of bargaining," Trakman wrote. The *lex mercatoria*'s informal rules didn't. Merchants needed a common legal system that transcended local languages, cultures, and variances in national laws. But they also needed a system that could vary according to merchants' regional needs and requirements in specific types of trade. The Law Merchant satisfied both needs at once.

Shortcomings of Government Systems

Merchants couldn't rely on government legal systems for this purpose. Eleventh- and twelfth-century governments weren't normally willing to adjudicate commercial agreements forged in foreign nations. Even if they had been, it's hard to see how medieval merchants could have used State courts to adjudicate their disputes. Governments of this era often didn't honor contracts that involved interest payments. This posed a significant problem for international merchants since they used credit agreements extensively. Common-law courts of the time didn't even permit books of account as evidence in commercial disputes. This also posed a major problem for international merchants since they relied heavily on such accounts. Fur-

ther, the scope of national governments' authority in the eleventh and twelfth centuries was extremely limited. Rulers couldn't yet reach individuals outside territory they directly controlled. Thus their ability to enforce State-court-rendered decisions was nearly nonexistent.

The Law Merchant was indispensable to the Commercial Revolution. Besides providing rules for international commerce, it gave birth to negotiable credit instruments, such as promissory notes and bills of exchange, which are critical to modern trade. Before the twelfth century these credit devices didn't exist. It's no exaggeration to say the Law Merchant played a critical role in pulling Europe into the modern world.

Contemporary Role

Contemporary international trade continues to rely heavily on the Law Merchant to govern private international commerce. A similar body of international legal customs—the successor to the private legal rules of the medieval *lex mercatoria*—provides the basis for contemporary international dispute resolution. In place of medieval merchants' "dusty feet courts," modern international traders' disputes are resolved by arbitrators who work for private associations such as the International Chamber of Commerce's (ICC) International Court of Arbitration.

> Contemporary international trade relies on private arbitration to "delocalize" dispute resolution.

Nearly all modern international commercial contracts contain clauses specifying appeal to such associations in the event of contractual disagreements. In addition to selecting an arbitration forum, modern international traders select the law they want the association to apply to their case, which can range from any country's national law to international commercial custom. International traders may even select the identity of the particular arbitrators who will hear their case.

These associations emerged as a market response to the demands of contemporary international traders who see State courts as inferior forums of dispute resolution. The ability of contemporary international traders to rely on State courts to adjudicate conflicts confronts problems similar to the ones their medieval predecessors confronted. National courts' refusal to adjudicate international commercial contracts is an example. Enforceability of State court decisions is also a significant obstacle: If a Korean court declares that a Canadian citizen owes his Korean trading partner money, how can it seize the Canadian's assets in Canada for payment? Like the medieval merchant courts that preceded them, private international arbitration associations overcome these problems by "delocalizing" dispute resolution.

Also like their medieval predecessors, modern international traders rely predominantly on private means to enforce arbitration decisions. As private organizations, international arbitration associations don't have formal authority to enforce their decisions. They can't seize noncompliant traders' assets or put such traders in jail. But this doesn't prevent their decisions from being enforced. The community of international traders uses the threat of destroyed reputation and the associated loss of business to encourage losing parties to comply with arbitration decisions. This threat is highly effective. The ICC, the world's largest international arbitration association, estimates that traders voluntarily comply with its decisions 90 percent of the time, according to Jan Paulsson, W. Laurence Craig, and William W. Park in *International Chamber of Commerce Arbitration*.

Shadows and the State

There's at least one potentially important difference between the enforcement environment that medieval international traders faced and the one that modern international traders face, however. Since 1958 compliance with many arbitration decisions occurs under potential threat of State enforcement. In that year a handful of countries signed a multinational treaty called the United Nations New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (NYC). Over the last half-century many other countries have also joined the NYC. According to the

convention, signatories agree to enforce international arbitral awards brought to their courts.

This has led some to claim that supposedly private international commercial enforcement takes place in the "shadow of the State." According to this view, government, not private effort, is ultimately responsible for the incredible success of modern international trade.

Yet there are reasons to be skeptical of this view. In a 2008 study Leeson empirically investigated the NYC's effect on international trade and found that its impact has been economically modest. Trade between merchants in countries that are NYC signatories—the potential beneficiaries of ostensible State enforcement—is higher than trade between merchants in countries that aren't signatories, but State enforcement seems to be a weaker influence on international commerce than other determinants. Leeson's results suggest that private means, rather than the specter of the government, are responsible for most of modern international trade's growth and success.

The popular wisdom that flourishing international trade requires government may be popular, but it's also wrong.

A still more important problem for the "shadow of the State" view is that, like all multinational treaties, the NYC derives its "force" exclusively from the promises of the countries that have signed it. There's no supranational organization with formal authority to compel compliance if signatories choose otherwise. What, then, enforces the NYC? The same private mechanisms that enforced merchant-court decisions under the medieval *lex mercatoria* and enforce most private international arbitration association decisions today: the threat of lost reputation and boycott—only between national governments. If the NYC really does provide significant enforcement of private international commercial agreements, this enforcement has its source not in the formal force of government but in the informal force of private punishment.

Multinational treaties such as the NYC may help remove international traders from the state of "anarchy" they find themselves in, but they don't help remove the governments that supposedly give the NYC power from the state of "anarchy" they exist in. The absence of a formal supranational sovereign—a world government—means that international treaties between governments are always forged and enforced (or not enforced) in a state of "international anarchy" (meaning statelessness not chaos). Thus rather than seeing private enforcement as functioning only in the "shadow of the State" provided by the NYC, it's more appropriate to see the NYC as functioning in the "shadow of private enforcement" provided by the very mechanisms that support international trade.

The popular wisdom that flourishing international trade requires government may be popular, but it's also wrong. We have the Law Merchant to thank for the incredible wealth that commerce has created. Today, international trade accounts for nearly one-third of world GDP—some $6 trillion in 2008. That's an astonishing volume—produced predominantly on the basis of private order. FEE

Safe Food at Any Cost

BY PAUL SCHWENNESEN

We all want safe food. Question is, how do we get it? "There oughta be a law" seems to be the generally conceived approach, as evidenced by recent passage of the now-famous food safety bill. A tidy and altogether comforting solution: Simply slay the beast of dangerous food with the bludgeon of enlightened bureaucracy. But for the foodies who support this kind of top-down solution, beware: The kind of government meddling that created cheap food at any cost is now about to do the same for safe food.

But isn't food safety a pressing concern, a public-health problem we can't afford to fool around with? Problem is, the problem isn't. Emotional rants that "thousands die every year!" do not help us grapple with the scope or magnitude of this alleged threat. Let's try some perspective: According to the Centers for Disease Control, the estimated number of deaths caused by foodborne illness falls between 5,000 and 8,000 a year (down a substantial 35 percent, by the way, from ten years ago). Sounds pretty bad, eh? Time to call in the Salmonella SWAT team? Before you do, consider that the same number of people die by intentionally strangling themselves each year. Or that the same number of people die from Alzheimer's in *California alone* each year. Or that four times that number die each year accidentally falling off of things. Moreover, 70 percent of foodborne illness (and presumably deaths) results from poor food-handling procedures during preparation, not from poor food-production practices. The number of people we're attempting to save with this kind of legislation, in a cosmic feat of irony, is significantly lower than the number of people who die each year from malnutrition (known in the business as "starving").

The same kind of meddling that created cheap food at any cost is about to do the same for safe food.

Unless you're also on a crusade to flatten everything, I'd think twice about ceding greater authority over our food system to centralized management.

True to form, Congress has blithely offered its professional problem-solving services to rid us of the menace of deadly food. And, true to form, it's about to embark on another unarmed expedition into the tortuous territory of unintended consequences.

Adding more regulations to a sector always reduces the number of operators in that sector. It can be dramatic (as in the case of the payday loan industry), or it can be insidious (as in the case of the livestock industry). The food industry is no exception; it's impossible to envision a wave of enthusiastic newcomers clamoring at the gates to enter the food business now that the FDA has been granted the most sweeping extension of its powers in 70 years. Granted, some of the bad actors *need* to be pushed out of the industry (as in the Peanut Corp. of America, which apparently intentionally distributed salmonella-laced product). Call me a Pollyanna, but I don't think the bad actors generally represent the food industry. The people who *do* represent a large part of the industry are

Paul Schwennesen (schwennesen@mac.com) is a southern Arizona rancher and a regular contributor to PERC, the Property and Environment Research Center.

the small, local, independent operators who have been squeaking by for decades. This kind of regulatory barrage is exactly the sort of thing to make them call it quits. BSE (mad cow) regulations pushed my predecessor at the meat-packing operation I own to hang up his hat. The increasing silliness over *E. coli* testing pushed *his* predecessor over the brink years ago. Warranted or not, an increasingly difficult regulatory environment will always winnow out the small players, leaving the field more sparse than before.

Fewer Hands

Of course the demand for food hasn't gone down, so how does the system accommodate a hungry public? Well, that's where Cargill, Tyson, Monsanto, and the rest of the Big Food set come in. They're not evil (despite bumper-sticker claims to the contrary); they're just picking up the slack left when the small guys get pushed out by big government. I know, I know: It's easier to blame their success on high-priced lobbying and a cozy relationship with regulators. But consider this: The lobbying and cozying can only manipulate government action when government hands are firmly on the wheel of that particular industry.

The unintended consequence in this legislative bid to create safer food is to push more and more production into fewer and fewer hands. As we all know, the more top-heavy a thing gets, the more prone it is to toppling. As Tom Philpott writes, "[T]he real systematic risk of the food system [is] the exponential expansion of hazard that comes from concentrating huge amounts of production in relatively small spaces."

So is there any solution? If we agree that even one death from foodborne illness is too many (and it is), then how can we aim to squeeze out that lingering menace without artificially exacerbating the very problem we are trying to solve? How can we do to *Listeria* what we did to malaria in the United States?

I may be waxing heretical, but might I suggest *de*regulation? Contrary to myth, markets are in fact very good at giving us what we want, even if those things are intangibles like clean air or safe food.

Let me give you an example: As a producer of livestock and owner of a small (*very* small, according to the USDA) packing house, I know about the raft of bureaucratic "protections" between you and the beef I produce. There is little or no incentive for me to create a remarkably safer production system because my processes are effectively in the hands of our state inspector. The incentive among producers is to win the race toward the bottom, where you can most cheaply and easily meet the minimum standard. Imagine for a moment what the food world would look like if we made food safety a competitive advantage. What if I could demonstrate (through third-party quality assurance, a sophisticated testing regime, or something completely unthought-of as yet) that my beef was quantitatively safer than my competition's? I suspect that the maligned self-interest of "money-grubbing capitalists" would be instantly harnessed toward the greater public good. I for one would probably behave considerably differently if I were continually striving for the next-higher grade on something like a "Good Housekeeping Seal of Approval" scale instead of aiming simply for the "Inspected—Passed" stamp.

Regulations are good for imposing minimums, but not for creating excellence.

We didn't regulate malaria out of existence; we simply ensured that millions of empowered individual actors had the information to combat it (that, and some choice applications of DDT). Allowing food processors to compete for customers by marketing their very best possible food-handling practices would have a similar effect.

Regulations are good for imposing minimums, but not for creating excellence. Since our food safety "problem" is clearly in the vanishing margins, excellence is what we need. This can only really be attained when incentives are structured to push our producers (and consumers) to go the extra step to make food as safe as it can possibly be.

Many foodies rightly criticize government meddling in the food sector in the late 1940s for attempting to create cheap food at tremendous ecological and sociological expense. Let us not condone the same mistake under the aegis of "safe food." FEE

The Ominous Expansion of Class-Action Suits: *Walmart v. Dukes*

BY WENDY MCELROY

In the largest class-action lawsuit in American history, *Walmart v. Dukes*, Walmart stands accused of systematically discriminating against as many as 1.5 million women in wages and promotions. The Supreme Court has agreed to a limited review, judging solely whether class-action certification was justified.

At stake are billions of dollars and the creation of a new standard for certifying class-action lawsuits, which would make such suits far more common than they are now, increasing the potential for legal harassment. Walmart disputes the grounds on which class certification was granted to female employees at 3,400 stores.

In 2000 an ex-greeter named Betty Dukes sued Walmart under Title VII of the Civil Rights Act (an obvious intervention in the market) for lack of promotion. Walmart unsuccessfully argued that Dukes had received frequent reprimands for lateness from her female supervisor, which led to a demotion.

In 2001 Dukes and several other plaintiffs asked the U.S. District Court in San Francisco to "class certify" their case. Class-action lawsuits are a "procedural mechanism" through which individual claims based on a common interest are aggregated to ensure both judicial efficiency and the ability of low-income individuals to sue.

In 2004 certification was granted; *Dukes* became the largest class suit ever certified on the basis of a small number of reported incidents. Walmart appealed.

In February 2007 a three-judge panel of the Ninth Circuit Court affirmed certification. Walmart filed for a rehearing before the full bench.

In April 2010 the full court affirmed the certification, 6-5. The suit was then modified; for example, past employees were excluded without prejudice, allowing them to sue separately. (The number of plaintiffs is variably cited as 1.5 million or 500,000, depending on whether the past employees and their follow-on suits are included.)

Chief Judge Alex Kozinski voiced strong dissent, stating, "[N]o court has ever certified a case like this." He said the decision invites other class-action lawsuits "based on nothing more than general and conclusory allegations, a handful of anecdotes, and statistical disparities." The strength of Kozinski's dissent reflected the political and legal stakes.

At stake is a new standard that would make class-action lawsuits far more common.

The case has been heavily politicized by labor advocates. For example, in her 2004 book, *Selling Women Short: The Landmark Battle for Workers' Rights at Wal-Mart*, journalist Liza Featherstone excoriated the retail giant's labor practices. In follow-up articles and interviews she likened Dukes to civil-rights heroine Rosa Parks.

Politics has obscured the more technical legal issues.

Legally speaking, the debate over *Dukes v. Walmart* revolves around the nature of evidence that could be properly admitted to justify class certification, and whether the nature of the suit itself satisfied the basic requirements of class certification.

Contributing editor Wendy McElroy (wendy@wendymcelroy.com) is an author and the editor of ifeminists.com.

In terms of evidence, the suit set a precedent on what is admissible to class-certify a "harm." The labor law firm Littler Mendelson commented:

> [T]he court credited plaintiffs' sociology expert's opinions despite acknowledging they were replete with conjecture . . . [,] allowed aggregation of the statistical data at the regional and national level, and accepted the use of a formula for determining damages instead of individualized findings. . . . Most ominous, the Dukes court gave short shrift to the multiple defenses raised in opposition. . . . Roadblocks that defendants have successfully used against other class certification motions were summarily brushed aside, making molehills out of what previously were mountains.

Grounds for Dissent

Two grounds on which Walmart contested the suit's eligibility for certification were a lack of "commonality" and "manageability."

Ideally, all members of a class suit should have a clear "commonality" of harm, such as acquiring a disease from toxic exposure. A class should also have "manageability" to ensure an effective defense is possible; otherwise the defendant's Fourth Amendment right to due process is jeopardized.

Commonality. The 2004 certifying court had criticized Walmart's "excessive subjectivity" of policy, which gave managers "substantial discretion" in promotion and salary. Ironically, "subjectivity" was a key point in Walmart's defense. The corporation argued that each outlet operates as an independent business and so women alleging bias needed to file individual lawsuits against specific stores. In short, the plaintiffs did not share a common harm.

Kozinski echoed Walmart's argument in his dissent:

> Maybe there'd be no difference between 500 employees and 500,000 employees if they all had similar jobs, worked at the same half-billion square foot store and were supervised by the same managers. But the half-million members of the majority's approved class held a multitude of jobs, at different levels of Wal-Mart's hierarchy, for variable lengths of time, in 3,400 stores, sprinkled across 50 states, with a kaleidoscope of supervisors (male and female), subject to a variety of regional policies that all differed depending on each class member's job, location and period of employment. Some thrived while others did poorly. They have little in common but their sex and this lawsuit.

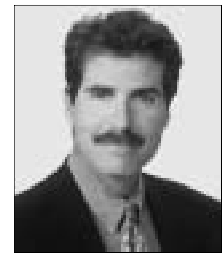
Nevertheless, in the certifying court's judgment, a typical class-plaintiff was defined by sociological analysis (known as "social framework testimony"), statistical aggregation, and the vagaries of "too much" managerial discretion.

Manageability. Walmart also argued that the suit's sheer size prevented an effective defense. The company raised not merely constitutional due-process concerns but also the violation of its rights under Title VII. Under that title Walmart has the right to defend individual pay and promotion decisions, the exercise of which becomes a practical impossibility due to *Dukes*'s size and lack of individual hearings.

Thus the corporation's lead counsel, Theodore Boutros, Jr., argued that class certification violated "both due process and federal class action rules, contradicting numerous decisions of other federal appellate courts and the Supreme Court itself." In short, the case's manageability does not conform to controlling law.

Oral arguments before the Supreme Court took place in March. Walmart is expected to prevail. Before the Supreme Court agreed to hear the case, Professor Deborah Hensler of Stanford Law School told UPI that acceptance would "signal this business-friendly court is hostile to class actions against corporate defendants."

If review had been declined, Walmart would have been under extreme pressure to settle and an avalanche of similar lawsuits against corporate giants might have ensued, especially in the western states overseen by the Ninth Circuit. If Walmart does not prevail, that outcome becomes likely once more. FEE



Spontaneous Order

BY JOHN STOSSEL

You are our Ruler. An entrepreneur tells you he wants to create something he calls a "skating rink." Young and old will strap blades to their feet and speed through an oval arena, weaving patterns as moods strike them.

You'd probably say, "We need regulation—skating stoplights, speed limits, turn signals—and a rink director to police the skaters. You can't expect skaters to navigate the rink on their own."

And yet they do. They spontaneously create their own order.

At last January's State of the Union, President Obama said America needs more passenger trains. How does he know? For years, politicians have promised that more of us will want to commute by train, but it doesn't happen. People like their cars. Some subsidized trains cost so much per commuter that it would be cheaper to buy them taxi rides.

The grand schemes of the politicians fail and fail again.

By contrast, the private sector, despite harassment from government, gives us better stuff for less money—without central planning. It's called a spontaneous order.

Lawrence Reed, president of FEE, explains it this way:

"Spontaneous order is what happens when you leave people alone—when entrepreneurs . . . see the desires of people . . . and then provide for them.

"They respond to market signals, to prices. Prices tell them what's needed and how urgently and where. And it's infinitely better and more productive than relying on a handful of elites in some distant bureaucracy."

This idea is not intuitive. Good things will happen if we leave people alone? Some of us are stupid—Obama and his advisers are smart. It's intuitive to think they should make decisions for the wider group.

"No," Reed responded. "In a market society, the bits of information that are needed to make things work—to result in the production of things that people want—are interspersed throughout the economy. What brings them together are forces of supply and demand, of changing prices."

The personal-computer revolution is a great example of spontaneous order.

"No politician, no bureaucrat, no central planner, no academic sat behind a desk before that happened, before Silicon Valley emerged and planned it," Reed added. "It happened because of private entrepreneurs responding to market opportunities. And one of the great virtues of that is if they don't get it right, they lose their shirts. The market sends a signal to do something else. When politicians get it wrong, you and I pay the price.

"We have this ingrained habit of thinking that if somebody plans it, if somebody lays down the law and writes the rules, order will follow," he continued. "And the absence of those things will somehow lead to chaos. But what you often get when you try to enforce mandates and restrictions from a distant bureaucracy is planned chaos, as the great economist Ludwig on Mises once said. We have to rely more upon what emerges spontaneously because it represents individuals' personal tastes and choices, not those of distant politicians." FEE

John Stossel hosts Stossel *on Fox Business and is the author of* Myths, Lies, and Downright Stupidity: Get Out the Shovel—Why Everything You Know is Wrong. *Copyright 2011 by JFS Productions, Inc. Distributed by Creators Syndicate, Inc.*

Capital Letters

"Economic Freedom of the World" Doesn't Endorse Free Trade Agreements

As two of the principal authors of the Economic Freedom of the World (EFW) index published by the Fraser Institute, we might be accused of being overly defensive when it comes to criticisms of such indexes. For this reason, we typically choose to remain silent when such criticisms appear. However, Kevin Carson's March 2011 article in *The Freeman*, "What Economic Freedom Indexes Leave Out," (www.tinyurl.com/4ofh67r) demands correction.

Most of Mr. Carson's attention is paid to our intellectual rival in the economic freedom index business, the Heritage Foundation's *Index of Economic Freedom*, though many of his criticisms could apply equally to our index. Let us highlight just a few problems.

First, Mr. Carson writes in the opening paragraph that the Heritage Foundation reclassified the U.S. economy from "totally free" to "mostly free." This is misleading at best. It is true that the Heritage index uses a labeling system that begins with "Free," continues to "Mostly Free," and then goes down to "Repressed." But nowhere does the Heritage index say the U.S. is or ever was "totally free." Even when the U.S. was labeled nominally free, the Heritage index was critical of various infringements against economic liberty conducted by U.S. authorities.

Second, Mr. Carson criticized the Heritage index for failing to support the contractual rights of workers when dismissed. This is just plain wrong. The applicable part of the Heritage index dealing with worker dismissal deals with *government-imposed* rules for notification and severance pay. Of course, the Heritage Foundation understands that contract enforcement is highly important for economic freedom! To suggest otherwise, as Mr. Carson does, is patently absurd. Mr. Carson's ranting about the alleged violation of contractual rights among GM's UAW workers is quite irrelevant. The fact is that whether the employee-employer relationship is at-will or subject to individual or collective (i.e., union) contract, the government has no place dictating the terms of these relationships.

Third, and most egregiously from our point of view, Mr. Carson claims that our EFW index "treats voting for anything called 'a free trade agreement' as a proxy for supporting free trade." What?! This is completely false. The EFW index does not factor in anything related to the so-called free-trade agreements that the EU and U.S. authorities are attempting to negotiate. We have no idea how anyone who has read the report could reach such a conclusion!

Quite frankly, this willful disregard for simple facts on the part of Mr. Carson is baffling. More baffling is why *The Freeman*, a publication we respect and are proud to have written for ourselves, would publish such inaccurate work.

—JOSHUA HALL AND ROBERT LAWSON

Kevin Carson replies:

Based on my exasperatingly frequent tendency toward a photographic memory of things I've seen—coupled with the lack of any clear idea of where I actually saw them—I could swear I recall seeing a chart in the Fraser Institute's Annual Report in which ratification of "free trade agreements" was taken as a proxy for freedom of trade. But try as I might, going through the Annual Report, I cannot find any such item. And almost six months after I finished writing my article, I'm afraid my original reading trail has gone completely cold. My only recourse, in this case, is a cheerful and ungrudging retraction—with sincere apologies—of my generalization regarding the Fraser Institute's use of free trade agreements. I can only chalk it up to an evident misreading that I am presently unable to reconstruct—and freely admit that I should have done better.

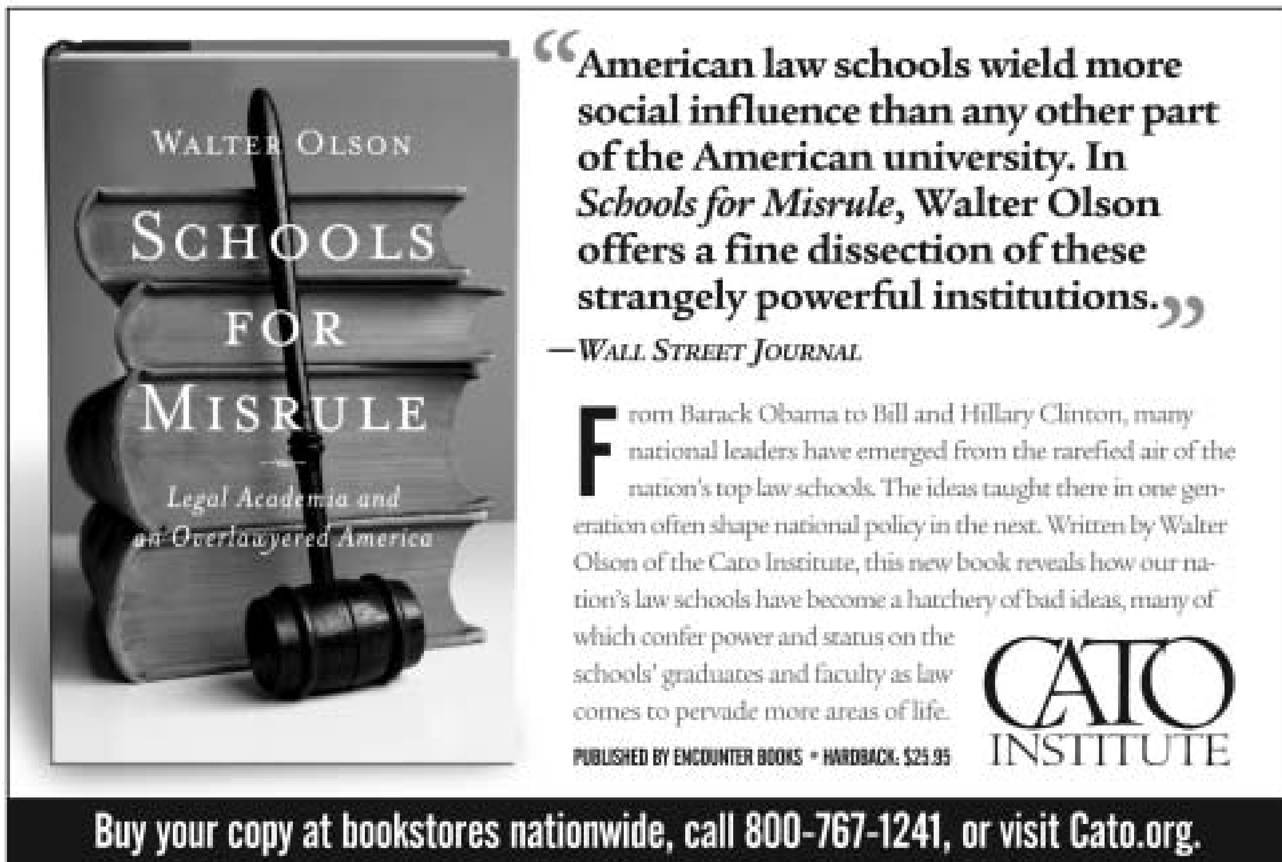
So much for Messrs. Hall and Lawson's third point. As for their first two, I believe it is they who are guilty of a misreading. Regarding the substance of the rest of the article, and my statements (which comprise the great bulk of the article) regarding the Heritage Foun-

dation's index, I stick by my guns. Taking in particular the first of Messrs. Hall and Lawson's other two specific examples of my many alleged errors: Heritage's Bill Beach explicitly referred, in the original John Stossel segment which drew the issue to my attention, to the United States being downgraded from "totally free" to "mostly free." And Heritage is on record advocating two structurally important features of that statist economy: "intellectual property" and the national-security state. Whether "free" and "totally free" were intended literally, Mr. Beach's and Heritage's choice of language suggests a tendency to gloss over the degree of statism before Barack Obama.

The other example concerns the freedom of labor. Whatever Heritage's position on the freedom of workers to leave the employment relationship, or on enforcement of workers' contractual protections, its index mentions only the relative ease with which employers can get rid of workers. Its emphasis and point of view are entirely from the employer's perspective, and the economic freedom of workers does not even arise as an issue.

We will print the most interesting and provocative letters we receive regarding articles in *The Freeman* and the issues they raise. Brevity is encouraged; longer letters may be edited because of space limitations. Address your letters to: *The Freeman*, FEE, 30 S. Broadway, Irvington-on-Hudson, NY 10533; e-mail: freeman@fee.org; fax: 914-591-8910.

Correction: Due to an editorial error, Edward J. López's December article, "Fashion Design and Copyright," incorrectly identified the executive director of the Council of Fashion Designers of America. He is Steven Kolb. Also, the source of two quotations, Kaomi Goetz, "Designers Get Fierce with Copyright on the Catwalk," NPR, September 16, 2010, (www.tinyurl.com/2b5pt4z) was incorrectly omitted.



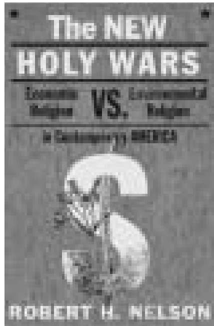
Book Reviews

The New Holy Wars: Economic Religion Versus Environmental Religion in Contemporary America

by Robert H. Nelson

Pennsylvania State University Press and The Independent Institute • 2010 • 416 pages/392 pages • $35.95 hardcover; $19.95 paperback

Reviewed by Art Carden



We all, like sheep, have gone astray. We have sinned. We must humble ourselves. We must repent and turn from our wicked ways. These are the messages of our modern-day secular religions: economic religion and environmental religion. Throughout *The New Holy Wars*, Robert H. Nelson uses theological reasoning to explore them. His book is an excellent contribution that will help us better understand the intersections between economics, ethics, and theology.

Economic and environmental religions both deliver old wine in new bottles. According to Nelson, a professor of public policy at the University of Maryland, a religion can be "understood . . . as a person's way of framing his or her basic perception of the world and its meaning." Religions require priesthoods. Some religions believe we need priests to mediate between God and man. Economic religion requires priests to mediate between gold and man. Environmental religion posits the need for mediators between Gaia and man. The 9/11 attacks, for example, were interpreted by some as punishment for our economic sins, while Hurricane Katrina was interpreted by others as punishment for our environmental sins.

Economics *as such* is value-free, but many economists are not. Twentieth-century neoclassical economics created, Nelson writes, a "gospel of efficiency." The most prominent economic religions he identifies are varieties of statism: socialism/communism, Keynesianism, and industrial policy. Socialism claimed that centrally planned economies would produce abundance, which would cure social ills. According to interventionist varieties of neoclassical economics, experts could "fine tune" the economy. The push for "scientific" policy-making turned economists into a group of gods-by-committee issuing edicts from Mount Olympus (or from seminar rooms at Harvard and MIT) to be followed by our wise and noble rulers.

Nelson also discusses the rhetoric of economic and environmental religions. Environmentalists' accounts of the "damage" we're doing to the natural environment or how this or that arrangement of flora and fauna has "intrinsic value" independent of its ability to satisfy human wants bring to mind Misesian/Hayekian questions: How do we know? How is "intrinsic value" measured? How is it a guide to action? On what basis does the activist substitute his or her judgment for mine? We can argue about who does or does not have superior revelation, but this is properly discussed as theology rather than economics or natural science.

Chapter eleven ("Environmental Colonialism: 'Saving' Africa from Africans") is especially interesting. In it Nelson recounts in detail various endeavors—all under the guise of "conservation"—that are basically a form of secular evangelism. One of the ironies Nelson points out is that the attempts to "restore nature" are actually attempts to subjugate complex natural processes. Africa's enormous national parks and reserves have more in common with *Jurassic Park* than with the prehuman African landscape.

Elsewhere, Nelson asks where environmentalists find their moral sentiments. It isn't clear what "healthy" and "sustainable" mean apart from human action in light of the relevant tradeoffs. There is little recognition of what happens when people disagree. For example, a statement like, "I believe in wilderness for itself alone" (quoting former Sierra Club leader David Brower), runs into unanswered complications: What if *I* don't? On what grounds are your values better than mine? Citing and quoting his faculty colleague Herman Daly, an ecological economist, Nelson notes that environmental religion is "theologically incoherent" if there is no purpose to the universe but we should still take great strides to protect nature. This is a serious issue that needs to be addressed head-on.

I fear that some readers will not separate "economic religion" as a religious concern with material abundance from the economic way of thinking, which focuses on incentives and opportunity costs. Nelson ought to have sharpened that distinction. Also, the differences between an ideology, a religion, and a philosophy are left unclear. Nonetheless, the theological approach Nelson adopts is illuminating, and he does a great service by pointing out how much of the materialist and environmentalist gospels are explicitly derived from religion.

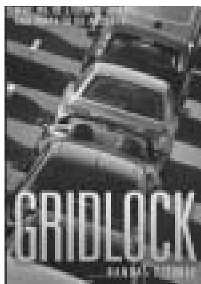
The Christian faith posits that God is the potter and we are the clay. In economic and environmental religion, our moral and intellectual surrogates are the potters and ordinary citizens are the clay. Both economic religion (a secular gospel of virtuous prosperity) and environmental religion (a secular gospel of virtuous poverty) are pretexts for managing the affairs of others and of directing them in how they should employ their capitals. Given these stakes, I fully agree with Deirdre McCloskey's back-cover endorsement: "Anyone who cares about the economy or the environment or religion needs to read *The New Holy Wars*." FEE

Art Carden (cardena@rhodes.edu) is a professor of economics at Rhodes College.

Gridlock: Why We're Stuck in Traffic and What to Do About It

by Randal O'Toole
Cato Institute • 2010 • 236 pages • $24.95

Reviewed by Gary M. Galles



Congestion is five times worse than in 1995. Why? What should we do about it? Those questions drive Randal O'Toole's *Gridlock*.

The main reason for the increase, the author writes, is that beginning in the 1960s, "Many people looked at the costs of the automobile without considering the benefits, and their solution was to get rid of cars and highways." The result was "an anti-mobility coalition that blames America's mobility for all sorts of problems, real and imaginary. . . . The only solution they see is to reduce mobility by reducing per-capita driving."

O'Toole, however, recognizes that cars, while costly, provide benefits that vastly outweigh their costs. He explains that the automobile provides tremendous mobility, giving Americans far greater choices about where they live, where they shop, and whom they visit. That mobility gives Americans higher incomes and lower consumer costs than most of the rest of the world, among other benefits. In sum, we owe our high standard of living to the mobility cars and trucks give us. Unfortunately, transportation planners want to discourage us from driving and believe they will be able to achieve their utopian vision by allowing traffic congestion to become as bad as possible.

How have the planners been able to impose their vision? They have taken advantage of the government monopoly on roads and most transit to advance their "smart-growth" theories. As a result, cost-efficient transportation planning has been largely abandoned.

O'Toole details how an alphabet soup of agencies and acts have imposed the planners' misguided vision. Those include UMTA (the Urban Mass Transportation Act of 1964), which essentially nationalized the transit industry by dishing out federal grants to any public agencies that took over private transit companies; FAHA (the Federal Aid Highway Act of 1982), which first introduced congressional earmarking to federal transportation funding decisions; CAAA (The Clean Air Act Amendments of 1990), whose presumption that highways increased pollution was used to discourage or forbid cities with poor air quality from using federal funds to build new roads; TEA (the 1998 Transportation Efficiency Act for the 21st Century), which promoted and, along with EPA programs, helped fund smart-growth lobby groups; and ISTEA (the 1999 Intermodal Surface Transportation Efficiency Act), which encouraged the diversion of federal gas tax funds from highways to mass transit.

O'Toole also discusses the massive problems with rail transit, the planners' panacea for both urban and intercity transportation. The results are bleak. "Since 1992," he writes, "American cities have invested some $100 billion in urban rail transit. Yet no rail system in the country has managed to increase transit's share of urban travel by even 1 percent." He calls high-speed rail "a giant black hole sucking in hundreds of billions of

dollars and producing negligible benefits." Due to the politicization of transportation, enormous sums of money are squandered on infrastructure people don't use, while the infrastructure they do is neglected.

The book also reveals the vast array of "strategic misrepresentation" that has allowed rail backers to spend billions on plans almost totally divorced from reality. These include ridership forecasts that were double actual usage; the understatement of costs by an average of 40 percent, using misleading time and distance comparisons (such as falsely assuming the relevant trip is train station to train station, rather than from where people start to where they want to go); and vast overstatement of savings in congestion and pollution.

O'Toole then uses three core principles—a system's users should finance it, negative effects should be dealt with cost-efficiently, and new technologies must be allowed to expand options and lower mobility costs—to point to far better possibilities that are now foreclosed by government control of transportation.

Gridlock combines a mastery of the details of transportation planning and funding with insightful and accurate analysis. It unveils abysmal realities of transportation policy that have long been hidden from public view behind an array of acronyms, misrepresentation, and outright lying, and contrasts them with what common-sense principles would dictate.

My one complaint with *Gridlock* is inherent in its attempt to reform government. O'Toole believes that the ultimate solution to transportation problems is to "privatize our roads and transit systems," and allow voluntary market solutions to work. I agree. But after declaring that approach politically impractical, he focuses instead on incremental changes to improve our transportation system. His proposals could generate significant gains, but the same special-interest, bureaucratic, and political pressures that created our current gridlock would almost certainly prevent such efficiency-enhancing reforms from being implemented. Instead, we should work toward the goal of a separation of transportation and State. FEE

Gary M. Galles (gary.galles@pepperdine.edu) is professor of economics at Pepperdine University.

Bought and Paid For

by Charles Gasparino

Sentinel • 2010 • 304 pages • $26.95

Reviewed by George Leef

Americans who have at least a modicum of political sophistication know that special-interest groups have enormous power to influence the political system, getting favors from government they couldn't obtain through voluntary means. Informed people know, for example, that many farmers receive subsidies, that labor unions have privileges to employ coercion that no other private organization has, and so on.

Few of us, however, think of Wall Street in a similar vein. Why, Wall Street consists of rich, Republican-leaning firms that make their money by financing business—right? Wall Street is interested in minimizing government because its business clients are harmed by the expansion of government—right?

Those notions could not be more mistaken, as veteran financial journalist Charles Gasparino demonstrates in his latest book, *Bought and Paid For: The Unholy Alliance Between Barack Obama and Wall Street*. Far from advocating a minimal, night-watchman State (or at least shrinking somewhat the bloated leviathan we now have), the big Wall Street firms earn such enormous profits from financing federal deficits that a shrinking State is the last thing they would ever want. On the contrary, expanding government that borrows heavily guarantees buckets of money in their coffers—far more than the big firms make from the difficult work of business finance.

If that isn't enough of a shock to people who accept the conventional wisdom about politics, Gasparino has many others in store. Most people would assume that wealthy Wall Streeters would have been scared silly of a candidate like Barack Obama, what with his Progressive/radical/community-organizer past and redistributionist rhetoric. The truth is just the opposite. Obama was the candidate *preferred* by the top Wall Street CEOs, who regarded him as more amenable to their interests than Hillary Clinton and far more inclined to expand

federal borrowing than any Republican in the 2008 field. It's true that in 2009, as president, Obama gave Wall Street a tongue-lashing for its gigantic bonuses (bonuses made possible by Obama administration policies), but that was pure political theater, Gasparino argues. There was and still is a symbiotic relationship between Obama and Wall Street. Obama expects and will probably get the same high level of campaign support from it in 2012 that he received in 2008.

Among the many enlightening revelations in the book is that the Wall Streeters factored into their support for Obama his pledge to raise income taxes on the wealthy. They concluded that paying somewhat higher taxes would be greatly outweighed by their profit gains. Other Americans might feel the sting of higher taxes, but Wall Street knew that it would be way ahead even with higher rates.

Compared with the likes of Wall Street giants like Goldman Sachs, other American special-interest groups seem puny. The advantages of being a government pet deemed "too big to fail" are immense. "Goldman," Gasparino writes, "more than any other firm, was able to use its status as a government-protected business to gain access to billions of dollars of borrowed money at rock-bottom rates and then use the funds to buy bonds—many of which were the same as those that had helped cause the financial crisis, but were now trading at just pennies on the dollar." Gasparino acknowledges that the men who run the big Wall Street firms are brilliant, but unfortunately they employ their brilliance in manipulating Washington.

It's not just Washington, though. Wall Street has also been earning great fees by helping states and localities borrow and spend beyond their means. Gasparino gives an illuminating history of the relationship between Merrill Lynch and supposedly prudent Orange County, California. Thanks to financial advice from a Wall Street consortium headed by Merrill, Orange County's government went on a spending binge that seemed affordable. Unfortunately, the investments that initially performed so well and lulled people into a false sense of security later crashed, leaving the county facing huge deficits. But Merrill had made its money. The same is true regarding bankrupt Greece. Wall Street was happy to sell the Greek government advice on how to continue borrowing and hiding its looming fiscal crisis, as long as firms got their fees up front.

We often hear politicians and big-business leaders cooing about how they will work together to solve the nation's problems. Gasparino says that idea is pure hokum. Teamwork between the federal government and Wall Street means "The big firms underwrite the massive amounts of debt being sold to keep the welfare state afloat, and the welfare state bails out the big firms from some of their most disastrous forays into risk." The huge cost of that partnership is paid for by the rest of America in higher taxes and a sluggish economy.

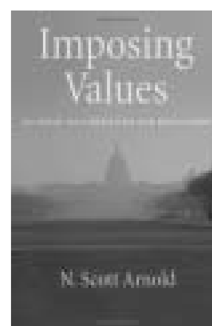
If this book doesn't make you angry over our crony-capitalist economy, I can't imagine what would. FEE

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

Imposing Values: An Essay on Liberalism and Regulation

by N. Scott Arnold
Oxford University Press • 2009 • 504 pages • $74.00 hardcover; $35.00 paperback

Reviewed by Daniel Shapiro



Liberalism comes in two varieties, classical and modern. All liberals support limitations on government power, but modern liberalism favors, while classical liberalism opposes, significant interference with private property rights. N. Scott Arnold's book on the classical-modern liberal debate focuses on the modern-liberal regulatory agenda, especially employment law (such as collective bargaining rules and antidiscrimination law), health and safety regulation (such as the FDA and OSHA), and federal land-use regulation (such as the Endangered Species Act and wetlands regulation).

Arnold first asks if reasoned agreement between liberals about this agenda could be achieved by some shared principle. Liberals disagree too much about basic rights to provide common ground, but perhaps this ground could be generated by a common principle that

the State has some role to play in providing public goods. Some classical liberals, however, accept the legitimacy of State-provided public goods only if they cannot feasibly be provided by nongovernmental means, and if the State does provide them, everyone who benefits must pay his share of the costs. But the goods provided by this regulatory agenda aren't really public goods (for example, product safety regulations), or could be provided privately (for example, the FDA's assurance of safe and effective drugs), or are not paid for proportionately by everyone who benefits (for example, land-use regulation's costs fall almost exclusively on affected landowners).

Finding no common ground between liberals on the modern liberal regulatory agenda, Arnold then discusses conversion arguments, arguments for why classical liberals ought to make exceptions to their principles about the scope of government action. Typically, modern liberals use these arguments by identifying some alleged failure in the market order that would supposedly be solved by government regulation; classical liberals reply that regulation makes things worse than they would be if the programs were dismantled or radically altered. After thoroughly canvassing this debate, Arnold concludes the replies are reasonable, which means reasonable disagreement between liberals persists.

Faced with persisting disagreement about the proper scope of government, Arnold argues that liberals must commit to certain procedural requirements to legitimately impose their values on society: The policies must be established democratically (by the elected branches of government) and be both publicly justified and transparent. By publicly justified, Arnold means that *reasons* must be given for legislation, which requires taking the views of the other side seriously and not misrepresenting its arguments. By transparency, he means that the beneficiaries and victims of legislation—both intended *and* unintended—must be identified. While the democracy requirement is, in my view, more contentious than Arnold appreciates, these requirements are quite modest. Public justification requires intellectual respect for opponents' arguments; transparency requires attention to the costs of the legislation.

Although these requirements are modest, Arnold shows that selected elements of the modern liberal regulatory agenda—the antidiscrimination regulatory regime, OSHA, and the FDA—dismally fail to meet them and thus have been illegitimately imposed. An exception is Title VII of the 1964 Civil Rights Act. In that case, the concern that banning employer discrimination on the basis of race would produce hiring by quotas was taken seriously by the bill's defenders. That led to clarification that the bill only made *intentional* discrimination illegal and didn't affect hiring decisions that had "disparate impact" on different races. (By contrast, proponents of the 1991 Civil Rights bill dismissed opponents' plausible claim that the bill's forbiddance of disparate-impact employment decisions—unless necessary for business survival—would lead to employers hiring by quotas to avoid lawsuits.)

As for OSHA the case was based only on anecdotes, which violated the public-justification requirement, as did the refusal to discuss the costs of the legislation. Furthermore, the statute's aim "to assure as far as possible every working man and woman in the Nation a safe and healthful working condition" was so vague as to violate the transparency requirement.

As an illustration of imposing values, Arnold's analysis of the sleight of hand behind the mandate that FDA-approved drugs require a doctor's prescription is particularly devastating. The 1938 Food, Drug, and Cosmetic Act required that drug labels contain directions for use, recommended dosages, and warnings of possible dangers. The FDA's given rationale was improved *self-medication*. Afterward, however, the FDA proclaimed the prescription requirement by regulation. A 1951 amendment solidified that requirement, but no justification was offered; indeed, a majority report admitted, "[A]t present the restrictions on dispensing 'prescription' drugs are not specifically stated in the [1938] statute." As Arnold dryly notes, that was "a polite way of saying that the FDA had just made it up."

Arnold's book belongs on every liberal's bookshelf. Quite simply, there is no book like it—a philosophically acute, exhaustive analysis of the classical-modern liberal debate about regulation, which ends up siding, in an original way, with classical liberalism. FEE

Daniel Shapiro (Daniel.Shapiro@mail.wvu.edu) is a professor of philosophy at West Virginia University and author of Is the Welfare State Justified?

Poverty Is Easy to Explain

BY WALTER E. WILLIAMS

Academics, politicians, clerics, and others always seem perplexed by the question: Why is there poverty? Answers usually range from exploitation and greed to slavery, colonialism, and other forms of immoral behavior. Poverty is seen as something to be explained with complicated analysis, conspiracy doctrines, and incantations. This vision of poverty is part of the problem in coming to grips with it.

There is very little either complicated or interesting about poverty. Poverty has been man's condition throughout his history. The causes of poverty are quite simple and straightforward. Generally, individual people or entire nations are poor for one or more of the following reasons: 1) they cannot produce many things highly valued by others; 2) they can produce things valued by others but they are prevented from doing so; or 3) they volunteer to be poor.

There is very little either complicated or interesting about poverty. Poverty has been man's condition throughout his history.

The true mystery is why there is any affluence at all. That is, how did a tiny proportion of man's population (mostly in the West) for only a tiny part of man's history (mainly in the nineteenth, twentieth, and twenty-first centuries) manage to escape the fate of their fellow men?

Sometimes, in reference to the United States, people point to its rich endowment of natural resources. This explanation is unsatisfactory. Were abundant natural resources the cause of affluence, Africa and South America would stand out as the richest continents, instead of being home to some of the world's most miserably poor people. By contrast, that explanation would suggest that resource-poor countries like Japan, Hong Kong, and Great Britain should be poor instead of ranking among the world's richest places.

Another unsatisfactory explanation of poverty is colonialism. This argument suggests that third-world poverty is a legacy of having been colonized, exploited, and robbed of its riches by the mother country. But it turns out that countries like the United States, Canada, Australia, and New Zealand were colonies; yet they are among the world's richest countries. Hong Kong was a colony of Great Britain until 1997, when China regained sovereignty, but it managed to become the second richest political jurisdiction in the Far East. On the other hand, Ethiopia, Liberia, Tibet, and Nepal were never colonies, or were so for only a few years, and they rank among the world's poorest and most backward countries.

Despite the many justified criticisms of colonialism and, I might add, multinationals, both served as a means of transferring Western technology and institutions, bringing backward peoples into greater contact with a more-developed Western world. A tragic fact is that many African countries have suffered significant decline since independence. In many of those countries the average citizen can boast that he ate more regularly and enjoyed greater human-rights protections under colonial rule. The colonial powers never perpetrated the unspeakable human rights abuses, including genocide, that we have seen in post-independence Burundi, Uganda, Zimbabwe, Sudan, Central African Empire, Somalia, and elsewhere.

Any economist who suggests he has a complete answer to the causes of affluence should be viewed with suspicion. We do not know fully what makes some societies richer than others. However, we can make guesses based on correlations. Start out by ranking

Walter Williams is the John M. Olin Distinguished Professor of Economics at George Mason University.

countries according to their economic systems. Conceptually we could arrange them from more capitalistic (having a larger free-market sector) to more communistic (with extensive State intervention and planning). Then consult Amnesty International's ranking of countries according to human-rights abuses. Then get World Bank income statistics and rank countries from highest to lowest per capita income.

Compiling the three lists, one would observe a very strong, though imperfect, correlation: Those countries with greater economic liberty tend also to have stronger protections of human rights. And their people are wealthier. That finding is not a coincidence, so let us speculate on the relationship.

Rights and Prosperity

One way to gauge human-rights protection is to ask to what extent the State protects voluntary exchange and private property. These signify the rights to acquire, keep, and dispose of property in any fashion so long as one does not violate the rights of others. The difference between private property rights and collectively held rights is not simply philosophical. Private property produces systemically different incentives and results from collective property.

Those countries with greater economic liberty tend also to have stronger protections of human rights.

Since collectivists often trivialize private property rights, they are worth elaborating. When property rights are held privately the costs and benefits of decisions are concentrated in the individual decision maker; with collectively held property rights they are dispersed across society. For example, private property forces homeowners to take into account the effect of their current decisions on the future value of their homes, because that value depends, among other things, on how long the property will provide housing services. Thus privately owned property holds one's personal wealth hostage to doing the socially responsible thing—economizing scarce resources.

Contrast these incentives to those of collective ownership. When the government owns the house, the individual has less incentive to take care of it simply because he does not capture the full benefit of his efforts. It is dispersed across society instead. The costs of neglecting the house are similarly spread. You do not have to be a rocket scientist to predict that under these circumstances, less care will be taken.

Nor is nominal collective ownership the only force that weakens social responsibility. When government taxes property, it changes the ownership characteristics. If government were to impose a 75 percent tax on a person selling his house, it would reduce his incentive to use the house wisely.

This argument applies to all activities, including work and investment. Whatever lowers the return from or raises the cost of an investment reduces incentives to make that investment in the first place. This applies to investment in human as well as physical capital—that is, those activities that raise the productive capacity of individuals.

To a significant degree the wealth of nations is embodied in their people. The starkest example of this is the experience of the Germans and Japanese after World War II. During the war, Allied bombing missions destroyed nearly the entire physical stock of each country. What was not destroyed was the human capital of the people: their skills and education. In two or three decades, both countries reemerged as formidable economic forces. The Marshall Plan and other U.S. subsidies to Europe and Japan cannot begin to explain their recovery.

Proper identification of the causes of poverty is critical. If it is seen, as is too often the case, as a result of exploitation, the policy recommendation that naturally emerges is income redistribution—that is, government confiscation of some people's "ill-gotten" gains and "restoration" to their "rightful" owners. This is the politics of envy: bigger and bigger welfare programs domestically and bigger and bigger foreign-aid programs internationally.

If poverty is correctly seen as a result of the unwise government intervention and lack of productive capacity, more effective policy recommendations emerge. FEE